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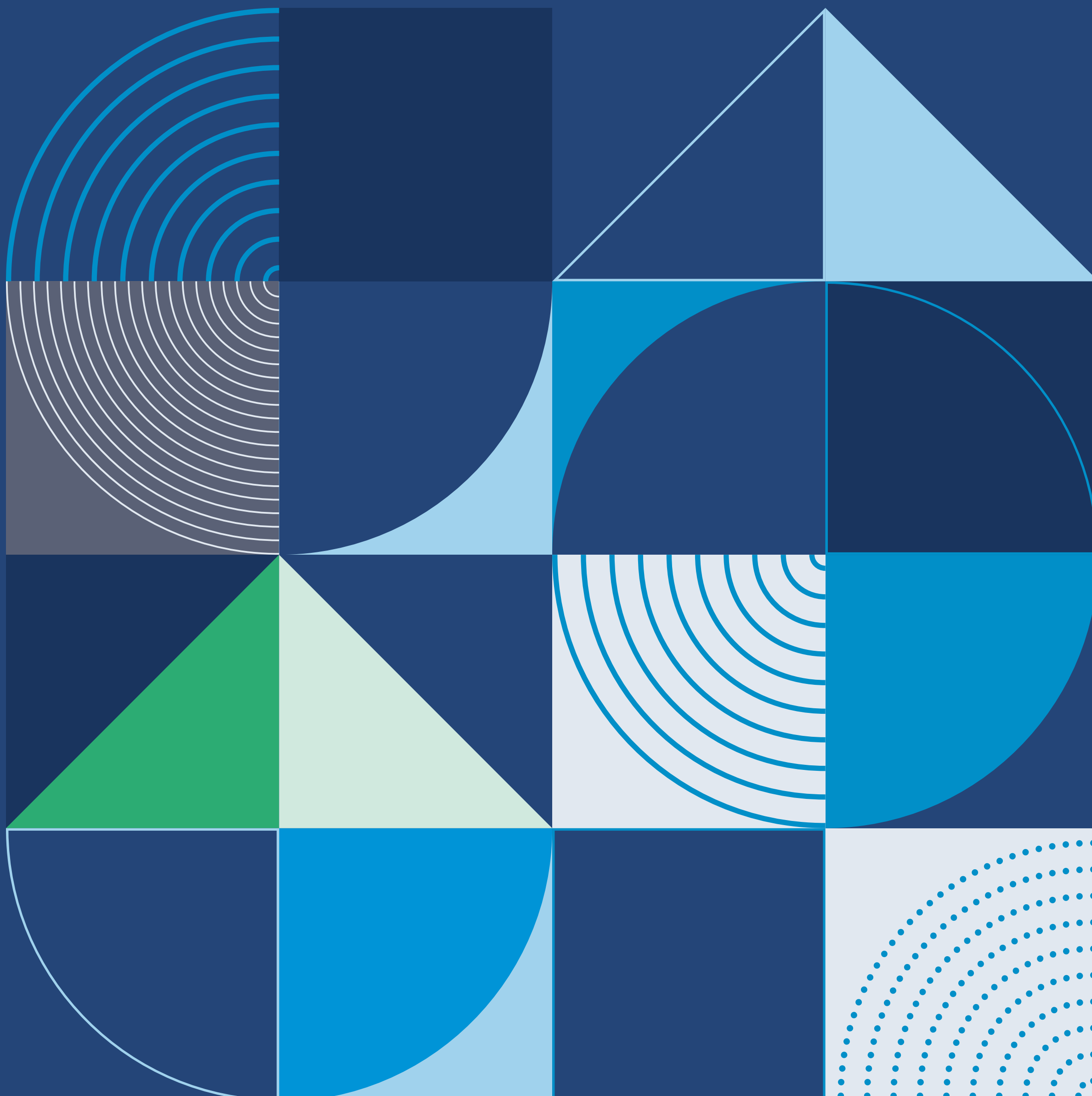

Basics of captive insurance companies:

an alternative risk financing tool

For almost 20 years, risk managers have enjoyed a soft insurance market where transferring risk to the insurance market through traditional insurance was inexpensive. In this low rate environment, many insureds chose to insure below their risk bearing capacity, as insurance was an efficient spend and use of capital. While captive insurance company usage was active during the soft market, widespread interest in captives is most prevalent during a hard market.

