

CAPTIVE
INNOVATIONS
Thinking Differently

2023

Thinking Outside the Box - Strategies to Grow and Manage Your Captive

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SESSION LEARNING OBJECTIVES

Participants will learn:

- How to identify key risks for your organization
- Determine which risks to place into captive or other risk financing vehicle
- Quantifying and tracking “safe” retention levels for optimal captive growth and performance
- Emerging trends and risk mitigation strategies
- Special focus topic on employee benefit trends

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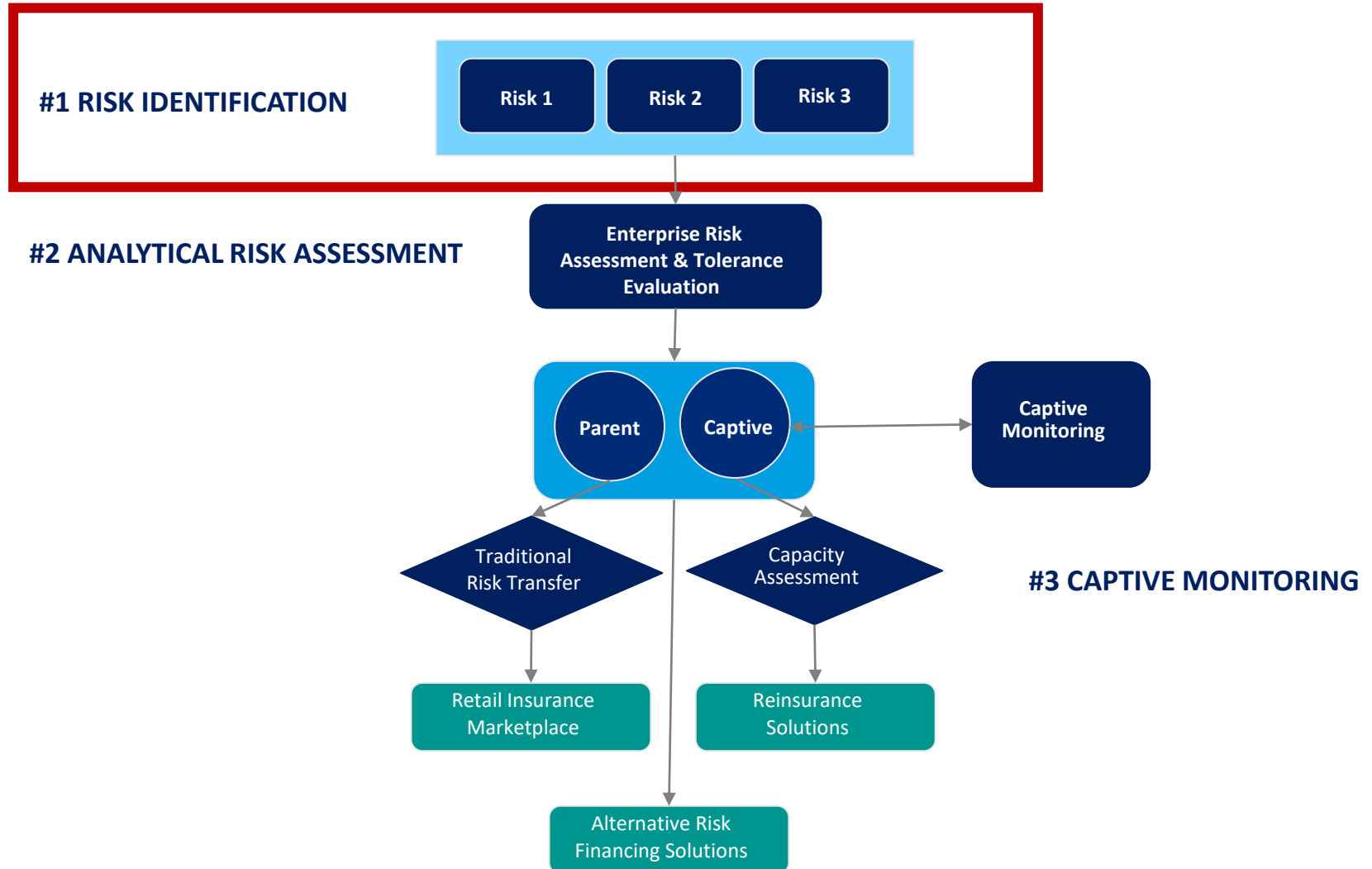


Polling Question #1

This morning, I am feeling...

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Risk Financing Decision Matrix





What RISKS are we trying to protect from?



Director's & Officers



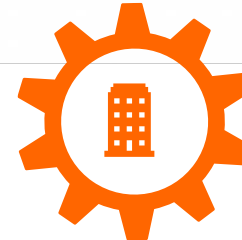
Workplace Violence



Key
Enterprise
Risks



General Liability



Property Casualty

PEOPLE



Workers' Comp

PLACES



Catastrophic

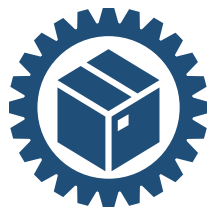


Crime

THINGS



Brand/Reputation



Supply Chain Disruptions



Cybersecurity



Regulatory



Economic/Market Conditions

5 Key Questions to Ask:

1. **Should we even purchase commercial insurance** (for some or all lines) given our balance sheet strength, cost of capital, and ability to self-insure? Should everything that can be placed in a captive be considered for the captive?
2. If we were to evaluate our commercial insurance spend like any other finance decision – i.e., **what is the ROI of insurance capital?** How has our ROI changed over time? Would we make the same decisions we do today regarding our risk transfer program?
3. **Are we stress testing our programs** (limits, attachment points, contract language) to keep pace with the evolving regulatory environment? The correlated nature of risk in our programs (e.g., between Cyber/E&O and D&O)? What organizational shifts are needed to ensure the programs are optimized and efficient?
4. How are we contemplating the **shift in our risk profile?** Do we consider emerging risks as they evolve? How do we quantify these?
5. What is our **balance between uninsurable and related insurable risk** and what should our strategy be to finance these?

