

Looking Forward

Banks are using captives for enterprise risk management in increasing numbers

By Josh Miller, CEO, KeyState

There is no avoiding it. Cybersecurity 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.

It's evident that bankers know not all enterprise risk is addressed with their commercial insurance package.

To address the concerns, banks throughout the country are forming captive insurance companies — known as captives — to cover these unfunded risks. A captive is a legally licensed, limited purpose, property and casualty insurance company that can write customized policies for related entities.

While larger institutions (typically \$5 billion in assets and larger) with specific organizational structures (i.e., lots of charters) have been utilizing these types of captives since 2006, captives really did not take hold



for mid-sized community banks (\$300 million to \$5 billion) until an updated structure was designed and vetted with regulators in 2012.

It is important to recognize that the captive structure does not typically replace a bank's primary commercial insurance program. It does, however, 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.

- Provides "difference in conditions" coverage for existing commercial policies, 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.

Along with benefits received from enhancing a bank's risk management process, Congress approved a small-business incentive for mid-sized 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 allows companies to pre-fund for potential future risks on a task-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.

In the December 2015 Appropriation Bill, Congress moved the annual allowable premium limit from \$1.2 million to \$2.2 million for the tax years after 2016. Financial institutions with larger baskets of unfunded risks will be able to continue to grow their captive over time as the institution grows organically or with acquisitions and the small-business incentive will also 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 earnings per share of 3-5 percent.

Of course, this solution is not a fit for every bank. This solution should only be implemented by banks with sufficient capital and earnings.

Captive insurance companies are a growing trend for high-performing banks throughout the country.

Holding companies that want to form a captive must be well managed and well capitalized, and their affiliated bank that pays premiums into their captive must have sufficient capital and earnings to support the additional insurance expense at the bank level.

Captive insurance companies are a growing trend for high-performing banks throughout the country. As banks become more

aware of their unfunded risks through ongoing enterprise risk management, the captive offers a unique and customized approach to identify and fund for those risks on an annual basis. And the significant small-business incentive provided under Section 831(b) of the tax

code provides further motivation to implement the structure.

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 or Julianna Graham at jgraham@calbankers.com. Currently more than 23 state banking associations throughout the country have endorsed bank captive programs for their members. **CB**



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