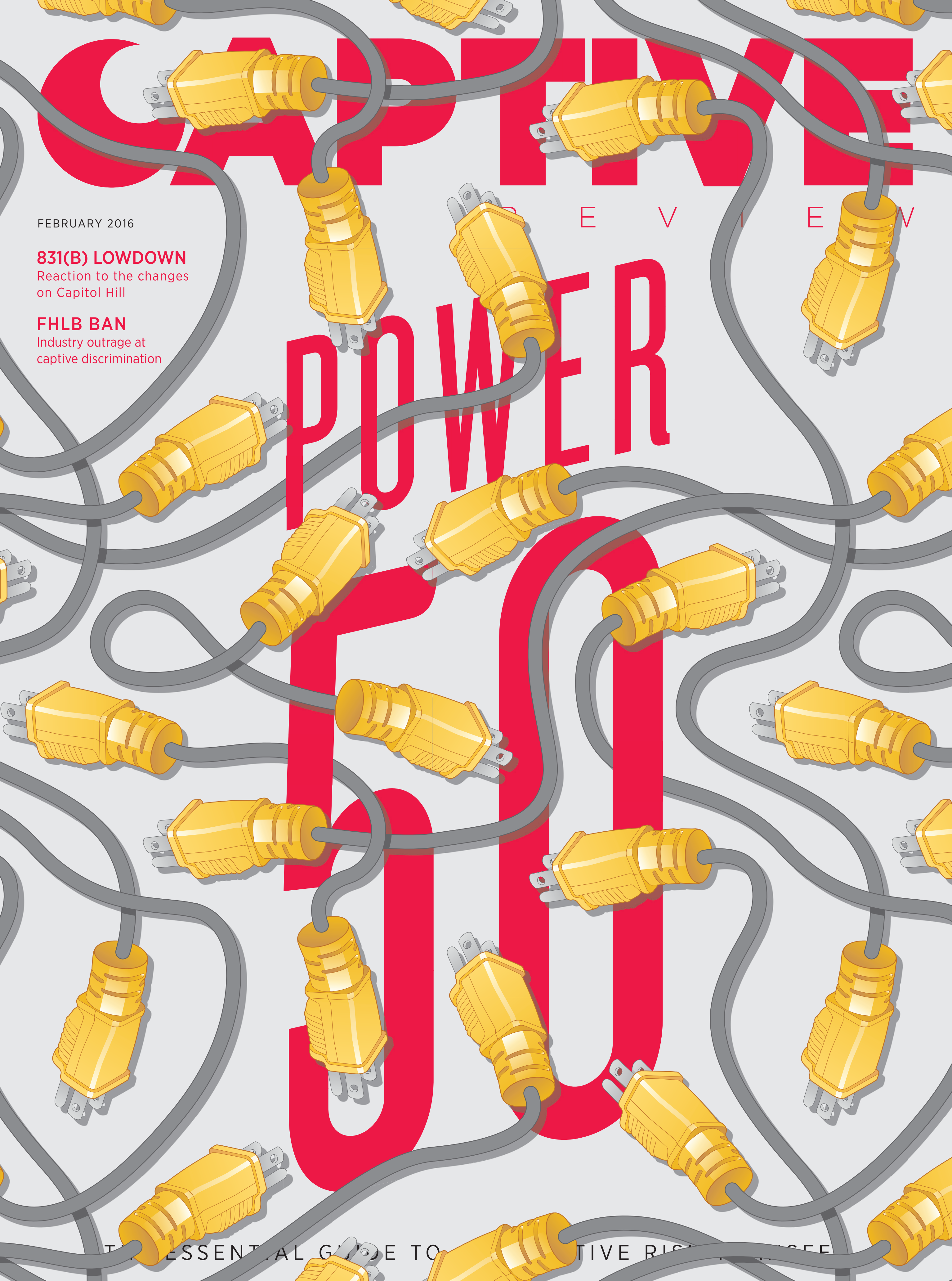


CAPTIVE
REVIEW
FEBRUARY 2016
831(B) LOWDOWN
Reaction to the changes on Capitol Hill
FHLB BAN
Industry outrage at captive discrimination
POWER
50

THE ACTUARY: STRENGTHENING INSURERS

Megan Brooks of Capstone Associated Services gives an detailed insight into actuary, pricing/remarking, Capital Adequacy and ORSA

The captive insurance movement is in full force. Corporations, non-profits, and association groups are realising the powerful benefits of captive formation. Closely held businesses operating in industries such as manufacturing, construction, healthcare and agriculture are forming their own captive insurance companies because of the unique flexibility and planning opportunities they provide. Gaps in commercial coverages are being filled and forward-looking coverages, such as those that cover cyber risks, are providing businesses with much-needed protections. It is clear that captive insurers aren't going away and it's time for all us to pay attention to the current and ever-evolving narrative surrounding captives and what they can do for middle-market business owners.

