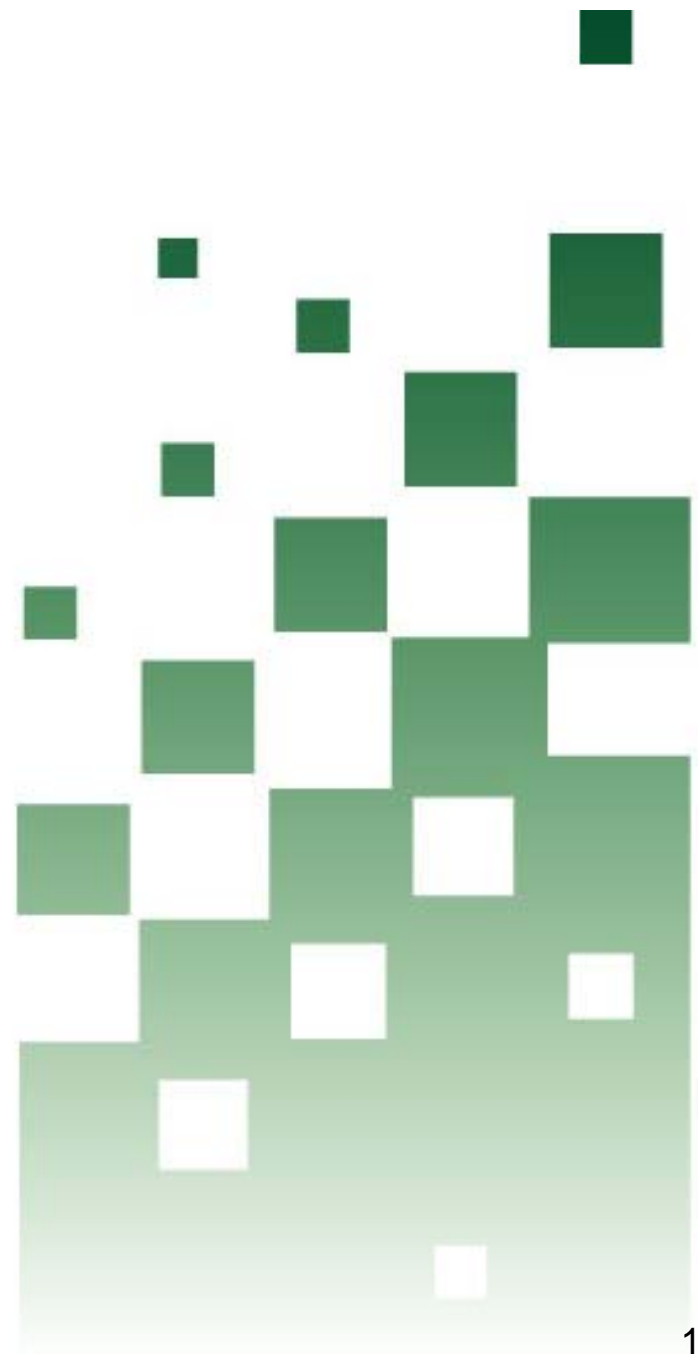


Self-Insurance and Captives

Basic Concepts

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Common Goal

- ◆ We are in the same business – the risk business.
- ◆ Treasury Operations and Risk Management share a common goal:

- ASSET PROTECTION

We're all risk managers

- ◆ **Risk Management** is the practice of avoiding, mitigating and transferring certain risk in order to create greater predictability for consumers and business.
- ◆ It allows people and organizations to use risk intelligently to maximize their opportunities.

Insurance

- ◆ **Insurance**, in law and economics, is a form of risk management primarily used to hedge against the risk of potential financial loss.
- ◆ Goal of insurance is to transfer risk away from buyer's balance sheet.
- ◆ The buyer exchanges a known cost (premium) for an unknown cost (loss) during a given period of time (policy period).

Commercial Insurance

- ◆ Commercial insurers:
 - Are able to aggregate risk, spread risk, and reinsure risk with a goal of making it affordable to most buyers.
 - Have to comply with regulatory bodies (rate-making and reserve-setting).
 - Have to be profitable.
 - Spread administrative overhead among all policyholders.

Commercial Insurance (cont.)

- ◆ What's wrong with Commercial Insurance?
 - It may not be affordable for potential buyers:
 - Bad risk profile (“cat” exposure);
 - Poor loss experience;
 - Bad venue (Cook County med mal);
 - Cost outweighs the potential benefit;
 - Inflexible terms and conditions

Alternative Risk Transfer (ART)

- ◆ ART is an alternative to traditional insurance.
- ◆ A company's risks are funded from something other than a traditional insurance policy.
- ◆ ART's include:
 - Self-insured trusts
 - Captive insurance companies

Self-Insurance

- ◆ **Self insurance** is a risk management method whereby risk is retained, with a calculated amount of money set aside to compensate for the potential future loss.
- ◆ The dollar amount is calculated using actuarial and exposure information as well as the law of large numbers, so that the amount set aside (similar to an insurance premium) is enough to cover the future losses.

