

# BUSINESS INSURANCE

## Captive College: Fundamentals and Development Issues

2018 World Captive Forum

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Fort Lauderdale, FL

*#WorldCaptiveForum*

# The Faculty

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# What is a Captive?

Differentiators (in handout)

To regulators (and the NAIC!) – Cells included?

To the IRS

To the DOL (Benefits)

To managers and service providers

And...their owners! ...or members

# Other forms of Captive

Risk Retention Groups

Reciprocal

PORCs and **agency-owned** captives

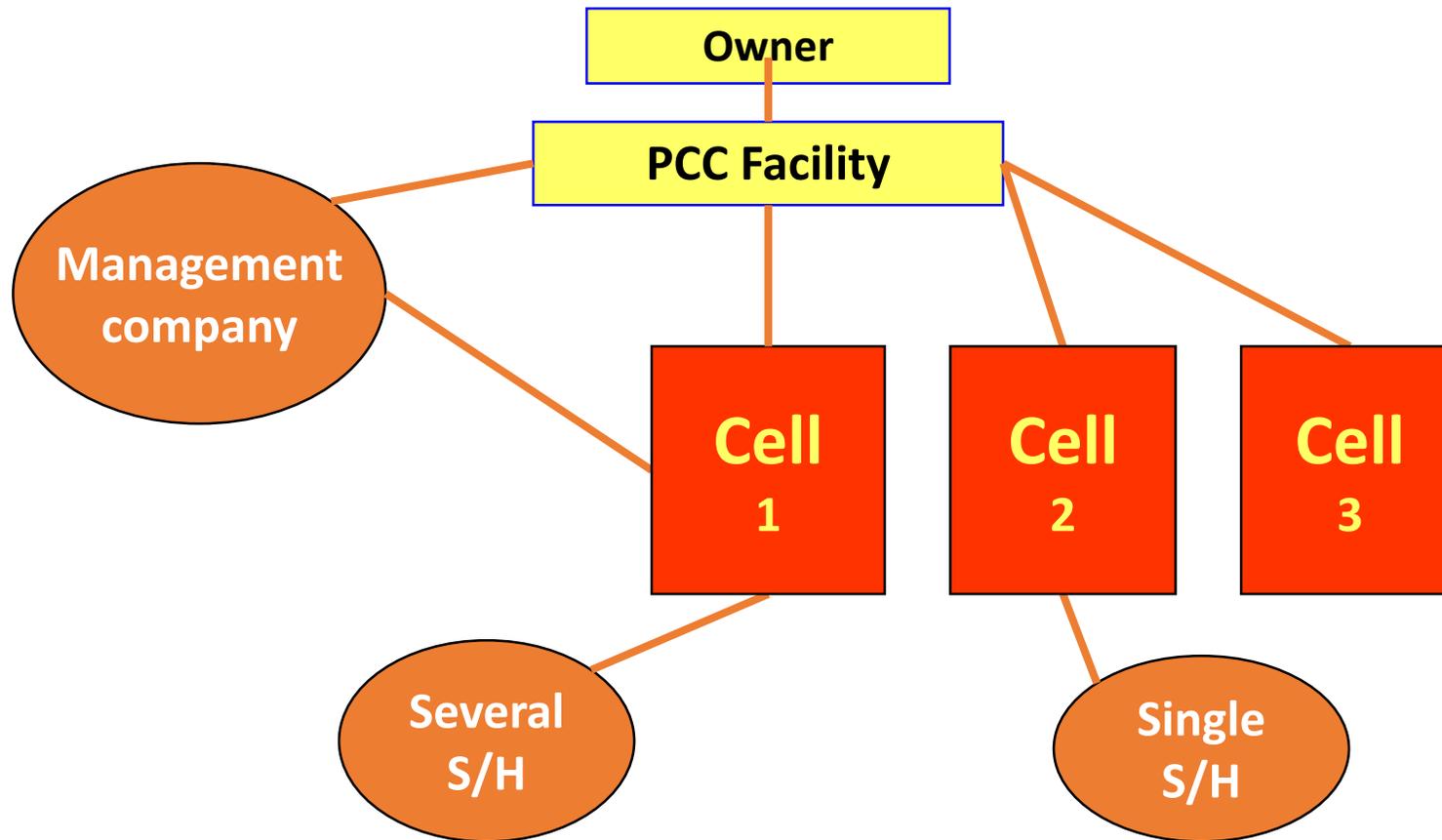
SPVs and XXX entities

**Mini or micro (“831-b”) captives**

Pools of Captives

# Other forms cont'd

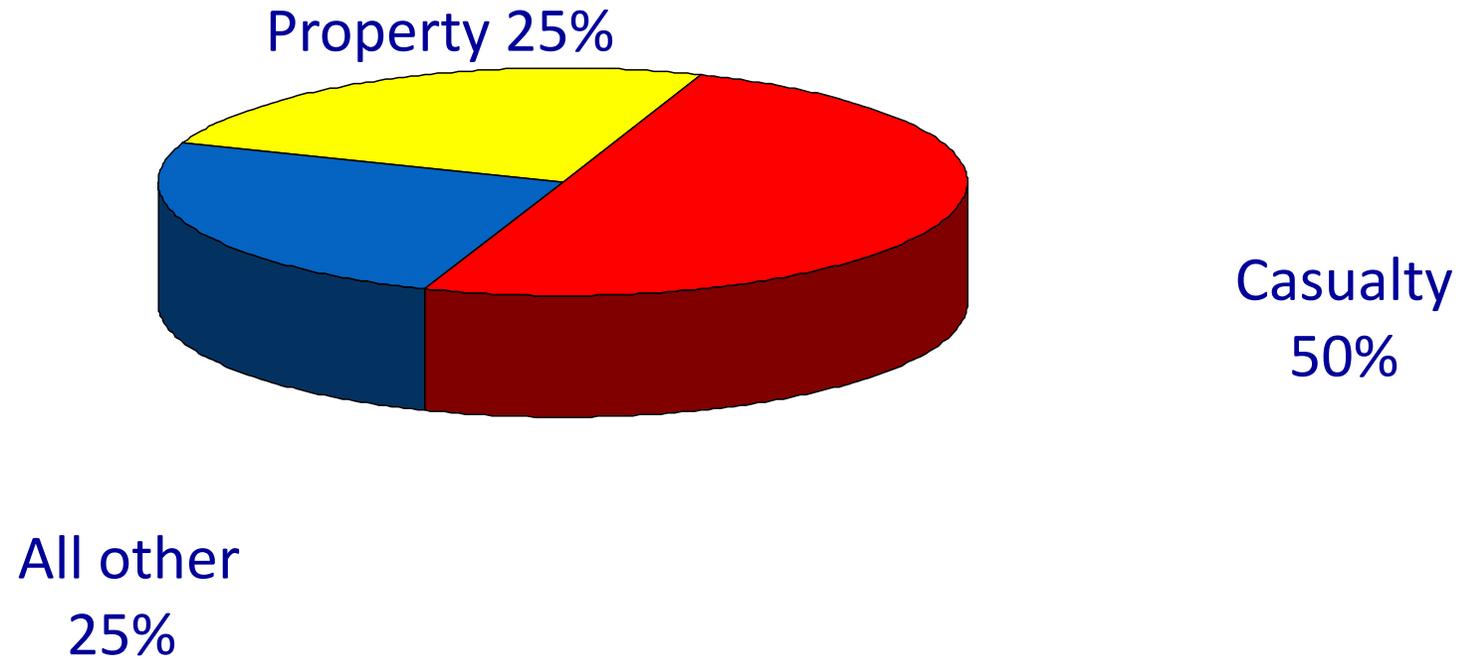
## Protected Cell Company - Structure



# Cell or Captive?

	Captive	Cell
Full control	More	Less
Capital	More	Less
Regulatory fees	More	Less
Management fees	More	Less
Auditor's fees	More	Maybe none
Directors' fees	More	None
Indirect costs	same	same
Liquidator's fees	Higher	lower