Types of captive insurers include wholly-owned subsidiaries of a parent company, association captives, and cell captives. Many domiciles, or captive jurisdictions, are located offshore, however an increasing number of states within the US provide an attractive domicile, including Delaware, Vermont, Tennessee and Texas. However, with this continued growth in the captive industry, scrutiny and regulatory changes are on the rise. Some insurance regulators are now requiring actuarial reports for each captive or analysis of certain functions, such as loss reserving.

What is an actuary?

Actuaries are insurance professionals, skilled in measuring and quantifying risk; they typically command an educational background in maths or statistics. Their knowledge base consists of all aspects of insurance operation such as claims, underwriting, marketing, legal, accounting, reinsurance and rate-making. Simply stated, actuaries attempt to predict the future. Aside from being soothsayers, they can help captive owners and managers figure out what premium to charge for coverage limits and deductibles, conduct retention level analysis, and set loss and loss adjustment expense reserve accruals for financial reporting purposes.

As a captive owner or manager, one should look for an actuary with the designation of Fellow, Casualty Actuarial Society (Fellow); this is the highest designation for a property and casualty actuary and they're held to a strict code of professional conduct and standard of practice. There are approximately 3,200 actuaries that hold the FCAS designation in the United States. By comparison, there are 1.3 million attorneys and more than 400,000 certified public accountants working in the United States; actuaries are a rare breed. Typical responsibilities an actuary may take on in the captive industry are: 1) premium pricing, 2) loss reserving and 3) capital adequacy.

Written by
Megan Brooks

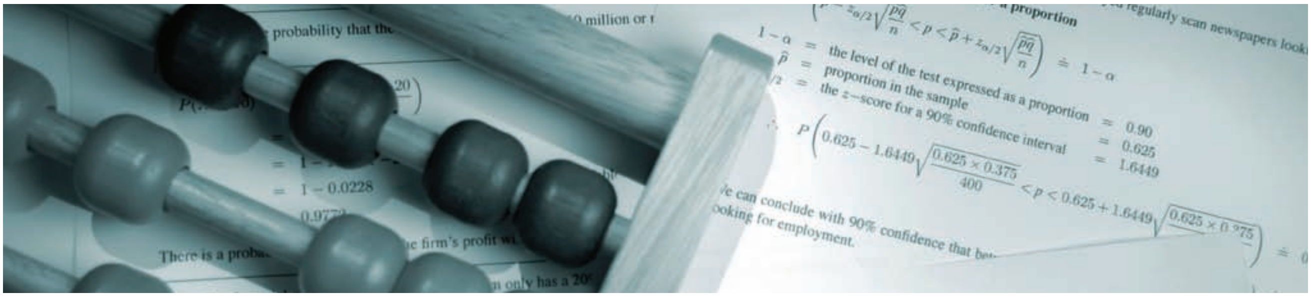
Megan Brooks is vice-president of operations at Capstone Associated Services. She has over 15 years of experience in the accounting field and 10 years of experience in the captive insurance industry. Ms. Brooks spearheads quality control initiatives, team coordination, training, and more.

Pricing/ratemaking

A captive's main purpose is to provide better risk mitigation for its affiliated or parent company. It puts power and money back into the hands of business owners, instead of diverting those assets to a commercial carrier. But captives are bona fide insurance companies and from an administrative standpoint, require experienced professionals to handle some of the hurdles – such as premium pricing. For the commercial market, pricing is considerably easier to handle, as there is an ample amount of data available and existing policies written to use as baselines. Of course, competitive forces within the insurance market make the process more difficult, but not impossible.

For coverages written through a captive, there are many factors that go into determining if a premium rate for an exposure is adequate or appropriate. It's best to avoid navigating these waters alone; an actuary is a great asset to a captive manager in helping to quantify the effects certain factors have on the pricing process and assert if the pricing makes sense. Premium rates need to appropriately reflect the risk being insured. Captive insurance companies typically write coverages that are not readily available in the commercial market or that are priced at a very high rate. Captive insurance owners establish their companies in an attempt to control their cost and mitigate their own risk. The use of commercial ratings is not always the best method because of these unique coverages and the captives' limited loss history.

In the absence of losses, the pricing may be an easy target for those reviewing and analysing the viability of these insurance companies – the



IRS, for example. The assistance and support of an experienced actuary is imperative for a captive insurance company to work as it should and as it was intended. An actuary will attempt to quantify many factors throughout the pricing process; these factors include the risk covered, the nature of the exposures and the changes in risk profile due to management initiatives.