Self-Insurance (cont.)

- ◆ Full or exclusive self-insurance is rare, as a combination of self-insurance and commercial insurance usually provides the best cover for the self-insured entity.
- ◆ Usually the predictable losses are retained and self-insured, forming a first layer or "working layer" of coverage.
- ◆ A stop-loss policy is purchased from the commercial insurance market to provide coverage for losses above the "working layer".

Self-Insurance (cont.)

- ◆ Depending on the level at which risks are stopped, commercial insurance cover *should* become less expensive the further away the commercial insurer moves from the “working layer”.

Self-Insurance Trusts

- ◆ Trusts are often used to fund the “working layer”
 - [a.k.a., a “Self-Insured Retention” (SIR)].
- ◆ Trusts are formal structures and have a self-insurance program or “Plan” document.

Self-Insurance Trusts (cont.)

- ◆ The “Plan” is similar to an insurance policy and often will cover:
 - Scope of coverage;
 - Exclusions;
 - Limitations on use of Plan funds;
 - Limits.

Self-Insurance Trusts (cont.)

- ◆ The insured organization sets aside money to cover losses that may occur.
 - This is *not* “pay as you go”.
- ◆ The money that would normally go to pay commercial insurance premiums is instead paid into a trust fund set up for this purpose.
 - Dedicated funds – not to be “raided”.
- ◆ The trust provides a source of payment for losses (indemnity) and litigation expenses.

Self-Insurance Trusts (cont.)

- ◆ The trust fund holds the reserves that are dedicated to cover claims and administration costs.
- ◆ The trust can be administered by an independent fiduciary, such as a bank, or private benefits administrator, with the obligations spelled out in a trust agreement.
- ◆ The commercial insurer providing insurance protection above the buyer's SIR underwrites the buyer's financial ability to pay claims from the SIR reserve.

Self-Insurance Trusts (cont.)

- ◆ Reserves and funding (contribution) levels are determined on the basis of an actuarial study performed at least annually.
- ◆ The trust administrator may require the assistance of claim professionals to manage claim activity and provide action to reduce the frequency and severity of losses.

Self-Insurance Trusts (cont.)

- ◆ The Trust Administrator also:
 - Consults with state authorities and/or legal counsel to see if the state allows self-insurance trusts, and/or has any reporting requirements.
 - Checks with their state's Medicaid cost reimbursement principles to see if fund contributions are allowable as a reimbursable cost.

State guidelines

The screenshot shows the official website for the Office of Insurance within the Department of Industrial Accidents, Division of Administration. The page features a blue header with the 'Mass.gov' logo and navigation links. The main content area is centered and includes the department name, office title, and names of the Deputy Commissioner and Director of Insurance. Below this, there are three columns of information: contact details for Boston, the Director, and Admin Assistants; a central section titled 'SELF INSURANCE' with a detailed description of the license requirements; and a right-hand column titled 'SELF-INSURANCE FORMS' listing various forms available for download.

Mass.gov • mass.gov home • online services • state agencies SEARCH MASS.GOV

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RESEARCH ANALYSTS

The Office of Insurance issues self insurance licenses, monitors all self insured employers and maintains the insurer register.

SELF INSURANCE

A license to self insure is available for qualified employers with at least 300 employees and \$750,000 in annual standard premium. To be self insured, employers must have enough capital to cover the expenses associated with self insurance (i.e. bond, reinsurance, TPA and lawyer). The Office of Insurance evaluates employers every year to determine their eligibility for self insurance and to establish new bond amounts.

Any business seeking self insurance status must first send in the company's most current annual report (10K), description of the business and credit rating from at

SELF-INSURANCE FORMS

[Self Insured Questionnaire](#)

[Bond Form](#)

[Reinsurance Certificate](#)

[Agreement of Deposit of Securities](#)

[Blank Guaranty of Parent Co. Guaranteeing Subsidiaries](#)

Pros of Self-Insurance Trusts

- ◆ Save premium dollars by not purchasing first dollar insurance coverage.
- ◆ Eliminate overhead costs that commercial insurer's build into their premium.
- ◆ Retain investment income on fund balances.
- ◆ Retain autonomy to manage claims -
 - Select your own legal panel
 - Settle when you want, not when they want
- ◆ Have flexibility in determining "Plan" coverage and exclusions.

