CAPTIVA
INSURANCE MANAGERS

REPORT

Why Enterprise Risk Management is good for you.

Those of you working in the 1980s will recall that the financial world and insurance in particular was in turmoil. The cause was a combination of factors including a decrease in interest rates and investment returns, a proliferation of tort litigation and large settlements, and alleged price fixing by insurers and reinsurers, This was especially the case in the US where everything tends to be bigger and, in this case, worse. The financial meltdown had hit.

One of the first impacts of this maelstrom was that between 1984 and 1987, annual premiums for general liability increased from approximately $6.5bn to $19.5bn. In addition, many insurers attempted to limit the number and cost of claims by changing policy coverage from an occurrence to a claims-made basis, expanding exclusions, raising deductibles, lowering policy limits on a per-claim basis, and introducing the notion of aggregate total exposure. Any one of these underwriting measures on its own would have been significant, but together they just made matters even worse for the insurance buyer and consumers worldwide.

Impact on small and medium sized businesses

The resulting crisis adversely affected a diverse range of industries and organisations, from social service providers to multinational pharmaceutical companies and everything in between. In the US, many organisations in the non-profit and government sector could no longer offer social, medical or recreational services due to the prohibitive cost or unavailability of liability coverage. Something had to be done.

Those companies that were large and diversified enough to afford it, set up their own captive insurance companies right across the world. However, small and medium-sized enterprises (SMEs) had no such option. Many types of insurance coverage were now unavailable or just not economical to purchase. It didn't take long for the results of under-insurance to hit SMEs, especially those in parts of the US prone to catastrophic risks, such as hurricanes and tornados.

Solution

Following the closure of thousands of SMEs country wide, the US authorities decided to do something about it.

Helping small businesses survive natural or human-caused disasters is important to any government and to its economy. This sector represented 99.7% of all employers in the US. Because of this, Congress introduced a special tax incentive aimed to induce businesses to manage their own risk more efficiently, and to do so for the public good. In other words, SMEs were actively encouraged to set up their own captive insurance companies. An insurance company of this sort may elect, under 28 U.S.C. sec. 831(b), to be taxed on its investment income only, so long as the company receives less than

$1.2 million in premiums each year. A captive that makes this election is often referred to as a "micro captive".

As a result, Section 831(b) is now widely used by mid-sized US businesses, and even lately some small businesses, to provide insurance coverage for risks which are either not economical at market prices or is unavailable to the business. The financial significance to an SME that owns its own 'micro' insurance company is huge. In addition to the captive being able to make a profit, the underwriting portion of which is tax-free, the original premiums paid in by the SME/insured can be treated as a taxable event in its profit and loss account. Therefore, a premium of up to $1.2m and a loss ratio of say 20%, will generate substantial returns.

Please note many captives buy reinsurance as protection against catastrophic events, but at wholesale rates.

What's this got to do with ERM?

This is all very interesting, but what's it got to do with enterprise risk management (ERM)? We know from experience that a micro captive needs approximately $500,000 of premiums to make it worthwhile and to cover expected costs of management and other associated expenses. However, when you consider that $500,000 or GBP350,000 is still quite a large amount for an SME to spend each year, how is the SME going to justify spending so much premium, especially in such a soft market as we have at the moment? The answer in the US is ERM.

In order to be considered a legitimate transaction for tax purposes, in addition to having enough premium to cover the captive's running costs, the SME needs to ensure that insurance coverage is not so remote as to be unbelievable, e.g. paying a large premium for tsunami insurance for a ski lodge in the Alps. Even if the outside risk exists, the premium should be minimal.

Premium amounts have to bear a relationship to market pricing, e.g. an insured should not pay $50,000 for $500,000 in coverage when it could be obtained on the open market for $1,000. An independent actuarial report is needed to support the above.

Utilising ERM principles enables SMEs to consider risks that they may never have thought of before. Below is an extract from an actuarial report, which gives you an idea of some of the types of non-traditional risks that are now being insured, albeit through captives.

Example of how ERM helps justify premiums

Traditional risks = Property, casualty/liability and business interruption.
Total annual premiums = $350,000.

Non-traditional risks =Deductible coverage, exclusions, operating risks, credit default, legal defence reimbursement, product warranty, pollution, cyber crime, employment practices reimbursement, key supplier, regulatory changes, trademark & patent legal expense reimbursement.
Total annual premiums = $150k.

The list of risks will vary from business to business. Historically captives tended to insure the traditional risks only, but ERM has shone the light on all those other risks which had previously been difficult to get from the insurance market.

As the 'entry' level for establishing a captive is an annual insurance premium of US$500,000

(GBP350,000), a large number for any SME, the majority of SMEs have not been able to afford their own captives. However, the application of ERM principles has identified many more risks which the SMEs have always been self-insuring.

Therefore, adding these non-traditional risks to the traditional, suddenly makes having a captive a genuine option, especially with the generous tax breaks available.

	Annual premiums	
Traditional risks	$350k	70%
Non-traditional risks	$150k	30%
Total annual premium	$500k	100%

Although ERM has been around in the UK for many years, it's very much the new kid on the block in the United States, and rightly so. Due to continual scrutiny by the Inland Revenue Services (IRS) into promoters abusing the 831(b) facility, setting up and operating micro-captives is far more difficult than in the past.

As illustrated above, promoters of micro-captives and actuaries are having to look beyond traditional loss events in order to find enough risk to justify the project. ERM provides all the holistic tools needed to identify, analyse, measure and control a host of "new" risks, not previously fully recognised by most US SMEs.

IRS – Tighter controls

Unfortunately, like all good things, the success of the 831(b) election has attracted unscrupulous financial consultants to set up many new structures with little or no attempt to demonstrate the transfer of an insurance risk. Many of these have been promoted by personal wealth and estate planning professionals with little or no knowledge of insurance. As a result, in its "Dirty Dozen" release (IR-2015-19), the IRS states that "another abuse involving a legitimate tax structure involves certain small or "micro" captive insurance companies".

To help stamp out this abuse the IRS, through Congress, passed its 2015 Appropriation Bill, which includes the first significant changes to Internal Revenue Code section 831(b) in nearly 30 years. Without going into detail, the two main changes in this badly worded piece of legislation will increase the current $1.2m limit on premiums to $2.2m (and be indexed against inflation), and require compliance with strict new diversification conditions.

Captives that have recently been applying ERM principles are now being referred to as Enterprise Risk Captives (ERC). The introduction of this new term is probably an excellent idea, keeping in mind that the IRS specifically mentions "micro" in the same sentence above as "abuse".

It's difficult to get a true picture of the current number of US owned ERCs, but estimates suggest that it is thousands. Although many of these are domiciled in various US states, many more are based offshore.

Conclusion

In conclusion, in order to meet the revised and updated tests of the IRS to qualify for the 831(b) election, US companies are going to have to justify the validity of their premiums on a regular basis. This in turn means more work for the actuaries and risk managers from around the world with ERM experience.

Risk management is about to enter a boom period, and will no longer be the preserve of only large organisations that can afford full-time risk managers. Perhaps it's time for the experienced UK risk manager to head west and make his or her fortune.

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