

CAPTIVE
INNOVATIONS
Thinking Differently

2023

CAPTIVE 101

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Agenda

Introductions

Risk Philosophy

Captive Basics

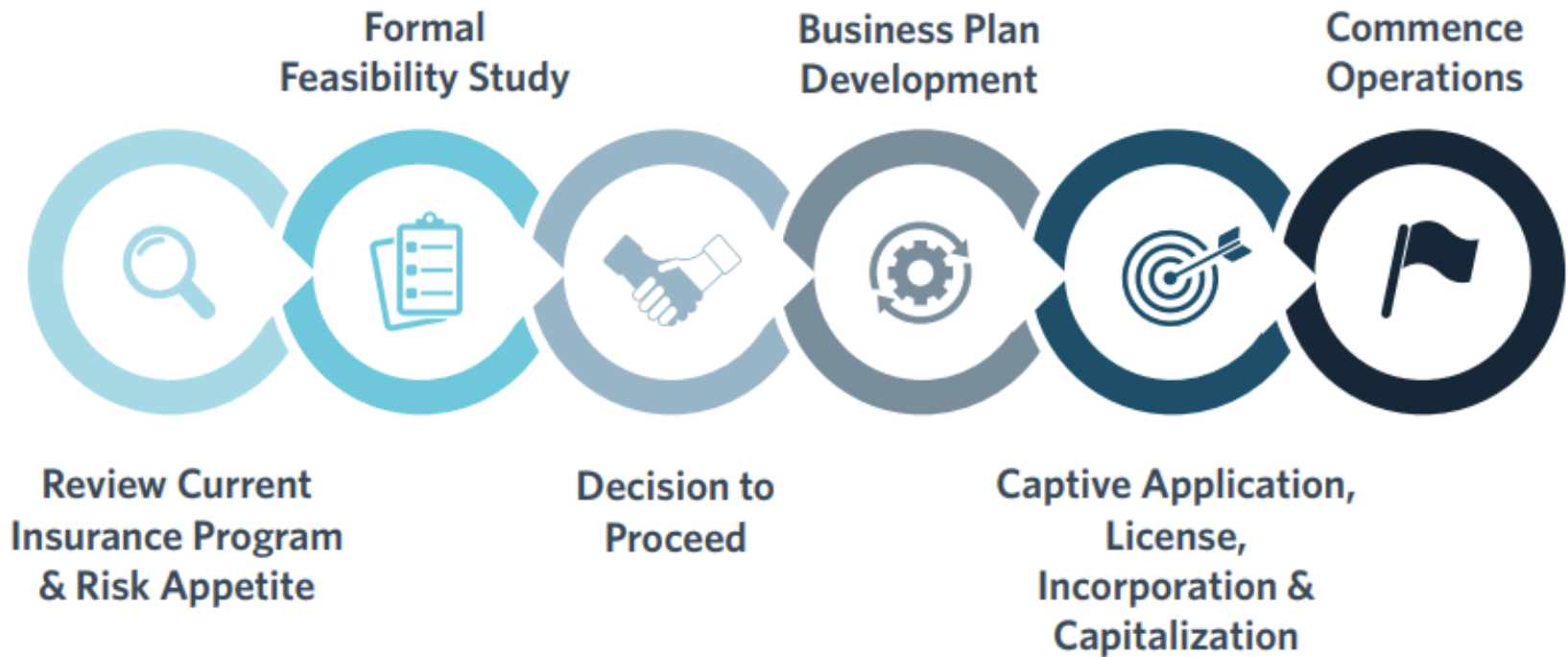
Captive Program Structures

The Captive Journey

Closing Thoughts / Q&A



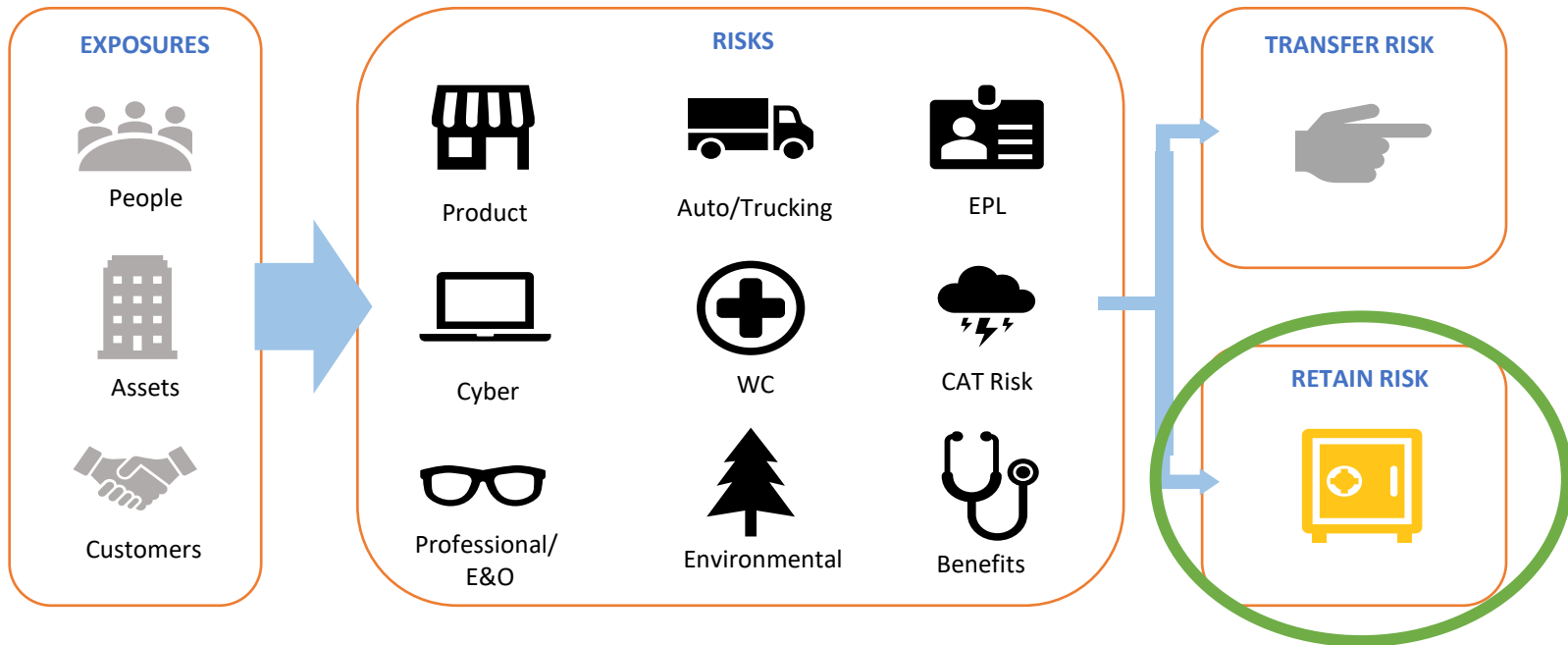
Please ask us questions throughout....