# Captives: What they write



# Risk Insured in Captives?

Property, Business Interruption

General Liability

Professional Liability

Automobile

Completed Operations Liability

# Risk Insured in Captives (cont'd)

Marine, transportation

Terrorism

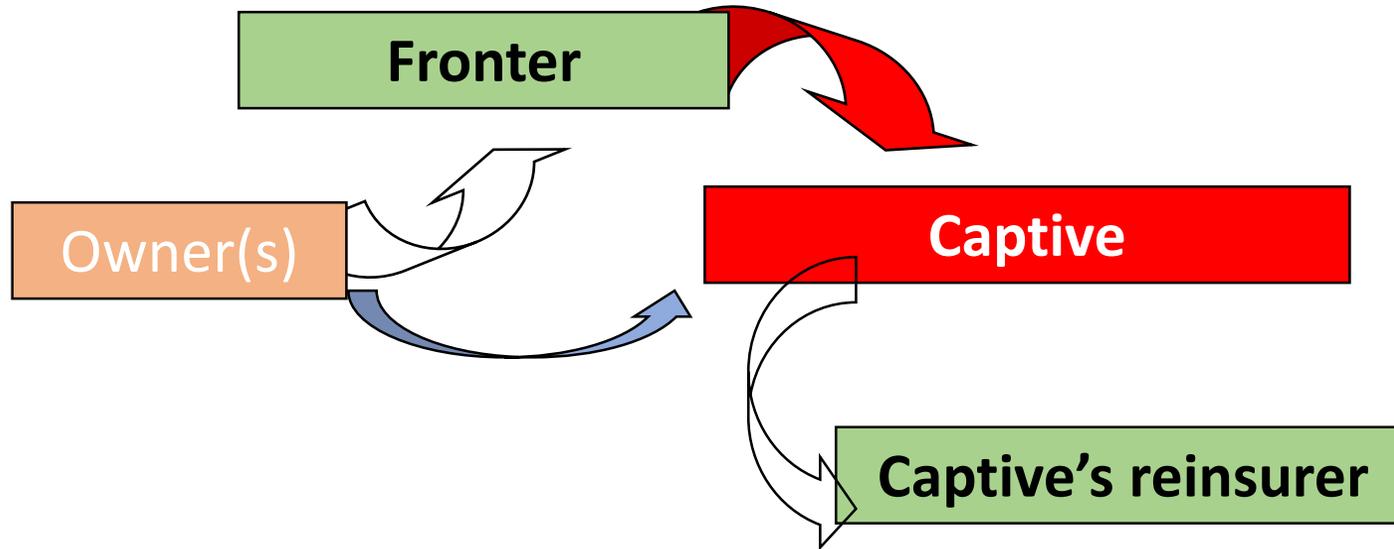
Workers Compensation

Employee Benefits

Cyber Liability

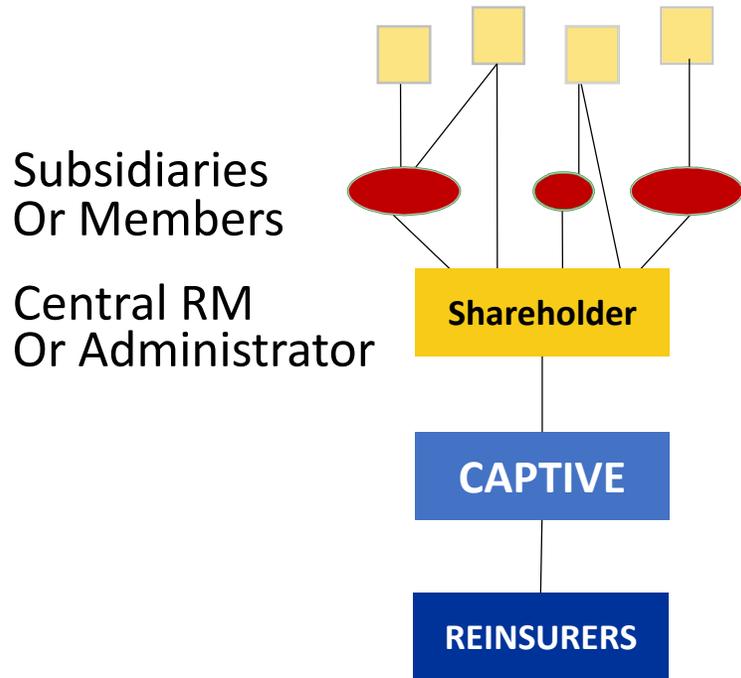
Customer, dealer, franchisee ins coverages

