
Captive Insurance and Municipalities



Introductions of Speakers



Ward Ching

Ward is currently a Managing Director with Aon's Commercial Risk Solutions and Insurance Managers Group in San Francisco. Ward has over 30 years of C-Suite management consulting, insurance risk management, and insurance brokerage focused on defining and implementing enterprise risk management solutions for Fortune 500 Corporations. Ward is an Adjunct Professor at the University of Southern California teaching Risk Management and Insurance at the Undergraduate academic level. He earned his BA, MA and Ph.D (ABD) in International Relations and Economics from the University of Southern California.



Kyle Powell

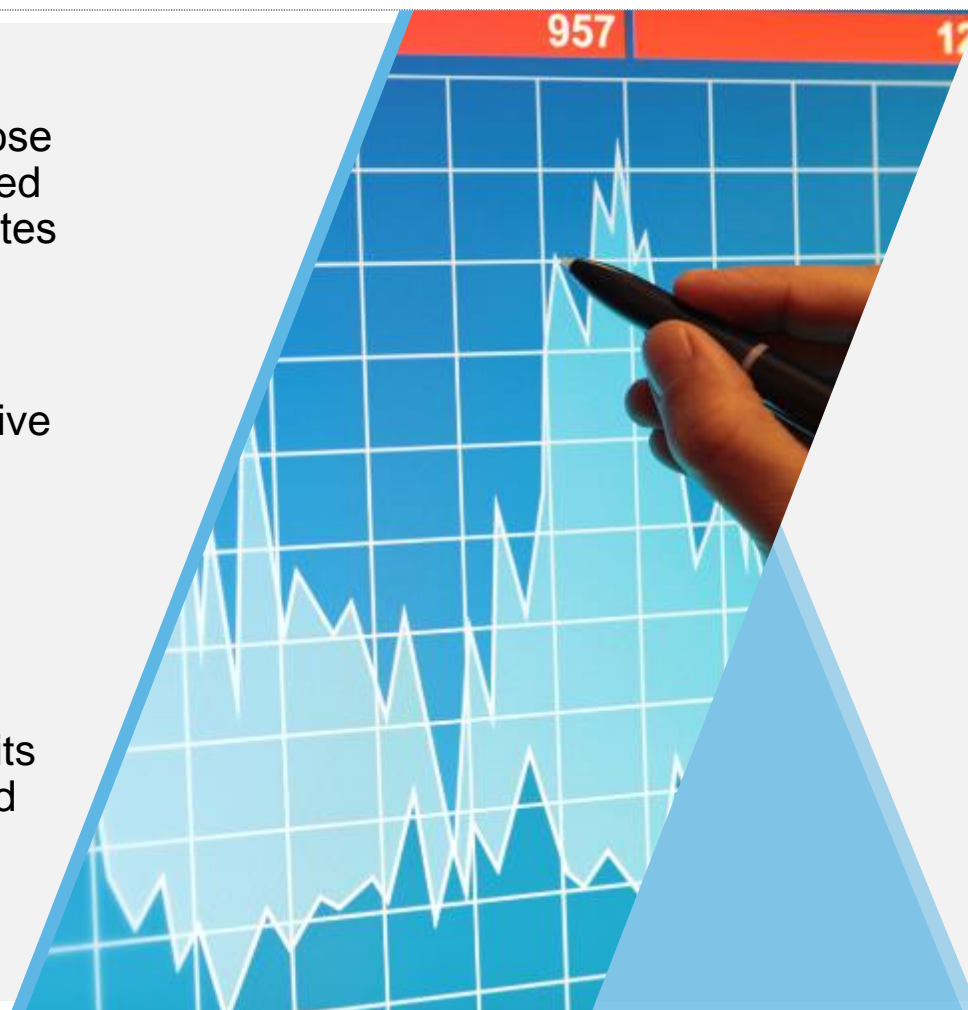
Kyle is an Account Executive within Aon's Public-Sector Practice in Los Angeles. In this role he is responsible for day to day contact with insureds as well as finding risk solutions for various clients. Prior to joining Aon in 2016, Kyle served as a public entity property underwriter for 3 and a half years as well as a public entity building appraiser. He first began working in the industry in 2011 and has an Associates in Risk Management from the Institutes as well as a BA in economics from Arizona State University.

What is a Captive?

Definition...

