CAPTIVE FEASIBILITY QUESTIONNAIRE

INSURANCE ISSUES

1. **Have you experienced volatility in coverage availability in the commercial market?**
   Yes □ No □ Somewhat □ Just Beginning □
   Certain coverages are more appropriate to a captive resulting in higher likelihood of captive success. Generally stated, coverages with long tails make better captive targets than short tailed lines. Captives can offer your organization stability in the underwriting cycles that cause large swings in premium and coverage amounts. Available coverage and prices, in the commercial market are driven by industry trends. Should your organization be on a cycle opposite to the industry, you may not find the availability and stability required to meet your needs. A captive will follow your organization's own risks. As the market tightens, you can place more risk into the captive and vice versa.

2. **Do you expect to realize instant and significant savings by having a captive?**
   Yes □ No □
   Premium savings are a key component to a successful captive. But immediate large premium savings are unrealistic. In any commercial insurance premium there is a significant charge with respect to the overhead costs of the insurance carrier. (With direct captive policies, savings can be realized since a captive's overhead tends not to be significant. Additionally, the captive will charge premiums based on the expected losses for your organization's particular risks rather than the insurance carrier's perception of the market for that particular coverage.)

3. **The success of a captive is very much based on the ability to manage and minimize claims costs. How much time and effort is your organization willing to commit to loss control and claims administration activities?**
   Minimal Time □ No Limit on Time □
   Captive owners most often cite control of the claim and risk control process as a dominant reason that their captive is an effective risk-financing tool. To the extent that control of this process is understood by and deemed important to senior management, the likelihood for captive success is increased.

4. **Do operating divisions, subsidiary corporations and/or joint ventures require low risk retention levels?**
   Not Important □ Ultimate Importance □
   An organization with many differing operations and partnerships has a practical problem bringing the risk retention capacity of the whole organization to the individual operating units. With a captive, many of these issues can be overcome with this more structured, efficient risk financing arrangement.

5. **Is it important that you separate risk financing from other operational funding?**
   Not Important □ Ultimate Importance □
   A captive insurance company will allow a risk manager to build resources in the form of loss reserves including losses incurred but not reported and in the form of the retained earnings in the captive. Having these funds available within a separate, regulated insurance company should help to ensure that the funds remain for risk management purposes and are not used for purposes unrelated to the parent's risk management activities. If management perceives the need to accumulate loss funding, the probability of captive success will be considerably higher.

6. **Have you considered other methods of financing retained losses instead of a captive?**
   Yes □ No □
   If other risk financing options are available and directly comparable, they should be considered and part of the feasibility study analysis. In some instances, alternative solutions (other than the captive) may prove to be a more cost-effective arrangement.

7. **Does your organization's insurance rates seem abnormally high compared to your loss history?**
   Yes □ No □
   Frequently, the best time to consider risk retention and perhaps a captive is at the time when the commercial market misperceives the true loss exposure. When the commercial marketplace ignores favorable loss experience, it is time to take control through another method. A captive is a means to capture this imperfection in the market. Risk retention, through a captive, eliminates the issue by charging a premium based on true loss exposure and/or by capturing the underwriting profit.

8. **Is your organization's loss pattern fairly predictable?**
   Yes □ No □
   Certain coverages are more appropriate to a captive resulting in higher likelihood of captive success. Captives have traditionally been used where losses were predictable and thus a reasonable premium calculation can be made. However, unpredictable claims can be funded successfully in a captive and today are becoming more common.

9. **Does your organization need specific coverages that the commercial market can not, or will not, underwrite?**
   Yes □ No □
   During hard markets, the commercial carriers abandoned particular lines of coverage. A captive can be utilized to fill these voids. High frequency and low severity exposures are the most predictable and are thus good candidates for a captive. High severity/low frequency exposures can be covered in a captive, but more capitalization will be needed and higher volatility can be expected as a result. If both are high, it will be difficult to successfully fund a captive. In such situations, risk transfer should be considered.

10. **Does your organization want to include catastrophic loss coverage in the captive?**
    Yes □ No □
    While captives can be used effectively for funding catastrophic exposures, most practitioners feel that loss predictability results in a better base for the long-term financial viability of a captive.

11. **Do your insurance rates seem abnormally high compared to the loss history for that line of business in the industry?**
    Low □ High □
    When the commercial marketplace ignores favorable loss experience, it is time to take control through another method. A captive is a means to capture this imperfection in the market. Risk retention, through a captive, eliminates the issue through capturing the excessive rate.

