CAPTIVES ARE HARD WORK… AND WORTH IT

Rob Walling, of Pinnacle Actuarial Resources, Inc., identifies the common challenges experienced in forming a captive and how to avoid them

Starting a business, any business, is hard work. This is doubly true when the industry you are entering is both highly technical and highly regulated, like insurance. A number of recent court cases and news items have highlighted the importance of doing the work up front to develop a well-designed and operated captive insurance company. So, what details go into forming and running a captive?

A key hurdle faced by many captives is that their owners typically have deep expertise in their current industry, but not in insurance. Knowing how to be a great beer distributor or roofing contractor does not guarantee a working knowledge of insurance company operations. Insurance companies of all sizes, including captives, engage in some common activities. For example, they:

- underwrite and assess risk
- determine and collect premiums
- design and issue policies
- have claims handling processes and pay claims
- establish unpaid claims liabilities
- invest funds
- produce financial statements

However, they do not do these tasks in the same manner. Rather, each insurance company's approach matches the scale and complexity of the insurer. The sheer size of State Farm's claims activity requires a dramatically different process than a small, domestic mutual insurer. In fact, many admitted and captive insurers alike outsource some of these activities when it makes economic sense.

Rob Walling

Rob Walling is a principal and consulting actuary with Pinnacle Actuarial Resources, Inc. He focuses on actuarial studies for captives and self-insureds, enterprise risk management, legislative costing, litigation support, regulatory costing, and commercial lines ratemaking and loss reserving. Walling is a Fellow of the Casualty Actuarial Society, a member of the American Academy of Actuaries and a chartered enterprise risk analyst. He has been named consecutively to Captive Review's Power 50 list.

In the life cycle of an insurance policy, the first step is the risk assessment or underwriting of an insured. It is no surprise that this is also the first place a prospective captive can get itself into trouble. A prospective captive owner that chooses to completely rely on captive advisers in the risk assessment process without getting personally involved misses out on a tremendous opportunity. They are unable to assess their current business on an enterprise-wide basis and then consider a captive as one possible way to better finance the risks identified. Unfortunately, there have been recent instances when this initial step was glossed over and the risks covered by the captive were duplicative of existing coverage, did not appear to be a material hazard for the insured (e.g., cyber liability for a livestock farm), or contained exclusions making the likelihood of coverage remote (e.g., a terrorism policy that excludes the insured's location). All insurance companies, including captives, should go through an appropriate underwriting and risk assessment process.

There are two issues related to the design of the captive that have recently received a great deal of attention: risk transfer and risk distribution. Risk transfer and risk distribution are necessary criteria for a transaction to be considered insurance. A detailed explanation of these topics is well beyond the scope of this article. However, risk transfer is essentially a requirement that the insurance company have a significant chance of a material loss from the risk it has assumed. The risk transfer requirement is called into question when the potential for a net loss is quite low or the magnitude of a potential loss is severely limited, for example through a low programme aggregate.

Risk distribution requires that there are a sufficient number of unrelated risks being pooled. Risk distribution can be accomplished with sufficient amounts of risk (e.g., number of stores, customers, employees) or through the brother-sister safe harbour based on the distribution of exposures within an organisation. Risk distribution can also be achieved by insuring unrelated risk. This can be via a group captive programme, insuring 'unrelated related' risks (such as subcontractors, tenants, or owner-operators) or by assuming independent risk through reinsurance or some other form of risk pool. In recent years, pools that have failed to demonstrate a non-tax business purpose or a non-circular flow of funds have been closely scrutinised and, in some cases, have been found to not be valid insurance.

Determining coverage premiums

Another insurance company function closely related to the risk assessment process is the determination of coverage premiums. Unfortunately, this too has been a common stumbling block of late. In fact, the underwriter in one recent tax court case described the initial premiums as a "wil(d) ass guess".

Actuarially reasonable premiums are not excessive, inadequate, or unfairly discriminatory. Typically, a qualified actuary provides a funding and feasibility study which documents how the premiums were determined and further provides an opinion that the premiums are actuarially reasonable. Captive owners that choose to skip a rigorous actuarial funding study do so at their own peril. One interesting wrinkle of late is that an actuarial sign-off on the premiums was not determined to be sufficient for the premiums to be deemed reasonable. Additional reasonableness tests including premiums as a percentage of the business' revenue, net income, or coverage limits (rate on line) have also been considered.

Once the risks have been underwritten and the premiums have been determined, policies need to be issued. Recently, issues that have arisen proving problematic for captives in this area include:

- late policy issuance
- sloppy policy language (conflicting coverage and exclusion language)
- typographical inconsistencies (named insureds in binders and policy forms)
- policy restrictions inconsistent with premiums
- and policy terms that restrict coverage in a manner inconsistent with current admitted market practices (extended reporting periods for claims-made coverages).

Policy language

Investing the time to ensure the policy language and terms have been well thought out is vital. After the risk is underwritten, premiums are determined and policies are issued, an insurance company must be able to pay claims. Insurance companies establish claims processes to verify coverage, establish case reserves, settle claims, and make payments. Unfortunately, captives have run into difficulties recently by paying claims that may not have been covered, or when insureds choose not to file a large claim, despite having applicable coverage. Concern on the part of outside parties has also arisen when there has been little or no claims activity over an extended period of time, particularly when the underwriting submission implied a significant amount of claims potential.

Many activities at an insurance company happen behind the scenes. These include establishing unpaid claims liabilities, investments, accounting, regulatory compliance, and reinsurance. All of which can be stumbling blocks to a captive insurance company if not given sufficient attention. There is a temptation for captives writing claims-made coverages to forego carrying an unpaid claims liability on their balance sheet which essentially assumes no additional development on claims. This acceleration of earnings into net income is not generally consistent with how insurance companies behave.

Investments must comply with the captive's investment policy (filed in the captive domicile) and ensure the captive has liquid funds available to pay claims. The focus of the investment portfolio is required to be investment grade assets, cash, bonds, stocks, etc. In cases when captives have built up sufficient capital and surplus, there may be an opportunity to invest some of these funds in non-investment grade assets, such as loans to the parent or property, but only when they do not impact liquidity, threaten solvency, or violate the approved investment policy.

Insurance companies are in a regulated industry and there are a number of compliance issues that must be satisfied. For captives, these include the frequency and location of board meetings, the production of financial statements, filing changes in operating plans or board members, the payment of premium taxes, self-procurement taxes and other assessments, and a number of other important details. It is difficult for even full-time insurance professionals to remain current on all of these regulatory compliance issues. As a result, a captive owner should select advisors and service providers that are capable of both ensuring compliance and fully communicating the rules to the captive owners.

> "A key hurdle faced by many captives is that their owners typically have deep expertise in their current industry, but not in insurance"

It is crucial to note that there are thousands of well-designed captive insurance companies that insure a wide variety of risks in US businesses. In fact, risk retention groups, a form of federally regulated captive, provide as much as 20% of the medical professional liability coverage in the US. Captives play a number of key roles. They allow companies to take more control of their risks and benefit from the improved loss experience. This focus on loss control often results in captive policyholders developing leading-edge safety and loss control protocols for the industries they serve. Captives insure risks that the admitted market is unwilling to insure at affordable premiums and are often sources of insurance coverage innovation that is later adopted by the admitted markets.

In short, well-designed and operated captive insurance companies are crucial to ensuring available and affordable insurance coverage to US businesses. Captives require hard work to be formed and operated well. The good news is that the hard work up front will most definitely pay off in the long run.