NLC NATIONAL LEAGUE OF CITIES

NLC-RISC RISK INFORMATION SHARING CONSORTIUM

40 YEARS OF LEADERSHIP & CONNECTION

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

AIG

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

Risk Management

- **Reduce the need for, and reliance on, commercial insurance**
- Promote loss control through effective risk management
- Provide coverage for difficult to insure risks
- Offer flexibility in program design
- Accessing the commercial reinsurance market and/or diversifying a retained layer with other Pools

Financial

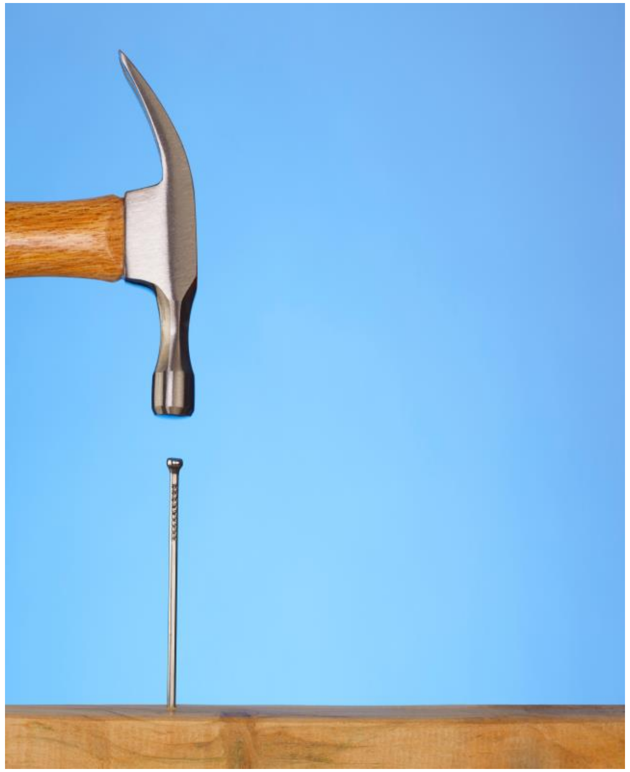
- Reduce total costs of risk
- **Investment earnings and flexibility**
- Balance sheet protection
- Potential profit center
- Allow for greater certainty in costs and flexibility through varying market cycles

Insurance

- **Participate in profitable risks – pay less to commercial insurers**
- Ability to set "own" terms and conditions
- Provide coverages either not available in the traditional market or considered too expensive
- Reduce dependency on conventional insurance markets
- Access the commercial reinsurance market

Strategic

- Integration with long term strategies
  - Parent company strategies
  - Joint ventures and new geographic territories
  - Capture Insurance related profits
  - **Collaboration with other group captive members**



Common Misconceptions about Captives

Having a bad year means the captive is unsuccessful

A captive is an immediate money saver

Captives are formed primarily because of the tax benefits.

A captive is used instead of commercial coverage.

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

Captive Feasibility Studies

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

Weak — **Strong**

Premium Size

Under $500,000 — Over $5 Million

Loss Ratio

Over 125% — Under 50%

Data Quality

Little or no data available — 10 years loss/premium history available

Motivation

Taxes or “my buddy has a captive” — Risk management or long-term cost savings

Owner Financial Strength

Private company w/ concerns about capital/cash flow — Fortune 500 company/major public entity

