

Captive 101

The Basics of Captive Insurance

DCIA Annual Forum
November 2, 2022



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WILMINGTON, DELAWARE

NOVEMBER 2-3, 2022

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Presentation Outline

1. What is a Captive – Risk Financing
2. Statistics & Domicile Selection
3. Role of the Domicile – Regulatory Framework
4. Does a Captive Make Sense for our Organization
5. Captive Formation Process
6. Ongoing Operation of a Captive
7. Industry Opportunities
8. Q&A

What is a Captive – Risk Financing



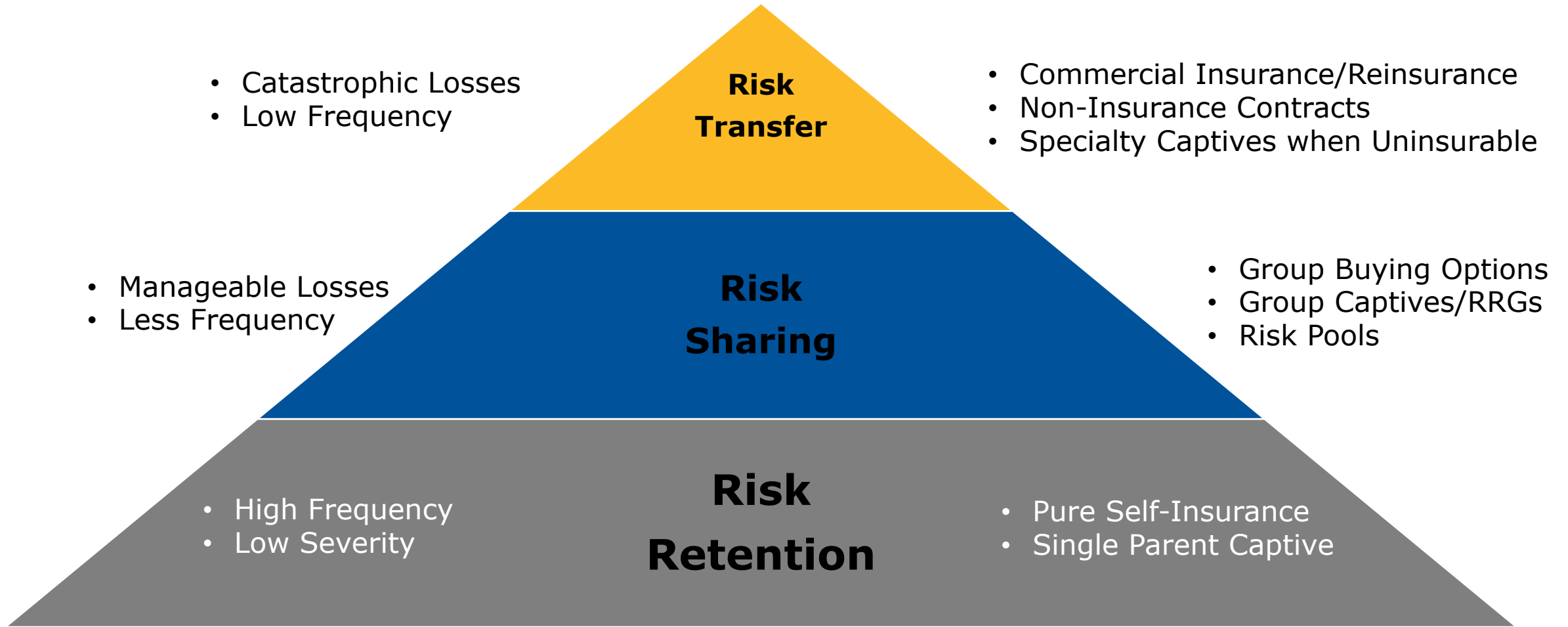
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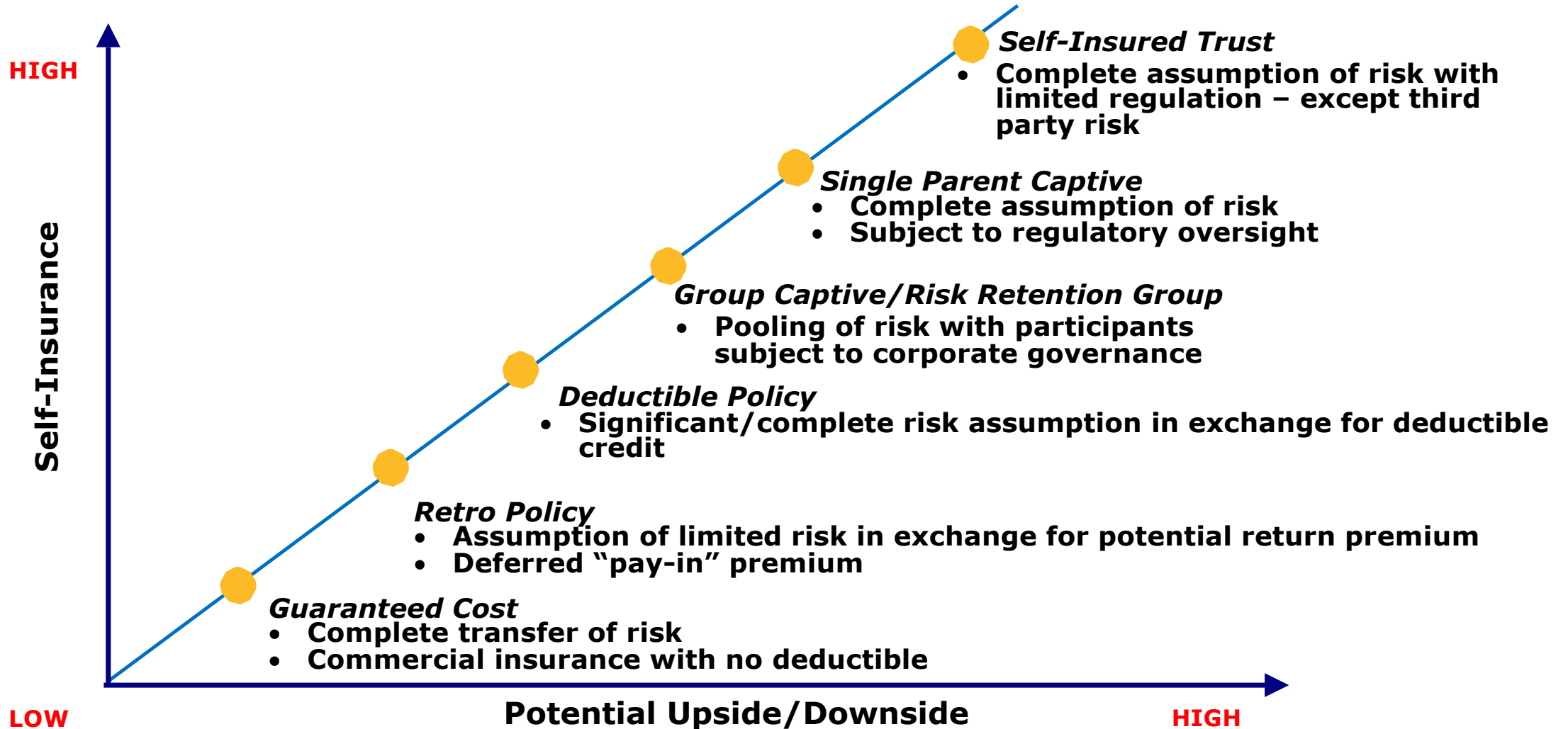
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Risk Management Framework