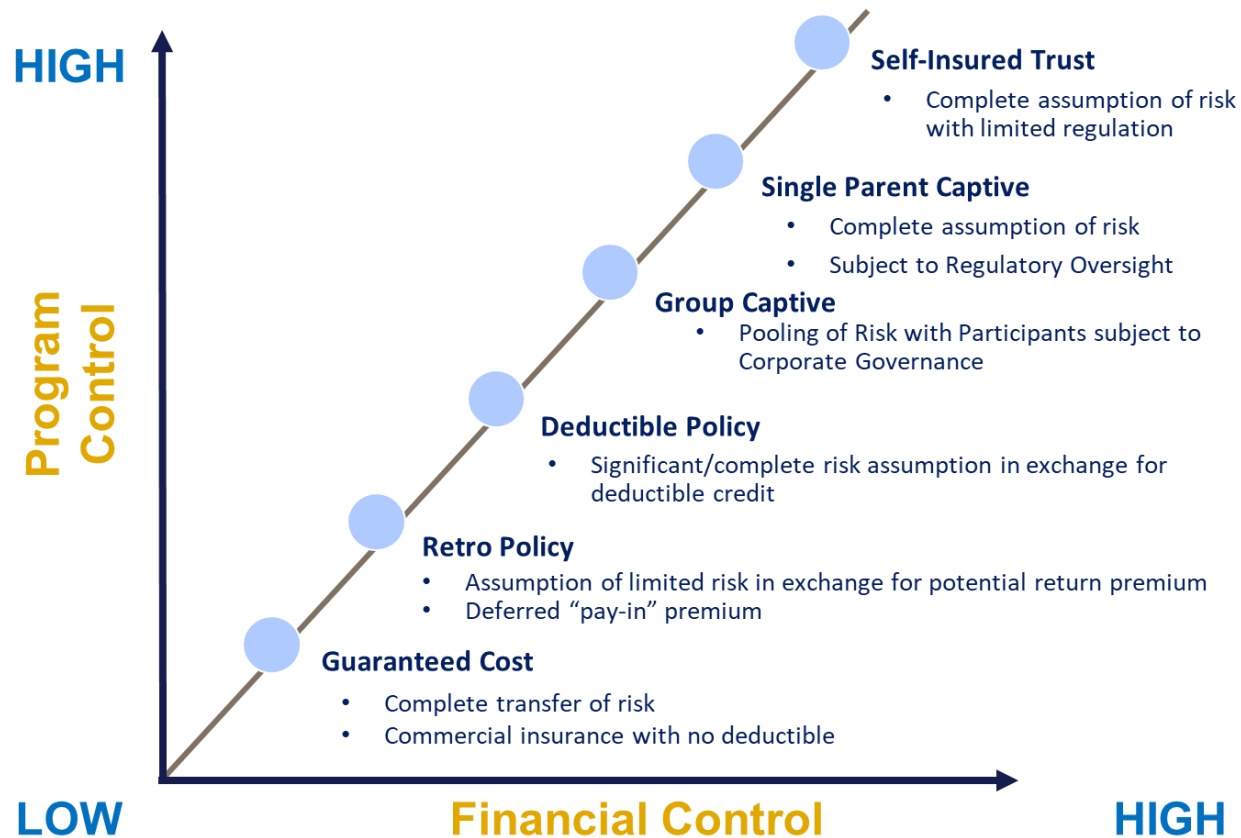


Risk Philosophy

Risk Transfer v. Risk Retention



Risk Appetite and Tolerance Spectrum



Determining Your Risk Tolerance

Measured as a % of:

Retained Earnings

EBITDA

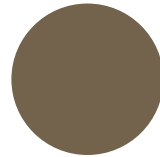
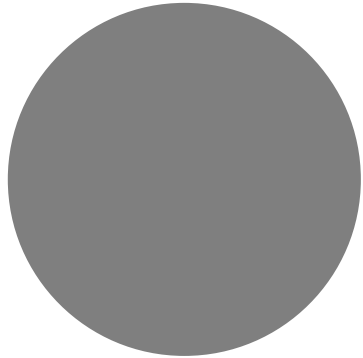
Net Cash Flow

Unique

Industry/Organization KPIs

The ultimate decision is tempered by individual company philosophy, risk tolerance, business development goals, shareholder expectations, etc.





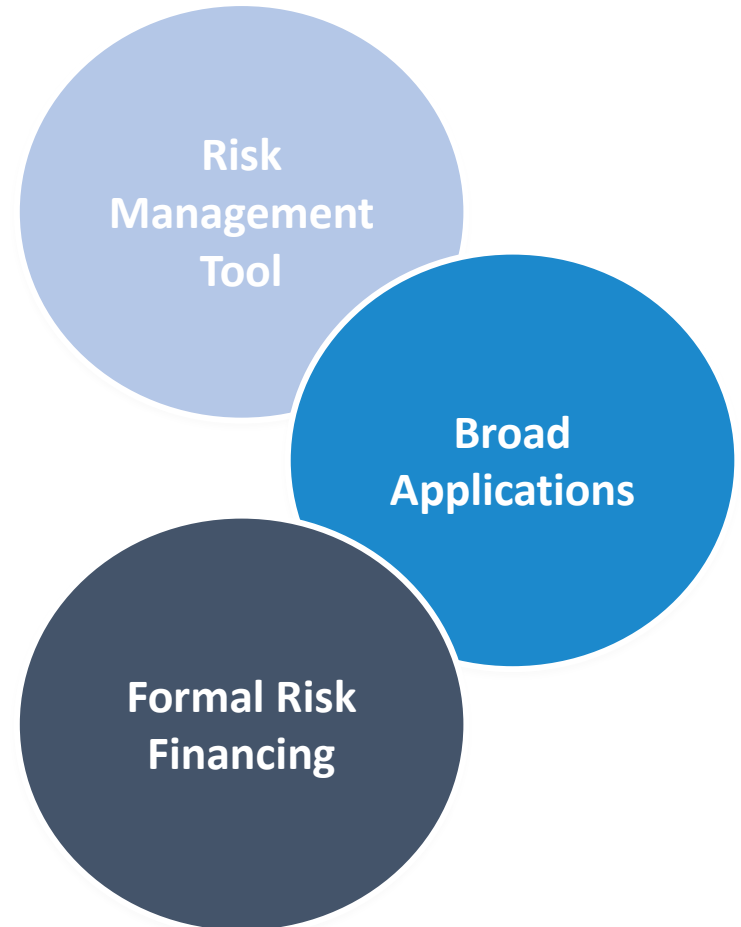
Captive Basics

What is a Captive?

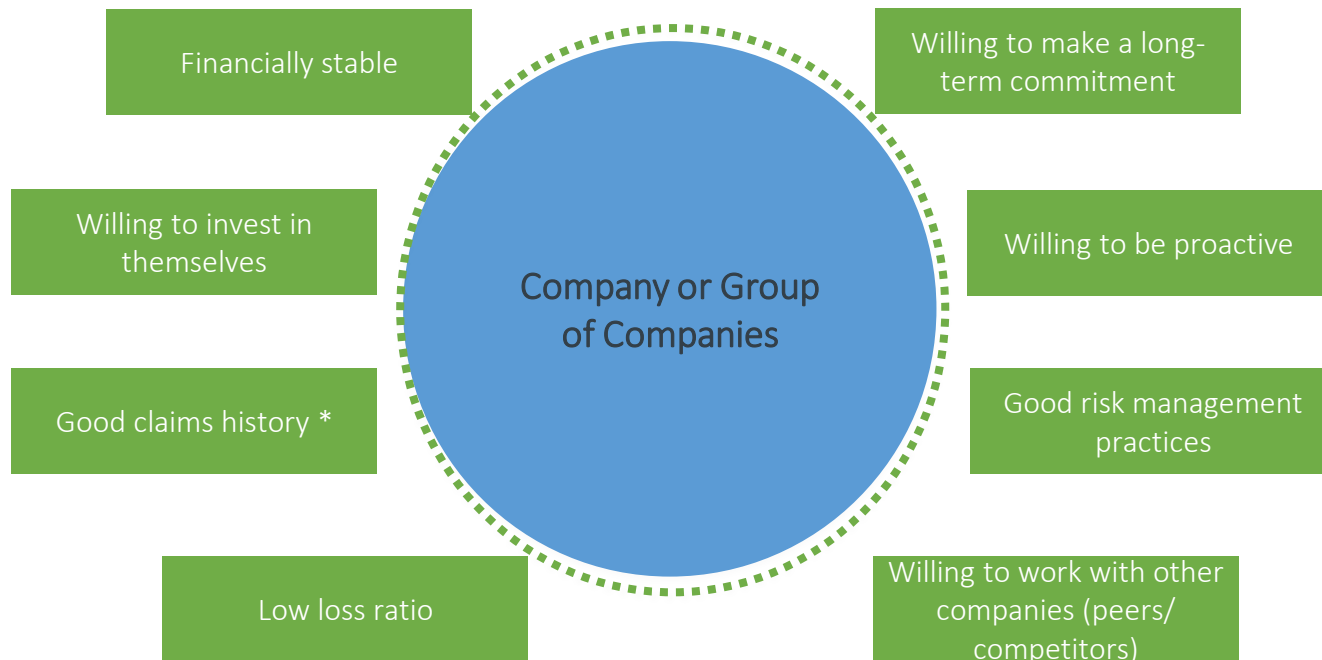
A **licensed insurance company** owned and controlled by those it insures

Insures or reinsures the risk of its parent(s) or affiliated companies

Formalized mechanism to finance **self-insured risk**



Who Should Consider a Captive?

