kenneth mejia
LA CITY CONTROLLER



RISK FINANCING OPTIONS

FOR THE CITY OF LOS ANGELES

Risk Financing Options For the City of Los Angeles

Our Office recently conducted a performance audit of Citywide risk management practices between Fiscal Year (FY) 2020 and FY 2025. The primary objectives of the audit were to assess Citywide risk management processes, and determine the governance, strategic, and communication issues that hamper its effectiveness. We found several weaknesses in the City's risk management approach, including its longstanding strategy to directly pay large liability claims using the City's General Fund.

The vulnerabilities of this strategy were exposed in early FY 2025. Three months into the fiscal year, the City faced $258.6 million in reported liability payout commitments against a $107.4 million budget allocation. This unexpected deficit compounded an already challenging fiscal environment that had prompted the Prioritized Critical Hiring process and service reductions in the City beginning in February 2024. Without updates to its liability estimation and risk financing approach, the lack of depth in the City's self-funding strategy will continue to be a source of budget volatility whenever claim payouts are higher than expected.

During our audit, the CAO and City Attorney's Office issued a joint report in March 2026 that recognized the need to reconsider the City's self-insurance approach. In parallel, our audit described several alternative risk financing strategies that, if implemented, could provide the City with greater budget certainty, long-term cost savings, and other benefits. This white paper supplements our audit by providing additional information on alternative risk financing mechanisms for the City to consider. Specifically, we elaborate on:

- **Lengthy claim closure timelines**, especially for claims exceeding $1 million, which disproportionately impact the City's total liability spending;
- **Liability claim reserves**, and how they can provide a more stable funding structure that also generates some income to offset annual liability costs;
- **Coverage through insurance and risk-sharing pools**, and how a careful analysis of retention amounts, coverage limits, and other terms and conditions is essential for evaluating the cost-effectiveness of these options; and
- **Captive insurance companies**, which come with their own set of risks, but provide a sophisticated self-insurance option that can be tailored to meet the needs of the City.

We also highlight how some other jurisdictions utilize these risk financing mechanisms to provide management and policymakers with additional context as the City reassesses its current self-insurance program for liability claims.

As described in the audit, the City Attorney's Office did not cooperate with our Office and did not respond to our requests for claim data. Instead, we used liability payout data from the City's Financial Management System (FMS) for our analysis. Readers should note that while this data is sufficient for a general overview, a more granular analysis would benefit from reliable claim data, which, as the audit report discusses, appears to be a systemic challenge for the City Attorney's Office.

This white paper is intended solely for educational and general informational purposes, and does not present new findings or recommendations beyond the audit report. Because risk financing can be highly situational and complex, further exploration of these (and other) options would benefit from the specialized analysis and advice of subject matter experts. The City should also perform its own due diligence to ensure that it understands the advantages, disadvantages, and risks associated with different liability financing mechanisms.

Finally, the City should evaluate the risk financing mechanisms under consideration by balancing their short- and long-term costs and benefits against the broader context of the City's overall financial health. In alignment with our audit's findings and recommendations, the City Administrative Officer (CAO) should engage with the City's insurance broker and actuary, and other subject matter experts as needed, to reassess the City's self-insurance model, evaluate alternative funding strategies, and propose a formal risk financing strategy for review and adoption by the Mayor and Council.

Large Liability Claims Against Public Entities Can Take Many Years to Close

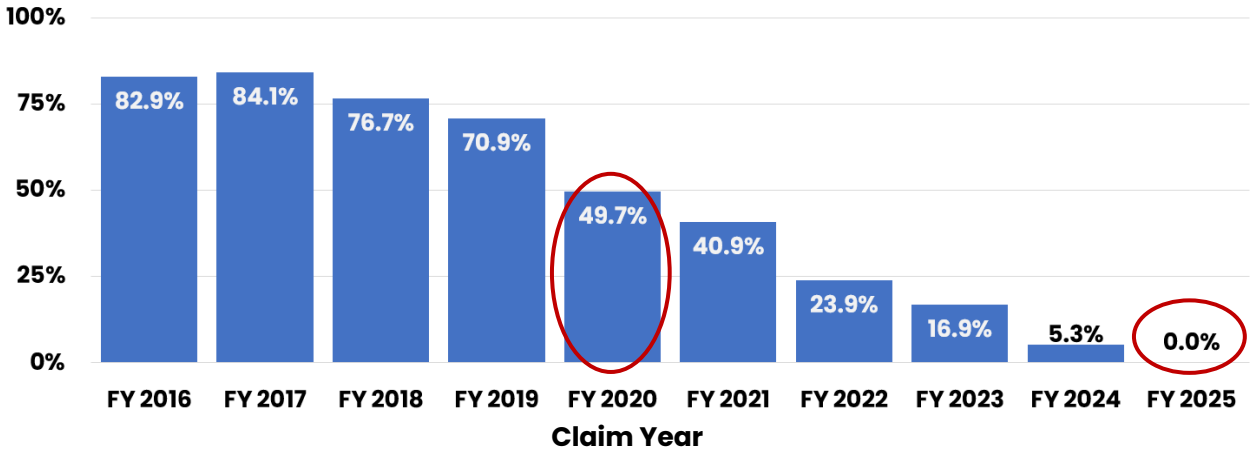
While timely claims resolution is essential, the process for investigating, evaluating, and settling liability claims can be lengthy, especially for high-value cases. This protracted claim adjustment process can result in long lead times between the date of the incident and the case's closure. The California Association of Joint Powers Authorities (CAJPA) estimates that, on average, it takes about 17 months to close a tort liability claim filed against a public entity. The average time to close increases to almost 6 years for large claims over $1 million.[1]

