CAPTIVE FORMATION FOR POOLS
Alternative risk transfer (ART) refers to any method of financing risk other than the standard method of insuring or self-insuring.

A captive insurance company (captive) is defined as a wholly owned company set up to provide its parent company with an alternative for self-insurance. Captives fall under the umbrella of ART.

The pooling sector has embraced captives as a method of ART for over 25 years. Some pools create captives to serve their own needs, while other pools have banded together to form reinsurance captives. Regardless, the thing each captive has in common is that it was formed to suit the risk financing needs of its owner(s).

**INTRODUCTION**

**A POOL’S ULTIMATE GOAL IS TO PROVIDE THE BEST FINANCING AND RISK MANAGEMENT SERVICES TO ITS MEMBERS. ONE POSSIBLE WAY TO DO THAT IS BY CREATING A CAPTIVE INSURANCE COMPANY.**

There are many reasons for creating a captive, but they all boil down to: (1) saving members premium dollars; and (2) maintaining control of one’s own risk financing through various channels. Some typical benefits of forming a captive include the following.

- **Underwriting.** A captive can be structured so that it accepts all risks covered by the underlying pool(s). Additionally, should it be the desire of the captive owners, there is the ability to structure underwriting to earn underwriting income.

- **Claims.** All losses that the pool covers are included in the captive’s policy and are paid for if the captive layer is hit by a claim. This is referred to as having the “claims pen.” Using the example [see the How This All Works on p. 3], a captive could write an insurance policy back to its owner pool, covering losses from the pool’s deductible of $100,000 [red line in Figure 2] to encompass the larger $700,000 loss. There are numerous ways this can be done, but the key is that the captive—rather than a commercial insurance company—is taking the risk (and the premium).

- **Pricing.** Captive insurance policies are not subject to the whims of the insurance market. No one is able to predict the next hard market (which can be brought on by either a single catastrophic event or the consistent erosion of profit in the insurance and reinsurance sector), but, when it happens, policyholders will likely face meteoric rate increases from their insurance and reinsurance carriers.

  A hard market will have less of an impact on pools operating their own captives. This pricing control provides additional motivation for pools to consider self-insuring a greater amount of their own risk.
The Law of Large Numbers continues to be the risk financier’s best friend. Figure 1 represents the total incurred losses for a single public entity pool with a relatively small amount of risk (in insurance, risk is always measured in dollars!). The graph represents an entire year of insurable losses. It can be easily seen that most losses are small and incidental, but every now and again there is an insurable loss of note for the pool (the highest bar looks to be about $95,000). The chances of this event happening may be the figurative “one-in-a-thousand,” but if there are hundreds of insurable losses per year, it doesn’t take too long (a couple of months or years) to land on one of these one-in-a-thousand events.

Aggregating several public entities’ losses together (in a captive, for example) has two effects (Figure 2). First, the volatility of losses is reduced below a more clearly defined threshold (this is usually where a deductible or self-insured retention is set). Therefore, losses are easier to predict (red line in Figure 2). Second, the $95,000 large loss of a single public entity pool (red arrow in Figure 2) is no longer an outlier. In fact, given the losses of others in the group, it becomes closer to a regular occurrence. Additionally, it is dwarfed by another pool’s unfortunate loss of about $700,000. This is the new outlier in the aggregated group.

From a risk financing perspective, the group has more predictable losses than each individual pool and is better suited to pay for the extreme loss than any individual pool would be on its own.

**HOW THIS ALL WORKS**

**BENEFITS CONTINUED**

- **Investment income.** Captives generally have more freedom to invest their assets than public entity risk pools. This flexibility allows captive owners to take advantage of revenue generated by the financial markets for the benefit of both the captive and the underlying pool(s) in previously unavailable ways.

  When a pool purchases a reinsurance or excess insurance policy to transfer risk (for a premium!), it loses control over all of the above, as well as any profit that might be generated for the benefit of its members.*

  *While “profit” is often a verboten word in pooling, with a private enterprise like a captive this is precisely the correct term. Profits—defined as premium less losses and expenses—don’t have to be negative or intended to line pockets. Profits can be used in the following ways:

  - to further enhance the uses of the captive,
  - to be returned to the pool as dividends,
  - as a premium credit, or
  - as investments in risk management initiatives.