“Closely held insurance company whose insurance business is primarily supplied and controlled by it’s owner and affiliates who are its principal beneficiaries”

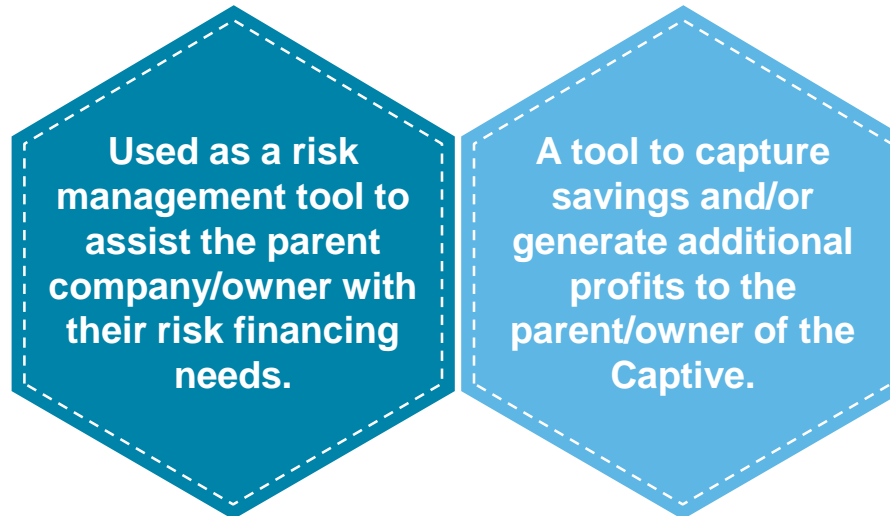
- No legal distinction between a captive and an insurance or reinsurance company
 - *BUT they are regulated under special legislation in the U.S. or offshore*
- May insure or reinsure the risks of its owner, affiliated parties or unrelated parties



What is a Captive? (cont'd)

A captive functions like a regular commercial insurer by:

- Issuing policies to the policyholders (the parent, affiliate, etc.)
- Collecting premiums
- Disbursing claim payments
- Preparing balance sheets and income statements
- Complying with the regulatory requirements of the jurisdiction in which it is domiciled



Types of Captives

Single Parent

A captive insurer owned by one company that inures all or part of the loss exposures of that company or its subsidiaries

Group Captive

A captive insurer owned by a group of companies, usually operating similar businesses, rather than a single parent

Association Captive

A group captive sponsored by an association

Risk Retention Group

A group captive formed under the requirements of the Liability Risk Retention Act of 1986 to insure the parent organization

Agency Captive

A type of group captive that is owned by insurance agents or brokers rather than by the organizations insured

Rent-a-captive

An arrangement under which an organization rents a captive, to which it pays premiums and receives reimbursement for its losses

Protected Cell Company

A corporation entity separated into cells so that each participation company owns an entire cell but only a portion of the overall company

Captive Benefits

Achieve Cost Savings

- Captures insurer profits
- Acceleration of tax deductions
- Global cash management
- Improved claim control
- Potential accelerated cashflow and tax benefits

Support the current program

- A captive can facilitate the negotiation during the renewal process and support the insurance program where needed
- Reduces the dependency on commercial markets
- Direct access to reinsurance markets
- Influence program design and cost

Greater control & flexibility

- Protect the budget of smaller subsidiaries
- Provides insurance coverage in fluctuating insurance cycles = price stabilization
- Provide insurance coverage for a variety of risks
- Central access to loss data and reserving practice
- Claims handling control
- As a separate subsidiary of the business, focuses senior management attention on risk

Capture revenue opportunities

- Offer insurance products with material revenue generating potential
- Re-engineer existing relationships with carriers to capture a greater share of the profits

