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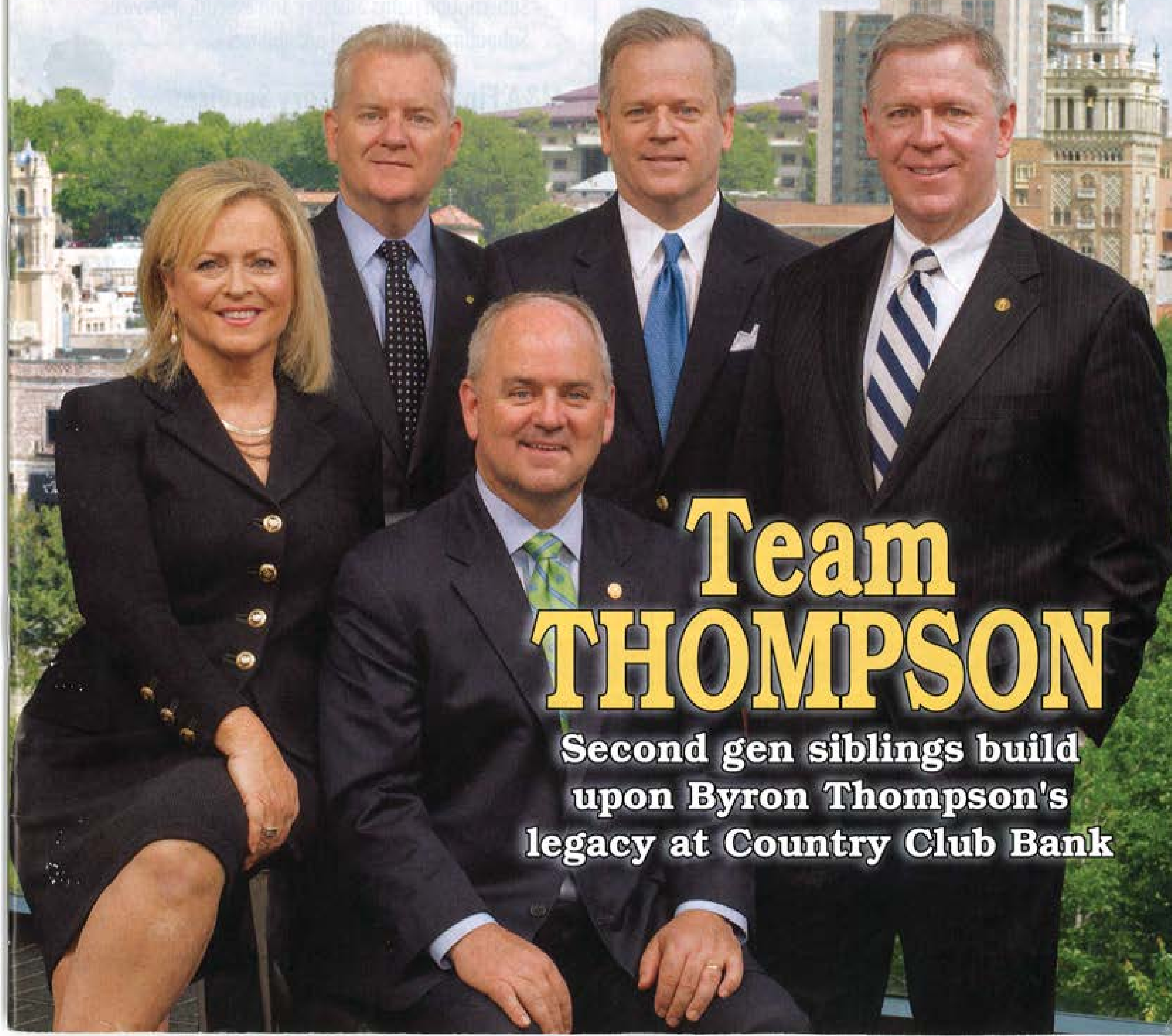
Captive insurance 101

Biography recounts Minnesotan's path to banking success



Team THOMPSON

Second gen siblings build upon Byron Thompson's legacy at Country Club Bank

RISK Repellent

Banks use captive insurance companies to enhance ERM

By Matthew Doffing

INSURANCE ALWAYS HAS been a staple in bank enterprise risk management. Banks use it to protect their assets, their depositors and their business. In recent years, a significant number of Midwest banks have decided to add another layer of protection to their risk management strategy: captive insurance companies, otherwise known as captives.