As a result, many claims from recent years remain open. CAJPA estimates that, as of June 30, 2025, about 44% of claims filed in FY 2025 against California public entities in its study have been closed. In addition, 97% of claims from FY 2020, five to six years before the study's cut-off date, were closed. However, this closure rate drops significantly for high-value claims (**Figure**

[1] For its April 6, 2026 update report, CAJPA partnered with Polco (a private data analysis company) to collect and analyze tort liability data valued as of 6/30/2025. This data reflects responses from over 1,500 public entities, including 86% of counties and 86% municipalities in the State, and hundreds of school districts and other agencies.

1). For example, no claims valued over $1 million from the FY 2025 claim year were closed, and only about 50% of these large cases from FY 2020 were resolved by the June 30, 2025 cutoff.

Figure 1. Closed, Million+ Dollar Liability Claims Against Public Entities, as of 6/30/2025



Source: Adopted from CAJPA's April 6, 2026 update report.

In general, the City of Los Angeles' experience with tort claims follows a similar time horizon. Using liability payout data from FY 2016 to FY 2025 obtained from FMS, we estimate that the average time to close out a case in the City (from the incident date to the date of the payout) is 2.1 years. However, the average closeout time generally increases with the value of the claim (**Table 1**). For larger liability claim payments over $1 million, the City took an average of 6 years to close these cases, which was consistent with CAJPA's findings.

Table 1 also shows that while high-value cases account for a relatively small number of payouts, their financial impact is disproportionate. From FY 2016 to FY 2025, payouts exceeding $100,000 represented just 8% of the count of payments, but equated to 88% of the total liability payout value.

(continues on the next page)

Table 1. Larger Claims Against the City Typically Take Longer to Pay Out

Payout Category	Average Time to Close a Claim (Years) [1]	Count of Payouts	Total Value of Payouts
Nuclear ($10M+) [2]	9.7	13 (0.1%)	$277,494,620 (17.5%)
Very Large (>$1M to $10M)	5.9	266 (1.5%)	$716,986,097 (45.1%)
Large (>$100k to $1M)	4.3	1,169 (6.6%)	$410,559,449 (25.8%)
Medium (>$50k to $100k)	3.5	690 (3.9%)	$57,148,793 (3.6%)
Small (>$10k to $50k)	2.6	3,417 (19.2%)	$94,780,156 (6.0%)
Very Small ($1-$10k)	1.6	12,247 (68.8%)	$33,603,869 (2.1%)
Total	**2.1**	**17,802 (100%)**	**$1,590,572,984 (100%)**

Sources: Analysis of liability payouts from the City's Financial Management System, from FY 2016 to FY 2025.

[1] The payments above include some claims with multiple payouts that may be spread across multiple years.

[2] "Nuclear" verdicts/settlements is a term from the insurance industry referring to payouts of more than $10 million.

As the City begins to reassess its self-insurance model, the CAO and policymakers may want to consider how the risk financing mechanisms they are evaluating can account for both the lengthy closure timelines typical of high-value cases, and their disproportionate impact on total spending.

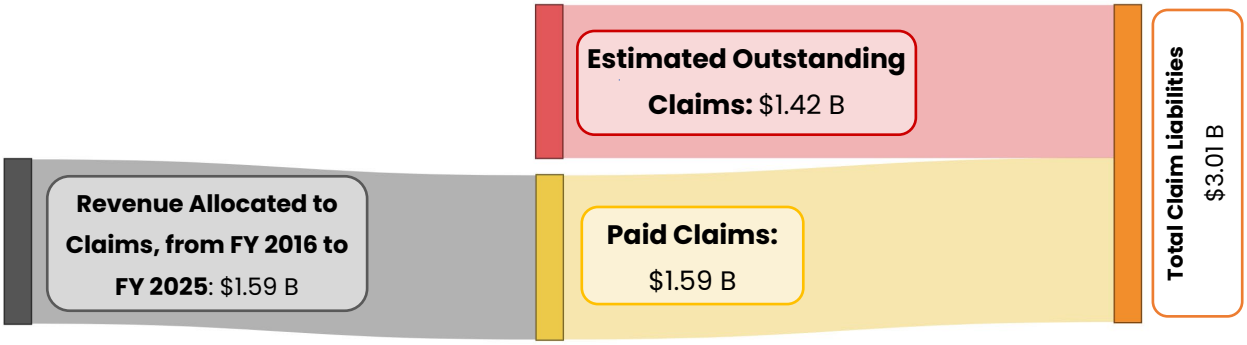
Dedicated Reserves for Liability Claims

If the City considers developing and adopting a policy to maintain a dedicated reserve for liability claims, the CAO and policymakers may want to consider how to determine the appropriate reserve level, and how investment income from those reserves could offset annual liability costs.

Determining Appropriate Reserve Level Targets

As discussed in the audit report and shown in **Figure 2**, the City does not set aside funding in a dedicated reserve for liability claims. Instead, claims are funded annually through the adopted budget and managed on a "pay-as-you-go" cash flow basis through the financial status reporting process. While the General Fund Reserve can be used for many competing priorities, there is no specific funding set aside for the City's estimated $1.4 billion tort liability.

