UNDERSTANDING THE BASICS OF CAPTIVE INSURANCE

September 7, 9:30-10:30 A.M.

DISB

GOVERNMENT OF THE DISTRICT OF COLUMBIA
MURIEL BOWSER, MAYOR

PRESENTERS DC DEPARTMENT

Dana Sheppard, JD, LLM
Associate Commissioner
Risk Finance Bureau
2005 – Present

Sean O'Donnell, CPA, CFE
Director of Financial Examination
Risk Finance Bureau
2007 – Present

PRESENTERS

PETER (PETE) A. KRANZ, CPA
SENIOR VICE PRESIDENT, DIRECTOR
RISK FINANCE AND STRATEGIC CONSULTING PRACTICE LEADER

Alliant

Pete Kranz recently joined Alliant with over 27 years of risk financing and consulting experience serving privately owned and publicly traded clients of all sizes, including significant work with Fortune 1000 companies.

Pete spent his first ten years in public accounting supporting clients with audit, tax, business consulting and advisory services. He spent the past seventeen years with Brown & Brown (previously Beecher Carlson), most recently leading the Captive Management and Consulting Practice, one of the world's largest and most recognized, for the past four years. In his role, Pete developed many successful, complex risk financing programs including utilization of captives. He worked with companies of all sizes to quantify risk tolerance and appetite and design the most efficient risk financing program for each, including consideration and utilization of integrated aggregates including multi-year, multi-line depleting aggregates; insurance linked securities; parametric programs; matching deductible and indemnification structures; and captives insurance companies (pure, group, sponsored / cell, risk retention groups). In addition, Pete worked with clients on ongoing strategic opportunities, including: opportunity analyses; sale of loss reserves to "runoff" markets, freeing up capital and mitigating cash flow implications; captive feasibility studies; captive health checks including development of ROIC, KPI, and metric analyses; and ongoing captive utilization within an organization's broader risk financing strategy, including identification of profitable opportunities to increase captive surplus allowing the client to take greater control of their risk financing destiny.

Pete earned his Bachelor of Science in Accounting from Champlain College in Burlington VT. He is a Certified Public Accountant, licensed in the State of Vermont. Pete is a frequent speaker at industry conferences, contributor on podcasts and webinars, and routinely writes for leading industry publications.

__Recent Recognitions__

- *2018 – Captive Review's "Ones to Watch"*
- *2019 – Captive Review's Captive Service Professional of the Year [Shortlist]*
- *2020 – Risk & Insurance Power Broker – Captives*
- *2020 – Captive Review's Captive Service Professional of the Year [Winner]*
- *2020 – Captive International's Feasibility Study (Individual) – [Highly Commended]*
- *2020 – Captive International's Captive Manager (Individual) – [Winner]*
- *2021 – Risk & Insurance Power Broker – Captives*
- *2021 – Captive Review's Power 50 (Rank #11)*
- *2021 – Captive International's Feasibility Study Specialist (Individual) – [Highly Commended]*
- *2021 – Captive International's Captive Manager (Individual) – [Highly Commended]*
- *2022 – Captive Review's Power 50 (Rank #12)*

ABOUT THE DC DEPARTMENT OF INSURANCE, SECURITIES AND BANKING

Mission

DISB is the District of Columbia's Financial Services Regulator.

DISB has a three-fold mission: 1) cultivate a regulatory environment that protects consumers and attracts and retains financial services firms to the District; 2) empower and educate residents on financial matters; and 3) provide financing for District small businesses.

DISB licenses approximately 1,300 insurance companies, more than 100,000 insurance agents, over 1,500 mortgage lenders and brokers, 135 money transmitters, 55 money lenders, over 1,500 securities broker-dealers, and more than 150 investment advisers.

