Captive Insurance

The Evolution of a Powerful Risk Management Tool

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Captive insurance companies are powerful new risk management tools that have grown dramatically in the past 50 years and continue to grow at an astounding pace. A captive can provide cost savings, flexibility and control for an organization's risk management program and can cover emerging risks for which there are no better alternatives. Future growth of captives will come mainly from medium-size and small organizations looking to solve particular risk management problems. Simultaneously, large organizations will place additional lines of business, such as supply chain and wage and hour risks, in their captives. This continued evolution makes it imperative for insurance professionals to understand the fundamentals of captives.

TOP 10 CAPTIVE DOMICILES WORLDWIDE IN 2014

- Bermuda – 800
- Cayman Islands – 759
- Vermont – 587
- Utah – 422
- Anguilla – 379
- Delaware – 333
- Guernsey – 321
- Nevis – 281
- Barbados – 271
- Luxembourg – 224

Source: Business Insurance, Insurance Information Institute

What Are Captives?

While the property-casualty insurance market has experienced its ups and downs during the past 50 years, captive insurance has grown steadily.

What started as a cottage industry, primarily serving the risk financing needs of United States Fortune 500 companies, has evolved into a global industry. Captives now provide risk financing for large, medium and small organizations, many privately held. Once primarily located in the Caribbean, they are growing rapidly in the U.S.; have become popular in Europe; and are starting to take hold in Asia, Mexico and Latin America. Today, there are more than 6,800 captives worldwide and more than 70 domiciles with legislation that encourages their formation. As a result, captives now account for as much as 10 percent of global direct-written commercial premiums.

In its simplest form, a captive is a subsidiary insurance company that covers the loss exposures of its parent. While you could think of it like self-insurance, it is different in that the insured organization owns an insurance company to which it pays premium and receives reimbursement for covered claims. In practice, there are many different types of captives.

From a broad perspective, a captive is an insurance company formed primarily to cover the loss exposures of its owner(s) or members. This expands the single-parent concept by recognizing that a captive may cover multiple owners or members. Organizations with similar loss exposures often pool premiums and claims in a captive, sharing risk and ownership. They benefit from favorable loss experience of the group through reduced premiums or by sharing in the captive's underwriting and investment income. This is called a group captive. Interestingly, two large insurers, ACE and XL, started out as group captives in the mid-1980s. Sometimes a group captive is owned or sponsored by an association for the benefit of its members and is referred to as an association captive.

Captives don't cover just their owner(s) or members; in some situations, someone other than the captive's owner or a member is an insured. In limited cases, a captive underwrites risks of organizations neither related to nor under the control of its parent. However, it is more common for captives to underwrite controlled unaffiliated business, which refers to risks that do not arise from the captive's parent or its subsidiaries, but over which the parent exercises some risk management control. A good example is a captive owned by a restaurant franchisor that underwrites property insurance on the restaurants that are independently owned by its franchisees.

An organization may choose to participate in a captive owned by an outside sponsor. This provides the insured with the benefits of a captive, and it usually saves a portion of start-up costs and ongoing expenses. This type of captive is known by various names, such as sponsored captive, rent-a-captive or cell captive. Many organizations use such a facility to establish a captive and later form a wholly owned captive to replace it as the premium volume grows. These types of captives have become popular in recent years because of their potential cost savings and ability to be set up quickly.

It is important to note that a captive is licensed as and functions in a similar manner to a commercial insurance or reinsurance company. Therefore, it needs to conduct various insurance company functions, such as underwriting, claims handling and loss control. It is also required to produce financial reports for policyholders, regulators and tax authorities.

The variety of captive insurers has enabled them to serve many different types and sizes of organizations. Captives provide risk management solutions for all major industries, most notably healthcare, given recent changes in the U.S. healthcare delivery and reimbursement model.

Why Form a Captive?

The reasons for forming a captive insurer are well documented and are often referred to as the three Cs of captives: cost, capacity and control.

COST

The first major reason an organization forms a captive insurer is to reduce its cost of risk, consisting of the following:

- Insurance premiums
- Cost of losses not reimbursed by insurance or outside sources
- Cost of risk control techniques to prevent or reduce the size of losses
- Cost of administering risk management activities

The best way to compare the cost of a captive with conventional insurance is to examine its income and expenses relative to those of a commercial insurer. It is important to keep in mind that the parent owns the captive insurer and therefore benefits from any profits that captive generates.