Figure 2. The City Has Not Set Aside Reserves For $1.4 Billion In Outstanding Claims



Source: Analysis of liability payouts in FMS, and the City's Tort Liability Actuarial Study completed in March 2026.

Other jurisdictions maintain dedicated liability claim reserves. As a case develops and liability is determined, its estimated remaining cost to settle or resolve the claim (case reserve) tends to become clearer. However, the way in which case reserves translate into an actual reserve for future claim payments varies. As the examples in **Table 2** show, policy goals for liability claim reserve amounts can differ significantly by jurisdiction.

Table 2. Other Municipalities Have Adopted Policies for Liability Claim Reserves.

Municipality	Policy Language for Liability Claim Reserves
San Diego	"The City will maintain reserves equal to 50% of the value of outstanding public liability claims."
Irvine	"The City shall maintain reserves to fund its outstanding self-insured liabilities at a level of 70%."
Riverside	"The policy establishes a [50]% minimum funding level of the total combined current claims liability outstanding for the Self-Insurance Trust Funds…"
San Luis Obispo	"Within the Insurance Fund, a self-insured retention (SIR)…will be funded based on 150%…[of]…claims experience."
South Pasadena	"The city's goal is to maintain reserves to fund its outstanding self-insured liabilities at the minimum level of 70 percent."

Sources: Analysis of risk management policy documentation from various jurisdictions

Across many of the reserve policies from other jurisdictions we reviewed, one common factor was the use of actuarial studies to estimate outstanding claim liabilities. These studies typically rely on case reserve data for making their estimates, which are then used as the basis for determining reserve levels. Jurisdictions differed, however, in how they apply actuarial estimates over time.

Because liability estimates can fluctuate, some jurisdictions use smoothing methodologies to stabilize funding requirements. For example, the City of San Diego's policy stipulates that "a smoothing methodology using the annual actuarial liability valuations for the **three most recent fiscal years** will be used to determine the value of outstanding public liability claims for purposes of calculating the reserve level." Another example is the City of San Luis Obispo, whose self-insured retention amount is based on 150% of the **previous five-year average** claims experience, which includes claims paid, reserves for known claims, and administrative expenses.

Some of the policies we reviewed also established interim targets for their liability claim reserves. For entities starting with insufficient funding set aside for their liability claims, establishing intermediate goals can help the organization gradually build up towards the targeted policy level. One example is the City of Riverside, which adopted its reserve policy in November 2017, and set an initial funding target of 40% of total combined current claims liability effective June 30, 2018. Riverside's policy also established a goal to increase its reserve funding level to 50% of outstanding claim liabilities effective June 30, 2020.

Figure 3. San Diego's Policy Set Intermediate Funding Targets for Its Liability Reserve

Target Date	*Target %*
June 30, 2016	40%
June 30, 2017	43%
June 30, 2018	47%
June 30, 2019	50%

Source: Adapted from San Diego's Policy No. 100-20.

The City of San Diego's reserve policy follows a similar model, establishing the interim funding targets shown in **Figure 3**, which allowed the municipality to gradually reach its policy goal over four years. According to its FY 2025 annual comprehensive financial report, San Diego's reserve target for 50% of outstanding public liability claims was valued at $39.7 million, while its reserve sat at $38.4 million.

Finally, while establishing reserve goals is important, execution and monitoring are vital for implementation. Riverside's policy requires staff to monitor and report on reserve balances, and present a plan during the budget process to bring the balance above the minimum requirement within three fiscal years if balances fall below the 50% policy goal.

In compliance with their policy, Riverside staff reported in their annual financial review for FY 2026 that the reserve had a cash balance of about $34 million, which was sufficient to cover 48% of their long-term costs for both workers' compensation and general liability. Riverside staff also reported that they would present a plan to City Council to achieve compliance with the reserve policy as part of the 2026-2028 biennial budget.

Income Generated By Reserve Investments Could Offset Some Liability Claim Costs

One additional factor to consider is the income generated by creating, funding, and investing the reserve for liability claims. The City's General Fund Reserve (approximately $400 to $500 million) is currently invested by the Office of Finance as part of a general pool of funds valued at more than $16 billion as of June 30, 2026. A dedicated liability reserve would be invested similarly, benefiting from the pool's returns.

If the City of Los Angeles adopted a 50% reserve target like San Diego, it would have to set aside approximately $700 million (50% of $1.4 billion) to pay for these accrued claim liabilities in the future. Investing $700 million at the current general pool's yield of 3.37% (as of June 30, 2026) would generate about $23.6 million. These investment earnings could offset a portion of the City's annual liability costs. In FY 2026, this income would have paid for about 11% of the $213 million liability claim payouts for the year.

Liability Coverage Through Risk-Sharing Pools and Insurance

Following the legal reforms and challenging insurance markets of the 1960s and 1970s, risk-sharing pools emerged as a common solution to manage local government liability costs. For example, between PRISM and CJPIA alone, two of the largest risk-sharing pools in California, over 160 cities and 51 of the State's 58 counties obtain liability coverage.[2] Many smaller risk-sharing pools (including those mentioned in the CAO/City Attorney's joint March 2026 report) exist throughout the State and provide liability coverage to other cities.