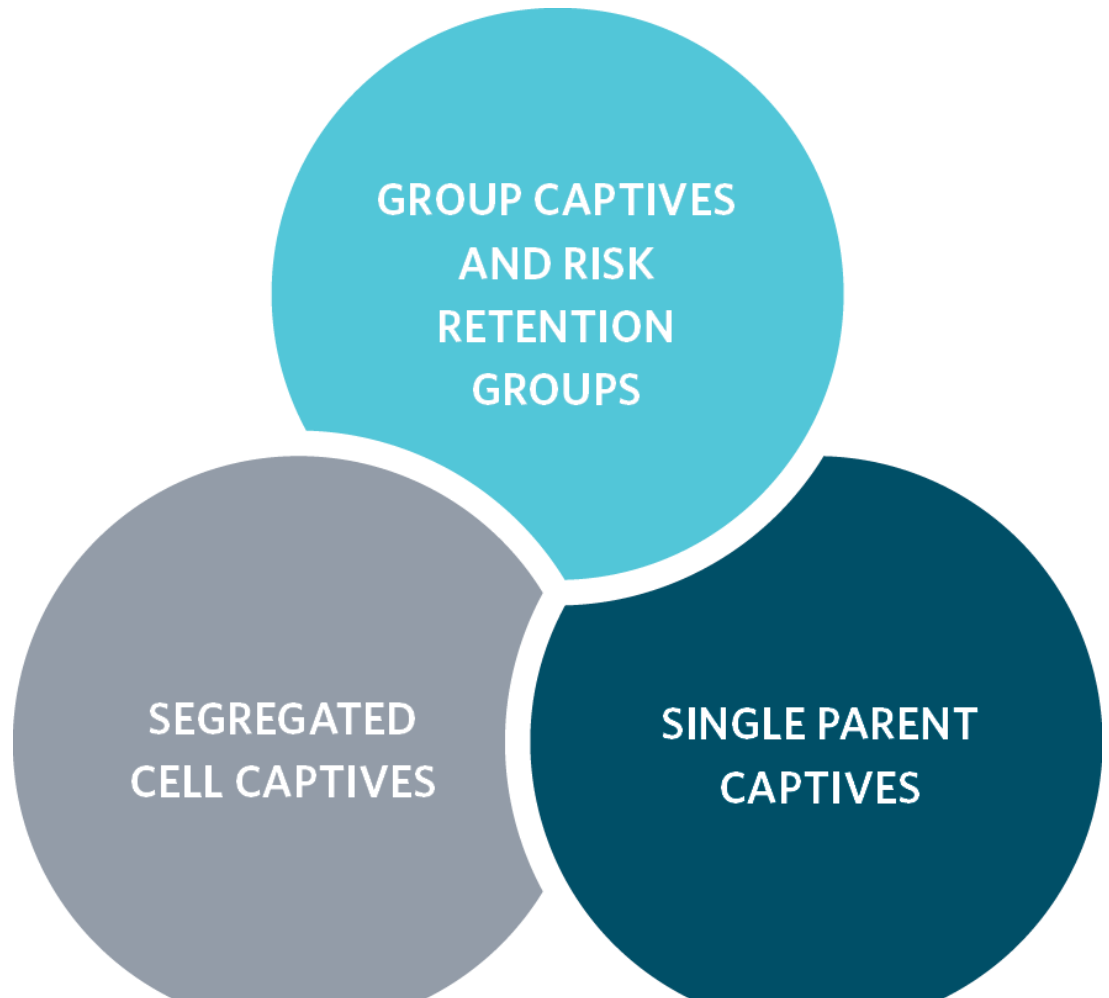


Why are Captives Formed?

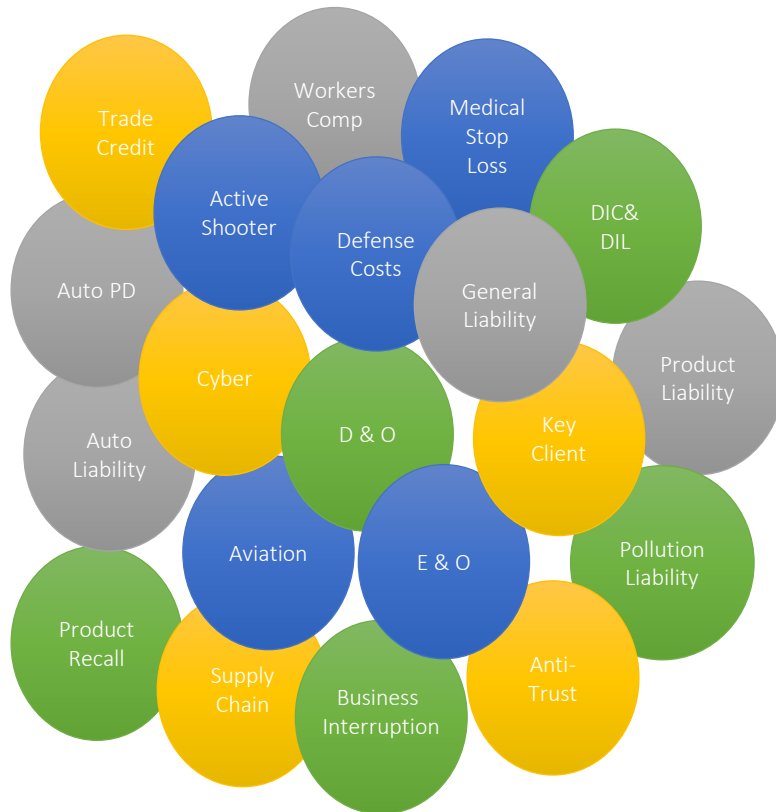


Types of Captives

Which option is best for you?



