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SELF INSURANCE AND CAPTIVES

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The producers of credit and group insurance are retaining insurance profits by reinsuring through captives. Corporations are saving risk charges and taxes by self insuring and using captives. What are the implications to the life insurance industry?

1. How does the captive insurance concept work?

2. What applications of the captive insurance concept already exist in the life insurance industry?

3. What competition exists from non-admitted insurers and reinsurers promoting captives and self insurance?

4. What future do the captive and self insurance concepts have in the life insurance industry?

5. Will captives and self insurance affect the real cost of insurance?

SELF INSURANCE AND CAPTIVES

MR. RICHARD E. SWAGER: This is Panel Discussion Number 6, Captives and Self Insurance. I will be serving as both Moderator and Recorder today, so if any of you want to make comments that should go into the Record, you should submit them to me in writing after the Meeting. We will start with a bit of introduction before I introduce our Panelists.

The motives for forming captive insurance companies, no matter how we finally decide to define captive insurance companies, are probably as varied as the persons or entities who might actually form them. There are two kinds of companies that are commonly referred to as "captives", but they are really quite different in concept, and they are often very different in corporate form as well. A true captive insurance company, which we will refer to as a CIC, is usually formed by associations, groups, or corporations, primarily for the purpose of insuring or reinsuring their own risks. Most CIC's have become involved in insuring outside business as well, but primarily for satisfying IRS requirements. The general goal of a CIC is a reduction in the ultimate insurance costs of its parent owner. Some more specific motivations for forming a CIC might include the following:

1. It would give the parent company managers some incentives to practice good loss control via the life insurance product or property casualty insurance product.

2. It would allow the captive to tailor-make insurance coverage for the parent rather than forcing the parent to buy what is available in the open insurance marketplace.

3. It is usually believed that it would lower actual insurance costs through good claims control.

4. It would allow the parent some flexibility in sharing 100% of its own good experience. Parents of CIC's are always optimists. Their experience is always expected to be better than average.

5. The parent quite often might want to provide for some uninsurable risk, a risk that the normal insurance marketplace just would not write: space exploration, oil rigs, and crazy things like that.

6. A captive is often able to obtain better reinsurance terms in the open marketplace than would be offered to the parent over a self-insured deductible. We will get into some of those issues when we talk about third party administrators and self insurance later.

7. It would allow the parent to obtain current tax deductibility for future losses. I would make a note that tax deductibility is a very complex issue, and tax counsel should make sure that whatever the captive does will qualify for tax deductibility.

I would like to also note that historically the use of the true captive has been most prevalent for property casualty insurance, although we are seeing more and more in the life area.

The second type of insurance company commonly referred to as a captive is actually quite different from a CIC. Often they are formed by insurance agents, individual or corporate investors, U.S. or foreign corporations, or some other entity, and these insurance companies have profits as a primary motivation - purely making a profit or sharing a profit. We will call this type of company a PIC, a profit insurance captive. A couple of specific motivations for establishing a PIC might include:

1. It could capture profits otherwise going to an insurance company on business controlled by an agent or agency.

2. It could obtain access to good books of business, at least good books as perceived by the agent, where no direct insurance product exists. An example might be Colonial Penn's approach to AARP. That was not really a captive situation, but it was a controlled agency situation with a product line that was not currently being offered.

3. It offers considerable flexibility in designing imaginative reinsurance programs, be they individual, group or otherwise for the producers' insurance customers.

To some extent the profit motive exists in both the CIC and PIC, and each seeks to extract profits from the insurance carriers on blocks of business that they control. However, I think the primary difference is that the CIC has the motivation of capturing its own lost profits and a PIC has the motivation to share in the profits of the business it produces.

To summarize then, CIC's and PIC's are often formed to structure insurance to suit particular needs, to obtain financial advantages, to offer unusual coverages not readily available in the marketplace, or to achieve tax flexibility. Self insurance has many of the same motivations and characteristics, so it naturally falls into our discussion. We will try to cover the dynamics of CIC's, PIC's, self insurance and the traditional insurance marketplace, and we will ask some questions about the probable successes of the various concepts and their effect on the life insurance industry.

Perhaps the most mature segment of the life insurance business that has dealt with captives is the credit insurance industry, and we would like to use a discussion of the captive concept as it applies to credit insurers as a means to look at the mechanics and the evolution of what has taken place in that industry. We hope that the discussion will be interesting in its own right, but we think it will also give some ideas as to what might happen in less mature uses of captives in traditional insurance and reinsurance marketplaces, particularly with respect to such evolving issues as brokered structured settlements for settlement of property casualty claims, the large looming liability under asbestosis facing the property casualty insurance industry (and perhaps life companies participating therein), and also the expansion of producer-oriented captives in traditional life insurance products which have normally been our bread and butter. First we will explore the bank holding company concept and then move on to producer-oriented captives. We will look at them onshore and offshore. We will then go into ERISA captives and self insurance, provided we have some time.

