2024 Annual Conference

Texas Captives: Empowering Texas Business

Captive Horizons

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Agenda

- The Captive Landscape
  - Marketplace Perspective
  - Texas as a Captive Domicile
- Risk Factors
- Emerging Trends & Opportunities for Captives
  - Medical Stop Loss & Medical Expense Cost Containment ("MECC")
  - Cyber
  - ESG

Marketplace Perspective

- A.M. Best estimates over 7,000 captive insurance companies worldwide, an increase from 1,000 or so from 1980.
- There are 40 U.S. captive domiciles, 70 worldwide.
- According to Ernst & Young's 2024 Global Insurance Outlook Report, "*Captives now represent nearly 25% of the overall commercial insurance market*."
- Captive Review reported, in 2023 $180 billion in premiums were written by captives globally, approximately $100 billion of which was written through captives domiciled in the U.S.
- An article published by Risk Management Magazine on November 28, 2023, stated "*The captive insurance industry is evolving rapidly, poised to reach a projected $250 billion global market value by 2028.*"

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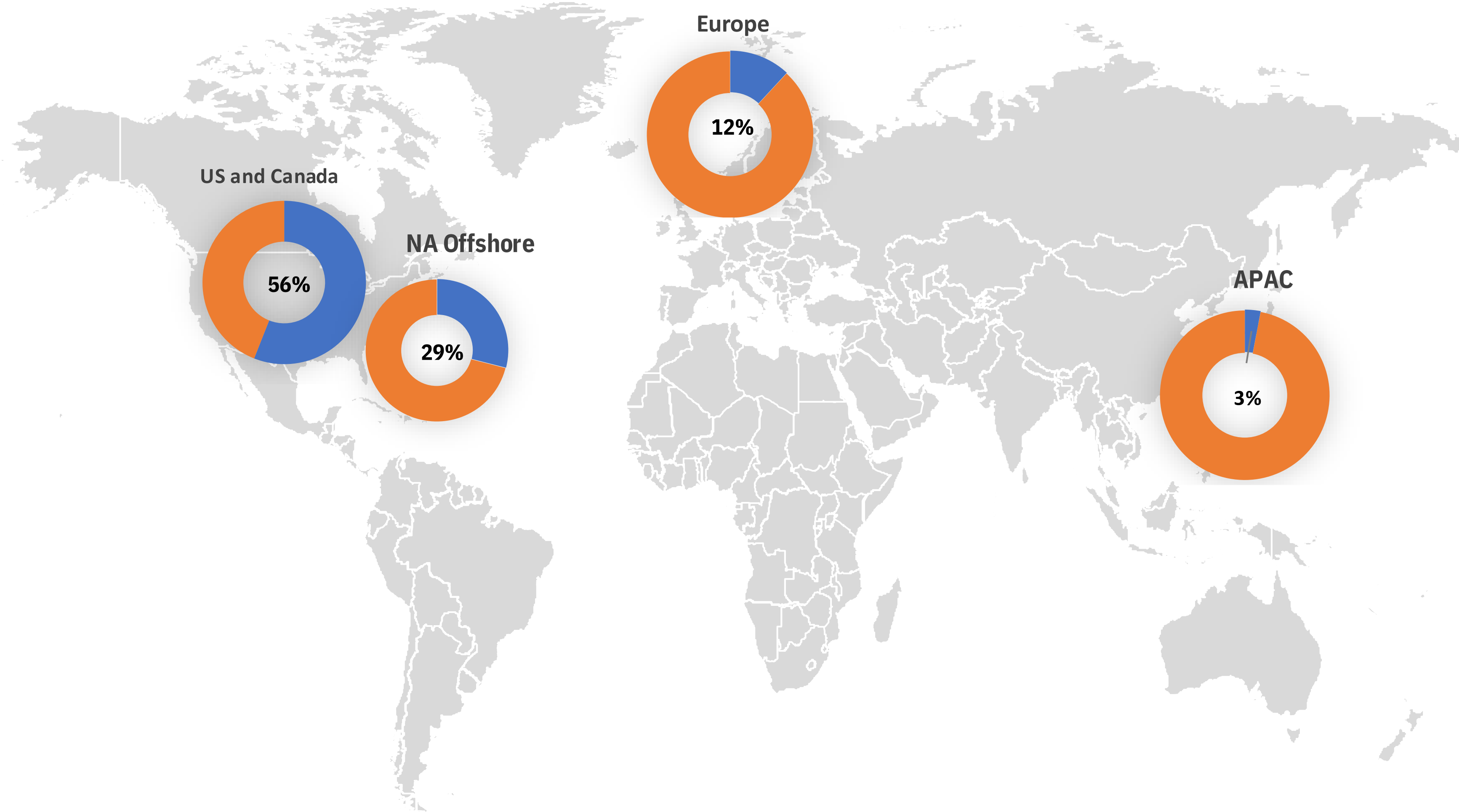
Locations of Captives