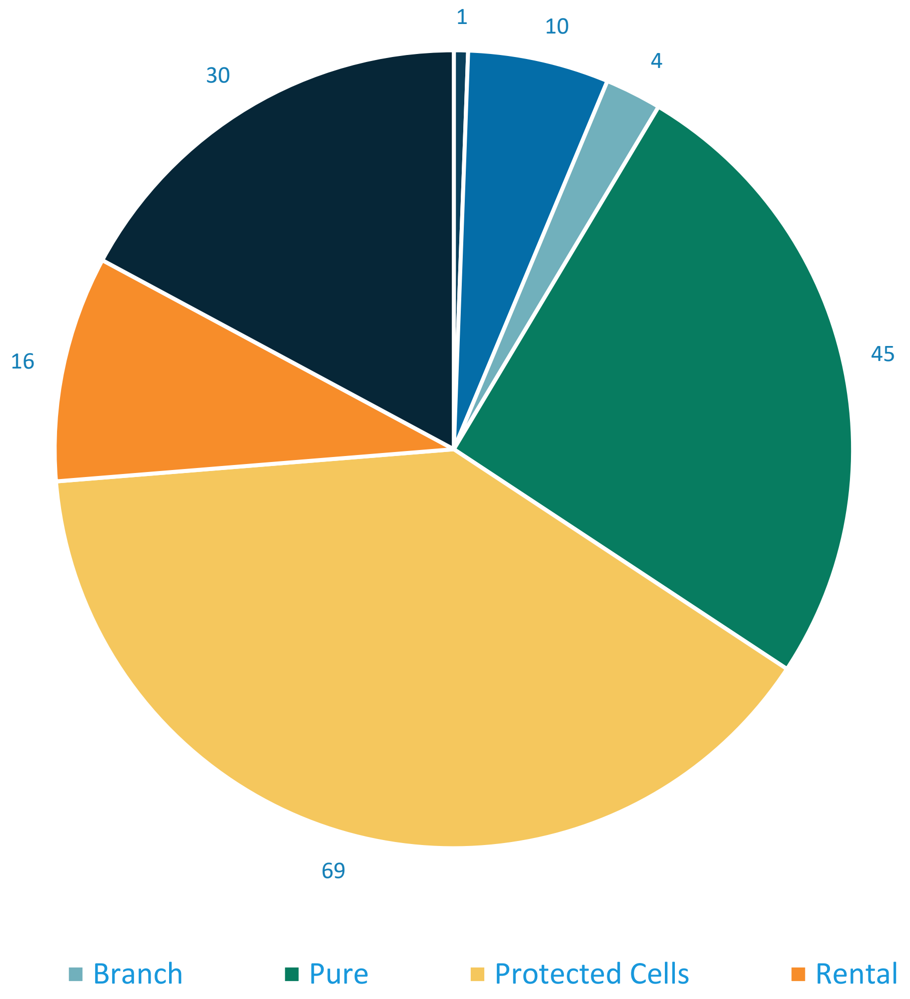
FY 2022 Budget is $34.1 million and 139 FTEs.

DC'S CAPTIVE INSURANCE PROGRAM

- First DC captive insurance law and regulations were enacted in 2000
- First captive licensed in April 2001
- The Risk Finance Bureau was formed in 2003 and we currently have 10 FTEs
- First captive law was repealed and replaced in 2004 and in 2007 the captive law was amended to authorize special purpose captives to allow insurance securitizations, and enhanced to authorize the formation of protected and incorporated cells.
- DC has licensed 335 since 2001, and currently has 175 active captives.
- One-third of captives and RRGs write medical liability coverage for hospitals, physicians, nursing homes, and assisted living facilities.
- DC was the first US jurisdiction to authorize the formation of protected cells (AKA segregated accounts) as separate legal entities.
- We are experiencing significant growth in protected cells.

BREAKDOWN OF CAPTIVE INSURANCE COMPANIES IN DC

As of August 6, 2022



ORGANIZATIONS THAT HAVE FORMED CAPTIVES IN DC

DOW CORNING

AARP

AON

THE UNIVERSITY OF CALIFORNIA · LET THERE BE LIGHT · 1868

GM

TISHMAN SPEYER

SUBARU

ally

AMTRAK

Brookfield Properties

THE PORT AUTHORITY OF NY & NJ

CareFirst

FannieMae

FreddieMac

THE GEORGE WASHINGTON UNIVERSITY

WASHINGTON, DC

Carrier

Canon

MARSH

PRESENTATION AGENDA

- ALTERNATIVE RISK FINANCING
- CAPTIVE INDUSTRY OVERVIEW
- TYPES OF CAPTIVES
- ADVANTAGES AND DISADVANTAGES OF CAPTIVES
- RISKS COMMONLY INSURED IN CAPTIVES
- EVALUATION PROCESS

ALTERNATIVE RISK FINANCING

WHAT DO WE MEAN BY ALTERNATIVE RISK FINANCING?