12. **Are your organization's liability lines more frequency or severity oriented?**
    LS/LF □ LS/HF □ HS/LF □ HS/HF □
    High frequency and low severity exposures are the most predictable and are thus good candidates for a captive. High severity/low frequency exposures can be covered in a captive but more capitalization will be needed and higher volatility can be expected as a result. If both are high, it will be difficult to successfully fund a captive.

13. **Does your organization wish to consolidate all or most of its insurance needs into a single multi-line program?**
    Not Important □ Ultimate Importance □
    In organizations where the structure is highly decentralized, making effective cost allocation of shared retentions is difficult, if not impossible. A captive can assist greatly in creating an organized, consolidated risk management program. A captive also allows each entity to choose its own level of risk within a single organizational retention while the captive assumes a corporate risk retention level with a commercial carrier.

CORPORATE ISSUES

1. **Is the organization to be covered in the captive tax-exempt?**
   Yes □ No □
   Many tax-exempt organizations, in particular tax-exempt hospitals and educational institutions, have been utilizing captive insurance companies for many years now. Ownership of a captive by a tax-exempt organization should not jeopardize its tax-exempt status. Captives can be established to insure not only the risks of the tax-exempt organization and its tax-exempt affiliates but also its taxable affiliates.

2. **Is this company privately held or publicly traded?**
   Private □ Public □
   Both privately held and public companies have had much success in forming captive insurance companies. Private companies not only enjoy all of the same risk management benefits that may accrue to public companies, but also, may have an opportunity to use the captive insurance company to transfer a portion of the owner's estate to heirs at personal tax rates, rather than at estate tax rates.

3. **What is your organization's risk appetite?**
   Avoid Risk □   Aggressive Risk Taker □
   When you set-up a captive, you are getting into the insurance business. And with insurance comes risk. If management is not willing to assume additional risk, the potential for captive success is seriously diminished. When assessing your risk tolerance, you must use the risk retention capacity of the organization as a whole.

4. **Are you considering a captive to remedy a short-term situation?**
   Yes □ No □
   Creating a captive with the intention of utilizing it for less than 5 years seldom results in economic benefits. This risk-financing tool works best if used over a long period of time, typically 10 years. If you are considering this option as a solution to a short-term problem, other alternatives should be considered.

5. **Is your company rapidly growing or diversifying?**
   Yes □ No □
   Rapidly growing organizations are typically more interested in the captive concept. This is because rapidly growing organizations are looking for risk financing opportunities that can keep up with their changing and expanding business. A captive can offer broader and greater flexibility in coverage, hence meeting the needs of growing organizations. However, growing organizations may not be willing to tie up funds to capitalize a captive in lieu of financing growth.

6. **Is your organization concerned with equitable cost allocation between subsidiaries?**
   Yes □ No □
   Generally stated, the more complex the organizational structure, the more a captive can assist in taking advantage of an overall risk management strategy through the issuance of separate coverages to operational units.

7. **Is it important to isolate risk management funding from general operational funding?**
   Not Important □ Ultimate Importance □
   This is one of the essential purposes of a captive: Accumulating funds so losses can be paid when due and capturing profits in the program. If management perceives the need to accumulate loss funding, the probability of captive success will be considerably higher.

TAX ISSUES

1. **Does your organization currently pay federal income taxes?**
   Yes □ No □
   If the captive insurance company is treated as a bona fide insurance company, it can accelerate tax deductions by estimating loss reserves in advance. To be treated as insurance, captive transactions must pass a three-prong test established by the courts:
   - Insurance risk must be present (Investment risk is insufficient).
   - Risk shifting and risk distribution.
   - The transactions must follow commonly accepted notions of insurance.

Many tax-exempt organizations, in particular tax-exempt hospitals and educational institutions, have been utilizing captive insurance companies for many years now. Ownership of a captive by a tax-exempt organization should not jeopardize its tax-exempt status. Captives can be established to insure not only the risks of the tax-exempt organization and its tax-exempt affiliates but also its taxable affiliates.

2. **How important are income tax considerations?**
   Not Important □ Ultimate Importance □
   In general, for non-insurance companies, a loss is only deductible for federal income tax purposes when all events have occurred to fix the amount of liability and economic performance has occurred. Because of this, in many risk-financing programs that contain retentions/deductibles, certain amounts will require a charge against earnings without a corresponding tax deduction. Utilizing an alternative risk transfer program, such as a captive, which converts retentions/deductibles from unpaid accrued losses and un-accrued losses to paid insurance premiums may significantly benefit cash flow from tax benefits and reduce the cost of risk management.

3. **Is your organization willing to take aggressive tax positions?**
   Avoid IRS Audits □ Take Questionable Deductions □
   While income tax is not the primary reason for forming a captive, it is often the tax-deferred aspect of a captive, which makes this risk financing technique cost effective. In this regard, the deductibility of premiums paid to an affiliated insurance company has long been an area of controversy between taxpayers and the IRS. Although the definition of insurance has now been fairly defined in the courts, the IRS continues to argue the applicability to captive insurance companies.

