CHICAGOLAND RISK FORUM
THE CHICAGO RIMS CHAPTER

Captive Management:

What Are the Roles and Responsibilities of a Captive Manager?

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What Is a Captive Insurance Company?

A captive is…

- A separate legal entity created or used by a company

More specifically, it is…

- An insurance or reinsurance company formed primarily to insure its owner(s) and affiliated companies
- A risk management and financing vehicle that offers an alternative to conventional insurance
- A regulated entity within the domicile in which it operates

A captive typically…

- Has no employees so all of the usual “insurance company” functions are outsourced to third parties
- Provides coverages that the owner wishes to retain or that are unavailable in the traditional market
- Is not rated by AM Best, S&P or Moody’s like a traditional insurance company is

What Is a Captive Insurance Company? *(Continued)*

A captive may...

- Be owned by a single company, a group/association, or a sponsor who rents itself ("cells") to unrelated third party companies who don't want to form their own captive
- Be viewed as a form of formalized self-insurance
- Write some third-party business depending on the captive's jurisdiction and definition
- Operate as either an insurance or reinsurance company
- Reduce the need for, and reliance on, commercial insurance
- Allow for flexibility in program design and coverage for difficult to insure risks
- Access the commercial reinsurance market directly
- Provide financial benefits such as reduced total costs of risk, investment earnings and cash flow, balance sheet protection, and tax planning opportunities
- Provide incentive for loss control and increase senior management's awareness of the cost of risk and control

Why Do Companies Use Captives?

Companies use captives for a variety of reasons, but most often, to improve the cost of and/or control over their overall corporate risk

Risk Management

- Reduce the need for, and reliance on, commercial insurance
- Promote loss control through effective risk management
- Provide coverage for difficult to insure risks
- Offer flexibility in program design
- Access the commercial reinsurance market

Financial

- Reduce total costs of risk
- Investment earnings and cash flow
- Balance sheet protection
- Tax planning opportunities
- Potential profit center

Insurance

- Participate in profitable risks
- Evidence insurance coverage requirements
- Ability to set “own” terms and conditions
- Allow for greater certainty in costs and flexibility through varying market cycles
- Provide coverages either not available in the traditional market or considered too expensive
- Reduce dependency on conventional insurance markets

Strategic

- Integration with long term client strategy
  - Parent company strategies
  - Joint ventures and new geographic territories
  - Capture Insurance related (life/non-life) profits

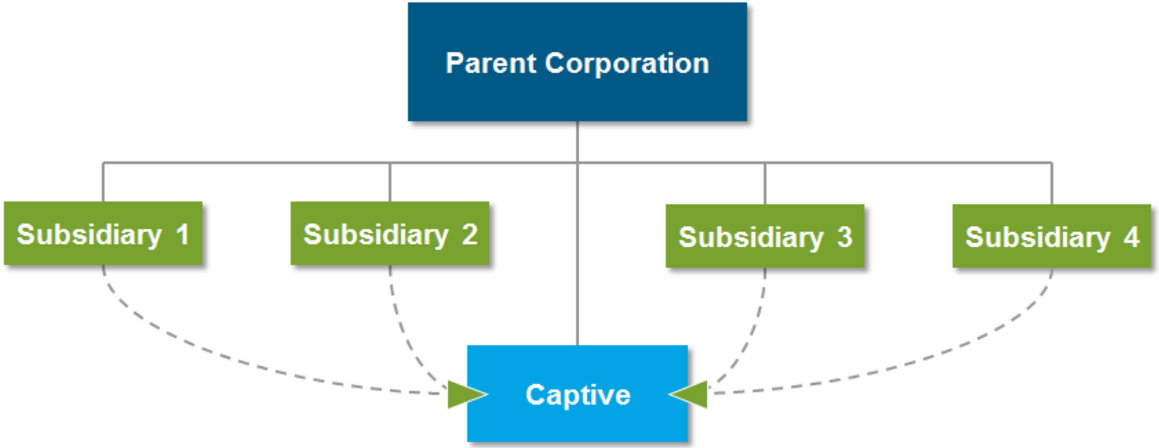
Types of Captives

- **Single Parent Captive:** An insurance or reinsurance company formed primarily to insure its owner (parent company) and its affiliated companies.
- **Rent-A-Captive:** A client "rents" a portion or segregated "cell" within a sponsored captive facility. Clients without a captive can experience many of the benefits of a captive through participation without having to go the lengths of creating their own single parent captive. These arrangements may also be referred to as a Protected Cell Company (PCC) or Segregated Accounts Company (SAC).
- **Association or Group Captive:** An insurance company which is formed and owned by an industry, trade or service group, or a group of companies strictly for the benefit of its members to meet a shared insurance need.