Project Leader

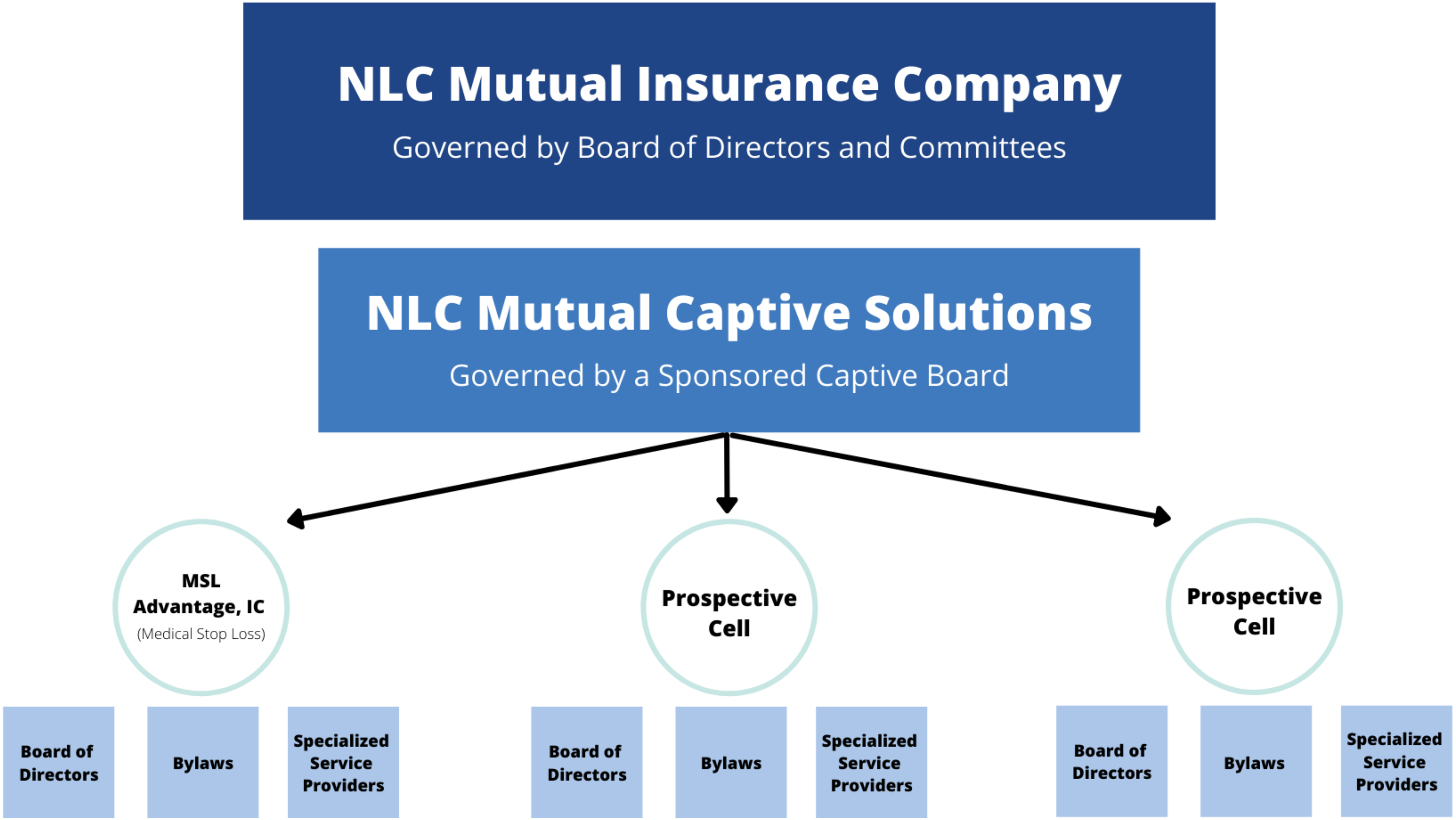
Tax advisor — Broker — Risk Manager/ Owner