Risk Financing Options



What is a Captive

Definition: A closely held insurance company that is owned and controlled primarily by its insureds

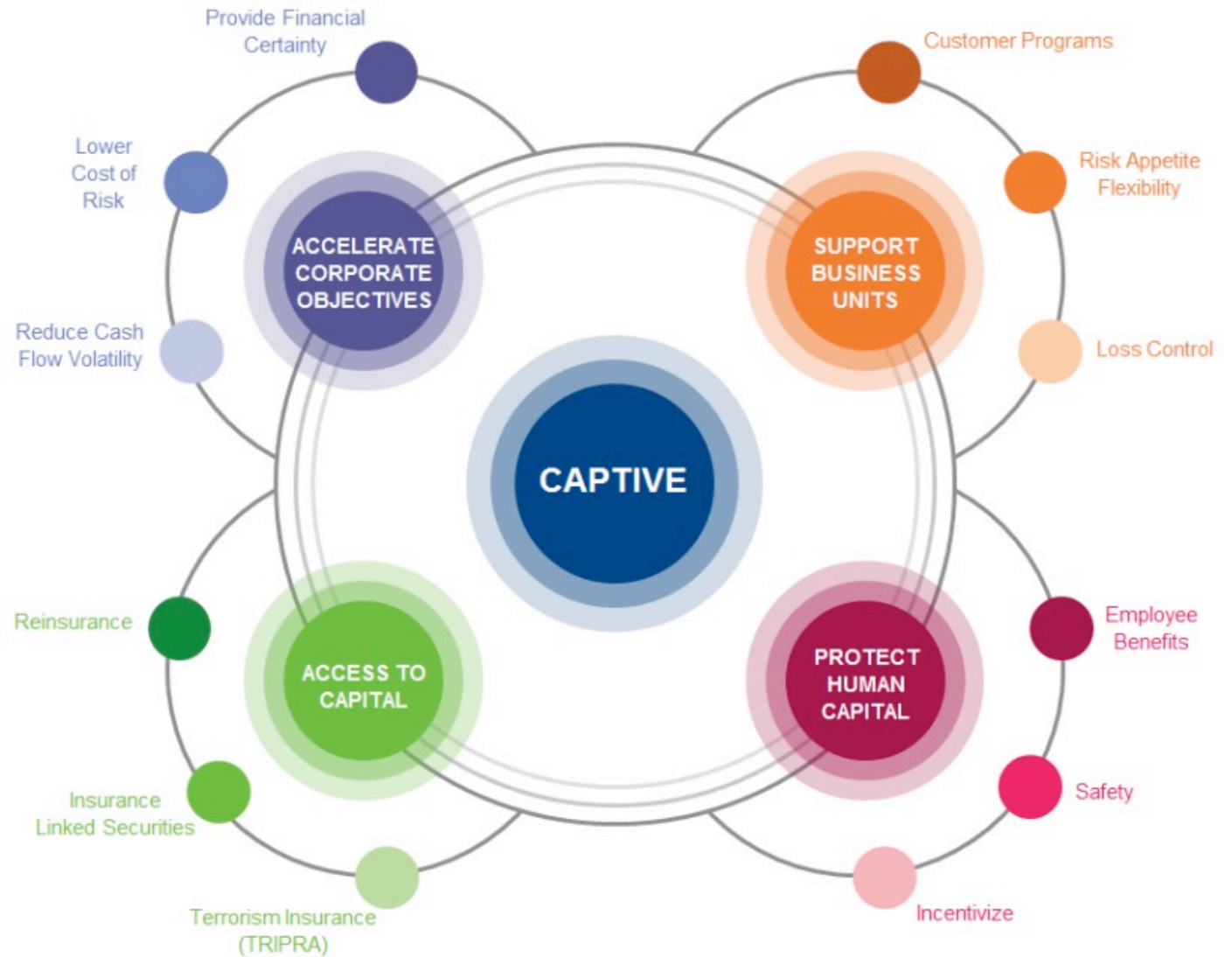
Characteristics:

- A licensed insurance company
- Regulated under special legislation regulating captives
- Generally licensed in only one domicile
- Formed to insure or reinsure the risks of its owners or related parties of their choosing
- Capitalized and controlled by parent/sponsor, but day-to-day operations are typically outsourced

Why Form a Captive?

Captive development is most often driven by the need for increased control of the insurance transaction.

As the commercial market has hardened, captives are increasing retained risk and participating in excess layers compared to the traditional primary layer risk financing.



Why Form a Captive? - Control

- The main reason captives are formed is to increase the level of control over all facets of insurance
- Increase control over
 - Ultimate cost on Net Present Value After Tax (NPVAT) analysis
 - Coverage breadth
 - Claims handling
 - Loss control
 - Embedded insurance program profit
- Complete insulation/separation from the commercial insurance market is challenging due to capital requirements

Most Common Risks Placed in Captives

CASUALTY

Workers' Compensation

General & Auto Liability

Pollution & Product Liability

Employment Practices Liability

Directors & Officers Liability

Cyber & Professional Liability

PROPERTY

Commercial Property

Specialty Property/Cargo

Inventory

Terrorism

Business Interruption

Difference-In-Conditions

EMPLOYEE BENEFITS

Medical Stop-Loss

Group Life (ERISA)

Long-Term Disability (ERISA)

Accidental Death &
Dismemberment (ERISA)

Other ERISA-governed and
voluntary benefits

**ANY RISK THAT IS FORTUITOUS AND CAN BE QUANTIFIED AS INSURANCE RISK
COULD POTENTIALLY BE PLACED IN A CAPTIVE**

Captive Obstacles

- Cost/Cash Flow: Capital and upfront/ongoing cost of operation
- Captive assets segregation (typically not available for corporate projects)
- Slight administrative time commitment
- Does not eliminate impact of commercial market cycles
- May incur some exit costs should captive not be needed in the future

Keys to Successful Captives

- Sense of urgency – problem to solve or clearly defined objective.
- **Properly priced/funded** relative to risk profile.
- Focus on **loss control** and claims management.
- **Long-term commitment** - discipline to “stay the course” through market cycles; clear understanding of the benefits and operational challenges.
- Strong business partners – captive manager, claims service, actuary, banking and investment advisors.

Statistics & Domicile Selection



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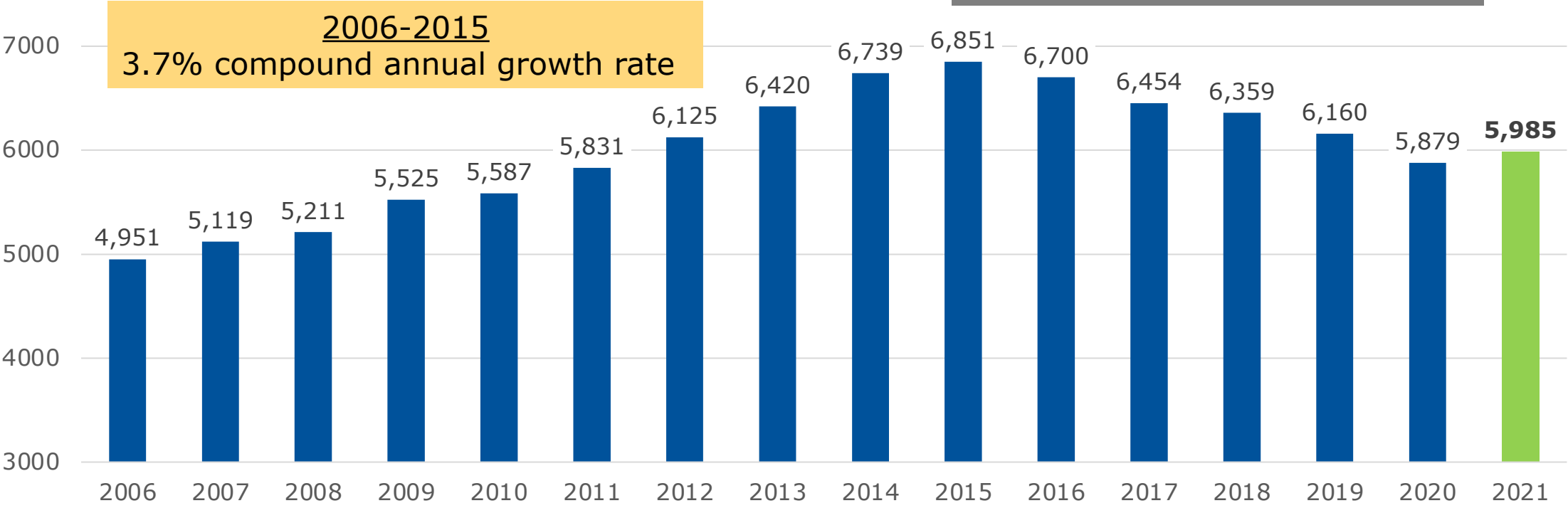