- Broad term to capture any risk financing techniques used other than traditional insurance
- Can include (but not limited to) deductibles / SIRs (self-funding), risk purchasing groups, insurance linked securities, reinsurance, matching deductibles, aggregate deductibles, multi-year / multi-line integrated aggregate programs and, most prevalently, captives and risk retention groups
- At the end of the day insurance is a financing transaction

Risk Purchasing Group

A risk purchasing group (otherwise known as, RPG) consists of insurance customers who join together to purchase their insurance coverage (may be limited to liability coverages) from an insurance company. The RPG is the insurance purchasing vehicle for its members. Purchasing insurance like this benefits the members of the RPG because it allows them to get the insurance at a lower premium, with broader coverage terms, and loss control/risk management programs.

Insurance Linked Securities

Insurance linked securities are the product of insurance risks (typically finite risks) converted to investments via special purpose vehicles (SPVs) which are used to access capital markets (example – hedge funds) directly. They are used by insurance, reinsurance and, increasingly, captive insurers.

Integrated Aggregate Programs

Multi-year / multi-line integrated aggregate programs provide coverage for a myriad of exposures in a single solution, whereby the insured benefits from the efficiency of having created risk diversification prior to accessing the insurance marketplace. Usually structured within captive insurance companies.

How and when should captives be considered with placing traditional insurance programs?

- Determine the optimal retention
  - Avoid "dollar trading" – don't pay a carrier premium for expected losses as they are just marking it up and then only returning the loss piece
- Above the dollar trading, evaluate the premium credit from increased retentions versus the increased risk retained, while also evaluating if the increased risk can be mitigated via an aggregate (see illustration)
- Consider financing retained losses (risks) in a captive – IF it makes sense

Initial program structure

Guaranteed cost program	
No deductible or retention	
Premiums - risk transfer	$ 1,000,000
Annual expected losses	$ 200,000

New program structure

Deductible	$ 250,000
Deductible - aggregate	$ 750,000
(aggregate is 80% confidence level - 1 in 5 year event)	
Premiums - risk transfer	$ 500,000
Annual expected losses	$ 200,000

	Initial	**New**
Premiums - risk transfer	$ 1,000,000	$ 500,000
Annual expected losses	$ -	$ 200,000
Cost at expected	$ 1,000,000	$ 700,000
Program savings - annual		$ 300,000
Program savings - 5-year		$ 1,500,000
Additional losses to aggregate (1 in 5 year event)		$ 550,000
Net 5-year program savings		**$ 950,000**