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Texas as a Captive Domicile

Domicile	# of Captives
Vermont	680
Utah	419
Delaware	330
North Carolina	294
Hawaii	255
South Carolina	208
Arizona	162
Nevada	155
Tennessee	150
District of Columbia (DC)	113
Montana	101
Texas	73
Connecticut	57
Georgia	56
Missouri	54
Alabama	51
Oklahoma	47
New York	38
Kentucky	32
Michigan	24
Oregon	21
New Jersey	20

- Different domiciles have chosen different growth strategies.
- Texas passed Senate Bill 734 on June 14, 2013, to authorize the formation of captive insurance company in the state.
- Governor Greg Abbott signed House Bill 1944 in June 2017 to enact a number of changes to existing law.
- Vermont captives wrote $31 billion of premium in 2023. It is rumored that just five Texas-domiciled captives wrote a combined $10 billion during the same period.
- The nation's 8th largest Risk Retention Group ("RRG") is domiciled in Texas.

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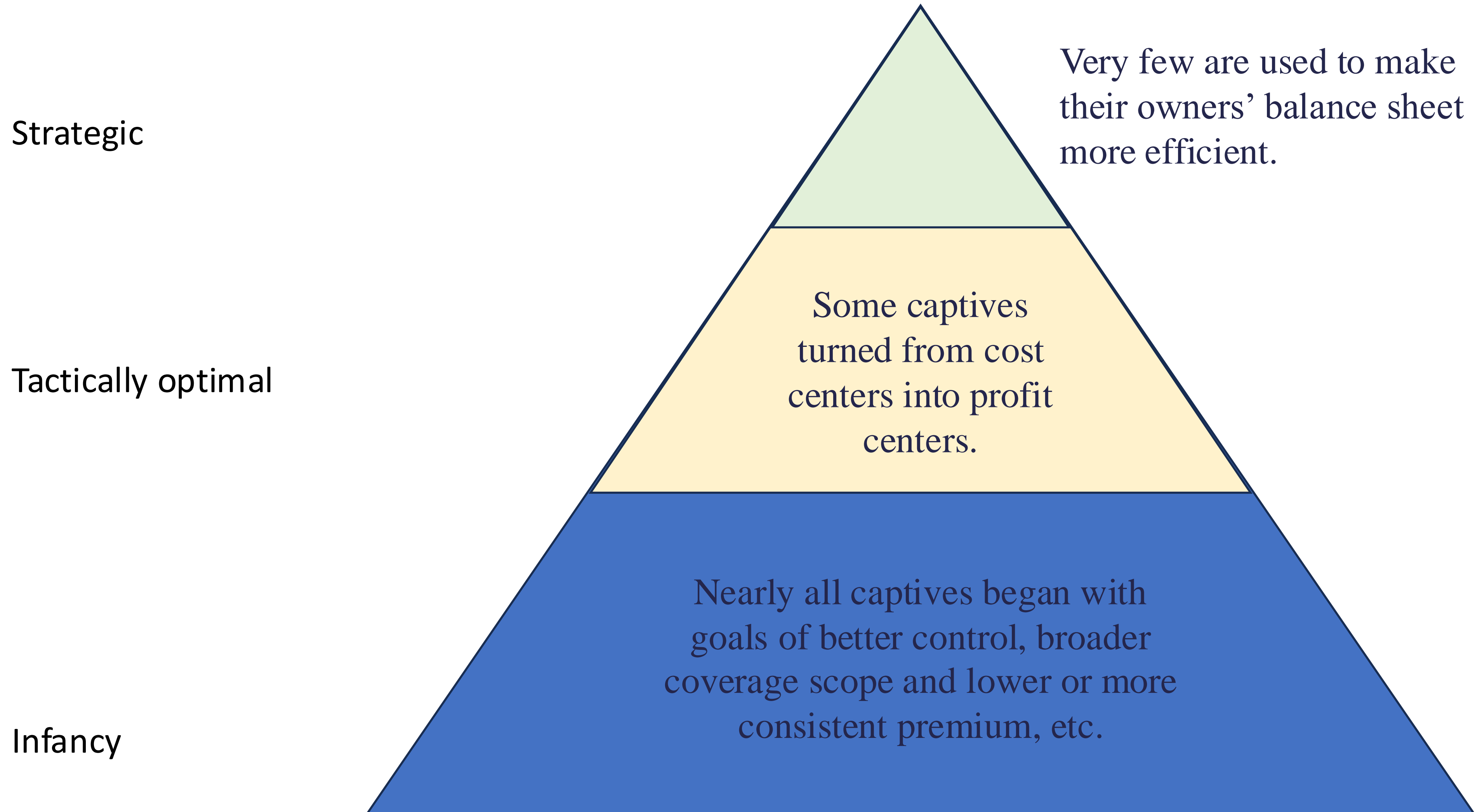
The Three Levels of Captive Utilization