A captive allows an organization to “unbundle” the expenses otherwise built into a commercial insurance premium. In addition to expense loadings for claims handling and loss control services, a commercial insurance company includes in its premium a risk margin to compensate for potential loss variability, as well as charges for overhead and reinsurance. Most captives operate with lower expenses than a commercial insurer and can directly negotiate their reinsurance contracts, often capturing a reinsurance ceding commission, which would otherwise go to a commercial insurer.

Insurers earn a portion of their profit by investing the financial assets that back their claim reserves until the assets are liquidated to pay those claims. A captive can capture this investment income that, again, would otherwise go to a commercial insurer.

Still, captives do generate additional expenses not incurred with commercial insurance. They include capitalization and start-up costs, including legal and consulting fees. Many jurisdictions allow the capitalization requirement to be met with a letter of credit, conserving the captive owner’s cash. For a captive to be economically viable compared with commercial insurance, its combined savings from lower expenses and its investment income must be more than sufficient to offset the start-up and opportunity costs on any tied-up cash capital.

CAPACITY

Another reason an organization forms a captive insurer is to expand capacity. A captive provides access to coverage that is not otherwise available or is unaffordable. Insurance for certain types of risks, such as cyber or product liability, may be unavailable or unaffordable in the commercial insurance market. An organization could fund these risks by placing them in its captive. The captive may also be able to directly access the reinsurance market to transfer some or all of these risks.

Take the case of an organization that needs to certify to its creditors that it has product liability insurance for underground piping made of a new “space-age” composite material. If the commercial insurance market refuses to cover this risk because of a lack of claims history with the material, the organization has the option to fund the risk in a captive. The captive could issue an insurance policy to the parent organization and certificates of insurance to the creditors. After a few years, given sufficient claims experience with this new material, the captive may be able to transfer some or all of the risk to the reinsurance market.

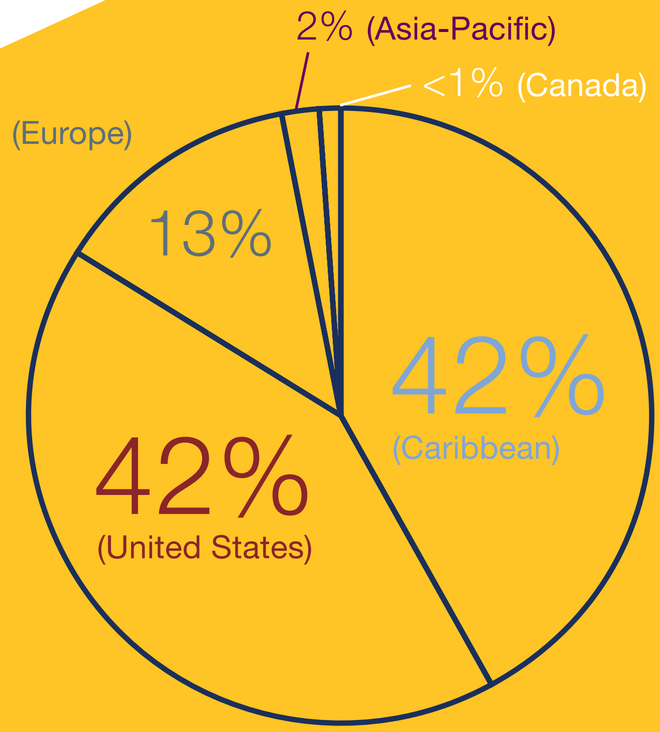
CONTROL

A third reason often cited for forming a captive is control over the risk management program. For instance, a captive allows an insured to tailor its policy wording. (For most specialty lines of insurance, a captive is free from regulation of policy wording as long as the captive complies with the business plan filed with its domicile’s regulator.) A good example is supply chain risk, for which a captive can write a policy that covers losses arising from many different types of events, such as political expropriation of the assets of a supplier. A commercial insurer might not be willing to write this risk, limiting coverage to losses contingent on damage to tangible property, as under the standard property insurance form.

A captive insurer can choose whether to self-administer its claims or hire a third-party administrator (TPA). Under either approach, the parent often has more control over claims handling than with commercial insurance. For example, the captive can direct the selection of legal counsel and investigative services, often saving substantial amounts in claim payments.

The cost savings, capacity and control associated with captive insurers have enabled them to become an effective risk management tool. Captives are also a tremendous asset for an organization’s enterprise risk management program because they can be used to cover risks not traditionally insurable, such as financial and operational risks, subject to approval by the domiciliary regulator. Examples are foreign exchange rate risk and commodity price risk.