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CAPTIVE INDUSTRY OVERVIEW

Captive Insurance

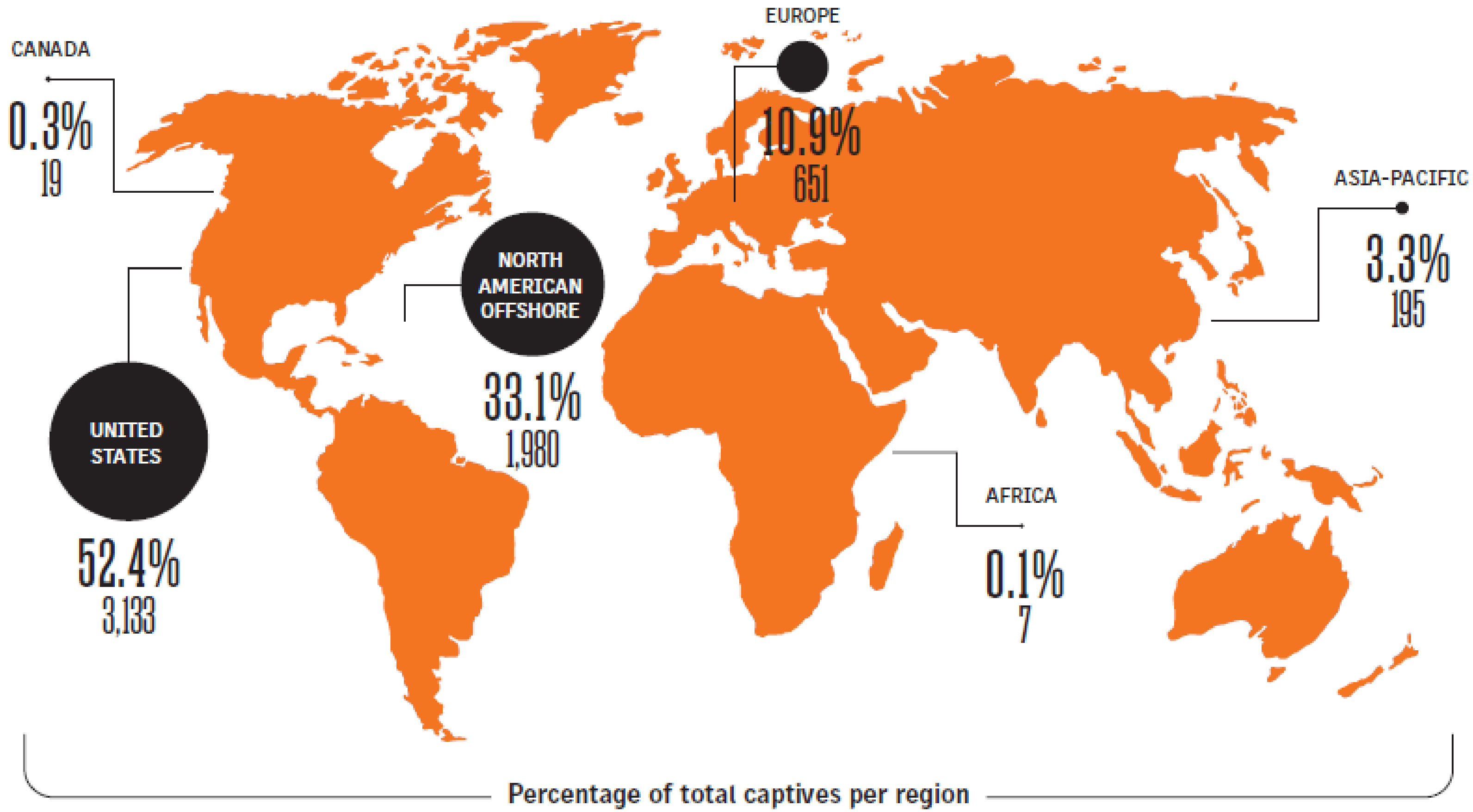
A "captive insurer" is generally defined as an insurance company that is wholly owned and controlled by its insureds; its primary purpose is to insure the risks of its owners, and its insureds benefit from the captive insurer's underwriting profits.

GLOBAL CAPTIVE MARKETPLACE

ONSHORE/
OFFSHORE
BY THE NUMBERS

There were 5,985 captives in 2021, not including microcaptives, series captives, or individual cells or cell members in protected cell companies.

Source: *BI* survey



WHAT ARE WE SEEING IN THE INDUSTRY?

- Growth across all industry verticals
- Growth across all lines with current focus on lines like cyber and D+O
- Shift from pure captives for large companies to lower upper market and middle market, including
- Increased interest in group captives, typically via cell structures
- Risk financing is changing – traditional markets are moving further away from risk; future of risk financing is going to be focused on diversified pools of risk (integrated aggregates) created by insureds and financed holistically

TYPES OF CAPTIVES

TYPES OF CAPTIVES

PURE / SINGLE PARENT

- Wholly owned or controlled company
- Insures and / or reinsures the risks of its parent and / or affiliates and controlled, unaffiliated business

GROUP / ASSOCIATION

- Owned by two (or more) companies
- Usually a trade association or homogenous companies
- Insures and / or reinsures the risks of the group

