Total Cost of Risk—The Captive Focus

by Hugh Rosenbaum
Hughro Ltd

In March 2016, at the CICA meeting, a panel led by Hugh Rosenbaum explored the subject of the total cost of risk (TCOR). The question was whether, for single-owner captives, proper attention is being paid to premiums insured or reinsured by captives and losses retained in them, and whether the technical aspects of captive insurance accounting are being recognized in the TCOR calculation. On the panel was a risk manager who does include it, an actuary who wasn’t so sure you should, and a representative from the annual cost of risk (COR) survey who said that most respondents don’t break it out. There were more than 50 in the audience. When asked whether they (or their clients) keep track of the TCOR, only four raised their hands indicating they did.

Background

To remind readers of the basics, the TCOR includes premiums paid, losses retained, and administrative and other expenses. Captives are involved in all three.

TCOR does not cover these important areas:

- Noninsured exposures, such as the imputed cost of $1 billion excess $1 billion that the buyer would like to buy but can’t find a seller
- Employee benefits of all kinds
- Other aspects of enterprise risk management (ERM) such as reputation risk, cyber-risk, loss of market

So the notion of TCOR is restricted to insurable exposures in the property/casualty area only.

Analyst Wayne Wickham of Advisen Ltd., an information service company which manages the annual COR survey, explained that their basic metric was comparing the ratio of TCOR to reported revenues. This, he explained, permitted smoothing the irregularities of large versus small participants and different cohorts of those participating from year to year. He showed this comparison to the operating ratios

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of commercial insurers in the United States. It shows fairly convincingly how the TCOR ratio follows insurer operating ratios fairly closely, a year or two later. But from that, he said, one should not be tempted to simply use insurance premiums in the denominator. That’s because they are sometimes less than 50 percent of the TCOR for sophisticated retention programs. The main attraction of participation in Advisen’s annual TCOR survey is the benchmark it provides to compare to other risk and insurance management programs.

**Dynamic Cost of Risk**

The question posed in the right-hand box under “losses retained” in the table on the next page asks “But what amount?” That has always been a problem for TCOR calculations. How can the TCOR be calculated if the loss amount figure keeps changing? This panel came up with an answer, calling a component of the “Dynamic Cost of Risk” compared to the static one that is reported in things like the annual survey.

The three ways of expressing the loss component of the TCOR for a given year are the basis for calling the TCOR “dynamic.” They involve constantly changing amounts for liability retained losses as well as some business interruption losses.

- Paid losses, but reallocated to either the policy year, the accident year, or the calendar year in which the claims arise
- Incurred losses including incurred but not reported (IBNR) claims, with all years restated annually—all reflected in this year’s adjusted loss incurred amount
- Incurred losses including IBNR claims with only this year’s loss figures included—all prior years’ figures are adjusted and restated.

Actuary Joel Chansky reviewed the three techniques, explaining that IBNR claims aren’t the only variable in loss estimations. Confidence levels selected are variables, as well as “cushions” or risk margins (different from the profit-making risk margins in our table), as well as discounting are further variables. He gave further details on these three techniques:

- **Method 1:** Select loss pick for upcoming accident year; do not change prior accident years’ retained losses. This is rarely used, but is a default when historical information is uncertain or unreliable.
- **Method 2:** Select loss pick for upcoming accident year; restate prior accident years’ retained losses based on updated loss estimates. Retained losses used in cost of risk calculation are updated (restated) each year. This method is often used by captive owners because it often allows the appearance of “smoothing” over time.
- **Method 3:** Select loss pick for upcoming accident year; restate prior accident years’
<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>COR IN GENERAL</th>
<th>CAPTIVE INVOLVEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums Paid</td>
<td>To all external insurers</td>
<td>If original gross premium (OGP) (the total of what is charged out to operating entities) is the figure reported, and it does not include captive premium retention, this figure should be reduced because the captive is not an external insurer. But if the captive buys reinsurance, it should be increased by the annual reinsurance premiums paid.</td>
</tr>
<tr>
<td>Losses Retained</td>
<td>Usually the annual aggregate of losses retained under deductible amounts</td>
<td>If OGP charged out includes captive retained losses, they should be added to this figure if it is only entity-retained losses. (But what amount?)</td>
</tr>
<tr>
<td>Risk Margins</td>
<td>Never included in TCOR calculations</td>
<td>If captive is running an annual surplus, should it be deducted from the TCOR? If so, from which figure? Probably from “below the line.”</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>Usually departmental and external service charges</td>
<td>Should include captive fees and expenses. Should include cost of fronting, if in reinsurance mode.</td>
</tr>
</tbody>
</table>

Source: Captive Insurance Companies Association (CICA). Used with permission.

TCOR VERSUS INSURER OPERATING RATIOS

Source: Captive Insurance Companies Association (CICA). Used with permission.
retained losses but account for the changes in current calendar year retained losses. This is usually used by commercial insurers but suffers from wide swings where there are surprises caused by settlements of old cases.

One Real Example

The session then included the example of how one risk manager uses the TCOR calculation, including the captive figures, in his reports to management. James Snell, the director of Risk Management for the Dutch multinational Ahold NV, reports to the International CFO. Ahold’s supermarket business is 60 percent in the United States with some 750 locations—with names like Stop & Shop and Giant Food Stores—generate more than $200 million in workers compensation losses alone. Sales from US operations are some $26 billion estimated for 2016. Annual premiums from fronting companies are between $150 and $300 million a year. Ninety percent of their TCOR is allocated to US operating companies.

The Vermont captive, Mollyana Insurance Company, is a large one with retentions of $5 million per loss, lines of business include workers compensation, general liability, auto liability, and property, assets of “many hundreds of millions” and net worth (capital and surplus) of more than $50 million.

The TCOR he measures uses the second method and includes captive expenses and only external insurance premiums. The main components are:

- Retained losses 80 percent
- External insurance 10 percent
- Administrative expenses, including fronting 10 percent

When asked about profit or risk margins that might be retained in the captive, Mr. Snell indicated that most of it is returned to the operating companies, prospectively. The annual TCOR, or at least the loss retained component, as a percentage of sales, has stayed constant for the past few years.

This metric, TCOR as a percentage of sales, is considered of great importance to management, especially since the percentage has been holding steady as sales increased. Since the involvement of the captive in retained losses is the major component of the TCOR, Mr. Snell was able to conclude that the involvement of their captive in the TCOR calculations has had a significant impact on their TCOR. And management agrees with him. 

Captive Insurance: Claims Opening the Door to the Future

by Michael Maglaras
Michael Maglaras & Company

Take a look at the photograph below.

This is a photo of an institutional door handle. The handle is made of copper. You grab the bottom of the latch and pull it up, and the door to a hospital patient’s room opens. Connecting this handle, captive insurance companies
underwriting medical professional liability insurance, and what happens to you or me when we spend a night in a hospital bed is what this article is about.

**Background**

There are two reasons why commercial insurance companies exist. The first reason, in a general sense, is to protect assets. The second reason is to pay claims.

What is true for commercial insurance companies is also true for captive insurance companies. Captives are also asset protection mechanisms, and they also exist as exceptional vehicles for the management, reserving, compromising, and payment of claims.

At captive insurance industry meetings, not enough useful and practical information is discussed and debated on the subject of claims management and how captives are instrumental in helping insureds connect the dots between the causality of loss and the improvement of a business model. There are some obvious reasons for this. The whole subject of the adjustment of claims has limited sex appeal for most captive professionals. However, when we speak of medical professional liability captives, and we marry that idea to the important issues arising under accountable care, the way in which claims are paid, the way in which we learn from claims with merit, and the social media and reputational impact of claims are all important reasons why, in this lingering and what may be a “forever” soft market, captives still prosper.

**Debunking Some Myths**

Captives underwriting medical professional and general liability for acute care facilities, individual physician practices, managed care organizations, and other providers of healthcare services have a long history of the management and adjustment of claims.

In many states, given individual jurisdictional concerns and the claims history of the parent organization, captives regularly investigate, reserve, defend, and adjust claims of significant size for medical professional, general, and umbrella liability. My firm has no clients who are novices in this regard.

In many acute care facilities, it’s not uncommon to find medical professional liability limits totaling $50 million or more, where the first $3 million to $5 million is retained as net in a captive on a per claim basis, with a multiple of four times that amount on an aggregate basis. This means that complex and sophisticated claims management processes are in place and have been for decades. There is no lack of experience in the captive market in this regard.