An Incomplete List of Risk Factors from Form 10-K

- Actions by advocacy group
- Climate change
- Commodity pricing volatility
- Control of joint ventures
- Counter-parties' distressed financial conditions
- Currency exchange rate fluctuations
- **Cybersecurity**
- **Environmental, Social and Governance ("ESG")**
- Failure to fully identify potential problems with M&A or divestments
- Geopolitical uncertainties
- Proposed changes to federal, state and local regulations
- **Rising health care costs**
- Uncertainty in the capital markets

Commercial insurance isn't available or affordable to cover all risks.

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Medical Stop Loss Captives

- Prior to the Affordable Care Act ("ACA"), Medical Stop Loss ("MSL") captives represented a negligible segment of the MSL market. In 2010, MSL was a $7-$8 billion market with MSL captives taking a very small % of market share.

- The MSL market is now approaching $35 billion, at least $4 billion of which goes to MSL captives.

- A preferred employer profile for MSL captives:

Join a group captive if you have/are	Start or add to your own captive if you have/are
50-1,000 employees (100-500 preferred target)	Over 1,000 employees
Currently self-funded or fully-insured with claims experience	
Good claims history / track record	
Financially stable with the ability to assume additional risk	
Committed to actively participating in progressive risk control initiatives	

Captive structuring - MECC

Overview, approach, and key considerations

Overview: Include in a captive insurance company a reimbursement policy for employee related self-insured health benefits obligations. (e.g. health, vision, dental, pharma)

Approach: Analyze the insurance and tax efficiencies of an indemnity policy of insurance, written by the Captive, that would reimburse health benefit spend above a certain threshold (self-insured aggregate).

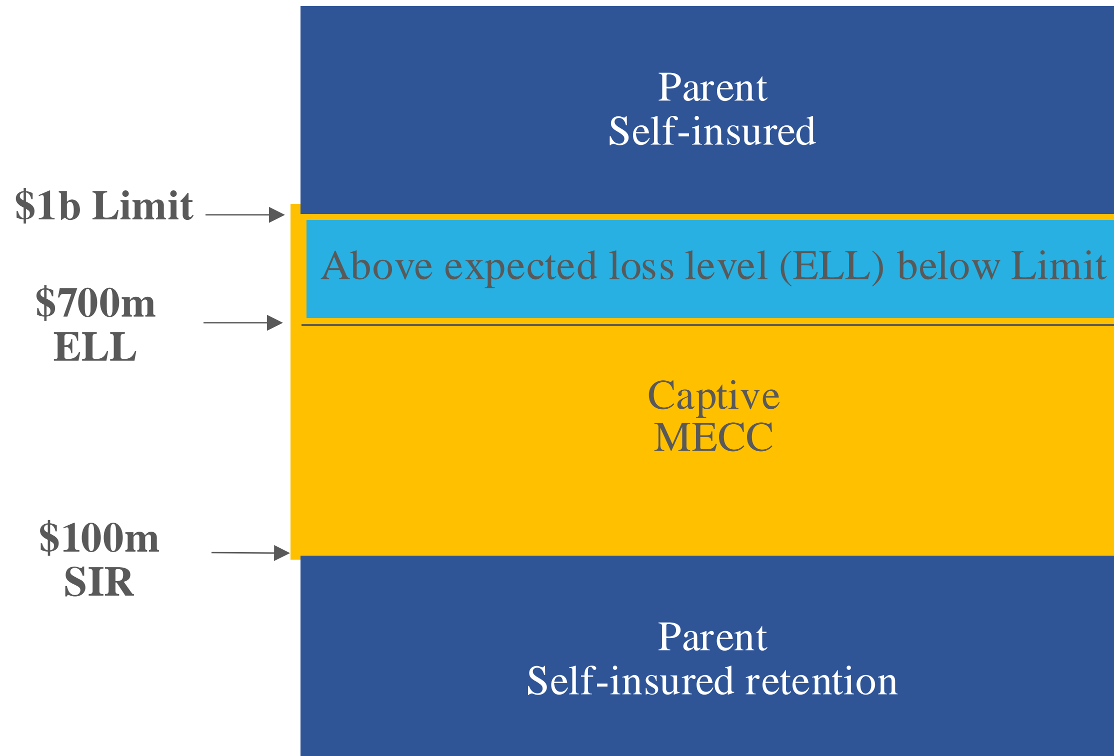
Key considerations:

