The growth of bank captives

More banks in Tennessee form captive insurance companies and look to Tennessee as the preferred domicile

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There is no avoiding it. Cyber security and reputation protection are among today's significant, emerging risks, thus creating exposures for banks of all sizes. At the same time, commercial insurance carriers are pushing banks to higher deductibles, so significant gaps remain in coverage and exclusions in commercial insurance policies. This creates unfunded risks, which must be evaluated as a part of any bank's enterprise risk management process.

To address the concerns, banks throughout the country are forming captive insurance companies to cover these unfunded risks. A captive is a legally licensed, limited purpose, property and casualty insurance company, which can write customized policies for related entities. The largest growth has been among financial institutions with $1 billion to $5 billion in assets.

"Our first member bank joined the Bank Captive Program in 2015 and the TBA now has five members that have captive insurance companies," said Colin Barrett, CEO of Tennessee Bankers Association. "We are also very pleased that the Tennessee Department of Commerce and Insurance has developed a robust and business friendly approach to regulating captives. It allows Tennessee banks to keep their captives in-state."

Michael Corbett, director of captive for the State of Tennessee, was asked about the Insurance Department's commitment to growing captive insurance in Tennessee. "We have made captive insurance a priority in Tennessee by ensuring that our statutory and regulatory approach is business friendly and innovative. We are encouraged by the number of Tennessee banks that have formed captives or are considering the formation of a Tennessee captive to insure risks that are not currently covered by their commercial policies."

Identifying and Addressing Your Bank's Unfunded Risks

It is important to recognize that the captive structure does not typically replace a bank's commercial insurance program. Instead, it allows a bank to more formally self-insure risks that are currently unfunded or that the bank has considered retaining. Typically, the captive augments commercial policies in the following ways:

- Covers the bank's commercial deductible layers, including specific deductibles for more catastrophic losses such as flood, windstorm, and hail damage
- Provides "difference in conditions" coverage for existing commercial policies like cyber risk, which primarily relate to sublimits and exclusions on the commercial policy form
- Increases coverage levels on existing policies (excess layers)
- Identifies other currently unfunded risks where commercial insurance is not available to the bank, such as reputation risk

Federal and State Statutes and Regulatory Framework

Along with benefits received from enhancing a bank's risk management process, Congress approved a small business incentive for mid-size companies that form their own insurance companies to insure these currently unfunded risks. Through the incentive, banks can form their own captive insurance companies and then make an election under Section 831(b) of the Internal Revenue Code. This "small captive" provision allows companies

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Tennessee Bankers Association and 28 other state bankers associations have endorsed KeyState's Bank Captive Program for their members. Banks with an interest in exploring whether a captive insurance company is a good fit for their institution should contact Josh Miller at *jmiller@key-state.com*.

to pre-fund for potential future risks on a tax advantaged basis, provide an incentive to set money aside for future potential claims, and create a mechanism for companies to formalize their current self-insurance program.

Recent federal legislation demonstrated Congress' renewed intent to support mid-size businesses utilizing captive insurance companies to create a contingency plan for unfunded risks. In the December 2015 Appropriation Bill, Congress increased the annual allowable premium limit for small captives from $1.2 million to $2.3 million in 2019, which now adjusts annually with CPI. This increase has spurred additional interest for banks that with plans to grow beyond $2 billion in assets. As a bank and its unfunded risks grow, it can increase its captive insurance coverage. Since 2016, the IRS has required an additional filing requirement for certain captive insurance companies that make the Section 831(b) election, their insureds, and their owners. Banks forming captives should consult with their tax advisors to fully understand the new filing requirement.

Captive insurance programs are fully supported in Tennessee by a robust professional association, full commitment from the Tennessee Department of Commerce & Insurance, and the Tennessee General Assembly. Since modernizing Tennessee's captive law in 2011, the law has been further updated on four occasions to respond to demands for new innovations and flexibility from captive insurance owners. Tennessee's captive insurance law allows bank owners to create customized solutions tailored for the bank's risk management needs uninhibited by traditional insurance company underwriting requirements or burdensome government regulations that shouldn't apply when the owner and the insured are one and the same.

Forming a captive insurance company is not a good fit for every financial institution. In most cases, the Federal Reserve has determined that this solution can only be implemented by holding companies that are well managed and well capitalized. inancial institutions evaluating a captive typically have over $1 billion in assets.