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Office of the President

TO MEMBERS OF THE FINANCE AND CAPITAL STRATEGIES COMMITTEE:

DISCUSSION ITEM

For Meeting of January 24, 2018

FIAT LUX – THE UNIVERSITY OF CALIFORNIA'S CAPTIVE INSURANCE COMPANY: A FIVE-YEAR UPDATE

EXECUTIVE SUMMARY

The purpose of this item is to provide an update on the captive insurance initiative: Fiat Lux Risk and Insurance Company (Fiat Lux) and UC Health RRG.

UC originally formed Fiat Lux to consolidate risk finance activities, allow for the pooling of UC retained risk assets, and to more efficiently finance the University's organizational risk. Fiat Lux has allowed UC to purchase risk transfer directly with reinsurers, fill gaps in insurance coverage, retain risk, and participate with underwriters where it is profitable while maintaining reasonable retentions. The results to date have Fiat Lux creating savings or new earnings for UC in excess of $25 million annually. Since 2012 the Office of Risk Services has dedicated resources and attention to advancing these activities, and it continues to explore opportunities to achieve financial efficiencies through expanded utilization of the captive insurance platform for UC.

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 also a closely held insurance company whose insurance business is supplied and controlled by its owner, in this case, the UC Regents, who are 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.

A captive, otherwise known as an alternative risk vehicle, is a wholly-owned insurance subsidiary that is licensed and regulated by an authorized domicile to insure the risks of its parent and affiliated entities. That definition has expanded over the 60 years captive insurance companies have been utilized. Captive insurance organizations represent a substantial component of an organization's risk management platform and deliver considerable value to organizations that choose to use them effectively.

The origin of the captive concept is rooted in the financing of corporate retained risks and accessing reinsurance markets. Over time, however, the captive utilization concept has broadened to include the underwriting of related, third-party business both in an effort to advance corporate enterprise risk management goals and also to pursue the revenue imbedded in profitable insurance business from related parties.

There are more than 7,000 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. There are hundreds of higher education institutions that 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.

The Regents approved the formation of captives in order to:

- Access better coverage, cost and capacity for property terrorism risks;
- Smooth the cost of retained risks by line of business for workers' compensation, general liability, automobile liability, professional liability, and employment practices liability risks;
- Take insurance program successes and deploy them towards building and supporting nascent value-added enterprise risk management-oriented third-party solutions; and
- Have a better tool for managing uninsured programs overall such as for the terrorism casualty program.

The University of California launched its captive, Fiat Lux, in 2012 to deliver considerable positive fiscal impact to its community and its mission. It is domiciled in Washington, D.C. because the District of Columbia has the broadest set of options for corporate and operational structure, an excellent pedigree and reputation, an excellent regulatory framework, and a balanced and experienced oversight regime; an additional benefit is that the University has a presence in D.C. and key prospective stakeholders already travel to D.C. annually. Subsequent captives may have other domiciles.

Fiat Lux is regulated by the Department of Insurance, Securities and Banking in Washington D.C. Willis Towers Watson provides consulting and management services to Fiat Lux. 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 D.C. and is eligible to operate as a captive.

Both Fiat Lux and UC Health Risk Retention Group (a separate captive insurance company formed by UC and discussed later in this report) are subject to specific governance and operational requirements. A captive insurance company is required by the D.C. regulators to:

- Have a board of directors;
- Have an annual meeting of the board of directors in the captive's domicile;
- Hire a licensed captive manager;
- Hire an independent auditor;
- Hire an independent actuary;
- File annually audited financial statements;
- Meet specific filing requirements with the domicile regulatory authority; and
- Present any change in business plan to the regulators with an actuarial study.

There is constant oversight on the premium to surplus ratio by the D.C. regulators. After five years the regulators perform their own audit. The assets of Fiat Lux, as a nonprofit corporation, are intended to be irrevocably dedicated to University purposes.

All members of the board of directors of Fiat Lux are members of University management or appointed by the university as follows:

- The President or his or her designee;
- The Chief Financial Officer (Chair);
- The General Counsel or his or her 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; and
- Two independent directors appointed by the President (preferably UC alumni with insurance company or alternative risk experience).

