Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of May 16, 2012

FORMATION OF A CAPTIVE INSURANCE COMPANY

EXECUTIVE SUMMARY

As reported at the March 2012 meeting, the Chief Financial Officer in coordination with the Office of Risk Services commissioned a feasibility study, conducted by the University’s actuarial and risk consulting firm, Bickmore Risk Services, which concluded that the formation and utilization of a captive insurance company to complement our existing self-insurance program would be beneficial.

This initiative will reduce UC’s cost of traditional insurance, while giving it greater control over the various risks for which it is responsible. Many large public and private entities have successfully used captives to achieve significant cost savings and to offer improved risk and insurance-related services. The study revealed that captive insurance technologies would provide the University the flexibility to meet several of its risk management objectives, including lowering costs and enhancing coverage. Utilization of a captive insurance company would not represent a change in risk retention on the part of the Office of Risk Services, it would simply allow for a more effective execution of risk retention practices.

This item requests approval for the formation of a captive insurance company and authorization for the President to create additional captive insurance companies, as necessary, to meet the University’s future needs.

RECOMMENDATION

The President recommends that the Committee on Finance recommend that the Regents:

1. Approve the University’s participation in a captive insurance company ("Captive Insurance Company"), and authorize the President or his designee to execute any documents reasonably required for the formation of and participation in such company, following consultation with the General Counsel, provided that: a) it is wholly owned by the Regents, except to the extent the company is a nonprofit corporation; b) it is established and operated for University-related purposes; c) its Bylaws give the University the right to appoint all directors of the Captive Insurance Company; and d) its
Bylaws provide for the formation of other captive insurance companies, only with the unanimous consent of the Captive Insurance Company’s Board.

2. Authorize the President, following consultation with the General Counsel, to create other captive insurance companies, as needed, with the Captive Insurance Company’s Board’s approval pursuant to the Captive Insurance Company’s Bylaws, and approve the University’s participation in such other companies provided that: a) they are established and operated for University-related purposes; and, b) each such company’s Bylaws give the University the right to appoint all directors of such company.

3. Require the President to report on the University’s captive insurance program in the Annual Report on Enterprise Risk Management.

BACKGROUND

A captive insurance company is a wholly-owned insurance company that is licensed and regulated by an authorized domicile to insure the risks of affiliated entities. A captive is a closely held insurance company whose insurance business is supplied and controlled by its owner, who is also its principal beneficiary. While the captive insurance company is a separate legal entity subject to corporate formalities, its owner (e.g., UC Regents) has direct involvement in and influence over the captive’s major operations, including underwriting, claims management, policy form, and investments.

There are more than 5,000 captives domiciled throughout the world today and between 40 percent and 50 percent of major U.S. corporations utilize them, including many major university-affiliated health systems. Over 1,000 higher education institutions own or participate in captive insurance structures in the United States alone. Prominent among these universities and colleges are the University of Minnesota, Yale, Stanford, Duke, Northwestern, Pennsylvania State University, the University of Michigan, Rutgers, Cornell, and Columbia.

A captive insurance company will yield the following benefits:

- Because it is a self-insurance vehicle, the captive is not subject to the wide swings of commercial insurance pricing and therefore use of a captive improves cost stability and predictability.

- Non-traditional (e.g., earthquake) and difficult to place risks (construction surety bonds) may be accommodated in a captive.

- Captive insurance companies are held to rigorous external accounting and auditing standards, which compel formalized risk financing policy and practice.

- Because it is considered a formal “insurance company,” a captive insurance company can directly access the reinsurance markets. This increases the number of insurance companies available to compete for UC business.
• A captive would facilitate the provision of insurance to non-UC organizations (third parties such as affiliated physicians or joint ventures).

• Because the captive controls and issues the captive insurance policy (or “policy of indemnification”), it is able to structure terms and conditions. Instead of issuing their own policies, reinsurers would be asked to accept the terms and conditions of the captive company. Consequently, terms and conditions can be structured to enable the owner to control claims all the way up to the ultimate limit, eliminating control of claims by insurers and providing UC final decision-making authority over if and when to settle, regardless of the amount of the claim.

• The captive strategy is financially superior to the current program by an estimated $7.3 million after five years.

Although the UC’s long term captive insurance company utilization strategy may involve all four of the utilization categories described in the informational item provided for the March 2012 Board of Regents meeting (retained risk finance, access to reinsurance markets’ rate and capacity, third party business aligned to Enterprise Risk Management, and third party business in pursuit of new revenue streams), the initial captive utilization plan focuses on retained risk finance.

“Retained risk” is just as it sounds: retention and management of certain exposures, especially for those exposures where commercially viable risk transfer options are not available. “Retained risk finance” refers to the utilization of a captive insurance entity to optimize an organization’s management of its own risks. These risks may span conventional insurances such as the deductibles under commercial property and casualty risk placements (i.e., general liability, workers’ compensation, and automobile) and may also include areas of insurable risk where an organization has chosen not to purchase risk transfer and more esoteric risks where commercial risk transfer markets do not offer relevant solutions (for example, earthquake, nuclear, terrorism, and business interruption).