Cons of Self-Insurance Trusts

- ◆ By funding claims in the “working layer” frequency of claims becomes a big issue.
- ◆ No tax deduction for premium costs (if applicable).
- ◆ Forced to rely on third party administrators or other claim personnel to set accurate reserves, handle, and investigate claims.

Cons (cont.)

- ◆ Potential disallowance of fund contributions by Medicaid,
- ◆ Difficulty evidencing insurance coverages required by lease, mortgage, or financing agreements.

Sample Language

- ◆ **Minimum Insurance Requirements:**

Commercial General Liability (CGL Insurance): on occurrence form ISO 1988 or later, including Blanket Contractual, Broad Form PD, Independent Contractors or Contractors Protective Liability, Personal Injury and if applicable XCU; \$2,000,000 each occurrence for Bodily Injury and Property Damage

Products / Completed Operations Insurance: If furnishing to Company (by sale or otherwise), products, material or construction, installation, maintenance or repair services. CGL will be endorsed to include products/ Completed Operations coverage in the amount of \$5,000,000 per occurrence.

Insurance Companies providing coverage will be rated at least AVII by A.M. Best.

Lessor, its affiliates, divisions, subsidiaries, officer, and directors will be identified as additional insured's and the Supplier and its insurer's will waive its rights of subrogation in favor of Lessor, its affiliates, divisions, subsidiaries, officers and directors.

Captives

- ◆ A captive insurance company insures all or part of the risks of its parent company.
- ◆ It is a subsidiary of the parent.
- ◆ The most common types:
 - Single Parent Captive – insures only the risk of the parent company
 - Group Captive – owned by multiple organizations that share a similar risk profile with the captive providing insurance to each entity.

Captives (cont.)

- ◆ Captives operate similarly to commercial insurers:
 - Issue an insurance policy;
 - Assume risk in exchange for payment of a predetermined premium;
 - Have to be licensed in its “domicile”;
 - Are subject to insurance regulation

Captives (cont.)

- ◆ Domiciles – is the state or area where the captive resides. The captive is governed by their laws.
- ◆ Off-shore domiciles
 - Bermuda, Cayman Islands, BVI, and Barbados
- ◆ On-shore domiciles
 - Vermont, Hawaii, South Carolina, and District of Columbia

Domiciles (cont.)

LEADING CAPTIVE DOMICILES

Rank	Location	2004
◆ 1	Bermuda (1)	1,150
◆ 2	Cayman Islands	694
◆ 3	Vermont	524
◆ 4	Guernsey	410
◆ 5	British Virgin Islands	350
◆ 6	Barbados	257
◆ 7	Luxembourg (1)	219
◆ 8	Dublin	214
◆ 9	Isle of Man	175
◆ 10	Turks & Caicos (2)	164
◆ 11	Hawaii	147
◆ 12	South Carolina	114
◆ 13	Singapore	57
◆ 14	Switzerland	50
◆ 15	District of Columbia	40

Source: www.iii.org/media/hottopics/insurance

Domiciles (cont.)

- ◆ Offshore captive jurisdictions have increased captive regulatory oversight and has become comparable to U.S. captive regulation.
- ◆ Annual meetings at the location of the domicile are typically required.
- ◆ Capitalization amounts vary by domicile.

Pre-feasibility study:

- Review current insurance program to see if a captive is a viable option.
 - Not surprisingly, there are many consultants available to assist (for a fee) with this analysis.
 - Insurance brokers, specialty consultants, and law firms are potential sources for this service.

Pre-feasibility study (cont.)

- Provides the prospective captive owner with an analysis of:
 - Organizational structure
 - Domicile selection pros/cons
 - Risk Management purpose – i.e., can you meet your risk financing objectives?

Health Care Industry Captive Insurance

More than 20 years ago, McDermott Will & Emery created a distinct practice subgroup focusing exclusively on risk funding, captive insurance and professional liability issues in the health care industry. An adjunct to our extensive health care practice generally and our multi-industry captive insurance practice specifically, this sub-specialty combines the in-depth experience of several partners from different departments and offices. Our team has the diverse experience required to form and operate a self-insurance program. Equally adept in handling issues of taxable and tax-exempt health care entities, whether in a single participant or group setting, we have broad experience across the United States in structuring and implementing professional and general liability risk financing programs for hospitals, clinics, physicians, blood banks, assisted living centers, managed care providers and other health care providers. By applying innovative approaches to familiar problems, we have achieved tax-efficient and regulatory compliant results in complex insurance environments.

[▶ View the Health Care Industry Captive Insurance Detailed Description](#)

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Feasibility Study:

- ◆ STEP 1: Actuarial Study

- Hire actuary to:

1. Review past claims
2. Provide information about trends, attachment points, and premium.
3. Obtain projection on “expected” versus “worst case” claims scenarios.