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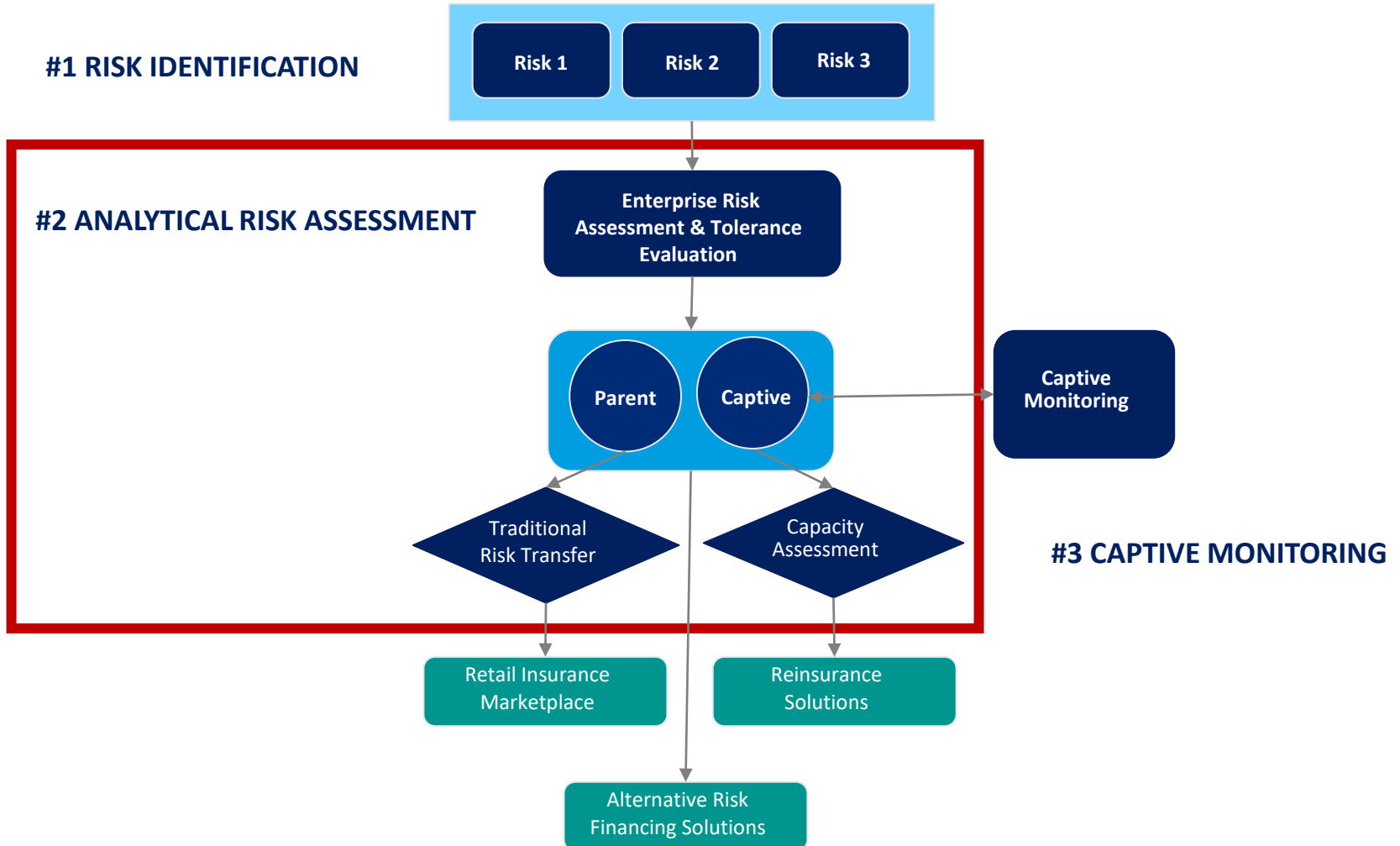
Polling Question #2



With respect to your organization, what keeps you up at night?

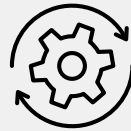
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Risk Financing Decision Matrix



Analytics play an integral role in strategic growth of a captive

Entities that retain risk are tasked with competing goals:



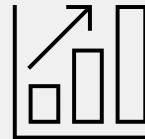
Reduce Insurance Costs

vs.



Reduce Volatility

Conditions are favorable to grow the captive:



Surplus growth over the years



Hard market conditions

When growing your captive, a decision making analytical framework is an important strategic tool

The benefits of using modeling to grow your captive

Understand your changing risk profile

Retaining more of your risks will lead to **increased volatility**....But how much more?

