# CAPTIVES FOR PUBLIC ENTITIES

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Does the captive approach to insurance work for public entities? This question is popping up more and more as public entities want to know:

- How does a captive compare to public entity pooling?
- What is the organizational and governance infrastructure of captives?
- Are captives more or less restrictive than traditional pooling facilities?

To address these questions we first summarize captive concepts and then discuss how captives may be used, with significant benefit, by public entities.

## WHAT IS A CAPTIVE?

In short, a captive is an insurance company; typically, an insurance company which has been established for the principal purpose of insuring its owners and its owners' affiliates. There are many types of captive programs, and captives come in many different structures. A 'captive program' relates to how the captive is used – what its focus is. A 'captive facility/structure' relates to the actual corporate and legal infrastructure being used. We will concentrate on two captive programs: single parent captives and group captives.

## CAPTIVE INSURANCE PROGRAMS

**A SINGLE PARENT CAPTIVE** program is set up by an organization to insure, exclusively, its own risk. The insured owns the captive, and the experience of the captive derives from the owner's risks having been insured by the captive. The owner of the captive is not sharing risk with other entities, is not pooling risk with other entities and is liable only for its own risks. Organizations will create single parent captive programs for a variety of reasons. For public entities, those reasons could include:

- Transparency, validation and rationalization of retained risk positions
- Robust operational and governance regime implementation around retained risks
- Access to capacity and risk transfer rate arbitrage

## SINGLE PARENT CAPTIVE

**A captive with a single risk participant**

**Pros**

- No risk sharing
- Classic risk financing
- Improved transparency, validation, and rationalization of retained risk positions

**Cons**

- Risk assumption is limited to individual wherewithal

## GROUP CAPTIVE

**A captive with several risk participants who share in each other's risks and enable increased levels of risk assumption**

**Pros**

- Ability to assume risk beyond individual wherewithal
- Group purchasing of services and risk transfer
- Communal accountability
- Improved transparency, validation and rationalization of retained risk positions

**Cons**

- Risk sharing – Exposure to other members experiences

In a **GROUP CAPTIVE**, a group of insureds band together to share their risks. Each organization is an owner of the captive, and each is an insured of the captive. When losses happen, the pool of participants share in the results of the insurance portfolio. Organizations create group captive programs for a variety of reasons. For public entities, those reasons could include:

- Collective bargaining in risk transfer capacity and rate arbitrage
- Collectivization of retained risk capabilities
- Development of risk management, loss control and claim management best practices
- Development of statistically larger data sets for risk transfer and retention rate setting
- Transparency, validation and rationalization of retained risk positions
- Robust operational and governance regime implementation around retained risks

# CAPTIVE INSURANCE FACILITIES

Separate from the question of captive insurance programs, is the matter of captive insurance facilities or structures. The participant in a single parent captive may either create its own captive (called an "equity captive") or rent space in someone else's captive (typically a "cell of a segregated captive facility"). Similarly, the participants in a group captive program may set up their own captive or rent space in a segregated facility.

Equity captives are rather simple: an owner goes through the process of establishing the company, capitalizing the company and securing a license, and then operationally needs to select providers and run the company. Using a cell of a segregated captive is even simpler: essentially, users of a cell (be they single parent or group) need to execute a rental agreement with the cell facility owner and operate their cell. In a segregated captive facility, the service providers and operations for the facility are managed by the facility owner. The differences can be compared to owning a house versus renting an apartment. When you own a home, you have nearly complete flexibility in service providers and operations; however, the barrier to entry can be substantial.

When you rent, the barrier to entry is low, but you have little flexibility in terms of service providers and operations of your home. But in both cases you are separated from those around you. The critical element in a segregated captive facility is that users of different cells are segregated from each other in terms of assets and liabilities.

It is becoming more common for a group of affiliated entities to create their own segregated captive facility and then each rent cells for their own single parent captive programs. This way, each has its own risks segregated from the risks of its fellows, while sharing in the cost of captive services and operations. They also then have the flexibility to pool certain risks by both having their own cells for their single parent programs and participating in a group captive in yet another cell. Segregated captives for those in pooling facilities are an excellent model for enhancing the pool infrastructure with a combination of risk segregation and risk pooling.

## CAPTIVE UTILIZATION FOR PUBLIC ENTITIES

In the current insurance marketplace, it is common for organizations to employ captives as tools for improving their risk transfer and risk retention schemes. Public entities could benefit from captive utilization in four principal areas:

**RETAINED RISK FINANCE**

- Infrastructure for providing transparency, validation, and rationalization of retained risk positions
- Enhancing risk management efforts

**RISK TRANSFER RATE ARBITRAGE**

- Reinsurance market cost of risk transfer is less than commercial retail cost of risk transfer
- Better use of capital to retain risk than transfer it
- Managing total cost of risk

**ACCESS TO CAPACITY**

- Federal programs (TRIA)
- Reinsurance capacity, which may not be otherwise accessible in commercial retail market (trade credit risk, +10 yr pollutions risks)

1. Through the use of a captive, public entities enter into a governance and controls regime which may be more robust than that which governs public entity pools. Captives are regulated by the department of insurance in the captive's domicile. While the level of regulation varies from domicile to domicile, this regulation generally provides for actuarial, captive management, audit and examiner oversight in operations and loss funding determination. Consequently, a captive is a vigorously monitored entity, designed to ensure that several 'sets of eyes' are reviewing its financial health regularly, thereby identifying issues and resolving them in a timely fashion. The regulatory and governance regimes embedded in the captive technology comprise the infrastructure that provides transparency, validation and rationalization of retained risk positions and provides for a regulatory body that insists its liabilities are adequately funded. While some commercial organizations may see this as a bureaucratic barrier to captives, public entities are usually looking for a stable environment in which to secure their obligations and validate the funding of their liabilities. A captive provides such an infrastructure.