More than 50 community banks across the country have launched captives since 2012, the majority of which have been in the Midwest, according to Josh Miller, CEO of The KeyState Companies, which helps banks create and manage captives. In Indiana, about 20 percent of the state's 114 banks have formed captives during the last four years. Two banks in Wisconsin and one regional bank in Minnesota have formed captives during the same period. During the next 12 months, banks across the country will launch another 50 captives, Miller estimated.

What's drawing banks to form their own insurance companies? Bankers and experts point to the attractive complementarity with commercial insurance and certain tax benefits as the primary reasons for the increase in bank captives.

Their own insurance company

A captive is a legally licensed insurance company chartered and owned 100 percent by a financial holding company, according to attorney Jim Sheriff, Reinhart Boerner Van Deuren. Banks commonly discuss the creation of their captive with their prudential regulator; however, in order to form a captive the holding company needs to take the financial holding company election, Sheriff said. "A captive can be formed with the help of a management firm like KeyState, an attorney and an accounting firm experienced with captives," he said.

As a licensed captive insurance company, a captive can write policies for their bank to cover risks that are not insured commercially. A bank captive can write policies to cover deductibles or to cover losses above and beyond what's covered by commercial insurance.

Typically community banks buy insurance for buildings and equipment, for protection against damage from floods and windstorms, for cyber liability, directors' and officers' liability, and for many other risks. All of a bank's different insurance policies have deductibles and limits. To diminish the deductible, or to increase the limit, would result in a bigger premium going out the door.

A captive can write a policy that reimburses the bank for all or part of its commercial insurance deductible. The advantage for doing so is that premiums paid to the captive for deductible reimbursements stay on the consolidated holding company financials. "Premiums paid to our captive stay on our books; commercial premiums are gone," said Jeff Humbarger, senior vice president, treasurer at iAB Financial Bank, Fort Wayne, Ind. The $1.05 billion bank finished what Humbarger estimated was a six month process to launch its captive in 2013.

After a period of time, if the captive builds up sufficient retained earnings, it can send dividend up to the holding company. "The funds can then be sent down to the bank again as capital," Humbarger said.

Generally, banks that form captives have $250 million or more in assets. "The majority of the banks in KeyState's program are over $500 million in assets," Miller said. The reason is the size of the premium. Depending on the market, a $500 million bank may pay about $100,000 for premiums on commercial insurance, according to Miller. A $500 million bank might pay about $800,000 in premiums to its captive, depending on coverages and associated premiums, Miller said. To support a captive, banks need strong earnings and capital to afford the premium.

While expensive, captives' attractive tax benefits are the other side of the coin, Miller said. In the absence of a claim, they bring an annual, permanent benefit of about $200,000 in tax savings for a $300 million holding company. For a $1 billion holding company, tax savings can reach $400,000. "The tax benefits depend on the size of the bank and the bundle of risk identified for coverage through the captive," Miller said. "For our product, Crowe Horwath will do a comprehensive insurance analysis to identify risks, which we then use to develop coverage. The premiums for that coverage are calculated by a third-party actuary. The bank must pay a premium consistent with the risks it selects to be covered by the captive."