Disadvantages

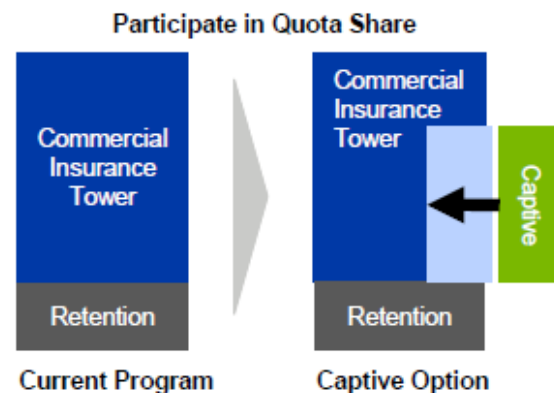
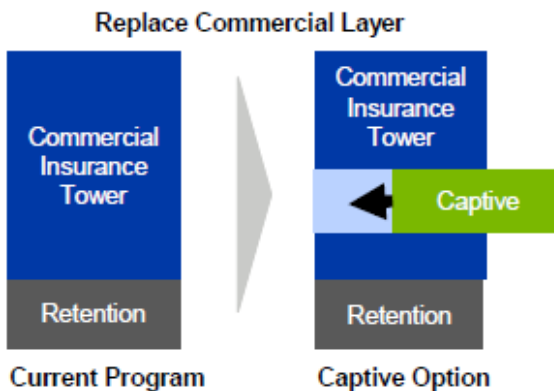
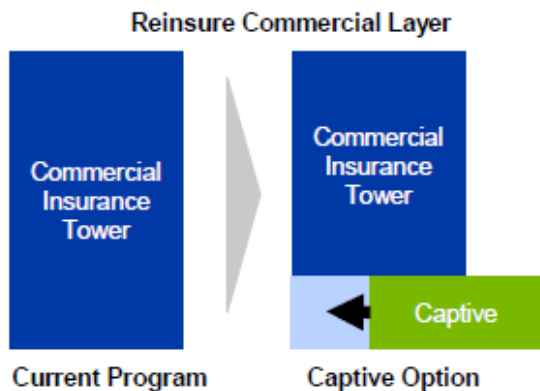
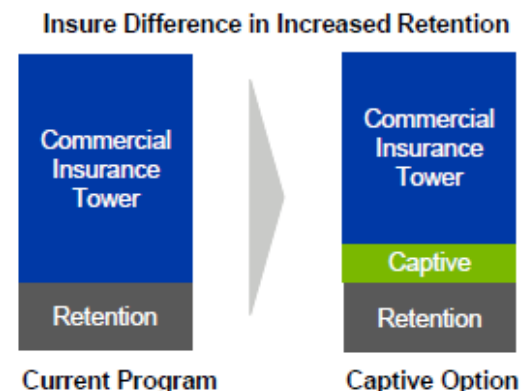
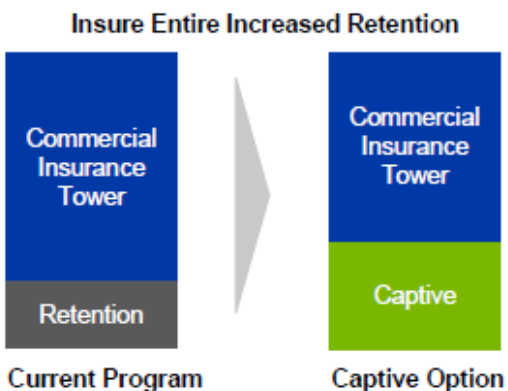
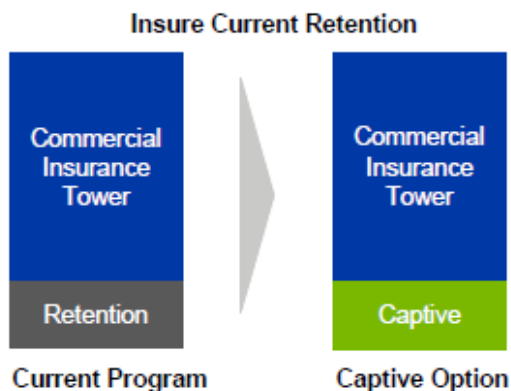
- Frictional costs;
- Increased regulatory requirements;
- Risk(s) to be insured may be inappropriate for retention;
- Poor early loss experience
- Increased management oversight;
- Lost opportunity cost of capital
- Exit strategies can be lengthy and complex;
- Up-front capital investment; and
- Potential for inadequate loss reserves.

When Might a Single Parent Captive Make Sense?

- Insurance program for the captive is of significant premium size – (At least \$1m)
- Good and Predictable historical loss experience
- Good loss control programs in place
- Insured's loss expectation is lower than traditional insurance market
- Insured's risk is unusual and is often misunderstood or poorly coded by carriers
- Insured's exposures not otherwise available in the traditional insurance market
- Insured is seeking a profit center using insurance to generate an income stream
- The insured is looking for tax benefits similar to commercial insurance expenses