Single Parent Captive

This is the simplest, and most common captive arrangement.

- Captive is a separate legal entity that insures the risks of its parent or affiliated entities.
- Capital is provided by the parent who maintains control over underwriting, reinsurance and investment policy decisions.



Rent-A-Captives/Segregated Cell Captives

A client “rents” a segregated cell within a sponsored captive facility.

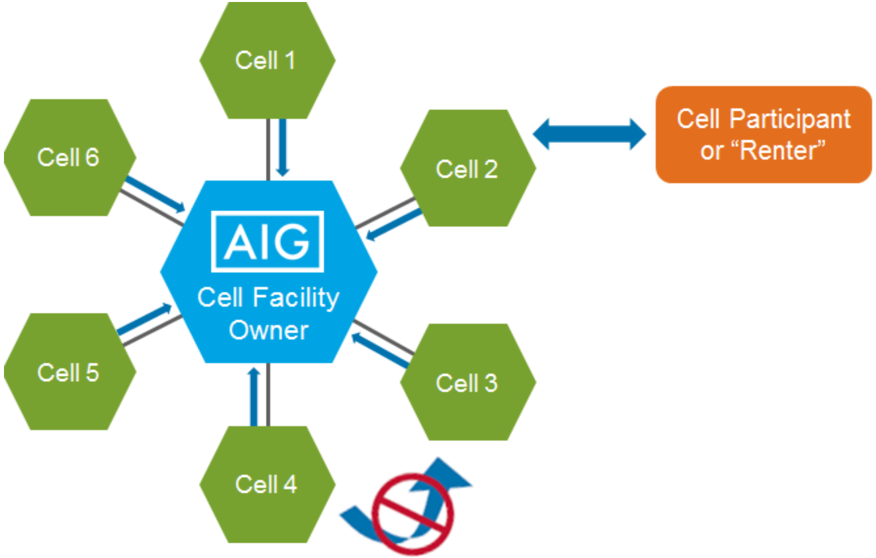
Differences compared to a wholly-owned/single parent captive:

- Faster to market with alternative; i.e. no start-up
- Reduced start-up and operating costs
- Less time to manage and no annual meeting requirement
- Client does relinquish some program control to the sponsor
- Easily converted to a standalone captive

Similarities compared to a wholly-owned/single parent captive:

- Available for virtually any line of business
- Potential to share in underwriting and investment profits
- Collateral requirements
- Enhanced management and control over losses
- All regulatory requirements and administrative tasks are carried out by a captive manager