Current Trends in Captives



DIC/DIL Policies

Trade Credit

G/L and Products

Auto Liability & PD

Property

Executive Risk

Medical Stop Loss

Voluntary Benefits

Benefits of Captives



Financial

- Reduce total cost of Risk
- Potential short- and long-term savings
- Financial reward for being better-than-average
- Cashflow - Capture investment returns
- Reduce frictional costs
- Remove traditional insurer's profit loading
- Potential profit center



Control

- Access to capacity
- Claims management
- Ability to better manage premium volatility from year-to-year
- Power to reduce costs over time by controlling losses
- Be rewarded for good loss prevention and claims management



Flexibility

- Ability to craft coverages to meet specific insured's needs and enable organizational strategy
- Options for customized value-added services
- Insulated from market conditions; address insured needs, not the insurance market

Considerations



- VARIATION = Incurring unexpectedly large losses
- Compliance issues
- Meeting and maintaining capital requirements
- Competing uses for available capital
- Accessing capital for competing needs
- Distributing profits
- Winding down program
- Restrictions on selling or transferring ownership
- Focus and commitment must be long term
- Overcoming the learning curve

Captive Program Structures

Tax Considerations

QUALIFICATION FOR TAX DEDUCTIBILITY

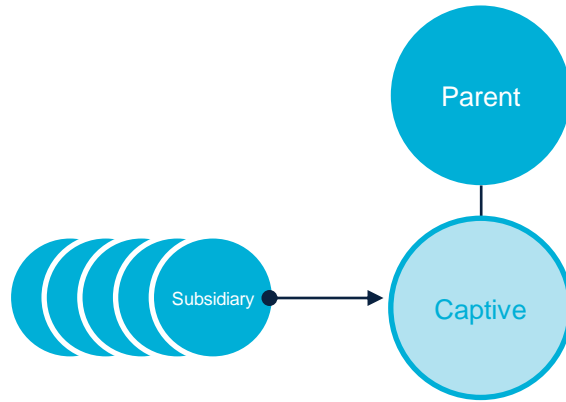
This arrangement must contain:

- Presence of insurance or insurable risk
- Risk shifting
- Risk distribution
- Commonly accepted notions of insurance

Must meet one of
the scenarios

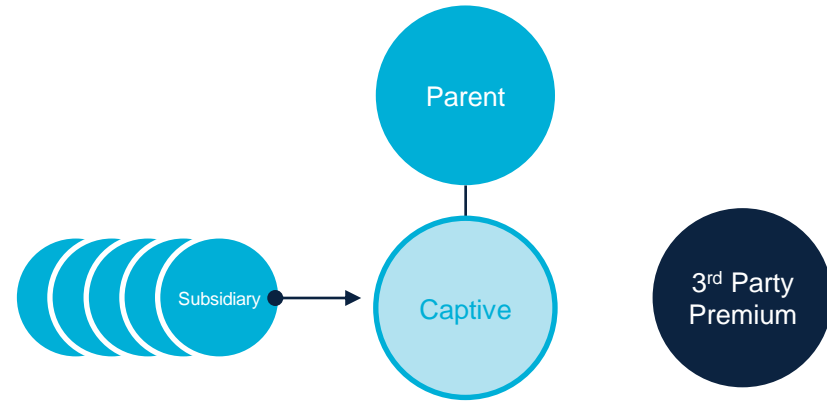
Scenario 1

100% Internal Risk

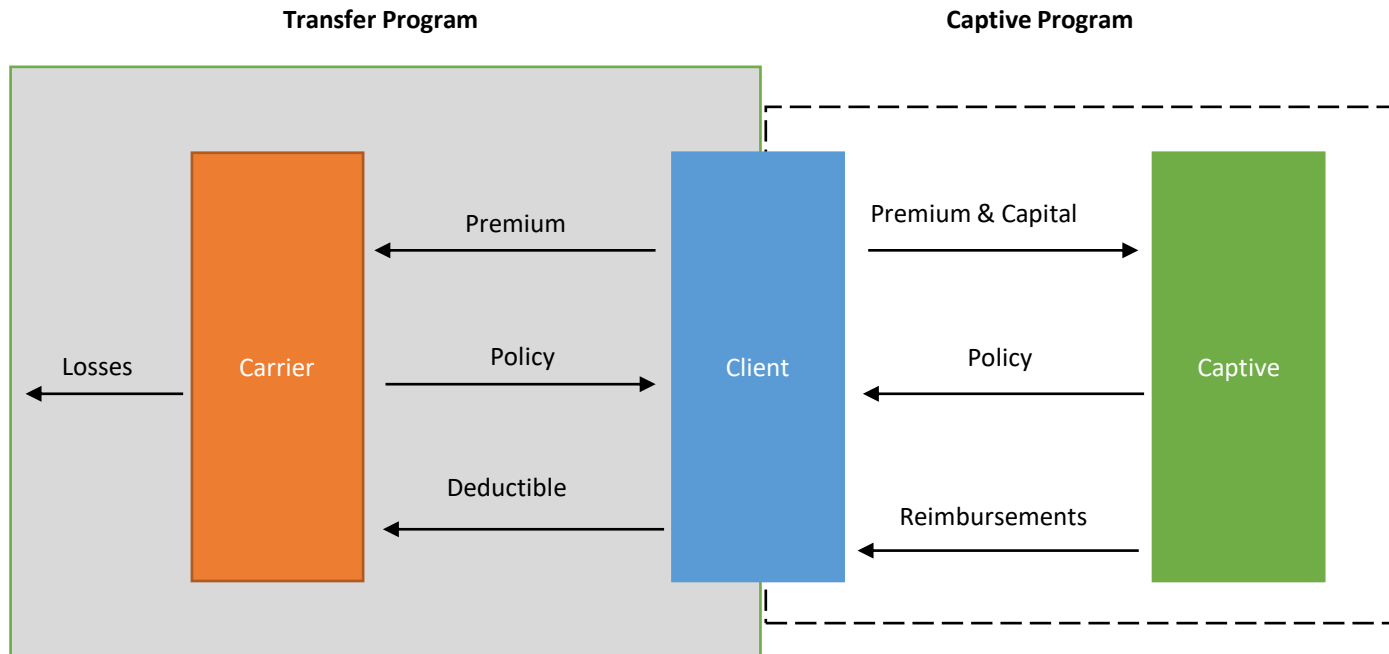


Scenario 2

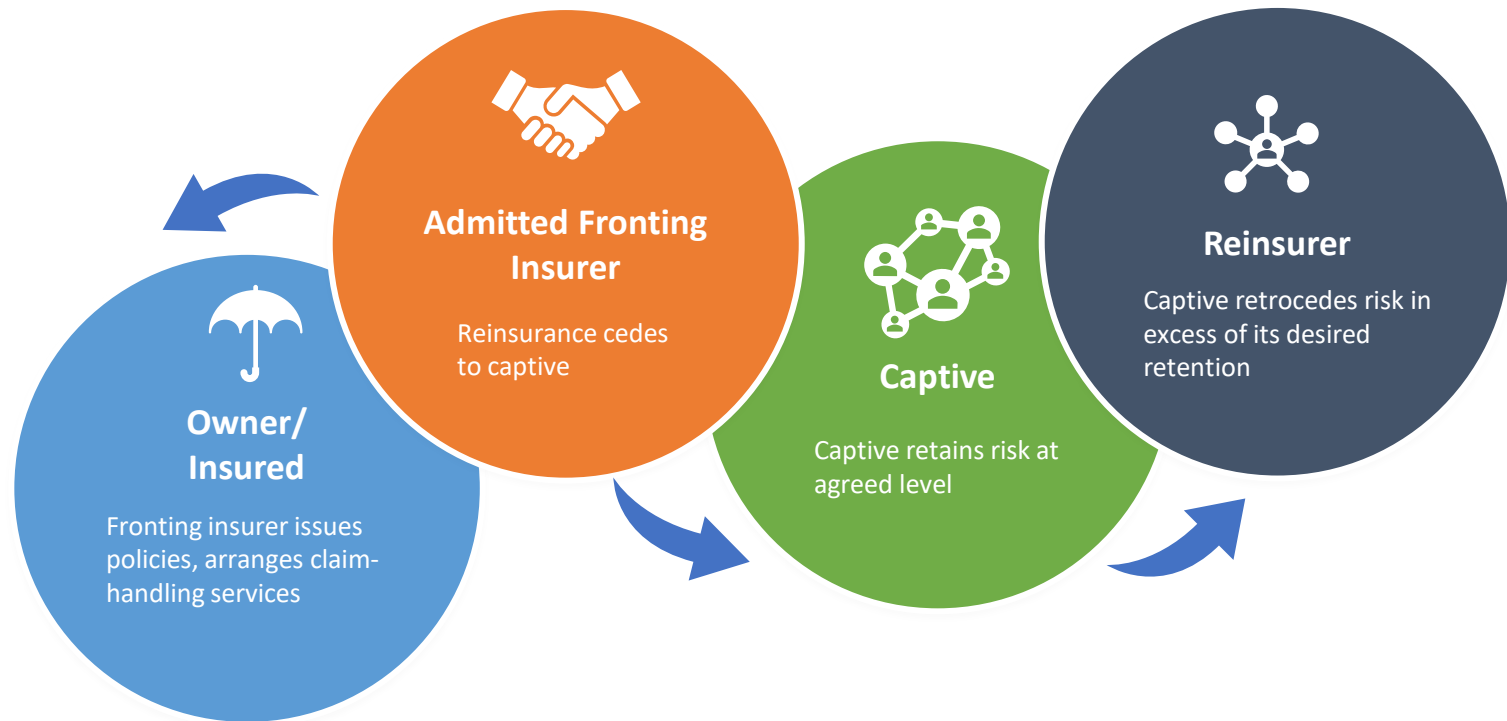
Greater than 30% of premium must be 3rd party