Captive Insurance Company Consulting

Captive insurance companies can be valuable strategic tools in today's marketplace. Tillinghast has extensive experience in the design and review of captives and other alternative risk financing vehicles. We have helped hundreds of clients study the feasibility of a captive, and start and operate captives and other related entities. We have also helped numerous clients decide against the formation of a captive when it was not an appropriate vehicle, or to terminate a captive that was no longer useful.

Our captive consulting services include:

- Feasibility studies
- Implementation assistance
- Ongoing actuarial support and strategic planning.

Feasibility Study (cont.):

- ◆ STEP 2: Financial/Operations Evaluation & Business Plan
 - Pro-forma financial statements for the captive
 - Net present value cash flow analysis of the captive
 - Review of tax situation
 - Executive Summary for senior management

Feasibility Study (cont.):

- ◆ **STEP 3: Start the Paperwork!**
 - File the application with the domicile.
 - Line up all the “service providers” that you will need.

“Service Providers”

- ◆ Captive manager
- ◆ Auditor
- ◆ Bank (Letter of Credit)
- ◆ Consulting attorney
- ◆ Investment Manager
- ◆ Third Party Administrator (TPA)
- ◆ Others – (reinsurance intermediary, tax attorney)

What does this cost?

Service Provider	Low End	High End
Actuary	\$50,000	\$250,000
Captive Manager	\$5,000	\$50,000
Auditor	\$10,000	\$50,000
Bank (LOC)	25 basis points	50 basis points
Investment Manager	30 basis points	50 basis points
Attorney	\$250 per hour	\$500 per hour
TPA	Varies	
Consultants	Varies	

Business Plan

- ◆ The captive manager details in a business plan the following:
 - Proposed ownership
 - Reinsurance protection, if any
 - List of service providers
 - Premium allocation methodologies
 - Resumes of all directors/officers
 - Copy of the proposed insurance plan document

Approval

- ◆ Once the domicile regulators approve the plan, they issue a certificate of authority
 - Any changes from the original business plan have to be pre-approved by the regulators.
 - The time frame on approval can vary so be prepared to wait.

Steps to forming a Captive

Generally, the process of incorporating a captive insurer in Vermont and applying for a license from the Department of Banking, Insurance, Securities and Health Care Administration will involve the following steps:

1. [Arrange a meeting](#) with the Deputy Commissioner of Captive Insurance and staff to discuss the proposed captive and obtain initial reactions from the Department.
2. Prepare documents necessary for incorporation. The services of a local lawyer may be desirable.
3. Prepare documents necessary for application to the Department (see [captive application](#) for a list of these items.)
4. Submit one copy of all materials in numbers (2) and (3) above to the Commissioner of Banking, Insurance, Securities and Health Care Administration for review. Include a \$200.00 application fee and \$3,200.00 review firm fee.
5. Submit one additional copy of the application material to the assigned review firm when instructed to do so by the Commissioner.
6. Petition the Commissioner to issue a Certificate of Public Good. The factors to be addressed are outlined in 8 V.S.A. Sec 6006(d).
7. After the Commissioner has issued the Certificate of Public Good, present this and the documents in number (2) above to the Secretary of State's office along with the appropriate fee in order to incorporate the captive (see 11 V.S.A. Sec 2201).
8. After the incorporation, apply to the Commissioner for a Certificate of Authority and enclose the Power of Attorney form along with a \$300.00 license fee.

Other requirements:

1. Select a [Vermont approved management firm](#)
2. Have your CPA complete the necessary form for authorization to perform audits.
3. Have your actuary complete the necessary form for authorization to render the opinion on reserves.
4. An organizational exam may be performed by the Department as soon as possible after you receive the Certificate of Authority and have capitalized the captive. The cost of this exam will be borne by the applicant.



Why form a Captive Insurer?

- ◆ Potential tax advantages
- ◆ Price stability
- ◆ Coverage flexibility
- ◆ Claims resolution
- ◆ Reduced reliance on commercial insurance
- ◆ Reduced administrative overhead
- ◆ Cash flow

Why not form a Captive?

- ◆ High start-up costs
- ◆ Increased administrative costs
- ◆ Initial capitalization required by the domicile's regulatory body – could be low - \$250,000; or high - \$2 million or more
- ◆ Board meetings; Board stewardship
- ◆ Regulatory reporting

Conclusion

- ◆ Both self insurance trusts and captives have the primary function of reducing the overall cost of insurance.
- ◆ Either can only be successful if there is a commitment to loss avoidance, loss control, and loss prevention.

Captives in Higher Ed.

- ◆ Cornell
- ◆ Duke
- ◆ Northwestern
- ◆ Nova Southeastern
- ◆ Penn State
- ◆ Rutgers
- ◆ University of Michigan
- ◆ University of Washington

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