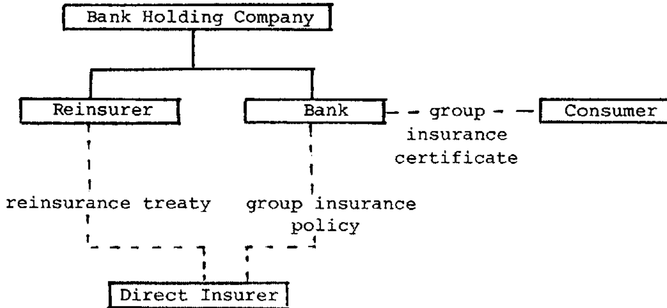
Among our three panelists, the common thread in their backgrounds is credit insurance, although they have experience in a number of different areas. I would like to introduce them to you now. On my far right is Mr. William R. Horbatt, Actuarial Director of Group Credit Operations of the Prudential Insurance Company, working out of the Roseland, New Jersey office. In the middle is Mr. James H. Gordon, Actuary with the Wyatt Company, based in their Phoenix, Arizona office. And Mr. Gary Fagg, to my immediate right, is Senior Vice President of The Credit Life Insurance Company, Springfield, Ohio, one of the largest independent credit insurers. To kick things off, Mr. Horbatt will talk about bank holding companies.

MR. WILLIAM R. HORBATT: Bank holding company captive insurance companies are important in this discussion in two senses. First, they probably are the simplest form of captive and thus form a framework for the discussion that follows. Second, their numbers make them material in the credit insurance marketplace. In my portion of the panel discussion I plan to go over what a bank holding company captive is, why they are formed, how they operate, some caveats as to what can go wrong and, if I have time, some comments on why direct writers are active in this marketplace.

Bank Holding Company Captive Insurers

To start out, a bank holding company (or BHC) captive is a wholly-owned subsidiary of a bank holding company. National banks are generally not allowed to own non-bank subsidiaries, so they form upstream holding companies which own both the bank and the credit insurance company. The 1971

amendments to Regulation Y of the 1956 Bank Holding Company Act permit underwriting of credit insurance originating at affiliated banks. The diagram below illustrates this relationship.



You can see the bank holding company is at the top since it owns both the national bank and the reinsurer. In addition, you can see the direct writer, a company like Prudential or Credit Life, and next to the bank you can see the consumer, who is the ultimate source of this endeavor. Linking the reinsurer and the direct writer is a reinsurance treaty; linking the bank and the direct writer is a group insurance policy; linking consumers to all of this are group insurance certificates issued by the group policyholder bank to loan customers. The cash flow follows the same lines. Comsumers pay the premiums, or more accurately what we refer to as identifiable charges. These charges are accumulated and paid monthly to the direct writer as the premiums under the group insurance policy. The direct writer, in turn, cedes the premium net of various deductions to the reinsurer. Claim payments flow in the opposite direction.

Normally the captive insurance company acts only as a reinsurance company, although there are situations, particularly involving BHC's in Texas, where bank captives act as direct writers as well. The bank holding company engages a separate direct writing company for several reasons:

1. The direct writer is admitted in the national bank's state. The direct writer meets all requirements, including minimum capitalization.

2. The direct writer has filed and approved credit insurance policies.

3. The direct writer has established procedures and the skilled staff necessary to administer the business.

The direct writer's capitalization can be very important for BHC's located in the states like New York where $5 million of capital and surplus is needed.

The captive reinsurer is normally domiciled in the states with low capitalization requirements, the three most common states being Arizona with a $150,000 minimum, Texas with a $200,000 minimum, and Delaware with a $400,000 minimum.

Motivation

The next question to be addressed is why bank holding companies form captives. Motivations can be subdivided into financial reasons and non-financial reasons.

Financial

1. From a financial standpoint, one of the most important things is the underwriting profit. This is particularly important in light of state regulation of credit insurance premium rates and commissions. This regulation is intended to prevent what is called "reverse competition". Since the creditor (or in this case the captive) benefits from the excess of the premiums over claims and expenses there is a tendency to raise premium rates to increase profits. State regulations counteract this tendency by establishing maximum premium rates that can be charged. Maximum compensation rates are frequently established as well under the rationale that if the credit insurance program is meeting the state's benchmark loss ratio, then there is no money above the maximum compensation rate available for paying compensation to the creditor. The total compensation to the BHC and its captive can thus be subdivided into three components: the maximum compensation permitted by law, the excess of the state's benchmark loss ratio over the actual loss ratio, and the excess of the margin included in the premium rates over actual expenses. The last two components are available only through the captive mechanism.

2. Another source of income is investment income. Most credit insurance is written on a single premium basis, and unearned premium reserves can be substantial, frequently equaling the annual written premium. Claim reserves on health insurance can also be substantial, frequently equaling three quarters of annual paid claims.

3. And finally, from a financial standpoint there are tax considerations. A captive that qualifies as a life insurance company under the Federal Income Tax Code has several advantages, including the small business deduction and the tax deferral on amounts contributed to the Policyholder's Surplus Account. If a life insurance company subsidiary qualifies as a life company, it will also be taxed independently of the parent company, which can be advantageous when the parent's marginal tax rate is high.

Non-Financial

1. From a non-financial perspective, one of the most important incentives is to establish the credit insurance program as a profit center within the financial institution. It becomes evident to top management whether or not credit insurance is contributing a profit to the bank holding company.

2. Another item is the possibility of bank deregulation. With the evolution of bank deregulation, banks are trying to gain staff that is skilled in insurance. This applies primarily to marketing and

administrative staffs, but bank executive officers are also interested in learning how insurance works. Running a captive is a good learning experience.