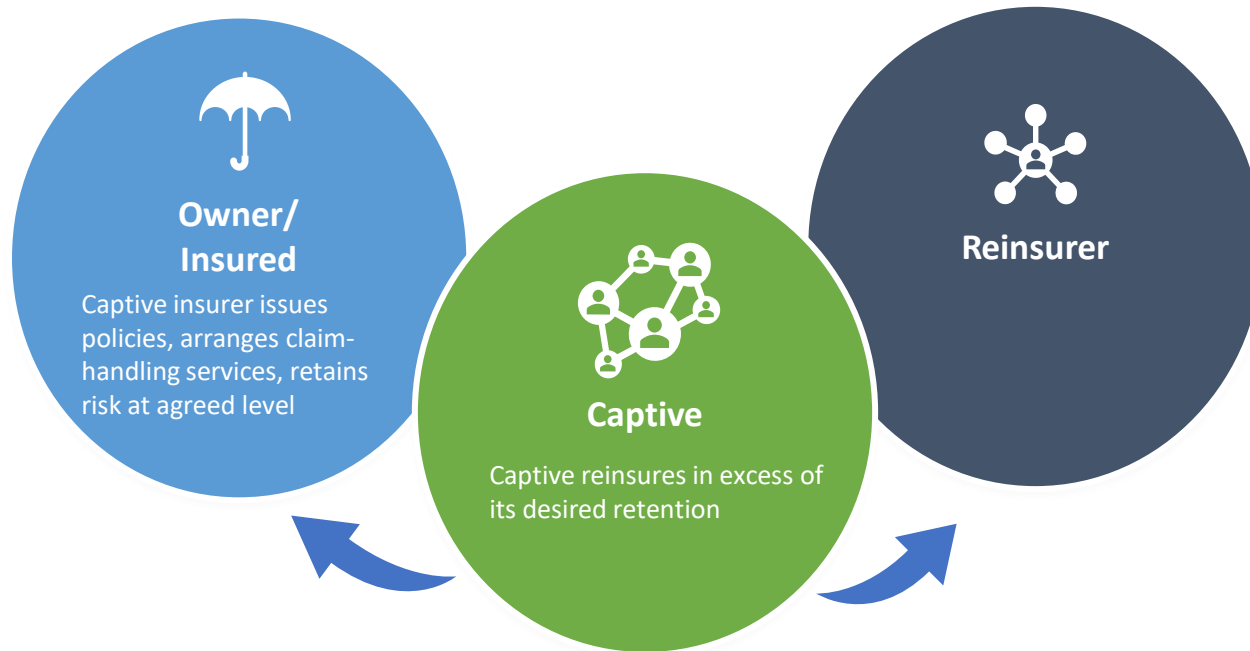
Deductible Buy-Back



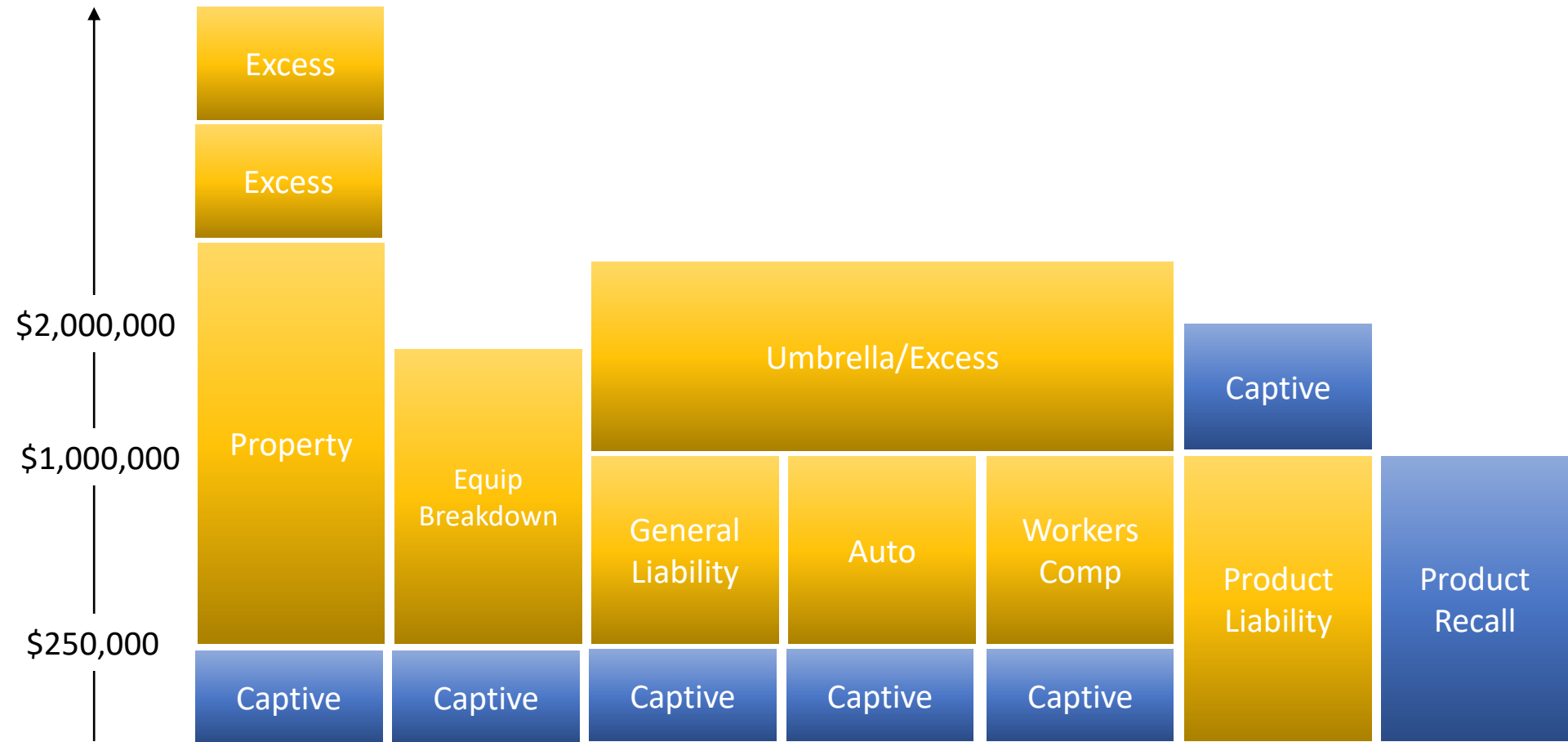
Fronted Reinsurance



Direct Issue



Sample Captive Structure



The Captive Journey

Captive Evaluation Process



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Feasibility Analysis



• 02 •

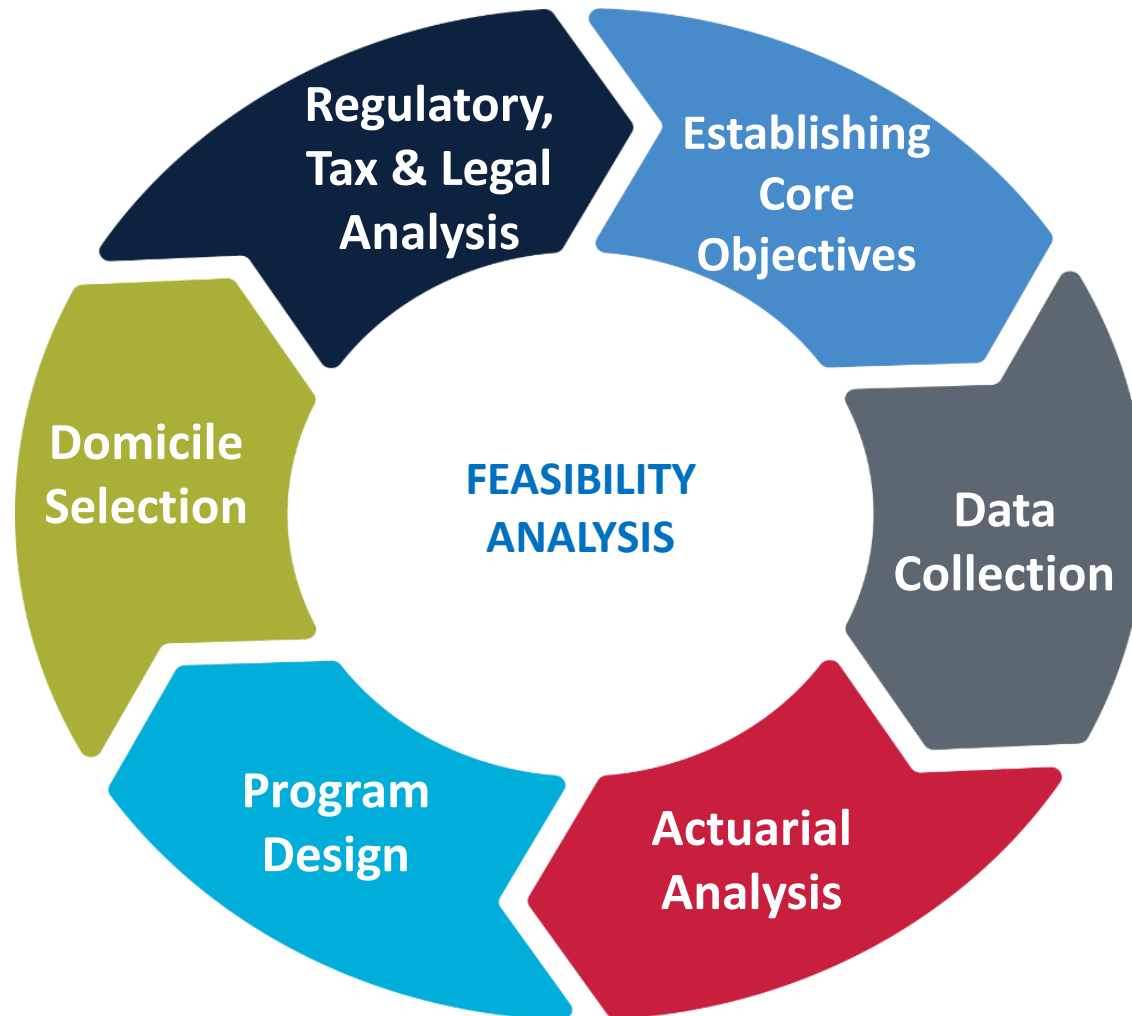
Implementation



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Captive Management

Feasibility Study



Feasibility Analysis

Evaluate

- Current exposures and future growth
- Coverage needs
- Cash-flow requirements
- Current program
- Service Providers

Analysis

- Domicile analysis
- Ownership and structure analysis
- Actuarial analysis
 - **EXPECTED LOSSES + CAPITAL**
 - **CONFIDENCE INTERVAL FUNDING**
 - **EXPENSES**

Considerations

- Investment considerations
- Regulatory and legal considerations
- Federal and state tax considerations
- Cost considerations

Implementation plan for execution

Actuarial Feasibility Analysis

Why is it necessary?

**Measures
Financial
Viability**

**Required by
Regulators**

**Reinsurance
Negotiations**

What is included?

Loss Rates/Premiums/Loss Ratios

- Expected
- Adverse

Pro Forma Financial Statements

- Includes:
 - Income Statement
 - Balance Sheet
 - Statement of Cash Flows
- 5-Year Projections (typically)
- Based on Expected and Adverse Scenarios

Data Collection

Background	Loss Data	Exposures	Other
<ul style="list-style-type: none">• Company Specific<ul style="list-style-type: none">• Goals• Constraints• Operational<ul style="list-style-type: none">• Account Background• Management<ul style="list-style-type: none">• Claims• Risk	<ul style="list-style-type: none">• Historical<ul style="list-style-type: none">• Annual Evaluations• Detailed claim run• Large loss listing	<ul style="list-style-type: none">• Historical<ul style="list-style-type: none">• Will vary by LOB<ul style="list-style-type: none">• Payroll• Sales• Vehicles• Prospective• Descriptions<ul style="list-style-type: none">• Locations	<ul style="list-style-type: none">• Expenses (will vary)<ul style="list-style-type: none">• Type of Captive• Domicile• Other Assumptions<ul style="list-style-type: none">• Growth• Rate of Return