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Captive Industry Growth

Total Captives Worldwide*



* Excludes cells and series

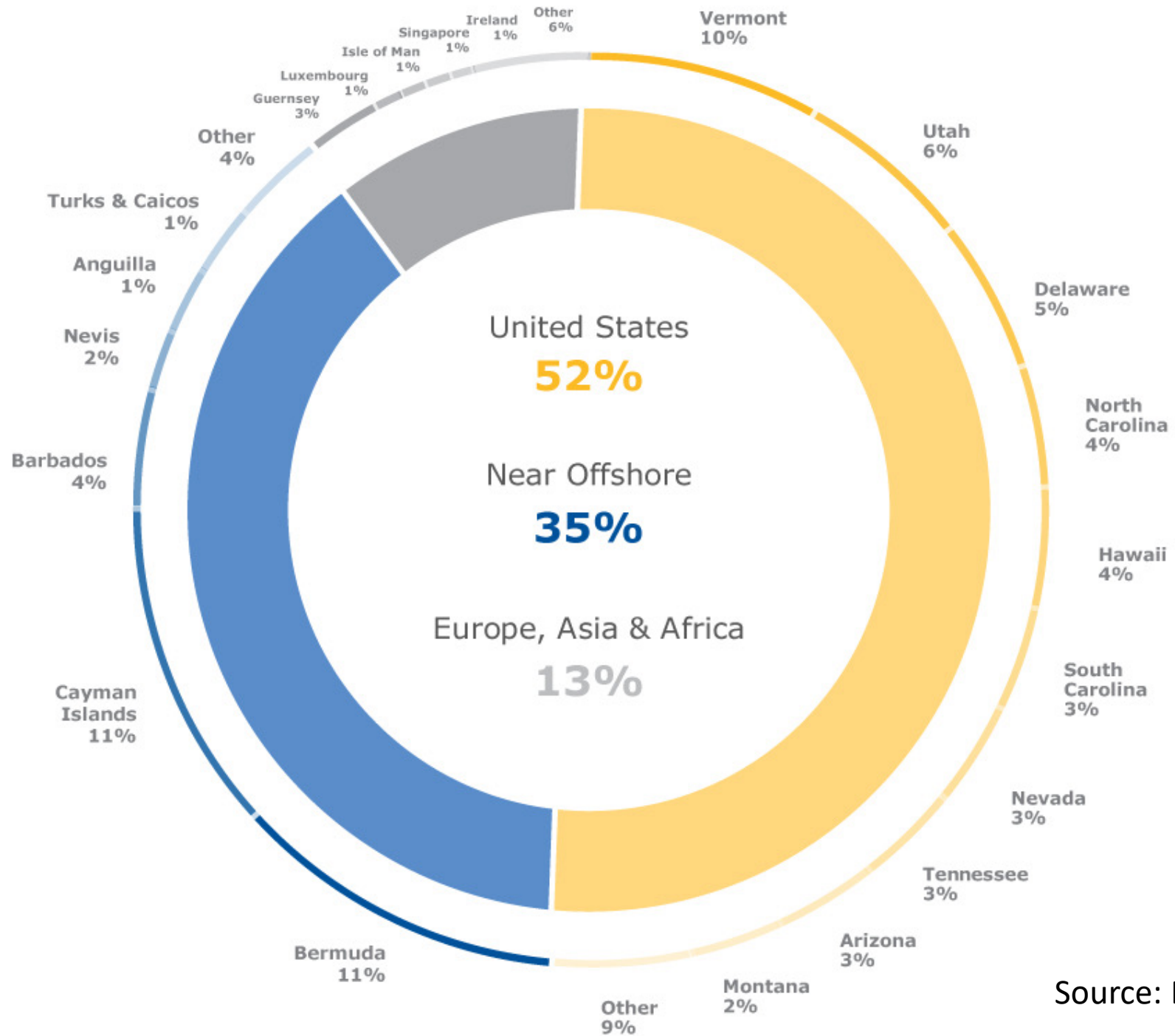
Source: Business Insurance
Restated 2021 totals