3. The final non-financial reason for setting up a captive up is that everyone else is doing it. This may be one of the most important reasons today. To give some perspective, in 1971 when Regulation Y was amended to formally permit this activity, there had been only 10 captives, and now there are over 150, maybe over 200.

Example

To provide a better description of how this process works, let us look at a simplified captive income statement.

REINSURANCE COMPANY
INCOME STATEMENT

Premiums before Reinsurance	$100	
Public Benefit Reduction	- 2	
		$98
Claims	$ 50	
Creditor Compensation	39	
Ceding Fee	3	
Premium Tax	2	
Total Deductions		-$94
Underwriting Profit		4
Investment Income		+ 10
Pre Tax Profit		$14
Federal Income Tax		- 3
After Tax Profit		$11

The income statement starts out with the premium that would have existed even without a captive credit insurance program, which in this example is $100. The next item is the "pro bono" or public benefit required by the Federal Reserve Board for the BHC to gain approval to engage in this activity. In this case we are saying it is 2%, while it actually varies with the life insurance premium rate. The net amount of premium after the public benefit reduction is the actual premium that is being collected from the debtors. Deducted from premiums are claims at a 50% loss ratio. This is the most common benchmark loss ratio in consumer credit regulation today, although the trend is toward the 60% loss ratio in the NAIC Model Credit Insurance Regulation. Also deducted is creditor compensation of $39, which is 40% of net premium. We are assuming that this is the maximum permitted by law. The direct writer's ceding fee of $3 is deducted, which is totally illustrative, and a $2 premium tax is deducted, resulting in $4 of underwriting profit. Adding $10 of investment income yields a pre-tax profit of $14. The $10 investment yield is not an unreasonable number considering that the unearned premium which is roughly equal to

written premium earns 10% interest. Federal Income Tax is $3, assuming the marginal tax rate for a qualified life company is approximately 24%, and this leaves an after-tax profit of $11 that would not have been available to the BHC without forming a captive. Let's take this one step further by looking at the after-tax effect of compensation paid to the creditor and comparing it to what would would have happened under a traditional program.

BANK HOLDING COMPANY
INCOME STATEMENT

	With Reinsurance	Without Reinsurance
Compensation Paid by Direct Writer	$39	$40
Federal Income Tax at 46%	- 18	- 18
	$21	$22
Reinsurer Retained Income	$11	$--
Net Income After F.I.T.	$32	$22

Under the traditional program, the direct compensation would be a little higher because there is no public benefit applied to the premium rates. Both situations incur income tax charges, but the net effect is to show a traditional program being slightly more profitable than a captive program until the after-tax income of the captive is added, then the relationship is reversed.

Operational Considerations

Captives generally operate very simply. The bank holding company normally contracts for most of the services required. As mentioned earlier, the direct writer handles items like claim administration and basic premium accounting, giving the reinsurer only summary financial statements. Additional services are provided by outside counsel and consulting actuaries.

To start a BHC captive company, the first thing that has to be obtained is Federal Reserve Board approval, and the primary requirement in this process is to demonstrate a public benefit. At the same time, the captive has to be incorporated and chartered. In Arizona this normally costs from $2,000 to $3,000. On an ongoing basis, someone has to maintain the books, prepare annual statements, file income tax returns, act as a statutory agent in the captive's state of domicile and be available at the times of insurance department examinations. These services cost anywhere from under $5,000 to over $10,000 a year.

Bank captive company investment portfolios are usually uncomplicated, although I have seen situations where management has used all the flexibility permitted by insurance law. Generally investments are conservative securities like bank certificates of deposit and U.S. Government bonds.

It should also be mentioned that since the captive is usually relatively small and is not normally admitted in the state where the credit insurance originates, the direct writer normally requires some form of collateral

from the captive, taking the form of either a custodial agreement or a letter of credit in an amount equal to the captive's reserves.

Caveats

Going on to the caveats, we will see what can go wrong if a captive is established. I think the panelists have seen each of the examples to be given.

The most obvious is adverse claim fluctuation, where claims exceed the level assumed when the venture was started. This can create interesting situations. For example, if you have a finance company and a bank both owned by a BHC but where one controls the captive and the other does not, then you can start receiving letters from the one controlling the captive to reduce compensation to the other party. You do not know who to listen to. There can also be the problem of finding what went wrong. When a bank has a traditional credit insurance program, the bankers are not interested in the direct writer's losses, but with a captive program adverse claim fluctuation can mean that a subsidiary is going insolvent and they care a lot more.

There can also be a problem with surplus strain. This has happened frequently with credit insurance programs in New York State where the average premium rate is about $5 per annum per $1,000 insured while the average claim rate for calculating mortality reserves is about $10. Every time more business is written mortality reserves increase faster than the premium income. The same type of problem can occur because of the direct charge off of expenses as they are paid, particularly when high bank compensation is paid on a guaranteed basis.

Another problem is the qualification of the company under the Federal Income Tax Code as a "life insurance company". Assuming the parent has a high marginal tax rate, the parent will generally not want the captive to be consolidated with it. To accomplish this the captive must qualify as a life insurance company under the tax code and this requires that over 50% of the captive's reserves and liabilities be life insurance reserves. This can be an important issue when it conflicts with the desire to maximize investment income since credit A&H reserves are not considered to be life insurance reserves. That creates a balancing problem which is frequently resolved by the direct writer holding the unearned A&H premiums.

