CAPTIVE INSURANCE SUBSIDIARIES

LEGAL AND REGULATORY ISSUES

James A. Sheriff
jsheriff@reinhartlaw.com
(414) 298-8413

Partnering for your Success
Why Form a Captive?

• The number of banks that have formed or are considering forming a captive insurance subsidiary has grown dramatically in the last four years. There are probably between 60-100 wholly-owned captives of banks at this time.

• We will discuss today why this trend is accelerating and review the basics on how captives are structured and operate.

• Captive insurance subsidiaries are being formed to provide better risk management practices and insurance coverages for financial institutions, at a significant tax advantage due to IRC provisions to encourage small businesses to form captive insurance companies.

• Josh Miller will later be describing these different insurance coverages, including coverage of existing exclusions and deductibles.
Legal Structure

- Captive is a licensed, limited purpose property and casualty insurance company that is wholly owned by the holding company.
- Usually formed in Nevada or one of several other states that have passed favorable laws to encourage small insurance company formation.
- Sole purpose of captive is to write policies and provide coverages for its related entities (the bank) on a tax-advantaged basis.
- Nevada requires an initial capital transfer of $250,000 to form the insurance company.
- The captive is regulated solely by (in the case of Nevada) the Nevada Division of Insurance.
Financial Holding Company Status

- Only a bank holding company which has filed a written election with its Federal Reserve Bank to be treated as a "financial holding company" may own a captive and share insurance risk as described below.
- Banks may not currently own a captive insurance company directly, but FRB and some state regulators are supposedly reviewing this.
- To be certified by FRB as a financial holding company, all of a bank holding company's subsidiary banks must be well-capitalized and well-managed.
- Once formed, a captive typically is operated under a "turn-key" captive insurance services and administration program with a third party that specializes in this, such as KeyState Captive Management, a Nevada firm that does this for more than 60 bank captives.
Tax Benefits

• For years, larger corporations have operated captive insurers as a form of self-insurance of risks and have received significant tax benefits in doing so.

• Section 831(b) of Internal Revenue Code was created to permit smaller companies to insure their own risks on a tax-advantaged basis, if they follow certain IRS Revenue Rulings on structuring their captive.

• One IRS Ruling requires that the captive must share at least 50% of its risk exposure with unaffiliated third parties, in order to achieve the intended tax benefits.

• Josh Miller will describe how the necessary risk sharing is accomplished under the KeyState/Crowe Horwath turnkey program.
Why Haven't More Banks Formed Captives?

- Community banks have been slow to organize captives, even though legal authority to form captives was given by FRB in 2012.
- Costs to organize a captive were high; legal and regulatory authority for banks to form a captive was, at best, unsettled.
- Negative impact on earnings and on ROA has held some banks back; the insurance premiums paid by bank to captive may reduce the bank's ROA substantially.
- Ability to obtain approvals here, form a captive and immediately offload the operations to an experienced, compliant turnkey vendor makes decision to organize easier than in the past.
- In Indiana, the number of banks that have formed captive insurers recently has "exploded," according to the head of the Indiana Bankers Association, and now includes over 20.
Addressing Risk with Captives

Josh Miller, CEO KeyState Captive Management
Why Form a Captive?

• Lower first-dollar insurance costs.

• Rising or undisclosed self-insurance risks.

• Not all business risks are addressed by commercially available insurance.

• A captive identifies and initially fills gaps in current coverage. These gaps are risks that already exist.

• Enhanced organizational view of risk management.

• With the appropriate financial institution profile, the captive will provide additional protection from risk and a significant net increase in book income.
Typical Community Bank Commercial Program

- Building, Personal Property, EDP, Equipment
- Flood, Earthquake, Windstorm
- Business Income & Extra Expense
- Pollution Liability
- Workers Compensation
- General Liability
- Employers Liability
- Auto Liability
- Financial Institution Bond
- Cyber Liability
- Directors and Officers Liability
- Banker's Professional Liability
- Employment Practice Liability
- Fiduciary Liability
- Trust Liability
- Excess and Umbrella Coverage

Deductible
Waiting Period
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Deductible
Typical Captive Program

