CAPTIVE INSURANCE COMPANY REPORTS

Corporate Governance Best Practices for Captive Insurance Companies

Ben Whitehouse
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Editor's Note: This article is authored by **Ben Whitehouse,** senior counsel, Butler Snow, LLP, Nashville. He previously served as counsel to the Captive Insurance Section of the Tennessee Department of Commerce and Insurance. He can be reached via email at Ben.Whitehouse@butlersnow.com.

Adopting good corporate governance best practices is essential to the long-term success of any captive insurance company. This article will discuss a number of salient points that should be a feature of any captive insurance program regardless of size. Good corporate governance practices can help keep a captive focused on its core mission of aiding the risk management program of its owner/insureds. Good corporate governance will help keep the captive in good standing with the regulator and can identify problems before they become serious.

Choose Board Members Wisely

Board members for a captive should not be chosen based solely on their degree of kinship to the company founder. Even if your captive is located in a desirable vacation destination, board members should not be chosen solely based on a company executive's affinity for scuba diving in the Caymans or surfing in Hawaii in conjunction with the next board meeting.

Board members should be chosen based on who is best positioned to drive the company's risk management goals. As a threshold requirement, all board members should possess a degree of financial literacy. This doesn't mean that they need to have finance or accounting degrees. Board members should, however, be able to read and understand a balance sheet and be able to ask pointed questions.

There should be a diversity of representation on the board. Diverse membership, which includes ensuring that different operating units, departments, management levels, and plant locations have a seat and voice on the board, is a bulwark against groupthink. Board members should be independent when serving on the board. Board members are fiduciaries of the captive insurance company, not the parent company or their primary employer.

It is also a good idea for board members, especially company representative board members, to receive direct compensation for their service on the board. Compensating board members fosters a further degree of independence and impresses upon board members their obligations to the board above and beyond their primary roles with the parent company.

A discussion about choosing board members would be incomplete without talking about the vetting process. In the United States, it is a federal criminal offense for any person convicted of a felony involving dishonesty from participating in the business of insurance.[1] It is also a crime to knowingly allow such a felon to practice in the business of insurance. Many states have similar criminal statutes barring such individuals from the insurance business.

State insurance regulators are permitted to issue a waiver to allow such persons to engage in the business of insurance. The federal statute is somewhat vague on which felonies are covered by this prohibition. As embarrassing as it can be for individuals who may have made mistakes in their past and who have sought to overcome them, it is important that any board member or key stakeholder involved with a captive insurance company be vetted appropriately and had a background check performed. If there is an issue, an open discussion with the regulator about the issue is essential.

Educate and Evaluate

Board member education should be a part of every board meeting. Captive insurance companies can be complex entities. Occasionally, board members will find themselves appointed to a captive's board first before they even have a chance to look up the Wikipedia entry on "captive insurance." That's perfectly fine as long as there is a training and education process to bring new board members along.

[1] 18 U.S.C. § 1033

Education can come in the form of inviting service providers or the regulator attend board meetings and give more in-depth presentations on their background and how their services are utilized by the captive. Sending board members to industry conferences or signing up board members for the many educational webinars or professional certifications can also be of great benefit.

A board should also regularly undergo a formal self-evaluation process. Through self-evaluation, the board examines its own structure, membership, training program, and board member effectiveness. A self-evaluation can include the following questions.

Does the board do the following?

- Review the company's business and strategic plans and assess the implementation of and performance against these plans?
- Understand its oversight and policymaking roles and functions independent of the service providers and officers?
- Monitor the company's operating and financial performance?
- Understand the key issues and challenges facing the company and use this understanding to assess and guide the company's performance?
- Identify risks and opportunities critical to the company's success, and take an initiative in giving appropriate direction to service providers and officers?
- Receive clear and concise agendas and background materials in advance of meetings, and are such materials both helpful and objective?
- Conduct meetings in a manner that promotes candid and constructive dialogue,

meaningful participation, and timely resolution of issues?

- Have the right mix of expertise, skills, experiences, and background?

Don't Be Captive to a Service Provider

Captive owners and captive board members should rely heavily on their captive manager and program manager as applicable. These are, after all, the insurance experts a captive has retained to run a successful insurance program. While the cliché trust but verify is overused, it is very good advice when working closely with a captive manager or program manager. Verification can come from the independent audits (see "Get Audited Financials").

Having an attorney on retainer who attends board meetings and is available to take calls from individual board members can also be an effective functional check to ensure that the captive or program managers are not the sole gatekeeper of information about the captive's operation. An education plan that sees the captive's actuary, auditor, investment adviser, and regulator rotate through board meetings also gives board members direct access to independent stakeholders who can signal important points for the board's consideration beyond the captive manager's prepared agenda.