1

"1 + 1 ≠ 2"

Two equal sized risks is smaller than one large risk due to benefit of diversification

2

Enterprise risk-reward decision making tool

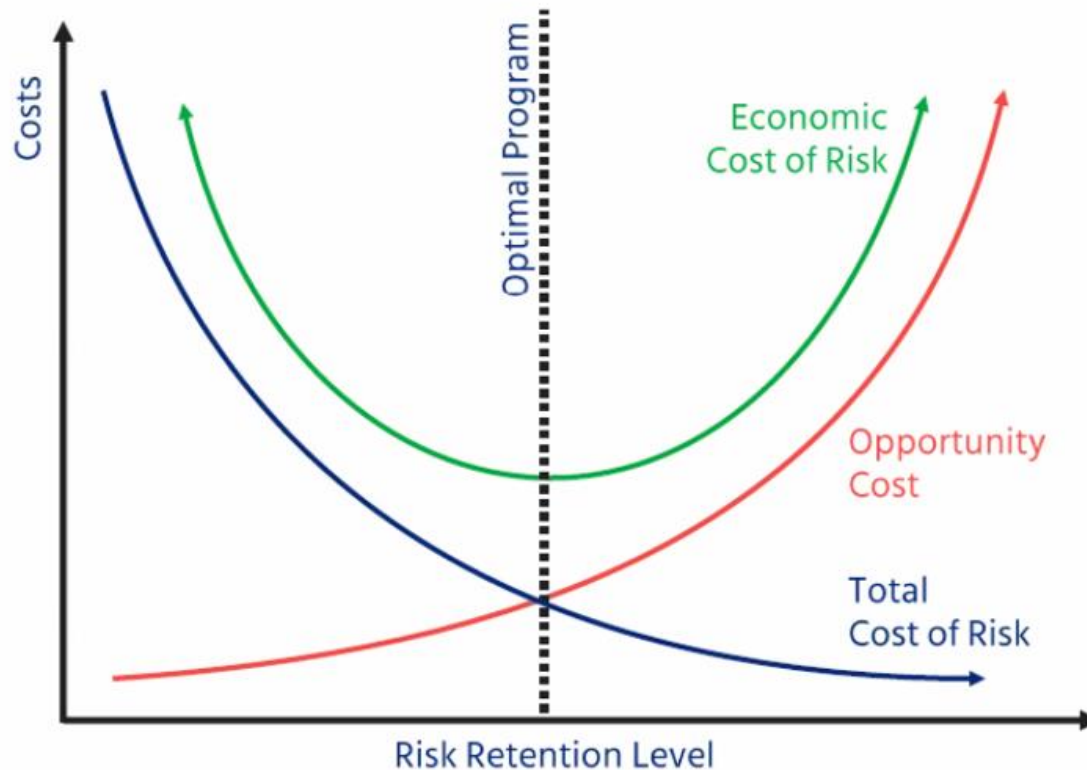
An analytical framework for optimizing risk decisions

3

Captive capital strategy

Traditional financial metric solvency ratios assume steady state risk profile

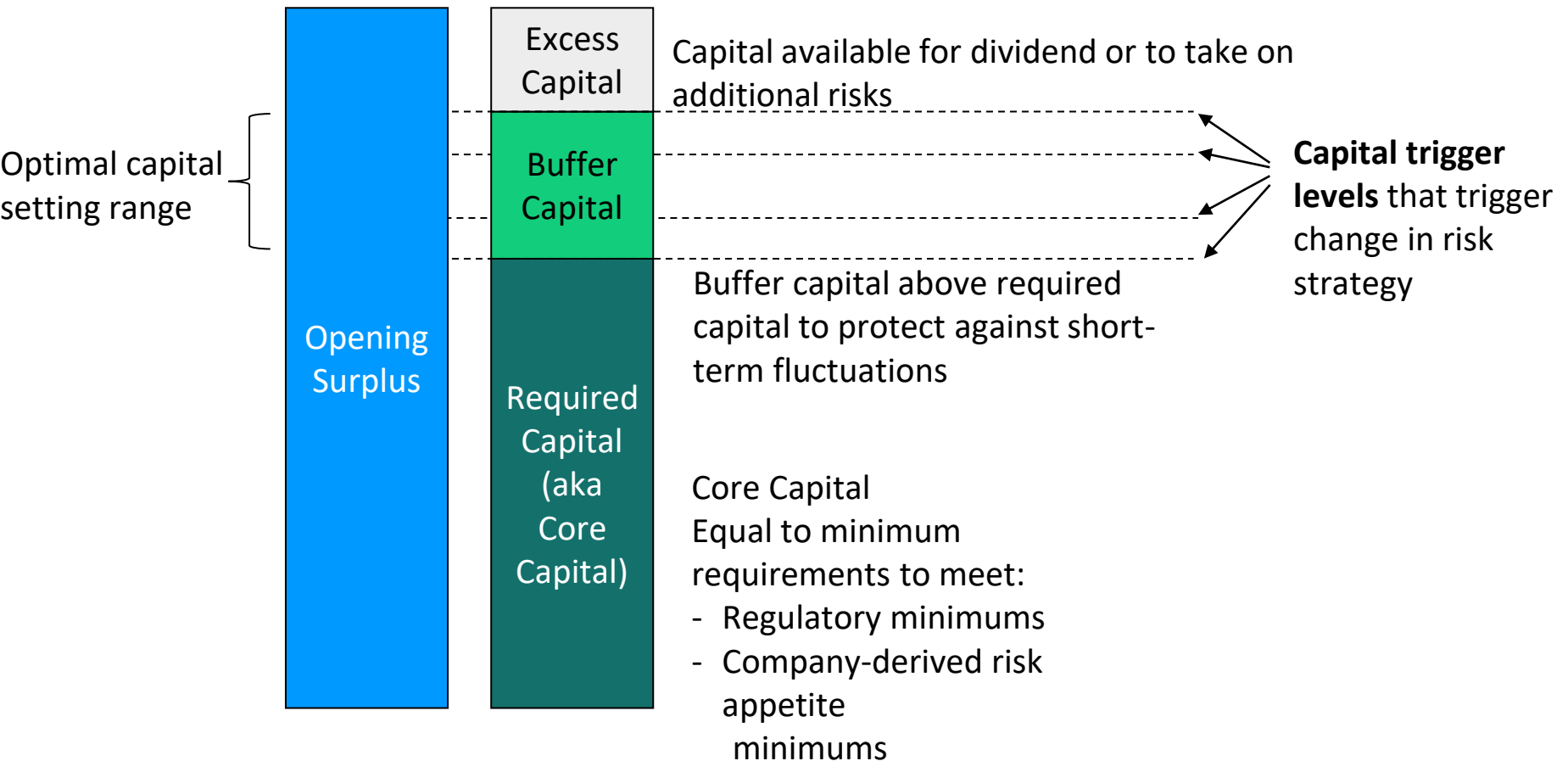
Using Economic Cost of Risk metric to evaluate insurance options