- No disruption to plan participants or the front-end administration of the benefits program(s)
- No increase in costs to plan participants
- Minimize capital and cash retention in the captive through prudent company and commercial investments
- Minimize overall internal ongoing administration time
- Minimize external vendor expense
- Typically, no/limited change to organizational structure
- Does not involve Employment Retirement Income Security Act of 1974 (“ERISA”) or require Department of Labor (“DOL”) approval
- Enhances qualification of Captive as an insurance company for federal income tax purposes (benefits funding may be considered third party)
- Obtain insurance and tax efficiencies.

Captive structuring - MECC

Insurance structure*

Captive program



Employee benefits reimbursement (illustrative)

Overview

Summary

- The indemnity contract is designed to provide payment reimbursement to Parent/subsidiaries for contractual obligations relating to the Parents' Active and/or Retiree Health Plans.
- The policy is designed to insure for an excess aggregation of plan participant expense past a certain threshold, the SIR.
- This is also capped at the aggregate limit.
- The policy form will be designed specifically for this transaction and will follow standard industry terms and conditions.

Sample terms*

Limit	—$1b, excess of SIR	
SIR	—	$100
Expected loss to Captive	—	$700m
Premium	—	$770m

*SIR is set above annual employee withholdings for benefits

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Captive structuring - MECC

Sample future state

Sample future state

No anticipated change to current state cash flow funding

Captive — MECC premium → **Parent/ subsidiaries**; MECC claims ←

Capital/premium investments

Parent/ subsidiaries — Reimbursements → **Parent paymaster**; Expense allocation ←