Some less enlightened commercial markets, led by mutuals and others devoted primarily to the insuring of what is, alas, a shrinking physician personal asset protection market, still hold the view that captive insureds are not the best gatekeepers of the claims management and defense process. All the evidence is to the contrary.

In fact, the Lloyd’s market, representing long-standing syndicate and London company players with significant multidecade U.S. healthcare liability captive experience, subscribe to the view that the best insured (or reinsured) is the self-administered-claim insured. I have been to many meetings in London over the last 30 years, and while the London market is supportive of many sound strategies to manage captive risk, the leading underwriters in the hospital and physician medical professional liability marketplace are unanimous in their view that a well-conceived and well-established internal captive claims management process yields the best results with regard to net retained losses, and in turn keeps them out of harm’s way with regard to excess claims.
The idea that risk management staff in the acute care setting or in a large super-group physician practice setting cannot be trained to manage an internalized claims process is an idea that has come and gone. Whether through internal resources or through a combination of those resources and externalized assistance, such as unbundled third-party administration intervention, self-insureds and their captives are adjusting and paying losses successfully every day of the week. What’s more important is that captive owners are vigorously defending and winning on claims filed without merit, as all the data clearly shows, including the paid claim data available as public information in Connecticut, Ohio, and elsewhere, where captive insurers dominate the market.

**Defining the Process**

The careful management, reserving, and adjustment of losses under a captive insurance company architecture is at the heart of any self-insurance program. How a captive handles a claim involving, for example, as frequent an allegation as infection due to a retained foreign object—how counsel is chosen, when counsel is assigned, what the loss run looks like, how reinsurers are placed on notice of a potential loss involving them—is the most important function of a captive. This function is far more important than is generally believed, and not enough attention is given to both the process and the outcome at captive board meetings.

With regard to claim reserving and adjustment, and speaking specifically of captives writing medical professional liability insurance, the process has become much more complex and demanding, but ultimately more rewarding, thanks to what we generally refer to as “Accountable Care.”

Simply put, providers of health care are not going to be paid in the future for their mistakes. We are moving inexorably in this direction; and, in fact, with respect to the largest single payer system in the history of the United States, otherwise known as Medicare, we are already there.

So what are the basic elements of a good internalized healthcare provider-owned captive claims management process?

1. **A way to get information into the hands of the right people:** All healthcare systems and many larger physician practices now use sophisticated electronic incident and claim reporting systems supported by a handful of software vendors well known to the industry. Many of these claims management systems have rolled out only in the past 5 years or so. Getting an incident report into the hands of a hospital or physician practice risk manager, so that it can be triaged, assessed, and acted upon, is a smoother process than it
was a decade ago, and this process has been robustly supported by the healthcare liability captive budgets of captives domiciled in Vermont, Grand Cayman, Bermuda, and elsewhere. The biggest concern here is speed of information and data transfer. The second but equally important concern is the protection of personal health information at a time and in an age when a patient’s private health record is of increasing value on the black market. It’s not uncommon for an acute care system risk management staff to triage 2,000 electronic incident reports in a month, and for that work to result in only 15 or so potentially compensable events, that in the following quarter show up on a captive’s balance sheet.

2. **A reserving policy that makes sense and is consistently applied:** This means clearly defining what an “incident” is, what a “potentially compensable event” is, and, finally, what a “claim” is, all consistent with captive policy language and excess or reinsurance program terms and conditions. The reserving process is, by definition, dynamic. Claims are a function of the people who caused them and the people on the receiving end. They are defined by human nature. Therefore, they evolve over their natural life, are subject to change, subject to variability, and subject to surprise. Claim reserves must be assessed on a regular basis, not stair-stepped, and where subjective views are tempered by a hard look at judgment value, including economic and noneconomic loss potential, jurisdictional implications, and the credibility of all witnesses and participants. Defense counsel must be intimately involved in determining the fact scenario and helping a captive’s owners gauge the percentage of success or failure.

3. **Managing litigation:** Some in the commercial insurance market still support the view that it is only commercial insurers that have the experience and credentials necessary to manage a process involving complex litigation. The results, visible on many captive balance sheets, speak differently to this point, as captive surplus has grown exponentially since St. Paul Insurance Company exited the medical professional liability insurance market in 2001. When the St. Paul packed up its bags precipitously and exited the market, healthcare providers with captives had to scramble. They had to add surplus to captive balance sheets. They had to put in place disciplined claims management protocols. They were optionless, and they have never forgotten the way in which the commercial market abandoned them. The good news is that a number of enlightened commercial insurers have come around to the idea that they can partner with healthcare providers and their captives. There is strength to be derived from both sides of this equation. Self-insureds, and in particular captive owners, are now very skilled at setting the framework under which matters are litigated, skilled at monitoring defense counsel costs and strategy, and skilled at assisting in the scheduling of staff interviews and depositions, and, in general, in guiding the process of the kind of litigation that happens when people’s lives are affected by unintended outcomes.

**The Effects of Accountable Care**

Lastly, and perhaps most importantly of all, healthcare liability captives now lead efforts, in a very direct sense, at improving the quality of your care and mine. In short, we have entered the era of the socially responsible captive.
Because healthcare liability captives have multidecade experience in the handling and assessment of medical professional liability claims, these captives’ healthcare provider parents are now moving quickly and eagerly into the analysis of how the claims paid and the lessons learned can be translated into increased patient safety and better reimbursement by payers under the revolution mandated by the Affordable Care Act.

It is here where the proverbial rubber hits the road. It is in fact the reason that, in what has been the longest soft professional liability insurance market in history, healthcare liability captives continue to grow and expand their underwriting profiles; simply put, when you get in the habit of learning from the losses you’ve had, you never go back. And by this, I mean that you never go back to the commercial insurance market, where the adjustment of the loss under a “duty to defend” contract is taken out of your hands and, therefore, out of your sight.

Medical professional liability captives contain the seeds of what will now grow into a more visible focus on patient safety. But there’s more. For a claim that used to be an isolated event is now recognized as not being that at all. Every claim impacting a captive insurance company writing healthcare liability takes on the aspects of an octopus. The graphic above shows what now happens in the real world when an adverse event results in a claim with merit made against a healthcare provider.
That claim now ripples not only through the organization itself and its captive but strikes at the very heart of the institution’s public face. Claims with merit regularly (and unfortunately) are discussed and debated on Twitter and Facebook. What happened, when it happened, and why it happened affect the recruitment of employed and community physicians, the morale of nursing staff, Internet grading, reimbursement from payers, and of course, finally, reputation. There is no greater concern in the competitive healthcare market than what people think and say about you. And, of course, at a time when everyone is buying everybody else, negative publicity related to claim activity may decide whether or not you are a good or not so good acquisition risk.

So Now Back to the Door Handle ...

More than a decade ago, at the board meeting of a captive owned by a major healthcare institution employing thousands of physicians, the captive’s directors, many representing the community served by the captive’s parent, went into a rebellion.

They received a report about an increase in the parent organization’s nosocomial infection rate. A nosocomial infection is an infection you get while you are a patient—you didn’t walk in with it. When you get a bad one, your health is frequently compromised, and sometimes your life is lost.

The board demanded action. They authorized $500,000 to fund a study involving the analysis of more than a decade’s history of claims paid by this captive to patients and family members who had been harmed by hospital-acquired infections. A year later, that report was released, and some of us in the industry saw it. It tackled the subject of these kinds of claims in a candid and revealing way.

As a result of this study, the captive’s parent instituted a broad-based effort at reducing its infection rates, including using new technologies to zap bugs with ultraviolet light, as well as more simple ideas, such as improvements in raising awareness among healthcare professionals about the importance of washing their hands.

Buried down inside the depths of the report was a recommendation that at first went unnoticed. That recommendation suggested that when the parent organization built its next new hospital facility, every door handle should be made of copper. Why? Because the study revealed what science had long known: copper has antimicrobial properties. The bugs that sicken you or me and that remain on a door handle to a patient’s room die faster on a copper handle than on a handle made of some other material.

Captive Practices and Procedures

How to structure and operate a successful captive insurance program.

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Walk into a private patient room in any hospital built in the last couple of years. Check the handle. A captive made all the difference.

I began and I end with a fundamental idea: in a continuing soft market, where medical professional liability insurance capacity abounds, and some, particularly in the commercial market, question why more captives aren’t folding their tents, the captive claim process becomes a way in which the door is opened to success under Accountable Care.