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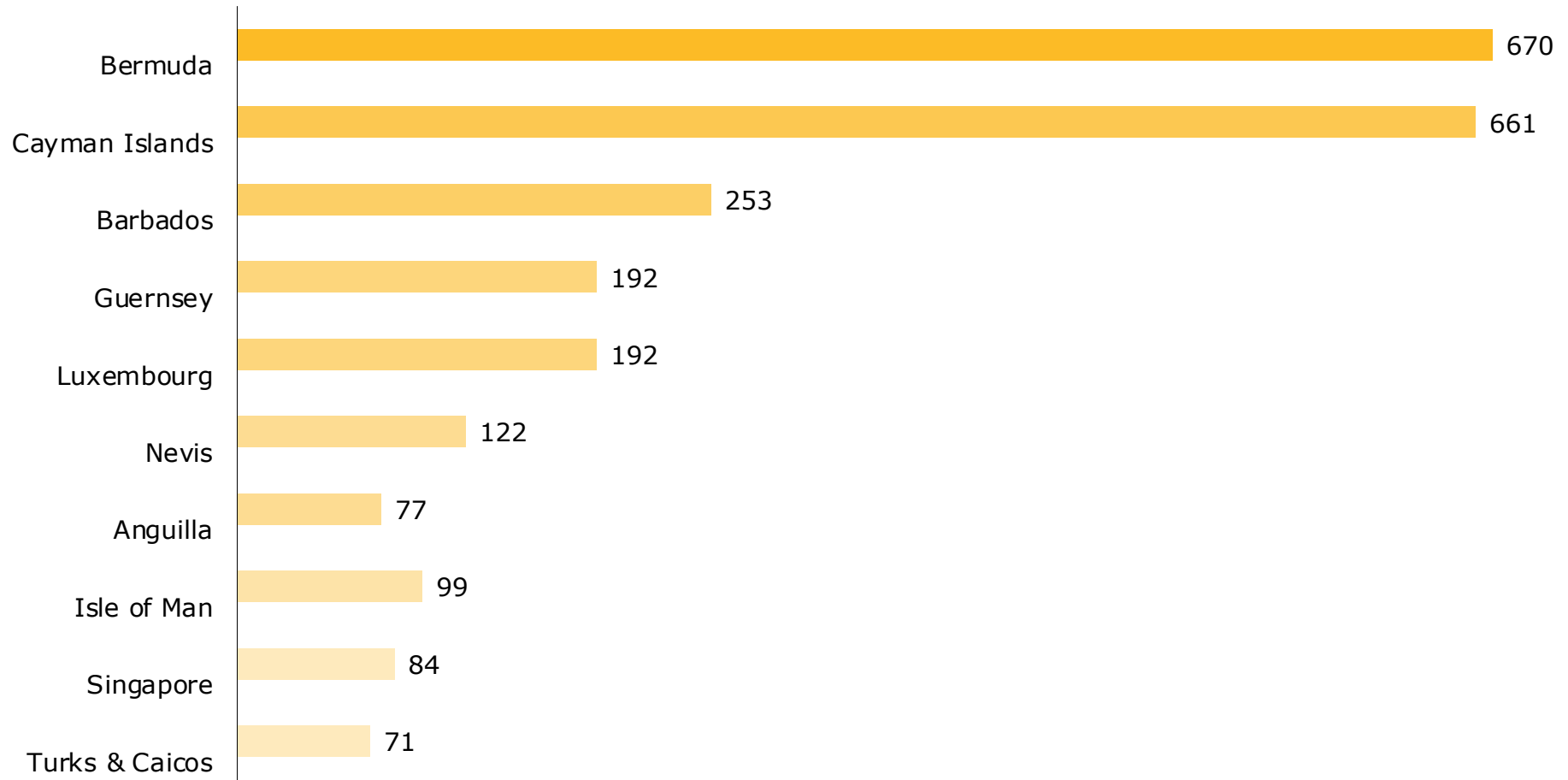
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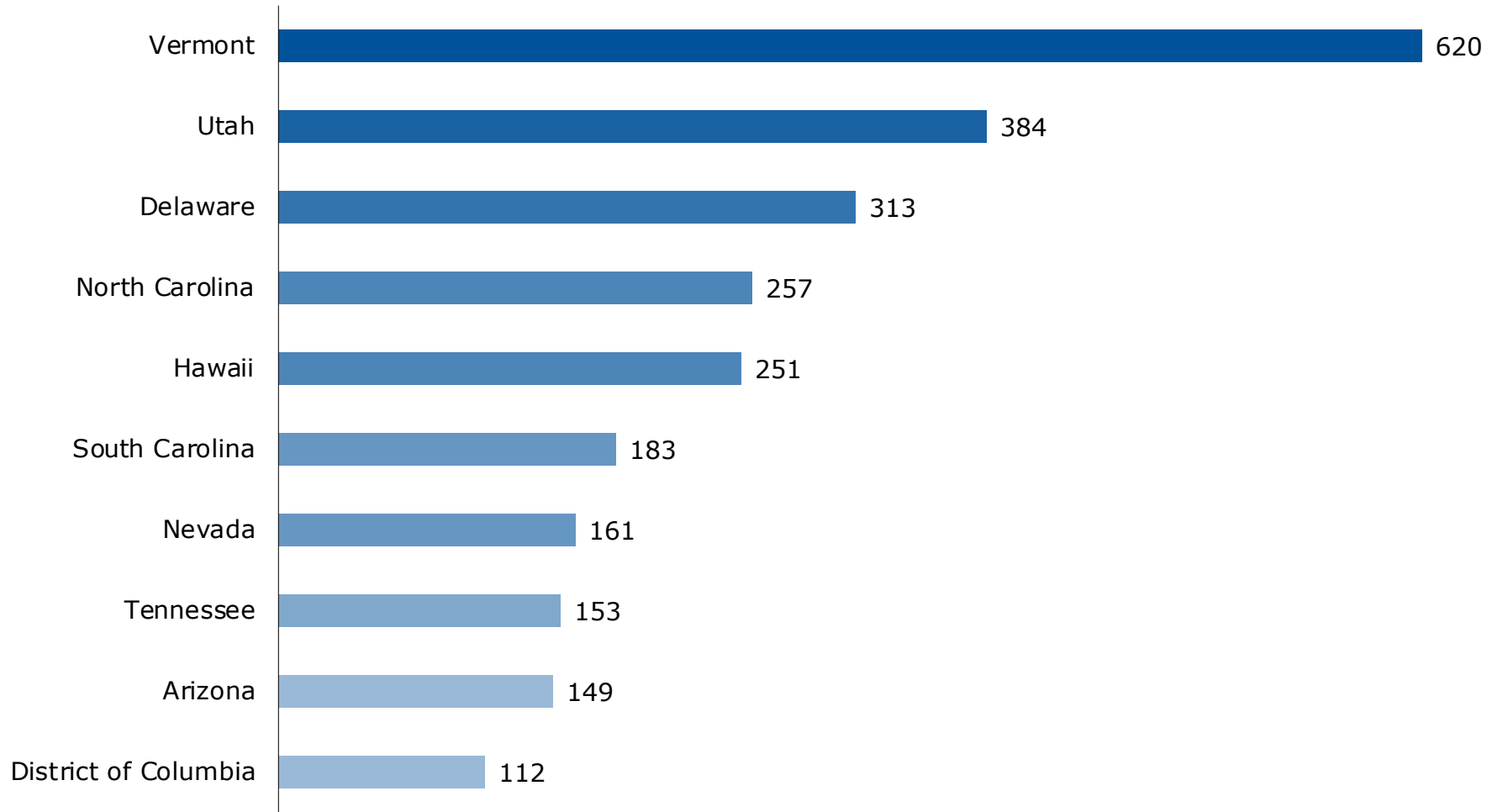


