Reining in Unique Risks

Enterprise risk captives fill niche for small and midsize firms, but preserving their power has proven to be an ongoing quest

Some risks are so unusual to insure that they actually have their own self-funding mechanism. One such approach involves the use of an enterprise risk captive (ERC), which weathered a nearly yearlong legislative attempt to render the arrangement and other captive programs useless.

ERCs generally address uninsured risks or gaps in commercial insurance programs for first party, claims-made exposures of the short-tail variety, including business interruptions.

Written by Bruce Shutan

They're also typically owned by small or privately held enterprises rather than big, publicly held companies. In contrast, a medical stop-loss captive or workers' comp captive is designed to simply help manage the cost of a commercial insurance program.

"What we have here is a tool that is meeting a risk management need and that's why it continues to be popular and grow, despite the whirlwind of controversy around it,"

says Jeff Simpson, an attorney with Gordon, Fournaris & Mammarella, P.A. who chairs SIIA's Alternative Risk Transfer Committee. It's seen as particularly useful for small and midsize employers.

The tie-in to self-insurance is that many captives mitigate against stop-loss risk, according to Ryan Work, SIIA's VP of government relations.

The regulatory reins on small captives were loosened under recent changes to Section 831(b) of the Internal Revenue Code. Premiums allowed for property and casualty insurers under elections made to this part of the tax code will increase to $2.2 million from $1.2 million and be adjusted to inflation for the first time since 1986. A subset of ERCs actually takes the 831(b) election, explains Simpson. The Protecting Americans from Tax Hikes Act of 2015 was signed into law by President Obama before Congress adjourned for 2015.

Work says quite a bit of headway has been made since a legislative proposal made in February 2015 that could have been disastrous for the captive industry. "SIIA has really stepped up to the plate in terms of our protection and advocacy for the ERC industry," he reports.

That effort includes educating policymakers and members of Congress about what 831(b) captives mean, especially to small and midsize businesses and their ability to mitigate unique risks such as cyber security or wind damage.

Simpson believes the relative newness and mounting popularity of captives may explain why they landed on the IRS's infamous "dirty dozen" list of tax scams and are prone to misconception or suspicion of ulterior motives. "The IRS hates captives, always has," he says. Regulators, on the other hand, in large part appreciate and generally understand captives, he adds, though there are still a fair number of them who are skeptical or misinformed.

Filling a Void

Whatever happens with respect to government oversight in the months and years ahead is anyone's guess, but there's no doubt that ERCs fill a void in the marketplace. They're essentially alternative risk insurance companies that insure unique risks that are not covered in traditional market policies, explained Mike O'Malley, managing director of Strategic Risk Solutions, Inc., during a panel discussion at SIIA's recent national conference.

They not only complement other types of coverage, but also offer protection against unusual or rare sets of circumstances based on a very different set of actuarial methods and assumptions, noted Rob Walling, a principal and consulting actuary with Pinnacle Actuarial Resources, Inc.

He cited two client examples. One involved product contamination and recall coverage purchased for a consumer food producer that experienced three large claims over an eight-year span. These claims fell under the policy exclusions and created material financial volatility. Another case involved a computer software developer that purchased cyber liability that expanded software use to a handheld sales environment, including personal information.

"Those kinds of conversations are nontraditional, to say the least, but they require a dialogue between the insured and captive at a bare minimum to understand what the real problem is and what the risk is," he said.

The educational workshop – "Enterprise Risk Captives: How does the Insurance Actually Work?" – examined the inner-workings of ERCs and what makes them unique. Simpson acted as moderator and deftly fielded questions throughout the session.

Assessing Risks

The focus is on risk management, since each captive structure requires real risk. As such, "a good starting point is a formal risk assessment to quantify the frequency and severity of each risk considered," according to O'Malley. It's also vital that risk is re-evaluated annually to determine any changes in underlying exposure.

Two other tips he imparted is that the resulting captive premium be calculated on an arm's-length basis by a qualified actuary or underwriting professional and that captive operations be governed by a common-sense approach that's similar to the traditional insurance market. For example, it's important to price risks and determine premiums just like other insurance companies perform these functions.

