UNRELATED RISKS:

What Are Captives Writing, Why & How?

PRESENTERS / AGENDA:

Moderator

– Brad Eichers, Kornerstone Guaranty Insurance Co.

What Are Captives Writing?

– Kate Westover, Innovative Captive Strategies

Compliance & Process

– Bill Whitehead, Lexington Insurance Company

Case Study - All Presenters

UNRELATED RISK

What are Captives Writing?

Kathryn A. Westover

Vice President, Alternative Risk Financing

Innovative Captive Strategies

INNOVATIVE CAPTIVE STRATEGIES

WHAT IS "UNRELATED RISK"

- A "risk" is the possibility of occurrence of loss
  - Requires an exposure, (as well as peril and hazard)
  - Employees, buildings and autos are exposures
- "Unrelated risks" (aka "unaffiliated") are not owned by the captive's shareholder
  - Insurance of the exposures of an "unrelated party"
- Unrelated risk test: Does the captive shareholder own 50% or more of the insured entity?
  - If no, it is unrelated risk

CONTROLLED UNRELATED RISKS

- A term found in some domicile statutes
  - Some domicile laws state that a captive may only write unrelated risk if it's "controlled"
  - Other domiciles have different license classes depending on amount of unrelated risk
  - If risk is controlled, captive shareholder doesn't own the exposures but "controls" it, e.g.
    - Contractual authority over insured, e.g. franchisee, employee
    - Captive owner able to enforce loss control measures
  - Historical efforts by IRS to define "unrelated risk" as excluding those which are "controlled"

- Historically onshore domiciles prohibited direct underwriting of unrelated risks
  - Allowed for assumption of controlled unrelated risk via "fronting" arrangements
- Offshore domiciles did not require control (but could not enable direct writing)
  - Captives can't provide direct insurance to unrelated parties because only licensed in their domicile
  - How a captive writes unrelated risk is determined by state or country law where the risk is located, not the captive domicile

ARGUMENTS FOR "CONTROL"

- Why did onshore domiciles prohibit assumption of non-controlled unrelated risk?
- 1970S Offshore captive writing non-controlled unrelated risk suffered severe losses
  - Fear that the captive could be "naïve capacity" e.g. captives owned by manufacturing companies underwriting medical professional risks

WHY DID THEY DO IT??????

TAX REASONS FOR UNRELATED RISKS

- Captive owners attempting to get tax deductions for related risk premiums paid to their captive
  - IRS had developed “economic family” theory
  - No deduction for premiums for captive shareholder risks
  - Sears couldn’t get deduction for premium paid to Allstate!
  - Courts ruled that tax deduction for related risk premium possible, under certain scenarios

UNRELATED RISK CASES

Insured	**% of Net Premium**
Harper	29%
ODECO	44% and 66%

- Requirement to have enough unrelated risk on an annual basis
  - Calculated on risk retained by captive
  - Direct written or assumed
- Rev. Ruling 2002-89 IRS opines that 50% is adequate
  - No court case to-date to contradict the assertion

TAX MOTIVES CONT.

- Rev. Ruling 2005-40 establishes current IRS position re: what makes a "real" insurance company
  - One of the criterion: adequate pool of risks
- Now the definition of "risk" has been changed!
  - No longer a question about the amount of exposures, but about the SOURCES of the risks
  - How many separately incorporated entities are insured in the captive?
  - Not enough related sources? Look for unrelated.

SOURCES OF UNRELATED RISK

- Captive Pools
  - 2 or more pool participants i.e. captives/captive owners agree to share risks
  - Typical structure is a group captive owned by the participants but could be rental captive cell
  - Each captive cedes risk to the pool, or there is a front company ceding participant risk to the pool
  - Each captive assumes a % of all other pool member risks – pool retains zero
  - Participants do have influence over underwriting and claims handling

Example of a WC pool

Captive #1

Captive #2

Captives #3-12

Reinsurance Pool
Owned by captives
Or the owners of
The captive

Pool buys CAT or CLASH cover, plus Excess of Loss

Captive buys reinsurance ⟶

Captive reinsures a quota share of the pool ⇠

SOURCES OF UNRELATED RISK

- Commercial reinsurance
  - Assumes quota share part of their book of business
  - Rely on their underwriting and claims handling
- Controlled unrelated risk
  - Employees, customers, joint venture/business partners