Source: Business Insurance

Top 10 Leading Offshore Captive Domiciles 2021



Top 10 Leading U.S. Captive Domiciles 2021



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Domicile Selection – The TRIP Decision

There are four principal factors governing choice of domicile

Tax

Are there tax consequences associated with the domicile selection?

Regulatory

Does the domicile offer the regulatory flexibility I require to underwrite this risk? How much capital will I require?

Infrastructure

Does the domicile have the necessary infrastructure to support my captive?

Perception & Logistics

How easy is it to travel to the domicile and are there perception issues with the location?

Role of the Domicile



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Role of the domicile

Two key roles of a domicile:

- Licensing
- Regulation

Licensing

- Types of captives – Three most common types of captives licensed in Delaware are pure captives, series captive insurance companies and special purpose captives.
- Application for licensure – Delaware offers both a regular application process and a conditional application process.
- Review of application – Application is reviewed to determine if all necessary captive formation documents have been received.

Licensing

Additional items reviewed:

- Business Plan
- Coverages and reinsurance (if applicable)
- Financial information
- Ownership structure
- Verification of authorized service providers

Regulation

- Business Plan changes
- Annual requirements
- Examinations



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Regulation

Business Plan changes:

- Loan requests
- Dividend requests
- Ownership changes
- Officer/director changes
- Coverage and/or Insured changes
- Other

Regulation

Annual requirements:

- Annual Report – Due on April 15th.
- Premium Taxes and Fees – Due on April 15th
- Audited Financial Statements – Due on June 30th
- Statement of Actuarial Opinion – Due on June 30th

Regulation

Examinations – The first examination of a Delaware licensed captive will occur 3 years after licensure. Subsequent examinations will be either 3 or 5 years following the previous exam.



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Feasibility Study

Does a Captive Make Sense?