Abuse of 831(b):
The ERC Image Problem
by Jeffrey K. Simpson
and Andrew J. Rennick
Gordon, Fournaris & Mammarella

No segment of the captive insurance marketplace is as misunderstood as the segment that takes the election under Internal Revenue Code (IRC) 831(b). Whether you call them minis, micros, small captives, or enterprise risk captives, and whether you think abuse is rampant or hysterically overblown, the simple fact is that this segment has a serious image problem.

For purposes of this article, let’s call them enterprise risk captives (ERCs). Even though our friends at CICR make fun of us for this name, we think it’s important to get away from labeling these captives by a Code section. We also think innocuous labels like micro or small captive don’t do enough to articulate the risk management purpose of these captives. We recognize that ERC is not a perfect name, but we do think it’s better than any of the current alternatives.

Problem of Perception

ERCs have an image problem. But the problem is not that the Internal Revenue Service (IRS) doesn’t trust ERCs; the IRS doesn’t trust anything about any captive. The problem is that much of the captive industry doesn’t trust ERCs. The industry frets that ERCs are a tax-driven sham that will draw the ire of the IRS and others, ultimately ruining captives for us all. To be fair to the industry, ERCs are new, and new is different, and different always takes some getting used to. So, it’s no surprise if the industry is a little cautious of ERCs.

And ERC practitioners haven’t done much to help their own cause. A reader of online forums, blog posts, and other ERC-related

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(Photo and graphic are by Michael Maglaras and are used here with his permission.)

With more than 35 years of healthcare liability insurance and consulting experience, Mr. Maglaras is the principal of Michael Maglaras & Company, an international insurance consulting firm specializing in providing insurance program consulting advice for a variety of healthcare providers and other businesses. Find out more about the company, and watch Mr. Maglaras’s Captive Thought Leader videos on Captive.com.
promotional materials could easily conclude every service provider in the ERC market seems to think he’s the only one doing it right, and all the others are doomed to prison. To be fair, service providers need to distinguish themselves from one another to compete. But the unfortunate result has been ridiculous public battles that do nothing but diminish the credibility of all involved. Worse, they reinforce the fears of the industry.

The obvious question, then, is why should the industry trust and support ERCs in light of the way things have gone so far? The industry could reasonably argue that ERC service providers have made their own bed and played into the hands of the IRS, so ERCs do not merit industry support. But, the fact is that ERCs actually are important, ERC service providers really are well meaning, ERC abuses really are few, and marginalizing a material segment of the industry is a dangerous idea. ERCs need and deserve industry support, and the route to that support is interaction and understanding.

The Argument for ERCs

ERCs have become an important captive structure in that they are now a means by which middle market, privately held enterprises are being introduced to captives. ERC service providers are helping their privately held business clients manage risks in new and exciting ways. They help business owners appreciate that they can do more to manage risk than just buying workers comp, auto, and general liability coverage. Those business owners are now recognizing a much broader array of risks, considering the financial implications of those risks, funding in advance instead of crossing their fingers, and using pools to dilute the impact of large losses. All of this is good.

Our experience has been that ERC practitioners are competent, professional, and diligent insurance professionals, just like the rest of the captive industry. Actually, many participants in the ERC market are people you have known for years as thoughtful, reputable captive practitioners—and they still are. But the vast majority of those who are new to the captive insurance market, having come in through the ERC door, are acting responsibly too. They join the right associations, they attend the right conferences, and they earn the right credentials. They conduct themselves professionally and competently, earning the confidence and respect of peers, clients, and regulators.

An example is the ERC community’s thoughtful response to the recent Senate Finance Committee (SFC) proposal to amend 831(b). A group of ERC practitioners, working under the auspices of the Self-Insurance Institute of America (SIIA), is engaged in a dialogue with the SFC to develop an 831(b) amendment that protects the election and allows for the expansion long sought by Senator Chuck Grassley, but eliminates incentive for certain abuses identified by the IRS. In the interest of full disclosure, Jeff Simpson, coauthor of this article, chairs the SIIA committee working on this project. An important feature of the group is that it consists of ERC captive managers from a variety of organizations. Some are institutional, some are small consultancies, some are from insurance backgrounds, and some are not. But all agree that the opportunity to engage responsibly with legislators, and maybe the IRS, to untether ERCs from perceived abuse is critical for the long-run health, not just of ERCs, but of the captive insurance industry as a whole.

The perceived abuse being addressed by the SFC is estate planning using ERCs. Although the practice is entirely legal, the debate is about whether it should be. Credit the SIIA group for concluding that the risk management objectives of ERCs are more than enough without the added benefit of estate planning and proposing amendment language on that basis to the SFC. It is difficult to believe the group could have
reached that conclusion if its members were more interested in the allegedly abusive opportunity. What’s more, the National Association of Insurance Commissioners (NAIC) has also proposed language to the SFC that, with a few minor changes, generally tracks the SIIA proposal. So, the ERC community appears to be on the same page as the regulators, which ought to be a good sign to the industry.

Meanwhile, actual abusive practices in the ERC space are considerably less common than media hype and aggressive IRS scrutiny would lead you to believe. We have certainly seen a few abusive structures. But, we declined to be a party to those transactions, and the vast majority of ERC service providers have as well. More importantly, wherever possible, we try to educate ERC owners and service providers when we see actually or potentially abusive features in their transactions. With only a few exceptions, we have found them to be responsive. And those who are not responsive, we have noticed, whether from ignorance or disposition, are being policed. Peer ERC service providers, other advisers, and regulators have all begun to assume roles to address abuses.

**Cooperation Is Key**

While all of this is happening, we believe the captive insurance industry is better served by welcoming ERCs into the mainstream than by marginalizing them. While the captive industry might, in order to protect itself from something it doesn’t fully understand, be tempted to kick ERCs and ERC service providers to the curb, doing so would open the door to the domino effect. It would give the IRS a significant and material victory in its decades-long quest to conquer captive insurance. And that big victory would surely be interpreted as a success for the heavy-handed, scorched-earth tactics they are using to pursue alleged ERC abusers. Rest assured, if the IRS thinks those methods work, it will use those methods to target other areas of captive insurance, and anyone else working in captives could find themselves in the crosshairs.

We are all better served by working to understand ERC design and application and recognizing that ERCs are different, but different is not necessarily bad. Much of what passes for alleged abuse, in our view, is just failure to recognize differences in application. If ERCs are a novel concept in that they help privately held, middle-market companies cover risks that they have not historically covered, is it not reasonable that some of those risks would be different than what the industry has traditionally seen? Correspondingly, if these businesses are just beginning to address these risks, is it a surprise that they do not always have the necessary internal processes to identify and report losses covered by their captive policies? Similarly, if the pools used for ERC coverages are addressing risks that have not been pooled before, should we expect that these new pools would have loss ratios that correspond with the loss ratios of pools that cover different kinds of risk? We could go on and on.

The point is that ERCs are not necessarily bad or abusive because they are different. They are simply different. The challenge is not to try to make ERCs fit the ideal model of some other type of captive. The challenge is to figure out what should be the ideal model for an ERC. And figuring that out will take time, data, thoughtful policy debate, and engagement between ERC practitioners and traditional captive practitioners. The infrastructure for this engagement is only now being assembled, and the dialogue is just getting underway. The objective should not be to do away with ERCs, it should be to recognize the value that drives their popularity and understand how they should be ideally designed and operated.

**Conclusion**

As Ben Franklin purportedly said, “We must all hang together or we will surely all hang
separately.” Rather than allowing the ERC image problem to fracture the industry, the captive insurance community should welcome and engage ERC owners and service providers. Recognize and support the constructive efforts of the many positive actors in the ERC community and help them identify and eliminate abusive practices and abusive practitioners. You will find the ERC community is happy to work with you as it works out its image problem.

A Look at RRG Financial Exam Costs

by Erich A. Brandt, Greg Fears, and Robert J. Walling III
Pinnacle Actuarial Services

These exams are NOT to be confused with the initial exams required by a state. These are two different events, and costs. Initial exams are to establish that the basic financial presentations are reasonable and appropriate. Usually these are quick and not particularly expensive. Periodic exams are much more intensive and thorough.