The final situation is what can be referred to as the Phase Three problem. Once the Policyholder Surplus Account has reached its maximum, the marginal tax rate of the captive shoots up to 46%. The later panelists will be discussing the responses that the industry has developed to solve this problem in more detail. One such response is to cede the BHC's employee benefits to the captive, thus raising the maximum Policyholder Surplus Account by 50% of the increased premium revenue.

Direct Writer Incentives

Finally, I want to mention why established insurance companies decide to cede to BHC captives. First, there is a precedent in the group insurance field. Just as financial devices such as ASO and MPP plans became important in group insurance for cash flow and tax planning reasons, captives

became important in credit insurance. In both group and credit insurance there were existing relationships between the direct writer and the policyholders. Direct writers had staffs that knew how to handle the coverages and were doing much of the same type of work as now. The effect of the transition upon the direct writer's income was minimal since they were not retaining substantial profits from the business. Case earnings had been returned to policyholders as commission or as experience rating refunds in the case of stock companies and dividends in the case of mutual companies. The only real losses were the loss of investment income, most of which was being credited to policyholders anyway, and the loss of risk which actually is not such a bad thing to lose. Another incentive to cede reinsurance to bank captives was a philosophical interest in credit insurance. At least in terms of the Prudential, we have felt the need to continue to pursue an active regulatory role as a matter of corporate policy, particularly in terms of supporting the development by the NAIC and implementation by the states of effective credit insurance regulations. The bottom line is that direct writers can write captive business profitably. Interest lost would have been credited to the policyholder anyway; lower retentions are compensated for by lower risk retained; and there is an additional benefit in ceding away surplus strain. I think at this point Gary may want to go on to explain why The Credit Life is in the captive business.

MR. SWAGER: Exercising the moderator's perogative here, I would like to jump from credit insurance for just a moment to tie in some other things that are going on in other captive areas. Start with the idea that profits are equal to premiums plus investment income less claims less expenses less taxes. It often happens that when you start doing some of the things that Bill was discussing you put more and more people into the endeavor. That means more levels of expense. Credit insurance has traditionally been very profitable because of the reverse competition or reverse rating that Bill discussed. There has been more and more regulation to take some of the profits out, but it is obvious that the higher the profits in the direct business, the higher the incentive will be for the entity which controls the business to want to share those profits. There are a number of products being sold by insurance companies these days where profits are small or nonexistent. There may not be very much pressure for captives in those areas.

It is also interesting to focus on the fact that the bank is setting up its captive to capture profits. However, the insurance line of business, even though Bill has identified it as a profit center, is not the main business of the bank. It is an add-on and an additional service to the bank customer. I bring it up in the context that there are many industrial giants buying existing life insurance companies, sometimes gobbling them. There may be innovative agents of those insurance companies who will want to market products to the parent, to its employees, to its customers, and so on. I would see this as a place where some of the concepts we are discussing can branch out for the future. The question is whether there will be profits in those products to be sold. It is one thing to start a captive with a mature block of business and another thing to start one with a very thinly-priced, risky new block of business. The captive must have enough financial capacity to really take the risk that is being assumed.

We talked about producers being motivators. Mr. Fagg's company is dealing with banks and with individual producers as well. He will take the captive concept one step further.

MR. GARY T. FAGG: We want to continue the discussion in terms of the financial institution captives because they are the most dominant form of credit insurance captive. We will then talk about some of the other credit captives formed by auto dealers and general agents.

With a name like The Credit Life Insurance Company, it should not surprise anyone that we are in the credit business. Credit Life wrote the first group credit policy in 1926. We have stayed almost entirely in the credit specialty field. Our whole thrust is the direction of any product that can be marketed through financial institutions. Our main line of business is credit insurance and our secondary line of business is mortgage cancellation insurance sold through savings and loans. There is a clear trend of financial institutions entering into the insurance industry. Many of you have seen this already. There is another panel discussion going on now about it.

It is also clear that insurance is going to be sold in banks or through banks' customer lists. Several insurance companies are encouraging banks to get into the insurance business. Practically all of the major bank holding companies have credit insurance captives. These captives are positioned to write other forms of business. If Federal restrictions are lifted, they will be able to reinsure mortgage insurance and ordinary insurance, maybe even casualty insurance. Any of these lines can be marketed through the financial institution. Credit Life Insurance Company and others are willing to write the business, administer the business, and reinsure it into the captive. This will be a clear area of competition that the rest of the insurance industry must face. Some insurers are going to be working with the financial institutions, encouraging them to write insurance and be involved in the insurance field; they will be competing directly with the rest of the insurance industry. The industry must be aware of this competitive force. The ability of the bank to reinsure the business into their captive really makes a considerable difference to the bank.

If you read the papers about captives, you will see that several savings and loans have formed captives primarily to reinsure their mortgage decreasing term insurance. Some of these savings and loans are literally unregulated in terms of their insurance activity. There is one savings and loan in the state of Washington that owns one of the largest writers of single premium deferred annuities. That savings and loan is in an unusual statutory role in that they have no limitations on their insurance activities. As savings and loans become aggressive, more pressure will come from the bank holding companies, demanding the ability to compete.