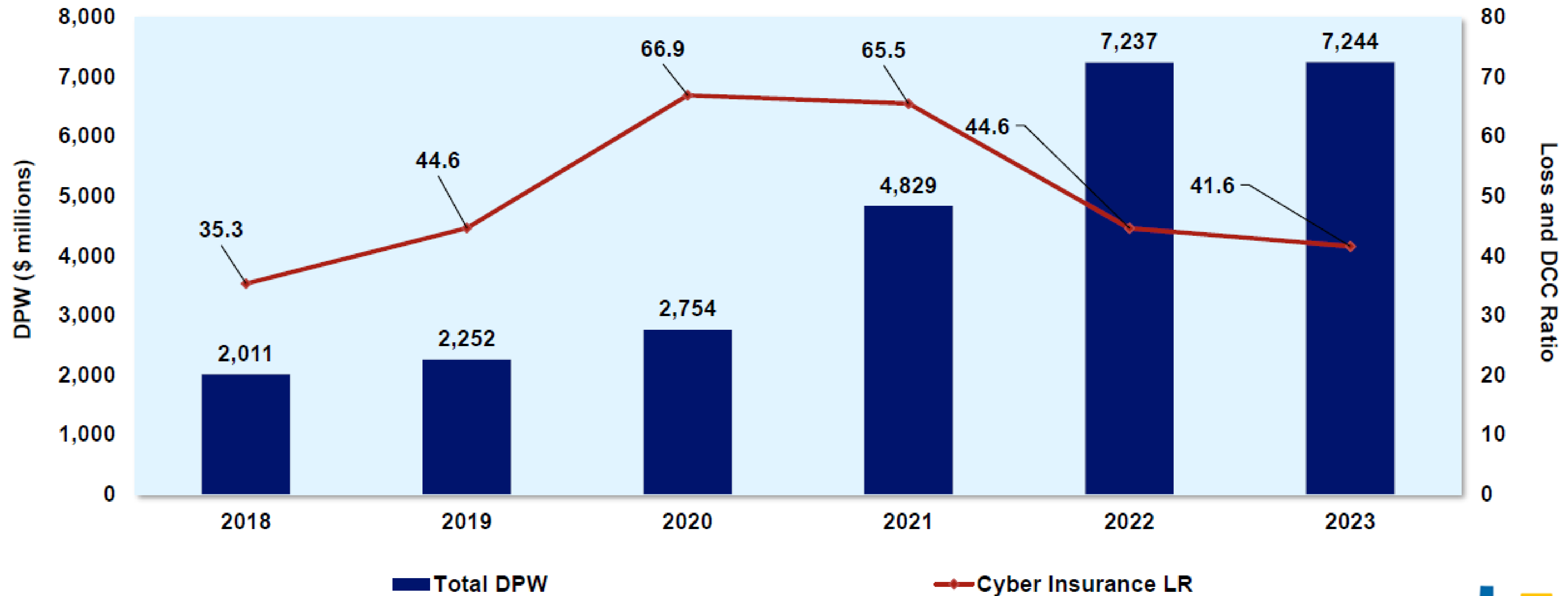
Parent paymaster — Reimbursements → **3rd party benefits administrator**; Expenses ←

3rd party benefits administrator — Medical expense → **Medical provider**; Expense payment ←

Plan participants — Medical expense → **Medical provider**

- There is no anticipated change in the benefits expense flow from Parent to Plan Participants
- Parent's subsidiaries contract with captive for a MECC policy (this can be done using Parent as the captive contracting party with premium allocations to subsidiaries, for ease)
- Subsidiaries pay premium to Captive (or are allocated premium expense from Parent)
- Captive reimburses benefits expense over self-insured retention ("SIR") aggregate amount - once an SIR is exceeded with expenses
- Captive can invest in Parent and subs, commercial market investments, or both

Cyber Risks per AM Best



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How Companies are Managing Cyber Risks

- There is a heavy dependence on reinsurance
- Managing exposure through underwriting and risk transfer:
  - Detailed underwriting application/questionnaire
  - Policy wording (i.e. war exclusions, addressing “silent” cyber)
  - Coverage terms and conditions
  - Utilizing vendor tools
  - Assessing aggregation risks
  - Risk transfer through cyber reinsurance treaties / ILS
- Cyber models continue to mature. Data quality and consistency continue to improve.
- Cyber specialists conduct real-time exposure monitoring.

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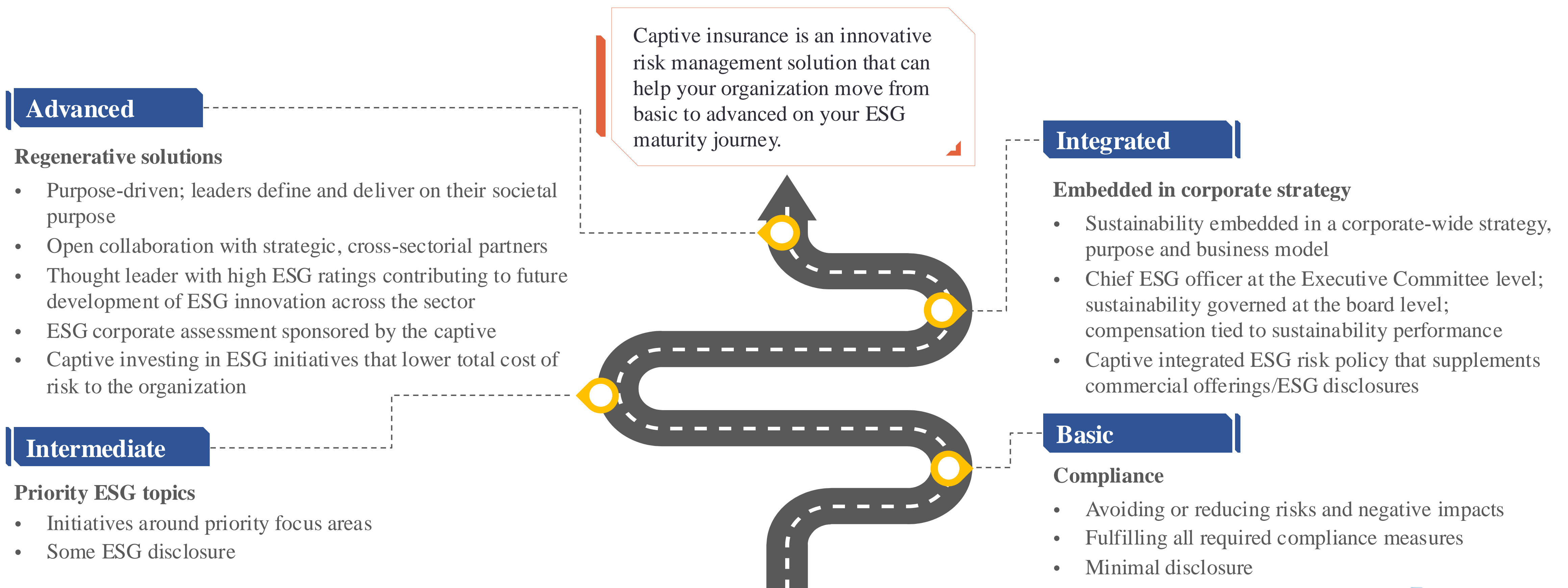
The road map to ESG maturity