Some domiciles have actuaries on staff to perform these duties; others hire outside staff. Sometimes the hiring of an outside firm is done through competitive bidding, but not always. There are cost differences with each approach. And, bear in mind, the actual financial costs pale in comparison to the cost in staff time, space needs, and upheaval of operations.

As captive growth and domicile expansion continue their strong upward moves, our suspicion is that periodic examinations are an expense not often discussed in the consideration of formation stages. After all, other than the initial exam, the periodic exams may be 3 to 5 years away, and who knows what the landscape will look like then? So, why cloud consideration for a captive discussions with these as yet undetermined costs? Because the costs will show up. It is better to understand them beforehand.

“Your Results May Vary”

When presenting domicile options to potential new captive owners, captive managers often go into great detail highlighting the differences in application fees, premium taxes, renewal fees, board meeting requirements, and other differentiators. One often neglected detail is the costs associated with financial examinations. One reason for the frequent exclusion of financial exam costs in domicile comparisons is that there is typically not a fixed cost or formal cost formula for financial exams. So, do financial costs really differ significantly by captive domicile? The answer requires a deeper look into captive financial statements.

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- How to determine if a captive is feasible
- How to choose a domicile
- How to manage and operate a captive

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Risk retention groups (RRGs) have different financial reporting requirements than most captive insurance companies. In particular, they are required to file financial statements in the format mandated by the NAIC. The NAIC format is much more detailed than the financials commonly used by captive insurers. One element of this detail is an intricate expense breakdown, including nearly isolating financial examination costs. Data for insurance companies filing NAIC annual statements is also available from the NAIC and from the A.M. Best Company. This is not commonly true of captive financial statements. While this data does not provide a comprehensive picture of financial examination costs for captives, the results are illustrative and enlightening.

Pinnacle Actuarial Services gathered data from the “Total Insurance Department Licenses and Fees” category from Part 3 of the Underwriting and Investment Exhibit, by RRG, along with domiciliary state. This expense category includes financial examinations as well as some other smaller expense items, such as agents’ licenses, certificates of authority, compliance deposits, and filing fees. Pinnacle analyzed 5 years of financial statement data—2010 through 2014—to isolate the financial examination costs, which only impact 1 or 2 years from the smaller, ongoing annual fees. There were some RRGs that had not had an exam during these years, and some very large RRGs with understandably larger financial examination costs that were removed to normalize the data. There were 149 small to medium-sized RRGs remaining in the final data. As a test of reasonableness, Pinnacle tested the average premium size of the RRGs in the group and found that 88 percent of those companies
had premium volume of under $25 million in 2014.

The average estimated fees associated with the financial examinations of the RRGs included in the analysis were about $35,700, ranging from about $3,000 to over $325,000. On average, this represented approximately 0.16 percent of surplus and coincidentally 0.16 percent of held loss and loss adjustment expense (LAE) reserves. As noted above, there was a significant dispersion in the financial exam costs by RRG. Almost a third of the RRGs had financial exam costs of less than $10,000 and another almost 20 percent fell between $10,000 and $25,000. Another third had financial exams costing between $25,000 and $50,000. Twenty-seven of the selected RRGs had financial exams costing more than $50,000. This information is summarized on the previous page.

Interestingly, there we are also substantial differences in average financial examination costs by domicile. The following chart illustrates the variability in actual exam fees in terms of absolute dollars and also as a percentage of both policyholder surplus and held loss and LAE reserves by state. The state names have been removed to allow the domiciles to remain anonymous. While there is significant volatility in the results due to sample size in some of the domiciles and individual RRG circumstances, some of the differences relate to differences in financial exam cost structures and regulatory

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**Average Financial Examination Fee by Domiciliary State**

<table>
<thead>
<tr>
<th>Domiciliary State</th>
<th>Average Exam Fee (in 000s)</th>
<th>Fees as % of Reserves</th>
<th>Fees as % of Surplus</th>
<th># of RRGs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>70</td>
<td>0.8%</td>
<td>0.9%</td>
<td>6</td>
</tr>
<tr>
<td>B</td>
<td>11</td>
<td>0.1%</td>
<td>0.0%</td>
<td>2</td>
</tr>
<tr>
<td>C</td>
<td>16</td>
<td>0.3%</td>
<td>0.2%</td>
<td>18</td>
</tr>
<tr>
<td>D</td>
<td>151</td>
<td>31.7%</td>
<td>2.2%</td>
<td>4</td>
</tr>
<tr>
<td>E</td>
<td>12</td>
<td>0.3%</td>
<td>0.2%</td>
<td>1</td>
</tr>
<tr>
<td>F</td>
<td>21</td>
<td>1.4%</td>
<td>1.0%</td>
<td>2</td>
</tr>
<tr>
<td>G</td>
<td>38</td>
<td>0.5%</td>
<td>0.3%</td>
<td>3</td>
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<td>H</td>
<td>72</td>
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<td>0.7%</td>
<td>14</td>
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<tr>
<td>I</td>
<td>27</td>
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<td>1</td>
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<tr>
<td>J</td>
<td>29</td>
<td>0.0%</td>
<td>0.3%</td>
<td>15</td>
</tr>
<tr>
<td>K</td>
<td>62</td>
<td>1.0%</td>
<td>1.1%</td>
<td>1</td>
</tr>
<tr>
<td>L</td>
<td>41</td>
<td>0.0%</td>
<td>0.1%</td>
<td>1</td>
</tr>
<tr>
<td>M</td>
<td>21</td>
<td>0.2%</td>
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<td>N</td>
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<td>0.1%</td>
<td>0.1%</td>
<td>62</td>
</tr>
</tbody>
</table>
approaches to RRGs. In addition, the RRGs with financial exam costs in excess of $50,000 tended to be concentrated in a few domiciles. Some of the domiciles with the highest average financial examination costs had RRGs with smaller-than-average premium volumes.

States use a variety of approaches to strike a balance between providing appropriate cost controls without sacrificing regulatory rigor. These approaches include:

- Allowing actuarial peer reviews, rather than full independent actuarial analyses, in some instances.
- Holding competitive bid processes to establish a pool of financial examination service providers, rather than relying on a single provider.
- Using staff examiners versus independent contractors.
- Establishing financial examination fee parameters and caps prior to the beginning of an examination.

Financial examination fees for RRGs may not be perfectly correlated to costs for captives as some domiciles use different regulatory processes for captives versus RRGs. However, this review of RRG financial examination costs certainly highlights that material differences in financial examination costs by domicile may exist and should be considered when choosing a domicile.

There have long been rumors in the captive insurance community of financial examination costs that were unreasonable at face value. The data in this analysis suggests that these rumors may have some factual support. There are 5 RRGs in the data with financial exams of more than $100,000, despite having less than $10 million of annual premium. There are 3 additional RRGs in the data with financial exam costs in excess of $250,000. Interestingly, these RRGs were not among the largest insurance companies in the database.

One of the important ways a captive insurance company passes savings on to its owners is by controlling expenses. This opportunity can turn into a material risk in domiciles where financial examination fees do not have a clear link to the size and complexity of the captive or RRG. To avoid this risk, captive managers and captive owners should make sure they understand how their selected domicile deals with financial examination costs. Be forewarned, your results may vary.

Protected Cell Captives and the Pac Re Case

by Jeffrey K. Simpson, Andrew J. Rennick, and Daniel L. Fitzgerald
Gordon, Fournaris & Mammarella

The recently decided case of Pac Re 5-AT v. Amtrust North America, Inc. CV-14-131-BLG-CSO, 2015 WL 2383406, 2015 U.S. Dist. LEXIS 65541 (D. Mont. May 13, 2015), has attracted a great deal of commentary in the captive insurance community. The case involves a Montana protected cell structure and considers the judicial status of an individual protected cell and the relationship between the individual protected cell and the company of which it is a part. This article briefly describes the nature of protected cell companies, summarizes the Pac Re case, and discusses its import, including a discussion of how sponsors can mitigate the uncertainty associated with the treatment of protected cells.

Protected Cell Structures

Numerous jurisdictions, both onshore and offshore, have adopted statutory provisions that permit protected cell arrangements. A protected cell captive (PCC) is a segregated account
that exists as a subset of a licensed captive insurance company. The assets and liabilities of each cell are segregated from the assets and liabilities of every other cell and of the company itself (often called the “core”). Each cell is therefore able to operate as if it were separate from the core and the other cells while still being administered and regulated in conjunction with the core. As a result, cells can often provide the benefits of a separate captive insurance company more quickly and at lower cost.

