

CAPTIVES 101

What is it, and why do I want one?

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Captive insurance companies are receiving increased attention as insurance and finance industries turn to new alternatives for risk financing. Although captives are a relatively mature risk solution, many business people have little understanding of how they operate or the knowledge necessary to evaluate the benefits for a particular situation. Even those who have looked into them previously may not be aware of all the factors that affect the decision about whether or not to establish a captive. This paper will explore those factors and provide a new perspective on evaluating this risk management solution.

To begin, the accepted definition of a captive is an insurance company that is owned by the insured. This is certainly true, but it is not useful for decision-making in a time of challenge. Captives are simply another method by which risk to loss is financed. The essence of risk finance is not to reduce premiums, but to make the process more cost effective and efficient through controlling the money that is used for risk. The fact that the insured, or an entity closely related to the insured, is the owner/operator is a separate and distinct fact, which may or may not affect the captive transaction.

Let us be clear that captives are all about money. You want one to make money. It will cost money to have one. And you will pay your own losses, come what may.

Alternative Risk Finance

Traditional insurance has many variations, but essentially you are giving underwriting information to a party who enters into a contract with you to provide repayment of losses under certain circumstances.

Once you go outside this structure, you enter the world of Alternative Risk Finance, which can take many forms including a captive insurance company. One advantage of alternative risk solutions is that the premium components will be "unbundled." Instead of "just writing a check," you will see all the components of the premium and play a part in their pricing and delivery.

A critical point to accept is that Alternative Risk Finance is not at odds with the traditional insurance company. In fact, most traditional companies work daily with captives and other forms of risk finance. As a part of the process, someone of financial strength must agree to reimburse claims. For large losses, a large insurer is required. That is probably not the captive.

However, the traditional insurer often prefers that the insured handle smaller losses. This provides an opportunity for the insurer to shift costs to the insured through the device of a captive. These costs can also be shifted through deductibles, retentions and co-insurance, but a captive can create the illusion of control for the insured, while eliminating nuisance costs for the insurer. This illusion can be a highly successful marketing tool for a traditional insurer.

Captive Advantages

Why choose a captive instead of deductibles/retentions or self-insurance? The simple answer is that there may be financial advantages. Current accounting and tax rules do not permit deductions for reserves held for the payment of losses in the future. But, if those funds are called an insurance premium, they are deductible.

Self-insurance is a legal form that is difficult, complex and really only for the very large risk. Therefore, a captive is a cost effective solution, but you must structure it in such a way as to participate in the profits of your own risk, not just accept unwanted costs. To

structure and partner in such a way that achieves real cost savings you must finance more than small risks. In order to gain the advantages that a captive offers, several elements are required.

The premiums paid must be sufficiently large, say over \$750,000 annually, to gain economic advantage, or coverage necessary to the operation of the business must be unobtainable. It is also possible, if it is your intention to establish a new profit-center, that the projections of the insurance business of others will make the captive seem like a good idea.

You must be able to pay the claims, and secure the future losses. Full projected amounts are rarely required to be posted in advance, but the ability to ultimately pay must be demonstrated. This cannot be overstated.

You must recognize that a captive is a business separate and apart from your other business, no matter what structure is ultimately selected. Pay close attention to the establishment and operation of the captive or the consequences will eradicate any hoped for gain.

Evaluating Captive Feasibility

There are six principal steps needed to decide whether or not a captive is the correct solution for your situation and to begin choosing the proper captive structure. The order of these steps can and does change and some steps occur simultaneously.

Feasibility Study - Determining the viability of a captive begins with an actuarial analysis of your past claims. This is a straightforward determination of the accepted level of claims for your business which gives clear trends and attachment points for premiums, costs and reinsurance. The actuarial analysis becomes part of the feasibility study which will determine early in the game if the proposed solution has a chance to deliver the hoped for results.

Goal Setting - After the actuary has advised on the numbers, time should be spent on the goal of the captive. The original inquiry may have been driven by high insurance premiums or even lack of availability, but there are other reasons to consider a captive. These include control of premium fluctuations, choice of vendors, choice of reinsurance structure, personal tax advantages and even a new profit center. It can be difficult to place a dollar value on all of these but they could materially affect the view toward cost effectiveness.

Domicile Selection - With an actuarial study and clearly articulated goals in hand, it is time to select a domicile. There are two basic choices: onshore, in one of the states that permits captive registration; or offshore, outside the United States. The goals of the captive will help guide the selection of the domicile. A principal difference between onshore and offshore is potential ease of regulation. Ease does not mean laxity. However, if your captive is located outside the US, on an island, it is not covering risks of that island. Therefore, the regulators take the view that, as long as you are well informed, well financed and well managed, you have greater freedom to use your captive as you see fit. Onshore regulators have other issues which become entwined with overall U.S. regulatory issues, and can cause delay and expense. This is not true of every situation and should not be the sole determinant. Rather, the quality and quantity of regulation and support services should be seen to bring the best fit to the goals of the captive.

