



The *Carnivale* of Risk

Captives: A View from the Ground Up

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public agency risk management association



Cast of Characters



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Agenda

Captive Basics

Investment Considerations

Captive Costs

Cost/Benefit Analysis

Implementation

The Law of Averages

“Future events are likely to balance any past deviation from a presumed average.”

→ Seldom will a year ever equal the average...

→ Some years results will be above average and others below average, so they tend to balance everything towards the average...

e.g. An actuary, an investment advisor, and two pool managers play a game of darts...



What is a Captive?

- What Is A Captive Insurance Company?
- Examples Of Captive Operations
 - CSAC – EIA (PRISM) → EIO (ARC)
 - University of California
 - ACWA, NBSIA, ASCIP, SDRMA
 - Montana Schools and Cities Pools
 - Nevada Pools

North Bay Insurance Group

Parent Organization: North Bay Schools Insurance Authority

Captive: North Bay Insurance Group

- Established: July 1, 2019
- Portfolio size: \$15 million
- What's in the captive:
 - Go forward losses (starting in 19/20)
 - Loss portfolio transfer 1/1/2022
(all outstanding losses)
 - Lines of coverage: Workers' Comp



California Water Insurance Fund

Parent Organization: Association of California Water Agencies
JPIA

Captive: California Water Insurance Fund

- Established: January 1, 2019
- Portfolio size: \$120 million
- What's in the captive:
 - Go forward (starting in 19/20)
 - Lines of coverage: Liability and Workers' Comp



California Water Insurance Fund

Why Use a Captive?

- Very Similar to Self-Insurance Model
 - Just a new way of doing the same thing you already do!
- Benefits of Captive
 - Flexibility in Coverage Options
 - Flexibility in Investments
 - Access to Reinsurance Markets
 - Low Regulation

Organizational Structure

- Organizational Structure Of A Captive
 - Stock Company
 - Mutual Company
 - Reciprocal
 - Not-for-profit (Typical Structure)
- Domicile For Captive Insurance Company
 - Many States are Potential Domiciles
 - Typically Utah (Low Cost, Experienced with Public Entity Captives)

Captive Management

- The primary function of a Captive Manager is to perform accounting and administration
 - Similar to accounting function performed by existing pool staff, but additional set of books to keep
 - Additional meetings and agendas to prepare
 - Completing annual report to state

Legal Counsel

- Local Legal Counsel is needed to:
 - Draw up original documents
 - Articles of incorporation and By Laws
 - IRS Sign-off for organizational structure
 - File documents with the insurance regulator and secretary of state
 - Retain for ongoing legal support
 - Attend annual captive meeting in state of domicile

Exposures

- Which Exposures Do We Place in the Captive?
 - All Years
 - Future Years (Baby Step)
 - Layers of Coverage (e.g., 3M x 2M)
 - Loss Portfolio Transfer

Inflation

It's Not That Bad...Is It??

Prices Are High



But...Some Prices Are Decreasing



Emphasize Stability



Put a Positive Spin on Increases



Investment Return

- One reason for considering a captive structure is flexibility in investments
- CA code requires bond only investment portfolio
- Current bond portfolio investment return expected to be less than 2% on average
 - Falling behind inflation!