# Direct or Reinsurance Captives?

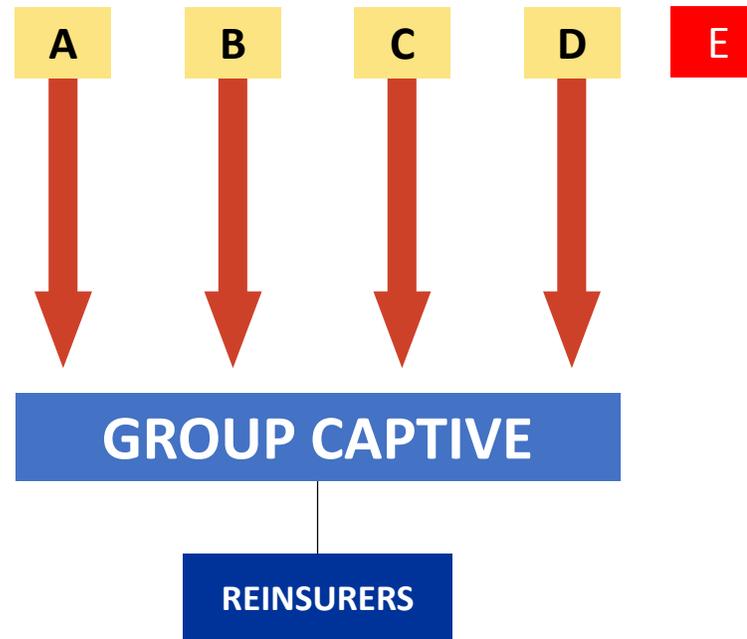


# Single Owner / Group Captives

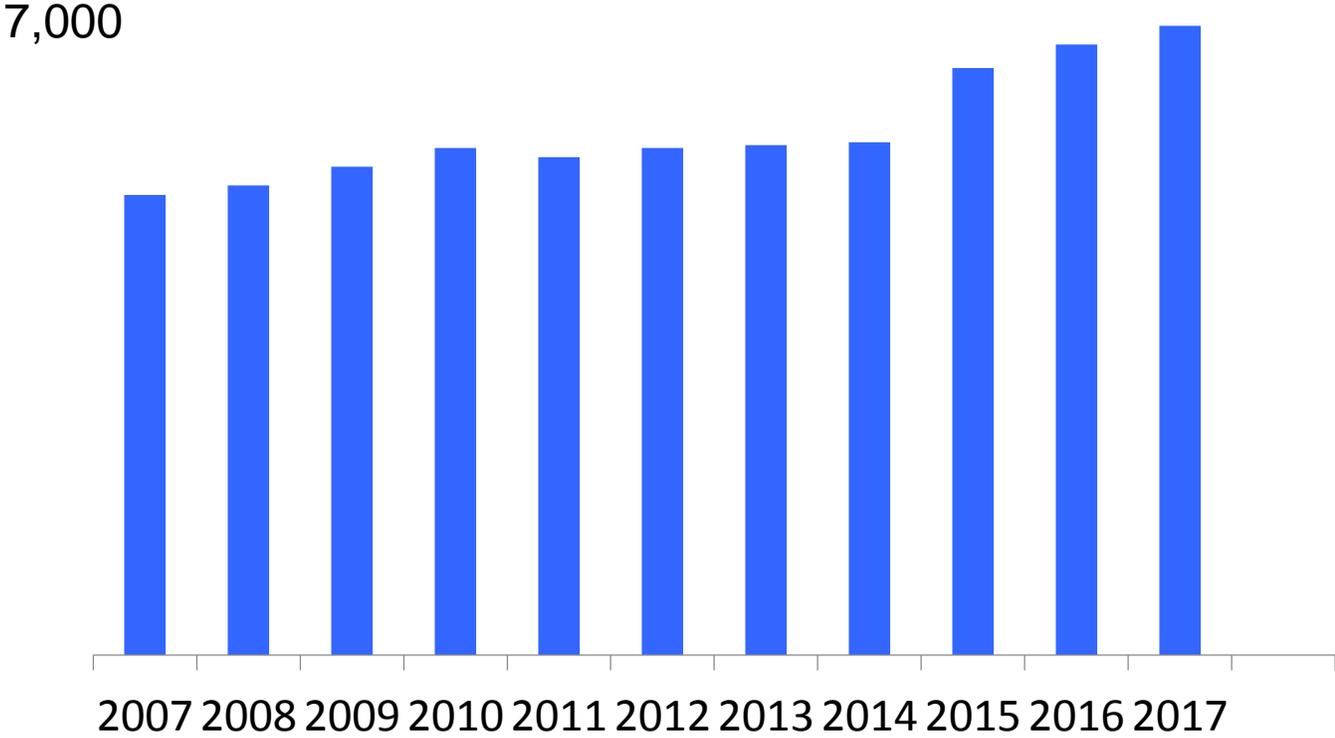
## Single Owner – Direct



## Group Captive – Direct



# Number of Captives: Continual Growth?



# Why Captives? The Key Reasons

**Cost reduction**

**Access to reinsurance**

**Investment income**

**Administrative tool**

# 1. Cost Reduction

*“I want to **reduce insurance costs.**”*

Obvious example:

*“**Low loss ratio?**”*       $\frac{\text{Losses incurred}}{\text{Premiums retained}}$   
***Less than 30%***