Both the bank and the captive play a role in the tax benefits estimated by Miller. The bank has a tax deductible expense for its premium which lowers its earnings; the result is lower taxable income at the bank level. According to revenue rulings from the IRS in 2002 and 2005, properly formed captives can take the small insurance company election under section 831(b) of the tax code. The election allows a captive's revenue, received in premiums from its

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bank, to be excluded from taxable income on the consolidated holding company financials.

Under section 831(b) of the tax code, there is a limit on the premium a bank can pay of $1.2 million per year. In 2015, Congress increased the limit to $2.2 million, effective Jan. 1, 2017.

Analyzing the premium expense

The cost of premiums is a key consideration for leaders at Midwest Bank, Detroit Lakes, Minn., as they look to bring a captive online this year. "We saw the potential for a captive as a risk tool but we really looked at our earnings and capital as we gauged our ability to do this," said Steve Daggett, the $364 million bank's president/CEO.

Midwest Bank has earned a return on assets between 2.14 percent and 2.63 percent every year since 2011. "We figured the earning impact will be about 25 basis points to 30 basis points to fund a captive," Daggett said. "We did not see it affecting our CAMELS rating.

"We did, however, analyze our growth," Daggett continued. "If we spend $800,000 on premiums [instead of retaining it for capital] that is $8 million in loans we couldn't fund, potentially. We had to analyze that; we also needed to foresee adequate distributions from the bank to the holding company in terms of dividends."

Daggett said the bank's leaders have decided creating a captive is a good move. With the Great Recession not too far in the rear-view mirror, no bank can predict its future earnings with complete certainty. One thing that gave Midwest Bank leaders additional comfort was that captive policies are renewed on an annual basis. A bank can let its captive go dormant, and then can go live with it again when earnings return.

Assuming sparse claims, financial holding companies can utilize capital in captives for future acquisitions, stock redemption and purchasing shares. Captive's insurance regulator requires that they maintain a certain level of capital and retained earnings before paying dividends up to the holding company. Most captives wait at least three years before initiating dividends.

Protected against catastrophe

Banks that have captives retain their commercial insurance. They augment commercial insurance through policies for deductible reimbursement through their captive. They also protect themselves from low frequency, high severity risks by buying coverage from their captive for losses over and above their commercial coverage, Miller said.

According to IRS revenue rulings, in order to be taxed as an insurance company, a bank captive must share 51 percent of its risk with other banks. Captives managed by KeyState share risk in a pool with other banks for property damage, crime, restoration of reputation, and other risks. Management related risks are not shared between banks; each bank underwrites its own directors' and officers' liability, for example.

Shared risk is beneficial for events like floods because the bank is protected against the most severe of calamities, Miller said. "For example, it is not uncommon for a bank to buy flood insurance only for branches in a flood plain," he said. "If there is an unusual flood that damages the bank's branches, especially the branches without flood insurance, it can be a significant claim.

"If the flood causes $750,000 in damage to branches not covered with commercial insurance, they can go to their captive pool for the loss," Miller continued. "They would be responsible for a $50,000 deductible, but then the remaining $700,000 would be shared among the banks' captives on a pro rata basis. The calculation is more complicated but loosely speaking each bank would pay $75,000."

Josh Miller

Given the additional protection available from shared risk, iAB Financial Bank looked holistically at its captive and its commercial insurance to better protect the bank, Humbarger said. "KeyState provides data from every bank in our pool, and we make sure we are taking similar risks to the other banks," he said. "There is good geographic distribution in our pool so that we do not all get hit by the same disaster.

"We also get together with all the banks in our captive pool every year," Humbarger continued, "so, we talk about risks and what they are doing. We have gotten to know other Indiana banks well but now we also have an Illinois bank and one from Wisconsin."

Humbarger sees little risk for large, frequent claims from other banks in iAB Financial's pool. "We insure very real risks that do not often happen. We might see a claim, but chances are very unlikely of it being catastrophic," he said. "After a few years with the tax benefits, even if you have a large claim in the shared pool, you still will be ahead more likely than not. On a consolidated basis, the premiums remained in-house." ■

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