Reasonably frequent small losses that might exceed the deductible, but don't approach the policy limit

A way of measuring the opportunity cost of reallocating capital from an investment to paying for an insurable loss

Setting appropriate capital target levels for a captive



Risk Financing Decision Making Process

Understanding Your Risk Profile

Quantify Balance Sheet Impact

KPI	Amount (m)	Weight	Low %	High %
Cash & Cash Equivalents	2000	30%	7.0%	12.0%
Cash Flow from Operating Activities	500	30%	2.5%	5.0%
EBITDA	400	20%	2.5%	5.0%
Total Revenue	7500	20%	0.5%	1.0%
RBC Range			55.25	98.50
RBC Midpoint			76.88	

Establish the amount of unexpected loss the balance sheet can bear before a material drop in company value

Analyze Data and Map Shock Events

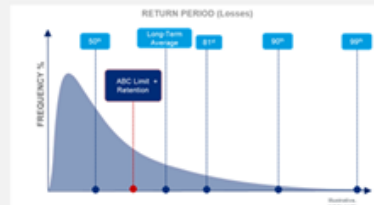


Quantify Your Cost of Risk

Simulate Risk Events

Risk Event	Average Loss	Median Loss	1 in 100 Year Loss	1 in 500 Year Loss
General Liability	11.9m	2.8m	171.5m	723.8m
Auto Liability	2.7m	1.2m	20.6m	95.1m
Workers' Compensation	5.6m	4.9m	17.2m	23.9m
Property	14.3m	0.5m	248.3m	550.7m
Cyber	3.9m	0.1m	58.7m	109.2m
Total Portfolio	38.4m	18.7m	387.4m	912.0m