**Retentions:** The group could take higher retentions, but the individual members or business units can't.

# 1. Cost Reduction: How?

Reduce or eliminate commissions

Eliminate insurer profit margins

Control of claims

# 1. Cost Reduction: How?

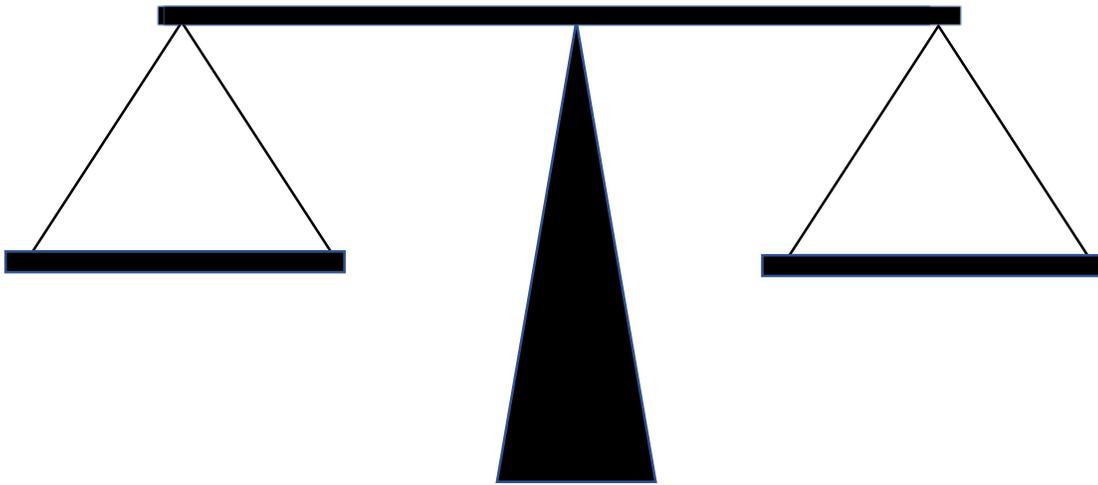
Reduce high commercial rates

Eliminate non-essential services

Eliminate pooling charges

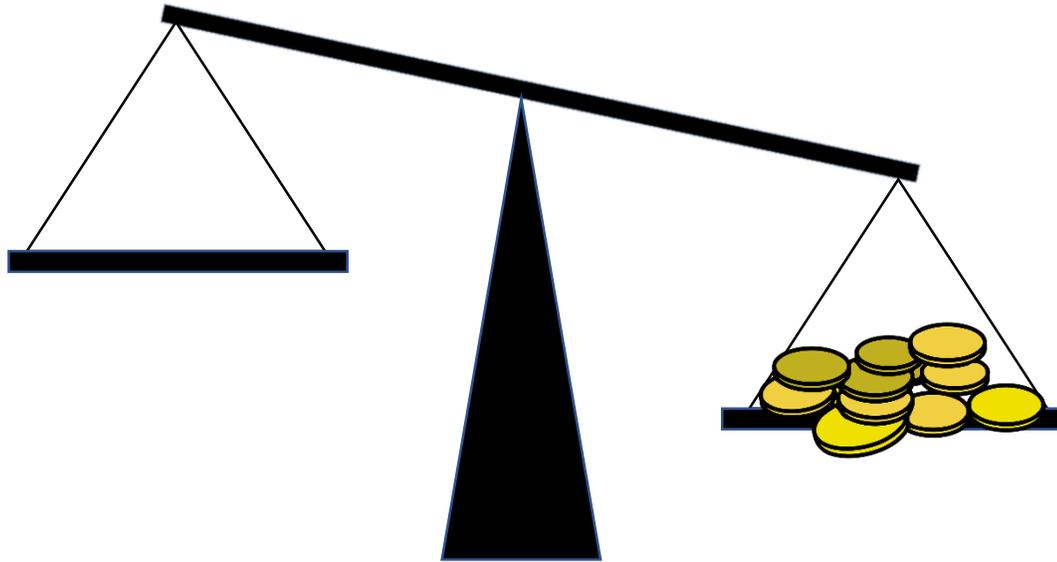
Avoid charges for guarantee funds

# Cost Savings? Discuss!

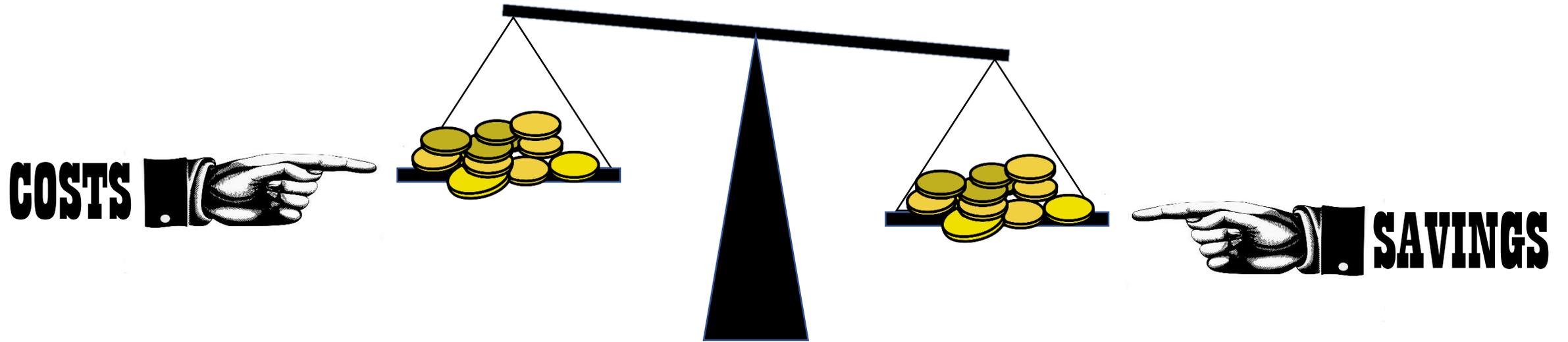


*Hmm...*

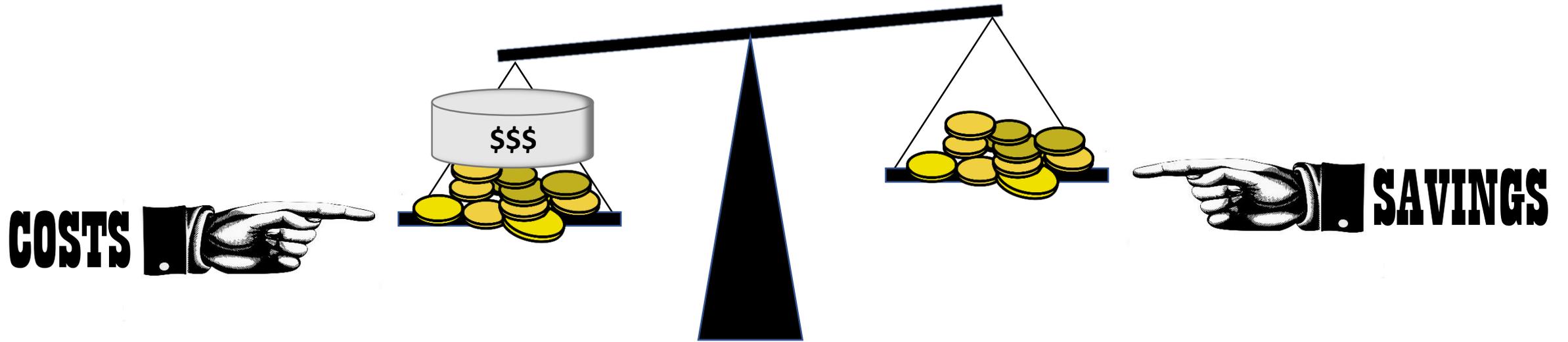
# Cost Savings? Discuss!



# Cost Savings? Discuss!



Cost Savings? Discuss!



# 2. Reinsurance

*“I want **access to reinsurance capacity.**”*

**Example:**

A large healthcare group found reinsurers were

**more willing to reinsure a captive**

**...than excess insurers willing to**

**insure above a SI trust**

**Reinsurance!** Where? How much? (Session on Thursday)

# 3. Investment Income



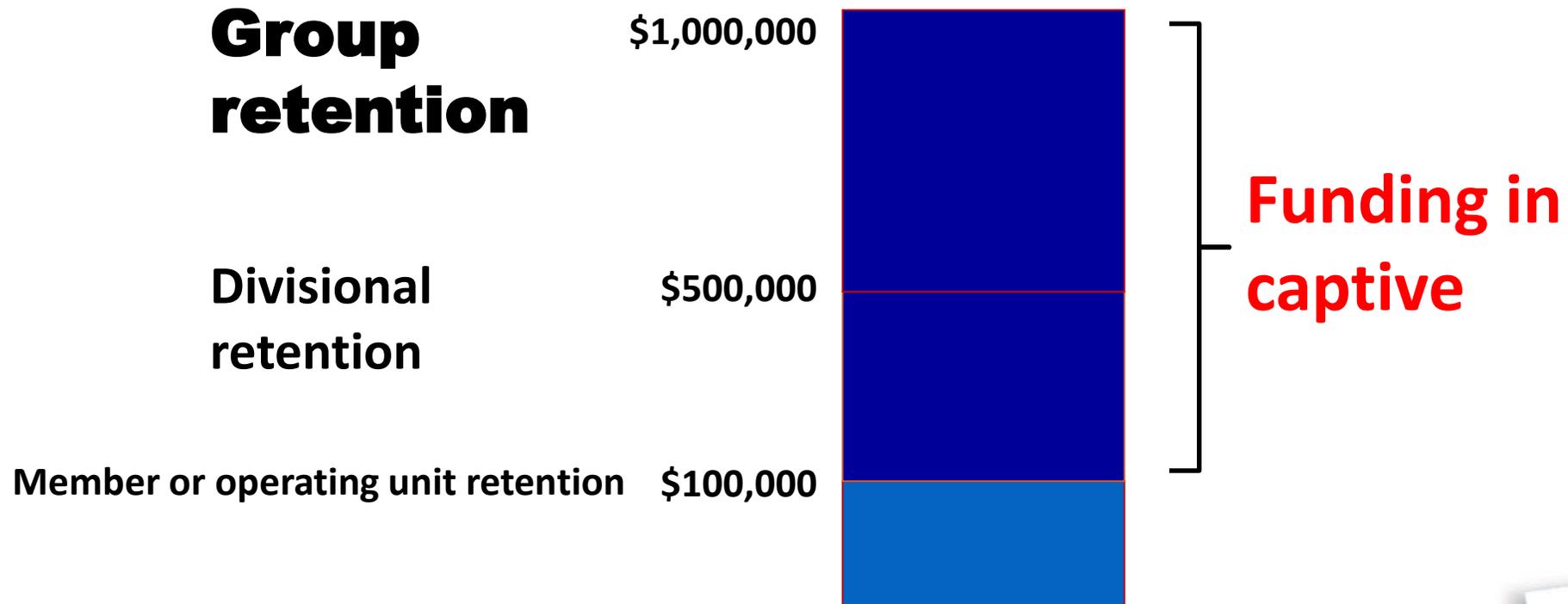
**When interest rates are high enough, loss reserves for lines with longer payout patterns generate extra income**

# 3. Investment Income (2)

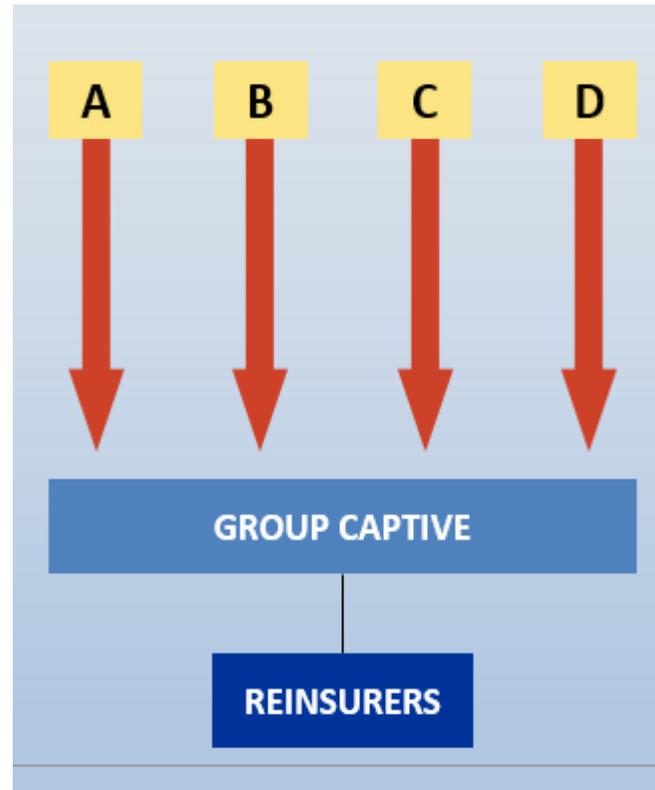
1,000,000 of loss reserves, paid out over seven years produces investment income

3%	104,000
4%	147,000
5%	181,000
7%	267,000

# 4. Administrative Tool



# Group Captive – *(reminder)*



# 4. Administrative Tool (cont.)

*There might be economies of scale in a **group captive***

All the previous reasons plus ...

