Captive Insurance for Public Entity Pools – The Fundamentals

by Andrew Halsall

There's a lot of interest in captives from the pooling sector. Several pools have set up their own captive or have joined an existing one. Some have done both. Others are considering it. It's a new and unfamiliar topic to most people, and so acquiring knowledge can be a challenge. Especially relevant knowledge. There's no shortage of captive "thought leadership" but the substance is often obscured by a mass of detail that really isn't needed in the conceptual stage. Also, most information is geared toward the private sector – where the captive value proposition is very different.

My goal with this write-up is to highlight what a captive can do for a pool. It's not a complete roadmap for implementation, but it hopefully provides a solid foundation.

Definition

As far as I'm aware, there isn't a textbook definition of a captive for pools, so here's a suggestion:

An insurance company owned by one or more pools, whose mission is to provide economic and/or strategic benefits to the participating pool(s) and ultimately their members.

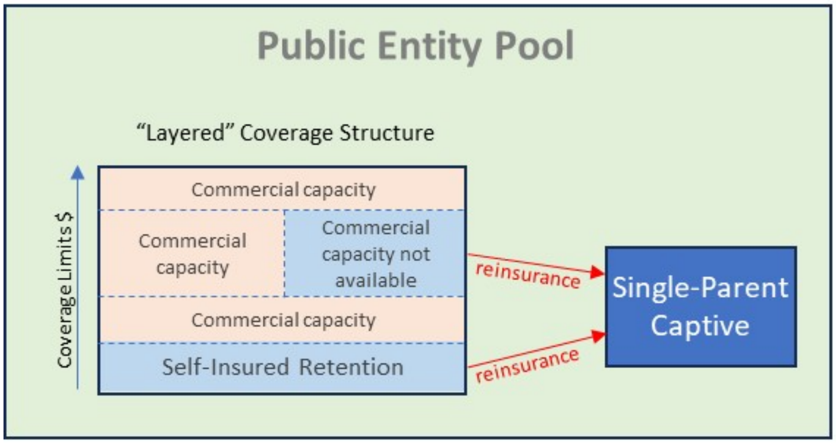
There are two main types: the single-parent captive and the group captive. They differ by virtue of their ownership.

Single-Parent Captive

A single-parent captive is created for and owned by one pool. It enables the pool to retain risk in a more cost-effective and/or strategically beneficial manner. In a typical "layered" coverage structure, part of the pool's self-insured retention may be transferred to the captive. The captive may also assume a layer (or part of a layer) for which commercial reinsurance is not available or is too costly. These retained risks are transferred to the captive via a reinsurance contract, in return for which the captive receives a reinsurance premium. It's important to note that, with a single-parent captive, no risk is transferred out of the pool; the exposure has just been moved to an entity whose financial results consolidate with those of the pool. Unlike commercial reinsurance, the captive does not reduce underwriting volatility. It doesn't create capacity.

A captive can generally participate in any coverage, but the most common are property and casualty. Each needs to be considered on its own merits.