SEGREGATED CELL

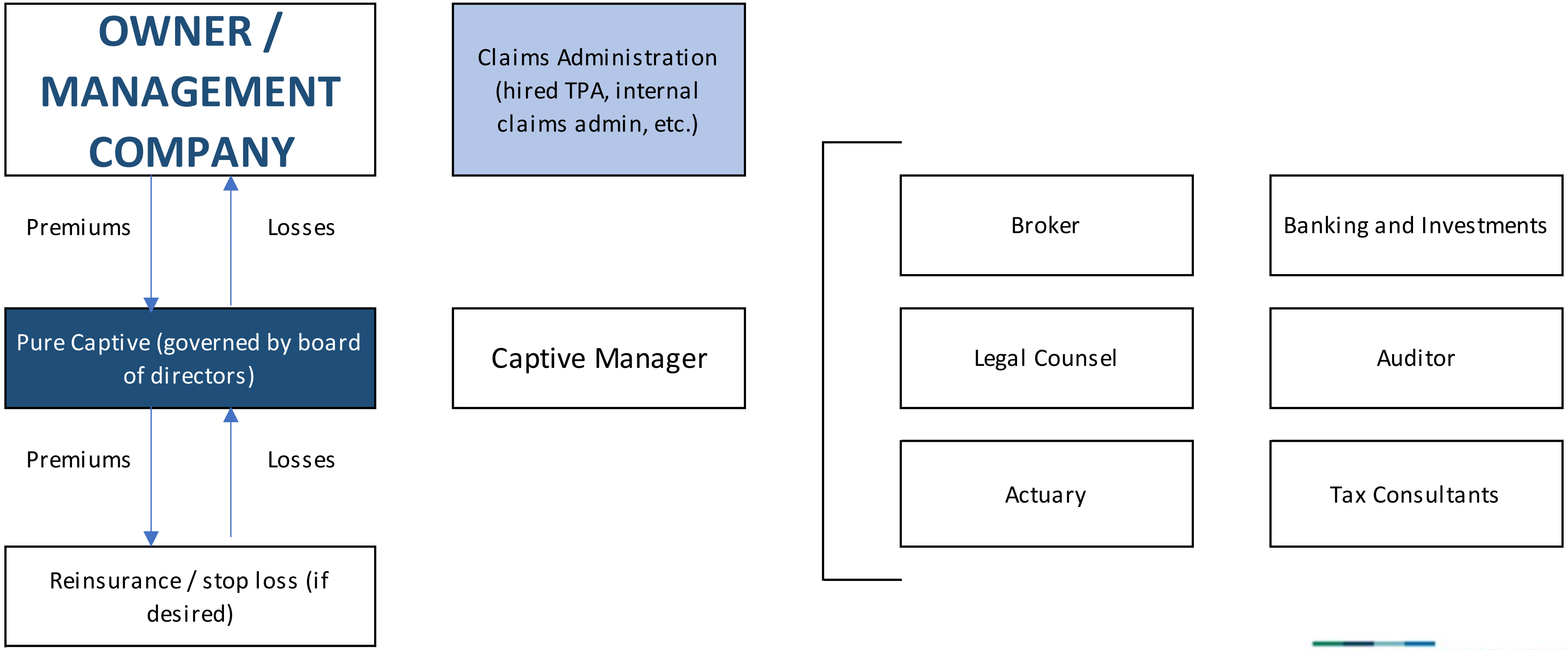
- Sponsor “sells” segregated accounts to participants
- Insures and / or reinsures risks of participant and / or affiliates and controlled, unaffiliated business
- Limits administrative costs of a captive
- Each cell protected from insolvency of other cells

RISK RETENTION GROUPS

- Form of group captive regulated under United States federal legislation
- Can operate in all 50 states but only needs to be licensed in state of domicile
- Insureds must be owners and owners must be insureds
- Can only write liability lines of business
- Popular for unrelated medical groups (medical malpractice lines)
- Most highly regulated form of captive
- Cannot provide reinsurance

Pure Captive Structure

- Single owner
    - Owner can be a multi-company organizational structure, however all entities have a relation to each other
- Captive manager manages all relationships, handles all financial and regulatory requirements, provides ongoing strategic guidance
- Captive manager should work in concert with owners' risk management and brokers to develop the right program structure and partners