The value of shared retentions, shared aggregates,  
shared services

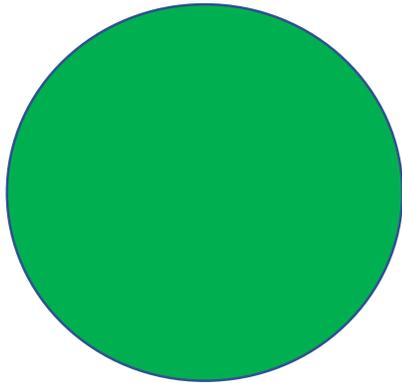
**Example: Risk Retention Groups** (Session on Friday)

-an “escape from fronting”

# Risk sharing – obstacle or mutuality

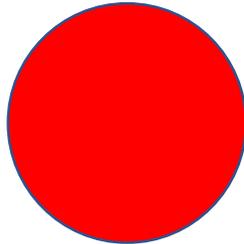
*Size of my account....*

**Expected case**



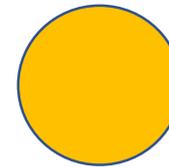
100

**After HIS heavy  
loss year**



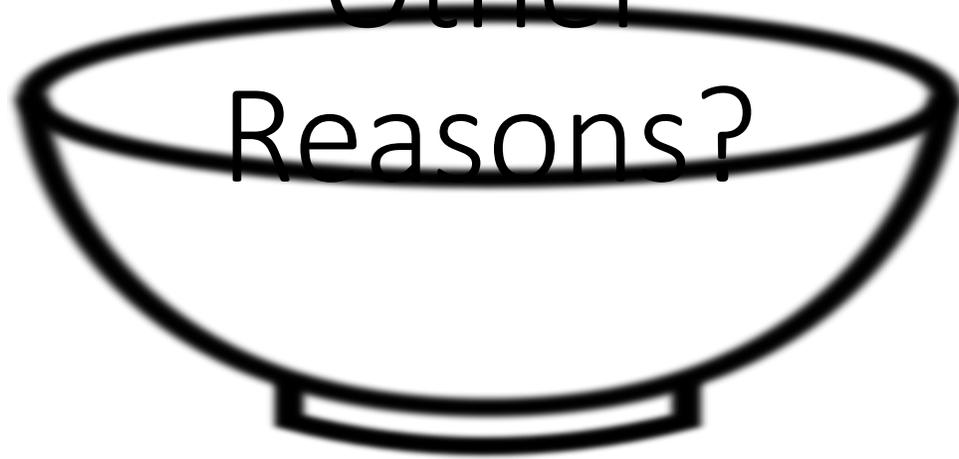
80

**After MY heavy  
loss year**



75

Other  
Reasons?



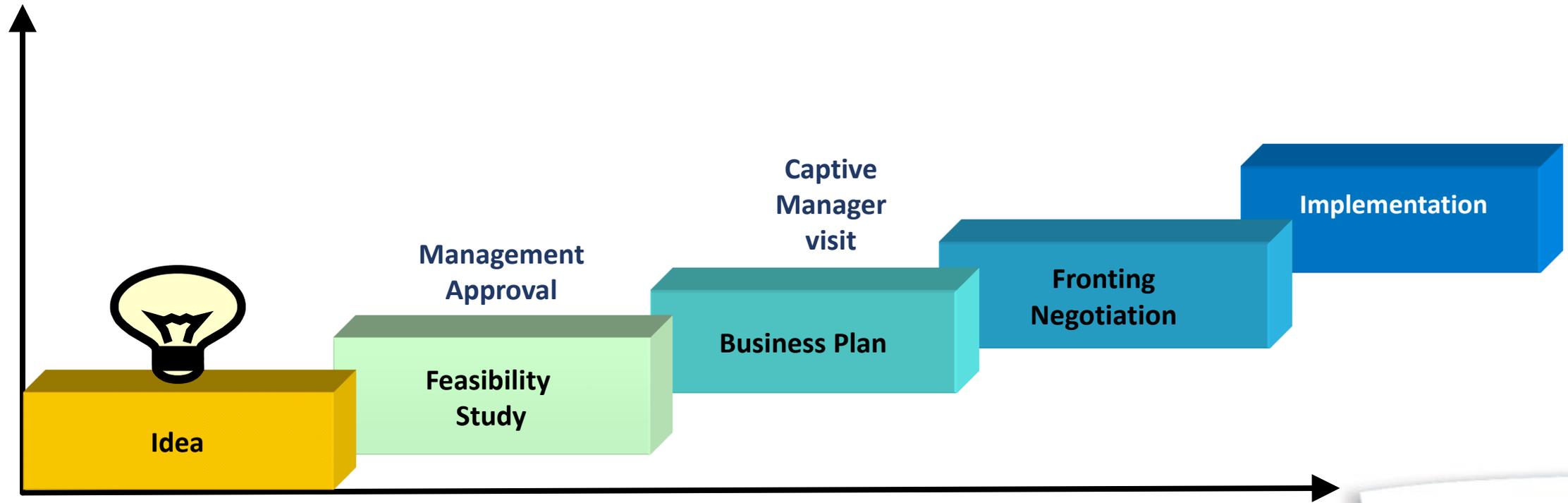
# Feasibility of a Captive



# Feasibility: The Numbers!

Proforma Projections						
	2016	2017	2018	2019	2020	Total
<b>Underwriting results</b>	1,156,452	1,252,952	1,186,200	1,251,360	1,542,340	6,389,303
Investment Income	<u>94,459</u>	<u>151,402</u>	<u>194,286</u>	<u>238,520</u>	<u>286,213</u>	<u>964,880</u>
<b>Captive net income</b>	1,250,911	1,404,354	1,380,485	1,489,879	1,828,553	
Income tax (if any)						
After-tax income	1,250,911	1,404,354	1,380,485	1,489,879	1,828,553	<b>7,354,183</b>

# Start up Captives: The Timeline



# Captives: The Big Issues

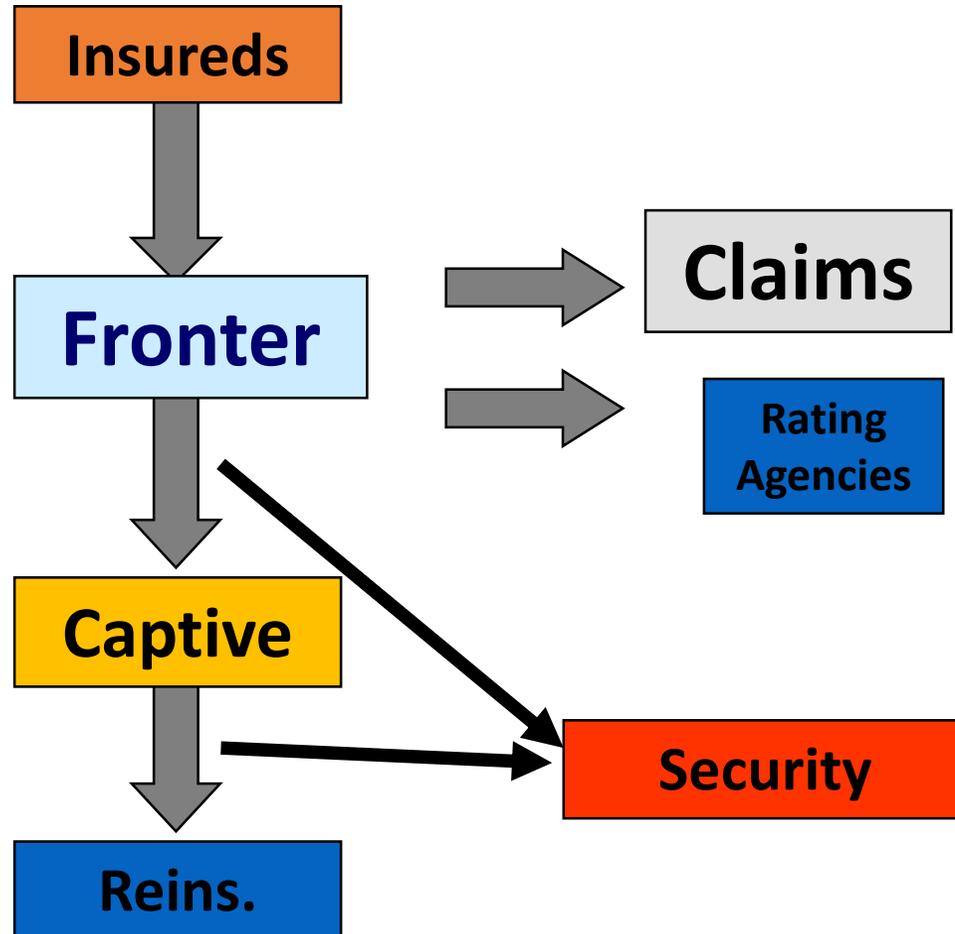
Fronting – what, why, how (in 2018)

