A Guide to CAPTIVE PREMIUM FINANCE

The benefits of forming your own premium finance company

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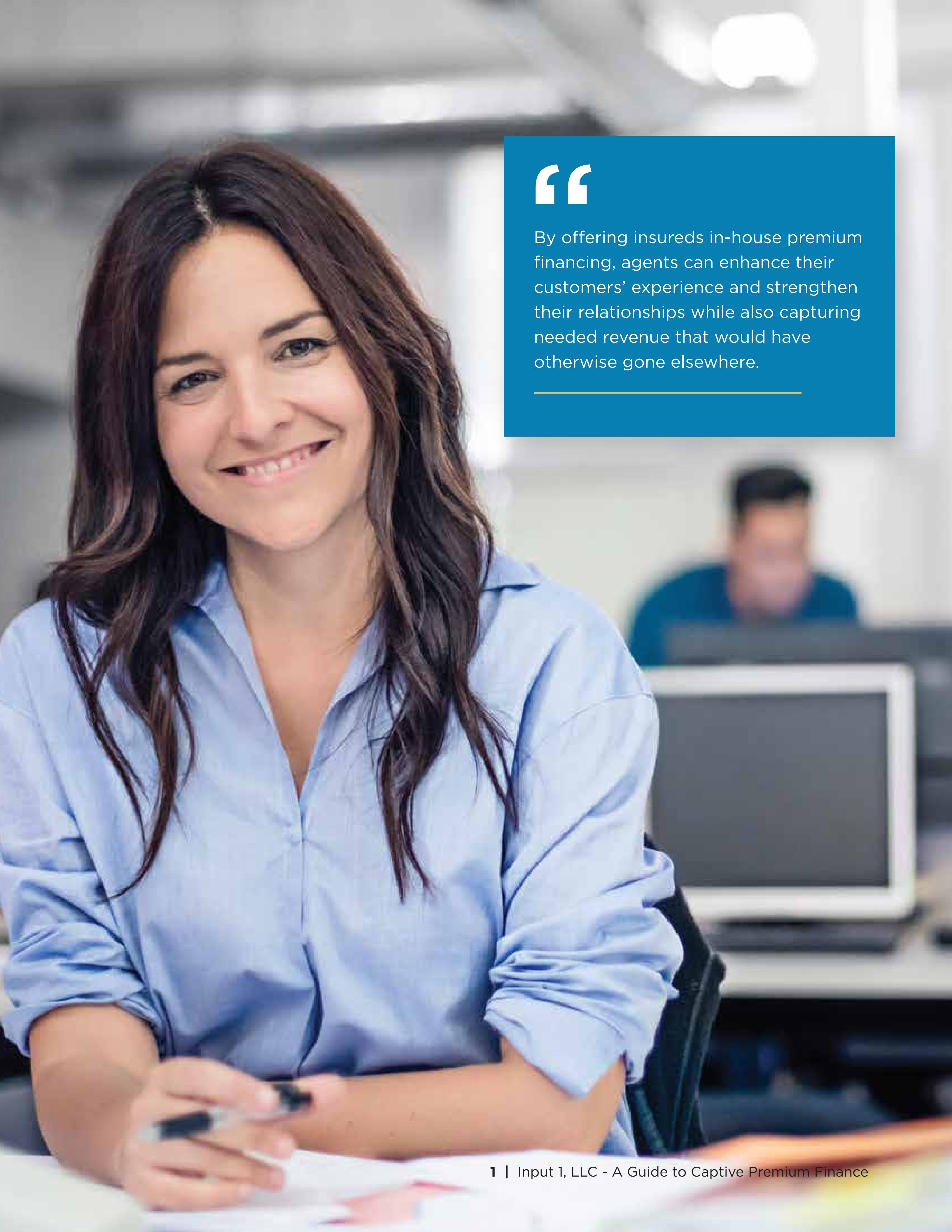


> By offering insureds in-house premium financing, agents can enhance their customers’ experience and strengthen their relationships while also capturing needed revenue that would have otherwise gone elsewhere.