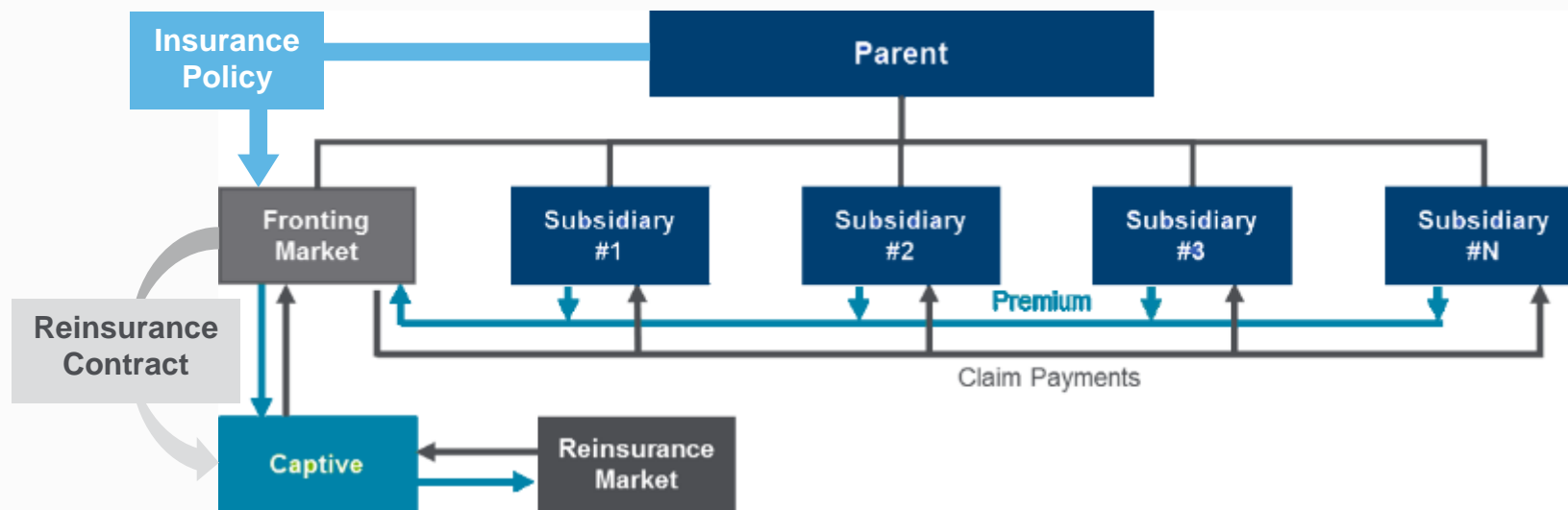
Fitting a Captive into a Regular Insurance Program

Any combination of structure options could be utilized by Municipalities to insure its risks in a captive:



Mechanics of a Captive – Via Fronting

- Certain classes need to be insured by licensed insurance companies, rather than a captive
- A fronting carrier is used to act as a conduit into the captive



Potential Lines for Consideration

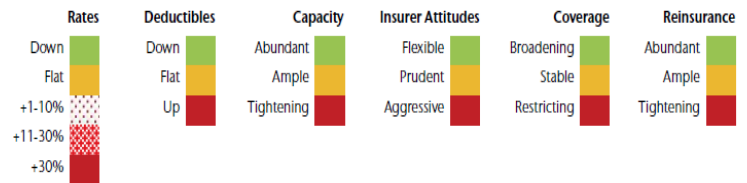
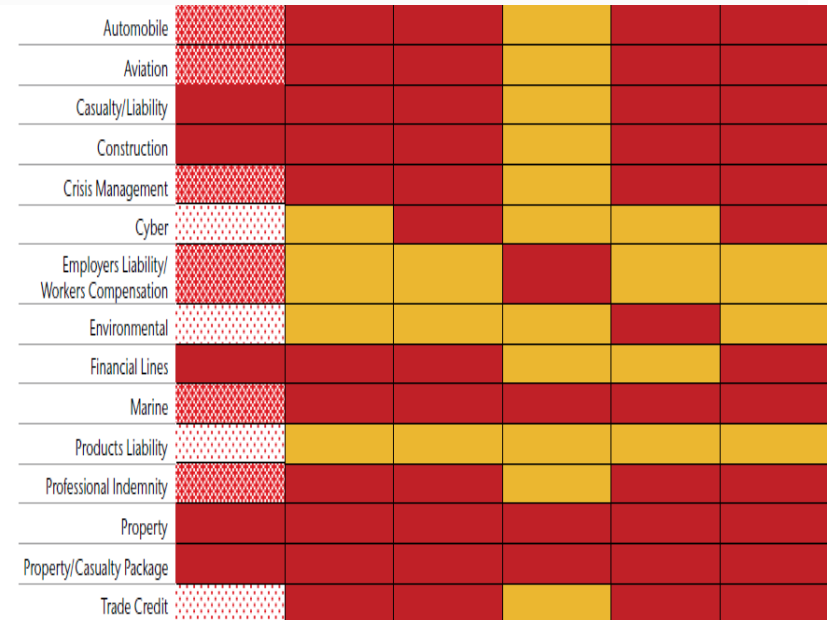


Examples of Potential Lines of Business in a Captive

- **Property and Business Interruption**
 - Asset All Risks
 - Terrorism
 - Business Interruption and Contingent BI extensions
- **Casualty**
 - Deductibles/Retentions
 - Workers' Compensation
 - General Liability
 - Auto Liability
 - Umbrella/Excess Layers
- **Employee Benefits**
 - Medical Stop Loss
 - Elective Benefits
- **Third Party Programs**
 - E.g. Extended Warranty
- **Emerging Risks**
 - Cyber
 - Brand/Reputation
 - Intellectual Property
 - Supply Chain

Why A Captive Now?