Domicile and **regulation**

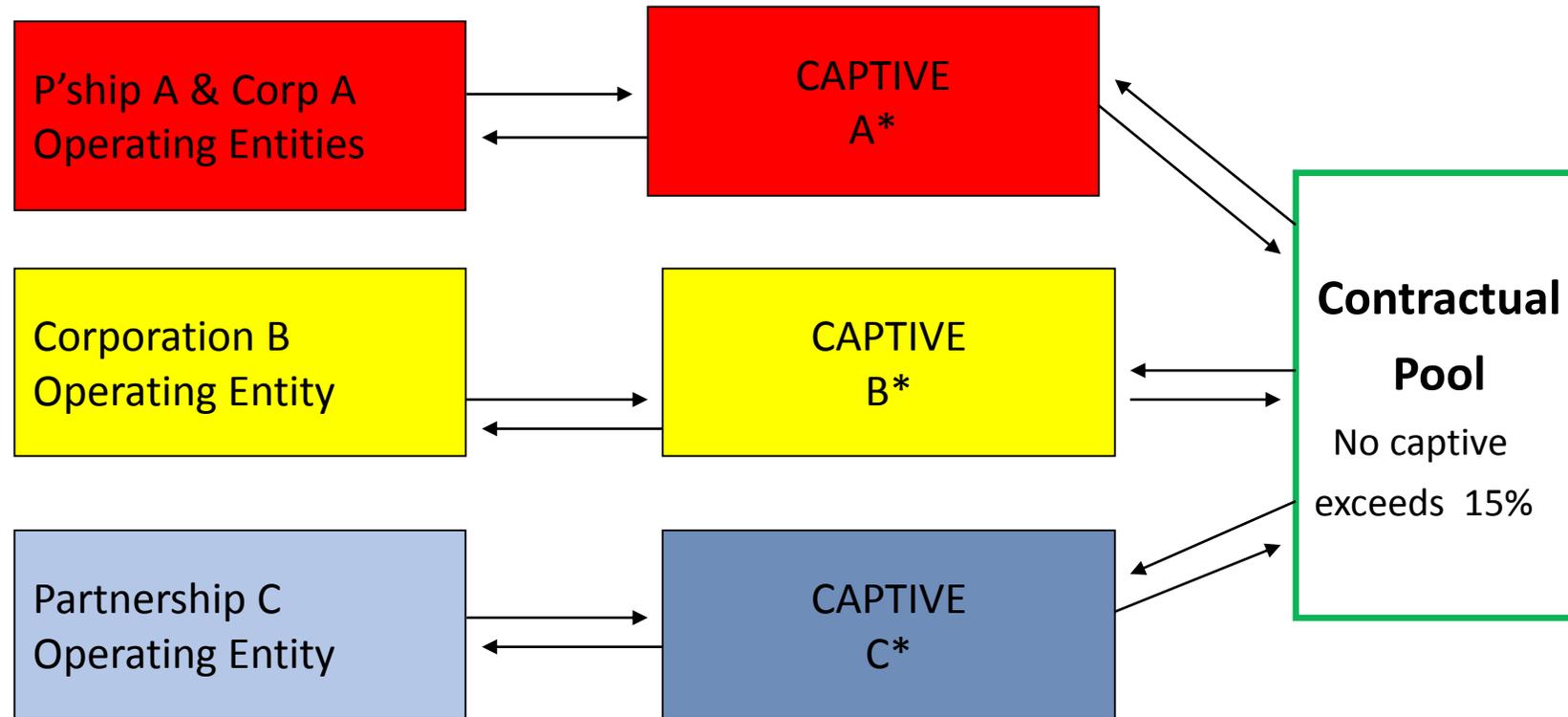
Captive management

....Tax factors

# Fronting: 2018 Problem #1



# Other issues: Pooling



Source: Chaz Lavelle Bingham Greenebaum Doll

# Captive Domiciles

*Onshore – offshore: the major factors in 2018*

## Perception

Regulation (..and FATCA – a non-issue for captives)

Accessibility (....also of the regulator!)

Tax factors (onshore, offshore, self-proc.)

... Costs

# Captive by Domicile / Number

2017 the top nine (out of 70!)		
Bermuda	776	
Cayman	711	
Vermont	593	
Utah	462	
Delaware	385	(1108)
Guernsey	321	
Anguilla	287 e	
Barbados	246	
Luxembourg	208	

Top 10 = 2/3 of total. US domiciles = 1/3 of all captives

# Domicile Selection

*Onshore? Offshore?*

Capitalization and surplus requirements

Receptiveness, stability of regulatory environment

Quality of local infrastructure

Availability of expertise

Costs



# Domicile Selection

*Onshore? Offshore?*

Investments: flexibility

Other captives like us domiciled there?

Experience in our business ?

Tax issues: US Federal, State

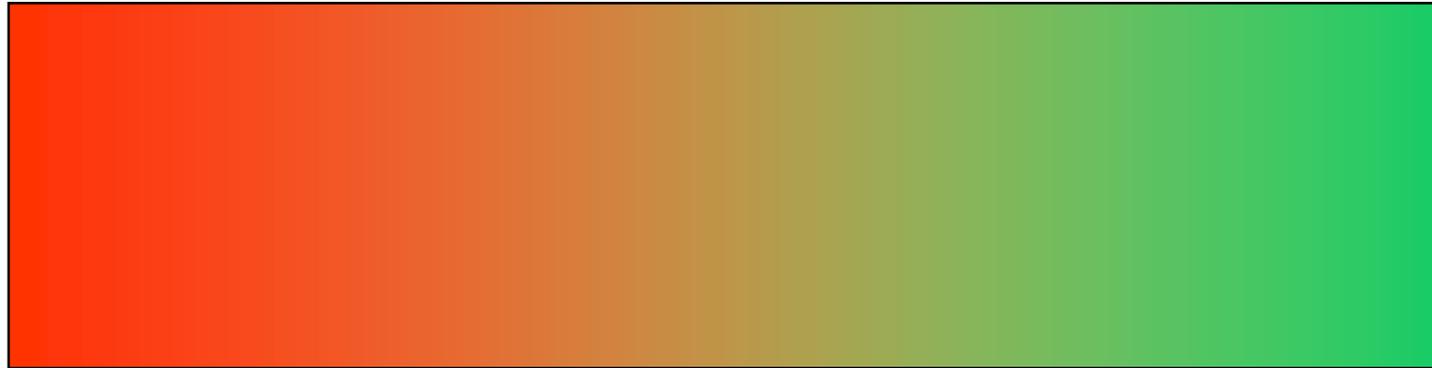
self-procurement, premium taxes



# Regulation



# Regulation Differences



Too much



**Just Right**



Too little



# Tax Factors: The three things

**Deductibility**

Must resemble  
"normal" insurance

**Tax On**  
Captive Income    Shareholders

"Elections"