INTRODUCTION

Similar to many other industries, the property and casualty insurance universe has particular trends that will dramatically change based on specific economic factors. A hard insurance market is one during which risks are harder to place and pricing is accelerating or already high. A soft insurance market is one in which competition is very intense, driving pricing down, with many carriers willing to write many risks. Establishing a premium financing vehicle can benefit an organization during both market cycles.

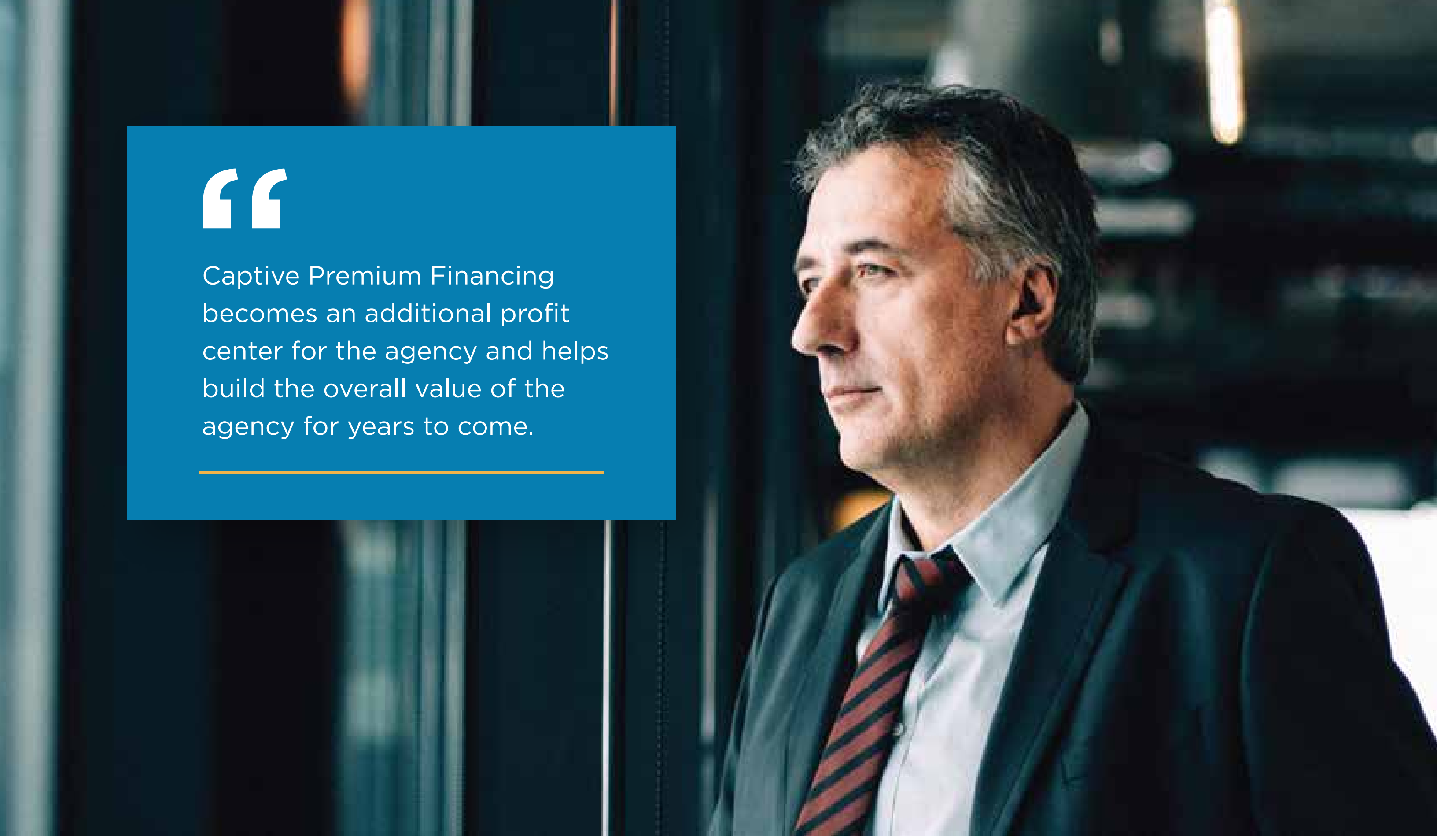
The Benefits of Forming Your Own Premium Finance Company