- Insurance is hardening
- Premiums are increasing
- Capacity is reducing
 - Some insurers will write smaller limits or be more selective
- Some clients will have trouble obtaining insurance
 - High risk industries
 - Companies with adverse loss history
 - Companies in areas exposed to catastrophic losses
- **A captive can provide options**
 - Leverage by providing an alternate to the commercial options
 - Additional capacity
 - Manuscript wordings
 - Ability to retain underwriting profits
 - Financial advantages



Feasibility Study



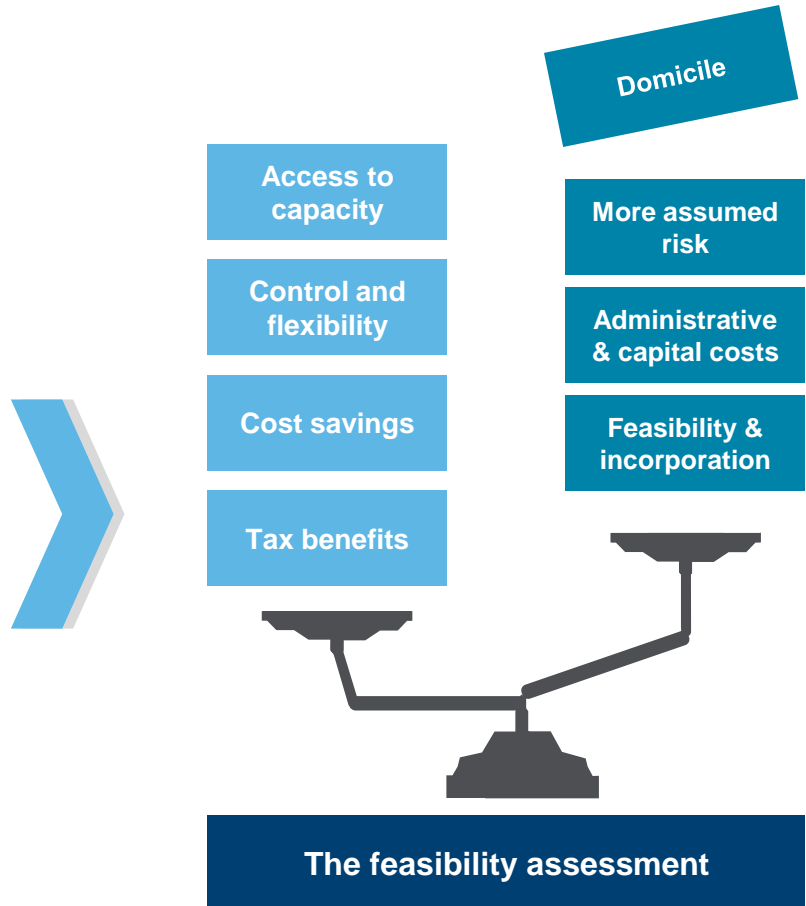
Feasibility Study: A Cost-Benefit Analysis