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

Accomplishments since 2012

1. Deductible buy-down – deductibles and retentions are now financed through the captive which allows investment earnings on the money until it is paid out.

2. Most lines of insurance are now underwritten by reinsurers rather than excess insurers. Greater access to the entire insurance marketplace yields better terms and better pricing. Essentially UC has moved from the retail market to the wholesale market for purchasing

risk transfer. Additionally, Fiat Lux now participates with casualty reinsurers, on a quota share basis, in premiums and claims at strategic levels throughout the towers of reinsurance coverage.

3. Representations and Warranty for Chief Investment Officer on real estate purchases. When this coverage is required it is now purchased from Fiat Lux rather than the open market.

4. Loss Portfolio Transfer – monies from both trusts were moved to Fiat Lux for the smoothing of losses between the lines of insurance and for the investment earnings. It also provides greater oversight by the Washington D.C. Department of Insurance, Securities and Banking.

5. Stop-loss reinsurance for both UC Care and student health insurance plans were purchased through Fiat Lux in order to access the more affordable rates provided by reinsurers.

6. A new captive insurance company was formed in 2016, UC Health RRG, a Reciprocal Risk Retention group, which will insure UC-affiliated independent physicians and physician groups for their medical professional liability exposures.

Board of Directors

The current board of directors is as follows:

Name	**Title**	**Board Relation**
Janet Napolitano	UC President	Ex Officio
Nathan Brostrom (Chair)	UC Executive Vice President and Chief Financial Officer	Ex Officio
Charles Robinson	UC General Counsel and Vice President – Legal Affairs	Ex Officio
Rachael Nava	UC Executive Vice President – Chief Operating Officer	Ex Officio
Cheryl Lloyd	UC Chief Risk Officer	Ex Officio
Steven Olsen	Vice Chancellor and Chief Financial Officer, UCLA	Internal Director
Max Jong	Director, Risk Management Advisors	Outside Director
Philip Super	Managing Partner/ RoedelSuper LLC	Outside Director

Service Providers

Service providers for Fiat Lux and UC Health RRG are:

Service	Firm	Specific Service
Captive consulting & management	Willis Towers Watson	Consulting and management for all UC captives
Legal counsel	McDermott, Will & Emory	Corporate structure and tax
Legal counsel	Primmer Piper Eggleston and Cramer PC	All other day-to-day legal counsel for UC captives
Actuary	Bickmore	All actuarial studies for UC captives
Auditors	PwC	All auditing of UC captives

UC HEALTH RRG, a Reciprocal Risk Retention Group

In 2017 UC launched a second captive, UC Health RRG (a reciprocal risk retention group) to meet the needs of UC Health chief strategy officers and UC medical centers. Charged with increasing the number of physician affiliates, the chief strategy officers were competing with other hospital systems without all of the tools needed, i.e. insurance solutions to cover the tail (unknown liability) of past medical malpractice, moonlighting, and day-to-day medical malpractice. Working with Willis Towers Watson, UC developed a solution to insure affiliated physicians to align the physicians with the UC Health risk management.

UC Health RRG is not a corporation and thus does not have a traditional board of directors. It has an Attorney In Fact and a Subscribers Advisory Committee. The AIF executes and conducts business on behalf of the subscribers. It mimics a board of directors in execution. The SAC is made up of representatives of the members and advises and guides the group on behalf of all members.

