FEATURE

WRITTEN BY KARRIE HYATT

# CAPTIVES AND FRONTING ARRANGEMENTS

The business arrangement of "fronting" is an often-overlooked facet of doing business as a captive. It's a necessity for almost all captives, just like paying taxes or conducting audits. The basic tenets of fronting have not undergone any substantial change and as each captive must negotiate their own arrangements, the subject is often taken for granted. Yet, during the past year, the necessity of captives and fronting company came to the forefront with the action taken by the Washington insurance department.

In May, the Washington state insurance commissioner issued a cease-and-desist order to Cypress Insurance Company, a pure captive owned by Microsoft Corporation, and domiciled in Arizona. The cease-and-desist order established that Cypress had not paid any premium tax on written policies, was not eligible to sell insurance in the state, and had not placed insurance through a fronting company licensed in the state. The captive was also served a bill for over $2 million in back taxes and fees.

While the issue was settled out of court for a reduced amount—and after Cypress had secured a fronting arrangement with a Washington-licensed insurer—the matter dredged up issues about fronting companies and captives.

## WHAT IS 'FRONTING'?

Captives are only licensed to operate in their domicile—whether a U.S. state or off-shore entity—while most often they are insuring their parent or members in other states. Most states don't allow entities doing business in their state to be insured by companies that have not been vetted by the state's insurance department as admitted carriers or licensed carriers. Captives, while regulated by their own domicile, still have to comply with the laws of the state in which they conduct their business. This is where a "fronting" arrangement comes in.

When a captive cannot legally insure risk in a state where they're not licensed to do business, it will contract with an insurer who is licensed in the state to write the policies in that state while the captive effectively becomes a reinsurer. It's an unusual reinsurance situation as the captive will have developed all the relevant data concerning the risk being insured, rather than the issuing insurer providing that information.

A fronting arrangement allows captives to comply with financial liability laws, to show evidence of coverage when contracting with other businesses, to provide evidence of financial strength, and to cover certain risks that are required to have a policy issued by a licensed insurer.

All captives that insure workers' compensation, healthcare benefits, auto, or any type of controlled lines of risk will need to make an arrangement with a fronting insurer if they aren't licensed to operate in a state. The fronting insurer cedes almost all of the risk to the captive, retaining only a small amount of the risk. Although, some state insurance departments require the fronting insurer to retain a set amount of risk, such as in California, fronting insurers must retain at least 10% of the risk.

In exchange for writing the policies in states where a captive cannot legally issue insurance, the fronting companies charge a fee of six to ten percent of gross written premiums—which depends on the types of services they are providing.

The most common services that are provided are: program administration, claims management, paying premium taxes, interacting with regulators, and auditing. As the fronting company is taking on some of the captive's risk, they will require some type of collateral—usually letters of credit or a trust account.

## RISKS AND BENEFITS FOR FRONTING INSURERS

Fronting for a captive can engender a significant amount of risk for an insurance company, which is one reason that fronting insurers tend to be among the large national and international companies. While fronting insurance companies take on a small portion of the risk retained by the captive, they are still legally responsible for paying out claims as the company of record on the policy.

If a captive cannot pay the claims as a reinsurer, the fronting carrier will have to lay out the capital to resolve them.

Insurance companies that front captives could lose underwriting capacity of their own. In effect, captives are leasing surplus capital through their fronting arrangement with an admitted insurer. The captive will show up on the fronting carrier's financial sheets as a nonadmitted reinsurer which can lead to reduced operation capacity.

As the fronting insurer is taking on risk through a non-admitted insurer, this can limit their underwriting ability in the state they are operating in. Although, this is not a likely scenario for large, multi-national insurance companies.

The fronting insurer will also bear the brunt of state regulation of the captive's policies and if those policies are written in more than one state, meeting the regulatory requirements can be a huge burden. In addition, the fronting insurer is responsible for all state taxes and fees, including premium taxes.

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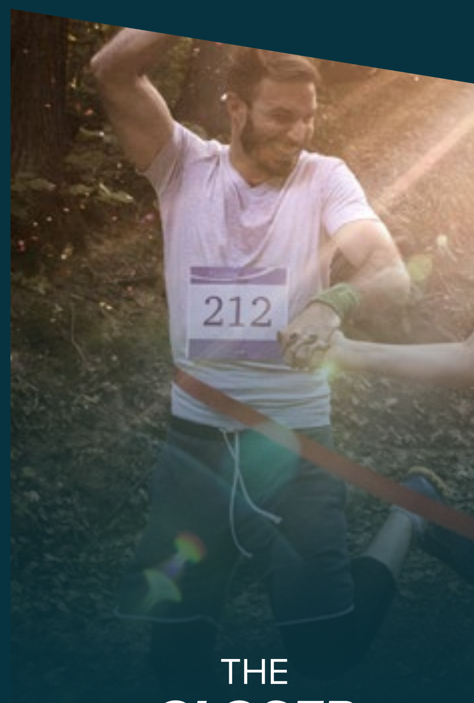


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However, fronting for a captive has its benefits. It can generate revenue and help grow premium for the fronting insurance company. The fronting insurer is providing the paper up front and will profit from the fronting fees without taking on substantial risk.

Captives bring to the table a higher level of risk management and expertise in their own risk, which makes insuring their risk less perilous. The enterprise risk management that captives have been known for helps reduce the risk of claims. The agreement also provides an alternate way for an insurance company to enter a new market by using the knowledge, risk management, and capital of the captive it fronts.

## DRAWBACKS FOR THE CAPTIVE

For both the captive and the fronting carrier, the most contentious issue in the arrangement is the collateral that fronting insurers will require before lending their paper. A fronting insurance company can require collateral upwards of 125 to 150 percent of projected losses. The number is usually determined through the fronting company's actuarial department.

The captive will likely conduct its own actuarial study and then negotiate the amount of collateral needed for the arrangement to go forward. How the collateral will be presented is also a negotiable item and the parties must decide on a letter of credit or a trust account that can be accessed by both parties. This is the most common way for a captive to provide capital.

Claims management can be another controversial part of creating a fronting agreement. As the fronting company is issuing the policies, and must meet the standards of state regulators, they often require that their own in-house claims management program be used and will have the choice of attorney if litigation is pursued.

One of the hallmarks of captive insurance companies is that the owner(s) retain control over risks, this includes which claims are considered and the selection of a defense attorney if the claim is contested. If a fronting company retains the right to claims management, the captive owner will have little or no say in how claims are handled.

With the success of Washington's case against Cypress, the insurance commissioner has been emboldened to look further into other captive insurance arrangements in the state. Since Washington's strategy proved successful, other state's might be encouraged to look into captives and fronting arrangements in their own jurisdiction, as it could generate extra revenue. Now is a good time for captives to revisit their fronting arrangements. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.