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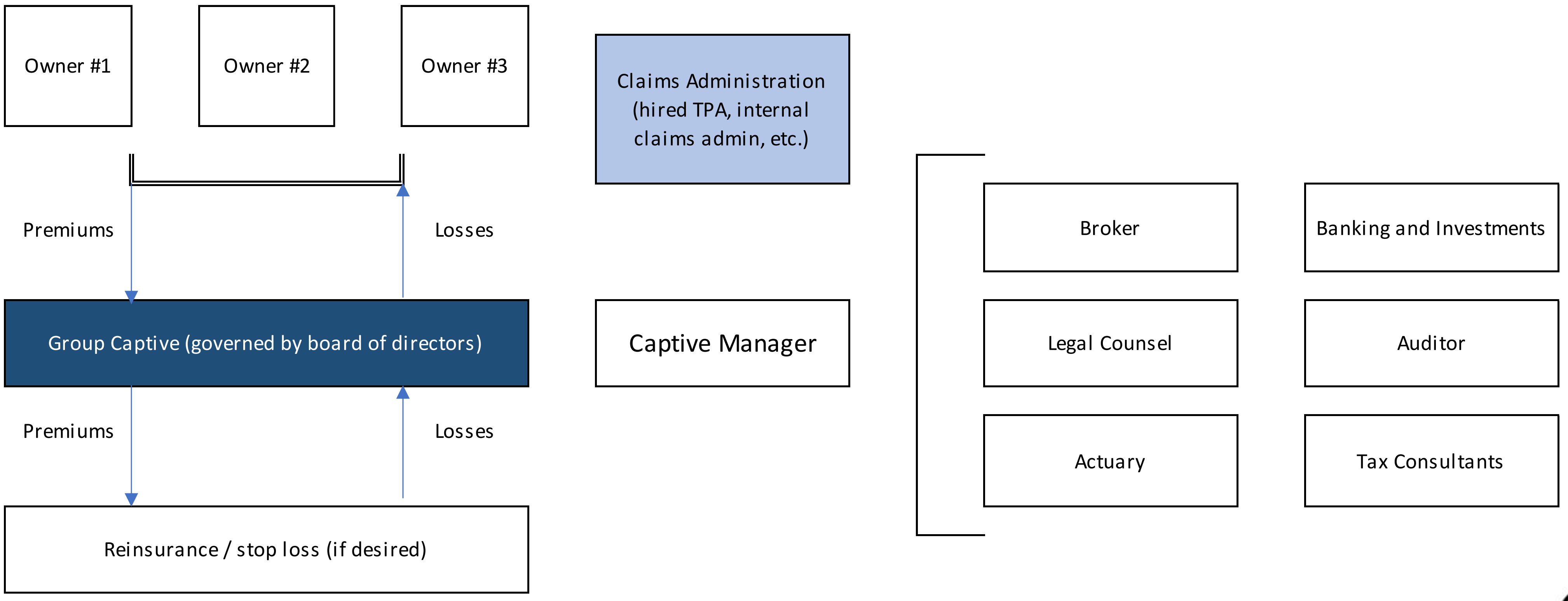
Group Captive Structure

- Multiple, unrelated owners
    - Owners can be multi-company organizational structures
- Captive manager manages all relationships, handles all financial and regulatory requirements, provides ongoing strategic guidance
- Captive manager should work in concert with owners' risk management and brokers to develop the right program structure and partners