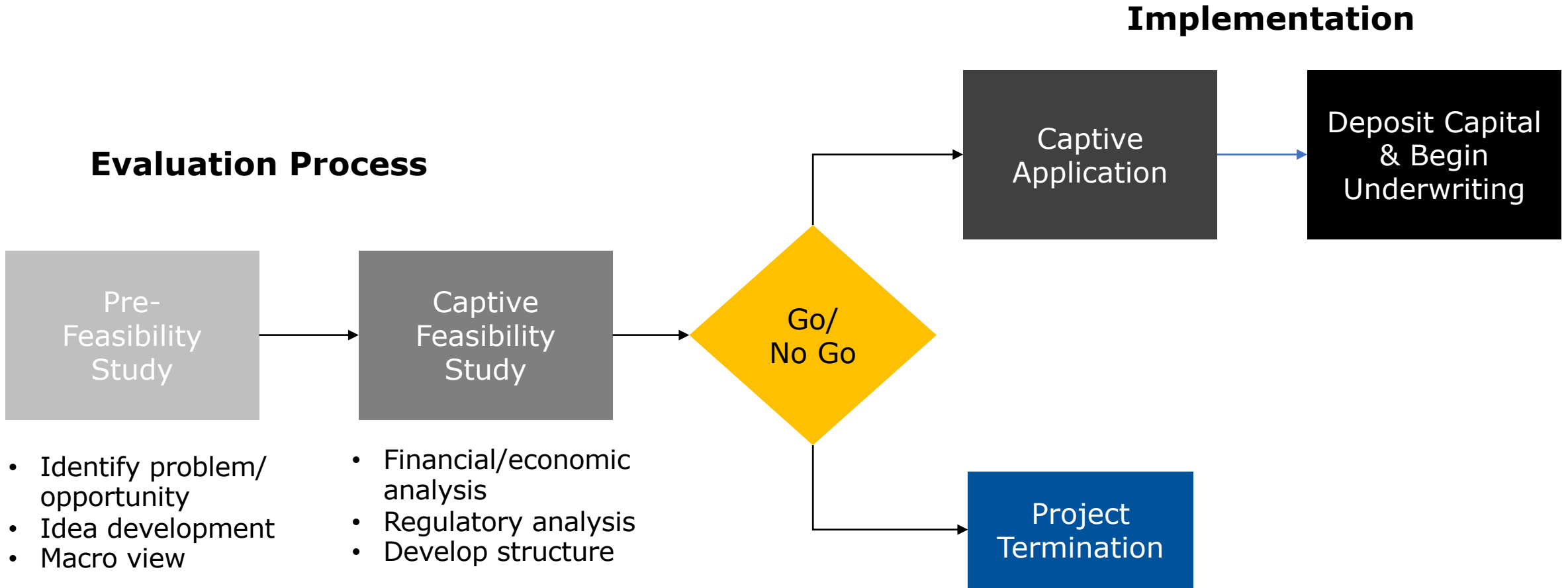


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Captive Decision Making Process



What is an actuary?

Actuaries are:

- Experts in measuring and managing risk
- Integral in designing and implementing sound risk management strategies
- Key to the ongoing financial strength of the program
- The life of every party...

Feasibility Process

- Initial Considerations
 - Retention levels and risk appetite
 - Reinsurance alternatives and considerations
 - Development of program structure
 - NPV comparison of alternatives
- Feasibility analysis
 - Project loss costs
 - Estimate other costs and develop premiums
 - Determine capital requirements
 - Pro forma financials

Derivation of premium

Premium is the sum of:

- Expected loss and loss adjustment expense
- Other operating expenses
- Risk margin

Variability in Results

- Insurance is designed to mitigate the risk of fortuitous events
 - Fortuitous events are unknown in
 - Timing
 - *and/or*
 - Severity
 - There is a range of possible results that need to be measured and accounted for

Derivation of Capitalization

- Capital is the financial assets necessary to absorb adverse loss experience
 - Computer simulation is utilized to measure the variability of potential outcomes based on the statistical distribution of loss relative to the level of risk exposure
 - Capital recommendation is based on the simulated losses at a selected confidence level

Actuarial Report

- An actuarial report is filed with the captive application and provides a written explanation of the actuary's analysis and the financial forecast for the captive
 - The report should provide a clear explanation of the assumptions and projected results included in the feasibility analysis
 - The report will also present the financial condition of the captive under both expected and adverse case scenarios

The Formation Process



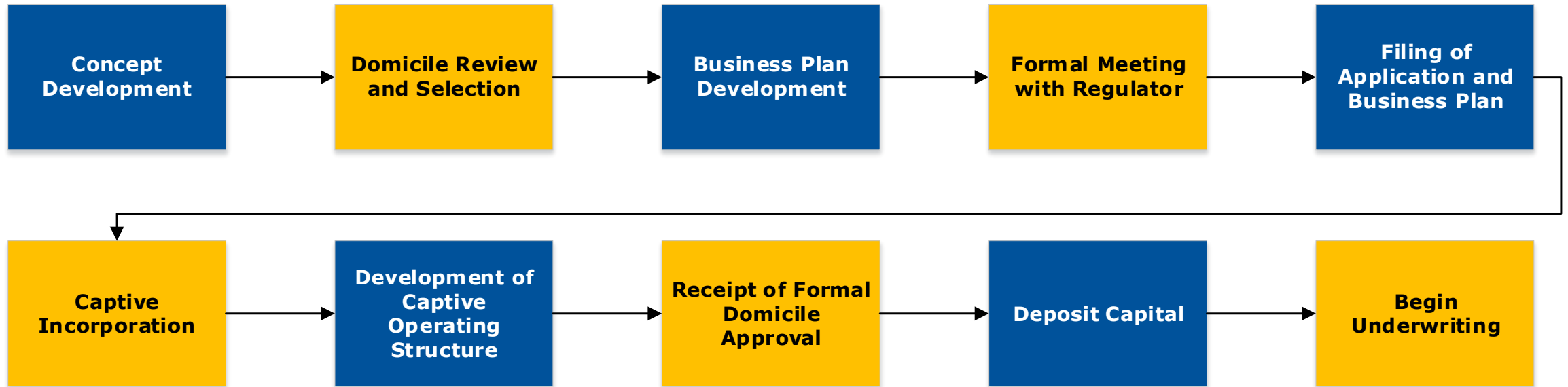
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Formation Steps



Captive formation process in Delaware

The process to form a captive in Delaware involves the following steps:

- Will this be a regular or conditional application?
- Submission of application, necessary documents and fees.
- Confirmation of minimum capital and surplus.
- Application is reviewed by Delaware Department of Insurance.
- Issuance of regular license if all necessary documents have been received and all requirements have been met.

Captive formation process in Delaware

General documents required for captive formation:

- Application
- Biographical Affidavits
- Organizational documents
- Business Plan
- Captive Management Agreement
- Insurance Policies and Reinsurance Agreements (if applicable)

Captive formation process in Delaware

General documents required for captive formation continued:

- Actuarial Feasibility Study with 5 year expected and adverse proformas
- Investment Policy (if applicable)
- Organizational Chart

Captive formation process in Delaware

General documents required for captive formation continued:

Please visit the Delaware Department of Insurance website [captive.delaware.gov](https://www.captive.delaware.gov) for additional detail regarding the application process and required documentation.