4. **Does your organization pay considerable foreign income taxes?**
   Yes □ No □
   The captive insurance company is an excellent vehicle for consolidating miscellaneous subsidy operations into your worldwide risk financing strategy. Certain worldwide tax efficiencies as well as a reduction in the organizations total cost of risk management may result.

CASH FLOW

1. **Is your organization willing to provide capital for a long-term commitment?**
   Yes □ No □
   A captive requires a long-term capital commitment. Capital can be in the form of cash, letters of credit, or other State approved forms. All captive insurance companies should be capitalized to industry standards. However, there are no set industry standards for the captive insurance company. The most common guideline used by State Regulators is Premium to Capital and Surplus Ratio. This ratio analyzes gross written premium to the capital and surplus (or shareholder’s funds). The range of ratios depends on the type of business written by the captive. The following are common “rules of thumb”:

   Long-tail casualty business - 1:1 to 4:1
   Shorter-tall casualty - 2:1 to 4:1

Property-type coverage - 2:1 to 3:1
High frequency, low severity - up to 5:1
An average of 3:1 for all lines.

Any captive writing at less than a 1:1 ratio is either highly capitalized to cover high-level excess losses, or over-capitalized, and could declare a dividend. However, a captive should not be judged by this ratio before other ratios and factors are considered. The bottom-line is that the primary activity of your organization is not to provide insurance coverages. If the operation of a captive results in financial stress, the captive choice is probably unwise.

2. **Does the risk manager/CFO and/or senior management want to make the risk management department a profit center?**
   Yes □ No □
   A captive can be an excellent vehicle for turning risk management operations into a profit center. It makes the risk management department more directly responsible for its results and increases the visibility of the risk management program to senior management

3. **Can your organization post letters of credit without disrupting the financing of other business activities?**
   Yes □ No □
   Captives can require substantial letters of credit (LOC) for capitalization and/or to secure fronting insurers. Without LOC capacity, the probability of running a captive successfully is diminished.

4. **What is the cost of letters of credit for your organization?**
   Less or equal than 1/2% □ Less or equal than 1% □ Greater than 1% □
   The availability and cost of Letters of Credit (LOC) generally run hand-in-hand. High LOC costs will increase the cost of operating the captive, thus making it less profitable, all other factors being held constant.

5. **Would posting letters of credit, in an amount of approximately half of the captive's premium, result in a reduced ability to finance other business activities?**
   Yes □ No □
   We assume in this model that the primary activity of the organization is not to provide insurance coverages. If the operation of a captive results in financial stress on the organization, the captive choice is probably unwise.

6. **What is the total premium for all lines of coverage to be covered by the captive?**
   Less than $750,001 □ Less than $1,250,000 □ Greater than $1,250,001 □
   Size is of critical importance to the success of a captive. Where a multi-line approach is used, the larger the total premiums ceded into the captive, the better the probability of positive financial results (assuming positive loss experience). The general rule of thumb is that your organization should be paying $1,000,000 in annual premium before considering a captive. But there is no absolute minimum and captives have been successful formed with less then this stated amount.

Captive Submission Information Requirements

1. **Single Parent or Group Captive Information**
   a) Name and address of Insured
   b) History of captive and/or group
      i. Purpose of formation
      ii. Description of operations
      iii. Number of years in existence
      iv. Number of members (if association/group captive)
      v. Average amount/member size (if association/group captive)
   c) Prior and current insurance structure – including lines of coverage, retention, limits, excess carriers, service companies
   d) Marketing Strategy
      i. Target Accounts
      ii. Projected Growth
      iii. Competition

2. **Financials**
   a) Audited financial statements (2 years)
   b) Investment strategy

3. **Program Information**
   a) Desired coverage by line of business
   b) Rating information by line of business
   c) Policy Forms
      i. Current policy forms
      ii. Copies of all endorsements
      iii. Pending changes (if applicable)
   d) Underwriting Administration
   e) Staff experience
   f) Underwriting guide and procedures
   g) Currently valued loss information for past 5 years
   h) Detailed description of all large losses excess of $50,000
   i) Actuarial Report including triangulated data, IBNR and loss reserve analysis, ultimate loss projections by line of business, rate analysis and capital/funding requirements

4. **Loss Control**
   a) Programs and guidelines
   b) Safety manual
   c) Copy of a specific report or survey

5. **Claims Administration and Management**
   a) TPA or Staff experience (including resumes of claims personnel)
   b) Procedures, authority levels
   c) Large loss strategy