Building, Personal Property, EDP, Equipment

- Flood, Earthquake, Windstorm
- Business Income & Extra Expense
- Pollution Liability
- Workers Compensation
- General Liability
- Employers Liability
- Auto Liability
- Financial Institution Bond
- Restoration of Reputation
- Loss of Key Employees
- Workplace Violence
- Cyber Liability
- Directors and Officers Liability
- Banker’s Professional Liability
- Employment Practice Liability
- Fiduciary Liability
- Trust Liability

Possible Captive Coverage

Possible Captive Coverage
Coverages Included in the Captive

General
• Property
• Crime Bond
• Workplace Violence
• Pollution
• Management (not shared) including Cyber

Additional
• Healthcare high deductible reimbursement
• Fraud Insurance for Accounts Receivable financing programs
• Vendor Single Interest
Typical Claim Activity

Property
- ATM Damage
- Storm or Weather Event Related Damage
  - Roof or building damage
  - Surge related power/computer equipment
  - Flood/water line break

Fraud
- ACH/Debit Card Fraud
- Check Fraud
- Wire Fraud
- Management
  - Employee Lawsuits
Small Captive

- When the gross premiums paid to the captive do not exceed $2.2 Million annually (as of 1/1/2017), and the captive makes an election under IRC §831(b), the premium income is exempt from federal income tax, and the captive is taxed solely on its investment income. Under IRC §831(b) the insurance company does not get a deduction for claims paid. The insurance company should carefully evaluate the impact of IRC §831(b) when considering the election.

$2,200,000 Annual Insurance Premium Deduction

Holding Company Owns 100% of All Subsidiaries and Affiliates

Business

$2,200,000 Premiums

Insurance Policies

Captive

Premium Income under $2,200,000

$2,200,000

Annual Premium Income
Safe Harbor Structure: Revenue Ruling 2002-89

- Greater than 50% of homogenous risk exposure is derived from a third party.
- Parent company/primary shareholders also own 100% of captive.
- Captive charges arms-length premiums, established by customary rating formulas.
- No parental or related party guarantees made in favor of captive.
- No loans from captive to parent or insured subs.
Pool Captive Structure

Holding Company
Owns 100% of All Subsidiaries
and Affiliates

Bank and Subsidiaries

$2.2 Million

Captive

Bank Risk

Assumed Risk

Shared Risk Pool*

* Note: Contractual reinsurance relationship only. Not an entity.
Best Candidate for a Captive

- Banks with assets of $350 MM and higher
- Strong earnings .8 ROA for C corp and 1.0 for S corp
- Banks considering increased commercial premium
- Banks facing a significant or growing unfunded risk
  - Storm deductibles
  - Flood exposure
  - Earthquake exposure, etc
Growth of Bank Captives

The number of banks forming captive insurance companies has exploded in the last three years.

• 53 banks have joined our program since December 2012
• Banks represent 15 states and 9 Fed districts
• Our program has been endorsed by 23 state banking associations

The Indiana Bankers Association states that 90% of Indiana banks that meet the asset and earnings criteria have put a captive in place.
Summary of Benefits

• Uniform risk management

• Additional/non-traditional risk financing

• Potential premium deduction for federal and state tax purposes

• Potential federally tax-exempt insurance income if premiums are below $1.2 million ($2.2 million after 2016).
Thank You for Your Consideration

Josh Miller, CEO
KeyState Captive Management
702.598.3738
hfrei@key-state.com

Lynn McGuire, CPA Tax Partner
Crowe Horwath LLP
615.360.5500
Lynn.McGuire@crowehorwath.com
Disclaimer

This document was not written with the intent to be tax advice directed at the particular facts and circumstances of any person. Persons interested in the matters presented today are encouraged to contact Crowe Horwath LLP to discuss the potential application of the subject matter to their particular facts and circumstances. There are no restrictions or limitations on any person from disclosing the tax treatment or tax structure of any matter addressed in this presentation.

Crowe Horwath LLP is an independent member of Crowe Horwath International, a Swiss verein. Each member firm of Crowe Horwath International is a separate and independent legal entity. Crowe Horwath LLP and its affiliates are not responsible or liable for any acts or omissions of Crowe Horwath International or any other member of Crowe Horwath International and specifically disclaim any and all responsibility or liability for acts or omissions of Crowe Horwath International or any other Crowe Horwath International member. Accountancy services in Kansas and North Carolina are rendered by Crowe Chizek LLP, which is not a member of Crowe Horwath International.© 2016 Crowe Horwath LLP.