Single-Parent Captive – Owned by the Pool



Risk transfer?
No, because the captive is wholly-owned by the Pool

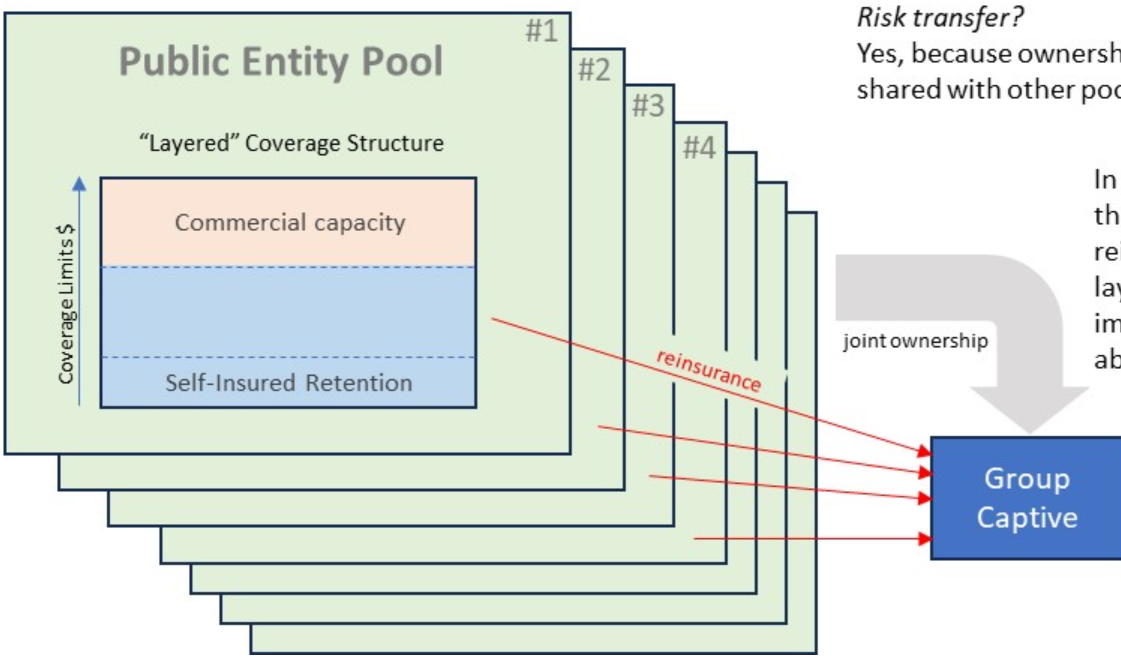
In this example, the captive reinsures:

- part of SIR
- portion of a layer for which commercial capacity is not available

Group Captive

A group captive, on the other hand, is owned by several pools. It's used in place of or in conjunction with commercial reinsurance. In a typical structure, the group captive will assume a layer immediately above the pool's self-insured retention. Because the group captive has external ownership, risk is transferred out of the individual pools. Like commercial reinsurance, the group captive reduces the pools' underwriting volatility. It is a source of capacity.

Group Captive – Owned by Several Pools



Risk transfer?
Yes, because ownership is shared with other pools

In this example, the captive reinsures the layer immediately above the SIR

There are several group captives that exclusively serve the public entity pooling sector, including GEM, NLC Mutual, County Reinsurance Limited, and Transit Re.

Benefits

Benefits for a single-parent captive include:

Enhanced investment opportunities	A captive has the flexibility to invest in fixed income, equities, and other instruments.
Retention of surplus	Captive regulators will allow the payment of dividends or other returns of surplus only if prudent to do so given the totality of risk. This safeguards the pool against pressure to draw down capital that's needed to absorb volatility.
Leverage in reinsurance placements	For a higher layer where external capacity is limited or expensive, co-participation by the captive may assist in reinsurance negotiations by demonstrating confidence and commitment, i.e., skin in the game.
Segregation of financials	The pool may prefer the greater transparency and accountability achieved through segregated financial statements.

[*As an aside, a private-sector captive would tout the benefits of tax efficiencies and enabling access to reinsurance markets. Clearly, these don't apply to public entity pools. Pools aren't taxpayers and they already buy reinsurance*.]

A group captive has similar benefits to a single-parent captive but also provides:

A hedge against reinsurance market volatility	A group captive can price for the long term and cut through the peaks and valleys of the commercial underwriting cycle. During a hard market, where capacity diminishes, the group captive should be able to offer the same limits as before. Since it does transfer risk from the pool, it's providing stability in place of volatility.
Pooling of knowledge and capabilities	A group captive is a forum for aggregating and channeling the collective insight and experience of the various pools' staff.

Moving Forward

My advice for anyone interested in forming or using a captive is to talk to someone who's already been through the process. They can relate their own experiences and may also share the lessons they learned – what they would do differently were they to do it again. The price for that valuable insight might only be a beer or two.

From there, involve an experienced advisor. Most brokers have captive expertise. There are also specialist captive insurance consultants.

If you do proceed with a captive, have a clear rationale for doing so; a value proposition. It should be brief, free of jargon, and understood by people who have a life. It should become familiar to everyone involved, including pool staff and members of your governing body. This statement will serve as a reminder to current stakeholders and as an explanation to those who become involved in the future.

Finally, if you do form your own captive, think of an interesting name for the entity. Have some fun with that, perhaps a vote from your team on their favorite name. What could possibly go wrong?

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Prior to joining GEM, Andrew specialized in captive insurance and alternative risk transfer. He served numerous organizations, both public and private sector, on four continents.