Rent-A-Captives/Segregated Cell Captives

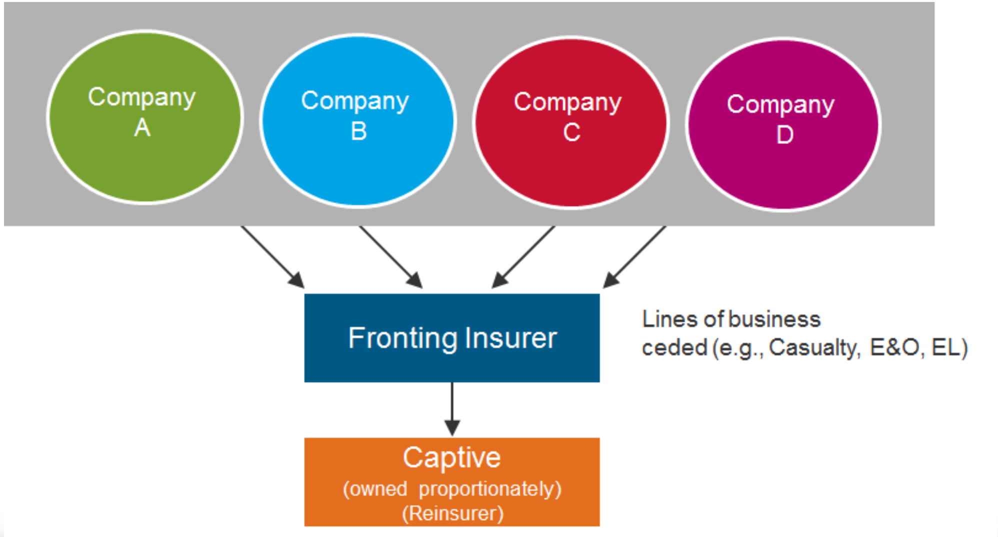


- The cell facility owner creates and capitalizes the core facility and rents its capital and insurance license to cell participants
- Built around that central core account, each cell essentially functions as its own captive for its participant (“renter”)
- Each cell insures the risk of a different participant/renter and its assets and liabilities are legally segregated
- There is no risk sharing between the cells

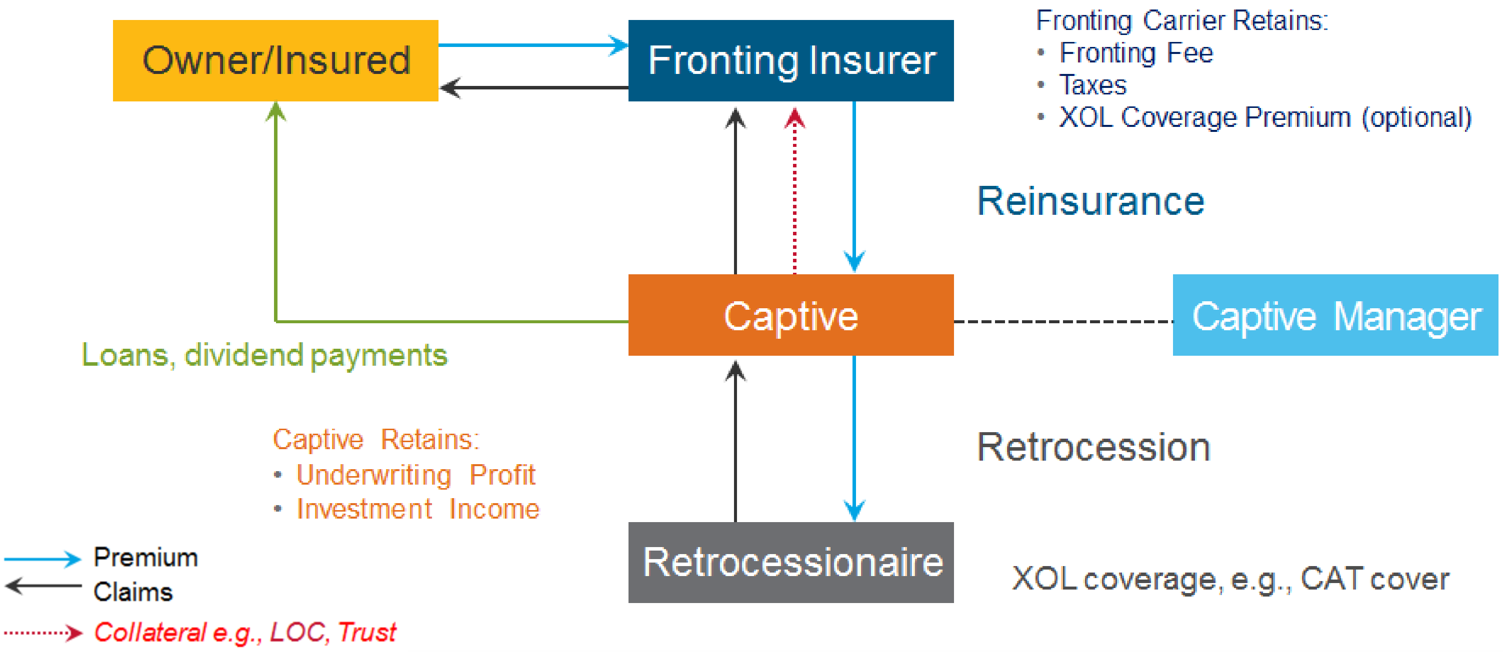
Benefits: Lower cost, easier/faster start-up, no separate capitalization requirement

Group Captive

A number of heterogeneous, but more often homogeneous companies come together to form a group captive to collectively insure a portion of their business, e.g., primary casualty.



Typical Captive Structure



What Is a Front and Why Is One Needed?

