F&I Participation Programs: A Look at the Options

By: Brian Feldman

Spencer Re's Brian Feldman examines the intricacies of reinsurance programs, including retros, CFCs and NCFCs.

There are many options for dealerships to participate in the profits (and losses) associated with the F&I business they produce. In our industry, we commonly refer to these programs as participation programs. While participation programs vary greatly by product, administrator and insurer, they generally can be classified into three categories: retrospective ("retro") programs, dealer- or producer-owned reinsurance companies (CFCs) and non-controlled foreign corporations (NCFCs).

How do you choose the best participation option for your customers? While there are many versions of these three main types of participation programs, their general characteristics hold true across the board. It is important for agents to understand these characteristics and key differences so that they are able to evaluate the options based on their customers' individual business needs.

Retrospective Programs

Commonly referred to as retro programs, these allow a dealer to participate in a portion of the underwriting profits associated with their business, along with a portion of the investment income. The participant's share of the underwriting is typically defined by a predetermined schedule that may or may not have volume levels and/or a loss ratio component. There may be additional factors that have an impact on the share amount. Investment income is typically also stated as a fixed amount.

Dealer- or Producer-Owned Reinsurance Companies

These participation programs are commonly referred to in our industry as CFCs. Simply put, the dealer or producer forms an offshore reinsurance company that makes both an 831(b) and 953(d) tax election. These companies will pay regular U.S. C-corporation tax on investment income generated. 831(b) companies are subject to a $1.2 million premium production cap.

In situations where the dealer or dealer group writes in excess of $1.2 million in premium, we sometimes see multiple 831(b) companies used to reinsure the business. While in some cases this may be acceptable, there are complex attribution and control group rules that need to be reviewed and followed. It is important to use a well-known and respected captive manager to ensure compliance with these and other items to avoid any potential problems.

Although they are an industry standard, a common objection to CFCs is that they offer little investment return potential, particularly in today's market. Traditional reinsurance programs use a very conservative investment approach. Many programs utilize money markets and fixed income securities as their investment vehicle. For some dealer participants, this extremely conservative approach is acceptable; for many others, it is not, and there is a need to seek a more lucrative option.

Non-Controlled Foreign Corporations

Commonly referred to as NCFCs, these are companies that reinsure risks and allow dealers and producers to participate in the offering by purchasing stock. The securities are typically private placement offerings that are exempt from securities registration. As such, they are only available to accredited investors as defined by the Securities Act of 1933.

NCFCs allow for tax deferral of underwriting and investment income. In addition, some NCFCs allow for annual or biannual distributions. The tax consequences of these distributions vary from company to company. In addition, a 1% federal excise tax applies to most NCFC transactions, unless exempt under a tax treaty.

Profit Potential and Income Generation

from a net potential perspective, retro programs offer the least amount of profit

sharing and investment income, and investment income is usually capped. Retros typically also have fixed schedules that define the payout, and sharing of the underwriting profit is typically less than 100%. In addition, penalties, payment delays and high fees are common. There is no beneficial tax treatment associated with this type of program. From a risk perspective, retro participants do not have any risk, as they have not put their own capital into the program. Should a retro perform poorly, the participant could lose the potential for future profits.

CFCs offer a higher income potential than retro programs. Typically, 100% of the premium is ceded to a CFC and the program earns 100% of the investment income. Insurers typically restrict the allowable investments so that they can take credit for the reinsurance on their statutory financials, and this can greatly reduce the potential for investment income. CFCs allow for tax deferral of underwriting profits but are taxed on investment income. CFC participants must form and capitalize a company, and a poorly performing CFC program could force the liquidation of the CFC and the loss of the initial capital along with accumulated surplus.

NCFCs offer the highest level of income potential among the three basic types. NCFC programs allow for tax deferral of both the underwriting profits and investment income. In addition, NCFCs are not subject to the $1.2 million premium cap as with CFCs. Most NCFCs have the ability to invest funds in a manner that can provide for a higher investment income than traditional reinsurance programs. This is due to the fact that they are not subject to the same investment restrictions as CFCs, allowing them to achieve superior returns. A poorly performing NCFC could cause the loss of the capital along with accumulated surplus. In addition to the loss of initial capital and accumulated surplus, participants in both CFCs and NCFCs could lose future income potential from the reinsured business should there be poor underwriting performance.

In Practice

A common misconception is the notion that NCFCs are only available to large dealerships and dealership groups. While each NCFC program is different, every dealer, regardless of size, should be able to utilize an NCFC. Let's consider a dealer producing $600,000 in net premium on an annual basis as our example. In most cases, an agent would not even consider an NCFC for this dealership. The dealer would use a CFC and earn a very minimal investment return that is then taxed. If they're lucky, the investment income offered by the CFC in this example will be enough to offset the company's annual operating expenses.

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Now let's take this same dealer and substitute an NCFC that allows participants to request dividends that are qualified for tax purposes. In 2014 alone, the dealer would have received approximately $30,000 in investment income after expenses. Keep in mind that the interest income earned compounds, and assuming the same premium levels and investment income return, this could lead to an investment income in excess of $60,000 in Year Two. Compare this to the CFC where investment income generated would most likely have been erased by taxes and operating expenses. If you were participating, which structure would you choose?

NCFCs Are Not a One-Size-Fits-All Solution

There are many NCFC programs available in the F&I marketplace with varying features. When looking at NCFCs, it is important to first understand the structure of the company. Some NCFCs are "closed" or "sponsored," meaning they only allow participants of a specific F&I administrator's program access to the NCFC. In other words, you will not be able to offer a closed NCFC to a dealer unless you represent that program. Other NCFCs are "open," meaning they allow multiple F&I providers access and have relationships with many different F&I providers.

In addition, NCFC features and benefits vary greatly. There are two main types of NCFC programs: dividend paying entities and tax deferral entities. Dividend paying entities typically provide annual dividends, which, out of most NCFCs, are considered ordinary income to the shareholder. On the other hand, tax deferral entities typically do not allow access to the profits until the stock is redeemed. Some NCFCs offer a combination of these two types of entities. This combined structure also allows for qualified dividends, meaning the dividend is taxed at the capital gains rate.

When evaluating an NCFC, it is also crucial to understand the company's investment plan and philosophy. Most NCFCs have unrestricted access to the premium dollar, and as such are not restricted as to how they invest their money on behalf of shareholders. It is extremely important to understand each NCFC's investment strategy, as bad investment decisions could cause premium dollars to be lost and significantly reduce the profits associated with the reinsured business.

Picking the Right Participation Program for Your Customer

With so many participation program options available, how do you determine the best option for your customers? Agents should be able to explain to their dealer customers the differences between each type of participation program in terms of cash flow, associated costs, tax consequences, investment strategy and how the distributions are handed. When evaluating the options, it is important for agents to understand their customers' wants, needs and appetite for risk.

Retro programs are the least lucrative as these programs almost always share less than 100% of the underwriting profits and investment income is capped. While CFCs are an industry standard, they offer little investment return potential, particularly in today's investment environment. NCFCs now offer options that were not available in the past and offer the highest income potential from both an investment income and tax perspective. If the potential for higher income with tax deferral is what the customer is looking for, then an NCFC is likely their best option. **AE**

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