Risk-sharing pools are a collective arrangement by a group of entities to share or "pool" their risks. Pools spread the financial impact of risk across the group, giving members an alternative way to insure against catastrophic losses. Within California's public sector, risk-sharing pools tend to operate as joint powers authorities, which are public entities formed by two or more public agencies through an agreement.

Although less common, some local governments purchase liability insurance independently, rather than participate in a risk-sharing pool. The examples shown in **Table 3** summarize and illustrate the wide range of liability coverage situations observed among local governments across the State.

[2] PRISM stands for the Public Risk Innovation, Solutions, and Management pool, while CJPIA is the California Joint Powers Insurance Authority pool.

Table 3. Liability Coverage Varies Significantly Across Local Governments

Local Government	Liability Coverage Mechanism	Self-Insured Retention	General Coverage Limits (Per Occurrence)
Los Angeles County	Insurance: across two policies	$20,000,000	$35,000,000
San Diego City	Risk-Sharing Pool: PRISM	$5,000,000	$50,000,000
Fresno City	Insurance: across four policies	$5,000,000	$25,000,000
Sacramento City	Risk-Sharing Pool: PRISM	$2,000,000	$40,000,000
Long Beach	Insurance: across three policies	$10,000,000	$40,000,000
Anaheim	Risk-Sharing Pool: ACCEL	$1,000,000	$60,000,000
Riverside City	Insurance: across three policies	$4,000,000	$25,000,000
Irvine	Risk-Sharing Pool: CIPA	$350,000	$38,000,000
Stockton	Risk-Sharing Pool: CJPRMA	$1,500,000	$40,000,000
West Covina	Risk-Sharing Pool: CJPIA	$1,000,000	$50,000,000
South Pasadena	Risk-Sharing Pool: PRISM	$250,000	$25,000,000

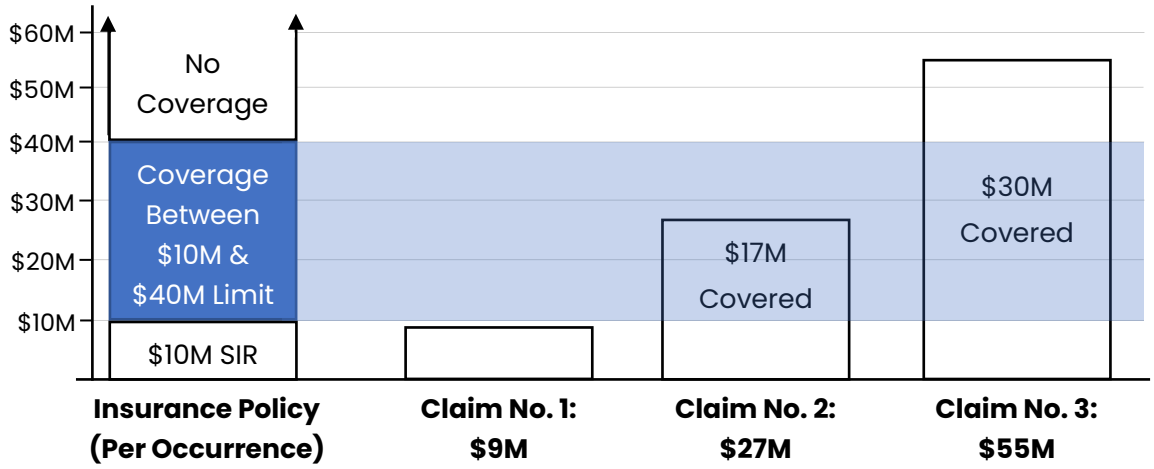
Sources: Analysis of risk financing and financial statement documentation from various jurisdictions

Note: Aggregate limits and other terms may apply, but are not shown in the table above. For example, Long Beach's combination of insurance policies reduces its self-insured retention to $5M for the first office-involved shooting claim, but its self-insured retention for law enforcement liability is otherwise at $10M.

The most common insurance structure we observed among local governments was excess coverage on a per occurrence basis. Under this model, the insured entity is still responsible for a self-insured retention (SIR) amount for each incident before insurance covers losses up to a set limit. **Figure 4** illustrates how a liability insurance policy with a $10 million SIR and a $40 million coverage limit might apply in different scenarios. Assuming there are no other limitations or exclusions, the coverage illustrated in the figure would apply only to the portion of the claim that fell within the coverage area.

(continues on the next page)

Figure 4. Coverage Applies Above the Self-Insured Retention (SIR) and Below the Limit



For example, the policyholder would be responsible for paying the entirety of the first claim in **Figure 4** because its $9 million settlement amount fell within the $10 million SIR. For the third claim in **Figure 4** that settled for $55 million, the insurer would only cover $30 million (the portion between $10 million and $40 million), while the policyholder would be responsible for the initial $10 million portion of the claim and the $15 million exceeding the coverage limit.

South Pasadena and Long Beach's Recent Experiences With Liability Insurance Coverage

Many sources we reviewed, some dating back to FY 2019, characterize the recent liability insurance market cycle as being in a "hard" phase. In general, a hard market is defined by higher insurance costs and more restrictive coverage. Because risk-sharing pools also purchase insurance to manage their collective liabilities, these rising costs have been felt across the public sector. Recent reports from South Pasadena and Long Beach highlight these market challenges.