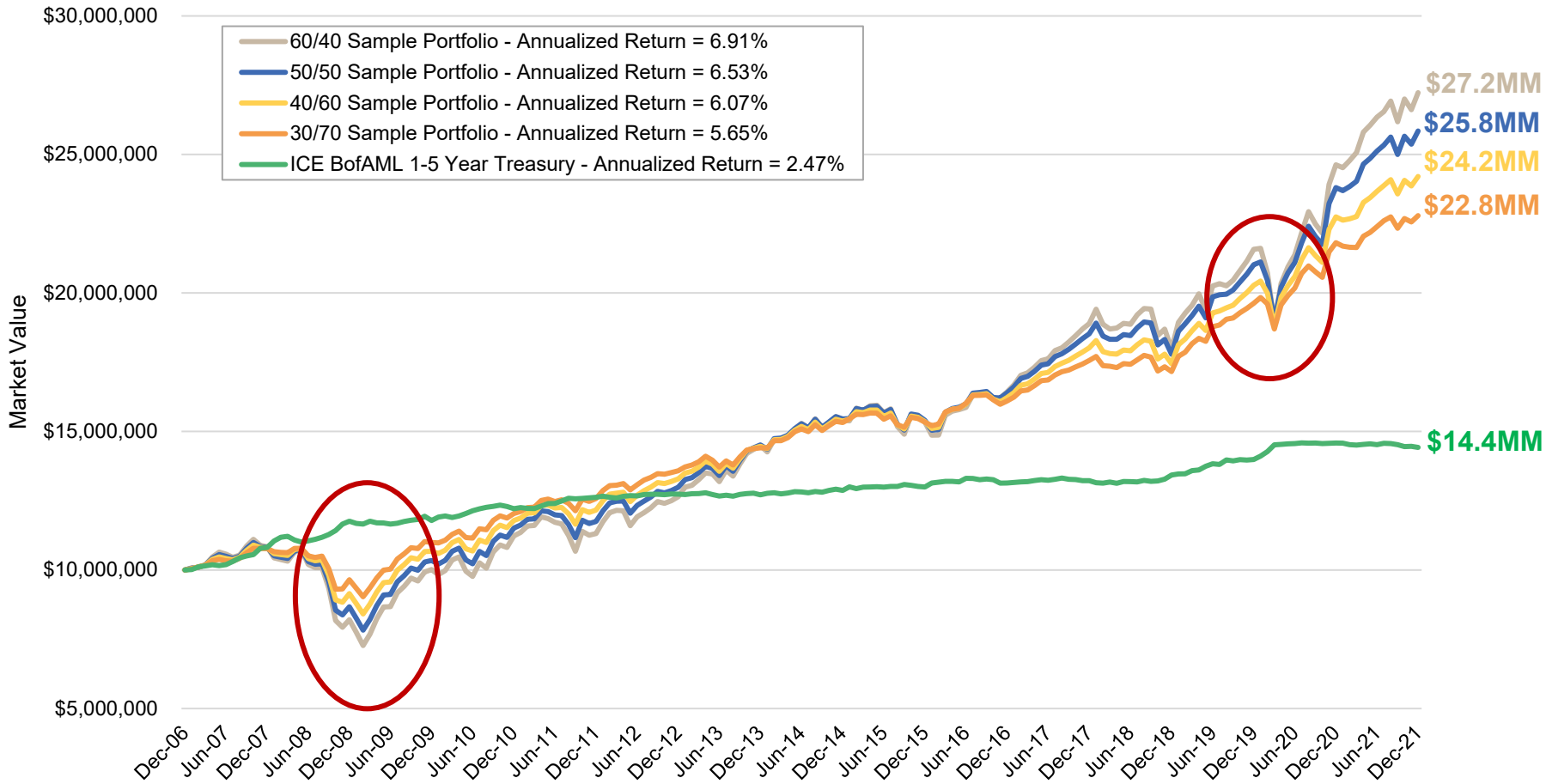
Captives Provide an Opportunity to Expand the Investment Universe

		Investment Authority
"Conventional" Fixed Income	U.S. Treasuries	CA Gov't Code
	Federal Agencies	CA Gov't Code
	Municipal Securities	CA Gov't Code
	Negotiable Certificates of Deposit	CA Gov't Code
	Prime Commercial Paper	CA Gov't Code
	Bankers' Acceptances	CA Gov't Code
	Medium-Term Corporate Bonds ("A" or Better)	CA Gov't Code
	Asset-Backed Securities (ABS)	CA Gov't Code
	Supranationals ("AA" or better)	CA Gov't Code
	Repurchase Agreements	CA Gov't Code
	Money Market Funds	CA Gov't Code
Local Government Investment Pools	CA Gov't Code	
Broader Fixed Income	Foreign Sovereign/Agencies	Captive
	Non-Agency MBS	Captive
	BBB and High-Yield	Captive
	Private Placements	Captive
	Convertibles	Captive
	Emerging Markets Debt	Captive
	Non-U.S. Dollar Investment Grade	Captive
	Bank Loans	Captive
Equities	Domestic Equities (Large Cap, Mid Cap, Small Cap)	Captive
	International Equities (Large Cap, Mid Cap, Small Cap)	Captive
	Emerging Markets	Captive
	Preferred Stock	Captive
	Equity Mutual Funds and ETFs	Captive
Alternatives	Commodities	Captive
	Real Estate	Captive
	Hedge Funds	Captive
	Private Equity	Captive

Source: California Government Code Section 53601.