Actuarial – Feasibility Analysis

Review Past
Experience

Actuarial
Adjustments

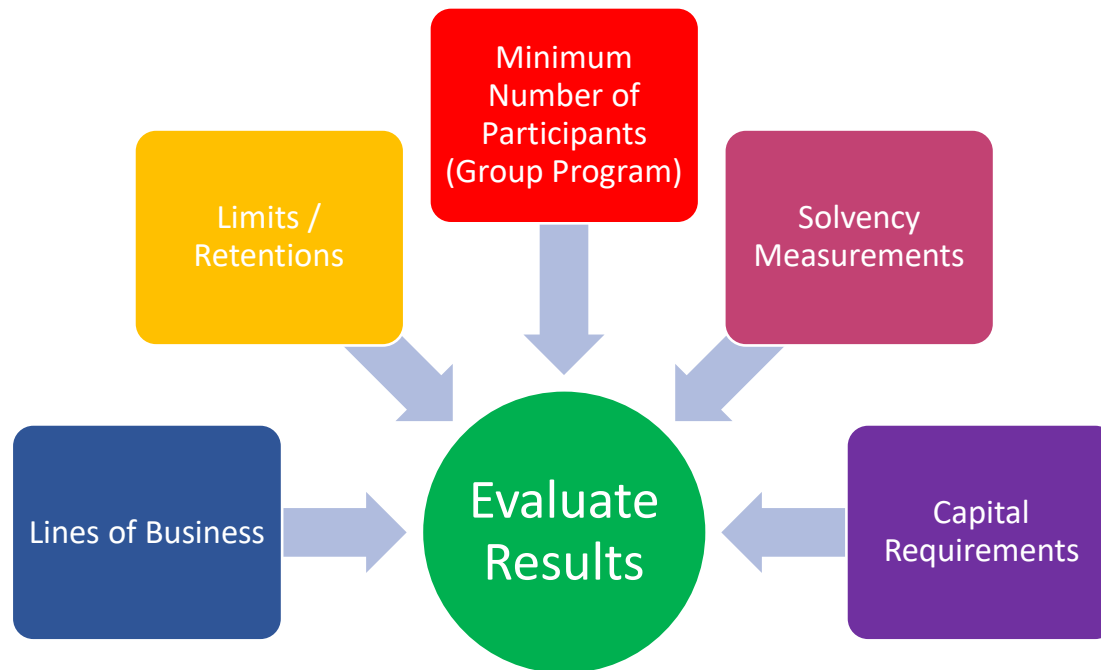
Internal
Factors

External
Factors

Selected Loss
Rate

Estimated
Ultimate Loss

Actuarial Feasibility Analysis - Results



Domicile Selection



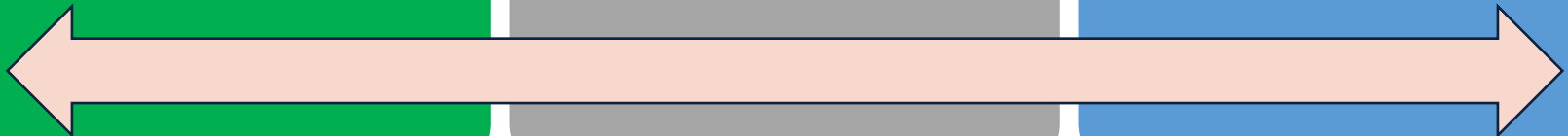
Strategic



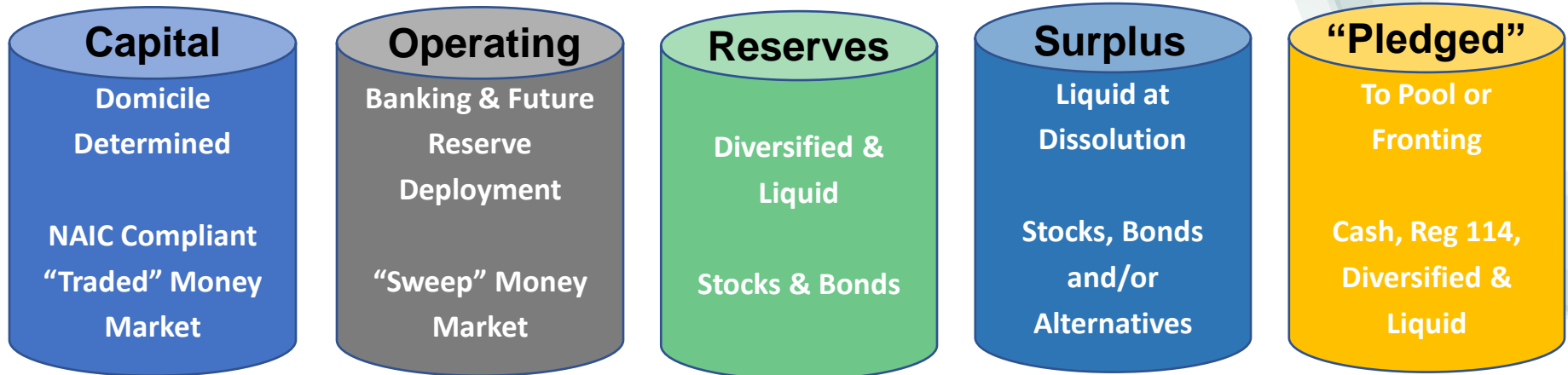
Financial



Operational



Investment Considerations

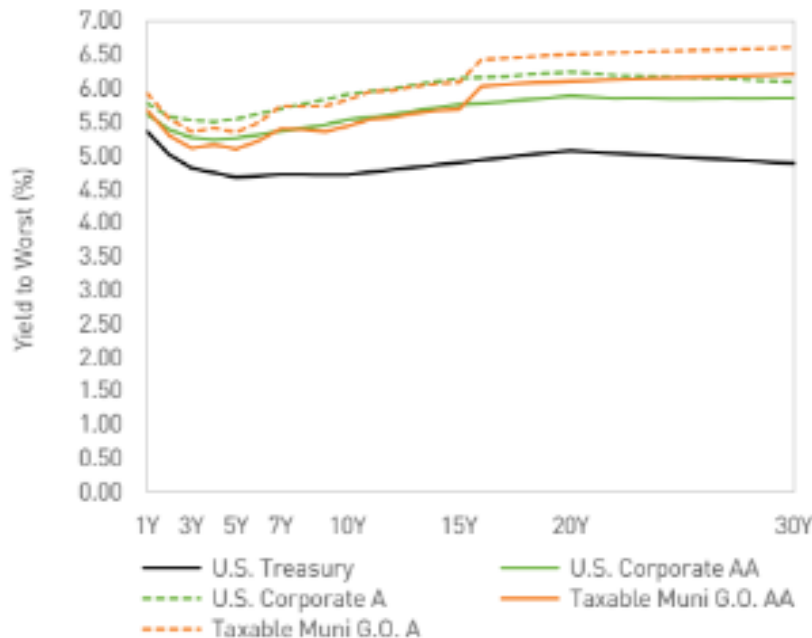


Align Short-Term & Long-Term Goals with Each Allocation or Requirement

- **Reserve matching assets** aim to ensure funds are available to meet future claims. Either match bond maturities with expected claim timing or hold cash and "Dollar-Cost-Average" into portfolio.
- **Capital growth assets** aim to build or grow surplus and may include equities and other diversifying assets. These assets can also help support experience different from expected.

Investment Considerations

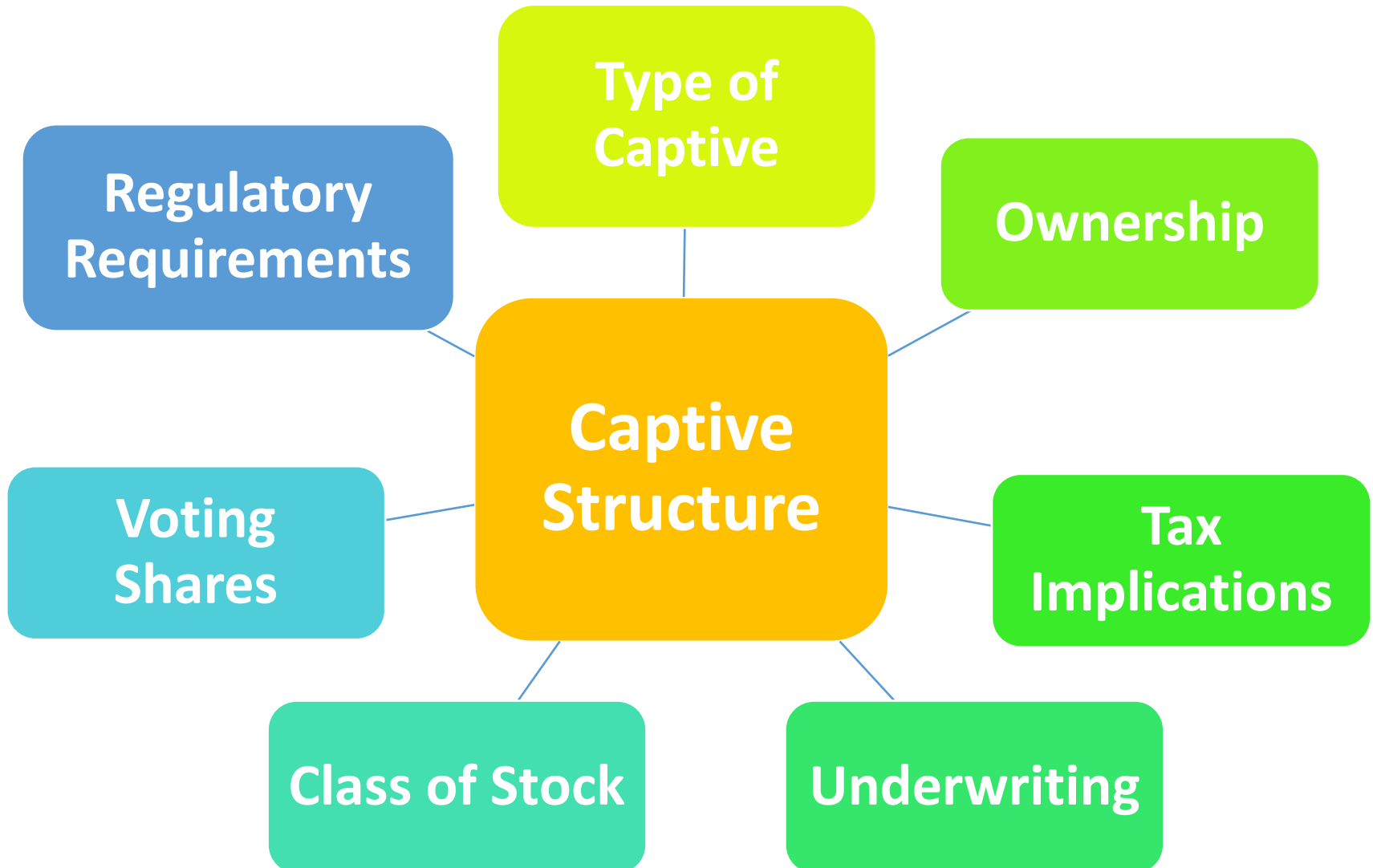
Select Taxable Sectors vs. Treasury Curve