Business purchase insurance for many reasons, but one of the most common is in order to satisfy customer and regulatory requirements:

- ✓ Most commercial customers require evidence of insurance from a licensed and rated insurance company before they will do business with a company
- ✓ Regulators typically place insurance requirements on companies, e.g. auto liability, workers compensation, environmental liability, etc.
- ✓ Lenders require that businesses and assets are insured before they will lend to them

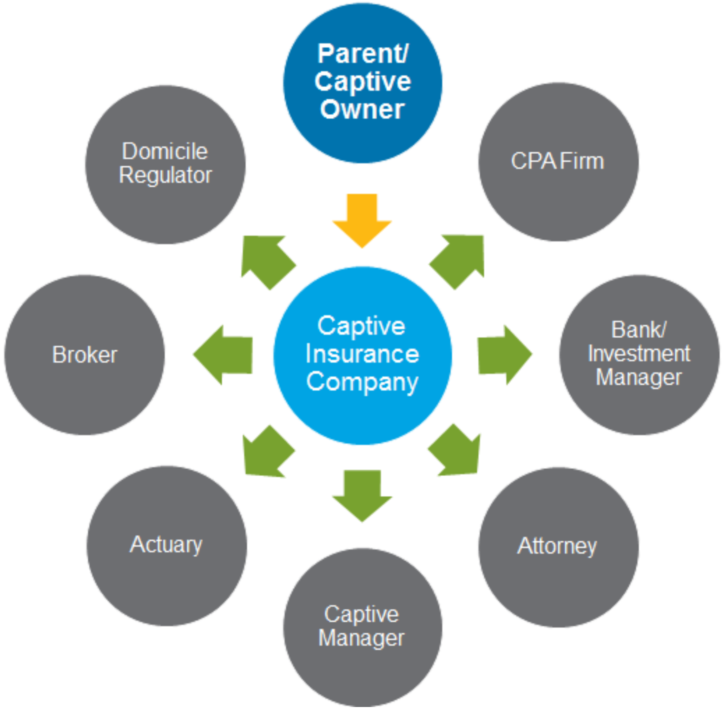
A **"front"** or **"fronted insurance policy"** is an insurance policy like any other, except that it intends to transfer (reinsure) all of the insurance risk outlined in the policy back to a captive (the client). The insurer on the face of the policy is, of course, responsible for all insurance risk outlined in the policy if the captive/reinsurer is unable or unwilling to pay.

In this arrangement, the fronting carrier accepts the credit risk of the captive that they will be able to bear all of the insurance risk it has assumed.

Role of the Captive Manager

- Maintain books and records of captive
- Ensure compliance with all domicile regulations – primary regulatory contact
- Provide monthly/quarterly financial and operational reports to captive owner
- File annual financial and premium tax returns
- Coordinate audit and actuarial reviews
- Coordinate board meetings
- Facilitate domicile examinations (3-5 years)
- Monitor compliance with established policies (investment, underwriting, etc.)
- Receive a fee for services provided, usually based on time spent

Captive Partners



Captive Feasibility Studies

A comprehensive captive feasibility study involves:

- Conduct overview of client's operations and future plans, including subsidiaries' operations and coverages
- Discuss risk retention philosophy
- Discuss and compare current and proposed insurance program
- Estimate loss experience and funding requirements
- Project loss pay-out patterns and match with investment strategy
- Identify domicile considerations
- Identify necessary services and providers