Understand Volatility



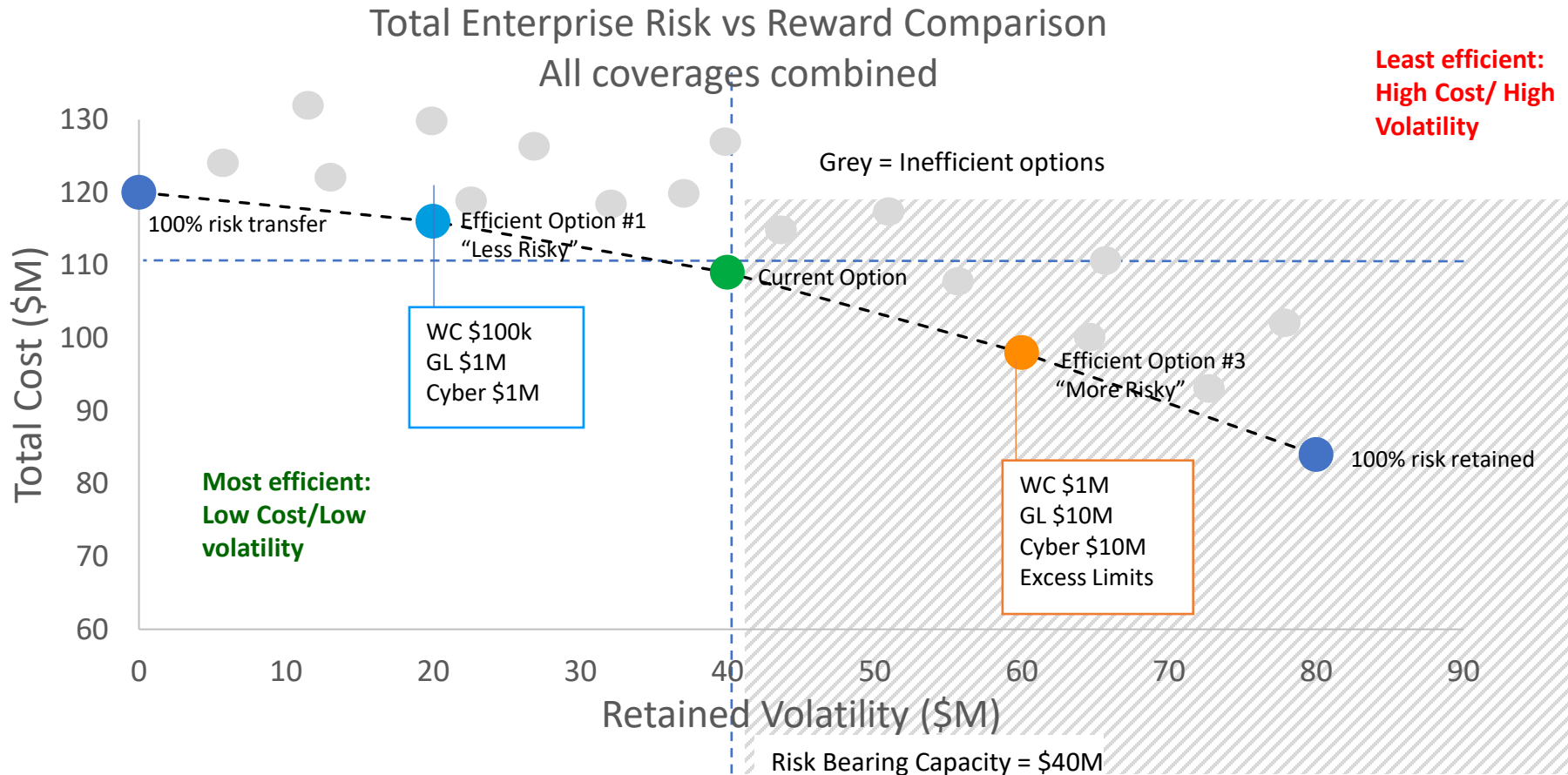
Securing Optimal Market Results

Optimize Insurance Portfolio



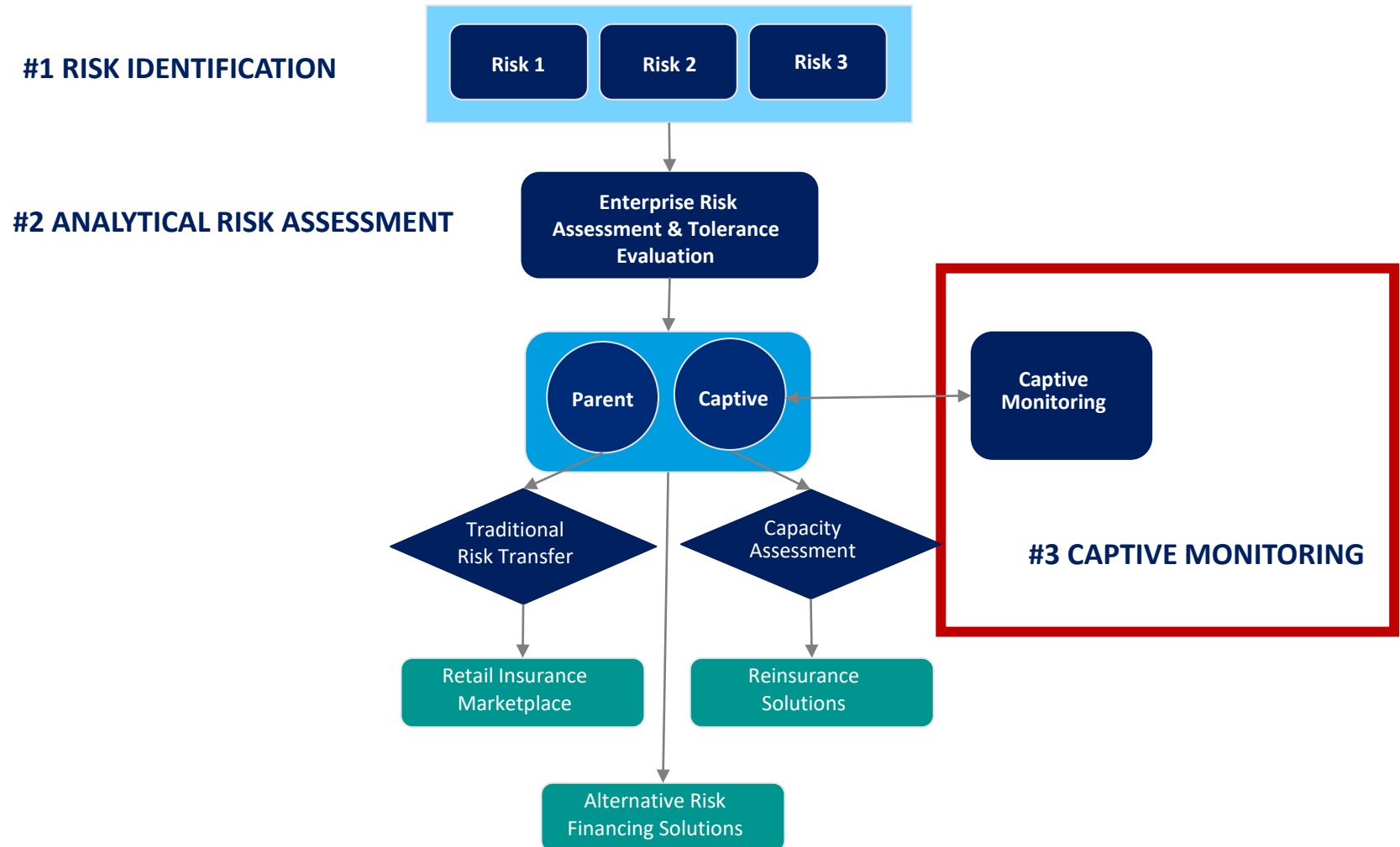
1. How much risk is the organization **exposed** to across the **risk portfolio**?
2. How much **volatility** can the **balance sheet retain**?
3. How can risk financing solutions align with **risk appetite**?
4. What **alternative risk financing strategies** can be considered? How can you **utilize a captive**?
5. What is the **return on investment** of risk transfer?