During a hard market, agents and managing general agents reap the benefits of growing premiums. However, while agents may be earning more commissions, they're also working harder than ever to retain their client base. Let's face it — clients facing a double- or triple-digit percentage increase in premium from one year to the next not only need constant attention but new products and services that will make their lives easier. Some may leave just based on appearances.

During a soft market, premiums are decelerating. It is good for the customer who pays less for insurance, but this translates into lower commissions for the agency despite a fixed cost in securing the sale. Lower profits mean increased difficulty in providing the high service

levels that won the deal in the first place.

By controlling the billing terms offered to insureds through an in-house premium finance company, agents can keep clients by (a) providing flexible terms which offer some relief during times of higher premiums and (b) capturing badly needed revenue that would go elsewhere and use that revenue to keep service levels high and continue reinvesting in the business.



> Captive Premium Financing becomes an additional profit center for the agency and helps build the overall value of the agency for years to come.

Agents already offer a myriad of insurance products and services to their clients, so captive financing fits nicely within the business model.

No one knows the needs and financial wherewithal of a policyholder better than the agent placing the risk. By creating an in-house finance company, an agent can create competitive payment terms based on individual needs that can make the difference between winning or losing the deal.

When you consider the number of financed policies an agency has the chance to place each week/month/year, and we're talking about a considerable income spike. This new venture becomes an additional profit center for the agency and helps build the overall value of the agency for years to come.

ADDITIONAL EARNING ON THE SAME BUSINESS

The income derived by the insurance financing transaction averages two to three equivalent commission points to the bottom line of an agency. Instead of making 10% or a $1,000.00 commission on a $10,000 premium, agents can earn $1,200.00 - $1,300.00 or more.

Despite the obvious benefits, most agents and MGAs that arrange financing for their insureds use an outside finance company. By doing so, wallet share is lost.

How is Premium Financing Used to Pay for Insurance?

Premium financing is used in place of inflexible carrier installment plans or if the only option is payment in full. The latter is typically the case with the excess & surplus market. By signing a finance agreement, the insured is agreeing to have the premium finance company advance the annual premium to the insurance company on their behalf.

The insured is then given a payment plan from the finance company that includes premium and interest payments. If the insured fails to pay installments when due, the premium finance company has the right to request cancellation of the policy from the insurance company.

How Does a Finance Company Generate Income?

A finance company generates income by borrowing money at a certain interest rate from one source (i.e., a bank, private investors, etc.) and lending that money at a higher rate to policyholders that request financing. Other sources for profits from premium financing include late fees and other incidental charges. The costs of forming and running a premium finance company include interest expense (i.e., cost to borrow the money), day-to-day administration and overhead, and licensing and accounting expenses.

With proper financial modeling and the commitment to promote the financing business, the income generated by a portfolio of premium financing loans can yield a considerable return on investment.

+INCOME SCENARIO

Experience shows that, at a minimum, a captive commercial premium finance operation with average size premiums of $3,000.00 could realize anywhere from $20,000.00 - $30,000.00 in income per year for every $1 million of financing.

This number will vary depending on a variety of factors, including the difference between the rate charged for funds and the rate paid for funds (i.e., the "spread"), the late fee income, and how one chooses to administer the book of business.

Why Consider Captive Financing?

The most obvious reason for captive financing is this: you (the agent) pay 100% of the cost to bring a deal in the door but fail to retain 100% of the potential income from that deal. In other words, you've left money on the table. Second, as covered above, when premium prices are on the rise, the insureds are strapped for cash to pay for their insurance. If they can't pay for it, they may choose not to purchase the policy or purchase less of it; neither of which are a good outcome for the insured or the agent.

Empowered with the ability to make decisions about your own finance company, as opposed to having terms dictated to you, your agency can fill an important gap in the sales process.

