



2016 Kentucky Captive Conference

U.S. Captive Industry at a Crossroads





Kentucky DOI

Administration Change

-Introduce:

New Commissioner—Brian Maynard

New Director of Financial Division—Sandra Batts

New General Counsel—Michael Wilson



Captive Insurance Industry at a Glance

- As of year-end 2015, over 8,000 globally
- Increasing growth and acceptance
- Approximately \$68 billion premium
- Fast growth:
 - At year-end 1999, alternative insurance market approximately 38% of total US commercial markets
 - Over 50% in 2015, according to CICA
- Largest Domiciles
 - Bermuda 831
 - Caymans 759



Top U.S. Domiciles

- Vermont 587
- Utah 422
- Delaware 333
- Hawaii 194
- D.C. 191
- Montana 177
- Nevada 160
- South Carolina 158
- Kentucky 88



Kentucky Captives

- Passed law in 2000, amended 2005, and 2010
- Approximately \$105 million premium
- 4 captives writing over \$5 million in premium,
- 9 captives writing \$2 to \$5 million in premium,
- 23 writing between \$1-\$2 million, and
- 52 writing \$1 million or less.



What Kentucky has to Offer

- --Captive Law that is up to date and well crafted
- --Regulator that is firm, but flexible
- --Service Providers who are knowledgeable and experienced
- --Owners who are engaged and satisfied
- --Association that is vocal and active
- --Legislature and Administration that is informed and supportive

Values/Goals Kentucky is promoting:

- --Long-term Stability
- --Reliability
- --Responsiveness
- --Convenience & Value



Raising the Bar (focused)

- 2009--Shift in Financial Reporting (info.)
- 2010--Compliance Reviews (bi-furcated)
- 2010--New Legislation (balanced items)
- 2011--Streamlined Examination Procedures (Focus on risk and rely on Auditor workpapers wherever possible)



Substantive Issues

- Direct & Indirect Leverage (premium to surplus ratio & reserve adequacy)
- Investments (losses, illiquidity, lack of diversification)
- Affiliated Transactions (loans/loan-backs & distributions)
- Reinsurance/Pooling (accounting, receivables & recoverables)
- Compliance Issues (not filing Form Ds & recordkeeping)



Analysis Issues

Change service provider without notice

No response to prior correspondence

Jurat Page & filings (draft, not signed, not notarized)

Change in Officer/Director without notice

Letter of Credit documentation & handling



Analysis Issues

Dividend paid w/out DOI approval

Loan issued w/out DOI approval

Loans w/out adequate documentation



Analysis Issues

Business Plan change w/out DOI approval

Material Investment Change w/out approval
-(loans & life insurance are investments)

Overdue receivables & recoverables

Material Weakness in Internal Controls



Examination Issues

- Poor record keeping & accounting
- Failure to record and settle reinsurance transactions
- Failure to file Form D and/or properly handle & document transactions with affiliates
- Improper documentation of claim files and/or failure to properly pay or deny claims
- Internal control issues
- Issuing unapproved policies outside license
- Policies written in excess of approved levels



Rapid Growth & Expansion

Trends and Concerns





Rapid Growth in Number of US Captives

Stunning growth in numbers:

- In 2013, 377 new captives licensed
- In 2014, 518 new captives licensed

Not the entire story:

- In 2013, 252 cells/SBUs formed
- In 2014, 688 new cells/SBUS formed

For a total of over 1,800+ new captive risk bearing entities in last 2 years

- more than total licensed in the previous 10 years



Domicile Expansion

- In 2000, only 8 to 10 active US domiciles catering to captives
- As of 2015, 36 active US captive domiciles (with over 1/2 new or re-activated in last 5 years)
- Domiciles struggle with managing rapid growth, recruiting and maintaining staff, and new budgetary austerity



Domicile Divergence

US domiciles have different and recently diverging standards, including on:

- capitalization & investments
- loans & affiliated transactions
- minimum standards for managers and service providers
- annual financial filings, audits, and actuarial certifications
- some waive or limit examinations (two domiciles passed laws dropping all exam requirements)



Rapid Growth in New Service Providers

- Inherent in captive concept is owner reliance on the knowledge, skills, and experience of managers and service providers
- Current “boom” has attracted (or was caused by) new and inexperienced captive managers and service providers
- The numbers are alarming with many domiciles doubling or tripling number of managers, CPAs, attorneys, investment advisors, & “consultants”



Miscellaneous Items

New Trends and Concerns





Employer Group Health

- Growing interest in captives to write group health and employee benefits (directly or through stop-loss)
- Good method to reduce costs and exposure for smaller businesses, and to retain more plan control
- Employee benefit captives may have special funding, investment, and fiduciary requirements
- Poorly constructed and managed plans could be abused to circumvent federal and state mandates
- Bottom line—Get good professional advice and do your due diligence



Expanding Cells and Series LLCs

- Cell and Series legislation varies widely regarding capitalization and security
- Most statutes permit reinsuring/pooling among cells
- Legal structure is untested and is leading to litigation with varied outcomes
- Marginal managers and service providers may fail to follow necessary formalities for these more complex structures



“Expanding” Groups

- Not just captives, but also self-insured groups
- Some states have amended statutes or used special purpose language to allow group/consortium and association captives to write risks other than those of group (up to 50%)
- Theoretically sound, but has led to more entrepreneurial use of captives & some have had financial difficulties
- Non-member risks raise issues under solvency and liquidation statutes



Life Insurance & Estate Planning

- Life agents and promoters are targeting captives as vehicles to facilitate sales
- Proposals include life policy as 80-100% of investable assets, and may include policy loan-backs
- Some sales practices identified as abusive
- It appears that the IRS recently targeted life insurance abuses
- IRS and Congress have concerns with abusive practices by estate planning providers using 831b captives



Tax-Driven Captives

- Captives recently placed on IRS “Dirty Dozen” list and IRS stated it is targeting unscrupulous captive promoters
- Captive audits are increasing
- Yellow flags include: questionable risks; excessive premiums; lack of actuarial support; failure to capitalize; failure to earn premium; backdating policies, premiums & claims; excessive loans and loan-backs; questionable investments & investments in owner affiliates.



Bottom Line

The flexibility of the captive structure allows you to do all kinds of beneficial things

But conservatism and moderation are needed to avoid “pitfalls for the unwary”



Questions & Answers

Q & A

Contact Info:

Russell Coy II, Captive Coordinator

Kentucky Department of Insurance

Financial Standards & Examinations Division

P.O. Box 517

Frankfort, Kentucky 40602-0517

(502) 564-6082, ext. 4274

(502) 564-4604-fax

Website: <http://captive.insurance.ky.gov>