To consider the other entities which have formed credit insurance captives, we need to digress a bit. The first real captives in the credit insurance field were in the 1950's. They were primarily finance companies. Finance companies produce a great deal of credit insurance. They are multi-state operations, which made it difficult to start an insurance company. So they came to companies like Credit Life and said that they wanted a direct writer to administer the business and reinsure it into

their captive. Many of their companies have since grown into stand-alone companies. They are very powerful companies in the credit insurance business. They are widely licensed and now have even expanded beyond credit insurance.

The basic problem with financial institutions and finance companies is that they are boring. They do everything right. They send in their premiums. They want to file their tax returns properly. You really have not experienced the captive market until you have dealt with an auto dealer captive. First of all, only large dealerships are able to generate enough premium income to cover the overhead costs. There are quite a few auto dealers who will produce a half million dollars of credit insurance premium in a year. Try to imagine sitting down to explain the intricacies of statutory accounting, GAAP accounting, and taxation of insurance companies to an auto dealer. Occasionally the owner thinks he owns the assets of the captive. We had a situation where an auto dealer formed a company and contributed his $150,000 capital and surplus. By the end of the year he had about $150,000 in reserves and $150,000 in capital and surplus; $300,000 in assets. He had another deal come along and needed $200,000. He cashed his certificates of deposits, wrote himself a check for $200,000, and bought his other investment. We got around to doing his financial statement at December 31 and found the check for $200,000. We called him to ask what he was doing. We told him that he had just made his company insolvent and had probably committed a criminal act. His response was that it was his company and the assets were his. The concept that policy reserves do not belong to the stockholders or that you must have a minimum level of capital surplus was totally lost on him.

To carry auto dealers one step further, there are many instances when the auto dealer is not big enough to form his own captive. Several of them will get together and form what is generally referred to as an "exotic captive". An exotic captive is permitted under the laws of Arizona. Basically,you form one insurance company, but if there are five stockholders, each can have a class of common stock. It can be organized and run such that the profits on the business generated by each class of stock goes to the benefit of the owner of that class of stock. It is like having a condominium company. There are five different people that are associated together to form the company, but all of the profits for each class of common stock are the profits that are generated from the stockholder's credit insurance. These captives started having problems in the last couple of years when auto dealers began to fold. One bad apple might have already spent his portion of the premium and the other four auto dealers in the exotic would have to kick in the money to pay claims.

Along the same lines, there are producer-oriented captives. This is where there is a general agent who has over the years built up a base of creditors for whom he services the credit insurance needs of the account. These producers control the block of business. The creditors are normally small banks, small auto dealers, small credit unions, or credit unions in general. The producer will go to the direct writer and ask him to reinsure the business into the producer captive to get the underwriting profits and the tax advantages that are available to an insurance company. The producers were already getting much of the underwriting profits through contingent commission agreements. Therefore, insurance companies tend to go along with the request and help the agent set up the captive. Several of these producer-oriented captives have grown into stand alone companies.

Thus far, we have considered the situation for onshore captives. By onshore we mean the United States, and we are primarily talking about the state of Arizona. Arizona is nice, but it is just not the Cayman Islands or Bermuda for excitement. In recent years, producers and agents have started using offshore mechanisms to a greater degree to form their captives. There is a lot of appeal from certain standpoints. Offshore you can get into an environment where regulation is anywhere from non-existent to reasonable. Offshore regulation does not really restrain a captive very much in terms of operations. Some of them do not restrain the captive at all. There are good places to have offshore captives and there are less desirable places, at least for people who are trying to form a reputable captive. Bermuda and the Cayman Islands are now used frequently. They have a good insurance regulatory mechanism in place. There are a lot of professional people available in these two locations to service and handle the operations of the captive. But there are a lot of other places available too. One favorite is the Turks and Caicos. They have no insurance regulation. For $1,000 you can form a captive and operate on a virtually unregulated basis.

To investigate offshore captives, we must define a controlled foreign corporation (CFC). A CFC means that, from the IRS viewpoint, a single U.S. stockholder controls enough of the stock to consider the company subject to U.S. taxation. There are some fairly intricate rules as to whether an offshore company is a CFC or not. If it is a controlled foreign corporation, the profits in that captive are taxed on a current basis just as if its income were earned in the United States. There is very little real advantage to forming a controlled foreign corporation as a captive since even though the profits go offshore, they are imputed to the parent as regular ordinary income and taxed as such. The primary advantage of this mechanism is in states where there is a maximum on creditor compensation. A creditor may not be able to get a direct commission (or any compensation) in excess of 40%. By reinsuring offshore, the creditor can obtain additional compensation if there are underwriting profits. The overhead expenses are small, and many places have low capital requirements.

The entity with real interest to most people is a "non-CFC", or a noncontrolled foreign corporation. These are more difficult to form. Probably the most simple way to form a noncontrolled foreign corporation is to have eleven stockholders, none of which owns more than 10% of the stock. The stockholders must be unrelated by IRS standards. If you achieve this result, you have a company whose earnings are not taxed until they are brought back onshore. The business is ceded offshore. The profits are earned offshore, and they are not subject to U.S. taxation until they are brought back onshore. If you leave the profits offshore until you are ready to liquidate the captive, you can sell your stock. Everything comes back as a capital gain. Obviously, these type of schemes have raised the interest of the IRS.