EMPLOYEE RISKS

- Revenue Ruling in 2007 established that group life insurance premiums are unrelated
  - The insured is the employee, not the captive owner
- Guidance as to **IRS** definition of unrelated risk
  - Not who pays the premium but who is the insured/reinsured (beneficiary of claim payment)
- Single parent captives writing employee benefits in captive typically looking for unrelated risk
  - Otherwise may be better to use VEBA to capture underwriting profits

OTHER EMPLOYEE RISKS

- LTD is popular (predictable, slow payout)
  - As with all group benefits requires DOL approval
- Could assume personal lines from a front company
  - Employer allows homeowners or auto liability insurer access to employees
  - Cannot be part of a benefit plan or DOL approval required
  - Question for the employer is whether reinsurance of employee risks will suffer from adverse selection

CUSTOMER RISKS

- Profit Center Captives
  - Banks historically reinsured customer credit risk (life, unemployment), and forced placed homeowners
  - Auto dealers also used captives for credit life and customer warranty
  - Distributors and shippers provide crime/property loss protection to their dealers and customers

KEY QUESTION: IS THIS “SELF DEALING”?

CUSTOMER AND BUSINESS PARTNER RISKS

- Business Support Captives
  - Construction companies may consider helping out key subcontractors
  - Trucking company may insure self-employed truckers
  - Hospitals may insure non-employed physicians

KEY QUESTION: IS THIS A GOOD USE OF CAPITAL?

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UNRELATED RISK

Compliance & Process

Bill Whitehead

Vice President, Captive/ART

Lexington Insurance Company

LEXINGTON INSURANCE
CHARTIS

MISSION STATEMENT

- Mission Statement – the critical guide to *good* decision making. Test all questions and assumptions against the statement; i.e. does this support the mission?
- Mission Statement– do what, for whom, to what end?

DECISIONS

- Direct write, RRG, or reinsure via front?
  - Statutory & business considerations (rating)
  - Licensing
    - Sales
    - Claims
  - Regulatory & financial filings
  - Policy management
  - Information ownership – client, policy, claim & financial records, integrated

FRONT CONSIDERATIONS

- Amount of risk assumption & how?
  - Quota share w/stop loss
  - XOL
- Collateral Securitization – unauthorized reinsurance
  - LOC
  - Trust
  - Funds Withheld

FRONT CONSIDERATIONS

- Admitted vs. non-admitted
  - Statutory cover or sales/enrollment process limitations
  - Form & rate freedom
  - Licensing
    - Number of states
    - Type
- Claims
  - Fronting carrier
  - TPA
  - Internal/self

- Policy Management
  - Master w/certs or individual?
  - Endorsements
  - Renewals, cancellations, re-writes
  - Payment/collections – who owns the credit risk?
  - Financing & impact on collateral management

POLICY & PREMIUMS

- Premium Cessions & Reinsurance Structure
  - Facultative or Treaty – timing
  - Netting for taxes, boards & bureaus, stop loss, front fee, commission expense, etc.
  - Unearned premium reserves & collateral impact (liability lines)
- Accounting
  - Statutory & GAAP
  - Premium versus deposit – congruency with front– what constitutes risk transfer?

CONTRACTS

- Agency, brokerage, program agent
- Reinsurance
- Policy & excess (if any) form congruency
- Claim (TPA) agreement– with whom – what authorities
- LOCs/Trusts
- Indemnifications – sometimes used as regards assessments

UNRELATED RISK

Case Study: Kornerstone

Brad Eichers

President

Kornerstone Guaranty Ins. Co.

Kornerstone Administrative Services
A member of the Ken Garff Automotive Group

Kornerstone Guaranty Insurance Company

A Utah Captive Insurance Company

Who formed Kornerstone Guaranty?

Ken Garff Auto Group & its affiliated companies

- Why did we form this company?
  - Underwriting Profits
  - Greater Investment Returns
  - More control over our cash and operations
  - Possible income tax benefits
- How our program works
  - We insure products sold by our automobile dealerships
  - Extended Warranties, Gap Waivers, and Theft products

- What's next?
  - Property & Casualty large deductibles
  - Workers Compensation – not allowed by Utah Captive Statute
  - Self-insured Medical Plans and Employee Benefits
  - Other unrelated risk opportunities - open discussion

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QUESTIONS?