Captives and Their Role for Public Entity Risk Pools

Wednesday, October 19th | 11:30am
Agenda and Goals

• Overview of captives
• Key considerations
• Captive Solutions and MSL Advantage
• Other examples
• Q&A and Opportunities for Pools
What Is a Captive Insurance Company?

A captive is…
- A separate legal entity, created or used by a company / pool or group of companies / pools

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

A captive typically…
- Has no employees so all of the usual “insurance company” functions are outsourced to third parties
- Provides coverages that the owner wishes to retain or that are unavailable in the traditional market
- Does not have its financial strength rated by AM Best, S&P or Moody’s like a traditional insurance company
Why Do Organizations Use Captives?

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

<table>
<thead>
<tr>
<th>Risk Management</th>
<th>Financial</th>
<th>Insurance</th>
<th>Strategic</th>
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</thead>
<tbody>
<tr>
<td>Reduce the need for, and reliance on, commercial insurance</td>
<td>Reduce total costs of risk</td>
<td>Participate in profitable risks – pay less to commercial insurers</td>
<td>Integration with long term strategies</td>
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<td>Promote loss control through effective risk management</td>
<td>Investment earnings and flexibility</td>
<td>Ability to set “own” terms and conditions</td>
<td>– Parent company strategies</td>
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<td>Provide coverage for difficult to insure risks</td>
<td>Balance sheet protection</td>
<td>Provide coverages either not available in the traditional market or considered too expensive</td>
<td>– Joint ventures and new geographic territories</td>
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<td>Offer flexibility in program design</td>
<td>Potential profit center</td>
<td>Reduce dependency on conventional insurance markets</td>
<td>– Capture Insurance related profits</td>
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<td>Accessing the commercial reinsurance market and/or diversifying a retained layer with other Pools</td>
<td>Allow for greater certainty in costs and flexibility through varying market cycles</td>
<td>Access the commercial reinsurance market</td>
<td>– Collaboration with other group captive members</td>
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Common Misconceptions about Captives

Having a bad year means the captive is unsuccessful.

A captive is used instead of commercial coverage.

A captive is an immediate money saver.

Captives are formed primarily because of the tax benefits.

Captives are subject to far less regulation than traditional insurers.
KEY CONSIDERATIONS

• When? Back of the napkin
• Discuss, Feasibility study
• Pricing / Capital investment
• Risk Profile – controls / group
• Additional governance
• State regulatory environment & authority to form a captive
• Evaluate tax status of cell and impacts to pool
• Staffing and partnerships to administer
• Political considerations – about where to form captive
A comprehensive feasibility study should include:

- Discussion of the advantages and disadvantages of a captive
- Analysis of proposed retentions and coverages assumed by the captive
- Estimates of loss experience and capital funding requirements
- Domicile comparison with recommendation, including regulatory requirements
- Preparation of five-year financial projections for the captive based on preferred structure
- Written business plan for the captive with proposed coverages
Characteristics of a Strong Captive Opportunity

<table>
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<tr>
<th>Weak</th>
<th>Strong</th>
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<tbody>
<tr>
<td>Premium Size</td>
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<tr>
<td>Under $500,000</td>
<td>Over $5 Million</td>
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<tr>
<td>Loss Ratio</td>
<td></td>
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<tr>
<td>Over 125%</td>
<td>Under 50%</td>
</tr>
<tr>
<td>Data Quality</td>
<td></td>
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<tr>
<td>Little or no data available</td>
<td>10 years loss/premium history available</td>
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<tr>
<td>Motivation</td>
<td></td>
</tr>
<tr>
<td>Taxes or “my buddy has a captive”</td>
<td>Risk management or long-term cost savings</td>
</tr>
<tr>
<td>Owner Financial Strength</td>
<td></td>
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<tr>
<td>Private company w/ concerns about capital/cash flow</td>
<td>Fortune 500 company/major public entity</td>
</tr>
<tr>
<td>Project Leader</td>
<td></td>
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<tr>
<td>Tax advisor</td>
<td>Broker</td>
</tr>
<tr>
<td></td>
<td>Risk Manager/ Owner</td>
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Sponsored Captive & Cells
NLC Mutual Insurance Company

• Quick facts about NLC Mutual:
  • Established in 1986
  • Member owned and powered
  • Started with six states, currently in 27 states
  • Every member has a seat on the Board
  • Committed to current public entity issues
  • Established January 1, 2022 NLC Mutual Captive Solutions as a risk-sharing option for unique or complex risks
NLC Mutual: Sponsored Captive Structure

NLC Mutual Insurance Company
Governed by Board of Directors and Committees

NLC Mutual Captive Solutions
Governed by a Sponsored Captive Board

- MSL Advantage, IC (Medical Stop Loss)
- Prospective Cell
- Prospective Cell

Board of Directors
Bylaws
Specialized Service Providers
Board of Directors
Bylaws
Specialized Service Providers
Board of Directors
Bylaws
Specialized Service Providers
Captive Cell - Illustration

- The Pool’s Self-Insured Retention varies to reflect the size and risk appetite of the pool member.
- The captive layer premium reflects each pool’s chosen limit.
MSL Advantage, IC

• Four founding health pool members

• Medical Stop Loss:
  • Pool specific retentions range from $500K to $2.5M
  • Captive layer - $1M above pool medical stop loss deductible
  • Excess coverage above purchased through the commercial market

• Contributions & Premiums:
  • First-year Premiums
  • Minimum participation agreement (e.g., 3 years)
  • Initial Capital Investment – funded by participating health pools

• Coverages Provided:
  • Individual stop loss above pool retentions
  • Aggregate stop loss on captives retained losses
  • Aggregate stop loss on individual pools’ retained losses
Other examples: How pools are using captives

• Government entity pool – Workers Compensation
  • Run off book / LPT / run off in captive / excess to members
  • Investment flexibility
  • Strategic – future uses

• Government entity pool – General Liability
  • Hard market / excess reinsurance expensive & excluding more / captive retains portions & certain exclusions / tool when negotiating renewals / focus attention on that exposure
  • Investment flexibility
  • Strategic – If reinsurers exclude more things in the future, a captive can price and track that exposure over time to ensure proper funding exists
Opportunities for Pools

**Opportunities**

• Strategic Advantages
  • Possible use of cells by members
  • Ability to isolate groups of risk over time, by line
  • Provides an opportunity to take a small portion of risk for challenging products
  • Additional flexibility for member surplus management

• Strengthens member relationships
  • Increased member engagement
  • Serves as a go-to-resource to help meet member needs

• Leverage expertise (internal & external), administration & staffing
Discussion: Where are you seeing pain? Ideas for forming Captives . . .

Cyber?

Medical Stop Loss?

Property?

Other?