Captive Collateralization from a Carrier's Perspective

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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 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 realize the potential profits generated through underwriting and 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 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 effectively 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 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 reinsure*r. 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 cash, evergreen Letters of Credit (LOCs) or funds held in a Regulation 114 Reinsurance Trust.

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.

A carrier will usually require 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)* can be determined. The duration can be as little as a few months for short-tail coverages, such as medical stop loss, to several years for longer-tail coverages such as workers compensation. 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

■ *Letters of Credit (LOCs)*

LOCs are the most widely used form of alternative risk collateralization. An LOC is an agreement issued by an accredited 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.

An LOC agreement 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 to cash or highly marketable (liquid) securities from the employer as funding for the LOC. The bank will also charge a fee based on the amount of the secured obligation for issuing the 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. LOCs typically expire one year from the issuance date. However; most ceding insurers will require an "evergreen clause" which automatically renews 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.

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■ *Reinsurance Trusts*

A second alternative form of collateralization is a reinsurance trust – sometimes referred to as a *Regulation 114 Trust*. 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 and the trust is funded by cash or marketable securities that can be easily converted to cash.

■ *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 can be closed. Funds Withheld arrangements are usually the easiest and most inexpensive method of risk collateralization.

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 will become increasingly important.

About the Author

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