Also, if the business within an individual cell constitutes insurance for tax purposes, then the Internal Revenue Service (IRS), pursuant to Rev. Rul. 2008–8 and the subsequent proposed regulations, will treat the cell as a separate taxpayer, allowing it to obtain its own federal employer identification number and file its own tax return as an insurance company. Because they are faster, less expensive, and can be treated as insurance companies for tax purposes, cells have become popular vehicles.

In a protected cell arrangement, a captive insurance company establishes a number of protected cells by creating segregated accounts for the benefit of participants in the captive insurance program. The applicable captive insurance statute typically requires that each protected cell be governed by a contract between the participant and the company. This participant contract allocates to the protected cell certain risk and premiums written by the company, while the applicable protected cell statute provides for segregation of the assets and liabilities of the protected cell from the assets and liabilities of the other protected cells and the core. Since forming a protected cell is a contractual and regulatory matter which requires no filings with the Secretary of State and no registered agent or office in the domicile, the protected cell structure offers cost efficiencies to the participant, particularly if the captive statute allows for reduced capital requirements for protected cells. Since the protected cell is part of the company and operates under the company’s license, there may be administrative efficiencies as well.

There are, however, two primary challenges related to protected cells, namely that the segregation of assets and liabilities has not been tested in court, and protected cells generally cannot contract in their own names. First, notwithstanding clear statutory language supporting the segregation of assets and liabilities in a cell, no known caselaw affirms that segregation, and, in fact, no case has yet addressed the question. Some practitioners interpret the absence of applicable caselaw as indicative of uncertainty over whether the segregation will be respected. Second, protected cells generally lack the statutory authority to contract in their own names. Where a cell cannot contract in its own name, the core generally contracts for and on behalf of the cell. Some practitioners believe that having the core contract for and on behalf of the cell unnecessarily exposes the core. It can also preclude contracts between and among cells because the core cannot contract with itself.

Attempts to address the shortcomings of cell structures have led to the availability of a variety of similar vehicles, including protected cell companies, incorporated cell companies, and series limited liability company (LLC) captives, each with unique features and strengths and weaknesses. However, the absence of applicable caselaw continues to be the Achilles’ heel of protected cell companies, and Pac Re is important because it goes directly to the issue of the separateness of protected cells.

**Pac Re**

_Pac Re_ is interesting, even exciting, as the first case to directly address the separateness of a protected cell. While the court found that a protected cell is not a separate legal entity and
cannot be sued apart from the protected cell company that houses it, the court also noted that the assets and liabilities of a protected cell are, in fact, segregated.

The Pac Re case involved a protected cell company domiciled in Montana. Pac Re, Inc. (the core) established Cell 5-AT (“Cell 5”) to reinsure general liability risks written by a fronting insurer. Pursuant to the applicable reinsurance contracts, Cell 5 was required to maintain a minimum level of assets and provide security for its reinsurance obligations. The fronting insurer alleged that Cell 5 did not comply with the minimum asset and security requirements, and, on that basis, the fronting insurer demanded arbitration. But the fronting insurer did not make its demand against Cell 5. Instead, the fronting insurer sued Pac Re, the core. Pac Re then moved to dismiss the claim, arguing that Pac Re was the wrong party, and the suit could only be brought against Cell 5 itself.

The federal court for the District of Montana denied Pac Re’s motion and concluded that Pac Re was the proper party. In denying Pac Re’s motion, the court distinguished between the segregation of assets provided by Montana’s captive insurance statute and the separateness of Cell 5’s identity. The court noted that Cell 5 was not a separate legal person and could not be sued independently from Pac Re. The court cited sections of the Montana captive statute providing that the formation of a protected cell creates a separate legal person only if “the protected cell is an incorporated cell.”

The Montana court concluded, correctly in our opinion, that Cell 5 could only be sued through Pac Re for and on behalf of Cell 5, in the same manner that Pac Re entered contracts for and on behalf of Cell 5. This case stands simply for the proposition that, to sue a cell of a protected cell company, one must sue the protected cell company for and on behalf of the cell. Since cells do not exist as separate legal entities, the conclusion makes perfect sense. Frankly, no one should be surprised by this outcome.

This ruling was limited to the procedural matter of how to sue a cell. Accordingly, assertions by some commentators and practitioners that this case in any way implies that Pac Re’s core assets are potentially exposed, or that the segregation of assets and liabilities will not be respected, are both premature and unsupported. This case did not address those issues and cannot reasonably be read to have done so.

While finding that Pac Re was the proper party, the court nevertheless noted that the Montana protected cell statute provides for the segregation of assets and liabilities. If anything, this is an indication by the court that it would respect that segregation.

**Importance of Pac Re**

The Pac Re court was exactly right. The importance of the case is not that it casts doubt on the integrity of protected cell companies or the segregation of assets and liabilities, because it does not. In fact, it suggests that the segregation will be respected. The importance of the case is that it confirms the conventional understanding of the structure and operation of protected cell companies—protected cells are not separate legal entities and cannot contract or be sued in their own names, but they nevertheless segregate assets and liabilities.

If there is a lesson in Pac Re, it is that protected cell companies should be designed and operated in a manner that maximizes the likelihood that the statutory segregation of assets and liabilities will be respected. This includes following the formalities applicable to cells, contracting in a manner that minimizes the likelihood of lawsuits and operating in domiciles that will be inclined to understand and respect the structure.
The first step in getting a court to enforce the segregation of assets and liabilities is respecting the formalities that yield that segregation. Every protected cell statute includes language about the formalities applicable to protected cells. Generally, those formalities are that the cell be formed pursuant to a contract, that the assets and liabilities of the cell be identified with sufficient specificity, and that separate books and records be kept for each cell. Compliance is relatively simple. First, form each protected cell pursuant to a professionally prepared contract designed to conform to the requirements of the applicable protected cell statute. Second, although the core must contract for the protected cells, it should do so “for and on behalf of” a specific and clearly identified protected cell, and maintain separate bank or other accounts in the same manner—“for and on behalf of” a specific and clearly identified protected cell. Finally, the books and accounting records of the protected cell company should include a separate record exclusively for the financial results of each protected cell.

Another step in defending the segregation of assets and liabilities is not having that segregation challenged in the first place. The owners of protected cell companies (typically called “sponsors”) should design their protected cell companies to minimize the potential for lawsuits. While we do not agree that the absence of applicable caselaw is a reason for not using protected cell companies, we do see it as a reason to be cautious and not invite challenges. Accordingly, we encourage sponsors to consider who might be motivated to sue and what their objectives in the suit might be. We suggest that sponsors avoid allowing or simply prohibit protected cells from entering the kinds of contractual relationships that could result in unrelated or unknown creditors who might have an interest in challenging the integrity of the protected cells.

Finally, a third step in protecting the segregation of assets and liabilities is ensuring that any challenge occurs in a jurisdiction that should be inclined to respect that segregation. Generally, as occurred in Pac Re, courts in the jurisdiction where a captive is formed should understand and be inclined to enforce the local laws providing for the captive’s existence. Accordingly, we encourage sponsors to design their protected cell companies to maximize the likelihood that any dispute will be addressed in the state of domicile. Contracts should include provisions for exclusive venue and jurisdiction in the state of domicile, and the captive’s activities should occur entirely and exclusively within the state of domicile.

Summary

The Pac Re case highlights a disadvantage of the protected cell structure—namely, that any contracting and litigation involving a protected cell must necessarily implicate the core, as the protected cell does not have sufficient indicia of separateness to contract and litigate on its own. Pac Re did not address the segregation of assets and liabilities in protected cell companies. However, the case did not threaten that segregation, and it even appears the court signaled that it would respect the segregation.

While the lack of a court ruling expressly affirming the segregation of assets and liabilities in protected cell companies has some practitioners and commentators advising against their use, we view the absence of applicable caselaw as a business risk that should be clearly explained to prospective sponsors and participants, and that can be mitigated. By incorporating appropriate features into a protected cell program, including following the formalities applicable to cells, contracting in a manner that minimizes the likelihood of lawsuits and operating in domiciles that will be inclined to understand and respect the structure, sponsors and participants can minimize the likelihood of a negative outcome.
Captive Insurance Issues and Trends 2017

**Credentialing Captive Managers?**

by Rod Morris  
R&Q Captive Management

At the recent Western Region Captive Insurance Conference in early May 2016, one of the panels was dedicated to a discussion of “The Biggest Threats Facing Our Industry.” The attendees were polled in advance for their own thoughts, and the panelists seemed somewhat surprised that the poll indicated more concern about the expertise and marketing practices (think integrity) of captive managers than even federal/state regulations or the Internal Revenue Service (IRS). And yet, the more the panelists discussed the issue, the more they seemed to agree.