The AIF members currently are:

Name	Title	Role	Board Relation
Cheryl Lloyd	UC Chief Risk Officer	President	Ex Officio
Courtney Claflin	UC Executive Director – Captive Programs	Vice President	Ex Officio
Nathan Brostrom	UC Executive Vice President and Chief Financial Officer	Treasurer	Ex Officio
Rachel Nosowsky	UC Deputy General Counsel – Health Law & Medical Center Services	Secretary	Ex Officio

The SAC members currently are:

Name	Title	Location
Cheryl Lloyd	Chief Risk Officer	UCOP
Rachel Nosowsky	UC Deputy General Counsel – Health Law & Medical Center Services	UCOP
Teresa Conk	Chief Strategy Officer	UC Irvine Health
Douglas Cates	Chief Strategy Officer	UC San Diego
Maureen McKennan	Regional Affiliations Officer	UC Davis
Santiago Munoz	Chief Strategy Officer	UCLA
Shelby Decosta	Chief Strategy Officer	UCSF Health

The sales process has just begun and UC Health RRG just issued its first policy. UC Health RRG is also domiciled in Washington, D.C. The current sales pipeline consists of about 200 physicians.

What's next on the horizon for Fiat Lux?

Fiat lux, now a five-year-old company, is in a strong position and looking forward to implementing other initiatives that were originally slated at its inception in 2012. Those include:

- Student renters coverage – Right now students purchase renter's insurance to protect their personal property from theft, fire, water damage, and other perils from outside insurance companies. Fiat Lux has been working with a potential carrier to offer a "college student specific" product that may be more responsive to their needs.

- Voluntary Benefits – Many large employers of UC's size utilize their captives to enhance and streamline the delivery of voluntary benefits coverage (life, disability etc.) to their employees. Fiat Lux and the University have engaged Willis Towers Watson to conduct a feasibility study to determine if any cost avoidance savings can be generated in this area.

- Equipment Warranty Insurance program – The University purchases insurance warranties for the majority of the equipment it purchases and uses in day-to-day operations. The captive is working with Procurement to leverage that insurance spend via Fiat Lux.

- Establishing a cell captive structure – The original feasibility study for Fiat Lux contemplated the establishment of a cell captive structure that would enable Fiat Lux to launch segregated cell captives for use by UC and other public entities and/or educational institutions.

CONCLUSION

In summary, Fiat Lux, a wholly-owned subsidiary of the Regents of the University of California, is achieving its goals of optimizing the University's management of retained and transferred

risks. This strategic initiative is enabling the University to reduce the chance of loss, create greater financial stability, and protect its resources. These risks have included conventional insurance such as deductibles under commercial property and casualty risk placements, areas of insurable risk where the University has chosen previously not to purchase risk transfer, and more esoteric risks where commercial risk transfer markets to not offer relevant solutions.

The University's Executive Vice President and Chief Financial Officer and the Office of Risk Services can provide an annual update on the captive and its activities.

Key to Acronyms

AIF	Attorney In Fact
DISB	Department of Insurance, Securities, and Banking
RRG	Reciprocal risk retention group
SAC	Subscribers Advisory Committee
UCOP	University of California, Office of the President

ATTACHMENTS:

Attachment 1:	Example of single-year economic impact to the University of California system
Attachment 2:	Diagram of captive structure

ATTACHMENT 1

Example of single-year economic impact to the University of California system

Approximate Savings/New Revenues Provided by Fiat Lux 2016	Annual Savings ($000s)	Annual New Revenue ($000s)
Trust fees saved by aggregating and combining all of the former siloed liabilities programs	700	
UC Care Health Plan*	1,300	
UC SHIP Health Plan*	1,900	
Real Estate Loan and Guarantee Insurance for Office of the Chief Investment Officer (CIO)	900	
Quota Share Arrangement	600	
Investment income opportunity from moving the trusts/banking programs to Fiat Lux		20,000

* Savings to the budgeted amount they were going to pay

Fiat Lux	2016 ($000s)
Current Assets	1,100,000
Current Liabilities	895,000
Premium*	900,000

* $629 million from one-time contractual transfer from UC

Fiat Lux Risk & Insurance Company,
a component unit of the University of California
Statements of Net Position
As of June 30, 2017