Primary Benefits

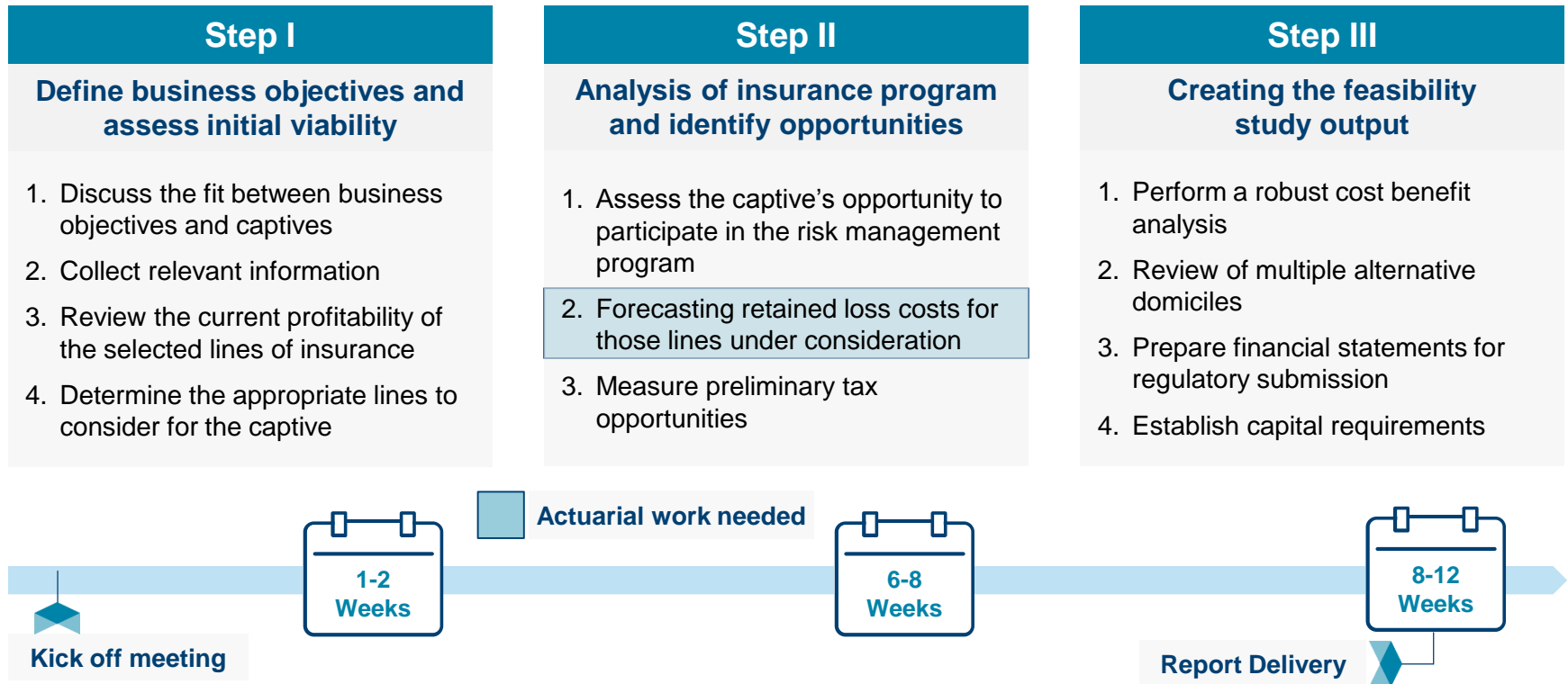
- 1 Save premiums / access reinsurance capacity
- 2 Greater control & flexibility
- 3 Material costs savings
- 4 Tax benefits

Key considerations

- 1 Alignment with the risk appetite and risk bearing capacity
- 2 Assessment of the additional capital tied-up in the new entity
- 3 Assessment of your incorporation costs and ongoing administration costs.
- 4 Selection of optimum domicile



Typical Feasibility Study Process & Timeline



Data Requirements

General Information

- Understanding of Municipalities risk management and risk financing philosophy;
- Appreciation of management's understanding of Municipalities overall risk appetite;
- Description of organization legal and tax structure, including operating entities and taxable status;
- Key Financial decision criteria:
 - Weighted Average Cost of Capital ("WACC");
 - Details of Net Operating Loss carry forwards, etc.;
 - Letter of credit costs, short term unsecured borrowing rates and effective tax rates (state and federal, and if impacted by net operating loss carry forward); and
 - Any financial performance objectives, etc.