A Comparison of Investment Strategies: Historic Growth

Growth of \$10 Million 15 Years Ending December 31, 2021



Looking Forward: Selected 2022 Capital Market Assumptions

		Expected Return (%)	
		Intermediate Term (5 years)	Long Term (30 years)
Equities	U.S. Equity	7.2	7.6
	U.S. Small Cap	8.8	8.0
	Developed ex-U.S.	7.5	7.3
	Emerging Markets	7.5	7.7
Fixed Income	Short Bonds	-0.1	3.0
	Core Bonds	-0.9	3.9
	Int IG Corporates	0.1	3.9
	High-Yield Corporates	2.4	5.0
Alternatives	Commodities	2.8	4.2
	REITs	6.3	6.6

Source: PFMAM's 2022 Capital Market Assumptions. Please contact your client representative if you would like more information or a copy of PFMAM's 2022 Capital Market Assumptions.

Accessing Expanded Investment Universe Increases Return and Risk

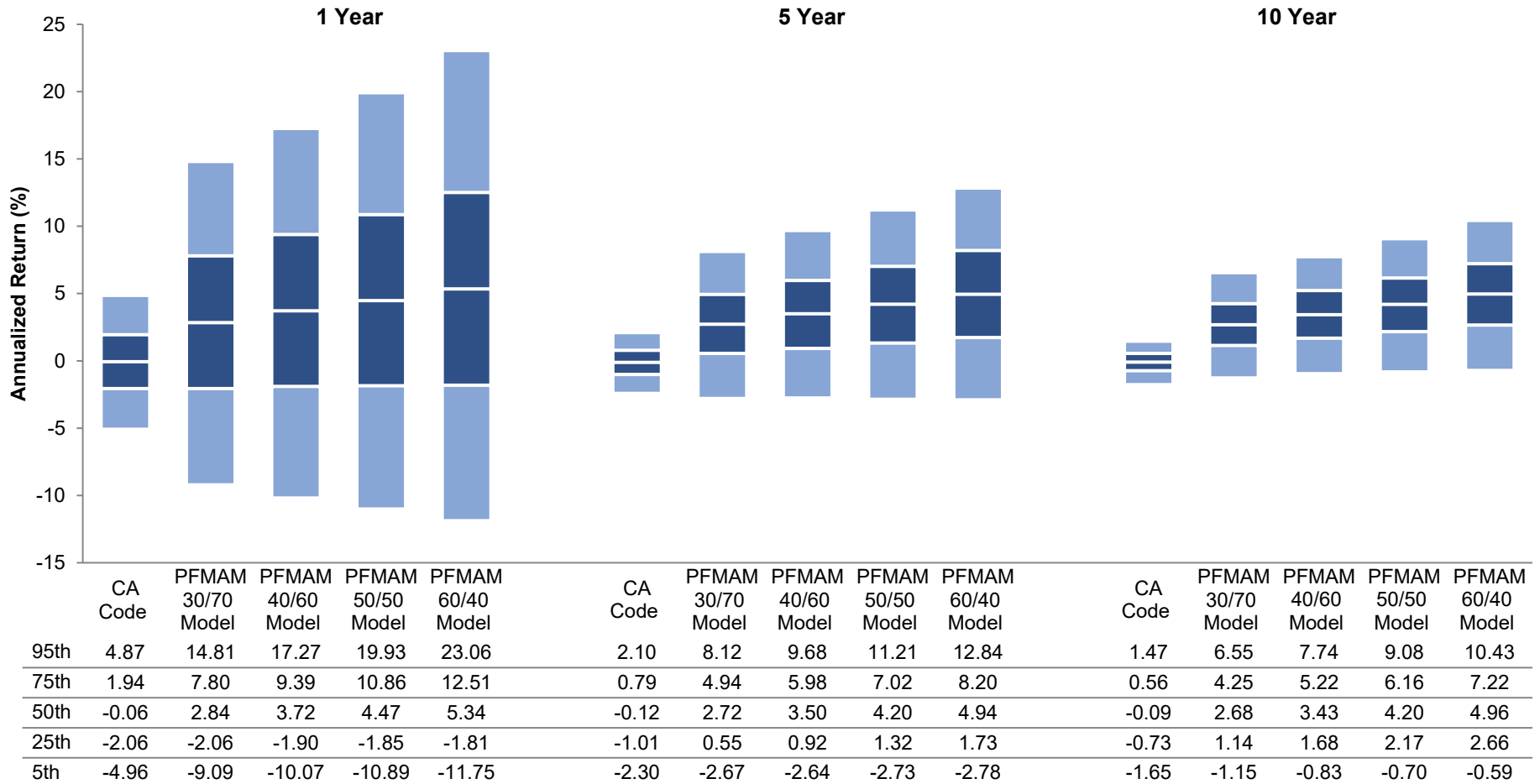
	CA Code	PFMAM 30/70 Model	PFMAM 40/60 Model	PFMAM 50/50 Model	PFMAM 60/40 Model
Equity	0.0%	30.0%	40.0%	50.0%	60.0%
Domestic Equity	0.0%	20.0%	26.0%	33.0%	39.0%
International Developed Equity	0.0%	7.0%	10.0%	12.0%	15.0%
Emerging Markets Equity	0.0%	3.0%	4.0%	5.0%	6.0%
Fixed Income	100.0%	70.0%	60.0%	50.0%	40.0%
Core Fixed Income	0.0%	35.0%	30.0%	25.0%	20.0%
Short-Term Fixed Income	100.0%	0.0%	0.0%	0.0%	0.0%
Investment Grade Corporate	0.0%	17.5%	15.0%	12.5%	10.0%
Emerging Markets Debt	0.0%	8.8%	7.5%	6.3%	5.0%
High Yield	0.0%	8.8%	7.5%	6.3%	5.0%

