An Overview of Captive Colleralization

Phillip C. Giles, CEBS

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Introduction

The primary motivation for an insured to participate in a captive or other alternative risk program is to control the ultimate cost of risk by reducing their reliance on traditional insurance coverage. As a result, the employer (or the insured) retains more predictable layers of risk while transferring more unpredictable or catastrophic layers to an insurer. The insured also maintains the ability to strategically deploy surplus and to realize the net potential profits generated through favorable underwriting results and positive investment returns. The amount of profitability return will be proportionate to the amount of risk retained by the insured and held within the captive arrangement.

One of the most important, and often misunderstood, components of a captive or other alternative risk program is the amount of collateralization required of the insured by a fronting (or issuing) carrier to secure the portion of risk retained within the program. Within the overall structure of a fronted program, the captive becomes a reinsurer of the issuing carrier. The carrier is agreeing to cede a portion of the risk, as reinsurance, to the captive which is owned by the insured. Viewing the importance of collateralization from a carrier's perspective will be helpful in providing more understanding to an insured.

Closing the Credit Gap

An insurance carrier faces an inherent credit or financial risk when issuing a policy in front of an alternative risk arrangement. In order to alleviate this credit risk, the carrier requires the posting of collateral commensurate with risk gaps to ensure appropriate funds are always available to pay claim obligations incurred by the captive. Collateralization is actually a requirement imposed on carriers by the National Association of Insurance Commissioners (NAIC) as liabilities and ceded risk amounts must be recognized on the insurer's annual financial reports.

Schedule F is the section of an insurer s annual statement filed with regulators and discloses the insurer's reinsurance transactions. Reinsurance transactions are an obvious and important consideration in determining an insurer's strength and, ultimately, the financial rating it receives.

Every time an insurer writes an account, particularly those associated with most alternative risk arrangements, the corresponding reserving requirements tied to that business will have some diminishing implications to the carrier's surplus ratio. These negative surplus implications can be offset by the portion of risk the carrier chooses to cede to a qualified reinsurer. Statutory accounting procedures allow an insurer to recognize amounts of risk ceded to reinsurers as either assets or reductions from liability which provide a corresponding offset to the surplus reductions associated with writing amounts of insurance business.

Reinsurers are classified as either *authorized* or *unauthorized*. The classification is based on various criteria; however, most weight is assigned to the reinsurer's financial strength and its capacity to assume risk. In order for the reinsurance offset credit to be recognized in the insurers annual statement, the reinsurance must be ceded only to an *authorized reinsurer*. Regulators do not permit *Schedule F* credit to be taken for reinsurance placed with an *unauthorized reinsurer*. Such a transaction would result in a corresponding decrease to the insurer's statutory surplus unless the transaction has been fully secured through acceptable forms of collateral as defined by the NAIC. Approved forms of collateral are Letters of Credit (LOC's), funds held in a Regulation 114 Reinsurance Trust, or cash (as described below).

As mentioned earlier, in a fronted alternative risk arrangement, the captive itself is serving as a reinsurer to its issuing carrier for the amount of risk that is retained by the captive. In most cases, the captive is considered to be an unauthorized reinsurer. In order for the carrier not to be "penalized" for unauthorized reinsurance, full collateralization for the amount of risk ceded to the captive will be required.

Important Considerations

The amount of collateral that will be required by a fronting carrier is an important consideration when determining the amount of risk to be retained by the captive. The amount of collateral required by the fronting carrier will increase at a level that is commensurate with the amount of risk retained by the captive. A carrier will usually require full collateralization for the "gap" which is created by the difference between the amount of funds available to pay claims (loss funds less the internal gross-to-net expense retention) and the point at which reinsurance attaches. Collateralization is held until such time as potential claims liabilities, especially Incurred but Not Reported (IBNR) liability, can be determined for each policy year. The duration can be as little as a few months for short-tail coverages (such as property or medical stop loss coverage) to several years for longer-tail coverages (such as workers compensation). The claims tail for some policy years will overlap with newer policy years. Each policy year will require separate collateralization. Thus, the buildup (known as collateral *stacking* or *pyramiding*) of collateral over multiple policy years is common. This can create a significant, multi-year, asset encumbrance for captives. As loss periods become actuarially mature and the books are closed on specific plan years, the carrier will be able to begin releasing amounts of collateral allocated to that year as the full amount of securitization is no longer necessary.

Common forms of Collateralization

To ensure appropriate stability and liquidity, NAIC regulations only recognize three forms of acceptable collateral: Letters of Credit, Reinsurance Trusts, and Cash.