In today's hardening insurance market, there is no shortage of news about captive insurance companies and their ability to subsidize or even replace traditional insurance. Many articles assume the reader has a basic understanding of captive insurance company utilization and operation, but that is not always the case. In this paper, we take a step back and explain some of the basics of captives.

A captive is not a silver finance bullet that allows a company to avoid the financial impact of self-insured losses or smooth loss volatility over multiple years. Forming a captive does deliver certain benefits to an organization, but it also comes with some costs. Determining whether a captive makes sense for a particular company is clearly not a one-size-fits-all analysis. The answer to that question is, "it depends."

A captive insurance company – defined

THE BASICS: The National Association of Insurance Commissioners (NAIC) defines a captive as an insurance company created and wholly owned by one or more non-insurance companies to insure the risks of its owner. Essentially, captives are a form of self-insurance whereby the insurer, or the captive, is owned wholly by the insured.

A captive is typically established to meet the risk management needs of its owner. The general context is that a captive is wholly owned by the insured; provides coverage and support for the risks associated with its owner; and allows the owner to take advantage of certain financial aspects of the underwriting and insurance process.

Recently, there has been no shortage of discussion regarding captive insurance companies; yet, the concept is not new to the industry. The first active captive insurance company in the United States was started in Ohio by Fred Reiss who founded Steel Insurance Company of America in 1953. Reiss drew the term "captive" from the steel company's captive mines that were sending ore back to the company's mills. By 1960, there were more than 100 captive insurance companies operating in the U.S., providing insurance that was commercially unattainable or purchasing supplemental insurance to round out an existing coverage portfolio, according to The CPA Journal of December, 2018.

The entities forming captives range from major multi-national corporations to non-profit and public entity organizations. Once deployed, the captive largely operates like any commercial insurance company and is subject to state regulatory requirements for reporting, capitalization, and reserves.

There are several types of captives. The most common type is the pure or single parent captive that is owned by an individual company. Other options are an association or group captive that is owned by several firms, and a cell captive that operates independent, segregated cells, often referred to as a protected cell captive or rent-a-captive. There are advantages and disadvantages to each type, and the determination of the right type to utilize is dependent on a company's unique attributes.

DIGGING DEEPER - HOW DOES A CAPTIVE WORK: A captive is a tool available to the risk professional to evaluate a company's program risk and help determine the most effective and efficient means of financing those risks. The company may elect to self-insure the risk outside the captive; buy traditional insurance; or "insure" the risk through the captive, either in the form of direct insurance or reinsurance. If pure self-insurance is selected, there is no premium paid and no transfer of risk. If traditional insurance is selected, premium is paid to the insurer and the risk of loss is transferred to the insurer. If captive utilization is selected, premium is paid to the captive insurance company and the risk of loss is transferred to the captive.

One good question often posed is how paying premium and transferring risk to a subsidiary produces a different result than just purely self-insuring the risk. Because the captive is a subsidiary of the parent company, its financials flow to the parent upon consolidation, meaning the revenue and losses of the captive become revenue and losses of the parent. However, as discussed below, there are financial and operational advantages that may inure to the parent company that owns the captive.

From a monetary perspective, the basic tenets of a captive are the following:

- The parent company or captive owner provides the initial capital funding necessary to establish the captive.
- Before underwriting a specific risk, the captive will evaluate projected losses and determine if there is sufficient financial strength in the captive to cover the losses. The risks assumed or exposure financed are key determinants of the financial assets required to insure the risk. For this reason, captives typically cover more predictable or "working layer" losses and leave catastrophic exposure to larger traditional insurers and reinsurers capable of spreading the risk across a larger portfolio of insureds.
- The captive's insureds (generally subsidiaries of the parent company) pay premiums to the captive that are used to fund losses.
- In exchange for the premium, the captive issues a policy of insurance to the subsidiaries or insureds, covering certain losses as with traditional insurance.
- In the event of a covered loss, the captive is obligated to pay the loss to the respective subsidiary or insured, thus impacting the captives financials.
- The parent company, through consolidation of financials, ultimately absorbs any profits or losses generated by the captive.