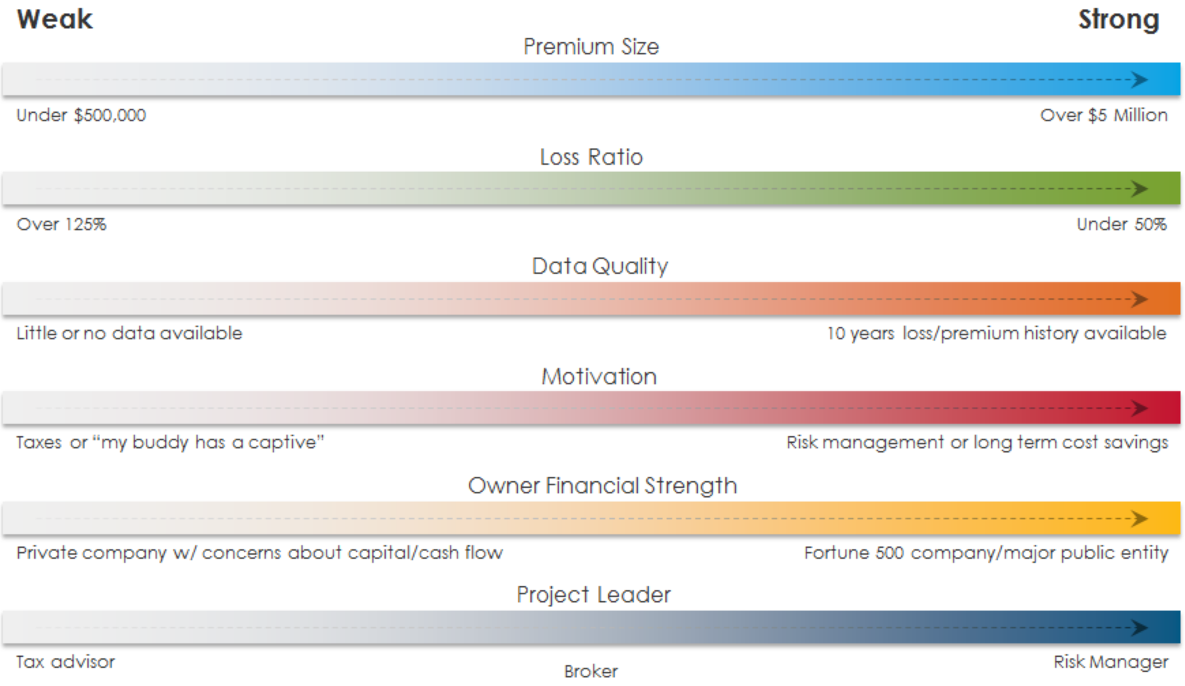
What Does a Feasibility Study Cost?

A captive feasibility study is tailored to the client's specific needs.

The cost of a feasibility study varies, and depends on the following variables:

- Number of lines of business under consideration
- Amount of loss history/volume of data
- Number and type of captives considered: single parent, rent-a-captive/cell, etc.
- Tax considerations/complications
- Actuarial work requirement – does client have an actuarial review of its loss data?
- Cost of the study is typically between $15,000 and $40,000. If a client utilizes its own actuary for loss analysis, this cost may be reduced

Characteristics of a Strong Captive Opportunity



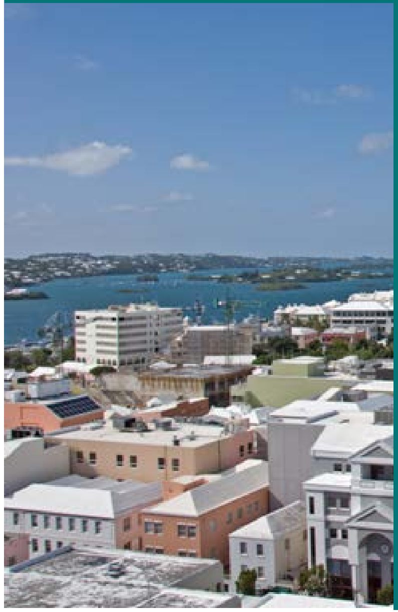
Domicile Selection – *Where to Locate a Captive?*

Think of taking a "TRIP"

- **T**axes – both state/domicile taxes and Federal issues should be addressed
- **R**egulation – balance of flexibility and certainty
- **I**nfrastructure – established domiciles typically have stronger infrastructure (audit firms, law firms, actuarial resources)
- **P**ricing (and **P**olitics) – cost of doing business, political support

A captive manager should be neutral to choice

Among the world's largest captive domiciles are Bermuda, Cayman, Vermont, Guernsey, Utah and Delaware



