Setting Up A Captive: It's About Having Control

Featuring Michael R. Mead, CPCU, President, M.R. Mead & Company, Inc.

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At the Peak Performance Insurance Ski Insurance Conference this past January, I caught up with **Mike Mead**, President of M.R. Mead & Company, to discuss captives, setting them up, and how they can benefit a client. M.R. Mead & Company is an insurance intermediary specializing in captives and alternative risk finance for privately held organizations and multiple companies throughout the United States. M.R. Mead offers retail and wholesale services such as fronting/risk sharing, excess and aggregate coverage, finite policies, and deductible reimbursement programs.

Mike has been in the insurance industry for many years, beginning as a surety bond underwriter and then working on the agency side with brokerage firm Fred. S. James & Company where he became very interested in captives. After leaving the firm, he entered the world of captives and eventually along with a partner formed Lionheart Insurance Group (known as Crusader International Management in the Cayman Islands which was founded by his partner). Today, he heads M.R. Mead and is known for his expertise in the captive space. Mike has served in a variety of leadership positions in the industry including Director and Chair of the Captive Insurance Companies Association, President and Director of the Arizona Captive Insurance Association, and Director of the Captive Insurance Council of the District of Columbia and of the International Center for Captive insurance Education. He is the 2011 winner of the Captive Insurance Companies Association Distinguished Service Award, the highest in the industry.

Captives are still very popular, according to Mike. "It's estimated that 51% of the commercial property/casualty market is in the alternative risk market. There were hundreds of new captives licensed this past year, even in a down economic market. They're extremely popular with estate planners, and many high net worth individuals use captives."

Annie George (AG): Mike, provide us with an overview of what you offer and why captives can work well for specific clients.

Mike Mead (MM): "I help people to set up and manage captives. Basically, I'm working with privately held companies and high net worth individuals who currently don't have a captive. Setting up a captive allows you to control your own money; it's another method by which risk to loss is financed. When we refer to real estate, we say it's all about 'location, location, location'. When it comes to captives, I always say it's about 'control, control, control'. If you have the financial ability to finance a large portion of your own risk, and if you have the ability to manage those risks, you can save yourself a great deal of money with a captive. You may even make money with a captive. Control is the key advantage.

"Another advantage is that you can obtain coverages that are either not widely available or properly priced in the marketplace. You can also fill in coverage gaps that are needed but have not been offered to you. And of course, there are tax benefits as well. I work with the client's tax advisor when setting up a captive."

AG: What's involved in establishing a captive?

MM: "First, I educate my clients so that they can understand what a captive is all about and what we're trying to accomplish. If, for example, someone says to me, 'I want lower premiums', I point out that his/her objective should be to mitigate and minimize lawsuits.

"We'll go through an educational process, followed by the gathering of underwriting information – exposure and loss data, for example – everything you would need in placing insurance. We then select an actuary and work with him/her to come up with a feasibility study. We'll also choose a domicile in which to put the captive. There are about 32 states that are captive domiciles and dozens outside the U.S. We'll help the client decide which domicile is best.

"Additionally, we'll work on the ownership structure to obtain tax benefits. We'll choose the service providers: For example, do you need a front? Do you need reinsurance? Do you need claims management, legal council, audit and accounting staff? We'll put this all together and present the client with a report showing how the captive would operate once the actuarial work is completed. If the client then decides to go ahead, we meet with the domicile regulators as well as the other service providers we've selected, fill out the application and, once licensed, we'll begin to manage the captive.

"What's more, we design each captive, whether it's pure, group, an association, to the specific customer's needs. I don't put customers into a program just because it's easiest for me or because there are volume commitments with fronting companies and reinsurers. I do what's best for the client."

AG: Where do the majority of your clients come from and what financial requirements are there?

MM: "Most of my business comes from retail agents. They'll have a client that gets bigger and bigger and wants to set up a captive. The agents feel comfortable working with me, as I'm independent.

"The potential client should be paying around $1 million in premium a year at least. We've set up captives for clients that are smaller, but you lose the financial benefit of the captive because you have certain fixed costs that need to be covered. It should also be a risk that manages its losses well."

AG: Does a captive require a significant amount of money?

There are six principal steps needed to decide whether a captive is the correct solution for a client:

Feasibility Study: Determining the viability of a captive begins with an actuarial analysis of past claims.
Goal Setting: Time should be spent on the goal of the captive.
Domicile Selection: The quality and quantity of regulation and support services should be seen to bring the best fit to the goals of the captive.
Partner Selection - Depending on circumstances, a U.S. consultant, a domicile manager, a risk sharing entity, attorney, accountant, banker and actuary will be needed.
Company Formation - A company must be formed with officers and directors.
Risk Sharing Partner – Obtaining the entity that is on the line for the largest and most frequent claims; generally is a U.S. licensed and admitted insurer.

MM: "It can. Like any insurance company, the regulators expect the captive to follow prescribed ratios of premium to surplus. The difference is that the captive can usually satisfy the requirement with letters of credit, rather than cash. Also, captives don't use the same accounting system as insurers. They don't use statutory accounting, they use GAAP, which means that the captive, in addition to being able to use letters of credit, can discount the reserves on their books and still take the deduction. Most of the time, a captive is set up because the firm is paying a lot of premium, has low losses, and is tired of dealing with the insurance company."

AG: Even in a soft market where premiums have been competitive, companies are looking to captives?

MM: "The market will eventually harden. Now is the time to get the good deals and put them in place. When the market hardens, you're already set up. You get underwriters, even on captives, fronting, and reinsurance, to offer you deals that they won't be offering when the market hardens."

AG: What are the downsides to captives?

MM: "People often ask me 'why would a captive fail?' In studying them, fundamentally there are two basic reasons: Undercapitalization - you just didn't put enough money in and the losses started coming. And secondly, the executive management of the parent didn't pay any attention to the captive. It's a separate business unit, you can have a risk manager or CFO heading it, but the individuals at the top need to know what's going on and they need to make decisions.

"Additionally, captives are sometimes formed for a specific purpose and then closed when that reason no longer is valid. For example, a manufacturer is going to close a plant in a particular state and it has some Workers Comp issues and has to deal with unions. They put the Comp into the captive and when the plant is closed, the captive is closed as well."

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AG: Which states are really big on captives?

MM: "Vermont is the biggest U.S. captive domicile. Part of what I do, as I mentioned earlier, is choose the right domicile for the client, a very important step in the process; it makes a huge difference. For example, Arizona and Utah have no premium taxes on captives. Everybody else does. If that's important to you as the client, it must be looked at."

AG: If you have states where there are no taxes on the premium, why would you go somewhere else?

MM: "You have to also look at state regulations. What does each state allow you to do and what are their restrictions? A common restriction involves the way in which you can invest reserves. Some states say you must act like an insurance company with investments made in blue chip stocks and bonds. Other states allow you to invest in other things and will allow loan backs as a corporation as well as different types of structures. Some states are pretty straightforward – you can have pure, group, and association captives, but cannot have protected cells, series LLCs.

"Choosing the right domicile with its respective regulations will depend on the client and what's important in terms of the goals that have been established. You also need to look at the domicile's regulator and likes and dislikes. All regulators require an initial meeting prior to filing an application; they want to know if you know what you're doing and why you're coming to them. I research these domiciles and stay up-to-date on them, which is critical."

Mike also explained, "captives are not a solution for every situation. But under the right circumstances, a carefully planned, properly executed and diligently managed captive can be an ongoing source of profit for years to come." If you would like to discuss the establishment of a captive for one your insureds, please feel free to contact Mike at: **773.693.4990**, or via email at mmead@mrmeadandco.com.