**Brady Young**, panelist and president of Strategic Risk Solutions, has been advocating for greater self-policing within the captive industry for years after witnessing incompetence, conflicts of interest, and inappropriate manipulation of clients by less-than-scrupulous managers.

**Chuck Cohen**, panelist and attorney specializing in insurance and corporate matters, was also the Director of Insurance in Arizona from 1998 to 2003 during the conception and inception of its captive program. He spoke of an evolution in his attitude on the subject. While director, he strongly believed that the Department of Insurance should not be in the business of credentialing service providers but, after seeing abuses that came with the exponential growth of captives, he has changed his opinion.

I [author Rod Morris] can identify with Brady’s concerns and Chuck’s evolution. I was a regulator of captives myself a dozen years ago when there were only a handful of domestic domiciles and nonbroker-owned captive managers. Everyone in the industry knew each other, and there wasn’t a lot of mystery in what their strengths and weaknesses were. But, at least a couple of things changed that altered the captive business materially: the proliferation of domiciles, and the emergence of small captives with 831(b) federal tax elections.

The proliferation of domiciles created an atmosphere encouraging growth in both captives and in the service providers servicing them. Also, aggressive promoters and facilitators sprang up to solicit 831(b) eligible captives who, it might be fair to say, showed more interest in growth and profits than with an entirely responsible approach to management. All of us know that captives have been formed for very small owners with very little risk but hungry for tax avoidance or exemption even if based on unjustifiably inflated premiums, questionable coverages, and even more questionable reinsurance pools.

So, do we need some improvements in the industry? Of course. Will credentialing help? Maybe. If it will, I’m all for it.

**Measuring Knowledge**

It seems to me that the purpose(s) of a formal credentialing process would be to determine a captive manager’s worthiness to represent not only the client but also the domicile. After all, regulators should be in the business of protecting the public, but they should also be free to differentiate themselves from other domiciles, including control of who they want to work with. But how exactly would that be determined, and how might it work?

Is worthiness a function of knowledge? If so, how would a regulator determine who knows what and whether what they know is sufficient? After all, who hasn’t known “professionals” with lofty, even multiple academic degrees and certifications who can’t effectively compete with those who just dig in and learn by doing or succeed with on-the-job training? Older readers
might remember that, for the first few years after the introduction of the Chartered Property Casualty Underwriter (CPCU) designation, the joke was that it stood for “can’t produce, can’t underwrite.” I don’t think it was meant to be so much insulting as much as an expression of a well-entrenched conviction that the best insurance professionals come from practical experience rather than “book learning.” That said, how does a third party, such as a regulator, identify or measure practical knowledge and experience by some objective measurement if not by degrees or certifications? So, I don’t think “knowledge” is sufficient in itself.

**Measuring Experience**

Is worthiness a function of experience? Who hasn’t seen plenty of examples of someone with 1 year’s worth of experience times 15 rather than 15 years of accumulated, deepening expertise? And what kind of experience would be necessary-years in the insurance industry, years in captive insurance, number of captives managed, or number of captives managed in each type of captive? For instance, does experience in forming or handling 20 (or even 200) pure, single-parent captives provide the experience necessary to manage a risk retention group?

**Measuring Reputation**

Maybe credentialing should be based on reputation, but reputation with whom—clients, peers, the specific regulator, or other regulators who have worked with them? I have to admit that I know some managers with less than impressive reputations, yet they produce a ton of business and, remarkably, just keep sailing along even though many within the industry know that their reputations are undeserved. Speaking of what others in the industry know about the integrity or responsibility of managers, what does it say about other service providers that feed or deal with them? Should they be tainted by association?

In my opinion, none of us should tolerate unethical, irresponsible, or conflicted practices. I’d rather be out of business than be complicit with unethical behavior. And why, by the way, should credentialing be a topic of discussion for captive managers only? I have had more than a few conversations with lawyers and accountants who are completely clueless.

**Solving Problems from Within**

I want to work in an industry that is clean, ethical, and fixes its own problems when they’re discovered. I come at this issue from three perspectives: as a former captive regulator, as a captive manager, and as an expert witness on captive and industry issues. Actually, I guess there’s a fourth perspective as a senior officer in the insurance business for over 4 decades. If all of that experience has taught me anything, it is that we should never rely on those from outside of the industry to fix our problems and do the right thing for our clients and our industry. I neither want nor trust the IRS, attorney generals, cops of any description, or even arbitrators to address our problems fairly, competently or in a timely manner.

As a captive manager and certainly as a regulator, I have seen and heard about irresponsible conduct, but as an expert witness, I have first-hand knowledge of the details of some pretty egregious conduct—the kind of conduct that the critics of the industry complain about, the kind that should be punished, the kind that should get someone “drummed out of the corps.” But they often don’t and, even more astoundingly, I’ve seen them prevail in arbitration brought by aggrieved clients—against all logic, against evidence of irresponsible conduct, and in spite of admissions of inappropriate conduct and provable, blatant perjury.

Arbitration should be one of the mechanisms that help us identify and punish the bad guys, but if we can’t trust arbitration to arrive at
logical, informed, and fair judgments, it’s worthless. And if it’s secret, it identifies no one, and it provides no insight into what or who is right or wrong. The industry learns nothing, and we repeat the same mistakes with the same people over and over again. Clients keep getting burned, the critics add more fuel to the fire, and the bad guys aren’t exposed. So, again, we have problems, but is “credentialing” the answer to the ethical problems of the industry?

**Self-Policing**

I think that regulators should vet, scrutinize, and question captive managers and any other service provider with each application. I don’t think they should “approve” or “credential” them and then publish them on a website implying that the approved entities are good for all captives under all circumstances at all times. Captive managers—all service providers—should be viewed as components of each captive application, and the regulator should have the right, if not obligation, to make a decision about the acceptability of each under the specific circumstances at hand, in the same way that they would question the specific aspects of the captive structure, ownership, membership, coverages, rates, etc. Is it subjective? Of course. But how do you force objectivity into a process that is inherently subject to judgment—judgment about knowledge, experience, reputation, and whether any of those things have changed for the better or worse since the last review or approval?

Still, the Departments of Insurance (DOIs) cannot be the industry’s sole response to self-policing or ethical, responsible behavior of the industry’s practitioners. The DOIs cannot adequately control tax issues, legal structures, or even the interdependencies and conflicts of interest within the service providers. They don’t even know what is being disclosed, discovered, or adjudicated in arbitration that has direct bearing on these issues. Maybe they should.

The bottom line is that we have to develop a method of holding people accountable in a much more comprehensive and transparent way. The issue is not credentialing. It’s self-policing, and it’s an issue overdue for some formal debate.

Self-policing would be grand in theory, just as more regulation from above would be grievous, in theory. Unfortunately, more regulation from above is the most likely scenario. Regulating is what regulators do. Bermuda has announced plans to put in place for January 1, 2017, rules for captive managers and captive boards. Will the idea spread? You bet. Will some new regulations still allow those who we all “know” should be excluded? Yes. Will some new regulations hurt some who are doing a good job? The answer is also yes.

The qualifications and abilities of some managers and service providers are certainly questionable. Rod’s point about service providers other than managers is a great one and should be more widely discussed. The first point of understanding should be with the prospective client, but that begs the question of, with whom do they check?

Going to the well-known domiciles is always a good start but can be limiting. They have ideas that may conflict with yours; good, bad, or not. Going to a public, “big name” source is also limiting as they will likely be self-aggrandizing. “We can do it all!” Sure, but how well? It is axiomatic in the world of large entities that revenues must be found to pay for the ancillary operations when they are not producing self-sustaining revenues. “Use our actuary/accountant/attorney! Please!”

The smaller firms/sources may give good advice but maybe not as much due to their size. Experience in a large firm can be very broadening, if you are paying attention, as you will see
a lot of “things,” probably more than the smaller firms. But people leave large firms to start their own firms so that they can offer superior knowledge with little cost for expensive ancillary parts in some cases.

At the end of the day, captives are similar to any other industry. There are good apples and bad apples, and it is hard to sort them out.