How Do You Get Started?

Every business has its minimums and premium financing is no different. The total amount of premiums that could be financed needs to be at a certain level to meet the startup and minimum ongoing costs of owning a premium finance company.

What that minimum is also depends on the total number of loans that would be financed in a given year. That interest rates that will be charged for each premium range are also very important.

These factors can help make the financial forecast much clearer in terms of understanding the return one can expect. Companies such as Input 1 can run a pro forma financial statement for you at no

cost, to help you in this process. Once a decision has been made to proceed, the first task to consider should be the acquisition of capital. Agents may be able to work with their local bank or lending institution or even have a servicing / software vendor like Input 1 introduce them to lending relationships that specialize in this niche market.

While you are securing your financing, you will want to start the licensing process. You will need to secure licenses in all the states in which you write business. While many states share basic licensing requirements, there are also states that have more complex requirements.

It is advisable to contact your legal counsel or a consultant to assist in the preparation of some or all the licenses you may require. Doing so will allow you to continue to concentrate on your business while your finance company is being formed. Third party premium finance administrators and software development firms typically offer licensing services in their suite of products.

The Benefits of Forming a Captive Finance Company are summarized in the table below:

Area Of Interest	Captive Premium Finance
Commissions	Earned up front as soon as the down payment is collected from the insured instead of over the life of the policy as the insured makes payments *(common with direct bill)*.
Increased Profits	Agency revenue equating to a 2-3% increase in commission per loan can be obtained via a captive premium finance operation.
Cash Flow for your Insured	You determine the billing terms on a case-by-case basis depending on the risk. You have 100% control in offering more flexible payment terms for your insureds.
Control	Costly cancellations and rewrites can be avoided by monitoring your accounts and offering flexible payment dates, terms or holds when needed.

The Pros and Cons of Outsourcing a Captive Premium Finance Company vs Licensing the Software and Running it In-House

Agents and managing general agents that become interested in the set-up and formation of a captive premium finance company must eventually make a critical choice in running their business: outsourcing their business to a third-party servicer for all of their servicing needs or licensing the necessary software and running the entire operation in-house. The business philosophy and future goals of the agency will have a great influence on this decision. Agents need to consider each option before making their choice.

The Choice to Outsource

Outsourcing is not unfamiliar territory for the insurance industry. Functions that are outsourced are areas not core to the expertise of a business For example, insurance carriers routinely outsource policy administration and billing so they can concentrate on pricing the risk and investing the premium dollars - their core competency.

Since financing premiums is typically not a core competency of an insurance agent, it is a good candidate for outsourcing. When set up properly, a wholly owned third-party finance company. Your staff will interface with your “virtual service center” (i.e., your outsourcing partner) who will run your business using your preset underwriting and servicing standards.

The framework of the business must start with a concise and detailed set of workflow procedures established by you and your outsourcing partner. These procedures should be determined by you but with your partner’s guidance and experience. A proper workflow process takes time to build and is constantly amended. The concept of establishing a workflow for a business sounds routine, but many new owners make the mistake of rushing into a business they know very little about which inevitably leads to problems.

A management-level discussion between you and the outsourcing partner should take place no less than monthly for the first 6 — 12 months. Many processes that you have established along the way should be carefully reviewed within the first few months to ensure they meet your objectives.

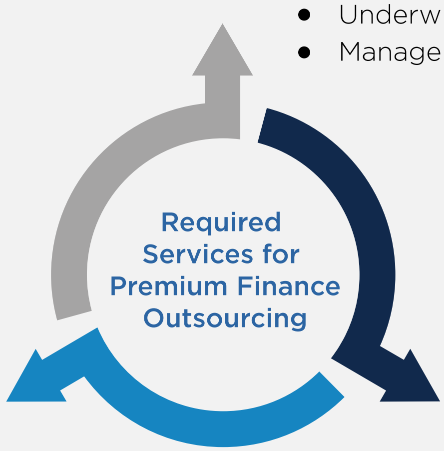
Last but not least, your outsourcing partner should provide you with abundant management-level reporting so that you can evaluate the results of your finance company. It's important to note that if you establish a line of credit with a lender, they will have very specific reporting requirements.

