INFORMATION STATEMENT REGARDING MICRO-CAPTIVES

August 17, 2015

Micro-captives are simply small captive insurance companies generally utilized by middle-market, privately held businesses. The insurance and risk management challenges faced by small businesses differ in some important respects from those of larger companies. 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. Further, these organizations tend to procure fairly standard commercial insurance coverages and policies from a variety of global carriers on an annual basis. The coverages are, as a general statement, 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, making their business models much more fragile. On occasion, such enterprises may face unique business risks that could imperil their financial longevity; however, many such risks may not be insurable on a commercial basis.

Consequently, micro-captives often focus on insuring first-party exposures (including deductible reimbursements), business interruption or loss of income events, and other low-frequency/high-severity events that larger companies, with their more robust business models, may informally "self-insure." Some micro-captives have sought to insure some of their unique business risks uninsurable in the traditional market (or not available under commercially viable terms and conditions), thus creating some unique challenges.

Smaller closely held 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 closely held businesses have traditionally relied upon independent, outside financial professionals, including CPA's, business and estate planning attorneys, investment advisors, and insurance agents, to guide them. Consequently, small and mid-market businesses are increasingly learning about captive insurance companies from these "non-traditional" captive insurance advisors.

The purpose of this Information Statement is to supplement CICA's two existing Best Practices Guidelines:

- <u>Captive Best Practices Guidelines – Volume 1</u>
  - Business Alignment
  - Corporate Governance
  - Regulatory Compliance
- <u>Captive Best Practices Guidelines – Volume 2 – Utilizing Service Providers</u>
  - Actuary/Consultant
  - Attorney
  - Captive Manager
  - Auditor

In addition, this Information Statement must be read in conjunction with CICA's previously issued statement on 831(b) Captives: "Do 831(b) Captives Right or Don't Do Them at All".

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. Rather, CICA strives to provide meaningful, objective guidance that will help CICA members and the public to better operate and understand captive insurers. 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.

Many micro-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 micro-captives formed in recent years are poorly organized, have not been managed or operated appropriately, and lack sufficient non-tax business purposes. In particular, some micro-captives utilizing the Internal Revenue Code 831(b) election (sometimes referred to as 831(b) captives) have been subject to these criticisms.

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

1) Business Purposes: The micro-captive must have a valid non-tax business purpose centered upon effective risk management through valid insurance arrangements.

2) Service Providers: The micro-captive must engage a captive manager and other service providers with appropriate insurance-related experience and/or credentials. 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 micro-captives in this instance. Those service providers must serve and advise independently of each other, but still act as a team. Micro-captives must have independent counsel familiar with the design and operation of captives.

3) Insurance Coverages: The coverages provided by the micro-captive must address insurance risks that are applicable to the insured enterprise and rely on policy forms that are properly manuscripted for that purpose. Such coverages should mirror traditional policies as a general statement and incorporate the necessary elements of an insurance contract.

4) Premiums: Premium development must be, insofar as possible, actuarially derived; be unique to the insured enterprise; identify specifically applicable coverages; document the corresponding exposure and pricing development; be compared to market when possible (either to establish that no comparable market exists or to establish a reference point for comparison); and show evidence of reaction to experience. When no market based premium comparisons are available, premiums should be developed with robust analytics and exposure based comparisons to evaluate a range of potential pricing outcomes.

5) Risk Pools: Most micro-captives participate in a risk distribution pool to minimize the impact of large losses. Typically, such pools are also designed to conform to the legal requirements to

achieve risk distribution for tax purposes. The risk pool operator must be able to explain and document the proportionate share of risk being shifted to and from the pool, along with the actuarial basis for determining the premium. In addition, the pool must have a method of independently reviewing and approving claims and the pool must have a method of securing the payment of those claims.

6) Corporate Governance: A micro-captive must comply with the standards of corporate governance required by captive enabling statutes. Micro-captive owners should identify and appreciate the conflicts of interest that arise in micro-captive design and operation. In particular, micro-captive owners must be aware of their own conflicts in being both the owner and customer of the captive and of their service providers' conflicts in regard to advising the captive and continuing their own contracts with the captive.

7) Investments: Micro-captives must balance their regulatory investment parameters with prudent investment practices that will ensure liquidity as their projected needs arise. Micro-captives must have a formalized investment policy statement, and they should make investments that are consistent with the provisions of the investment policy statement. As an over-arching statement, a captive is best served by employing an investment mandate that tends to mirror those in place in the traditional insurance company universe; that is, 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 not be an emphasis upon seeking 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 micro-captive in fulfilling its primary insurance purpose rather than the personal purposes of the micro-captive's owners.

8) Claims: The micro-captive must set aside adequate reserves to pay all claims on a timely basis and must either have internal claims settlement capability or retain the services of a qualified claims settlement provider. Further, the loss reserves of the micro-captive should be subject to a diligent annual actuarial reserve review from a credentialed firm with the requisite experience in both captive insurance companies and as respects the underlying risks.

In addition, a micro-captive must engage one or more qualified experts to determine:

- That the micro-captive has a mechanism for distributing risk to spread the impact of a large loss across premium from multiple risks, including that this mechanism meets the IRS's test for risk distribution, e.g., insuring multiple risks/polices into the captive,
- That the ownership structure of the micro-captive accomplishes the objectives of the business owner, including that this ownership structure meets the IRS's test for risk shifting, e.g., maintaining an ownership structure that clearly transfers risk,
- That the micro-captive times the binding of the coverage so that coverage is bound in advance of the risk being insured and not delayed until after a profit is guaranteed in the captive, e.g., insuring a calendar year's worth of business interruption at the end of the same year, and
- That distributions from the micro-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 just operate as a pass-through vehicle for profits to the micro-captive's shareholders.

These practices can be critical to distinguishing the micro-captive as a legitimate insurance company from IRS, regulatory and audit perspectives.

Any micro-captive formation process, structural organization, or operational characteristics that materially diverge from the eight 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 micro-captive and not to serve a comprehensive, stand-alone document. In addition, this Statement Regarding Micro-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".