Source: Bloomberg, LP, Thomson Reuters TM3-MMD, PNC Fixed Income

- Material capital market changes over the last 18+ months warrants an “active” oversight of assets
- With a shift in Fed policy, a focus on principal preservation and liquidity should be a priority
- Opportunity costs of employing a passive approach could be costly

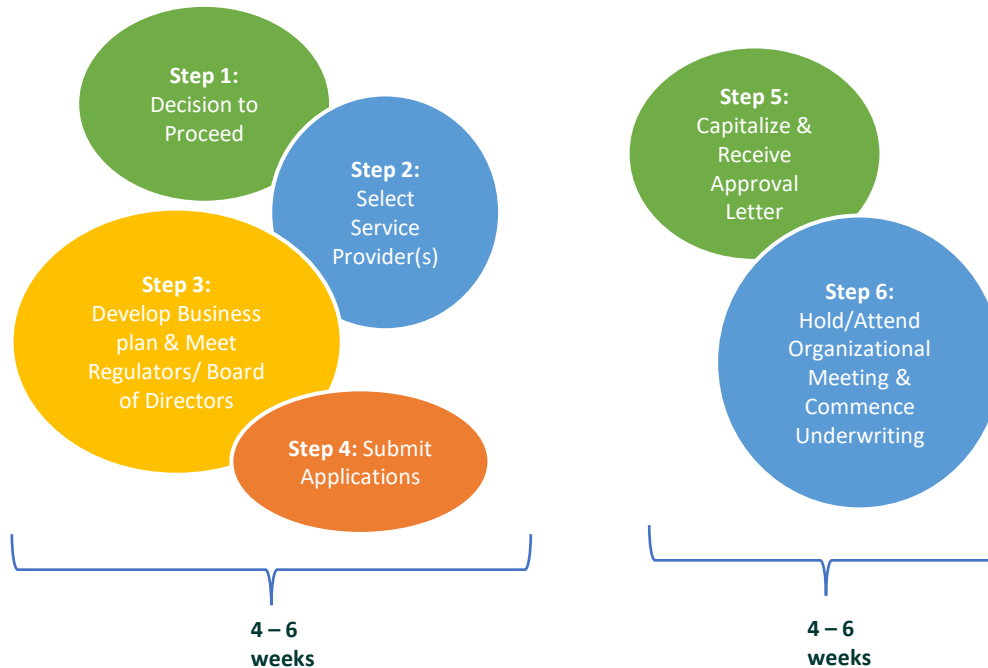
Regulatory, Tax & Legal Considerations



Implementation



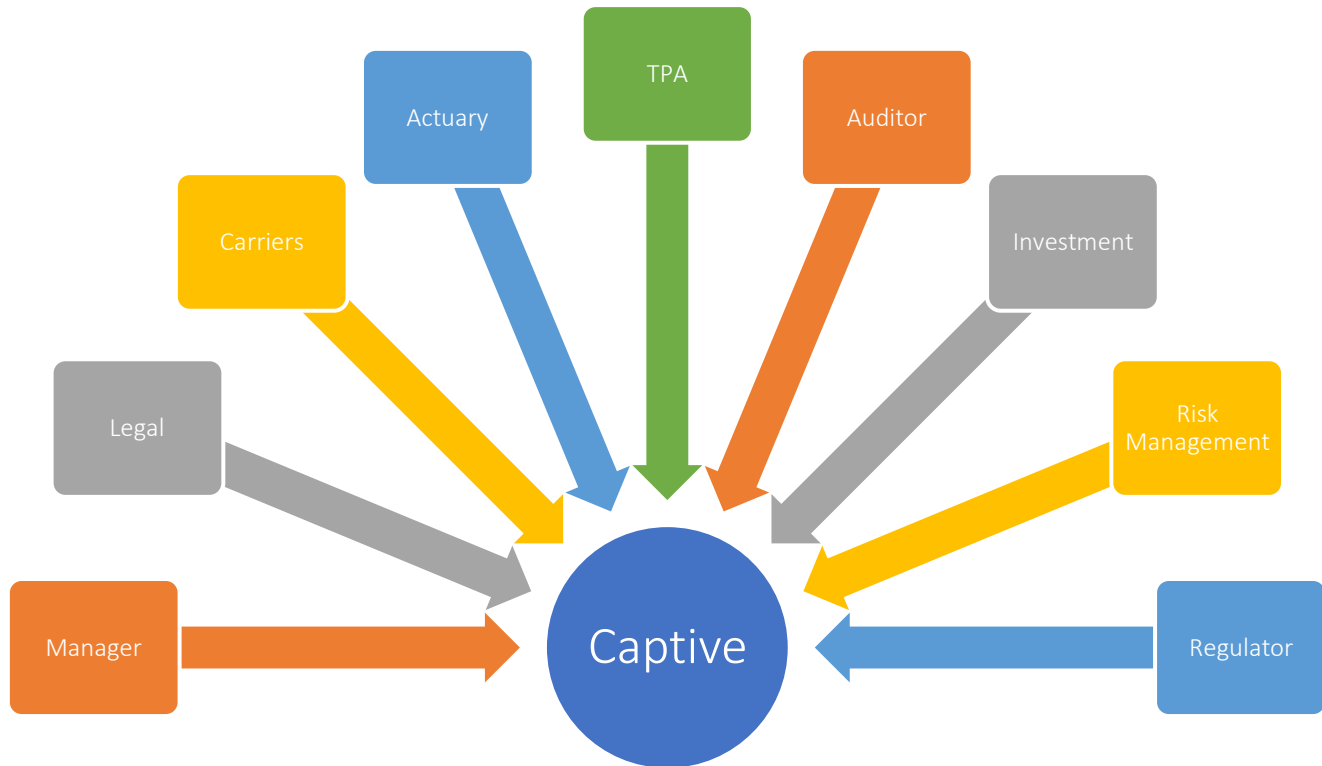
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Captive Operations



• 03 •



Closing Thoughts and Considerations

If you determine that a captive is the right choice for your organization, engage experts who can guide you through the process

Corporate governance starts at the top

Running an insurance company is likely much different than the business that you are in. Treat it as such. Stay involved

Ask questions on anything and everything you don't understand

Communication with service providers is critical

Plan early for the future (sharing of dividends, assessments; member leaving the group, captive closing)

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HAWAII CAPTIVE INSURANCE COUNCIL

2023





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