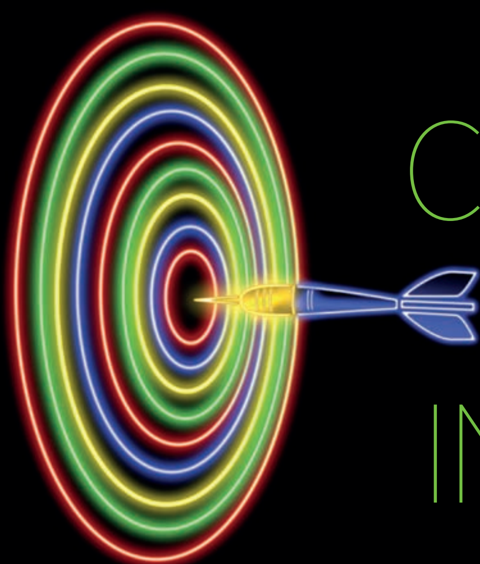

CAPTIVE BEST PRACTICE INNOVATIONS

Tom Cifelli of Captive Experts discusses best practice issues faced by smaller captive managers

The small and mid-market captive industry, often referred to as micro-captives, drives most innovations today. These include expanding the number of domiciles licensing captives, new insurance policy types (stimulating expansion of policy offerings by major commercial insurers), risk pooling arrangements, and adoption of more sophisticated safety, loss control and risk management practices by privately held companies. Management and operating practice standards by these smaller captives however are not always as good as they should be. This article highlights best practice issues and components captive owners and managers of all size and types of captives should consider implementing if they truly want to operate a best of class captive programme.

Captive insurance company design, formation and management practices vary greatly between captive managers. Additionally, while government insurance departments across the globe have similar governing statutes for licensing captives and captive service providers, actual regulatory policies, practices and procedures can vary significantly between domiciles. Even staff changes within a domicile can materially impact that domicile's regulatory requirements and practices.

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In today's increasing regulatory environment, a higher degree of structure, control and expertise in managing the day-to-day operations of a captive is required. Increasing regulatory oversight and additional mandatory disclosures are the trend in both the US and abroad. Reviewing your corporate governance policies and procedures and implementing best practices is indicated. This is particularly important if you want the predictability in the flow of funds associated with your captive operations.

Management commitment

Creating and operating a captive has long-term business implications. Failure to meet expanding best practice standards could have materially negative consequences. Management needs to make an appropriate commitment to the insurance venture and maintaining sound business practices.

Business plans and beyond

Considering captives are highly regulated entities which may experience changes in domicile regulatory staff if not a change in domicile during its life cycle, every captive should in its first year adopt comprehensive foundational business formation and operating documentation. Excellent corporate governance requires more than the feasibility study, actuarial report, and business plan typically required of licensing domiciles followed by commencement of its financial reporting system and issuance of insurance policies.

A feasibility study, basic business plan and financial proformas are merely core introductory business practice documents generally needed to apply for an insurance company licence. While each domicile has unique guidelines and specific requirements, good business plans and associated organisational documentation should address these "corporate engineering" concerns:

- organisational structure
- domicile selection
- ownership composition

- management and board composition
- committee functional scope and composition
- risk assessment, measurement and management members
- banking and investment management members
- accounting, financial and tax compliance members
- key policies and procedures
- organisational meeting minutes
- other corporate book documentation, and where applicable
- private offering related securities offering documentation when applicable

The business plan and related exhibits should address resources and procedures needed to create, operate and maintain required insurance policy, premium invoicing and collection, banking, investment, accounting, financial reporting, compliance reporting and overall organisational management. The plan should determine the extent of outside resources needed and budget associated costs. Defining how the internal and external resources will collaborate to maintain a system of controls to benchmark, collect and report data will assist efficient controlled operations.

Additional corporate governance elements

Required administrative management to assure fairness, accountability, transparency and discipline fall within the realm of corporate governance. Sufficient experience to operate an insurance business should be reflected within the experience of the board of directors. As needed, outside directors should be retained. An independent director and one or more management committees are recommended. Each management committee could also include qualified independent members whether voting or not.

All captives should strive to have the following, updated annually, even if not required by the regulating domicile, and irrespective of the legal form selected for the captive insurance entity:

- a board of directors
- officers
- corporate articles and by-laws (or operating agreement)
- corporate book (and board and committee minutes)
- management policies and procedures
- policy coverage, premium and actuarial review meetings
- financial performance and audit review meetings
- loss and safety control review meetings
- continuing education should be provided to board members
- an owner manual handbook
- periodic personnel and service provider performance reviews
- periodic testing of internal controls should be part of the policies and procedures
- committees should be formed and given primary responsibility for underwriting and risk management, finance and investment activity, and audit and regulatory compliance
- committee reports for submission to the board

A good set of corporate governance guidelines would also include board operations manuals, financial controls, investment strategy policies (including a conflict of interest and code of ethics policy), and outside service provider management.

Regulatory compliance

Captive operations must not only meet owner objectives, but must comply with industry and domicile rules and regulations. Accordingly, captive management should maintain calendar-based checklists of all required regulatory requirements to share with the board and effected committees. Non-compliance events should be documented and timely corrected. These checklists should address licensing requirements, insurance policy periods, insurance renewal procedures, financial reporting requirements, capital and solvency requirements, audit and tax compliance requirements, other regulatory filings, and all time sensitive matters impacting third parties.

Captive management staff training manuals are recommended so staff turnover or absences do not cause reporting compliance issues for client captives. Every captive should have daily, monthly, quarterly and annual activity checklists and guidelines shared with owners so they can effectively manage the captive management staff as all owners and captive officers are ultimately responsible for compliance and operational controls.

Solvency and financial strength are key issues for regulatory agencies. Maintenance of the following ratios for periodic board consideration are recommended:

- premium to surplus ratios
- expense ratios
- loss ratios
- investment income ratios
- reserves to surplus ratios
- retention to surplus ratios

Communication and document storage protocols

Ongoing communication between the board, management, service providers and regulators should be maintained. Operational data should be maintained for the life of the captive, and for the period of years required after wind-up. Information technology should be fully utilised for easy access, back-up and secure virtual storage of records with associated IT security policies and procedures.

Insured operating company risk management policies and procedures

Companies that decide to include a captive insurance company as part of the enterprise risk management programme should also assess risk safety and loss control policies and procedures. These are normally part of group and association captive arrangements, but not typically part of the best practice standards for many smaller family owned captives. The availability of safety and loss control consultants has expanded and these services are now very affordable. It makes good business sense for companies investing in captive insurance companies to increase investment in loss and safety control training and associated policy and procedure initiatives, even if your captive manager does not have related affiliated resources as part of their service arsenal.

> "It makes good business sense for companies investing in captive insurance companies to increase investment in loss and safety control training"

For detailed guidance on captive best practices, manager selection, domicile selection, insurance programme coverage design, risk pool considerations, tax planning and other valuable information, read *Navigating Captive Insurance Companies - Storm Proof Your Risk Vessel*. This is the most up to date book on small to mid-market sized company captive risk management programmes.