Mindful that an ERC's business purpose is insurance, Walling said these captives are expected to produce a myriad of documentation to support their mission. Included in that mix are financial statements; premium and loss accruals; and cash flows – especially premiums, reinsurance premiums and losses. Other key areas address the treatment of loan backs and dividends; as well as an actuarial loss reserve analysis; statement of actuarial opinion; and audit opinion.

Walling also identified the need for market-comparable pricing and to determine the rate-of-return model being used. In addition, he said actuaries need to consider nontraditional data sources and it's important to recognize the length of a captive. "Oftentimes you're dealing with losses from 10 or 12 years ago," he added.

Dana Sheridan, general counsel and chief compliance officer at Active Captive Management, LLC, detailed several best practices in insurance policy drafting and claims adjusting for ERC insurers. Her checklist for standard policy features included application documents, a declarations page, insuring agreement, definitions, exclusions and conditions to coverage.

She also reiterated what she'd written in the April 2015 issue of Captive Visions: "Any captive policy should adequately describe the risk transferred in a way that insurable interest could be substantiated in the contract terms itself."

That same article noted that "artful policy drafting happens when it's possible to hand craft policies tailored specifically to the risk, which is why captive policies can present an ideal policy drafting scenario… [and] it's not always possible for the commercial market to hand tailor a line for a single insured, or a single series of related insureds, or for the nuanced risk of a particular type of industry."

ERC captives should follow best practices not only in how they write their lines, she said, but also in how they interpret them in the context of claims, which means taking consistent coverage positions under the same policy language for all claims that trigger the coverage.

With regard to claims adjusting, Sheridan stated that proper claim documentation is at the center of effective adjusting. Claims adjusting generally involves investigating claims and documenting the coverage evaluation, as well as setting and documenting reserves, she added.

Questions to Ask

In looking at the big picture, O'Malley suggested there are several meaningful questions to ask when considering an ERC and assessing risk. They include the following:

- What are the major risks that impact long-term viability of the operations?
- What controls are currently in place to manage these risks?
- How effective are the controls in place?

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As part of that process, he said it's critical to conduct a risk assessment to identify potential hazards and analyze what could happen if a hazard occurs. In addition, a business impact analysis will help determine the potential impacts resulting from the interruption of time-sensitive or critical business processes.

The risk-assessment process involves several major steps that identify or assess relevant business objectives, events that could affect the achievement of objectives and risk tolerance, as well as both the inherent and residual likelihood and impact of risks in those two scenarios. It's also important to evaluate the portfolio of risks and determine risk responses – and as such, consider the captive approach as one of several options to help control cost.

Another key theme involved the risk-sharing terms associated with risk distribution. There must be sufficient exposure units and the involvement of many insured individuals, while one test occasionally used is that an insured not pay its own losses.

Each member of the ERC shares its respective risk and exposure and in return, receives the benefits of "pool risk," which O'Malley noted evenly distributes the risk and is "the foundation of insurance in general."

The panel also discussed risk shifting, citing Revenue Ruling 2002-91. It was noted that any financial loss by the insured is offset by an insurance payment after some or all of the financial consequences of the potential loss is transferred to the carrier.

Any prospective ERC customers should be on their guard when assessing this arrangement, according to O'Malley, whose parting words were: "If it's too good to be true, it's too good to be true." He suggested a strong need to closely consider the fact pattern of the entity and follow fundamental core concepts such as arm's length pricing, limited rollback and premiums being paid on time.

Although ERCs represent an alternative to traditional insurance, the arrangements still must adhere to basic principles to pass muster with industry regulators and draw customers.

"Insurance companies need to act like insurance companies and captive insurance companies are no different," Walling opined. That means posting reserves for unpaid claims, producing income statements, conducting rigorous reviews, ensuring that the captive's capitalization is reasonable after dividends are paid and the funds available to pay claims are unimpaired after a runback. ■

Bruce Shutan is a Los Angeles freelance writer who has closely covered the employee benefits industry for 28 years.