Cost vs. risk: Taking a holistic approach toward portfolio optimization

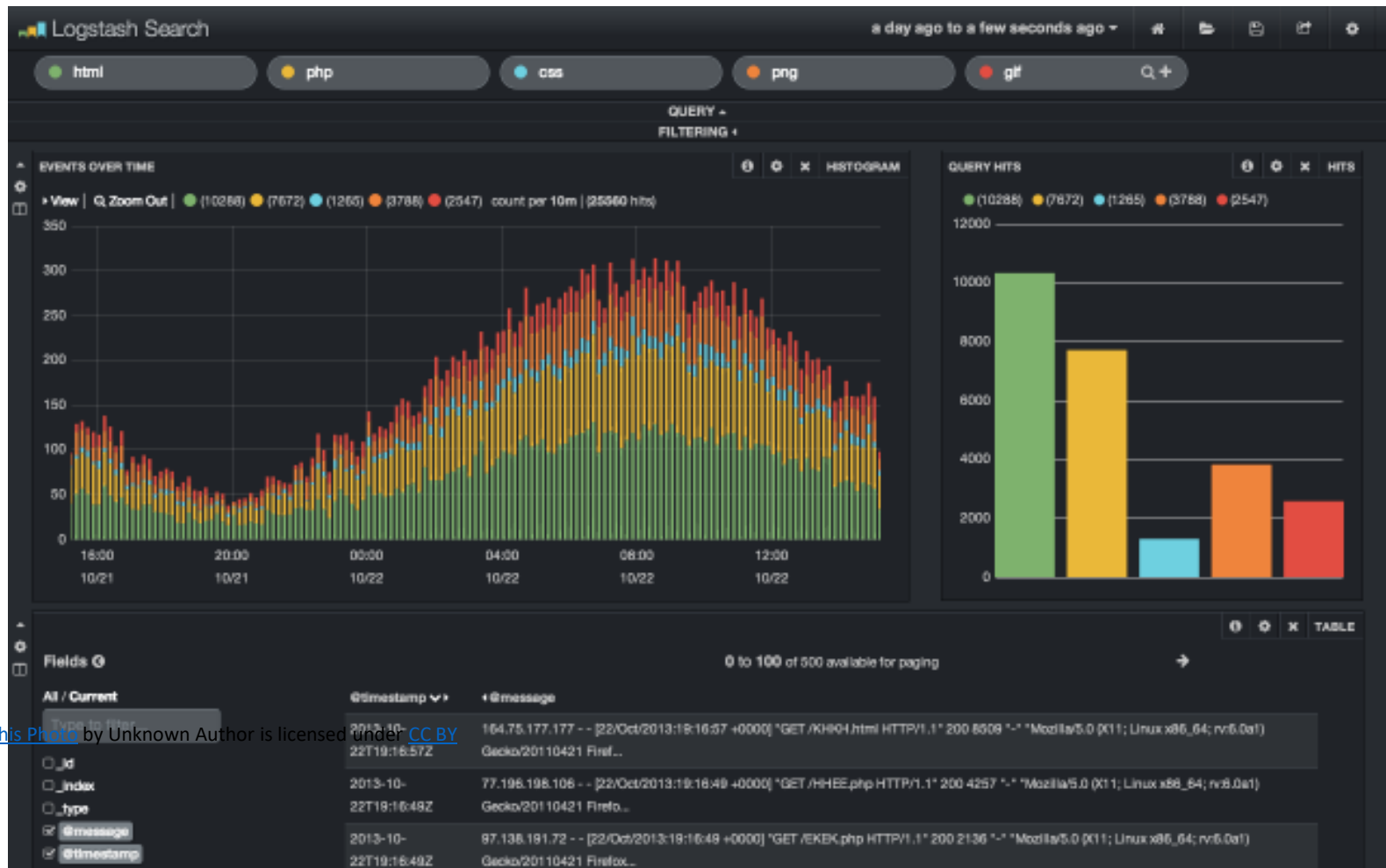


Combining the risk models across all coverages allow you to mix-and-match layer strategies to identify optimal portfolios that match your risk tolerance

Risk Financing Decision Matrix



Financial Approach to Monitoring Captives



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Financial Ratios You Can Use to Quickly Monitor Your Captive

	Ratio	Description	SISCO's Target
1)	$\frac{\text{Net Premiums Earned}}{\text{Surplus}}$	Ratio is a general gauge to insurer's relative security and ability to take on risk. Most frequently used measure of financial strength. Ratio above target means insurer has accepted risk that it might not be solvent enough to survive long-term (should overall actual claims exceed their estimated costs).	2.0 to 1 (or less)
2)	$\frac{\text{Loss Reserves}}{\text{Surplus}}$	Ratio measures how much the surplus might be impaired if loss reserves are undervalued. Ratio above target means the organization is at greater risk of inadequate surplus should overall actual claims exceed their estimated costs or if discount rate is dramatically reduced.	5.0 to 1 (or less)
3)	$\frac{\text{Maximum Policy Limit Per Claim}}{\text{Surplus}}$	Ratio of per occurrence loss exposure retained by captive to surplus. Provides gauge of potential effect of maximum loss from single event -- the "risk factor." A ratio that is above the target means that the organization has taken on higher-than-desired risk. A ratio below the target means that the organization is over their capitalization target (overcapitalized).	10 to 14%