Get Audited Financials

In most domiciles, there is an expectation or requirement that the captive's financials be subject to an independent audit. If your captive is in a domicile that doesn't mandate it (some domiciles don't require them but consequently require more frequent examinations), don't assume you are saving money in the long run by passing them up. If a captive thinks it can afford to forego the cost of the audit, it probably can't afford to be in business. An audit catches things that honest service providers miss.

If a problem with a captive comes up and there aren't audited financials to rely upon, then the captive is likely going to need to get those audited financials redone. If you think getting annual audited financials is expensive, consider what the cost is of doing audited financials stretching 3–5 years back when the essential records are hard to find. Having audited financials also goes a long way toward lowering the costs of the comprehensive examination. The auditor's work papers can guide an examiner through the business activity of the captive instead of the examiner having to find their own path. It not only saves examination time (which is usually billed hourly back to the captive), but it guards against the examiner going down unhelpful rabbit holes that you and your captive manager will have to spend time and money to address. For captive managers and captive owners, this best practice item should not even be a consideration.

Do a Pricing Review

An easy question that any captive board member should ask for is a comparison between the actuarially projected losses and the actual losses. The captive manager or the actuary should be able to give some rationale, especially once the captive has been in operation for several years. If the projected average loss ratio is 50 percent after 5 years, and the actual number is substantially different from that, either on the high or low side, ask why. Ask what needs to be done to either modify the premium rate or adjust the policy limits.

Invest Like an Insurance Company

Captive insurance companies are not like other business operating units, and their investments shouldn't be treated the same way either. Insurance companies invest their assets with an eye toward preserving liquidity to be able to pay any present liabilities when due and to invest in securities that will provide an adequate return so that future claims can be paid when they are due. A captive that insures high-frequency low-severity risks and expects funds will need to be disbursed within a short period of time after the premium is received will typically invest in highly liquid cash equivalents.

Conversely, captives that insure low-frequency high-severity risks will want a more aggressive investment strategy that will generate a higher return. However, a low-frequency high-severity captive still can't control when that big claim will hit and will still have to maintain sufficient liquidity to pay any contractually obligated losses when due.

Beyond these foundational principles, an investment adviser will need to have an understanding of how your captive will pay out losses. There will need to be a different investment strategy for a captive who pays claims in full shortly after they are filed versus a captive where a claim being filed is only the beginning stage of a long loss-adjustment period where litigation and other delays could result in it being several years before the final disbursements are made.

A captive's board of directors makes decisions based upon these investment requirements through the adoption of its statement of investment policy. This document gives the captive's investment adviser the direction on the types of investments a captive needs. An institutional investment adviser familiar with the needs and nuances of insurance companies and captive insurance companies is an important service provider and can help guide a board in developing and adjusting their statement of investment policy.

Have an Exit Strategy

One always hopes that the new captive will be wildly successful and have an extended run. Captives are formed to support the risk management and insurance needs of their owners. When they are no longer doing that, it is time to fold it in. Some captive owners decide to form a captive thinking they can beat the insurance price set by the traditional market. These types of captives are not always successful.

Perhaps the new risk management program and risk reduction strategies didn't reduce losses as expected. A traditional insurer may offer a quote for coverage at a rate that the captive can't beat. In the latter case, though, it is often best to look first at placing the captive into dormancy or insuring other coverage since low "teaser" rates don't usually get renewed in the long-term.

Whatever the reason, it's always a good idea for the captive to plan for an orderly dissolution when it is in the best interests of the company. The first item to consider is the run-off period: the length of time needed to resolve the insurance liabilities once the final insurance policy period closes. Even for claims-made policies, policyholders should have a reasonable fixed period of time to get claims in once the policy period closes. Then, a captive must address any open claims and see those to completion.

Alternatively, the captive can look to possibly novate the open claims to another insurer or reach a settlement. If the captive participated in a risk pool, it can take 2 years or longer to settle the pool liabilities. Reaching a negotiated settlement with a pool administrator can be quite difficult, especially when that administrator has a lot of bargaining leverage when he or she knows that the closing captive is anxious to be able to close and return assets back to the owner. If nothing else, the captive owner should have an idea of how long it would take to wind down the captive.

It can be helpful to put limitations in the policy documents that are designed to shorten the liability exposure period. Periodically negotiating for or soliciting quotes from reinsurers and runoff specialists can give the captive board an idea of the costs associated with liquidating a captive versus seeing it through a self-managed runoff. For captives that do write policies with long liability tails, it is often a prudent strategy to plan to sell off blocks of old liabilities via a loss portfolio transfer once their risk and value stabilize.