Insurance-Linked Securities and Captives

by Thomas Johansmeyer
ISO/Verisk Insurance Solutions

The convergence of the captive market and insurance-linked securities has begun. Although the early steps have been small and recent, they do suggest the potential for much more activity. ILS can help companies using captives to further refine their risk and capital management, taking advantage of both diverse capital sources and different structural elements that can provide plenty of flexibility.

Overview of the ILS Market

Last year, the global insurance and reinsurance industry raised approximately $6 billion in capital through 24 transactions. While this fell short of 2014’s record-setting $7.8 billion result, it still made 2015 one of the most active issuance years in catastrophe bond market history and shows that this form of risk transfer provides strategic value to cedents worldwide.

Nineteen of last year’s catastrophe bonds had at least some exposure to US risk, which remains the most frequently used risk area by a significant margin. Further, it was a market characterized by veteran sponsors—only four were debut transactions.

And that’s the opportunity for captive managers. Bringing original risks to the investor community can unlock new forms of capital for captive managers while giving diversification opportunities to capital providers. Even for traditional US property catastrophe risks ceded through catastrophe bonds, captives would be supplying additional risk to a market...

Sources: Artemis.bm and Property Claim Services® (PCS®), a unit of Verisk Analytics
faced with a scarcity of capital deployment opportunities.

**How Catastrophe Bonds Work**

A catastrophe bond provides protection to a cedent (usually an insurer or reinsurer, but also potentially captives and corporates) in exchange for a premium. So far, it’s much like any other form of risk transfer. The difference here is that the cedent “sponsors” a special purpose insurer (in Bermuda parlance; in the Cayman Islands, its special purpose vehicle) that provides the cedent with protection and issues notes that are consumed by investors. The investors receive an interest payment on the note in exchange for supplying the capital to collateralize the cover—and pay in the event that the catastrophe bond is triggered.

Investment bankers or the investment banking arms of reinsurance intermediaries tend to lead efforts around planning, structuring, and distribution (lining up investors). The investors in catastrophe bonds can vary. ILS fund managers gather assets from end investors—usually pension funds, sovereign wealth funds, traditional fixed-income investors, and other capital providers interested in the catastrophe bond asset class but who are not yet ready to invest in those instruments directly. End investors seek benefits including very low correlation to the global financial market and comparatively high yield relative to other fixed-income opportunities.

For investors, returns can vary with the expected loss of the bond (reflective of the level of risk being transferred by the cedent), the structure of the transaction (including the trigger used), and the cedent’s experience in the catastrophe bond market. Recently, many of those factors have been slightly muted, given the vast amounts of capacity already in the ILS market, estimated to be around $70 billion. And it’s been reported that global pension funds have a target asset allocation of 2 to 3 percent to global reinsurance risk, which could be as high as $900 billion.

Soft market conditions have led to favorable rates and terms for cedents in both the traditional reinsurance market and the ILS space.

**Key Considerations for Getting Started**

Of course, the decision to enter a new market is rarely made lightly. And, while there have been several captive- and corporate-sponsored catastrophe bonds, a learning curve remains. If you’re thinking of dipping your toe into the ILS market, here are a few important factors to consider.

First, size matters. When you look at the catastrophe bonds sponsored by captives, they all have one thing in common: size. PennUnion Re was sponsored by Amtrak, for example, and MetroCat Re came from the Metropolitan Transit Authority—both of which have captives in place with very significant exposures. To be cost-effective, catastrophe bonds generally require at least $100 million in risk to transfer. Last year, the average deal was about $250 million. Even if you don’t have that much risk to transfer, it’s still possible to access capital markets’ capacity. The vehicles are just a little different.

**“Cat Bond Lite”**

“Cat bond lite” can meet the liquidity mandates that many ILS funds have and offer reduced frictional costs that support tactical risk management. The average cat bond lite last year was a little over $30 million, with the smallest a mere $9.7 million. There’s plenty of flexibility here as well. The largest cat bond lite of 2015 was $71 million, and, over the past 2 years, transactions
have come to market with industry loss index (PCS®), parametric, and indemnity triggers.

So, what is cat bond lite? Basically, it’s a risk-transfer agreement, such as an industry loss warranty (ILW) or collateralized reinsurance contract, that’s transformed into a security. The cat bond lite structure seeks to offer cedents an approach to securitization that doesn’t include the sometimes cumbersome, expensive, and time-consuming overhead of traditional catastrophe bonds while still delivering the structural discipline and potential liquidity that catastrophe bonds provide. Consequently, sponsors have gained the ability to complete tactical capital management activities faster and with lower frictional costs while still accessing new sources of capital.

Industry loss index remains the trigger of choice for the cat bond lite market. Half of last year’s cat bond lite transactions (8) and $203 million (41 percent of limit) used the PCS Catastrophe Loss Index. There were fewer deals with indemnity triggers, but they were larger, adding up to $212 million in issuance, with an average size of $42.5 million. The average industry loss index-triggered cat bond lite was $25.4 million. No publicly revealed cat bond lites used parametric triggers last year (the approach taken in PennUnion Re and MetroCat Re), although three transactions did not have their triggers revealed, accounting for the remaining $75 million in limit.

Pooling is another way for captives to gain access to the scale they need for ILS to be cost-effective. Rather than go it alone, several captives could participate in a joint facility that would provide reinsurance protection for each while laying off (at least some of) the risk simultaneously through an ILS transaction. The participating captives would receive fully collateralized reinsurance protection as well as an alternative source of capital (that is, the capital markets), which would reduce both counterparty credit risk and systemic risk.

Since most catastrophe bonds come from single sponsors, pooling would be a novel approach—although one not without precedent. A handful of multi-sponsor catastrophe bonds have come to market. In 2012, Combine Re was sponsored by a reinsurer to provide $200 million in protection to two of its reinsureds for several perils. This was the only mainstream catastrophe bond to protect multiple underlying cedents. Somewhat different—but still useful in this context—is the catastrophe bond from the World Bank Caribbean Catastrophe Risk Insurance Facility, which provides $30 million in protection for multiple underlying cedents in a private deal (similar to a cat bond lite).

Using a pooled-captive facility would require some careful thinking around structuring, particularly for the reinsurance protection provided to the participating captives. However, the ILS portion should be relatively straightforward.

While size and scale are important, the real opportunity that captives provide for the ILS market (which could in turn benefit the captives themselves) is diversifying original risk. The ILS community has spoken for years about casualty
risk, specialty lines, terror, and cyber. There’s plenty of appetite outside property catastrophe, and for captives that were formed to provide coverage that a traditional insurer wouldn’t write, the ILS market could become a ready source of protection.

In particular, terror and cyber have come up frequently in client conversations, with capital provider appetite suggesting potentially significant new risk-transfer opportunities for captive sponsors worldwide. Further, investors have shown an interest in simplified but unconventional trigger types that could make it much easier to develop clear and effective transactions with the potential for fast execution and post-event resolution. For example, we’re working on a global terror parametric index-style trigger with data from Verisk Maplecroft that could be particularly effective on business interruption covers. Similar approaches could be effective for cyber as well.

Creativity will win the day. In addition to providing more original risk to the global ILS community, it will provide captives with the tools they need to manage their risk and capital more effectively, helping them achieve their mission as risk-financing tools to protect business owners and their ability to grow value. There’s a new source of capital available to captives, and it looks as though the proof of concept has been achieved. Now, the market needs to see if there’s a sustainable advantage to accessing the ILS market.

Repudiating the OECD’s Challenge to Captives

by Ian Kilpatrick
Advantage Insurance Holdings

In this age of a global economy, more and more captives are insuring their parents’ worldwide business risks and, as a result, they face extraordinary challenges. Keeping track of the myriad of regulations and tax compliance requirements in a multitude of countries can give rise to a major headache for the person responsible for managing a multinational enterprise’s (MNE’s) captive. Globalization has created substantial problems for member countries of the Organization for Economic Cooperation and Development (OECD), which is composed of 34 market dominant democracies, including all members of the G–20.

The original mission of the OECD was to promote economic growth, prosperity, and sustainable development in countries around the world to improve the economic and social well-being of their populaces. While that may have been the original purpose, today it appears that its main goal is to secure funding for its member states.