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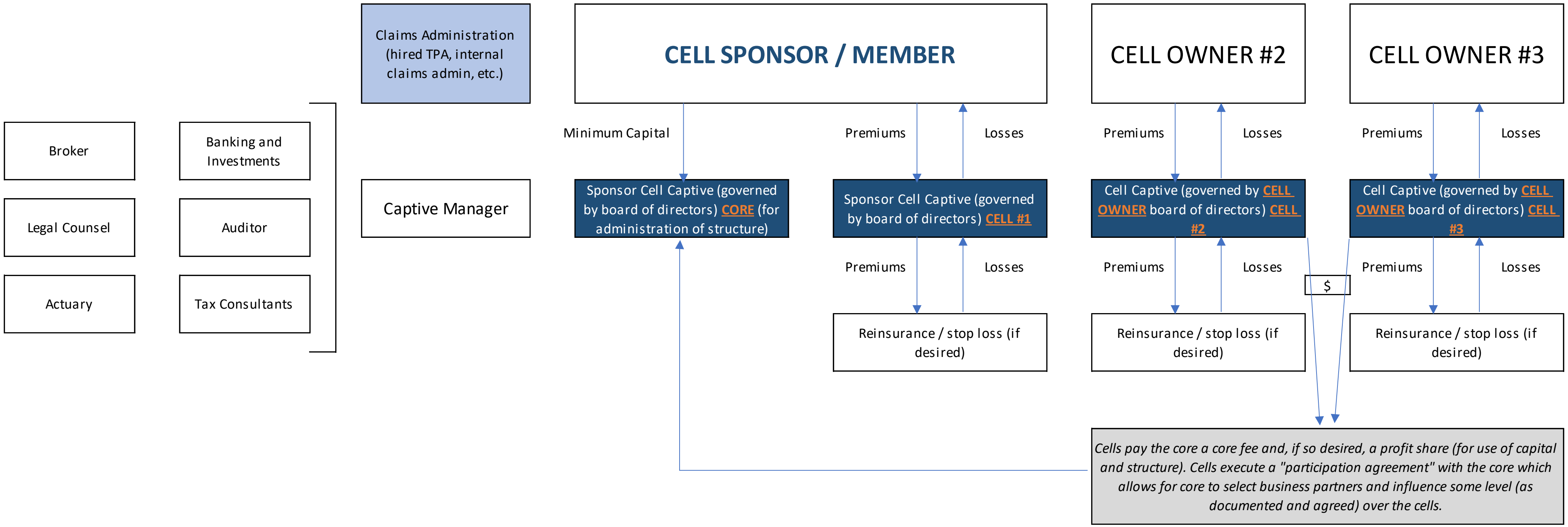
Cell Captive Structure

- Sponsor (related or unrelated)
- Single owner or multiple, unrelated owners
  - Owner(s) can be multi-company organizational structures
- Captive manager manages all relationships, handles all financial and regulatory requirements, provides ongoing strategic guidance
- Captive manager should work in concert with owners' risk management and brokers to develop the right program structure and partners



ADVANTAGES AND DISADVANTAGES OF CAPTIVES

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ADVANTAGES

- Cost efficiency through bundling of risks
- Reduces frictional costs (mitigation of cost of dollar trading)
- Provides direct access to reinsurance and alternative risk transfer markets
- May provide financial (net present value) benefit if transactions qualify as insurance for tax (expert tax counsel should be consulted)
- Ability to capture profit when compliance requirements prohibit captive writing directly (example – AM Best rated carrier paper required, captive reinsures carrier)
- Capture profitable lines of business (examples – multi-family tenant liability programs, warranty, vehicle service contract, commercial tenant program)
- Support insurance compliance requirement (insurance and compliance with insurance)
- Centralization of risk financing programs
- Formalization of insurance transactions for allocation (example – when joint ventures are involved, tenant insurance cost allocations)

DISADVANTAGES

- Requires capitalization (minimum, ratio requirements)
- Requires startup costs
- Can increase organizational complexity
- Long-term commitment
- Involves ongoing operating costs
- Increased retentions can result in adverse loss experience
- If taking a tax position, can be subject to IRS challenge
- Pooling (in whatever form) can subject insured to adverse loss experience of others
- Exit process (primarily from group structures being "sold" by brokers / unrelated entities) can be constrained and take time

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RISKS COMMONLY INSURED IN CAPTIVES

RISKS COMMONLY INSURED BY CAPTIVES

Nearly any risk that is self-insured, carries large deductibles / retentions, is commercially unavailable, or cost prohibitive can be insured in a captive

- Workers' Compensation
- General Liability
- Automobile Liability
- Professional Liability
- Warranty / Performance Guarantee Coverages
- Completed Operations Liability
- Property and Business Interruption
- Terrorism
- Employee Benefits
- Cyber Liability
- Customer, Dealer, and Franchisee Insurance Coverages

EVALUATION PROCESS

PROCESS OVERVIEW

PRELIMINARY REVIEW

- Should be a “no cost” review
- Gather data
  - Insurance program summary (retentions, retained losses, limits purchased, premiums for limits purchased)
  - Historical program details (exposures, known incurred / ultimate projected losses, payout pattern – if available)
- Review initial data to see if captive might be feasible
  - Non-actuarial
  - High-level to see if it’s an obvious “yes” or “no”
  - Leads into open and honest discussion with client or prospect
  - Some consultants are just selling captives without taking a solution-based approach
  - Review retentions, increasing retentions, profitable opportunities