Despite its small size, South Pasadena's liability coverage premiums have increased significantly. In April 2026, South Pasadena staff reported that their city's liability coverage premium with PRISM was expected to increase significantly for the upcoming renewal year, from about $1.1 million in FY 2026 to $2.2 million for FY 2027. In their report, they showed that the premium increase was part of longer term trend, where they paid about $642,000 in FY 2023 to an estimated $2.2 million for FY 2027, an increase of almost 250% over five years.

The magnitude of the proposed premium increase prompted South Pasadena staff to work with its insurance broker and risk management consultant to review actuarial estimates and the city's claims history. They also evaluated the potential impact of increasing the city's SIR amount with PRISM to mitigate costs.

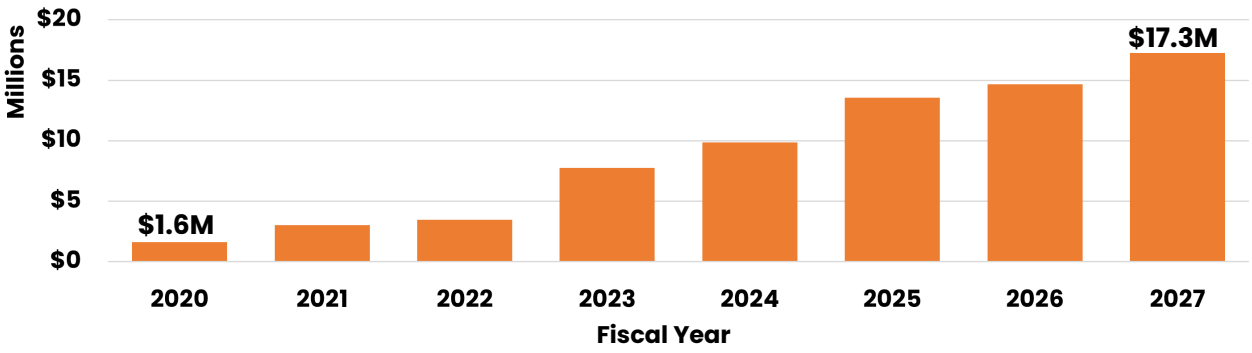
The result was a staff recommendation, adopted by their council, to increase South Pasadena's SIR from $100,000 to $250,000, and to place the expected premium savings of $456,000 into their Insurance Fund to earn additional interest income and cover their increased claim liabilities.

Similarly, Long Beach has also faced difficulties during the renewal process for purchasing commercially-available insurance. Long Beach staff have consistently warned about the hardening insurance market, which has caused carriers to:

- withdraw from the market altogether,
- reduce coverage limits,
- increase self-insurance retention amounts before coverage attaches,
- push for aggregate limits,
- restrict coverage through exclusionary language, and
- dramatically increase rates.

Indeed, as shown in **Figure 5**, Long Beach's total premiums for its various insurance policies for liability coverage have increased from $1.6M in FY 2020 to $17.3M in FY 2026.

Figure 5. Long Beach's Liability Insurance Premiums Jumped 975% Over Seven Years



Source: Analysis of Long Beach staff reports on insurance renewals.

Over that same period, Long Beach's SIR for its primary insurance policy doubled from $5 million to $10 million. At the same time, Long Beach has seen their coverage limit (per occurrence) change from $50 million to $30 million to $40 million. In response to the decreased coverage offered by their primary insurance policy, Long Beach has purchased additional supplemental policies to reduce their self-insured retention for both law enforcement and non-law enforcement liabilities.

Liability Coverage Analysis for the City of Los Angeles

For illustration purposes, we analyzed the City's liability payout data to determine what insurance payouts might have been if the City had purchased coverage from FY 2020 through FY 2025. Using the insurance policy described in **Figure 4** (similar to Long Beach's primary coverage) we determined how many liability payouts exceeded an SIR of $10 million and would have been covered by a $40 million limit. For comparison, we also modeled payouts using SIRs of $15 million and $20 million, with the $20 million level reflecting the start of Los Angeles County's liability insurance coverage.

Because the City Attorney's Office did not cooperate with our audit request for claim data, we used FMS payout data to reconstruct total payout amounts for each case paid from FY 2020 through FY 2025.[3] While sufficient for illustration purposes, this reconstruction should not be relied upon for the actual step of obtaining and evaluating different coverage options. If the City were to explore options from the insurance market or risk-sharing pools, it would likely be required to provide its claim history in order to receive accurate quotes.

As summarized in **Table 4**, our analysis shows that an insurance policy with a $10 million SIR and $40 million limit would have provided payouts worth about $139 million across 15 cases from FY 2020 to FY 2025. The City would have remained responsible for $887 million in payments, rather than $1.03 billion. To determine if such a policy is a prudent expense, the City should obtain a formal quote as part of its evaluation.

While Long Beach paid about $14 million in premiums for this type of coverage in FY 2027, it is not clear how cost-effective this option would be for the City of Los Angeles. As a city with roughly 8.5 times the population of Long Beach, a quote for Los Angeles would likely reflect both its larger size and its specific claim history.

To reduce the premium, the City could also explore more limited coverage by increasing the SIR or lowering the coverage limit. As shown in **Table 4**, increasing the SIR to $15 million or $20 million for the insurance policy reduces the number of covered claims and the total payout from the policy. Such policies would cost less but offer less financial protection.