Intermediate-Term Assumption (5 Years)					
Expected Return	-0.1%	2.7%	3.5%	4.2%	4.9%
Standard Deviation	3.0%	7.3%	8.3%	9.4%	10.6%
Long-Term Assumption (30 Years)					
Expected Return	3.0%	5.5%	5.9%	6.3%	6.6%
Standard Deviation	3.0%	7.3%	8.3%	9.4%	10.6%

Source: CA Code Portfolio represents a diversified, high-quality 1- to 5-year portfolio in compliance with the requirements of the California Government Code.

Return Projections

Based on Intermediate-Term Capital Market Assumptions



About Investment Options...

- Including stocks in the investment portfolio increases the expected investment return by 2% - 5%
 - Including stocks in the investment portfolio also increases the risk
 - Returns will be more volatile from year to year, but historically, a mix of bonds and stocks has generated a larger return in the long run.
- This is a long-term option, not short-term!

Feasibility Study

The first step in the exploratory process is to perform a feasibility study

- Options for state of domicile
- Options for captive exposure
- Actuarial analysis of losses
- Estimation of captive costs
- Cost/benefit analysis

Captive Costs



➤ Start Up Costs

▪ Travel Costs (Regulator/Attorney)	\$ 1,400
▪ Application Fee	200
▪ Legal Incorporation Fees	10,000
▪ Consulting Fees	25,000
○ Total	\$36,600

➤ Continuing Costs (increase at 3% per year)

▪ Travel Costs (Annual Meeting)	\$4,900
▪ Annual Fee	6,375
▪ Actuarial Fees (Assumes one coverage only)	5,000
▪ Legal Fees	7,000
▪ Audit and Tax Fees	6,000
▪ Management and Program Admin	50,000
○ Total	\$79,275

Cost/Benefit Analysis



OPTION	ESTIMATED PREMIUM	REQUIRED SURPLUS
1. Work Comp Go-Forward	16,080,000	5,360,000
2. Work Comp Go-Forward and Tail	102,269,000	34,090,000

Option	Average Amount Invested	YEAR 1 ANNUAL INVESTMENT RETURN			
		2.0%	2.5%	3.0%	3.5%
1	\$9,840,000	\$197,000	\$246,000	\$295,000	\$344,000
		Excess over 2.0%	\$49,000	\$98,000	\$147,000
2	\$73,364,000	\$1,467,000	\$1,834,000	\$2,201,000	\$2,568,000
		Excess over 2.0%	\$367,000	\$734,000	\$1,101,000

Year 1 operating costs are \$80,875, Year 2-5 average \$63,725.

*Surplus Requirement is 33% of Annual Premium

What's Next??



OR



Green Light!

If we decide to proceed, what are the next steps?



Create a Company

- An insurance company needs to be created before we can do any kind of business.
 - Name Captive 😊
 - Determine Board of Directors
 - Subset of Executive Committee? Odd number preferred.
 - Include attorney (resident of state of domicile)
 - File paperwork with the Secretary of State
 - Local attorney takes care of all the paperwork

Select Vendors

- Vendors need to be selected for the basic functions of the Captive.
 - Captive Implementation Consultant
 - Actuary
 - Investment Advisor
 - Attorney
 - Auditor
 - Captive Management Firm
- Typically, existing vendors for the pool are used for the Captive as well.