**Premium Taxes**

- State
- Federal Excise
- Self-Procurement

And...  
Offshore/onshore  
"non-profits"  
831-b small ones

# Tax Factors - Deductibility

*Must demonstrate*

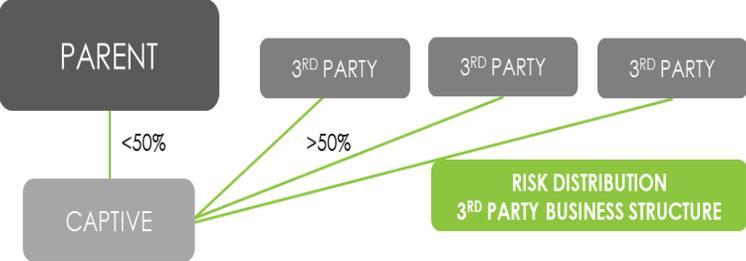
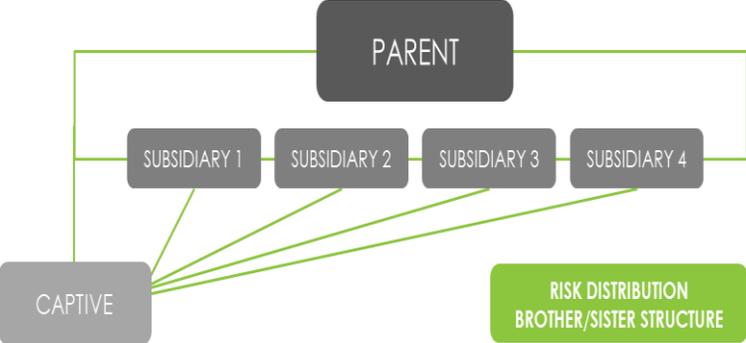
Risk shifting

Risk distribution

Business purpose

Attributes similar to the existing marketplace

# Deductibility – Two examples



# Taxation – Current Issues

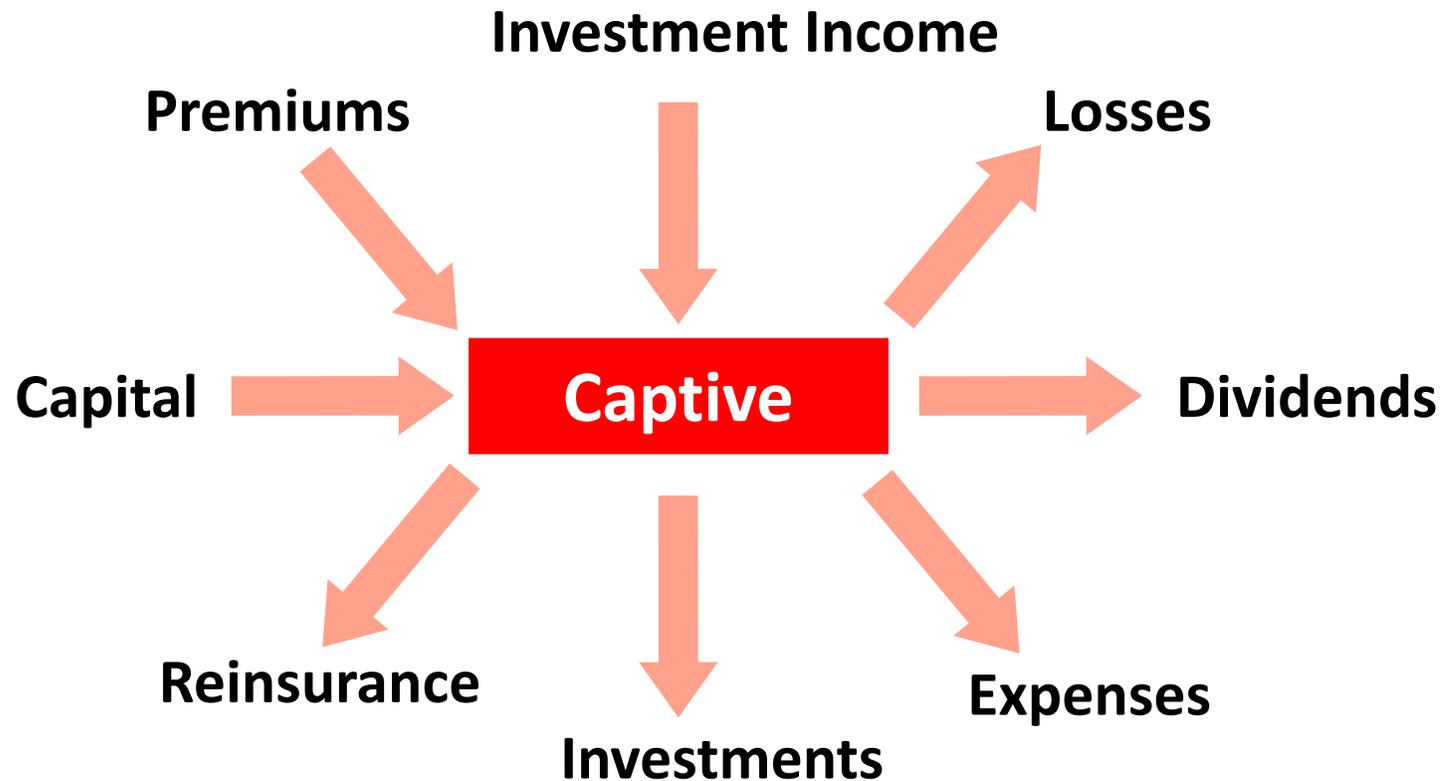
831b structures : use and abuse, IRS “attacking”

More intrusive activity for offshore

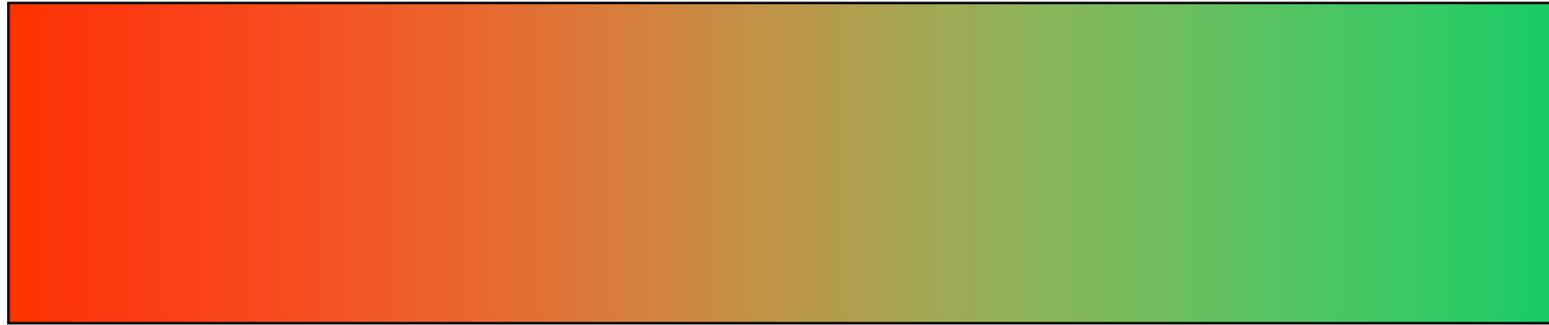
Example: FATCA

Other issues (Come to the round table!)