[3] Liability payouts are processed as individual transactions in FMS, which for a case may involve multiple payments. A single case may, for example, require multiple payments distributed to various parties (such as co-claimants or different law firms), or have a settlement that structures payouts at different times. To accurately analyze insurance coverage thresholds, we aggregated these discrete transactions into a single, comprehensive total for cases that we believed were likely to exceed $10 million. We excluded data from FY 2016 through FY 2019 from this analysis, as tracking limitations in these records prevented us from reliably reconstructing full case totals for that period.

Table 4. Analysis of Claim Payouts Under Different Liability Insurance Policy Scenarios

Number of Claims and Total Payouts	Fully Self-Insured	Insurance with $40 M Coverage Limit		
		$10M SIR	$15M SIR	$20M SIR
Number of Claims (City)	10,000+	10,000+	10,000+	10,000+
Total Payout (City)	$1.03 Billion	$887 M	$944 M	$977 M
Number of Claims (Policy)	N/A	15	8	5
Total Payout (Policy)	N/A	$139 M	$82 M	$49 M

Source: Analysis of liability payouts from the City's Financial Management System, from FY 2020 to FY 2025.

If the City chooses to explore liability coverage options, the CAO and policymakers should work with its insurance broker and actuary to determine the appropriate type and amount of coverage to obtain. In addition, the CAO and policymakers may want to consider how different retention amounts, coverage limits, and exclusions or other terms impact the premium charged by different insurance carriers.

Additional Considerations While Exploring Liability Insurance Coverage

Risk-sharing pools tend to market themselves as a more cost-effective coverage option for a number of reasons. As joint powers authorities, rather than commercial enterprises, risk-sharing pools are not profit-driven. Their membership consists of other public entities that, to varying degrees, face similar responsibilities and cost-pressures as the City of Los Angeles. In addition, the collective purchasing power of multiple public entities could result in lower costs when compared to individual insurance procurements.

While risk-sharing pools may be more cost-effective, membership often involves additional terms and conditions that the City should keep in mind as it is exploring its options. For example, members that participate in CJPIA's primarily liability program, which provides first-dollar coverage with no deductibles or member-retained limits, must transfer their claim settlement authority to the risk-sharing pool, who then retains ultimate settlement authority for that member's claims.

Even in pools with liability programs that allow members to retain the authority to administer and settle their own claims, cases that impact the pool require the pool's authorization to settle. As discussed in the audit report, it is also common for risk-sharing pools to conduct claim audits of its members that handle their own claims. Members may also be required to follow certain claim data standards and report their claims periodically.

Assuming that the City of Los Angeles can obtain several quotes, determining whether risk-sharing pools are more cost-effective than commercially-available insurance policies requires a thorough comparison of pricing alongside an evaluation of each option's terms, conditions, and additional services.

Captive Insurance Company

Another option the City could consider is establishing or participating in a captive insurance company. As a form of self-insurance, a captive insurance company is created to serve the risk financing needs of a parent organization or group of participants. According to the Self-Insurance Institute of America, a trade association for the self-insurance/captive industry, thousands of companies throughout the country utilize a captive insurance company as part of their corporate risk management strategy.

The City already has experience with establishing and using separate legal entities for specialized financing purposes. Formed as a nonprofit corporation in 1984, the Municipal Improvement Corporation of Los Angeles (MICLA) assists the City in financing capital projects and equipment acquisitions for the benefit of City residents. Establishing a captive insurance company would follow a structurally similar path to MICLA, but would be dedicated to risk financing rather than capital asset financing.

The use of captive insurance companies has also become more common across the public sector. Notable examples include:

- the University of California, which established "Fiat Lux" in 2012, the first of what are now four licensed and regulated captive insurance companies owned by the university;
- PRISM, which established and incorporated its captive insurance company, Affiliate Risk Captive (ARC), in 2016; and
- the Los Angeles Unified School District (LAUSD) Insurance Company, LLC, which the district's Board of Education authorized in 2024.

These public sector entities established their own insurance companies to take advantage of the following benefits that we discuss further in this white paper: (1) reduced costs for coverage, (2) increased control over insurance, and (3) Increased investment income.

Reducing Costs For Insurance Coverage

The Self-Insurance Institute of America's publication on "Managing the Cost of Corporate Risk Through Captive Insurance Solutions" advises that a captive can reduce insurance costs by:

- **Providing direct access to reinsurance markets**: as the provider of insurance for insurance companies, reinsurers typically have lower operating costs, and may be able to provide coverage that more closely matches the needs of the captive owner.
- **Capturing insurance profits**: through retaining a portion of its risk and reaping the benefits of any underwriting and investment income that would otherwise go to traditional insurance companies.

The University of California (UC) appears to have leveraged its captive insurance company to take advantage of these benefits. In a January 2017 update to its Board of Regents, the university system's Office of the President reported that "Fiat Lux…allows the UC the ability to capture underwriting profits and corresponding investment income that would normally be retained by traditional insurance companies."

In addition, the Office of the President noted that it also uses Fiat Lux to purchase "a majority of the insurance to cover the University's risks systemwide. Where in the past UC purchased this insurance 'retail' through brokers, now Fiat Lux purchases reinsurance directly from the markets (wholesale). This increases UC's capacity and reduces its expense."