Letters of Credit (LOC's)

LOC s are the most widely used form of alternative risk collateralization. An LOC is an agreement issued to the fronting carrier by an NAIC approved bank that guarantees the availability of funds to satisfy a payment obligation. In an alternative risk program, the payment obligation is created by an issuing carrier ceding risk to a captive. Should the captive not have available funds to meet the claim obligations, the fronting carrier presents its demand for these funds to the bank (by drawing on the LOC) to settle any unpaid claim liabilities of the captive.

An LOC is a simple one-page agreement which has three parties: the issuing bank, the insurance carrier (beneficiary) and the employer or captive (applicant). The LOC is typically issued for a specific dollar amount directly corresponding to the amount of risk ceded from the insurer to the captive. Banks typically require a pledge of cash or highly marketable (liquid) securities from the employer as funding for the LOC. The bank will also charge the applicant a fee based on the amount of the secured obligation for issuing the LOC.

The service charges for LOC s can be more expensive than other forms of collateralization; however, the investment of assets pledged to fund the LOC are not as restrictive as is applicable for reinsurance trusts. The potential for a more favorable investment return can offset the higher charges associated with issuance of an LOC.

An LOC usually needs to be irrevocable and unconditional in structure. An irrevocable LOC cannot be canceled or modified without the agreement of each of the three parties. LOC s typically expire one year from the issuance date. However, most ceding insurers will require an *evergreen clause* which automatically renews

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Letters of Credit (LOC's) *continued*

the LOC for additional terms as required for securing the full duration of the obligation. The amount and terms of the LOC cannot be modified or cancelled without the consent of the beneficiary. The ceding carrier, as the LOC beneficiary, periodically secures actuarially appropriate reporting, based on the certain confidence level, as to the captive s funding for potential liabilities. This reporting is used in arriving at whether a proportionate release of the LOC's is warranted.

Reinsurance Trusts

A second or alternative form of collateralization is a reinsurance trust sometimes referred to as a R*egulation 114 Trust*. (It is governed by Regulation 114 of the New York Department of Insurance regulations.) A trust is established by the captive and an agreement is entered into between the captive, the issuing carrier, and a bank. The bank serves as the trustee for the fund in this type of arrangement. As with an LOC, the insurer is named as the beneficiary. Due to increased complexity and more restrictive funding limitations, reinsurance trusts are not as widely used as LOC's. The trust agreement can be lengthy (up to 25 pages). Funding of the trust is conservative, limited to cash or highly-rated ("A" or higher) marketable securities that can be easily converted to cash.

Reinsurance trusts are less expensive than LOCs; however, the reduced potential for asset investment returns may make them less efficient from a net expense standpoint. In addition, beneficiary approval is required to disburse assets from the trust which can delay the release of excess collateral being held by the fronting carrier.

Cash

Cash is rarely used as collateral, mainly because LOC s and reinsurance trusts provide more security to the fronting carrier and increased investment flexibility for the captive. Some fronting carriers are reluctant to accept cash as collateral as it is not protected from bankruptcy proceedings. This exposes the fronting carrier to the potential loss of collateral to other secured creditors having higher claim settlement priority.

Funds Withheld Arrangements

Funds Withheld arrangements have become increasingly popular in recent years. In these arrangements, the issuing carrier holds the risk premium until all of the captive's loss obligations (claims) attributable to each securitized contract year have been closed. The captive does not typically receive investment returns on the reinsurance premium as it is held by the insurance carrier rather than the captive, to be available for claims. The carrier releases the reinsurance premium to the captive after the liabilities of the policy period have been closed. *Funds Withheld* arrangements are usually the easiest and most inexpensive method of risk collateralization.

Conclusion

Alternative risk collateralization has long been a source of confusion for many captive owners and insurance professionals not having regular experience with fronted captive arrangements. As more employers look to incorporate captives into their risk and benefits management strategies, an understanding of collateralization is important in the consideration and execution of such strategies.

About the Author

Phillip C. Giles, CEBS is Managing Director of MSL Captive Solutions, Inc. He has more than 30 years of Accident and Health and Property and Casualty alternative risk experience and leads the firm s business development initiatives.

In 2019, Phil was named Reinsurance Specialist of the Year by Cayman Captive Magazine. In 2017, Phil was presented with the Captive Professional of the Year recognition at the U.S. Captive Awards. He has been named to Captive Review's Power 50 listing of most influential individuals in the worldwide captive insurance industry and is a regular content contributor to several industry publications.

About MSL Captive Solutions, Inc.

MSL Captive Solutions is the industry's only platform devoted exclusively to the development of comprehensive (re)insurance solutions for group and single-parent medical stop loss captives.

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