Make sure that you know what those requirements are and be certain that your provider can deliver.

At a minimum, here are some specific areas that should be provided by your outsourcing partner:

Customer Service

- Quoting
- Data Processing
- Underwriting
- Management Review



Accounting Services

- Payment Processing
- Billing
- Collections

Business Services

- Correspondence
- Reporting
- Notice Generation & Mailing

The Outsourcing Advantage

1 Vendor Expertise

The outsourcing provider has years of experience in providing this type of service to the industry. The partner can help you get started quickly and can offer you sound consultative ideas on how to run your business.

2 No Staffing Concerns

When you outsource, you don't need to staff up. Your outsourcing provider bears the overhead of maintaining a trained staff to run the business.

3 Variable Costs

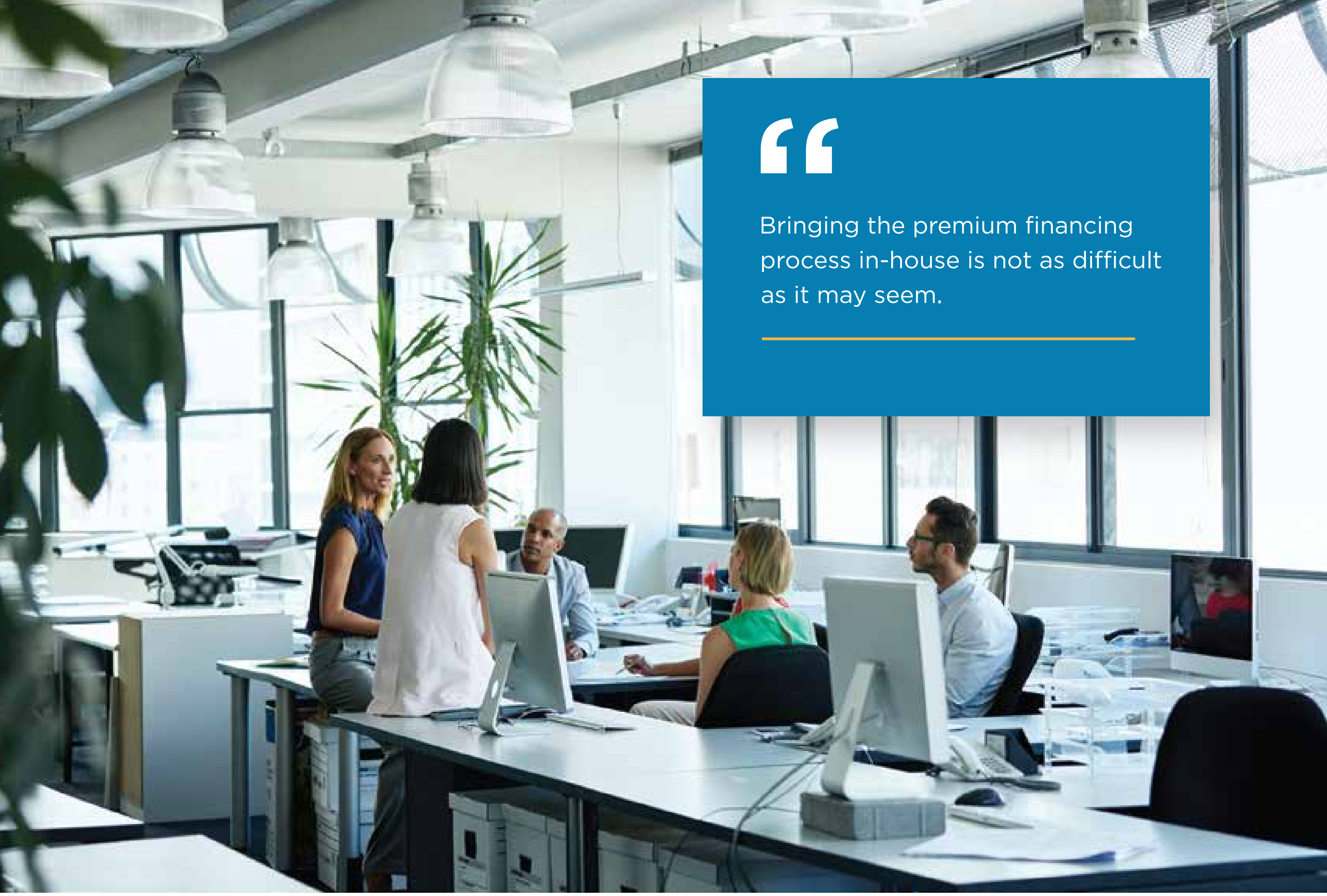
Your outsourcing provider should charge you a per loan administration fee each month for the production you generate. This way you pay based on volume.