Actuaries look at past experience of the coverage, inflation, expense forecast and the number of years the captive's been in business, and attempt to keep the coverage consistent from year to year. Captive insurers aren't on a level playing field as there's lack a credible loss history and examples of coverages written. Enlisting the work of an actuary will be a sure bet that a thorough analysis will be conducted and the risk of excessive or inadequate premiums will be reduced.

Loss reserving and actuaries

Another critical function in the daily management of a captive insurance company is setting loss reserves. Setting a reasonable accrual for unpaid loss and loss investment obligation requires thorough analysis of the programs actual data to the maximum extent possible to reflect the captive's unique loss characterisation.

Many insurance regulators require actuaries to review and certify the reasonableness of the loss and expense reserves held by the captive. We know that captive insurance companies typically write coverages that are either unavailable or exorbitantly priced in the commercial markets. But another key characteristic is that the losses are considered to be low-frequency and high-severity. Because of the relatively young industry, coupled with the aforementioned characteristics of captive insurance policies, the availability of loss data is limited. Actuaries can research and apply loss information from many other resources that are similar or may apply to the risk in the policies but they are reserving for.

Actuarial analysis is the science in which uncertainty is always a factor. Without uncertainty, there's no need for an actuary, or insurance for that matter. The loss reserves are an estimate – it is important that the actuary believes that the reserving is reliable in order to maximise the company's viability and profitability. In alignment with the actuary, an insurance regulator is concerned with the solvency of the captive insurance company and the reserves should be set at a conservative level. Actuaries understand the goal of the insurers and the regulators; their goal should be to meet the interest of all stakeholders in the captive.

Capital adequacy

Solvency II has been a hot topic among Europe's captive insurance market. However, it seems that the trend has crossed the pond. The United States and state insurance domiciles are working to create regulatory frameworks that will be deemed equivalent to Solvency II. Capital adequacy is typically an issue for captive insurance companies writing high levels of premiums; these captive insurance companies are considered to be larger captives whose premiums exceed 1.2 million, which are covered under the IRS Revenue Code Section 831(a).

> "It is clear that captive insurers aren't going away and it's time for all us to pay attention to the current and ever-evolving narrative surrounding captives"

As part of Solvency II, European regulators have established Own Risk Solvency Assessment (ORSA) where insurers evaluate their own risk and record the amount of capital required to support those risks. In order to strengthen their own regulatory framework, the National Association of Insurance commissioners (NAIC) adopted the ORSA Model Act in 2012, which came into effect at the beginning of January 2015.

What is ORSA?

ORSA is an internal process undertaken by an insurer to evaluate the capital adequacy of its insurance company and address an insurer's future solvency positions under normal or severe stress scenarios. ORSA requires that insurers analyse any material or relevant risks that could have an impact on the ability to meet its obligations. Analysis of underwriting, market, liquidity, operational and credit risk should be conducted. Although, initially ORSA will only apply to captive insurance companies with a high written premium volume, experts expect that similar frameworks will need to be established for captives writing lower premiums.

Analysis of capital adequacy typically includes economic capital modelling, which is essentially a probability-based scenario generator for determining future financial results of an insurance organisation. Setting up these models takes expertise, complex analysis and they should be handled by an actuary.

Although the initial setup may be complex, establishing an economic capital model or full implementation of ORSA will benefit the overall management and operations of the captive company. It will also ensure with some conviction that the captive strategy is sound and can meet all future policyholder obligations.

In conclusion

Actuarial analysis, like risk, is full of uncertainty. However, captive owners and managers can use this analysis framework to control how they run their day-to-day businesses. By working with an experienced actuary throughout the setup of the captive and the ongoing management, captive managers and owners can establish the viability and credibility of their captive insurance programme. Overall, there is no downside to working with an actuary who can help navigate the complexities of captive ownership.


LAWYERS WITH OVER 125 YEARS
OF
FEDERAL & STATE INCOME
ESTATE & GIFT TAX
CORPORATE, REGULATORY AND INSURANCE EXPERIENCE
+
TEAM CAPSTONE SINCE 1998
17 YEARS OF
CAPTIVE/ALTERNATIVE RISK PLANNING SERVICES SPANNING SEVEN DOMICILES
=
TRUE TURNKEY SERVICES
THE FELDMAN LAW FIRM LLP
25 Years of Excellence
POWER 50 2014
CAPSTONE NAMED AS 26TH MOST INFLUENTIAL IN THE CAPTIVE INDUSTRY
15+ years
CAPSTONE ASSOCIATED
CAPTIVE INSURANCE PLANNING FOR THE MIDDLE MARKET
CAPSTONE ASSOCIATED SERVICES, LTD.
WILMINGTON, DE | HOUSTON, TX | THE VALLEY, ANGUILLA, B.W.I.
WWW.CAPSTONEASSOCIATED.COM | 713.800.0500