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

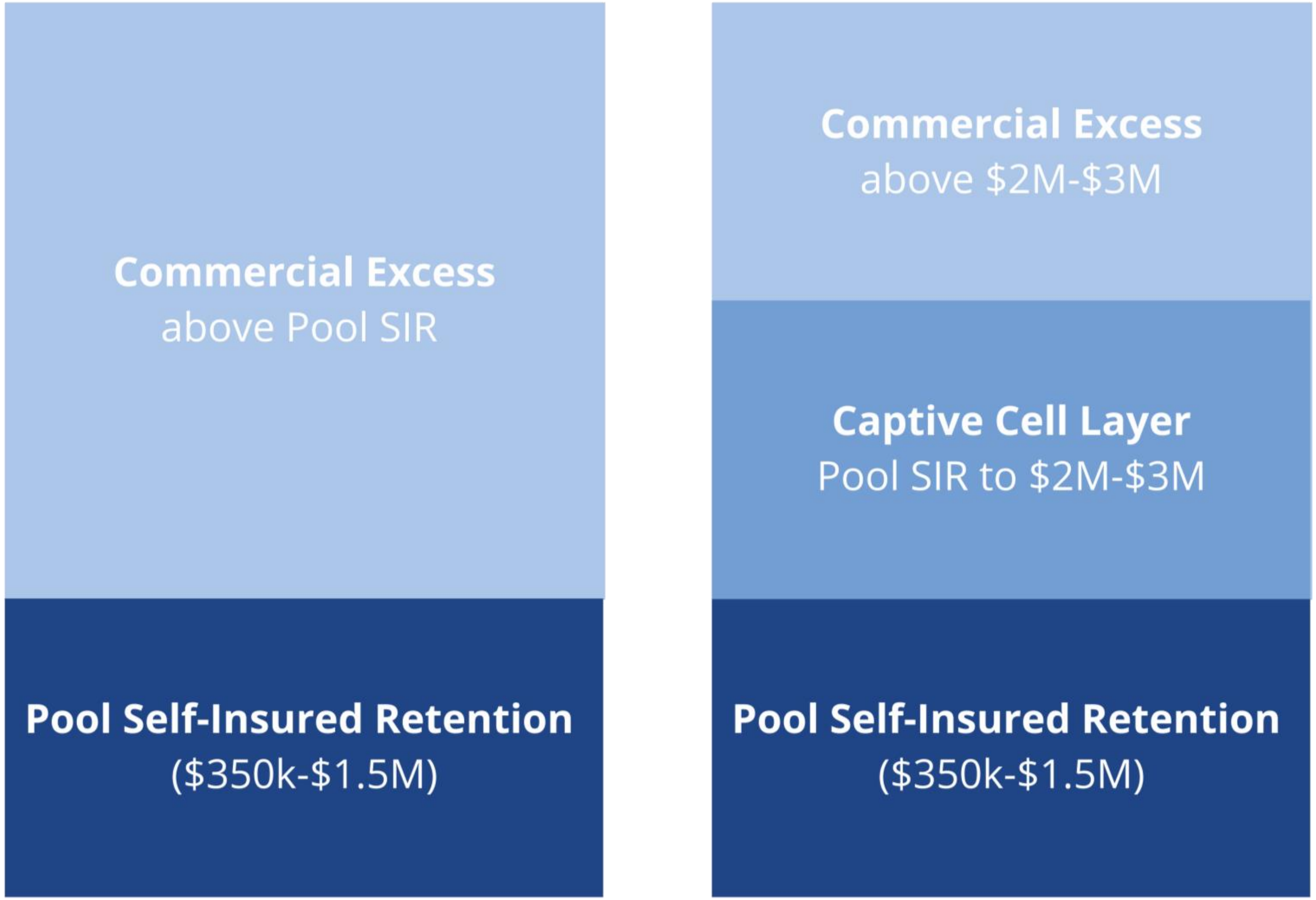
NLC MUTUAL INSURANCE COMPANY

NLC Mutual: Sponsored Captive Structure



Captive Cell - Illustration

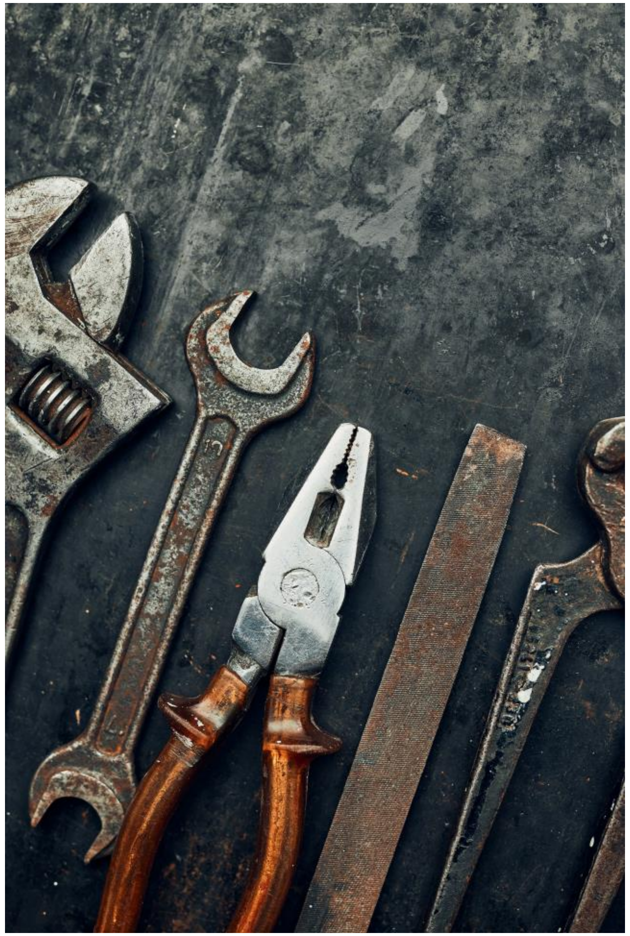
- The Pool's Self-Insured Retention varies to reflect the size and risk appetite of the pool member.
- The captive layer premium reflects each pool's chosen limit.



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

<u>Opportunities</u>

- 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?