The Law of Large Numbers continues to be the risk financier’s best friend. Figure 1 represents the total incurred losses for a single public entity pool with a relatively small amount of risk (in insurance, risk is always measured in dollars!). The graph represents an entire year of insurable losses. It can be easily seen that most losses are small and incidental, but every now and again there is an insurable loss of note for the pool (the highest bar looks to be about $95,000). The chances of this event happening may be the figurative “one-in-a-thousand,” but if there are hundreds of insurable losses per year, it doesn’t take too long (a couple of months or years) to land on one of these one-in-a-thousand events.

Aggregating several public entities’ losses together (in a captive, for example) has two effects (Figure 2).

First, the volatility of losses is reduced below a more clearly defined threshold (this is usually where a deductible or self-insured retention is set). Therefore, losses are easier to predict (red line in Figure 2).

Second, the $95,000 large loss of a single public entity pool (red arrow in Figure 2) is no longer an outlier. In fact, given the losses of others in the group, it becomes closer to a regular occurrence. Additionally, it is dwarfed by another pool’s unfortunate loss of about $700,000. This is the new outlier in the aggregated group.

From a risk financing perspective, the group has more predictable losses than each individual pool and is better suited to pay for the extreme loss than any individual pool would be on its own.
CONSIDERATIONS

AS OWNERS OF A CAPTIVE, POOL ADMINISTRATORS HAVE COMPLETE MANAGEMENT CONTROL OVER THE COMPANY, MAKING IT OPERATE EXACTLY AS IT NEEDS TO.

At the heart of every business decision is the question of whether benefits will outweigh costs. Each pool must make its own assessment in the following categories—at a minimum—when deciding whether to start a captive. As with most things in pooling, there are no absolutes here. The most important thing is that pool leadership have these conversations, weigh the pros and cons of the specific situation, and feel confident in their decisions before moving forward. (Remember, too, that if you choose to create a captive, there will be start-up costs.)

• **Coverages.** The line(s) of business your captive offers need to align with the coverage(s) offered by the underlying pool(s) on a basic level. If you have a multiline pool, you may decide to start a captive for one, some, or all of the coverages you offer. You might also scan the market and assess the types of claims that are currently being excluded or “price corrected” from commercial insurance and reinsurance company policies. (Current examples could include sexual abuse and molestation [SAM] coverage, and property coverages like hail and wildfire damage.) Most importantly, be sure to maintain broad vision and consider all the ways a captive could be helpful to your pool—not just a singular line of coverage or claim that may or may not continue to be impactful over time.

• **Risk financing structure.** You’ll also need to determine the best way for your captive coverage to attach to your pool operation. Typical options include:
  • Straight reinsurance—the captive offers a policy filling the gap between where the pool wants its self-insured retention (SIR) and where its reinsurance company prefers it.
  • Shock loss fund—the captive maintains a fund for a single (or double) shock loss, thus retaining that single event risk instead of a reinsurance company charging additional premium.
  • Aggregate coverage—the captive provides coverage after reinsurance limits are exhausted.
  • Custom coverage—any combination of the above.

• **Organizational structure.** Captives can be a single legal entity (pure) or a cell within a larger entity (sometimes called rent-a-captives or condo captives). A cell captive essentially “rents” capacity from a larger entity that insures or reinsures risks in individual underwriting cells.

Previously, cells were not separate legal entities, and their activity was governed by a participation agreement or preferred share arrangement. Today, due to concerns around unplanned risk-sharing among cells, most cell arrangements are separately incorporated and function similar to a pure captive. Pure captives have slightly higher operating costs and capital, with complete control. Cells have slightly lower costs and capital with less control, and may include additional fees.
• **Membership.** If a pure captive is being formed, one of the first things a pool must decide is whether to go it alone or form a “pool of pools.” A single-parent captive can be structured to be optimally beneficial for the underlying pool without taking any other entities into consideration. However, a pool of pools maximizes the benefits of the Law of Large Numbers [see the How This All Works on p. 3] for all members of the captive.

You may decide that the increased stability of a pool of pools is worth the tradeoff of sharing captive control. Or you could decide that sole management is more important than spreading risk. If you are forming a cell, it is likely your pool will be the only participant.

• **Administration.** Regardless of structure, a captive needs to be managed. Captives can have their own dedicated staff; share staff with the underlying pool(s); be completely outsourced to a captive management company; or operate with any staffing combination thereof. If staff is shared, pool administrators may find it difficult to manage a captive as well as the pool, even if both entities benefit from the shared work. (For example, large claims passed from the pool to the captive can be processed more efficiently with the same staff, but the day-to-day business of administering both a pool and captive might be too unwieldy to make that efficiency gain worthwhile.)