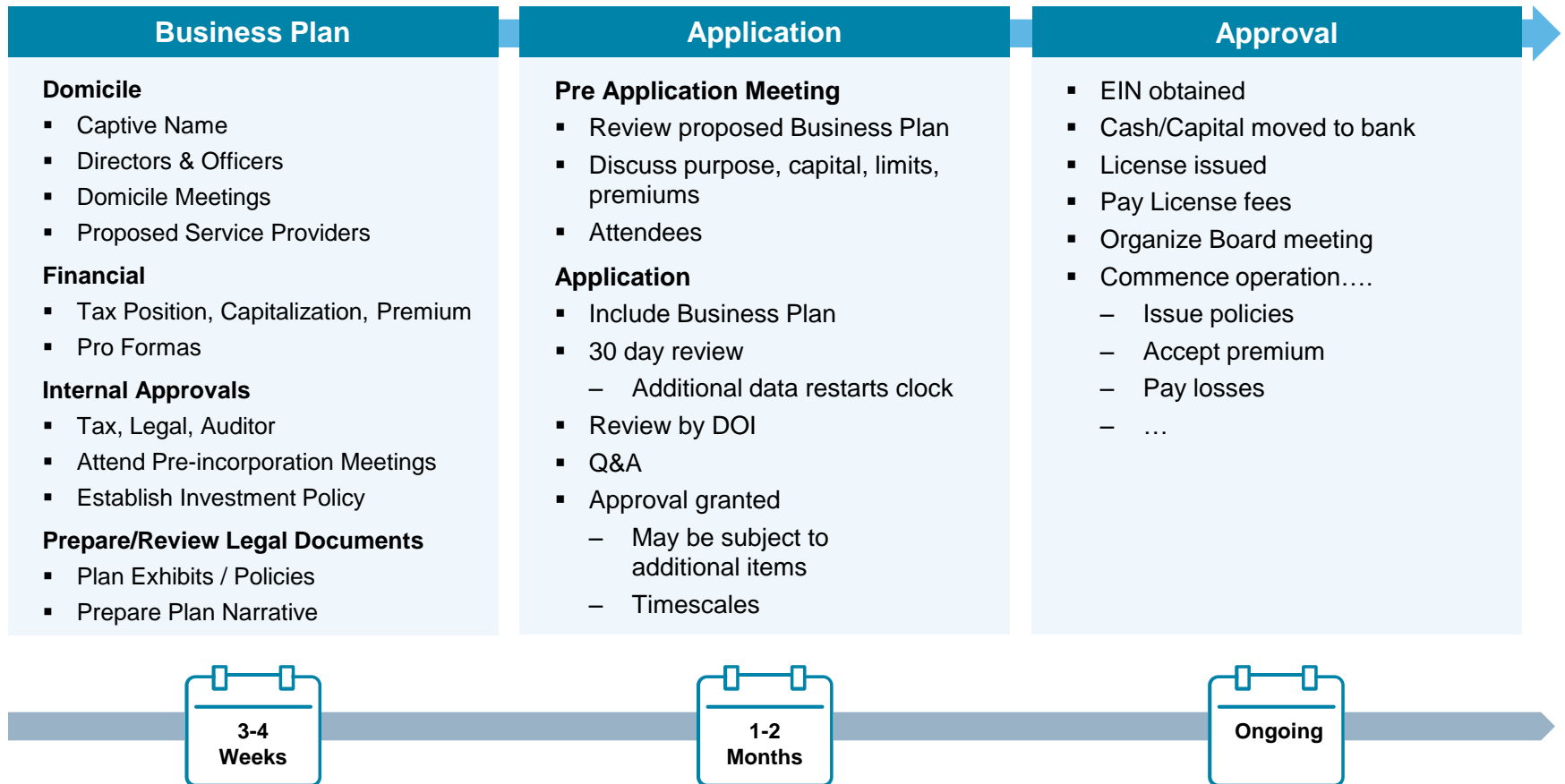
Loss and Exposure Information

- Five or more years of detailed loss history for each line of business under consideration
- Five or more years of exposure information mapped to the corporate legal and tax structure;
- Any actuarial analysis of exposure information that may be available for the lines under consideration;
- Current details for each policy under review, including limits, retentions, and premiums; and
- Information about any recent risk management initiatives (e.g. accelerated claims closure, loss portfolio transfer) that should be considered when reviewing historical claims data.

Captive Formation



Route to Captive Implementation and Operation



Captive is Live!



Outsourced Service Providers

Auditor

- Annual audits as required by local regulation
- Current audit services at the parent level may be extended to the captive
- All large multinational firms have a presence in major captive domiciles

Actuary

- Engagement of a loss reserve specialist in respect of the captive's loss and loss expense provisions is mandatory in some jurisdictions

Claims Management

- A captive is required to manage claims that occur within its share of retained risk
- This is usually outsourced to a TPA

Municipality

Captive Manager

- Financial Accounting/Management
- Insurance Services
- Compliance Services
- Cash Management
- Board Meeting Services

Investment Manager

- Long-term and more aggressive investment strategies should be developed by a professional investment manager
- Management of short term investments can be provided by the captive manager or in-house

Fronting and Partner Insurer(s)

- A fronting insurer may be required to issue a local policy where legislation requires it

Captive Management

Once a Captive is live, the below functions will need to be thought out to run the captive.

Finance Officer + Accounting Support Personnel

- Internal financial reporting
- Budgets and forecasts
- Statutory audit
- Cash receipts and disbursements
- Investment reporting
- Monitor investment strategy
- Underwriting results
- Actuarial review and support
- Liaise with tax advisors