IS A CAPTIVE "RIGHT" FOR EVERY COMPANY

There are many considerations for utilizing a captive, including these common goals:

- addressing difficulty in obtaining traditional insurance
- taking advantage of a favorable regulatory environment
- securing lower expenses than purchasing traditional commercial insurance
- providing access to reinsurance otherwise unavailable to the parent company
- creating a source of profit through third party business
- accumulating cash to replace or repair in the event of a loss
- securing tax advantaged premiums

Two companies, similarly situated, may legitimately reach a different conclusion on whether a captive makes sense. A company must have clarity to what it is primarily seeking to solve. It should also consider alternatives to captives, such as self-insuring the risk. For example, if a company's goal is to accumulate cash in the captive to be used in the event of a loss, considerable analysis should be given to alternative methods that do not require the regulatory oversight that comes with a captive.

Regardless of the reasons for considering use of a captive, the establishment and operation of a captive is a serious undertaking and involves a long-term commitment.

CAPTIVE ADVANTAGES AND BENEFITS

There are several options for structure and design that can be applied to captives. For example, a captive can reinsure traditional lines such as workers' compensation, general liability, auto liability, professional liability, and property exposures. Structure and design rely primarily on projected losses and exposures and an appetite for managing losses that may involve payments for many years after the incident occurred.

When considering the advantages and benefits for utilizing a captive, owners should consider:

1. **Control:** Control is one of the most powerful and important benefits of using a captive. In situations where self-insurance is not an option (such as when a business partner requires a policy of insurance as a condition of doing business), utilizing a captive gives the parent company another option to traditional insurance which may not be priced commensurate with the parent's risk level. In those situations – and particularly with low severity/high frequency, actuarily determinable losses – the risk may be transferred to the captive, allowing the parent to benefit from the lower overall cost. In a captive, the control element increases in accord with the captive's assets and longer-term design strategy. The larger the captive's loss reserves, the greater its ability to potentially control the cost of risk over time. Additionally, a company may see a more immediate benefit for its investment in loss control or safety rather than waiting several policy periods for that benefit as is typical with traditional insurance purchases.

2. **Access to reinsurance:** Primary insurers are engaged in underwriting which provides them direct access to reinsurers. Likewise, a captive holds the status of a primary insurer and therefore has access to the reinsurance market for its risk financing. It is important to differentiate between excess insurance and reinsurance. While there are many structural differences between excess insurance and reinsurance, the parent company purchases excess insurance where the captive itself purchases reinsurance.

3. **Investment income:** Usually an organization can earn investment returns only on funds it controls. In a wholly owned captive, the owner controls the loss funds, within certain limitations, until they are expensed as losses. Thus, for long-tail losses placed in the captive rather than with traditional insurance, the parent will benefit from the investment income on the loss reserves prior to the assets being utilized to fund the loss.

4. **Insurance accounting and premium tax deductibility:** Insurance companies and most captives enjoy specific tax advantages not available to non-insurance entities. While tax benefits may exist, tax is not generally a primary reason for captive formation. Organizations should consult with tax professionals in evaluating such matters.

5. **Enhanced loss prevention:** In the absence of loss prevention and safety activities, a captive or any other formal risk financing program will not succeed. Utilizing a captive may provide a better framework and infrastructure to invest in loss prevention, by tying safety records directly to premiums charged. Establishing and maintaining quality loss prevention standards and processes will pay dividends in the long-run and are critical to prudent risk management.

6. **Premium and loss allocation:** Captives, especially the single parent variety, can be effective tools to consolidate and manage the administrative side of financing risk. Allocation systems enable accountability for a loss to be appropriately assigned and distributed. In so doing, the desired operational behaviors of risk and internal control are more likely achieved. This is particularly true with foreign risks where accounting and tax rules can complicate a company's efforts to leverage its corporate financial strength and allocate losses.

7. **Rate/loss disparity:** A challenge to traditional insurance is when an organization pays insurance premiums based on its industry's collective loss experience even though the organization's loss experience is far better than that of the industry. To circumvent this, the risk manager might consider retaining significantly more risk, and a captive is a common way to do so.

Every risk financing alternative has benefits and risks. The key to successful risk financing, especially with captives, is to accurately compare the expected benefits with the riskiest elements that would apply to each potential owner. A prospective owner must be prepared to make an informed decision regarding whether and how an organization should pursue this new path as doing so is ideally a long-term commitment, not easily unwound.

Additional considerations

Identifying company goals: Before investing in a feasibility study, the company should identify the goals for the captive. It is important to understand what the company is trying to achieve or solve by establishing a captive. Consider the captive benefits listed above and identify what success looks like. Validate these goals with internal stakeholders, particularly senior finance management of the parent company. While the original interest and motivation may be insurance premium expense control or addressing the unavailability of traditional insurance, other reasons may be key motivators for many owners.