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Ongoing Operations



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Operations of a Captive Insurer

- Most captives are set up as virtual insurance companies. This typically means:
 - Overseen by a Board of Directors and Officers primarily made up of parent organization representatives
 - No employees
 - Highly reliant on service provider specialists
- Cost of operating a captive can vary materially, with a typical range of \$80,000 - \$175,000

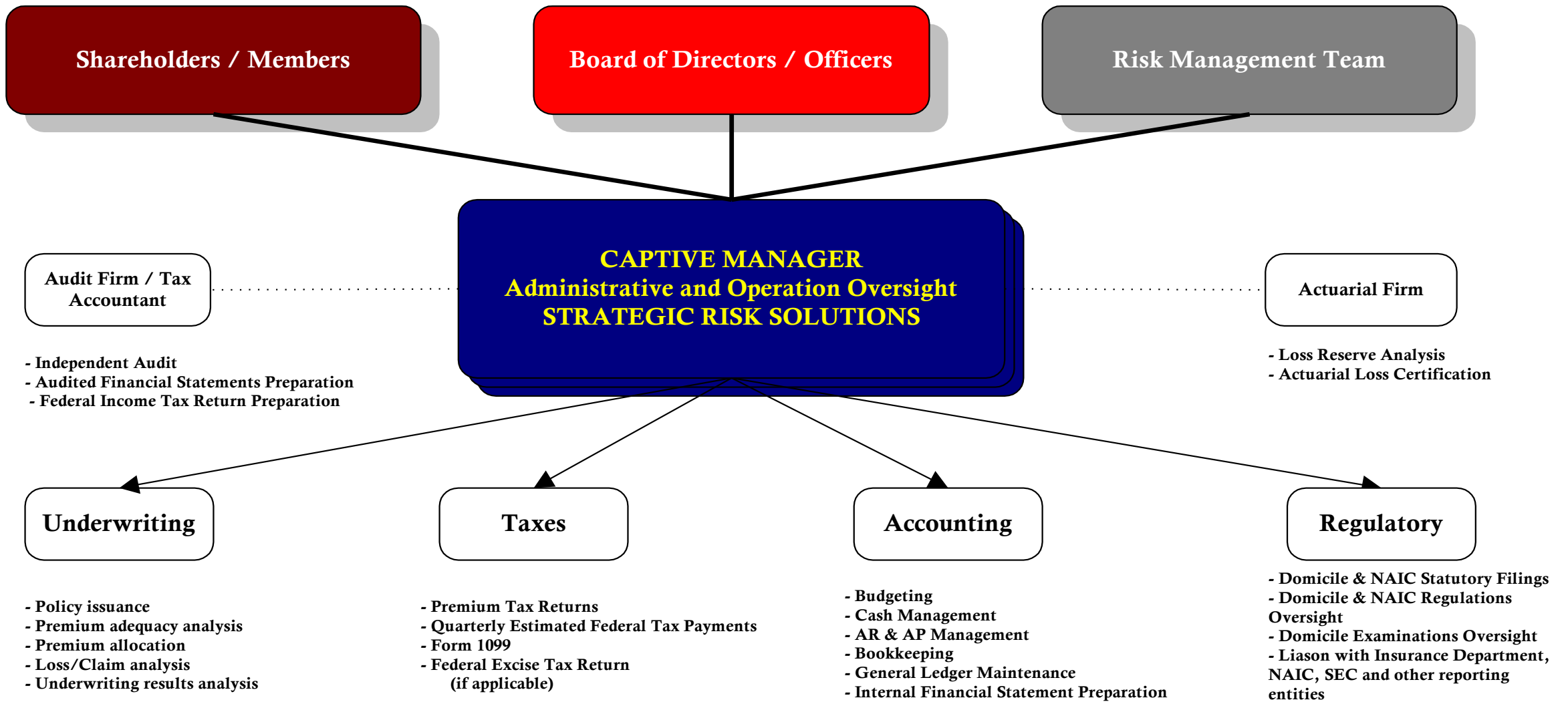
Service Providers

Feasibility, Development, Implementation, Ongoing Support

- Broker
 - Assist in policy coverage review
 - Support structure development
 - Issue certificates of insurance
 - Place reinsurance (if applicable)
- Captive Consultant
 - Advise on captive operations
 - Conduct strategic reviews & program assessment
 - Support coverage / Analytic modeling
- Actuary
 - Assist in rate-making and certification of balance sheet reserves
 - Analytic modeling

Operations

- Captive Manager
 - Back office support
 - Issue GAAP statements
 - Loss scorecards
 - Coordinate board meetings/insurance operations
 - Liaise between insured/owner and regulators
- Auditor / Tax Preparer
 - Conduct annual audit and tax filing
- Legal Counsel
- Third Party Administrator (Claims)
 - Assess, adjust, and settle captive claims
- Financial Institution / Custodian
- Investment Manager



Captive Management Structure

Typical Minimum Requirements

Annually:

- Board Meeting
- CPA Audit
- Actuarial Certification
- Regulatory Filings
- Premium Tax Return
- Federal Income Tax Return

Other:

- Business Plan Changes
- Regulatory Examinations

Industry Opportunities



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Your Questions



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