CICA
CAPTIVE INSURANCE COMPANIES ASSOCIATION

INFORMATION STATEMENT REGARDING SMALL CAPTIVES

Revised July 2, 2018

The captive industry's growth over the past decade has primarily been with smaller captive insurance company vehicles. As this market segment matures, significant innovation has occurred to tailor the usage of the captive vehicle to middle market businesses to solve their specific risk management needs. With a maturing smaller captive market segment also comes a better understanding of certain practices that were common when this market segment was in its infancy, but which we recommend should no longer be followed today.

The designation of "small" captive refers to those captives that are set up for middle market businesses and typically have a premium amount less than $10 million. Due to the size of these captives and the businesses that utilize them, the term "small" better refers to this market today.

The insurance and risk management challenges faced by small businesses differ in some important respects from those of larger companies, although the characteristics and best practices mentioned herein equally apply to both large and small captives. Fortune 1000 companies are often geographically diversified, have multiple revenue streams, have large balance sheets, and can readily access capital and credit markets to smooth cash flow fluctuations that result from unexpected contingencies. These companies tend to procure fairly standard commercial insurance coverages and policies from a variety of global carriers on an annual basis. In general, coverages placed for Fortune 1000 companies are consistent and are priced in a very dynamic competitive environment.

By contrast, smaller closely held businesses often operate in more geographically localized areas, have non-diversified revenue streams, have small and often highly leveraged balance sheets, and have very limited access to public capital and credit markets, which makes these business models much more fragile. On occasion, such enterprises may face risks that could imperil their financial longevity; importantly, many such risks may not be insurable by the commercial market or may be unaffordable for smaller business to insure by a commercial carrier.

Smaller businesses often lack expertise in matters of risk management and captive insurance, as well as expertise in matters of finance, tax, and asset management. Recognizing this, owners of these businesses have traditionally relied upon independent, outside financial professionals, including CPAs, business and estate planning attorneys, investment advisors, and insurance agents, to guide them. A person from the insured business should also participate in the management of the captive.

Most small captives are legitimately formed, have been operating for some time, and fulfill legitimate and valuable business purposes. However, it is also equally true that some small captives formed in recent years are poorly organized, have not been managed or operated appropriately, and lack sufficient non-tax business purposes.

<u>Small captives should comply with CICA's previously published *Best Practices Guidelines* in every respect.</u> In particular, a properly formed and operated small captive will demonstrate these characteristics:

1) **Business Purposes:** The small captive must have a valid non-tax business purpose centered upon one or more risk management and/or insurance goals.

2) **Service Providers:** The small captive must engage a captive manager authorized as such in a jurisdiction in which the captive will be formed and domiciled, and other service providers with appropriate insurance-related experience and/or credentials. It is important for the captive manager to establish a good working relationship with its captive client. A captive manager skilled in the design and operation of captive insurance companies will be able to guide the captive through the necessary requirements of maintaining a compliant, liquid and solvent, and operationally smooth captive. These service providers are, ideally, already focused on a broad array of captive structures in the general alternative risk marketplace and are, thus, merely providing their current insurance and risk services to a smaller market niche of small captives. All unrelated service providers must serve and advise independently of each other, but still act as a team.

3) **Insurance Coverages:** The coverages provided by the small captive must address insurable risks of the insured enterprise or the affiliated or controlled unaffiliated enterprise. Captives must use insurance policy forms that are properly drafted and follow the conventional format for how insurance contracts are written. Such coverages will thus mirror traditional policies and incorporate the necessary elements of an insurance contract, such as an Insuring Agreement, Definitions, Conditions, Exclusions and any required Endorsements. In addition, the captive should have sufficient liquid assets to support claim obligations for the risks being written, including one maximum limit claim. Captive policies may insure frequency type coverages, severity type coverages, or a blend of both.

4) **Premiums and Underwriting:** Premium development should: (1) be actuarially derived and based on underwriting criteria, judgment and expertise; (2) be determined for the specific insured enterprise; (3) identify specifically applicable coverages; (4) document the corresponding exposure and pricing development; (5) be priced in a range comparable to commercial market rates where similar coverage is offered and reasonable to do so; and, (6) show evidence of reaction to loss experience. Captive premium pricing may vary from the market rate for similar commercial coverage, but where the discrepancy is significant, sufficient underwriting and actuarial analysis should demonstrate why such premium rate is appropriate. Premiums should be developed with robust analytics and exposure-based analysis. As appropriate, premium amounts charged after the initial year should be adjusted higher or lower depending on claim activity, loss development and program experience, actuarial and underwriting input and judgment, and other aspects of the insured's exposures. Such adjustments are a core function of underwriting policies for the captive. The timing of premium payments to the captive should be prior to or during the policy period, not after the policy period has ended.

5) **Risk Distribution**: Captives of all sizes increase their risk distribution through participation in a risk pool/s or use other means, such as the commercial reinsurance market, to spread their risk. The insurance purpose of risk distribution is generally that the reasonable premiums of the many pay for the expected losses of the few. So, risk distribution in essence allows any insurance company, captives included, to reduce the possibility that a single costly claim will exceed the amount of overall premiums collected.

