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Headlines in Banking and Financial Institutions Law

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Banking Organizations: Have You Considered Forming A Captive Insurance Subsidiary?

The number of banking organizations that have formed or are considering forming a captive insurance subsidiary to insure the risks of their bank have dramatically increased over the past four years. This article briefly discusses what captive insurance subsidiaries ("captives") are and how they operate, and what the principal benefits are for a banking group to form a captive.

In short, banking organizations are forming captives to provide better risk management practices and insurance coverages at a significant tax advantage, based on provisions added to the Internal Revenue Code (the "Code") to encourage small business owners to form captive insurers.

Many marketplace risks faced by a bank today, such as cyber fraud and reputation risk, are either not insurable under present coverages, include large deductibles or are prohibitively expensive. A captive insurance company can cover these risks and deductibles, with tax-free premiums paid by its affiliated bank.

Legal Structure

A captive insurance company is a legally licensed, limited purpose property and casualty insurance company whose sole purpose is to write policies and provide coverage for its related entities. A captive is wholly-owned by its parent bank holding company, which must file a written election with its Federal Reserve Bank to be treated as a "financial holding company" under the Bank Holding Company Act in order to own the captive insurer and share risk as described below. The captive insurer is formed under the laws of one of several states that have enacted favorable captive insurance legislation. One popular state for this is Nevada, which quickly processes applications and requires an initial capital transfer of $250,000 to capitalize the insurance company.

To be certified as a “financial holding company” by the Federal Reserve, all subsidiary banks in the holding company must be well-capitalized and well-managed.

The captive is regulated and examined solely by the applicable state Department of Insurance. Bank captives are generally operated under “turn-key” captive insurance service and administration programs with third parties that specialize in captive management services, such as KeyState Captive Management, a firm based in Nevada that manages over 55 bank captives in 5 different domiciles throughout the US.

Why Form a Captive Insurance Company?

Since the 1950s, larger corporations have been forming captive insurers to self-insure their risks, to lower their insurance costs and cover gaps that existed in the commercial insurance market. In 1986, Congress amended the Code to encourage the formation of captive insurance companies by small businesses.

A captive insurer’s sole purpose is to insure the risks of its owner or affiliates on a tax advantaged basis, as permitted under Section 831(b) of the tax code assuming the taxpayer follows applicable IRS Revenue Rulings. The captive is intended to provide coverage on risks that either are unavailable in the standard insurance market or are prohibitively expensive, such as restoration of reputation coverage. The captive also provides the bank with coverage for any of their commercial insurance policies with higher deductibles, such as D&O and employment practices coverages. Note that the captive is not intended to duplicate or replace an organization’s present commercial insurance coverages, which generally will stay in place with the organization’s current insurance agent(s) and companies. (To that extent, insurance agents for the bank need not be fearful of a captive resulting in a loss of commissions.)

In addition to the enhancements in risk-management practices that a captive provides, favorable provisions in Code section 831(b) (which created a tax incentive for “small” insurance companies) can potentially increase the earnings per share at a holding company by 2%–5%, depending on the asset size of a bank, premium levels paid to the captive, and before any claims experience. As a result of recent legislation passed by Congress, which becomes effective on January 1, 2017, this tax benefit could be increased for some larger organizations that have formed captives.

Tax Benefits

Under Code section 831(b), a captive insurance company may elect to be taxed only on its investment income (not on its premium income received), as long as it receives less than $1.2 million in annual premiums.

However, the premiums for insurance coverage paid by the bank to the captive are fully deductible for the bank, creating up to a $1.2 million annual deduction in the bank. A captive pays taxes only on the income it earns through investments. So, this strategy could result in as much as a $450,000 gross annual tax savings for an organization before any claims are factored in, depending upon the bank's size and tax rates.

Recent legislation passed by Congress (the "PATH Act") will raise the annual limit on premiums that may be paid to the captive from $1.2 million to $2.2 million, beginning in 2017, and will be indexed against inflation thereafter. This should help larger banking organizations that can justify payment of higher premiums based on actuarial assessments. In my experience, a typical $500 million asset community bank might pay $700,000–$800,000 in annual premiums to its captive.

Why Have More Banking Organizations Not Formed Captives?

While the legal authority to form a small captive insurer has existed for a while, community banking organizations, until recently, have been slow to organize captives. The costs to form a captive were high and the legal and regulatory authority for banks to form a captive was, at best, unsettled. Important Revenue Rulings of the IRS relating to this area were issued in 2002 and again in 2005. Also, the existence of quality, knowledgeable third-party vendors to manage a turn-key captive insurance operation has grown significantly, simplifying this task.

Federal banking regulators did not issue their non-objection to the shared-risk pooled captive program described below until 2012.

In addition, some banks decide not to form captives due to the negative impact that would result on earnings, capital, and the bank's return on assets, which some bankers have reported could decrease by 25–40 basis points as a result of the premiums paid to the captive.

Many of these hurdles have recently been overcome, which is why we believe somewhere between 60 and 100 captives have now been formed or are under serious consideration, and this number should increase significantly in the coming years. The ability to quickly obtain approvals and organize a captive that can immediately be "offloaded" to a compliant turn-key vendor makes this decision easier than it was in the past.

For example, in Indiana, since 2012, most banking organizations that were good candidates for forming captives have done so, according to the head of the Indiana Banker's Association, who described the number of Indiana banks with captives as "exploding" since 2012.

Pooled Risk-Sharing

As a result of several key IRS Revenue Rulings related to captives, it becomes critical for each small captive to enter into a pooled risk-sharing arrangement with unaffiliated third parties to assure that more than 50% of the captive's risk exposure is derived from those parties.

In my experience, this typically has meant that groups of 7–15 banking organizations are placed by the captive manager into a shared-risk pool to meet the "greater than 50%" risk-sharing requirement. Risk sharing is accomplished through one-year reinsurance agreements among the participants; no separate "shared" entities are created. In most captive pooled risk-sharing programs there is no sharing by participants of what is deemed "management risk"; for example, Bank A would never share in any losses at Bank B which stem from management/director or officer fraud, or exposure created by an employee lawsuit.

Dividending Back Excess Capital From Captive

Assuming three years of favorable capital (i.e., retained earnings) build-up at the captive, it is possible for the captive in certain cases to begin dividending back to the parent company (tax free if the holding company is a C corp) portions of this excess capital. The parent then may use this cash for various purposes including stock repurchases, acquisitions or to drop down as capital to the bank.

Who Is Right For Forming a Captive Insurance Company?

Our experience has shown that it rarely makes sense, for various reasons, for a bank with less than $300 million in assets to form a captive. As stated above, the negative impact in the first and second year on a bank's return on assets, due to its deductible payment of insurance premiums to the captive, can be quite substantial, and this is of concern to some banks. Without several years of healthy earnings in its recent history, some bank regulators might discourage a bank from forming a captive until better earnings return.

In any event, forming a captive generally is only a one-year commitment, since most programs permit a bank to terminate its participation at the end of the year without any penalty, or essentially to "freeze" its continuing participation for a year if a reason would arise to do so.

Given the legal, regulatory, tax and insurance issues involved with organizing a captive, if this idea sounds of interest to further explore, your bank should consider retaining legal counsel who is well-versed in these areas and who has worked extensively with various turn-key providers of captive services.

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