	Unaudited 06/30/17
Assets	
Current Assets:	
Cash and Cash Equivalents	$ 702,588
Investments	538,905,493
Short Term Certificate of Deposit	0
Accrued Interest Receivable - Third Parties	525,265
Accrued Interest Receivable - STIP	-
Accrued Interest Receivable - UC Health, RRG	49,589
Insurance Premium Receivable	3,175,293
Due from Related Party - UC Health, RRG	848
Prepaid Reinsurance Premiums	-
Prepaid Expenses	142,763
Losses Recoverable	9,765
Reinsurance Recoverable	18,311,128
Incurred But Not Reported Reserves - Ceded	
Total Current Assets	561,822,732
Noncurrent Assets:	
Investments, at Fair Value	373,042,830
Related Party Note Receivable	2,000,000
Total Noncurrent Assets	375,042,830
Total Assets	$ 936,865,562
Liabilities	
Current Liabilities:	
Accounts Payable and Accrued Expenses	$ 279,844
Due to the University of California	125,100
Claims Payable	8,214,168
Reinsurance Premiums Payable	38,814
Unearned Premium Reserves	7,724,368
Reserves for Loss and Loss Adj Expense	180,273,128
Total Current Liabilities	196,655,422
Noncurrent Liabilities:	
Reserves for Loss and Loss Adj Expense	592,196,000
Total Noncurrent Liabilities	592,196,000
Total Liabilities	788,851,422
Unrestricted Net Position	
Contributed Capital	162,363,837
Retained Earnings (Accumulated Deficit)	(13,219,263)
Net Income (Loss)	(1,130,434)
Total Unrestricted Net Position	148,014,140
Total Liabilities & Net Position	$ 936,865,562

REGULATORY RATIOS:	
Premium to surplus -- Actual	**5.88**
Premium to surplus -- Target	**3.00**
Net Reserve to surplus -- Actual	**1.09**
Net Reserve to surplus -- Target	**3.00**

Fiat Lux Risk & Insurance Company,
a component unit of the University of California
Statements of Revenues, Expenses and Changes in Net Position
For the Periods Ending June 30, 2017

	Unaudited Quarter 06/30/17	Unaudited Year-to-Date 06/30/17
Underwriting Revenue:		
Direct Premium Written	$ 3,852,541	$ 870,858,477
Gross Ceded Premium	583,996	(20,539,537)
Change in Unearned Premium Reserves	49,897,482	(4,874,265)
Net Premium Earned	54,334,019	845,444,675
Underwriting Expenses:		
Losses & LAE Paid	34,993,526	176,851,671
ULAE Paid	8,150	42,139
Losses & LAE Recovered	(9,765)	(847,657)
Losses & LAE Paid, Net	34,991,911	176,046,153
Change in Loss Reserves	4,364,153	358,825,143
Change in IBNR Reserves	27,850,751	322,883,934
Net Losses & LAE Incurred	67,206,815	857,755,230
Tax Expenses	20,203	156,287
Total Underwriting Expenses	67,227,018	857,911,517
Net Underwriting Revenue (Expense)	(12,892,999)	(12,466,842)
Operating Expenses:		
Actuarial Fees	16,496	79,671
Audit Fees	36,993	207,972
Bank Service Fees	395	1,731
Consulting Fees	61,250	245,000
D & O Insurance Expense	6,541	27,974
Education & Seminars	1,804	10,623
Legal Fees	0	67,885
Management Fees	15,073	119,573
Memberships & Subscriptions	399	3,787
Miscellaneous Expense	76	7,320
Risk Services	155,134	554,006
State Filing Fees	235	547
Tax Preparation Fees	2,375	(600)
Travel & Meetings	14,664	105,501
Total General & Administrative Expenses	311,435	1,430,990
Net Operating Income (Loss)	(13,204,434)	(13,897,832)
Nonoperating Revenue:		
Money Market Interest Income	1,536	5,839
STIP Interest Income	(4)	6,374,248
TRIP Interest Income	0	129,528
State Street income	2,213,419	2,848,086
CD Interest Income	0	493
US Treasury Interest Income	0	336
Note Receivable Interest Income - Related Party	24,932	64,110
Net Unrealized Appreciation (Loss) on Investments	2,349,048	2,607,650
Realized Gain (Loss) on Investments	0	737,108
Total Nonoperating Revenue	4,588,462	12,767,398
Increase (Decrease) in Net Position	$ (8,615,972)	$ (1,130,434)