6) **Risk Pooling**: A risk pool allows multiple unrelated insureds or captives to have a portion of their risk insured or reinsured by the pool. The pool then cedes a share of its combined risk to the participating reinsurer captives, making each captive indirectly an insurer of a large number of independent risks. Pools may take a variety of different forms, including sharing low severity or high severity risk (or a combination of both), sharing one type of risk exposure or a variety of risk exposures, or having a different mechanism for how the flow of risk and premium is structured amongst the participants. Risk pools should retain sufficient premium, free surplus, assets and/or collateral to be able to timely pay covered claims. Risk pool premium pricing should follow the criteria outlined in number 4, above. Risk pools must have established claims handling procedures and should have a history of claims activity. [1]

7) **Corporate Governance:** A small captive must comply with the standards of corporate governance required by captive enabling statutes and, as appropriate, corporate law. Small captive owners should identify and appreciate the conflicts of interest that may arise with their own potential conflict in being both owner and customer. Corporate governance also includes record keeping as well as annual meetings of the shareholders and of the board of directors of the captive. These meetings, and any significant decisions or actions taken during these meetings, must be documented with agendas and minutes.

8) **Investments:** Small captives must balance their regulatory investment parameters with prudent investment practices that will ensure liquidity to pay claims as they arise. Small captives must have a formal investment policy, and they should make investments that are consistent with the provisions of the investment policy statement. In general, a captive is best served by employing an investment mandate that tends to mirror those utilized by traditional insurance companies; *i.e.*, an investment policy statement focused on liquidity, preservation of capital, prudent risk adjusted returns, and asset and liability matching using conservative and/or rated investment assets. There should be no seeking of outsized market returns, taking imprudent risks in terms of investment allocations or selection, or utilizing investments purely for their potential tax ramifications. Investment decisions must be based upon the needs of the small captive in fulfilling its primary insurance purpose rather than the personal purposes of the small captive's owners. Additionally, captive managers must be knowledgeable about jurisdictional requirements for investments and will typically be involved in reviewing and obtaining regulatory approval on material changes to the captive's investment policy.

9) **Loans:** Loans can be (state or offshore) department of insurance approved investment assets for a captive, but they are not without controversy from an income tax perspective. In general, loans - if utilized as investments - must represent bona fide indebtedness evidenced by a promissory note or some other formal, written document that is executed by the necessary parties. Loans must be enforceable and contain commercially reasonable repayment terms and appropriate interest. Loans should only be made from

[1] **Because these requirements are complex and the law in this area is developing, this Statement will not attempt to analyze them.**

excess surplus funds, and where required, reviewed or approved by the regulators. Loans should not impair the ability of the captive to pay claims, nor impair surplus. Principal and interest payments should be timely made under the loan contract.

10) **Distributions:** Similar to loans, distributions from the captive must consider the nature and timing of claims development and settlements, along with the reserves/capital necessary to grow as an insurance company, and not operate as a pass-through vehicle for profits to the small captive's shareholders.

11) **Claims:** Insureds must make diligent efforts to report all claims under their captive policies. When a captive has zero losses in a given year or a number of consecutive years, this may indicate that the insureds should review their internal risk management controls to make sure all possible claims are being tendered to the captive. Having zero losses in a captive is not a negative characteristic if the insured/s underlying risk management is effective and there was no need to tender any claims because there were none. The small captive must utilize the services of claims adjusters, have internal processes governing the adjusting of claims, and set aside adequate reserves to pay all claims on a timely basis. A qualified captive manager may be able to assist with claims adjusting, or the captive may outsource this function to a TPA.

12) **Domiciles:** Captives, large and small, are domiciled in only one jurisdiction, although they may have insured risks in many states and countries. Over the past several years there have been a significant number of states enacting captive insurance laws. At the same time, the training and experience of some offshore domiciles has also greatly increased, resulting in similarly strong regulatory oversight.

13) **Binding coverage:** The captive must bind coverage in advance of the risk being insured and not delayed until after a profit is guaranteed in the captive, *e.g.*, insuring a calendar years' worth of business interruption at the end of the same year. CICA recognizes that certain common insurance transactions are based on prior activity and may properly transfer the remaining risk to a captive (*e.g.*, loss portfolio transfers, prior acts or nose and tail coverages). The effective date of the policies must be on or after the license date of the captive.

14) **Tax Considerations:** Tax effects of forming and operating a captive should be considered just as they should be with the formation and operation of any corporation. Captives that qualify are entitled to tax benefits under the Internal Revenue Code. Advice from a qualified and experienced tax professional is strongly recommended so that a captive owner understands what tax benefit the captive may be entitled to and can then decide whether or not to elect any such benefit.

CICA's mission is to be the "best source of unbiased information, knowledge, and leadership for captive insurance decision makers." CICA does not favor some business models over others or favor one size of captive over another. CICA does not favor different standards of regulation for small versus big captives. Rather, CICA strives to provide meaningful, objective guidance that will help CICA members and the public to better operate and understand captive insurance companies. CICA recognizes that while similar principles can be followed regardless of captive size, smaller captives operate on a smaller budget and smaller scale. This guidance has many uses, including helping CICA members and the public differentiate between legitimate captive insurance arrangements and questionable ones motivated primarily by tax considerations, minimal effort on risk management or non-tax purposes.

Any small captive formation process, structural organization, or operational characteristics that materially diverge from the fourteen points listed above or from CICA's *Best Practices Guidelines* and additional noted practices-must be scrupulously avoided.

REMINDER: All of the foregoing guidance and commentary must be read in conjunction with CICA existing *Best Practices Guidelines*. This "Information Statement" is designed only to supplement existing *Best Practices Guidelines* for discussions involving small captives and not to serve as a comprehensive, stand-alone document. In addition, this Statement Regarding Small Captives should be read in conjunction with CICA's previously issued statement on 831(b) captives entitled "Do 831(b)s Right or Don't Do Them at All."