As part of the City's reevaluation of its self-insurance program, the CAO and policymakers may want to consider evaluating the cost of purchasing commercial insurance policies against the overall cost of establishing a captive insurance company to serve as a vehicle for purchasing reinsurance.

Using Captives to Increase Control Over Insurance Arrangements

Another potential benefit is the control a captive offers to meet the risk management needs of its owners. The Self-Insurance Institute of America notes that captives can offer:

- **Better availability** by providing coverage when commercial insurance will not provide certain types of insurance, or may charge unreasonably high premiums, and
- **More flexibility** than commercial insurers in the type of coverage it provides.

As discussed in the audit report, this degree of control appears to be a key factor in LAUSD's decision to establish its own captive. After its founding in June 2024, the district's captive expanded from insuring general liability and workers compensation to covering property damage as of January 1, 2025, although wildfire damage remains excluded.

LAUSD is also considering expanding the captive's scope. According to an article featuring LAUSD's deputy chief risk officer, the district is studying whether to move employee benefits, cyber insurance, and sexual molestation and abuse coverage into the captive, though the latter remains particularly difficult to insure.

Should the City consider establishing its own captive, it should carefully evaluate the control and flexibility this mechanism offers. As noted in the audit report, a captive could be used to self-insure liability risks, while tailoring policies to target specific exposures, such as vehicle accidents.

Moreover, a captive could also be used by the City to internalize costs by issuing targeted insurance policies and charging departments directly. For example, the City could bill LAPD directly for its specific law enforcement liability exposures. Much like the sexual abuse and molestation coverage being navigated by LAUSD, law enforcement liability appears to be difficult or expensive to cover in the commercial insurance market, making captives a potential alternative for managing these costs.

Increased Investment Income

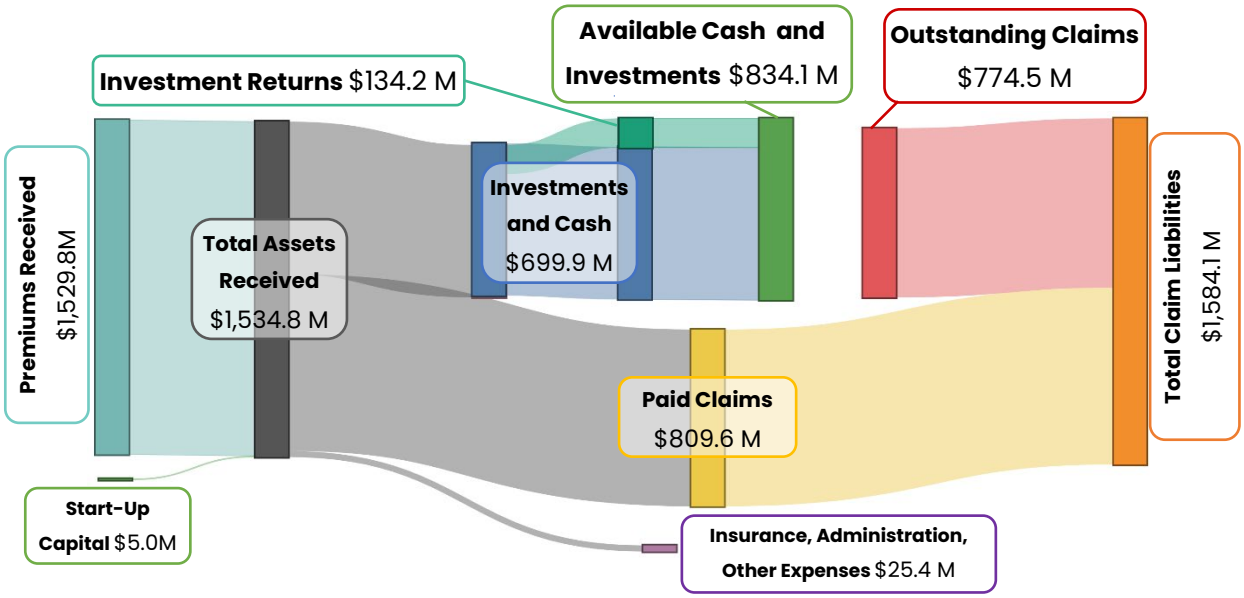
Because State law regulates local government investments, they are generally restricted to lower-risk instruments with a maximum maturity of five years. These restrictions apply to the City's general investment pool, which is how the General Fund Reserve and other fund balances are invested. Consequently, investment returns have typically ranged from 1% to 3% over the last 10 years, as the City prioritizes safety of capital and liquidity over income.

The State's investment regulations also apply to risk-sharing pools because they are joint powers authorities formed by other governmental entities. Therefore, while risk-sharing pools provide insurance-like coverage to local government entities, they are not allowed to invest their members' premiums in equities and other investments that offer a greater potential for higher returns. In contrast, commercial insurance companies can make these investments, which generally contribute significantly to their profitability.

To "provide a better rate of return on investments by matching [its] long-term liabilities…with a more diversified portfolio of investments than what is afforded in the California regulatory framework", PRISM established Affiliate Risk Captive (ARC) in June 2016. Over the following nine years, ARC received over $1.5 billion in insurance premiums from PRISM, and used these assets to pay for its operations and claims (**Figure 6**).

Importantly, PRISM ARC invested its remaining assets while waiting for claims to mature. By the end of FY 2025, the market value of PRISM ARC's available cash and investments ($834.1 million) exceeded that of its actuarially-estimated outstanding claim liabilities, despite collecting less in premiums than the value of its outstanding and paid claims (**Figure 6**).