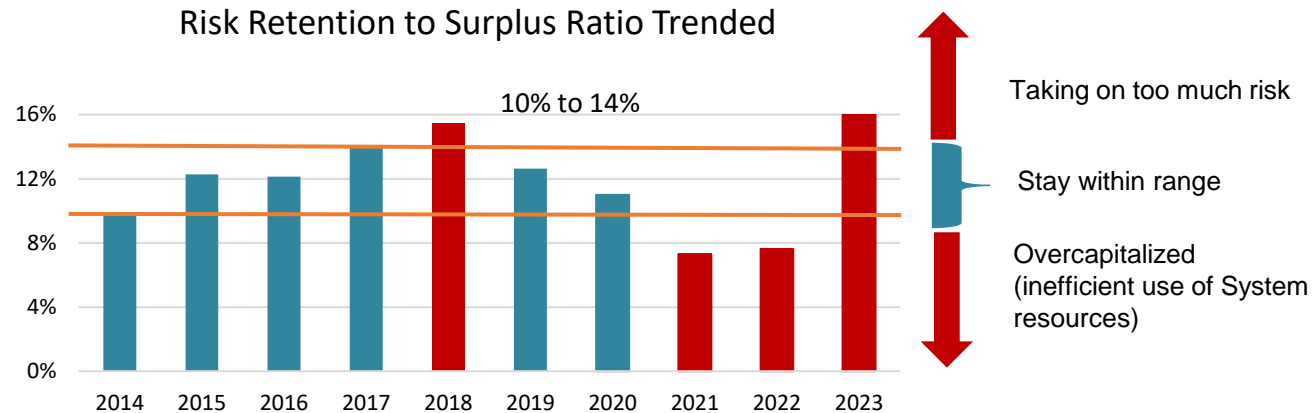
Financial Ratios You Can Use to Quickly Monitor Your Captive

	Ratio	Description	SISCO's Target
4)	Loss Ratio= $\frac{\text{Claims Losses}}{\text{Net Premiums Earned}}$	Ratio of losses and loss adjustment expenses (including TPA fees) to captive earned net premiums. Ratio gives percentage of each dollar that goes to pay losses and related expenses. Ratio above target means that more of insurer's premium dollar has gone into paying claims and less is available for expenses or building surplus.	85% or less
5)	Expense Ratio = $\frac{\text{Administrative Expenses}}{\text{Net Premiums Earned}}$	Ratio of non-loss expenses to captive written premiums. It is a measure of how much of each captive premium dollar goes to running the captive or (in SISCO's case) loss prevention programs. A ratio that is above target means that more of the insurer's premium dollar has gone into paying expenses and less is available for losses or building surplus.	20% or less
6)	Trade (Combined) Ratio = Loss Ratio + Expense Ratio	By combining loss & expense ratio, the combined ratio provides a single useful figure for measuring the captive's overall underwriting results, although it ignores investment income. A ratio above target means that without investment income to offset the amount over target, a draw on surplus (P&L loss) will occur.	105% or less

SISCO Uses Risk Retention to Surplus Ratio

- Assuming maximum policy limit across all lines of business is \$1 million.
- With a target of 10-14% your target surplus is between \$7.14 million and \$10 million.
- SISCO's target is more common of commercial insurer. Average captives may use 20%.
- Calculation derived as a follows:

Maximum Policy Limit Per Claim (\$1 million)
 10% or 14%



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Polling Question #3



What preferred financial ratio do you use to monitor your captive?

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What is the minimum statutory capital amount for HI Captives?

- Hawaii captive insurance companies are governed by Chapter 431, Article 19, of the Hawaii Revised Statutes.
- The minimum statutory capital amounts depend upon the class of captive.
 - Class 1 Pure captive that writes business only as a reinsurer \$100,000
 - Class 2 A pure captive that can be a reinsurer and/or a direct writer \$250,000
 - Class 3 An association or risk retention captive \$500,000 (RRG or Assoc.)
 - Class 4 A sponsored captive \$500,000
 - Class 5 A reinsurance captive at discretion of Insurance Commissioner

Qualitative Factors in Decision-Making for Managing Surplus

- Near-term risk retention decisions (taking more risk)
 - New coverage lines
 - Coverage lines with excessive loss ratios
 - Hardened reinsurance market/industry
- Potential financial insolvency or expected exiting of certain lines of reinsurers
- Investment market volatility
- Regulatory changes (Example: California MICRA)

Using Diversification of “Tail Time” to Grow Your Captive



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Polling Question #4



Does your captive include any risks that are not Property/Casualty?

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Employee Benefit Trends

- Two areas of captive growth emanate from outside the universe of traditional Risk Management/Finance/Treasury concern
- Employer stop loss
 - For self insured employee medical plans, risk of any one individual member consuming a lot of healthcare in a single program year
 - Stop Loss premiums grew by 32% in Marsh managed captives last year
- Voluntary benefits selected by employees at open enrollment
 - Critical Illness
 - Hospital Indemnity
 - Accident Insurance
 - Legal Expense
 - Many others
 - Voluntary benefits premium grew by 39% in Marsh managed captives last year

