More Banks in Arkansas Form Captive Insurance Companies and look to Arkansas as the Preferred Domicile

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The Growth of Bank Captives

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 there remain significant gaps 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.

While larger institutions (typically $10bn in assets and larger) with specific organizational structures (i.e., holding companies with numerous charters and subsidiaries) have been utilizing these types of captives since 2006, captives did were not an option for mid-size community banks ($1bn - $10bn) until an updated structure was designed and vetted with regulators in 2012.

"Since late 2012, we have seen the number of banks with captives explode. The majority of our banks that are good candidates for owning a captive either have one in place or are in process of putting one in place. Over 85% of Indiana banks with over $1bn in assets have formed captive insurance companies" said CEO of Indiana Bankers Association, Amber VanTil. "We have been discussing bank captives with other state banking associations throughout the country and there's been tremendous interest."

"Arkansas banks are increasingly looking to captive insurance companies as a tool for identifying and funding for risks that are not covered by their commercial insurance program," notes Lorrie Trogden, CEO of the Arkansas Bankers Association. "We are also very pleased that Arkansas Insurance Department Commissioner Allen Kerr has developed a robust and business friendly approach to regulating captives. It allows Arkansas banks to keep their captives in-state rather than looking to other popular domiciles like Vermont, Delaware or Nevada."

Commissioner Allen Kerr of the Arkansas Insurance Department was asked about the Insurance Department's commitment to growing captive insurance in Arkansas. Commissioner Kerr stated, "We have made captive insurance a priority in Arkansas through changing our laws to become more business friendly and traveling around the country to show business leaders how locating their captive business in our state makes good financial sense. We are working on returning Arkansas companies' captive business back home while showing outside businesses that Arkansas is a Natural State for captive business opportunities."

Identifying and Addressing Your Bank's Unfunded Risks

It is important to recognize that the captive structure does not typically replace a bank's primary commercial insurance program. However, it does allow a bank to more formally self-insure risks that are currently unfunded or that the bank has considered retaining (i.e., increased deductible layers). Typically, the captive augments commercial policies in the following ways:

- Covers the bank's commercial deductible layers, including specific deductibles for more catastrophic losses like 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 to insure where commercial insurance is not available to the bank like 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 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 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 in the allowable premium limit has spurred additional interest for larger institutions that have more significant unfunded risk. They can increase their captive insurance coverage as they grow.

The potential savings related to this small business subsidy (Section 831b) for captives varies from bank to bank, but they can be significant. In some cases, holding companies can see an increase to consolidated earnings per share of 1-3% prior to adjusting for claims made to the captive. Of course, a bank does not expect a significant claim each year. The captive is designed to cover risks that typically have high potential loss severity but low likely frequency. The captive becomes a way to put reserves away, literally for a rainy day.

Arkansas continues to update its captive framework to respond to businesses investigating the benefits of owning a captive insurance company. For instance, in 2017, Arkansas updated its laws addressing the formation and operation of captive insurance companies, adding provisions for formation of "incorporated protected cells" and broadening the organizational requirements to include limited liability companies. Additionally, the 2017 law created a mechanism for captives to enter "dormant status." The dormant status establishes a solution for a captive insurance company that has ceased insurance operations but does not want to relinquish its license should it determine that it wants to resume operations in the future. In 2019, the Arkansas legislature continued to improve the captive laws, decreasing the capital and surplus requirements for sponsored captives and adding greater flexibility for mergers.

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 institutions that are well managed and well capitalized. Holding companies that want to form a captive should typically have over $1bn in assets. There are exceptions but institutions of this size normally have a risk profile that justifies the formation of captive and the associated operating expenses.

Josh Miller, *CEO of KeyState Captive Management, launched the Bank Captive Program in 2012. He has worked with over 100 financial institutions across the country that have formed captive insurance companies. 28 state banking associations, including the Arkansas Bankers Association, 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.

Zach Steadman*, Member, Mitchell, Williams, Selig, Gates Woodyard PLLC, has been instrumental in the development and ongoing revisions to Arkansas law addressing captive insurance companies and has been in the formation of the majority of the captive insurance companies in Arkansas. Contact Zach Stedman at* zsteadman@mwlaw.com *to discuss whether forming a captive is a good strategy for your institution.*