Develop an Insurance Program

- An insurance program needs to be developed to define the purpose of the Captive.
 - Meet with regulators
 - Board of Directors complete Biographical Affidavits
 - Complete Captive Application
 - Develop Business Plan
 - Decide on exposure to place into the Captive
 - Determine Investment Strategy
 - Update Feasibility Study
 - Create Insurance Policy
 - File Paperwork with the Department of Insurance

Start and Run the Business

- Once approved, the administrative aspects of getting the Captive running must be completed.
 - Set up bank and investment accounts
 - Develop accounting procedures
 - Fund Captive with required capital
 - Collect Pool Premium (Loss Premium and Expense Premium)
 - Keep portion of Loss Premium with Pool for cashflow needs
 - Transfer remaining Loss Premium to Captive
 - Invest premium in Captive according to Investment Strategy
 - Pool pays claims from cash funds
 - Captive reimburses Pool for claim payments
 - Captive Board of Directors meets regularly

Questions? Reach Out!

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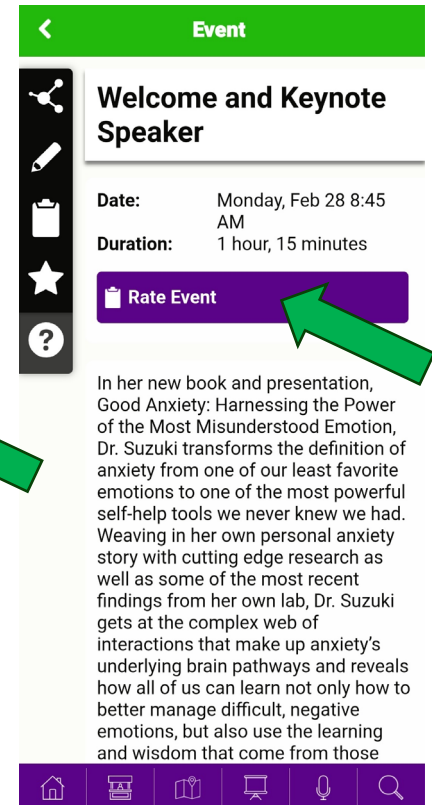
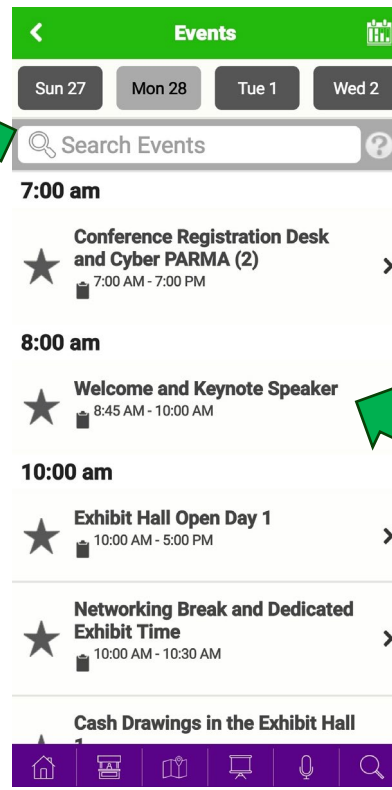
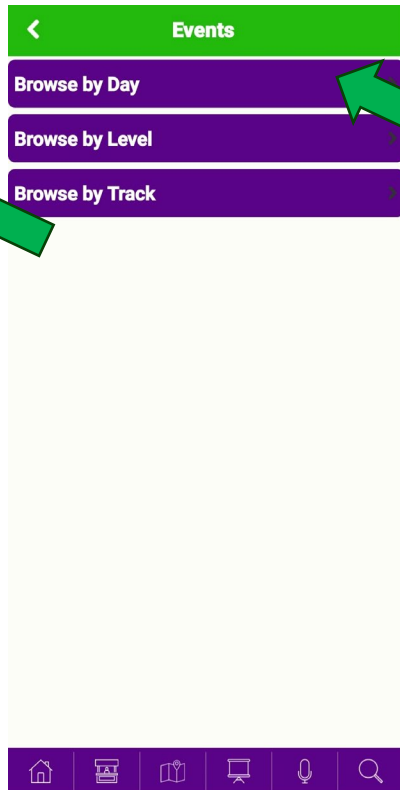
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