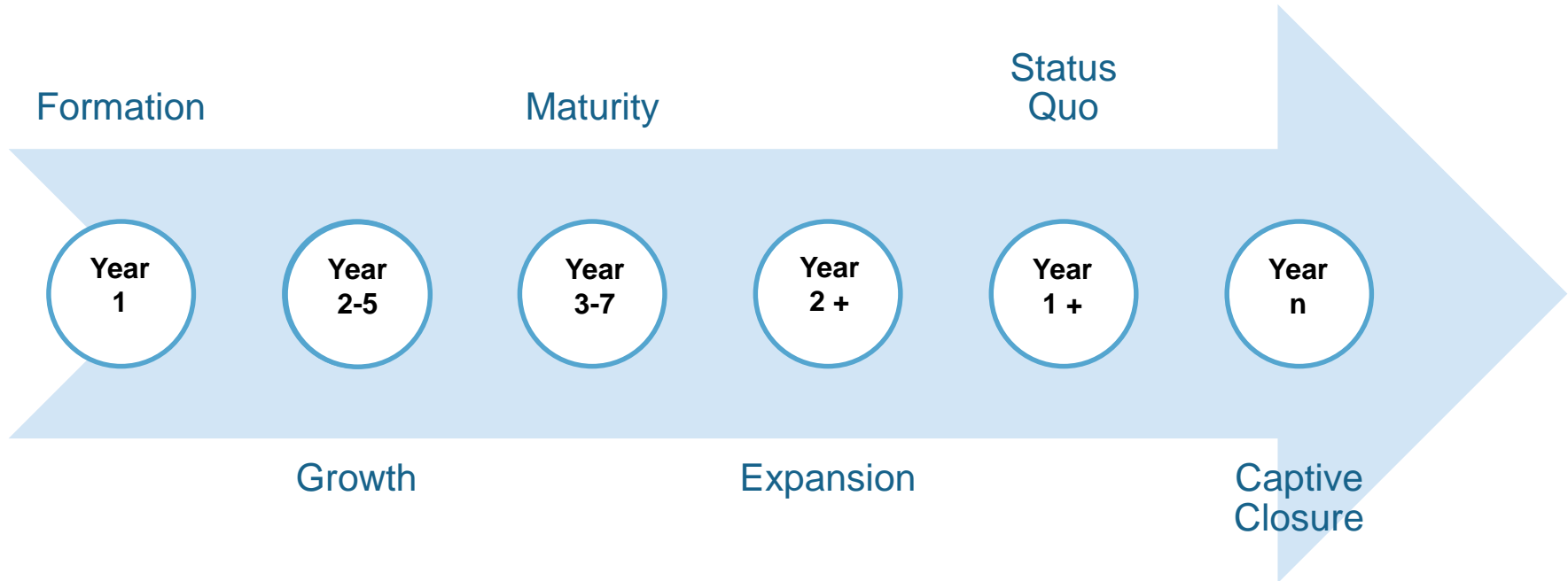
Regulatory Compliance Officer

- Handle financial reporting to regulators
- File premium tax returns
- Liaison with captive regulators
- Provide legislative updates
- Oversee corporate governance
- Fill resident director requirement if needed

Insurance Officer + Admin Support Personnel

- Provide insurance renewal support
- Draft and issue policies
- Compile and review any reinsurance agreements
- Prepare premium invoices
- Collect and pay premiums
- Assist in claims handling and payment processes as necessary
- Assist in reinsurance recovery process

Captive Lifecycle



Captives and Municipalities



How would a Captive benefit a Municipality?

Capacity

Wholly owned private Insurance Company

Will be a non-profit corporation

IRS Section 115 (Gross income exemptions)

Provides insurance coverage in fluctuating insurance cycles = price stabilization

Reduces the dependency on commercial markets

Direct Access to reinsurance markets

Cures market dislocation due to “best terms” requirement on quota-share placements

Structure Retained Risk Strategy

Greater structure and control over risk management and financing

Continuity and breadth of insurance coverage

Reduced volatility on insurance spend

Optimize cost benefit in retention versus transfer

Formalized Funding Vehicle

How would a Captive benefit a Municipality? Cont.

Risk Management and Control

Influence program design and cost

Central access to loss data and reserving practice

Claims handling control

Increase management awareness of risk management initiatives & the total cost of risk

Potentially reduced expense ration when compared to guaranteed cost options

Direct Financial Benefit

Wedge in market negotiations

Captures insurer profits

Cash management

Better use of capital to retain risk than transfer it

Direct control of investment income

What are disadvantages for a Municipality?

Disadvantages

Barrier to Entry for midsize to small Municipalities (up front costs)

How to budget for this large up front costs

Changing Municipal Budgets (especially now)

Can be difficult Politically to show immediate cost savings (takes a few years to see benefits)

Captives are subject to rules and regulations of where they are domiciled. This carries the risk of when there is insolvency of the captive, the municipality can be beholden to those rules and regulations.

Next Step for Municipalities who are ready to set up a Captive?

- Business Plan
 - Detail initial steps
 - Determine which type of captive to use
 - Initial set-up, including state regulations
 - Funding requirement
 - Operation procedures
 - Governance
 - Board of Directors
 - Management



Business Plan for a Captive

Organizational History

Maximum retained risk

Reinsurance of risk

Business flow chart

Feasibility Study

Biographies



Discussion

Thank You...

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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