4 No Equipment Needed

Outsourcing should mean no additional computers or office equipment of any kind. Your outsourcing partner should provide the technology you need to interface with and manage your finance company.

5 Technology

The right outsourcing provider should be able to offer you a myriad of other services to choose from, including internet-based quoting, account status and convenient online payment options that will enhance the experience your customers will have when doing business with your company.



> "Bringing the premium financing process in-house is not as difficult as it may seem.

The Choice to Run it Yourself

For a number of agency owners, the thought of outsourcing all or a piece of their organization is simply not an option.

Maybe your business philosophy is to handle everything in-house under one roof with your employees. Maybe you like the control. If this is the case, it's good to know that bringing this process in-house is not as difficult as it may seem.

An executive-level commitment is required by the agency principal to hire and maintain a staff to run your finance company. Depending on the volume of loans generated by your finance company, this can be a part-time, one-person shop or a 5-10 person staff dedicated to just your finance company.

For example, an agency financing 100 contracts a month would on average process five loans per day. One staff member using a software package from Input 1 should be able to quote, enter and process the entire loan in as little as 10 minutes - this comes to less than one hour a day. You must also consider the time needed to handle the customer service, payment processing, mailing, collections, accounting, banking, and other day-to-day tasks. For the example above, this should not add up to more than 2-3 additional hours per day.

With the right clientele and the right pricing (i.e., interest charges on the premium finance loans), it is quite conceivable that in as little as 6-9 months, you can create a revenue stream that will pay for your software investment.

One critical but often overlooked area in purchasing software is the technical support you will receive. The vendor should have a well-trained technical support staff that you can rely on. Does the vendor offer 24-hour emergency support? An experienced trainer / technician will be invaluable in helping you get off on the right foot. Nothing will frustrate you and your staff more than implementing a complex software solution without the guidance of professionals that use it.