Captive management companies offer a wide range of services and are able to administer captives competently. But these services come at an expense. If a captive management company is to be used for administration, the captive owners should issue an RFP for services to ensure they are getting the best the market has to offer.

• **Governance.** There are several options for structuring captive governance, including forgoing a governing board altogether. A pure captive can be represented by the underlying pool board, a whole new governance structure, or managed solely within the purview of pool administration for efficiency. Multi-pool captives often utilize boards to ensure all members are represented fairly and equally in decision-making. If you employ a captive management company, you may find it particularly important to have a governing board so that the interests of the pool are adequately communicated and represented.

When you are considering captive formation, be sure to include your pool’s governing board in strategic conversations and decision making before going forward.

• **Domicile.** Selecting a captive domicile is an important consideration that will have significant and long-lasting impact for many reasons, including regulation of captive operations. As a rule of thumb, captives are regulated by each domicile’s Department of Insurance, and their oversight is relatively modest compared to for-profit commercial insurance company regulation. Still, any level of supervision may be an adjustment for pool administrators accustomed to relaxed or minimal pool regulation.
Other items to consider when selecting a captive domicile include but are not limited to:

- capitalization requirements,
- operating costs,
- tax structure,
- government fees,
- investment restrictions,
- reporting and audit requirements,
- proximity to pool operations, and
- political messaging if the domicile is out of state.

As of 2019, 34 states plus the District of Columbia [see map] have laws enabling captive formation. A pool could also choose to place a captive offshore. If you are forming a cell, be sure to consider how the parent entity’s domicile could impact your own operations.

Decisions about the factors above will impact your captive’s foundational documents—such as bylaws, articles of incorporation, membership agreements for multi-pool captives, etc.—and operational policies and procedures.

**FEASIBILITY**

There are many moving parts to consider when creating a captive, but a good deal of uncertainty can be resolved with a feasibility study. This is an essential part of a captive’s application to its regulator and can also be comforting to the potential owners. Included in a feasibility study is a pro forma financial analysis, which projects the first five years of operations. Regulators’ prime directive is solvency, so compiling a snapshot of the first several years is important. The hardest elements to predict on the pro forma are premiums and losses, but trained actuaries can help with that. A feasibility study should also include an analysis of options for entity structure, formation, and operation to help you make an informed decision about captive construction.

Even if you plan to administer a captive yourself, you may find an experienced consultant particularly helpful when conducting the feasibility study.
COMMUNICATION

As with any new venture, appropriate messaging—what should be said to whom, and where, when, and how it should be said—is an important consideration. It may be difficult for the pool to explain to regulators, pool members, and (potentially) the public at large the rationale for creating a second, subservient entity. Before unveiling a new captive, therefore, be sure to consider communication needs and prepare accordingly.

CAPTIVATING QUESTIONS FOR POOLS

When considering captive formation, you might start with the following questions.

• What are the benefits and challenges that my specific pool has in creating a captive?
• What lines of business (or coverages) can the captive provide that will help my pool?
• What type of claims are currently being excluded from commercial insurance and reinsurance companies’ policies that my captive needs to cover?
• What type of risk financing structure can the captive provide that will help my pool?
• Should we form a cell, single-parent, or multi-pool captive?
• How will the captive be administered, and how much will that cost?
• What is the role of the pool governing board, both in captive formation and administration?
• What is the optimal governance structure for the captive? Why?
• Which captive domicile is appropriate for my captive? Why?
• Should we engage a captive management company to help with this process? If so, how and when?
• How will captive formation and operation be communicated to pool membership, regulators, the public, etc.?
• What is my pool’s budget for starting up a captive? For maintaining it?
• Are there other ART options beyond forming a captive, and should we consider them?

If these questions feel overwhelming, they very well may be. But with the right guidance and the proper analysis, you just might determine that creating a captive is right for your pool. There are plenty of brokers, consultants, and captive managers familiar with public entity pooling who can help you navigate initial discussion (start with AGRiP QEI Patrons). The industry standard website www.captive.com can also provide helpful information.
WE MAKE IT SIMPLE FOR POOLS TO ACCESS EXPERTS AND FOR EXPERTS TO ACCESS POOLS