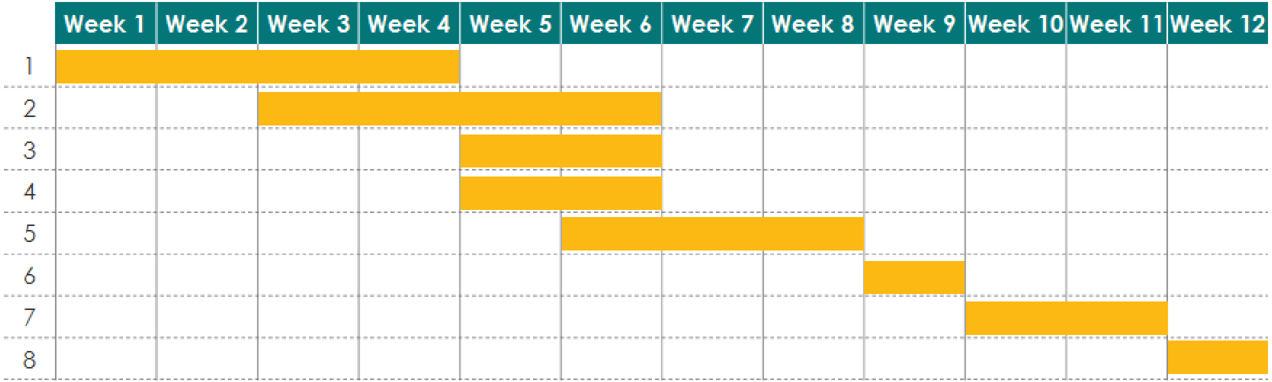
Captive Formation

During the formation process, the captive manager will:

- Coordinate with client’s broker and actuary regarding feasibility analysis
- Draft the captive business plan, which includes:
- Lines of business to be initially covered by the captive
- Capitalization requirements
- Taxation issues (in conjunction with client’s tax advisors)
- Domicile review and selection
- Prepare five year financial projections for the captive
- Coordinate with local legal counsel to obtain articles of incorporation and other domicile required documentation for insurance licensing
- Liaise with domicile regulators

The captive manager can assist the client and its attorneys, advisors, and consultants with all aspects of captive formation.

Formation Timeline – Wholly-Owned Captive



1. Review domiciles; begin business plan and analysis of financial statements and loss history.
2. Prepare feasibility study; begin drafting business plan and proforma financial statements.
3. Authorize attorney to begin bylaws, articles of incorporation, and name reservation.
4. Finalize domicile; identify service providers: auditors, banks, actuaries, etc.
5. Submit completed license application and liaison with regulator during review process.
6. Petition for certificate of general good and incorporate captive.
7. Work with client to finalize operational details.
8. Receive license, capitalize captive, establish bank accounts, order checks, and begin operations.

Ongoing Regulatory Oversight

- Financial reporting
- Obligation to update 5-Year proformas or when material changes are made to the business plan
- Monitoring of the approved business plan
- Financial analysis of captives and owners
- Loan-back monitoring
- Bank monitoring for Letters of Credit
- Periodic examinations

Captive Operational Review

- Periodic review of captive operations to ensure captive is being utilized to its fullest potential
- Mirrors initial feasibility study in many ways
- Brainstorming – captive is a very flexible structure and this should be maximized
- Will likely involve captive manager, actuary and broker

Business Plan Changes

- Captive is likely to evolve over time and the business plan will need to be amended
- Amendments may include:
  - Adding new lines of business
  - Expanding existing coverage
  - Adding or eliminating reinsurance coverage
- Often will involve actuarial analysis of new lines/coverages
- Will need to be approved by regulator

Common Misconceptions about Captives

A captive is used instead of commercial coverage.

A captive is an immediate money saver.

Captives are formed primarily because of the tax benefits.

Captives are subject to far less regulation than traditional insurers.

Misconceptions Explained

"A captive is an immediate money saver."

A captive may help companies save money over time but they should not be counted on to save money immediately. Savings can come from (1) self-insuring a risk more cost effectively than what the market would charge to insure it; (2) tax acceleration benefits; and/or (3) the implementation of a more comprehensive and rigorous risk management program which allocates losses to company subsidiaries, therefore incentivizing greater loss prevention measures.

"Captives are formed primary because of the tax benefits."

A captive may have tax benefits but that is not typically the reason they are formed. The most common tax benefit is that a captive may be able to deduct loss reserves, while non-insurance entities cannot. This results in the captive accelerating the deduction for claims, which can be significant for long-tailed lines.

"A captive is used instead of commercial coverage."

A captive is a vehicle for retaining risk, but rarely would a captive completely replace traditional commercial coverage. Clients will typically use a captive to retain the primary, or "frequency" layer, of their insurance program. But the client will typically buy traditional insurance above the captive layer.

"Captives are subject to far less regulation than traditional insurers."

As a form of self-insurance, captives are subject to different regulations than traditional insurers. But captives are still carefully regulated by the insurance regulators in their domiciles and are subject to regulatory requirements including financial reporting, capital and reserve requirements.

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