There are a few problems with going offshore. The most significant is the cost of 1% excise tax on the premium reinsured offshore. However, most direct writers will also insist that the full statutory reserves be established and backed by an irrevocable letter of credit. This cost is roughly 1/2 of 1% of the reserves. Establishing the letter of credit is the only way the direct writer can ensure that the reserves are there and that it can take reserve credit.

My final comment is the overriding lesson Credit Life has learned from its 25 years in the captive business. Never forget whose name is on the piece of paper that is held by the insured. If you are the direct writer, you are going to pay that claim no matter what happens. You cannot go moaning to an insurance department that you do not want to pay a claim because you cannot get the reinsurer to cough up their portion of the money. That is the risk of being a direct writer. You are on the risk. You will pay the claim. It is very important that you develop financial controls and have them in place to ensure that the reinsurers will do their duty when it comes time to pay the claims.

MR. SWAGER: Gary was a bit lighthearted in talking about auto dealers. We think of them as always trying to sell us a car. However, some of their captives are substantial.

Also, a number of very major general corporations, and a number of life and property casualty insurance companies in the U.S., have significant captive operations in Bermuda. We are talking about premium volumes of hundreds of millions of dollars annually. Offshore captives do not necessarily have only $1,000 of capitalization. These Bermuda captives are primarily property casualty captives, but there are some life captives as well. Almost all of the Fortune 100 corporations have one or more, and probably a majority of the Fortune 500 corporations, too.

Let us also focus on the idea that you have not heard any speaker talk about face amount of insurance. We have been talking about profits, which are a function of premiums, investment income, claims, expenses and taxes. Almost all captives measure their life or death, their success or failure, in terms of bottom line profits rather than in-force production goals. As an aside, although we have been talking about credit insurance, within the last 12 months our firm has been approached by at least four life insurance agents (writing for significant U.S. life companies) to see if we could find them a reinsurance vehicle. This would involve arranging the front company and designing a reinsurance program for their captive so that they can capture some of the profits from the business they are producing. It is interesting because at other Meetings of the Society a lot of us have been concerned that the profit levels in certain products are zero or minus. There is more pressure outside the credit insurance business to do these kinds of things. Are there profits there to do that?

One other example of absolutely staggering proportions where the captive concept could be used is in connection with some rather explosive exposures on asbestos claims facing the property and casualty insurers. The industry estimates that those future claims may be as high as $40 billion. One of the things that has happened is that a number of the major companies have formed a Bermuda captive, as a noncontrolled foreign corporation, to be able to gain all of the advantages that Gary talked about. By leaving all of the investment income and underwriting income in Bermuda, the captive is untaxed on a current basis. The idea is that they can put money offshore and allow Uncle Sam to pick up some of the exposure on these asbestos claims. Most of the claims will be protracted settlements over the next 20 or 30 years. When you put in some very high investment rates, the present value of the future liability is reduced to a not-so-staggering $10 billion or so. And, since the "profits" are brought back onshore only to pay losses, there are no adverse tax consequences even then.

One other thing on taxation. Gary mentioned that there is a 1% FET on reinsurance premium going offshore. Any direct insurance premium that a company would send to its own captive would carry an FET rate of 4%. Let us jump now to some traditional captives outside the credit insurance field. Jim Gordon will handle that area.

MR. JAMES H. GORDON: In a little over seventeen months, we will have the tenth anniversary of ERISA, on September 2, 1984. Prior to ERISA, there was no limitation as to the amount of premium dollars that could be written by an insurance company on affiliated companies. With the advent of ERISA, it became a prohibited transaction for an insurance company to write more than 5% of its premiums on affiliated companies. Large corporations like Sears Roebuck, which controls Allstate, had problems to the extent that their employee benefit packages were insured in their subsidiaries. There was soon filed with the Department of Labor a request for a prohibited transaction exemption on a class basis, and after several years of negotiations and false starts, the Department came out with PTE 79-41, which in effect said that as long as the premium volume from affiliates was not more than 50% of total premium, the insurance company was not in violation of ERISA. In fact, that limitation is applicable only to years after December 31, 1981, so that during the intervening years, any company which happened to exceed the 50% rule had no problems. This class exemption had the effect of doing everything for the larger companies that they wanted it to do. However, PTE 79-41 dealt only with direct business. The exemption does not cover reinsurance. Apparently the people in the Department of Labor were concerned about reinsurance to offshore companies, and they were concerned about losing control of the money. If a company is doing business with a reinsurer, they can file with the Department of Labor for an individual exemption. It will generally be approved in a reasonable period of time, say five to six months.

Bank holding companies have had a restriction on the type of business they could underwrite, either on a direct basis or on a reinsurance basis. The restriction was that the insurance had to be credit related business, and consequently they were in a box. The popular term these days is "Catch 22". They could not do what a lot of other major companies were doing by handling their own insurance. In April of 1981, Security Pacific Corporation, which is the bank holding company for Security Pacific Bank in Los Angeles, got together with a man in San Francisco by the name of John Hall. John writes a substantial amount of credit insurance business and other group products for West Coast Life.