Employer Stop Loss

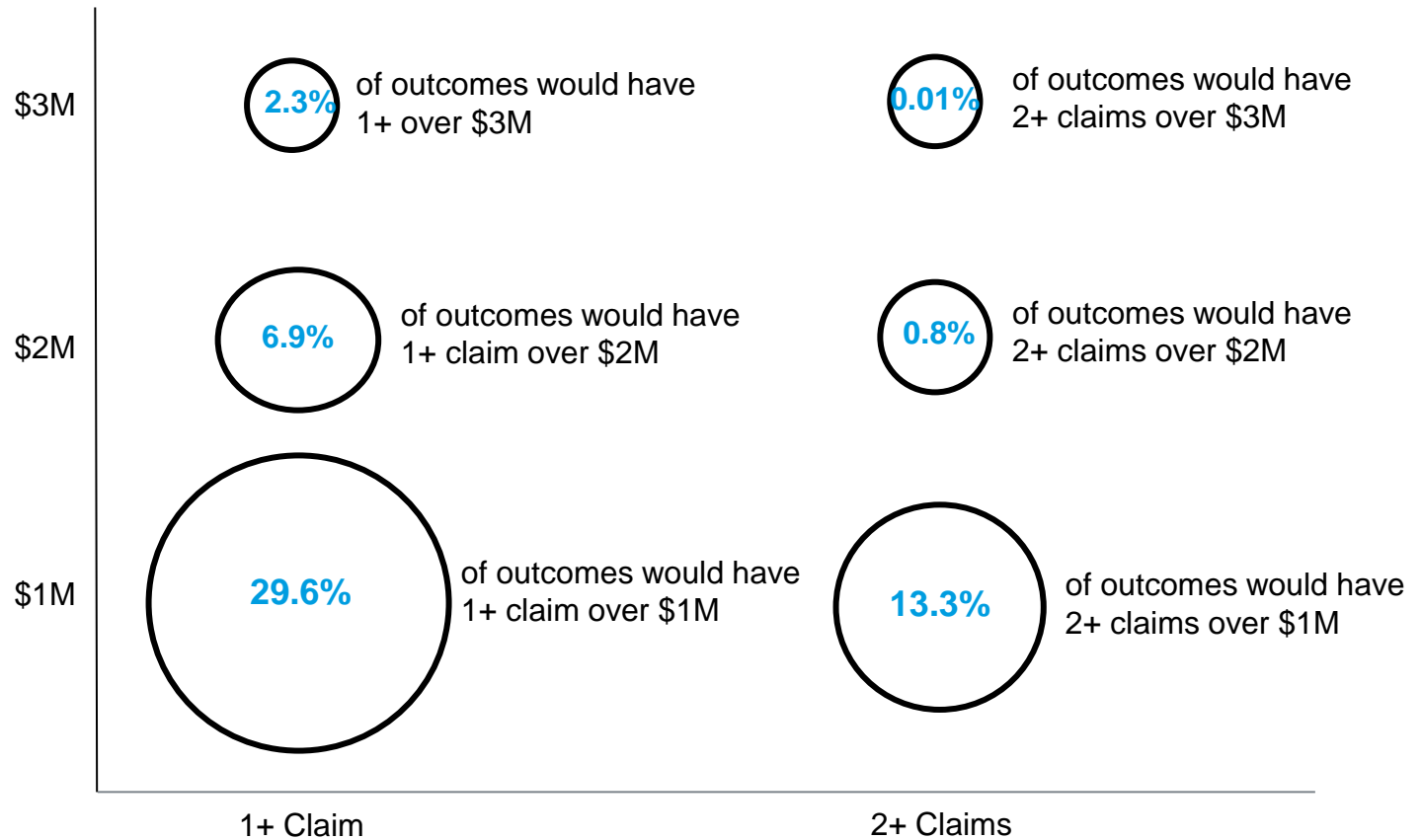
- Purchase of stop loss is critical to protecting the results of self-funded plan
- As coverage is an accumulation across the year, variance from budget arises at end of year when finding funds to address is hard
- Post-ACA, benefit is \$unlimited annually and over a members lifetime
 - Practical limits apply, but largest known claims are over \$30M in a single year
- Outdated mind-set that some companies are large enough not to need ESL
 - Few companies built to withstand sudden \$10M variance in employee plan expenses (insurance is a smoothing technique)
 - Sun Life (for example) with over 4M lives under risk buys reinsurance – are they not big enough?

Employer Stop Loss (cont.)

- Benefits of using the captive are consistent with other lines
 - Access to different markets/underwriters (reinsurance vs commercial insurance)
 - Participation in results
- Additional benefits include:
 - Flexibility in program design (captive entry/exit)
 - Potential to build capital to support medical risk not covered by market (lasers)
 - Excess capital could be returned to plan or used for greater risk program
 - Greater governance of medical risk held by the company
 - Greater interaction between risk/insurance side of house and HR/Rewards
- Significant hurdle to clear:
 - Greater interaction between risk/insurance side of house and HR/Rewards

Risk of Large Individual Claimant

Employer with
 2,800
 employees
(assuming all care included)



Voluntary Benefits

- Most voluntary benefits provide low risk and high predictability
 - Max benefit provided is fixed and often “low”
 - E.g., \$25,000 Critical Illness policy that pays a stated amount if certain diagnosis (Cancer) is made or event occurs (cardiac arrest)
- Despite those attributes, employee benefit programs can run at very favorable loss ratios (favorable to the market)
 - 25%-40% not uncommon
- Captive allows access to fronting arrangements via benefit pools that can offer the same coverage at lower cost to employees
 - Additional savings based on pool performance filter back to the employer benefit program

Voluntary Benefits (cont.)

- Most voluntary benefits are paid for by employee funds and thus covered by ERISA
- Creates restrictions on how surplus funds can be utilized. Some examples include:
 - Premium holiday
 - Enhance benefit plans
 - EAP enhancements
 - Well-being programs
- If benefit not paid for with employee funds you have great flexibility to use surplus funds

Stop Loss/Voluntary Benefits Baselines

	Employer Stop Loss	Voluntary Benefits
Minimum Size	~\$1M in commercial ESL premium spend	5,000+ employees
When to Start Looking (assumes 1/1)	Q2/Q3 with marketing in Sep/Oct	Q1/Q2 to allow premium to be set for OE in time
Proceeds Constrained by ERISA	Not likely	In most cases, yes
3 rd Party Risk	Not likely	Very likely

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Audience Q&A Session



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Mahalo. This concludes our presentation.

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