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# How captive insurance empowers banks during turbulent times

**By Christopher Gallo, CIC Services**

Following the Silicon Valley Bank collapse, small bank deposits were down a record $119 billion in March according to CNBC. While as of May, there are signs that this is stabilizing, it has still spread fear which has deeply impacted small and mid-sized banks. This combined with increased cyber-related threats, an uncertain economy, evolving compliance regulations and changing customer expectations leaves banks vulnerable to unique risks. Perhaps this is why banks are increasingly turning to captive insurance, an insurance company subsidiary owned by the bank itself, as a risk management solution.

James Mason, president of Bluegrass Insurance Services, LLC, owns and operates a P&C Independent Insurance Agency. He is also president of Magnolia Insurance Co, and Magnolia Bank shares a financial holding company which owns both Magnolia Captive Insurance Company and Magnolia Bank.  He believes Captive Insurance can help banks increase risk mitigation and profitability.

Magnolia Bank had off-balance sheet risks, which traditional insurance companies would not cover. Those same off-balance sheet risks were then insured in their captive. When off-balance sheet risk claims were paid by the captive to Magnolia Bank, the state banking regulators were pleased.

“When they saw the protection afforded by captive insurance, they thought it was an excellent tool for mitigating risks,” said Mason.

Benefits: Traditional cyber liability insurance excludes state attacks. Captive cyber liability insurance allows policy language to be personalized to benefit the business owner. Additionally, captive insurance provides hard market protection, premium cost control and capacity. Captive policy language is written to benefit business owners and can create potential tax savings.

“When CIC Services writes policies, we are looking to protect Magnolia Bank, and we’re taking a look at all the risks and we write the policy to safeguard the business,” said Chris Gallo of SeCAP Inc..

Gallo was an insurance regulator for 35 years and he says incorporating captive insurance can take banks from survival mode to thriving.

"It is critical no matter if it is a big business or a small business," said Gallo. Cash flow and liquidity are key to survival. We find that captives add cash flow, earnings and liquidity to the business owner."

According to author Jonathan Wegner in "Captive Insurance Subsidiaries Proliferate Among Bank Holding Companies," the Federal Reserve notes the number of captives has increased among banks in recent years. The pandemic drove a leap in captive insurance formations across industries which nearly doubled in 2020 and accounted for $60 billion in gross premiums, an increase of over $6 billion, as seen in the Captive Landscape Report. The continued rise in captive insurance adoption has aligned with businesses seeking greater control of their fate.

Establishing and operating a captive insurance company takes careful consideration, expertise and compliance with laws and regulations. Still, captive insurance can provide several benefits to small banks when it comes to mitigating risks that can positively impact operations, financial stability and reputation. Small- and medium-sized banks play an essential role in the American economy.

Lenders with less than $250 billion in assets account for roughly 50% of U.S. commercial and industrial lending, 60% of residential real estate lending, 80% of commercial real estate lending and 45% of consumer lending, according to a report by Goldman Sachs economists Manuel Abecasis and David Mericle. To the extent that banking stress that started with the resolution of Silicon Valley Bank impacts lending, it's likely to be concentrated in a section of small- and medium-sized banks. All things considered, operating a captive insurance company could provide numerous benefits to the banking industry.

**Providing a Stronger Approach to Risk Management and Profitability for Banks**

Cost Management: Small banks often face higher insurance premiums because of their size and limited bargaining power. By establishing a captive insurance company, a small bank can gain more control over its insurance costs. The bank has the power to tailor its insurance coverage to its specific needs, thereby avoiding unnecessary coverage and reducing premiums over time.

Regulatory Compliance: Banks are subject to various regulatory requirements related to risk management and insurance coverage. Captive insurance can help banks meet these regulatory obligations by providing a means to demonstrate sufficient insurance coverage for specific risks. The captive can be structured to comply with regulatory standards, ensuring that the bank fulfills its obligations while maintaining control over its insurance arrangements.

Risk Management: Captive insurance allows small banks to effectively manage their unique risks. Instead of relying solely on external insurers, the bank can customize its insurance policies to cover specific risks and exposures it could face. This flexibility allows the bank to have a comprehensive risk management strategy, including protection against emerging risks that may not be adequately addressed by traditional insurance policies.

Improved Coverage: Captive insurance allows small banks to obtain coverage for risks that may be difficult to insure through the traditional market. Traditional insurers might exclude certain risks or offer limited coverage options. By forming a captive, a small bank can fill gaps in coverage and make sure it has protection against risks that are critical to its operations.

Long-Term Cost Savings: Over time, if the captive insurance company performs well and experiences favorable claim experience, it can gain surplus funds. These funds can be invested and potentially generate investment income for the small bank.
Additionally, if the captive insurance company consistently demonstrates good risk management practices, it may be eligible for reinsurance, which can further reduce overall insurance costs.

Control and Flexibility: With captive insurance, the small bank has greater control over its insurance program. It can set underwriting guidelines, claims processes and risk management practices according to its specific needs and risk appetite. This level of control and flexibility allows the bank to respond quickly to changes in its risk profile and regulatory environment.

**Captive Insurance for Banks in Action**

While these benefits are all highly valuable for a bank, the application of captive insurance to a small or mid-sized bank can be best illustrated with an example such as this:

Imagine a bank that has been struggling with compliance costs and penalties associated with regulatory requirements, particularly related to cybersecurity. The bank has experienced several data breaches, resulting in substantial financial losses and reputational damage. Establishing a captive insurance company focused on cybersecurity risks could have provided benefits including enhanced cybersecurity coverage that is customized to address specific risks and vulnerabilities. The bank could have tailored protection against the risks it faces, like data breaches, privacy violations, legal expenses and potential regulatory fines.

As Magnolia Bank discovered when it comes to cyber liability, through traditional insurance there are always exclusions, commercial policies are more complex.

“We try to find ways to get things covered as opposed to trying to find ways to not cover things,” said Mason.

Also, by establishing a captive, the bank can assume a portion of the risk associated with cybersecurity incidents. This incentivizes the bank to implement stronger risk mitigation measures, invest in robust cybersecurity infrastructure and implement best practices to prevent breaches. The captive insurance structure reinforces a proactive approach to risk management and encourages loss control efforts.

“Currently our investment portfolio makes $2 million a year, when we started our captive, all our assets added together didn’t make $2 million, now our captive alone makes that amount,” said Mason.

The bank’s commitment to proactively managing cybersecurity risks through a captive insurance company can help build its reputation. Demonstrating a strong risk management framework and robust insurance coverage indicates that the bank is taking necessary steps to protect its customers’ data and maintain their trust.

In summary, the banking industry is facing various challenges and captive insurance offers small and mid-sized banks an opportunity to strengthen risk management practices, enhance profitability and build reputation in the face of evolving threats in the banking industry.

It’s important to work with insurance and legal professionals who specialize in captive insurance to get an accurate estimate of specific costs associated with forming and operating a captive insurance company for a small bank.