ATTACHMENT 2
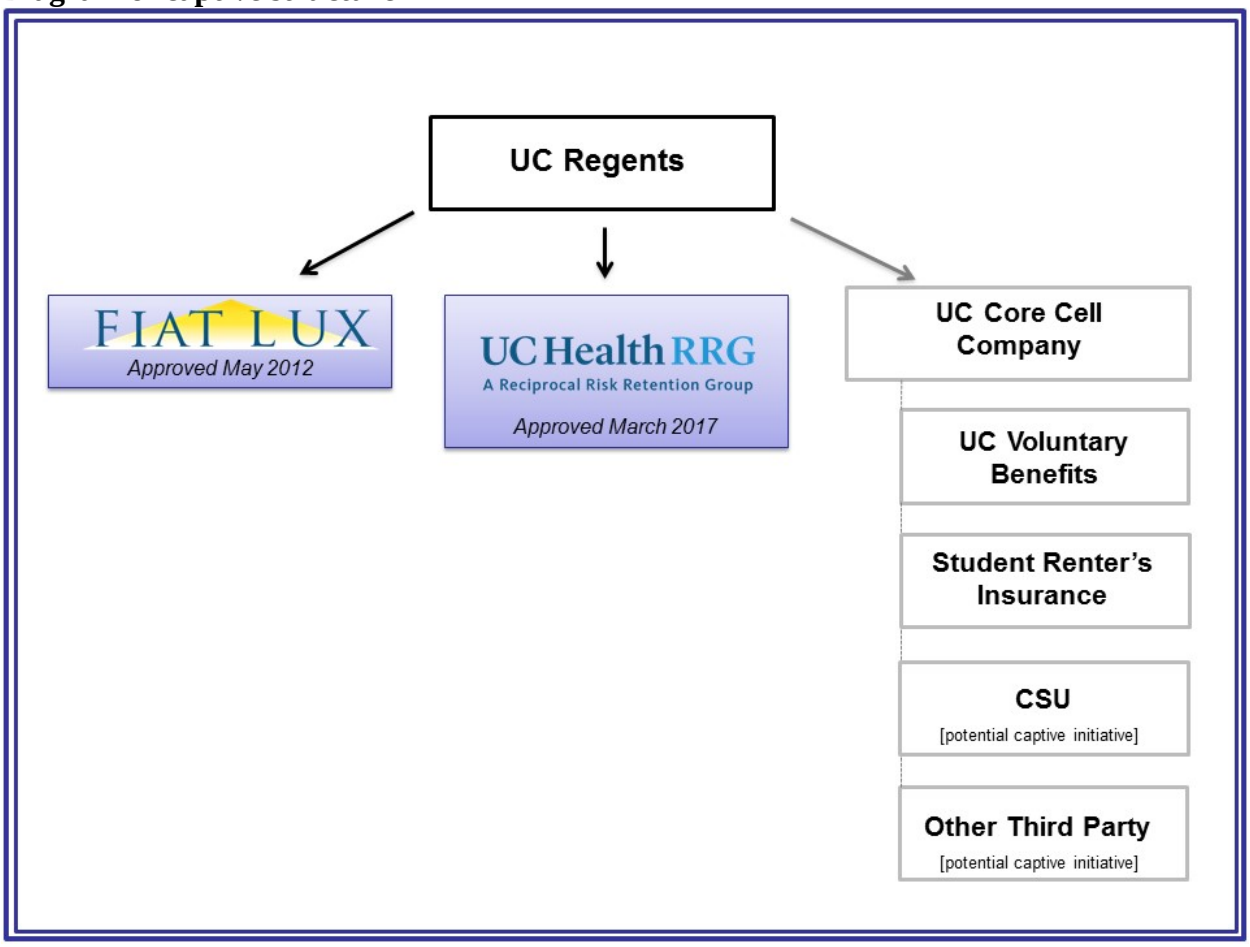
Diagram of captive structure