2. A captive may be used to access risk transfer capacity that might not be available to public entity pools (such as TRIA backstopped terrorism coverage) and may enable public entities to secure risk transfer rates at a lower cost through accessing the marketplace as an insurer looking for reinsurance rather than a pool looking for excess coverage.

**3.** Captives can be used for many lines of business, whether on a retained risk finance basis, a risk transfer capacity access or rate arbitrage scheme:

| TRADITIONAL | EXPANDED | EMERGING |
|---|---|---|
| Workers' Compensation | EE Benefits | Self-Insured Medical Stop-Loss (non-ERISA) |
| Auto Liability | Terrorism (TRIA) | Reputation/Brand/ Loss of Income Risks |
| General Liability | Shipping Coverage | Intellectual Property (patent, trademark, copyright) |
| Professional and Products Liability | Title and Private Mortgage Insurance | Product Recall Coverage |
| Directors and Officers Liability | Equipment Maintenance | Medicare "Fraud and Abuse" Insurance |
| Employment Practices Liability | Construction Exposures | Lease Residual Value Risk |
| Environmental Liability | Trade Credit Risk | Punitive Damages Coverage |
| Product or Service Extended Warranty | Cyber-Risk | International Kidnapping Protection |
| Property and Business Interruption | Managed Care Errors and Omissions | |

**4.** Captive insurance programs may be built to develop companion insurance programs to other forms of affiliation, such as public entity pooling. In such a scenario, workers' compensation risk may be organized in a traditional public entity pool while other risks, such as auto, terrorism, cyber and medical stop loss coverage, may be run through a captive mechanism since a captive affords better facilitation for those risks.

# OVERALL BENEFITS OF CAPTIVE USE

There are many benefits in forming a captive insurance company. In today's environment, with the emphasis on governance, it is often a catalyst in reducing a company's total cost of risk while maintaining a rationalized, validated and transparent risk retention philosophy. The main benefits can be summarized as follows:

## FORMALIZED FUNDING VEHICLE

While a company may be committed to risk funding in principle, an informal mechanism often hides the true costs of retained losses. The captive approach is formal and imposes discipline on the company. It is often easier, in the event of loss, to have a dedicated vehicle rather than having to tap the company's general funds.

## RATIONALIZATION OF DEDUCTIBLES

For a company with many subsidiaries of varying sizes a captive can be an effective means of retaining risk that the company as a whole can afford, while allowing the subsidiaries to retain the risk appropriate to their own balance sheets. The subsidiaries can be provided coverage by the captive, in excess of self-insured deductibles in line with their financial capability or some other rational allocation, up to the amount of the company's overall deductible being retained in the captive.

## REDUCED IMPACT DURING INSURANCE CYCLES

The captive can establish funding levels that directly relate to its individual experience. In contrast, the commercial market may set its pricing based on some or all of the following: the experience of a particular class of insured, its entire book of business, availability of reinsurance, or external economic conditions. A captive offers the flexibility to take advantage of a "soft" or a "hard" insurance market by adjusting retentions.

## ABILITY TO BUILD FINANCIAL MECHANISM FOR TAKING MORE RISK

Through the use of surpluses built up over time, a captive may provide its parent with the financing necessary to take a higher retention and further exit the risk transfer marketplace.

## BREADTH AND AVAILABILITY OF COVERAGE

Captives can be used as a mechanism to deal with coverage that is unavailable or prohibitively expensive in the traditional markets. While this will still mean the company retains the risk rather than transferring it, a number of financial advantages can be realized.

## FAVORABLE DEALING WITH EXCESS INSURANCE MARKETS

The presence of an adequate retained limit and funding level, along with an aggressive claim and risk management program will enhance the likelihood of favorable treatment for the captive owner in dealing with commercial excess market.

## REDUCED EXPENSE RATIO AS COMPARED TO GUARANTEED COST OPTIONS

Typically, dealing with the commercial insurance market, premiums will include an allowance of up to about 35% for the insurer's expenses. The use of a captive means some expenses can be eliminated and others reduced substantially, leading to an overall reduction in total premium costs.

## CASH FLOW

Payments to the captive may often be made in line with the cash flow requirements of the company. The captive can also take advantage of investment income on funds held for future payment of losses. With many liability coverages this can be substantial, due to the time it takes for many losses to be settled.

## DIRECT CONTROL OF INVESTMENT INCOME

Loss funding and claim reserve are held by the captive in an agency account until needed for loss settlements and expense payments. Particularly with Long Tail Liability coverages, this "holding time" can extend over a number of years allowing the captive to earn interest income. The funds can be invested in the manner recommended by the captive's financial advisers.

## ACCESS TO REINSURANCE

A captive may directly access reinsurance markets, which generally are less costly over time and are more responsive to the concept of risk retention. Since reinsurers are the ultimate risk takers in the insurance world, the closer an organization can get to them, the better the chances of a mutually beneficial long-term relationship.

## INCREASE MANAGEMENT AWARENESS OF RISK MANAGEMENT INITIATIVES & THE TOTAL COST OF RISK

The establishment of a captive gives senior management an increased understanding of risk, together with its management and financing. With this understanding, they will be more committed to, and give better support to, risk management programs throughout the company, which, in turn, often translates into a significant reduction of the company's overall cost of risk.

# CONTACTS

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