Figure 6. Investment Income Reduces Member Premiums Required To Pay For Claims



Source: Analysis of PRISM ARC's Annual Cash Flow Statements for FY 2017 through FY 2025.

The benefit of establishing PRISM's captive insurance company can also be seen by comparing investment returns over time. As shown in **Table 5**, PRISM ARC's investments achieved a higher rate of return than both PRISM and the City's general investment pool.

Table 5. PRISM ARC's Returns Exceeded PRISM's and the City's General Investment Pool

Investment Pool	Investment Period	Annualized Return Rate
The City's General Investment Pool*	7/1/2016 to 6/30/2026	1.77%
PRISM Investment Pool	7/1/2016 to 6/30/2026	2.03%
PRISM ARC Investment Pool**	9/1/2016 to 6/30/2026	4.09%

Source: Analysis of investment reports for the entities listed in the table.

*Yield may be a more appropriate measure of performance for the City's general investment pool.

**PRISM ARC's investments began on 9/1/2016, shortly after the captive insurance company was established.

While **Table 5** shows that PRISM ARC's overall annual rate of return was 4.09% since its inception, investment returns can vary significantly from year to year. For example, the total rate of return for PRISM ARC's investments in FY 2026 was 6.18%. If the City had a liability claim reserve of $700 million invested through a captive insurance company with similar performance, that reserve could have earned about $43.3 million in FY 2026, income which could have been used to offset even more of the cost of liability claims.

Potential Disadvantages and Risks of a Captive Insurance Company

While captive insurance companies can offer several benefits, they are not without risks. Depending on the City's intended use and fiscal situation, there are a number of potential risks and disadvantages that should be considered, including:

- **Added Complexity**: as a licensed entity, captive insurance companies are subject to many regulations and requirements that can vary depending on which state or country the entity is domiciled. The City would need to hire, oversee, and work with the captive's management company, investment manager, actuary, and other vendors to comply with financial and licensing requirements, and ensure that actual results follow the captive's business plan and accomplish its intended objectives.
- **Capitalization Costs and Funding Risk**: establishing a captive requires an initial capital contribution. Furthermore, underperforming investments or adverse claims activity could require additional funding in some years to strengthen the captive's finances. The City must balance this against investing in infrastructure repairs, training, and other risk management initiatives to reduce the frequency and severity of liability claims. Additionally, the City would need to consider the potential conflicts and public sensitivity surrounding the allocation of public revenues to equity markets.

PRISM ARC's experience provides a case study in the funding risks facing owners of captive insurance companies. In FY 2022, PRISM ARC recognized investment losses of $48.6 million, which, according to its annual financial statements, "was the result of volatility in the equities market, coupled with rising interest rates in the bond market."[4] In addition, these losses coincided with worse than expected development in claims from prior years, which resulted in a large decrease in the captive's net position.

To address this decrease in value of the captive's investments, PRISM made an additional capital contribution of $3.5 million to ARC on June 30, 2022. After financial markets and interest rates stabilized and its investment portfolio recovered, ARC was able to return the additional capital contribution of $3.5 million to PRISM.

While PRISM ARC was able to weather the situation described above, past performance is not indicative of future results, and there may be future market downturns or other scenarios that could create worse financial situations. If the City considers establishing or participating in a captive, it should engage professional advisors to thoroughly vet and understand these risks.

[4] Broad market indexes (i.e. the DJIA, S&P 500, and NASDAQ) fell between 11% and 21% during this same period.

To create a captive insurance company, the Self-Insurance Institute of America outlines several important steps, starting with a feasibility study and business plan. In addition to being a fundamental document used by the licensing state to assess the captive's future viability, the Self-Insurance Institute of America also advises that the feasibility study/business plan should be treated as a "dynamic document that is the mechanism used to explore, validate, and refine the approach" for the captive.

The remaining steps include choosing a state or country to domicile the captive, choosing vendor partners to operate the insurance company (including attorneys, accountants, actuaries, investment managers, and program managers), and navigating the licensing process. Given the highly technical and complex nature of these tasks, the City should work with the appropriate subject matter experts if it chooses to pursue this path.

Conclusion

As the City begins to reassess its current self-insurance model, the CAO and policymakers may want to consider how other jurisdictions have implemented dedicated liability reserves, participated in risk-sharing pools or buy commercial insurance policies, and the feasibility of establishing a captive insurance company. By adopting a more formal, proactive risk financing strategy, the City can better manage the financial impact of long-term liabilities and explore options for long-term savings.

Acknowledgements

Audit Services Division

The Office of the Controller was created by the Los Angeles City Charter as an independent office, and is headed by the Controller: the elected auditor, paymaster, and chief accounting officer for the City of Los Angeles. Under the Controller's leadership, the Office's Audit Services Division performs audits, investigations, and other oversight functions to help provide transparency, accountability, and improve City services for all Angelenos.

Audit Team

Michael Bauer, Staff Auditor
Oswin Chan, Project Lead
Nicholas Ketter, Project Supervisor
Devang Panchal, Director of Auditing

Contact

Phone: 213.978.7200
Email: controller.mejia@lacity.org
Website: https://controller.lacity.gov/

Copies of our audit reports are available at https://controller.lacity.gov/audits