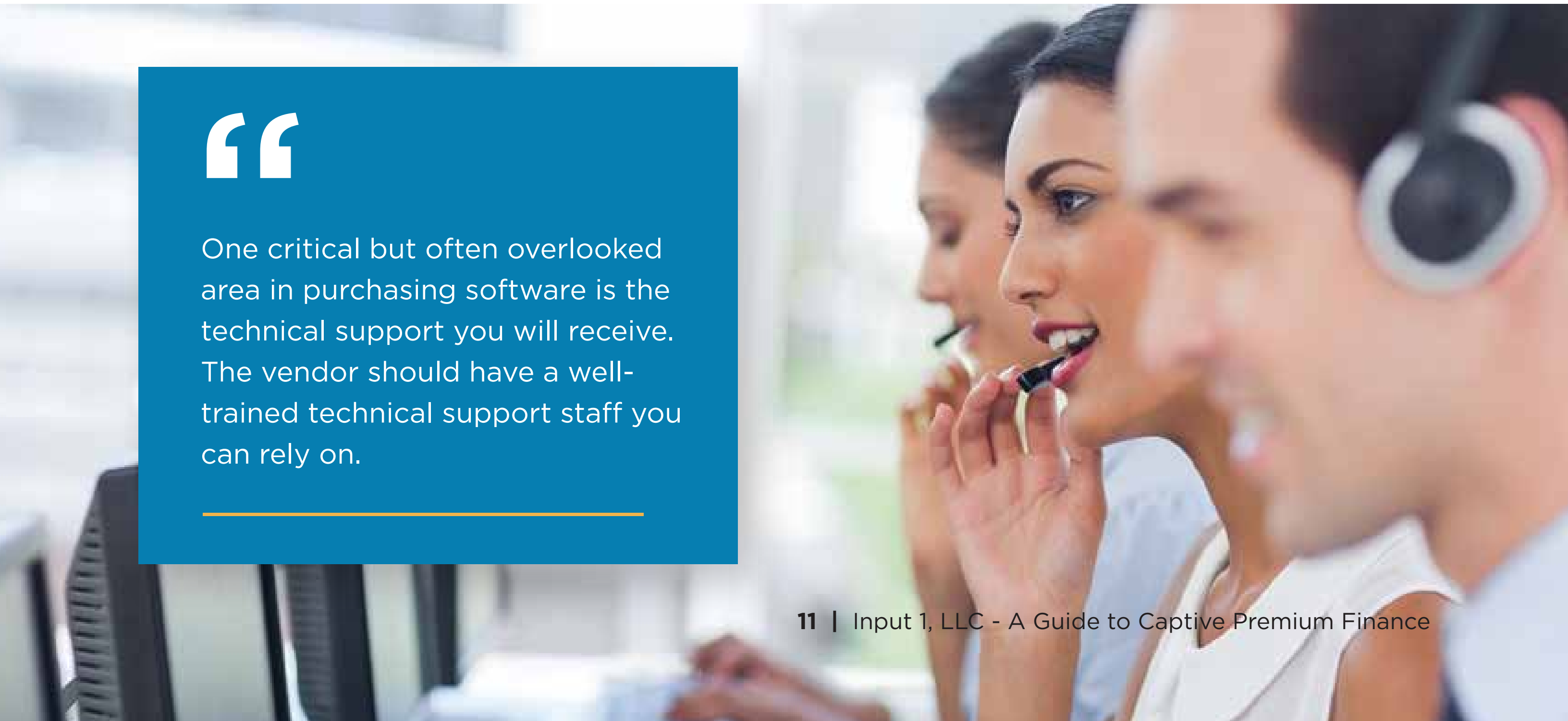
The Software License Advantage

CONTROL

If you need to touch and feel the operation and have it solely under your control, then this is the single most important factor in choosing to run the business yourself.

OVERHEAD EXPENSES IN PLACE

Depending on the type and volume of business, you may be able to absorb the staffing requirements of the finance company into your existing overhead. If you already have available resources to deploy towards this process, then additional expenses could be negligible.



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VENDOR EVALUATION

Make it a point to thoroughly research each vendor. Look for a track record of good relationships that can be proven by the vendor's existing clients. Ask for 5 referrals. It's not hard to make 1 or 2 customers happy so unless you speak to 4 or 5, you won't know enough about a vendor to make an informed decision. Once you get the referral list, you can decide how many calls to make.

Finally, unless it is cost prohibitive, ask to visit their offices so you can meet their management team and see their service center and their software in action and in person, before making a decision.

The Pitfalls One Can Avoid with Running a Captive Premium Finance Company

The decision has been made to form a captive premium finance company. The method by which you plan to run your operation has also been chosen — whether it be outsourcing to a third-party vendor or using software to run the operation in-house. Chances are your lending arrangement and state licensing are all in place as well. You're now ready to get started and you want to book your first loan. Before you open your doors for business, take a moment to consider some important factors in this new frontier of insurance premium financing.

Price and Terms

Building a sound game plan and understanding the components of your business are critical. The fundamental choice of the right interest rate, for example, is an important factor in determining your overall return. You want to make sure you charge an appropriate APR that will not only cover your borrowing costs, administrative overhead and other expenses, but one in which will allow you to make a healthy return on your investment.

