Why does a single parent or group captive insurance company need to expend the time and expense to find truly independent board directors. After all captives are unique entities. They are created to insure their owners’ risks. The captive owner, or owners, is the captive’s key stakeholder. Isn’t it a best practice, therefore, to have shareholder insiders direct the captive to ensure that it provides the coverage the shareholder, also known as the member insured, needs at terms within its risk appetite?

Furthermore, the captive is regulated, hires an independent auditor, employs an actuary to certify its reserves, and uses a captive manager approved by the captive domicile regulator. What could go wrong? Perhaps nothing. There are multiple layers of regulation. But the captive directors are also often torn by competing interests: their responsibilities as shareholder employees, and having the duty to act in the best interest of the captive, and its stakeholders. For some, this begs the question of whether it is time for captives to appoint independent directors before regulatory forces takeover and mandate it.

It is important to first understand what an independent director is. According to the Stanford University Business School Corporate Governance Initiative, outside directors are those who are not employees of the firm, contribute to the organisation by advising management on strategy and operations, drawing on their professional experience, and they monitor the company to ensure that executives act in the interest of the shareholders. And Stanford defines independent directors as outside directors with no material relationship to the company, as defined by the New York Stock Exchange listing requirements.

These definitions create a foundation from which a captive shareholder can justify the addition of a truly independent director on the captive board regardless of whether it is a single parent or group captive. Board skill, experience, objectivity, independence and transparency after all are the keystones of good governance.

Having said this, who does the captive board have a duty to? Is it:

- The captive owner/shareholder?
- The member insured?
- The claimants?
- The captive?

The answer is all the above. But the board cannot make decisions for the captive that are in the best interest of the shareholder to the detriment of the captive. Again, herein lies the problem. A
captive, whether owned by one or multiple shareholders, is a regulated legal entity. It has its own stakeholders beyond the shareholder such as regulators, professional service providers, insureds and claimants. And, again, in most cases, the captive directors are employees of the shareholder, the member insured, with management responsibilities.

Under these unique circumstances, can the inside board member successfully, without conflict, wear two hats? One while executing the business of the member insured, and the other one while making decisions at a captive insurance company board meeting?

There are even more important factors, however, that drive this need. The world of risk management is becoming a more complex and challenging place. Climate change, income inequality, terrorism, the growing need for skilled labor, global supply chains, a flatter world, and growing political risk are driving captives to become more responsive to their member insureds to provide more efficient and effective solutions to manage these threats and opportunities.

So, what does an independent director bring to the table? This depends upon his or her background and experience. Appointing an independent director for the sake of independence alone is short sighted. This individual should have the below experience and credentials to make an impact.

- Understand the alternative risk financing and transfer industry, specifically captive insurance
- Can apply risk management knowledge to enable the captive, and its member insured, to more efficaciously analyse and evaluate programme options, and assist the process of creating solutions to manage emerging risks
- Will work well with the board
- Has experience working with: Captive boards and shareholders (preferably as a risk manager that administered the captive); captive domicile regulators; captive managers, auditors, actuaries, investment managers, reinsurance brokers, and attorneys; and general risk and enterprise risk management expertise.
- Is not connected in any way with the shareholder or captive. This includes financial, bias or emotional ties
- Understands the role of a director; and can be completely transparent, loyal, candid, and able to execute her fiduciary duty
- Avoids making decisions without regard to merit
- Has the character of a trusted adviser that can act as a control against fraud

Specifically, the qualified independent director will: bring a knowledgeable and objective opinion to the captive strategic planning process as it seeks new ways to increase its shareholder value; assist with building regulator confidence; eliminate conflicts of interest that may colour captive service provider relationships; and provide the balance that may be lacking between the duty owed to the shareholder and the captive.

Moreover, an independent director has an incentive to perform his fiduciary duties in accordance with the rule of law pursuant to an ethical compass. Doing what is ‘just legal’ is an inadequate standard of care. The independent director’s reputation, and financial security, is dependent on acting legally and ethically in the best interest of the captive, the member insured and all stakeholders. The independent director must be experienced, loyal (disclose material conflicts of interest), operate openly and honestly, and have the competence to oversee the performance of the captive service providers.

Finally, why do captive shareholders need to appoint independent directors on captive boards now? Consider history, which is an effective teacher. The study of past events tells us that governments will fill a regulatory void with its own version of what it deems necessary to bring a system or business activity back into balance. Consider the history behind the US Environmental Protection Agency, Occupational Safety and Health Agency, and the passage of the Sarbanes–Oxley Act.

Moreover, the 2012 National Association of Insurance Commissioners (NAIC) Model Risk Retention Act was written in response to the risk retention group (RRG) governance abuses uncovered by the US General Accountability Office 2005 report. According to the literature, these abuses arose because of the dearth of governance standards within the federal Liability Risk Retention Act to ensure that RRGs would be governed in a way that protected the best interests of its insured members. The NAIC Model Act imposed RRG governance standards, which were adopted by accredited US RRG domiciles.

The NAIC Model Act is not a bad result, but that is not the point. The discussion should focus on why it was necessary in the first place. Captive owners should take a lesson from history and recruit qualified independent directors before it is imposed on them through rules and regulations that may be made more complex than necessary because of a legislative or regulatory process outside of their control.

In summary, isn’t it just good reputational risk management for the captive insurance industry to actively promote the practice of recruiting independent directors to its boards, whether single parent or group captives? There is, of course, a cost. But isn’t the upside benefit an acceptable return on investment? CIT