While intercompany transactions are an ordinary and unremarkable feature of the vast majority of MNEs’ daily operations, OECD member states have found them challenging to regulate and difficult to tax. The OECD believes that MNEs strive to avoid paying taxes by moving their profits to no or low tax countries. In attempts to reduce deficits in their national budgets, the OECD has attacked MNEs for structuring their operations in a manner to avoid “paying their fair share of taxes.” By targeting the practice of moving profits from one country to another by means of transfer pricing, which the OECD has given the loftier description of “Base Erosion and Profit Shifting” or BEPS, they believe they will be able to provide member countries with significant large increases in tax revenues.

The OECD admits that, in most cases, these strategies are legal, and it is not the MNEs that take advantage of these opportunities who are in the wrong, but the various countries, including member states, whose tax laws and regulations allow “MNEs to distort the integrity of the tax systems and cause fiscal and social hardship.”
OECD Speaks Out

The OECD first published a report in 1998, “Harmful Tax Competition—An Emerging Global Issue,” in which it expressed a view that “preferential regimes” (i.e., countries with lower tax rates than OECD member states) were encouraging MNE’s to participate in a “race to the bottom.” Since the introduction of that report, the OECD issued guidelines, directives, and published papers on harmful tax practices, which included transfer pricing, culminating in its report, “Base Erosion and Profit Shifting,” which was issued in February 2013.

That report identified transfer pricing as one of the major pressure areas, stating “transfer pricing, particularly in relation to the shifting of risks and intangibles, artificial splitting of ownership of assets between legal entities, and transactions between related-party entities that would rarely take place between independent entities” was “particularly troublesome.”

Along with transfer pricing, the report listed additional pressure areas to be addressed, including “tax treatment of related-party debt financing, captive insurance, and other intra-group transactions.” The report inferred that MNEs were using captives as a vehicle of tax avoidance by shifting profits from highly taxed countries to those with low or no income taxes, and this required greater transparency and oversight. The report raised the question of how risk is actually distributed among MNEs corporate entities and examined the economic substance of transactions. In particular, the OECD questioned the managerial capacity to control risk, the financial capacity of the arrangement to bear risk, and whether any indemnity payment should be made when risk is shifted between group members—all of which brings into question the reason for forming a captive.

Captive Response

The Captive Insurance Companies Association (CICA), together with the European Captive Insurance and Reinsurance Owners Association (ECIROA), responded to the report in a letter dated May 1, 2013, and pointed out many of the reasons captives are formed. In conclusion, the letter stated:

[T]he reference to Captives misusing their structures for tax circumvention or avoidance is misleading and without significant basis. Captives are extremely valuable risk management instruments which strengthen the market position of their parent company or organization during times of heavy claims and losses by facilitating the establishment of reserves to meet future losses. The most important point is that captive insurance companies are just that—insurance companies. Like all insurance companies, they are highly regulated by the financial authorities where they are registered. Captive insurance companies are a risk financing tool that is essential for stable business operations, not a tax avoidance business.

OECD Action Plan

In August 2013, the OECD followed up on its BEPS report with an Action Plan. The purpose of this Action Plan was to combat BEPS and revamp and update its earlier work on harmful tax practices, with a priority on improving exchange of information with no or low tax countries ensuring that substantial activity takes place in the MNE’s operation within the domicile of the preferential regime.

The Action Plan is based on the premise that “taxation is at the core of a country’s sovereignty.” When designing their domestic tax rules, sovereign states may not take into account the effect of other countries’ rules.
While international standards have sought to address this issue, gaps remain, causing both double taxation and the opportunity of BEPS. The OECD believes these anomalies must be addressed to restore both source and residence taxation where cross-border income would otherwise go untaxed, or taxed at very low rates. In the area of transfer pricing, the OECD actions are specifically designed to provide countries with the opportunity and capabilities to better align their rights to tax with economic substance and activity. The OECD’s proposed actions seek to put greater emphasis on value creation than formulary apportionment of profits.

The Action Plan listed 15 actions organized around three main pillars:

- The *coherence* of corporate tax at the international level

Meaning, currently not all countries are on the same playing field, i.e., they have different tax rates and different methods of collecting them. The OECD’s goal is to have all countries adopt similar tax laws thus removing any opportunity for an MNE to take advantage of any particular country’s favorable tax laws. To achieve this one, the Action Plan recommends changes to various domestic tax laws and also calls for changes to the OECD model tax treaty to create a multinational tax convention.

- A realignment of taxation and *substance*

The goal of the OECD is to realign MNE’s profits with the location of “real” activities of the MNE’s. Its BEPS report and Action Plan infer that captives are used to artificially transfer income from MNEs in a taxable jurisdiction. In reality, the formation of captives is driven by corporate risk management strategies that have substantial business purpose and are managed by key personnel who understand all aspects of each MNE’s risks. However, in light of the OECD’s demand for senior and experienced decision makers within the captive itself, it is likely the value added in the captive domicile compared to the value added by personnel located onshore, for example in the head office, may need evaluation.

Where it appears nontax benefits to the group from the transfer of risk are limited, or where the captive is too heavily dependent on personnel elsewhere in the group for underwriting, policy documentation, and pricing, challenges can be expected.

- *Transparency*, coupled with certainty and predictability

The goal is to require MNEs to report the activities of their various operations in every country with the tax authorities of not just the country of the operation, but all authorities where they have operations. They are setting their sights on operations of MNEs that are not only located in countries perceived as “tax havens,” but any country that offers business an incentive to invest there. To assist them in their efforts, the OECD is proposing the creation of standardized transfer pricing documentation which will result in improved reporting to tax authorities, thus allowing them to assess the true purpose of MNE’s intercompany transaction.

Complying with OECD’s Action Plan will require complete transparency and coherence between countries, which presents many challenges. While the OECD is trying to achieve tax harmonization, its member countries are striving to attract international business to their shores. It is likely these countries will continue to adopt policies to support their own economic advantage, making it difficult to achieve consensus. However, this lack of agreement will not deter OECD’s pursuit of preferential tax regimes. *When creating and managing a captive, it is important to clearly establish that the reasons for forming the*
Captive in its chosen domicile should not be based on tax minimization opportunities.

**Summary**

Detailed review and gathering of information for this article brought to light the following:

- Transfer pricing regulations in the United States and among OECD member countries already require captive owners to demonstrate that their insurance premiums are determined in line with the arm’s-length standard and that their transactions are consistent with third-party activities within the captive insurance industry.

- Captives are an integral part of the “enterprise risk management” of multinational enterprises (MNEs). And, captives are the only tool available to MNEs to manage otherwise uninsured risk exposure in a formalized and regulated way.

- Captives allow MNEs to reinsure risks directly to the reinsurance market (which is not possible without captive involvement). This makes it possible for MNEs to access the higher level of capacity they need to protect their risks.

- Captives are managed by personnel with advanced knowledge, training, and industry-approved certifications. This complies with OECD’s requirements that transactions undertaken must be able to establish economic substance and that the people who have the knowledge, authority, and ability to control the company—and the risks it accepts—are responsible for the transactions.

- The information that captives are required to disclose in regulatory filings upon formation and during their operation, combined with their financial and tax compliance reporting, is substantial. Significant and consistent documentation standards and practice could assist a tax administrator in more efficiently assessing tax compliance and perhaps alleviate some of the potential misunderstandings of the captive’s operations.

- Establishing a formal documentation process will increase transparency. Clearly outlining how the captive has considered the arm’s-length concept, use of educated third-party service providers, sound actuarial techniques, and significant federal and state regulatory oversight will prove necessary due diligence to comply with Internal Revenue Service (IRS), OECD, and other foreign regulatory requirements.

- Many of the issues raised in the OECD report related to captives can be correlated in one way or another to the captive’s insurance operations. If sufficient and routine consideration is given to the assessment of the captive’s tax position, this could mitigate or resolve many of the OECD’s concerns. Establishing a formal documentation process that addresses the various aspects as mentioned in this article is very important and will result in increased transparency.

- Current tax codes in the United States address concerns related to transactions with foreign entities with ties to US shareholders. Many foreign captives insuring US risks have (or should) consider the 953(d) election to avoid complexity and costly expense for complying with controlled foreign corporation rules, which are designed to help prevent some of the same concerns raised by the OECD.

Documenting all the steps you’ve taken about forming your captive and determining your transfer pricing will prepare you for the kind of challenge the OECD’s BEPS is proposing.
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Editors John Salisbury and John Foehl have more than 50 years of combined expertise in the captive arena.

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