Companies can no longer afford to ignore ESG due diligence - the risks, rewards and ramifications have become too great. Source: Law 36, Pillsbury.



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ESG - Captive Value Proposition

	Risks	Example policy/use case	Value to client
E	Environmental issues, such as carbon emissions, water scarcity and environmental pollution	**Legacy exposures**: Captives are a potential solution for ringfencing ESG legacy exposures, similar to the way that asbestosis got handled 30 years ago. "Brown industry" multinationals will be able to split off the bad business and maintain their credit rating. **Emissions**: A captive can provide a parametric insurance opportunity: If an organization's emissions rise above a predefined level, the captive would cover a loss to the organization for an amount that can be then invested in a carbon neutralizing investment, ensuring that the organization's net emissions are maintained within an agreed level.	Market reputation and credit rating are maintained and protected. A forward-looking solution to the potentially impacted communities can be provided. The environment is protected by limiting emissions to an acceptable level and improving investor relations.
S	Social issues, such as discrimination, gender issues, equal pay, equal benefits and wealth distribution	**Gender surgery**: A captive could provide coverage for gender-affirming surgery where a commercial insurer may be unable to due to changes in state law. **IVF**: In addition, some commercial insurance companies will not cover in vitro fertilization for female same-sex couples as they do not meet the prerequisites to qualify (i.e., they haven't had the history of trying and failing through natural means). A captive can fill such coverage gaps. **Mental health**: Insurers may outright exclude, set arbitrary treatment limits and refuse to pay for residential treatment for mental health and substance abuse disorders. In the case of substance abuse disorders, insurers may also refuse to cover or limit coverage for medication-assisted treatment and toxicology tests.	Offering these and similar types of benefits will allow organizations to publicly state that they have considered their diverse employee population and have taken steps to ensure that benefits are equally available to all, regardless of race, sexual orientation, gender identity or disability. These offerings could be decisive in attracting and retaining talent, which will improve both employee and corporate performance.
G	Governance issues, such as executive pay, corporate responsibility and regulatory intervention	**ESG health check**: A captive could provide structure in monitoring the effectiveness and efficiency of corporate ESG matters, with an eye to reducing risk through captive-related insurance focused on ESG. A captive can execute an ESG health check assessment. **Reputational risk**: A manuscript reputational risk captive policy can protect the organization against specific governance risks, including, but not limited to, a regulatory investigation, executive or board member departure, and negative product reviews.	Risk and captive insurance-related losses, brand and reputational mitigation are reduced. Distinct coverage is provided, potentially lowering the total cost of risk.