They reviewed the Bank Holding Company Act and became convinced that under certain sections of the Act they in fact had the authority to underwrite their pension plan or their group insurance programs. In April of 1981, they filed a letter with the Deputy Counsel of the Federal Reserve Board, setting forth the basis of their belief that these programs could be underwritten by their captive companies. After the Government's due deliberation time of about four months, they agreed that Security Pacific could underwrite both their pension program and their group insurance program in their captives. Security Pacific and their counsel believe that it can be done on either a direct basis or on a reinsurance basis. The difficulty arises from the fact that PTE 79-41 does not exempt reinsurance from being a prohibited transaction. If a bank holding company wants to

underwrite this class of business on a reinsurance basis, they have to go to the DOL or get approval of their qualified plans and their group insurance. I feel that no company is going to form a captive company simply to do their ERISA benefits or their pension plan or their group insurance. The savings are not sufficient to justify doing so.

Just as in a CIC, they are really just reinsuring or underwriting their own business, and the savings are probably not significant. But, it has also been pointed out that most of the bank holding companies today have PIC's, or profit insurance captives, and in that case the insurance may make sense for two reasons. First, they may be able to accomplish some administrative savings. Second, they may be able to do some tax planning to cure some of the problems that have been referred to, such as Phase Three taxes or qualification as a life insurer, because certain annuity reserves or certain retired lives reserves qualify as life reserves for Federal Income Tax purposes.

When the Security Pacific people were investigating the situation, they were also concerned about their fiduciary responsibility in entering into such an arrangement. One of the discussions considered whether, by moving pension assets into their life insurance company, they were failing in their fiduciary responsibility because they were, in effect, going to create some tax by moving the pension liabilities and assets from the tax exempt trust into an insurance company where some tax would be incurred on the investment income. They ultimately arrived at the decision that overall they were in fact strengthening the pension plan because they were improving the parent's ability to maintain the plan.

Other types of business that might be put into these captives, which are not ERISA benefits, are such things as non-qualifying benefits which most large bank holding companies have for a few individuals at the bank. Perhaps they have made special deferred compensation arrangements with key employees, and these benefits may be in non-qualified plans. When payments actually begin, insured products may be purchased from the insurer, either on a reinsurance or a direct basis, with no concern as to DOL regulation or the Federal Reserve Board. These are principally oriented toward the bank holding company, where they have a restriction on what they can insure in their company.

Recently one of our bank holding company clients said that their counsel suggested they could purchase from their wholly-owned insurance company a structured settlement on a wrongful injury claim. This was a person who had been an employee of the bank holding company and was apparently injured on the job. There were going to be substantial settlements over the next 20 to 30 years, and counsel had indicated that they could purchase an annuity from the insurance company to cover the payments. This may indicate the widening range of insurance permitted in captive companies.

Another item that has the bank holding companies excited these days is the new law in South Dakota which permits a state chartered bank to own an insurance company. It can then write any form of insurance that it wants to. Gary mentioned the savings and loan in Washington, which writes insurance relatively free of restrictions. As of now, that, of course, is

not true of bank holding companies because the insurance must be credit related. Even that can be tricky. You might think that mortgage guarantee insurance was credit rated, but the Federal Reserve Board has taken the position that it is not. Consequently, banks cannot underwrite that business in bank holding company captives at this point in time. The South Dakota law might permit the bank holding company to write such business.

We have already discussed being approached by individual agents regarding captives in the area of ordinary insurance. I am aware of one captive company currently in place that is reinsuring a portion of an agent's business with the agent's Arizona company. One of the objectives is to assist the agent in the area of tax planning. It gives him an opportunity to defer some compensation. I am aware of another company which is considering the formation of a captive simply for the purpose of reinsuring ordinary insurance, and they intend to use it to expand their role in the brokerage market. They believe that it will be a means of attracting business from brokers now writing for other companies who do not offer the captive option to them. The concept would also appear to be attractive to a sophisticated, knowledgeable, high-producing agent who is making perhaps more money than he really needs at the present time, and who would like to do some tax planning. Once again, you need to be aware of whose name is on the insurance policy or group certificate. The producers or individuals forming the captive companies, whether it be an individual bank holding company, an auto dealer, a finance company, or somebody in the ordinary insurance area, must have the resources to fund the captive to an appropriate level. To the extent that they have made an investment of any size, that money is at risk. Down the road they need to realize that the money in the captive is subject to considerable fluctuation.

MR. SWAGER: Very quickly, let's look at another contrast of credit insurance to the products Jim has been talking about. In the credit business, quite often the agent or the producer has been willing to take a lesser commission to get part of the profits down the way. To some extent, that reduces the persistency risk and perhaps increases overall profits, so there might be some interesting possibilities. However, in all of the approaches that have been made to our office, the agent wants his full commission plus a share of the profits.

Also, I would point out that credit insurance premiums are usually single premiums, and they cover a relatively short period of time and modest amounts. Many of the self-insurance products we will be discussing momentarily, such as major medical coverage, are also short-term products. Perhaps we should ask whether or not the dynamics of a life insurance product with high front-end expenses, lapse exposure, and other risks, and with very high issue limits, will fit the captive format quite as easily.