The down payment and installment terms you offer will have an effect your overall return. For example, playing it safe and offering terms of 25% down payment and 9 installments on your business will keep you above water in most circumstances. In specific cases (i.e., certain coverage types or geographic regions), you may be able to offer a lower down payment. In other cases, you will want to require a higher down payment. The same is true for the number of installments — in some cases, 9 or even 10, installments are just fine. In others, 7 or 8 might be a more prudent decision.

Your outsourced service provider and/or lender should be able to provide you with a pro forma income statement that helps you determine what you should be offering and the resulting return you can expect for your business.

Types of Coverage and Policy Provisions

Believe it or not, one of the most important factors in accurately determining the down payment and number of installments for a loan involves a clear understanding of the provisions that exist for a particular policy. It would be nice if every policy you plan to finance had a 10-day cancellation, no minimum earned premium, no auditable provisions, and is earned on a pro-rata basis. As you probably already know, this is seldom the case. What you may not know is how these provisions can affect the financing.

For example, for a policy exhibiting a short rate return instead of pro-rata return, you are going to receive 5% less in unearned premium in the event of a cancellation. If you financed a $10,000 policy, this means that your finance company may be as much as $500.00 short on the loan balance. This difference ends up coming out of your pocket unless you're lucky enough to convince the insured that they need to pay this difference.

In California, for example, the state mandates a pro-rata return when a policy is written by an admitted carrier and financed by a California-licensed finance company. This is not the case in all states.

Other policies, such as Liquor Legal Liability and D&O, may in fact have provisions that make the policy either fully earned or have an accelerated earning provision, thus making any expected return of premium less than what you expect.

The effect of reduced unearned premium can eat into the profits of your company. There are other policy coverages you will want to become more familiar with as well and, as we've discussed before, you should consult with your vendor, because if they're worth their weight, they should be able to help give you sound advice and feedback in this area.

Carrier Insolvency

Although the risk of an insurance carrier becoming insolvent is very low, it is still a risk that must be considered. It is advisable to finance premiums with carriers that have strong financial ratings and size. This can be checked against A.M. Best or Standard and Poor's, the two most common carrier rating bureaus. Most commercial premium finance companies will only consider financing premiums if the insurance carrier has an A.M. Best rating of B+ (Very Good) or better and a financial size of at least V (capital, surplus and reserve funds between $10 and $25 million).

The standards you choose to set for your own company will depend upon your risk tolerance.

Know Your State Laws

So you're running along smoothly and financing a lot of business when you get a phone call from the state governing body that oversees financing for the state(s) in which you operate. The regulatory body(ies) will want to conduct an onsite audit of your operation (if you have outsourced the servicing, the audit is typically handled by the service provider). Ensuring that you have charged the correct interest rates, charged the corrent late fees, and sent back all refunds exactly as required by the statutes will keep the regulators at bay. Be sure to choose a vendor that has a solid understanding of the laws of those states in which you choose to operate. The software system used, whether you outsource it or keep it in-house, must comply with such items as maximum allowable interest rates, minimum and maximum late charges and when cancellation notices can be mailed to the borrower. However, it is your responsibility and money on the line, so take a little extra time to become familiar with the laws.

Summary

Any endeavor that offers a considerable upside potential for profit requires a solid understanding of the risks and the operational requirements of the business.

Captive premium financing is by no means risk-free, but you can greatly mitigate the risk by doing your homework on the vendor with whom you chose to work, the states in which you plan to finance business, and the type of business you plan to finance.

Captive premium finance companies have routinely provided their owners with a tremendous return on their initial investment. It is up to you to determine when you're ready to start earning the additional profits from the business for which you have already worked so hard and paid so much to bring in.

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Chris Farfaras joined Input 1, LLC in April 1999. Previous to joining the company, Chris held the position of Vice President of National Accounts for one of the nation's largest premium finance companies where he was responsible for developing and managing a brand new Western Division. Chris has been involved in selling and marketing premium financing since 1994. With a unique understanding of both the sales and operational aspects of a premium finance business, he has helped Input 1 achieve growth within all segments of its business. He's authored numerous articles on premium financing which have appeared in well-respected insurance trade publications.

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