The utilization of a captive insurance company for retained risk finance will offer several benefits to UC. Principal among these are:

• Stabilization of retained risks’ cost across a broad spectrum of coverages. This is accomplished in part through applying the impact of successful outcomes in one area of retained risk to offset adverse outcomes in other areas of retained risk.

• A captive insurance organization may assist in insulating campuses and health systems from the full impact of organizational retained risk decisions while still enabling the organization to retain risk at levels with which it is comfortable.

• Improved management, visibility, transparency, and infrastructure around risk retention. A captive insurance organization has meaningful governance and regulatory requirements which, by necessity, call for an organization’s leadership to become more aware of, and be more active in management of, retained risks.
Several coverages are proposed for the captive insurance program:

- Deductible buy-down programs for Workers’ Compensation, General Liability, Auto Liability, Professional Liability, and Employment Practices Liability. This will result in the ability to share loss experience across the various lines of business and allow for deployment of successful results in lines of business with good loss results to support lines of risk retention where funding is stressed.

- Property Terrorism. This will allow the UC to purchase Terrorism insurance more efficiently, relying on federal backstops and deploying commercial insurances purchased to better optimize the overall risk transfer program. It will also allow the UC to have federal backstop for Nuclear, Biological, Chemical, and Radiological coverages, which are largely not available in sufficient capacity in the commercial marketplace.

- Casualty Terrorism. This will allow the UC to fund for and track casualty terrorism risks for which the UC is currently not purchasing commercial coverage.

- Small Vendor Program. This will allow the UC to support an important risk management initiative in its nascent stages.

**Governance and Structure**

The Office of the General Counsel has advised that there is no constitutional restriction regarding the University’s ability to create a captive insurance company. The initial captive will be formed as a non-profit member-governed corporation pursuant to the District of Columbia Non-Profit Corporation Code. The District of Columbia has been selected as the domicile because DC has the broadest set of options for corporate and operational structure available, has an excellent pedigree and reputation, an excellent regulatory framework, and a balanced and experienced oversight regime; the University has a presence in DC and key prospective stakeholders already travel to DC annually. Subsequent captives may have other domiciles.

Willis Group has been selected to provide consulting and management services to the UC and the Captive Insurance Company respectively. The Office of Risk Services in collaboration with Office of the General Counsel retained the expertise of McDermott, Will and Emery to provide guidance on the captive structure and specific elements of tax and regulatory considerations. Outside counsel has advised that a non-profit member-governed corporation is an authorized corporate structure in DC and is eligible to operate as a captive.

The captive insurance company will be regulated by the domicile’s department of insurance and will be subject to specific governance and operational requirements. A captive insurance company must have a Board of Directors; the Board of Directors is required to meet annually in the captive’s domicile; and the captive is required to hire a licensed captive manager, an independent actuary, and an independent auditor. Annually the captive must file audited financial statements and meet specific filing requirements with the domicile regulatory authority. The assets of the Captive Insurance Company, as a nonprofit corporation, are intended to be irrevocably dedicated to University purposes. The captive insurance company will be initially
capitalized through cash contributions, estimated to be $100,000. All members of the Board of Directors will be members of University management or appointed by the University as follows:

- The President, or his designee
- The Chief Financial Officer (Chair)
- The General Counsel, or his designee
- The Chief Risk Officer
- An Officer of the University with expertise in the lines of insurance underwritten by the captive, appointed by the President
- Two independent directors appointed by the President (preferably UC alumni with insurance company or alternative risk experience)

The Board of Directors of the captive will set terms for governance and length of Board member service.

The Captive Insurance Company likely will not be a taxpayer for income tax purposes for non-third party risks, at either the federal or state level. The Captive Insurance Company will seek 501c(3) status as a tax exempt entity for federal income tax purposes. The subject business itself will likely be organized so as to not qualify under Internal Revenue Service standards as a taxable insurance company. To the extent a vendor program is included in the Captive Insurance Company, there is the potential that some unrelated business tax income could be paid. The intention is that the Captive Insurance Company will not register to do business in California and that it will not be subject to California income tax. Outside counsel has advised that the Captive Insurance Company will not be subject to DC income tax, but will be subject to a tax on premiums. Any third party business underwritten by the captive in its current iteration or future iterations is expected to be fronted, thereby satisfying California insurance regulatory requirements.

As part of regular reporting on the Enterprise Risk Management and insurance programs to the Committee on Finance and the Committee on Compliance and Audit, the Chief Financial Officer and the Chief Risk Officer will include directors of the Captive Insurance Company and its management team to discuss coverage, reserves, and the University’s risk profile of the captive program. In addition, the Chief Financial Officer will include information regarding the captive insurance program in the Annual Report on Enterprise Risk Management.

**Subsequent Captives**

This item seeks approval that the President be authorized to create additional captive insurance companies as needed upon the unanimous consent of the Captive Insurance Company’s Board of Directors. (Additional captive insurance companies may become useful as the UC’s captive utilization framework expands beyond purely retained risk finance into other areas previously
outlined above.) If the Board of the Captive Insurance Company determines that it is beneficial to UC to create subsequent captive vehicles, it will be the Board’s obligation to conduct similar due diligence in forming such organizations, including the selection of domicile and review of legal, tax, and regulatory considerations. In addition, the Boards of Directors of any subsequently formed captive insurance companies will be comprised per the same framework as the original captive insurance company.