A couple of random practical thoughts on captives and self insurance might be in order. First, one of the things that each of our speakers has talked about with respect to captives is the very limited licensing of most captives. When the captive is offshore, quite often it has no U.S. presence, so they use letters of credit to allow the direct writer to take proper reserve credits. Currently, letters of credit must be "clean and evergreen" as the vernacular goes, but that usually means that they must be clean, irrevocable, and annually renewable in such a way that if the

entity for whom they are drawn presents the LOC to the bank for any reason, the bank pays. There are a number of states, notably Massachusetts and New York, which appear to be questioning the use of letters of credit for major reinsurance transactions. Nothing has come down in specific form, but there are numerous rumblings, and such changes, if they occur, will have significant impact first on the normal reinsurance transacted in the property and casualty field, but it will definitely affect captives as well.

Second, if any of you have thoughts about new captives, you should know that the true captive environment is now available in Vermont on very favorable terms. I know of at least two major corporations who are moving their captives from Bermuda to Vermont. The intricacies of the law are probably better discussed in another forum.

Third, I recently met with a subsidiary of a Fortune 50 company and was congratulating them on being able to write all of the group products for their parent. I found that the group A&H was not written by the life subsidiary because the insurance available in the open marketplace was more competitive. A number of consulting actuaries have run asset shares on life and group products before and after reinsurance. Reinsurance has normally been considered an expense, but the asset shares after reinsurance are more profitable for the ceding company than the asset shares before reinsurance. The question is whether there are profits for the reinsurance captive to capture.

Finally, let's go into self insurance for just a moment. The majority of the self insurance that we have seen on the life side of the business so far has been in the group and medical expense areas. I would like to offer an opinion about where some of these products might be going. The state of Minnesota has a new insurance commissioner. He spoke to the Twin Cities Actuarial Club just last week, and he had a very short talk. After all, he is new. He asked what insurance is. He observed that his father kept asking the question, but he always replied that he didn't know. The commissioner observed that insurers sell products that look like investments. And, HMO's provide health coverage, but they are not insurers, and they have no taxability. He also observed that there are all sorts of corporate entities providing products that look like insurance but that are not called insurance. They are taxed considerably differently one from the other. So, he said he really didn't know what insurance is. He then looked at what a regulator is supposed to do. Again, he said he didn't know. The regulations in various areas, particularly with regard to premium taxes, are really quite different. His approach was humorous, but his message was serious. I bring it up to point out that many insurers are going to ASO programs for their group coverages. Some of them were motivated by their customers. Some of them were motivated by the fact that investment income on non-qualifying reserves was so heavily taxed that they could actually give the client a better deal by letting him hold the funds rather than holding the funds, paying the tax, and crediting interest net of tax. There currently is no premium tax on ASO programs. However, there is a bill under consideration in Minnesota that would charge a 2% tax on all claims administered by third party administrators or ASO operations. The idea seems to be that if it looks like insurance, it must be insurance, and companies that are doing ASO business are doing so to avoid premium taxes. The Bill has just been introduced. If a straw vote of the actuaries in the room had been taken, I don't think

the Bill would have been given much chance of passing soon. However, there was some feeling that it will be passed eventually. Minnesota has a penchant for social reform.

Let us look at the basic premise that profits equal premiums plus investment income less claims less expenses less taxes as it might apply to self insurance. We have talked about doing tax planning with captives and self insurance. One of the historical drawbacks of self insurance has been the non-deductibility of reserves for future losses. The corporation has not been able to deduct these reserves. There are now a number of insurance programs, which are called fully-self-funded, partially-self-funded, or quasi-self-funded. They are bastardizations of insurance and self-funding concepts. It is important to note that when reinsurance is required on some of these self-funded vehicles, the reinsurers really do take a quite different view of third party administrators, captive insurance companies, or regular insurance companies administering their own claims. The third party administrator quite often fulfills the functions of marketing and claims administration. Some situations arise where it is not in his best interest to hammer home the fact that the employer needs to put through, say, a 42% rate increase. The scenario goes something like the following. The administrator tells the employer that he needs a 42% rate increase. The employer is reluctantly willing to consider 10%. The administrator knows that they really need 42%, but agrees to 10%. After about two or three years, a number of these self-funded programs are using capitation rates that are incredibly underfunded. Most self-funded small employers, and many large employers as well, have been covered or protected through various forms of reinsurance, usually a specific coverage over a set amount per life. Some buy an aggregate loss ratio cover as well. A number of reinsurers have been in the market and have already pulled out or radically changed their overall rate structures and underwriting guidelines. The same question arises again. If profits are important to reinsurers, and if profits are equal to the various components we have described, there must be some mechanism of underwriting self insurance that results in the production of profit for reinsurers, or the reinsurers will eventually go away.

There have been a number of Multiple Employer Trusts (MET's) that have gone insolvent recently, and several have taken down life insurance companies with them. Iowa State Travelers is a recent example. They had been around for 100 years. It is interesting that all of the elements that we've been talking about today come to play here. A traditional company that had never played with MET business started to play. They became involved with a third party administrator who did not do a particularly good job for them. They reinsured the business into the captive insurance company of the third party administrator. All of a sudden, the funds in the captive vanished. One of the things that surrounds the concepts that we have been talking about is the notoriety and bad publicity when bad things happen. Good things also go on. Captives can take a variety of forms, from auto dealer captives to those of major oil companies in Bermuda. Likewise, the success of self insurance seems to be very importantly connected to the competence of the TPA or ASO or administrator providing the services.