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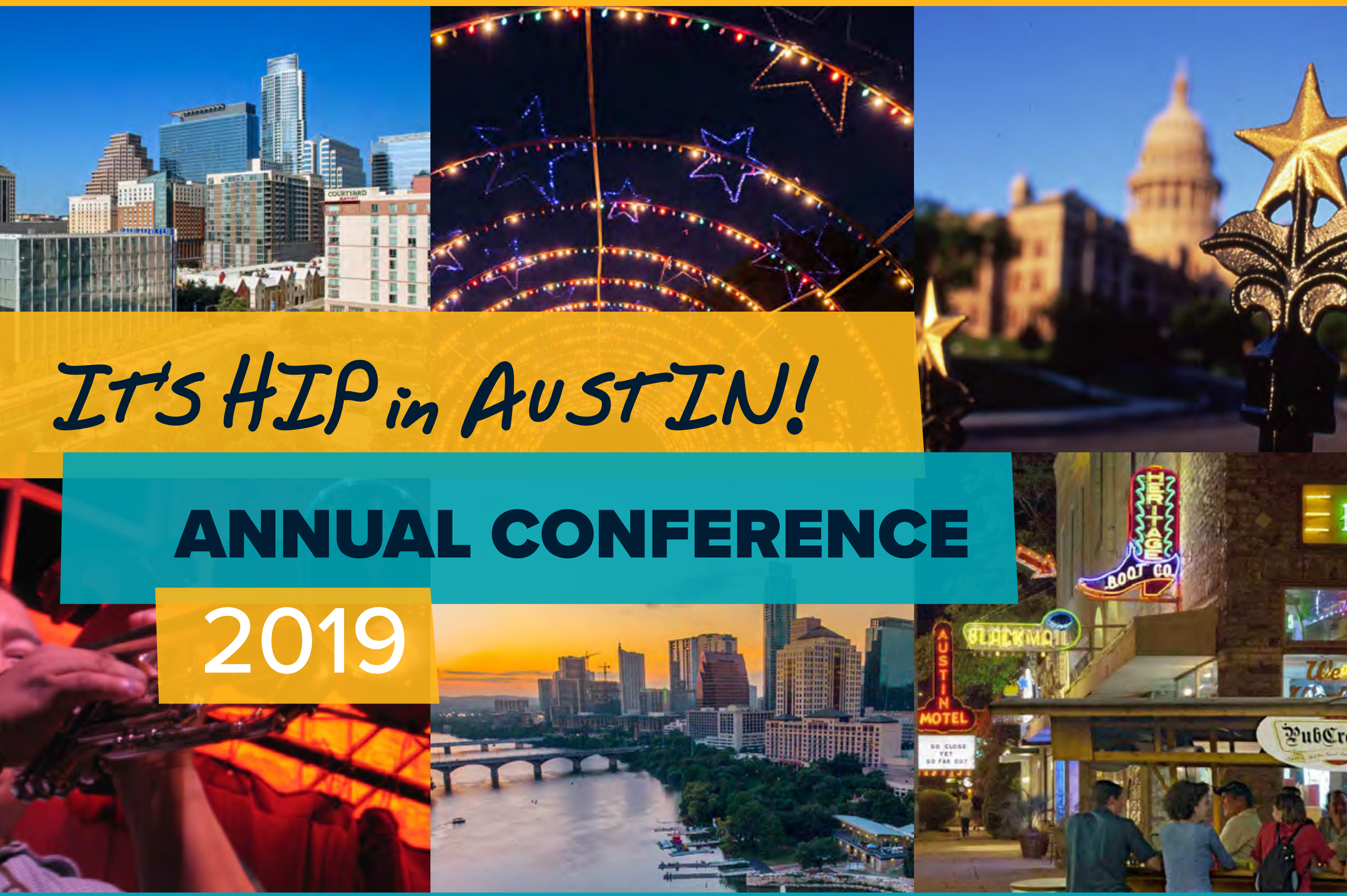

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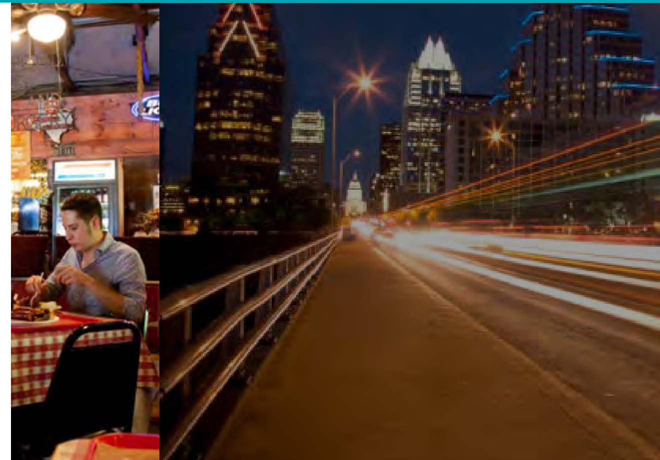

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Also in this issue: SPECIAL BUSINESS SERVICES SECTION

By Josh Miller, CEO, KeyState Captive

PREFERRED VENDOR

KeyState CAPTIVE MANAGEMENT

Banks Using Captives for Enterprise Risk Management in Increasing Numbers

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.

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, which can write customized policies for related entities.

While larger institutions (typically \$10bn 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-size community banks (\$500mm - \$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," 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."

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 significant "named storm" deductibles for banks with coastal branches
- 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-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 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.

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. This increase in the allowable premium limit has spurred additional interest for larger institutions (\$2bn plus) that have more significant unfunded risk.

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% prior to adjusting for claims made to the captive. Of course, a bank does not expect a significant claim year after 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.

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

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. Currently 27 state banking associations, including the Illinois Bankers Association, have the Bank Captive Program as a Preferred Vendor for their members.