FEASIBILITY STUDY

- Review targeted opportunities which would result in greatest potential benefit (benefit could be operational, financial)
- Actuarial estimates of losses, including at different retentions and confidence levels – allowing for optimization review as well as review of payback years based on premium credit for increased retention
- Domicile review and scorecard
- Capitalization
- Operational considerations
- Net present value calculations
- Pro-forma financial statements (expected and adverse)
- Discussion of tax and other considerations

FEASIBILITY STUDY – DOMICILE CONSIDERATIONS

- Onshore v. Offshore
  - Tax Ramifications
  - Economic Substance
  - Perceptions
  - Geography
- Quality and Consistency of Domicile
- Regulatory Requirements
- Service Provider Infrastructure
- Costs of Jurisdiction (Licensing, Premium Tax, Service Providers, etc.)
- Capitalization (Onshore Typically 3 : 1, Offshore Typically 4 or 5 : 1)
- Investment Restrictions
- Local Director Requirements
- Independent Annual Audit and Actuarial Opinion
- Tax Implications
  - Direct Placement
  - Federal and State Income
  - Federal Excise

CAPITALIZATION

ILLUSTRATIVE CASH / CAPITAL REQUIREMENTS:

	Year 1	Year 2	Year 3
Capitalization *	1,800,000	0	0
Premium Funding - Single Policy Year	5,250,000	5,250,000	5,250,000
Premium Funding - LPT (one-time)	0	0	0
Potential Loan Back to Parent **	0	0	0
Net Cash Required	**5,250,000**	**5,250,000**	**5,250,000**

Greater of:

Premium volume	5,250,000	
Minimum ($250,000)	250,000	
Ratio Based ($3 premium : $1 of capital)	1,800,000	*[round up]*
Additional Capital for LPT	0	

***Assumes no adverse loss experience - capital and surplus does not drop below 3 : 1 ratios**

***Capitalization can be cash or letter of credit (assumed letter of credit)**

**** Tax advisors typically advise no greaterer than 30% - 50% of investable assets (assumed 0%)**

APPLICATION AND LICENSING

- Organizational
  - Captive name, form of entity, organizational documentation, registered agent
- Directors and officers
  - Biographical affidavits
  - Resident director (if required)
- Business plan
  - Narrative
  - Loss control / mitigation programs
  - Policy forms / agreements (draft)
  - Economic benefit
  - Pro-forma financial statements (expected and adverse)
  - Actuarial loss support
  - Actuarial feasibility opinion
  - Investment policy (draft)

TYPICAL STARTUP AND ONGOING COSTS

SET UP COSTS (ONE-TIME)		
EXPENSES:	**Low Estimate**	**High Estimate**
Step 1 - Feasibility Study*:		
Captive Consulting	35,000	50,000
Actuarial - Loss Analyses	15,000	30,000
Tax Consulting **	25,000	75,000
	75,000	155,000
Step 2 - Licensure:		
Captive Management	20,000	30,000
Actuarial - Opinion	7,500	10,000
Legal	10,000	10,000
Regulatory	7,500	15,000
Travel and Other (Regulatory Briefing) ***	10,000	15,000
	55,000	80,000
	130,000	235,000

** Assumes feasibility study and ongoing management within a relevant range of lines of business*
*** Assumes lower scope (not a formal opinion which can cost $50,000 - $125,000)*
**** Regulators are holding briefings virtually at present which should result in savings*

ONGOING (ANNUAL) OPERATING COSTS		
Ongoing Captive Management*:	**Low Estimate**	**High Estimate**
Captive Management	60,000	100,000
Audit	25,000	45,000
Actuarial - Loss Analysis and Opinion	15,000	30,000
Regulatory (non-premium tax)	7,500	15,000
Legal	7,500	12,500
Miscellaneous	15,000	17,500
	130,000	220,000

**Does not include underwriting or capital related costs*

Register at www.dccaptives.org

Q & A

September 7, 9:30-10:30 A.M.

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THANK YOU!

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