# Captive Management: How It Works



# Management Matters



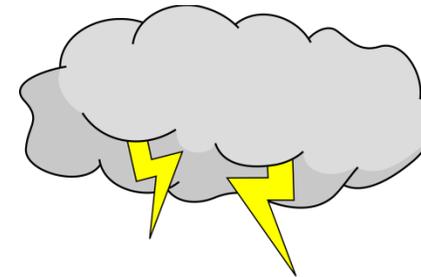
**Too much**



**Just Right**



**Too little**



# Unrelated business?

*Necessary, profitable, dangerous?*

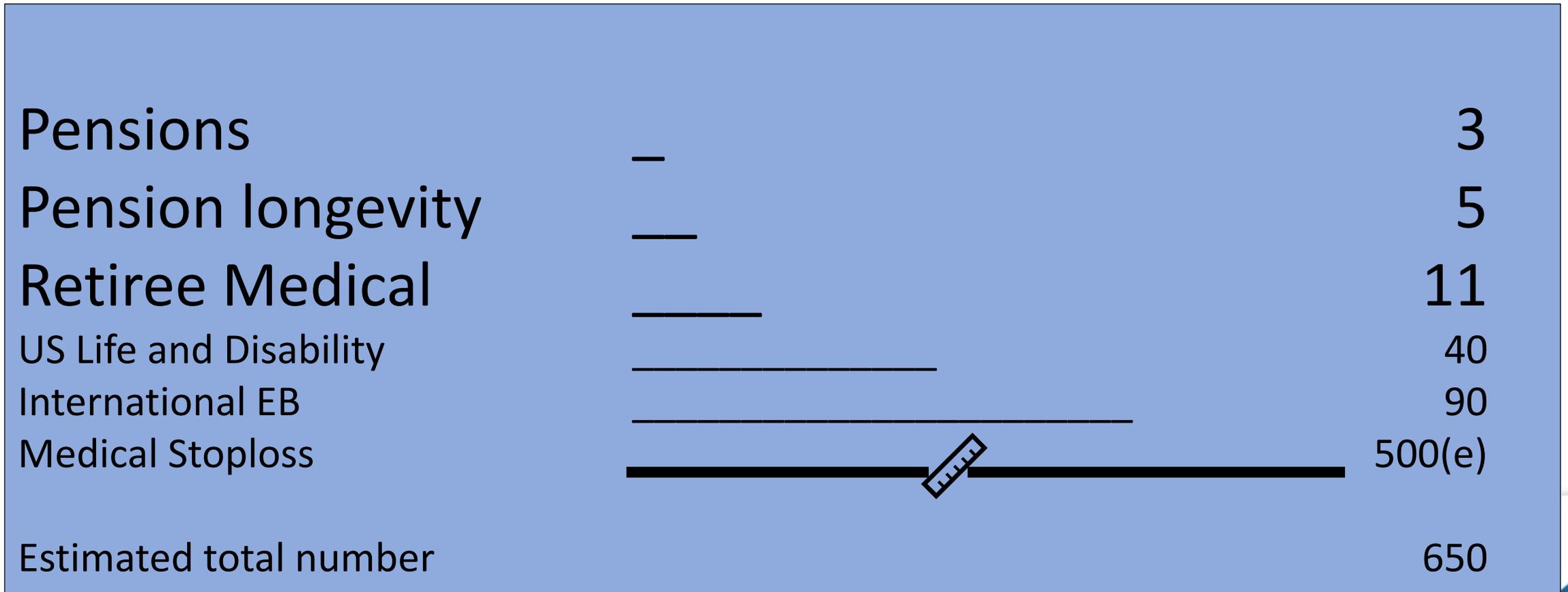


Your own (employee benefits)

Controlled unaffiliated

# Employee Benefits in Captives 2017

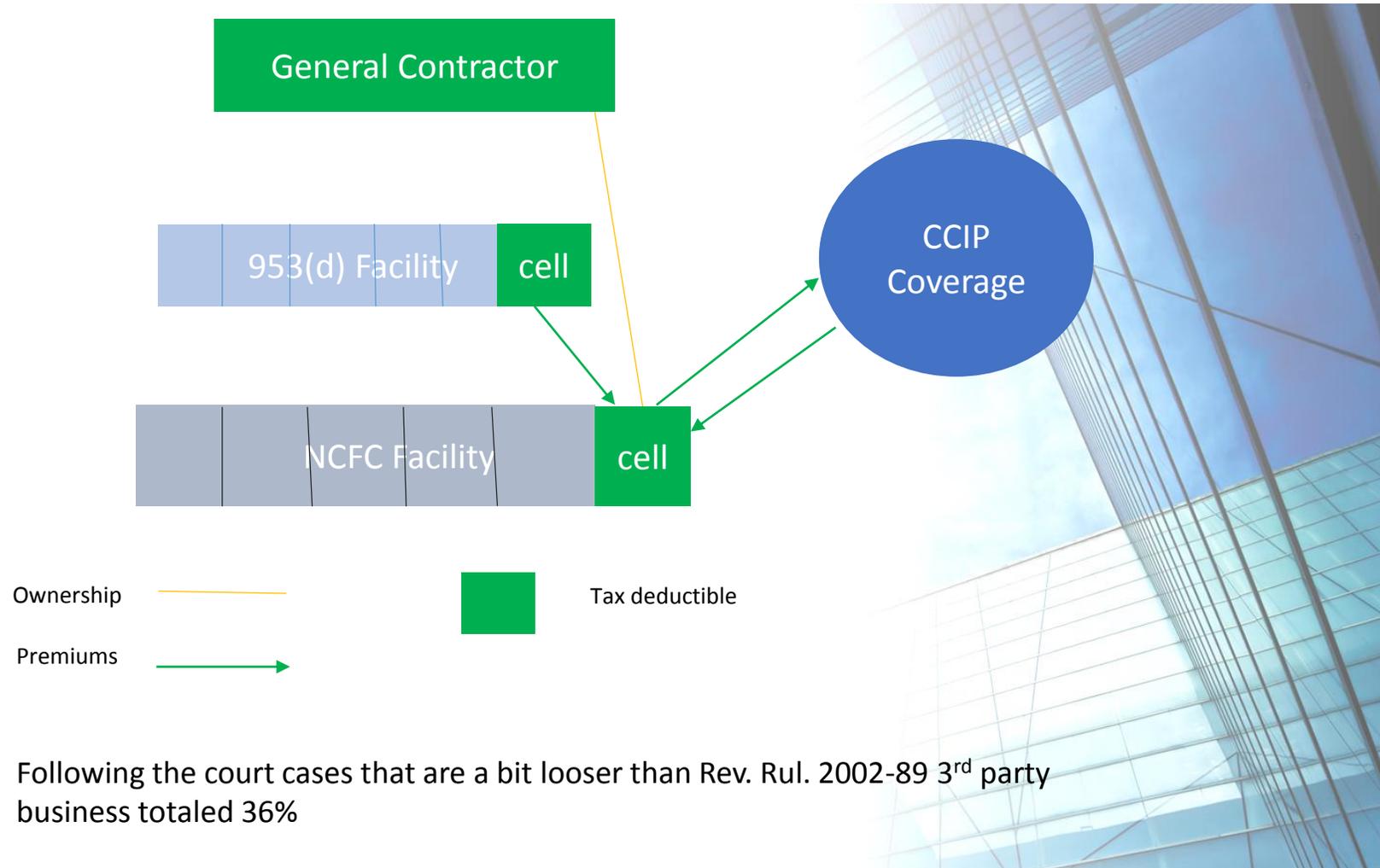
Estimated Number of Programs



# What are the savings?

Coverage	Savings Range*
Retiree medical	<ul style="list-style-type: none"><li>• 7% – 10%+ of the accumulated postretirement benefit obligation</li></ul>
Long-term disability	<ul style="list-style-type: none"><li>• 15% – 25% of commercial insurance</li><li>• On self-insurance, accelerated deduction of claims cost and tax-effective investment accumulation on reserves</li></ul>
Term life insurance	<ul style="list-style-type: none"><li>• 10% – 15% of commercial insurance</li></ul>
Multinational pooling	<ul style="list-style-type: none"><li>• 10% – 15% of the pooled premium</li></ul>
Active medical	<ul style="list-style-type: none"><li>• First year only, incurred but not yet paid</li><li>• After first year, medical trend</li></ul>
Multinational pooling	<ul style="list-style-type: none"><li>• 10% – 15% of the pooled premium</li></ul>
Active medical stop loss	<ul style="list-style-type: none"><li>• 10% – 12% of the cost of stop loss</li></ul>

# Case Study – Construction Company



Following the court cases that are a bit looser than Rev. Rul. 2002-89 3<sup>rd</sup> party business totaled 36%

# Financial Keys to Captive Financial Success

- The right **initial capital** (how much, what form?)
- **Surplus** accumulation
- The **right investments** (by whom?)
- **Return on capital** (what capital?)

# Operational Keys to Captive Financial Success



**The right rates** (who sets them?)



**Low expenses** (what expenses?)



**The right loss estimates** (actuaries!)



**Reinsurance** protection that works

# Two more keys to Captive Success

→ **Long-term dedication**

→ **Risk management**  
(of the **captive's** risks!)

# Our Time-tested slogan

**“Captive business  
is  
the best business”**