Actuarial analysis: An actuarial analysis of the claims history for the risks to be covered by the captive is an important step in evaluating the utility of a captive. This analysis will provide insight into the exposure trends, premium levels, projected costs, and reinsurance needs of the captive and help define the extent to which the proposed solution can deliver the targeted outcomes. The actuarial analysis may be part of a more formal feasibility study or may be conducted as a preliminary step before investing in the actual study.

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While an actuarially certified analysis may not be needed during the early phase of captive consideration, data integrity is essential. This is where companies often encounter difficulty, particularly with foreign operations where there may be less integrity around data collection. Similarly, companies may encounter inconsistencies while trying to collect data below a deductible or other threshold or for losses within a guaranteed cost insurance program. If the goals of the company include "insuring" these losses within a captive, the company should implement more structure around data collection in advance of the actuarial analysis.

Feasibility study: While there will be no shortage of consultants willing to conduct a captive feasibility study, a company should consider a very targeted and defined approach to such an analysis. If the company has identified its goals and done its homework to understand its claims exposures, the company will be in a better position to engage with the consultants and ensure the work product is tailored to the company's needs.

Domicile selection: Once a company has decided to establish a captive, selection of the captive's location must be made. Domicile choices can be either domestic or offshore. Currently, 39 states or territories have captive regulations and 39 countries have captive laws. While there are many drivers for domicile choice, the captive's goals should be the primary consideration.

A primary consideration between onshore and offshore domicile selection is the regulatory climate that could affect ease of operation. In general, domicile regulations typically reflect the fact that covered risks are not local or affecting that jurisdiction. Regulators generally take the view that, as long as the organization is knowledgeable of its risks, remains well-capitalized, and is attentive to facility needs, the company will have the freedom to operate within the regulatory framework of the chosen domicile.

The following factors are key considerations in captive domicile selection:

- **Required capital:** what is the minimum amount of capital required in the domicile? Capital required in offshore domiciles is often less than onshore.
- Type of coverage(s) to be written.
- **Regulatory fees and domicile taxes:** these will differ from domicile to domicile and can be material.
- **Breadth and depth of qualified service providers:** some domiciles are more mature and have more established infrastructure to support captive operations such as banks, actuaries, lawyers, or management companies.
- **Legal structure options:** domiciles will differ in terms of what legal structures they will authorize.

Partner selection: Consideration must also be given to professional services and partner selection. Early on, the company will need a captive consultant to help navigate the due diligence around captive considerations. Depending on the design strategy, several other captive partners will be needed including a captive manager, an attorney, an accountant, a banker, an actuary, a claims manager, and a "fronting" insurer partner. Some of these services may be obtained from current providers while others can be secured from within the parent organization.

With direction, the manager or consultant will prepare a proposed business plan that will be instrumental in receiving regulatory approval and risk-sharing support. It is obviously critical that they be knowledgeable about captives and the owner's goals and expectations. Engaging a respected manager who has good relationships with the regulators in the chosen domicile will help position the company for success.

Summary

While a captive may or may not be appropriate for your company, risk professionals should have a basic understanding of the benefits and downsides of captive utilization. At a minimum, they should conduct a self-examination of how a captive might contribute to their company's risk management strategy. Certainly, talking with peers about their captive usage is helpful, but it is important to remember that each company is different and what is considered a benefit for one company, may be a burden for another. While some companies may view the ability to retain and build loss reserves in the captive favorably, others may feel that "trapped" cash is an opportunity cost.

Exploring, establishing, and effectively utilizing a captive is an investment of time and resources. It is a decision that requires input from senior leaders within the organization, particularly within the finance department. Realistically, 6 to 12 months of lead time should be allowed prior to forming a captive to allow adequate time to complete an actuarial analysis and feasibility study, select a domicile, and secure professional business services. And, the organization needs to be committed to the captive for the long haul, particularly if longer tail lines or coverage are to be placed within the captive.

Selecting the right partners for captive exploration, establishment, and management is essential. It is important to consider partner relationships early in the due diligence and feasibility processes. These selected partners will be able to guide the organization in the development of strategies and tactics necessary to prevent and manage losses over the long-term. This will ultimately drive captive sustainability and success.

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