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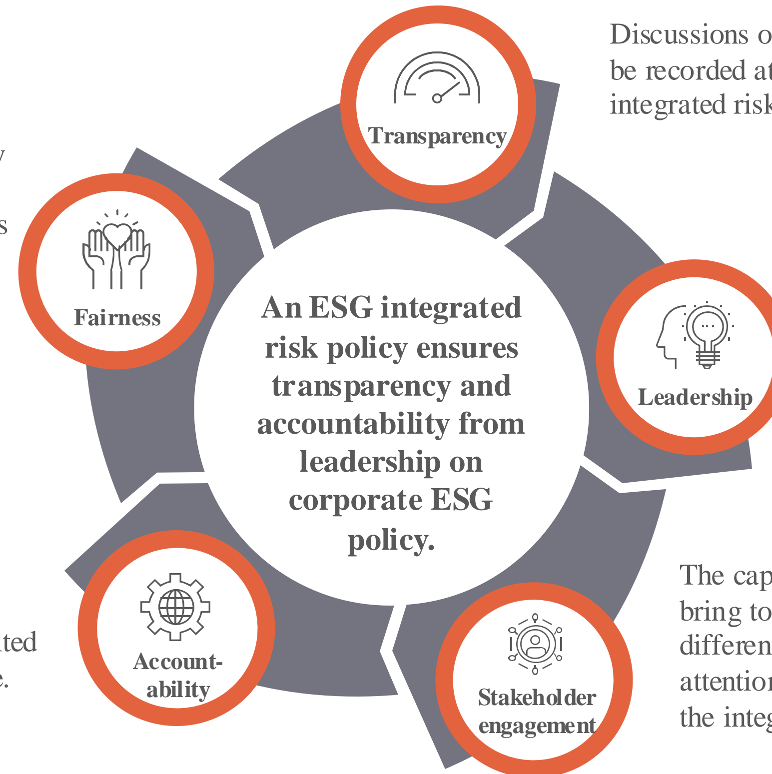
Captive ESG integrated risk policy

An integrated risk policy combines diverse coverages in a single, multiyear policy or program with one or more shared limits of liability. These policies can help insureds obtain more efficient use of their risk capital and potentially reduce their risk transfer costs. In addition, an integrated risk policy can be extended to include certain financial risks that are uninsurable in traditional insurance markets.

An integrated ESG policy can cover excluded matters in all existing policies, as well as any ESG claims that fall outside of the coverage parameters of existing policies but are labeled as ESG events.

How an ESG integrated risk policy improves corporate governance



Discussions on the ESG integrated risk policy will be recorded at captive board meetings. The ESG integrated risk policy is available to review.

Captives can coordinate ESG health checks to review equitability of corporate policies and procedures. These governance risks are captured within an integrated ESG policy.

The captive provides guidance to corporate leadership on ESG risk gaps through risk assessments via ESG health checks.

ESG integrated risk results are reported to the captive Board of Directors and included in the audited financial statements of the captive.

The captive Board of Directors and officers bring together senior stakeholders from different parts of the organization to focus attention on addressing ESG risks through the integrated policy.

Conclusion — Captive as a Focal Point for ESG

Governance is a critical factor influencing effective stakeholder engagement in an organization's ESG disclosure. The presence of an independent Board of Directors who can act on behalf of the shareholders, as well as stakeholders, including employees and the local communities, is crucial to the efficient execution of sustainable practices.

A captive has a Board of Directors comprising different stakeholders within the parent organization, typically from risk, finance and legal departments (among others). A captive is perfectly positioned to drive ESG best practice and meet ESG reporting requirements within the wider organization, both by issuing an integrated ESG risk policy and providing annual ESG corporate health checks.

Captive Board of Directors comprising different parts of the organization

Where we're heading: a global standard

The International Financial Reporting Standards Foundation (IFRS) announced in February 2021 that it will move forward with developing a worldwide sustainability reporting standard. The IFRS is supported by the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), CDP (formerly the Carbon Disclosure Project), the International Integrated Reporting Council (IIRC) and the Climate Disclosure Standards Board (CDSB) as the group of five collaborate to create a global standard for comprehensive corporate reporting. It is the first attempt by the five organizations to combine their existing standards frameworks to produce a common approach for reporting the impact of sustainability issues on company value.

Multiple stakeholders have expressed explicit support for the IFRS' work, including the International Monetary Fund, the UN, the Financial Stability Board and the United States, which is looking to address ESG disclosure requirements that will support the Biden Administration's climate agenda. The work of the IFRS was also accepted as an extension of the Task Force on Climate-Related Financial Disclosure (TCFD) framework by G7 finance ministers.

Questions?

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