Partner Selection - Following selection of a domicile, it is time to select partners. Depending on circumstances, you will need a U.S. consultant, a domicile manager, a risk sharing entity, attorney, accountant, banker and of course the actuary. Some of these may be vendor/partners that you are using currently. The manager or consultant will prepare, or assist you in preparing, a business plan, which will be instrumental in receiving regulatory

approval, and risk sharing support. It is critical that they be knowledgeable about captives, and your goals and expectations.

Company Formation - A company must be formed with officers and directors. The domicile manager and/or attorney can handle this task. Depending on domicile, there can be extensive referencing required which can be off-putting to some potential participants. New regulations on money laundering and transfer add materially to the time involved, so this activity should run concurrently with other tasks.

Risk Sharing - Critical to the success of the captive is selection of the risk sharing partner. This is the entity that is on the line for the largest and most frequent claims. This is generally a U.S. licensed and admitted insurance company. It will often offer many necessary services, including underwriting, risk engineering, loss adjusting, claims reserving, litigation and regulatory support. You may need to issue certificates of insurance to third parties assuring coverage. Generally a certificate from the captive will not suffice.

This risk sharing partner may be your current, traditional insurer, or you may have to form a new relationship. It is imperative that you begin exploring the dynamics of this relationship from the beginning of the captive process. The risk sharing partner will likely have strong opinions on your plan and your other partners. This partner will rely strongly on the work of the actuary. This Partner may have restrictions and requirements on practices, procedures and vendors that will make or break your captive so a solid relationship is essential. Management of this relationship should be conducted in such a manner that both sides are aware of all other arrangements and are fostering each other's profitability and growth in accordance with business plans.

A visit to the domicile that you have chosen may be in order. Many regulators want to have face-to-face knowledge of their owners. Maintaining a relationship with them is primarily the

domicile manager's job, but the owner's attendance is important to success. Some venues require annual meetings to be held at their location which can be an opportunity to solidify relationships with regulators.

Establishing Operations

Once all of these elements are completed and the license application is approved, the captive is ready to begin operation.

The captive will likely be a reinsurer to the risk sharing partner, accepting a pre-determined level of risk and the accompanying premiums. The captive is now a reinsurance company. It will also likely purchase reinsurance or excess insurance to protect from severe losses.

The start up process requires establishing appropriate committees such as underwriting, claims, investment and audit.

In the early stages, the most important of these is the Investment Committee. Funds will be received almost immediately and must be prudently invested so that they are available to pay claims. These funds will also generate additional revenue, just as they do for traditional, primary insurers. Over time, earnings from these investments can be considerable and may become the primary reason for the existence of the captive. Improperly managed, however, they can cost the owner substantial sums and even imperil the continuation of the captive. The domicile manager will do the actual investing, and offer advice, but he will not decide what instruments to purchase.

If the captive is to entertain risks other than that of the owners, then an Underwriting Committee must be established along with underwriting standards, lines of authority and procedures. This committee may also be responsible for arranging reinsurance. This is an opportunity to improve costs from pre-captive

structures.

At some early stage, a Claims Committee must be in place. It will regularly review claims reports to determine trends, underwriting violations and reserving practices. It may be involved in selection of adjusters, attorneys where appropriate, and reserve management. This is another area in which costs can be improved from the traditional placement.

Additional Considerations

While the basic premise for forming a captive is to use your risk management funds effectively, there are many other considerations and structures that may prove beneficial. A captive can reinsure traditional lines such as workers compensation, general liability, auto liability, professional liability and credit risk. This is due to the relative ease and certainty of projecting losses and revenues with coverages in which claim payments occur years after the incident of loss, known as long tail losses. More and more captives are entering property fields, or short tail losses that must be paid sooner. The traditional view of restricting captives to long tail business has encountered the reality of escalating prices and lack of availability.

A captive can also be used to provide coverage and limits not available in the market, such as credit risk and terrorism. The captive can provide a tax sheltered approach to large retentions. If no certificate is required, it can accept direct placements.

Captives today are often used to reinsure risk retention groups, providing the flexibility that is not allowed under the Federal act.

With considerable effort, there are occasional personal tax advantages that can be obtained with a captive, but these require a sophisticated, knowledgeable consultant, and there are the

usual caveats about taxing bodies.

Some captives have performed so well for their owners that they have re-domesticated to the US, filing for licensing as an admitted insurer in order to offer primary coverage, replacing their risk sharing partner.

Captives are not a solution for every situation. But in the right circumstances, a carefully planned, properly executed and diligently managed captive can be an ongoing source of profit for years to come.

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