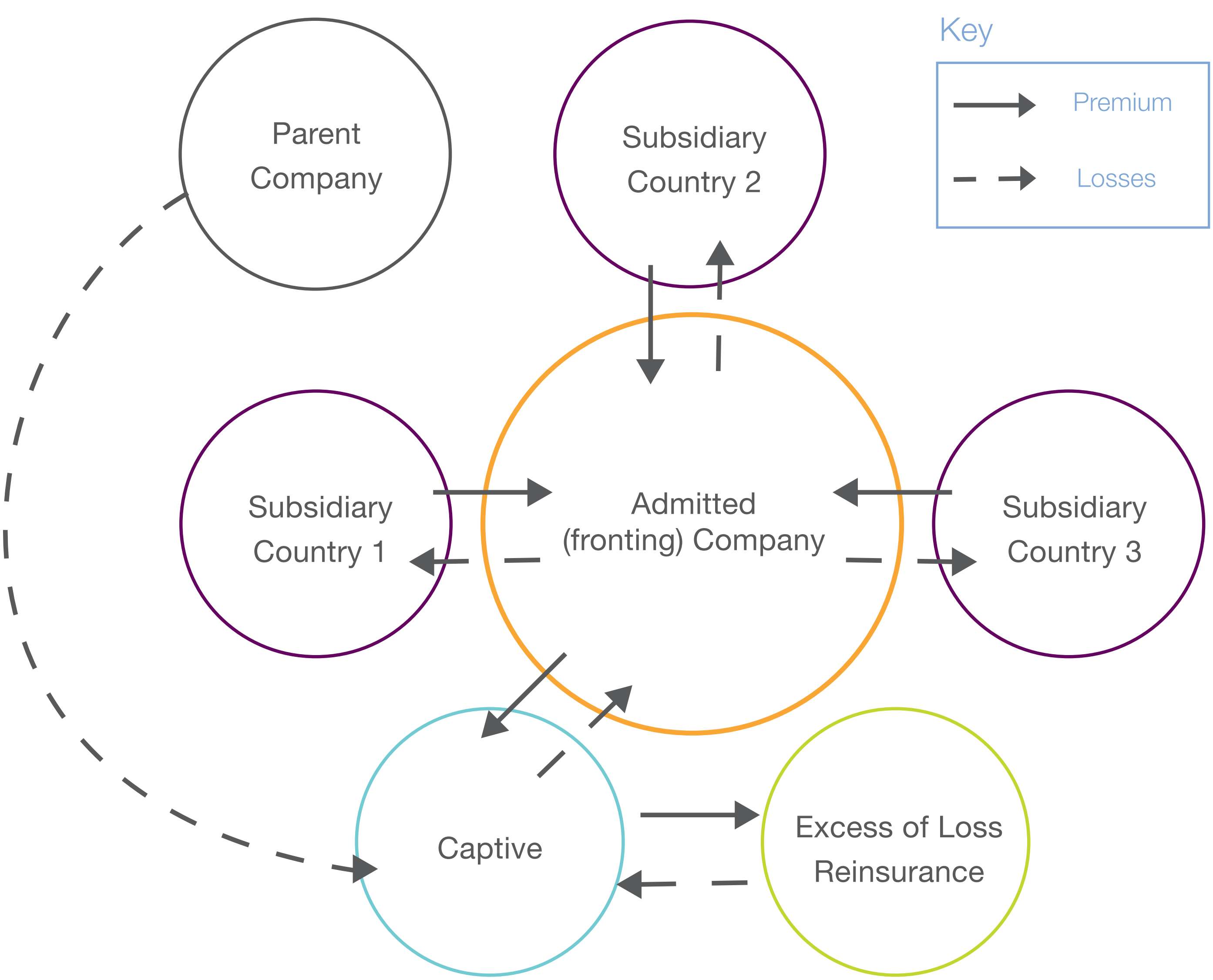
Captive Distribution by Global Region, 2014



Source: Business Insurance

Benefits to Multinational Insurance Programs

A captive offers flexibility and cost savings to organizations with a multinational insurance program. A global organization is usually required to purchase insurance from an admitted insurer in each of the countries in which it operates. The risks covered by these policies can be reinsured to a captive owned by the parent company. The captive pools the organization's global premiums and losses and usually purchases excess of loss reinsurance, which attaches above the portion of losses retained in the captive.



Current Captive Issues—Regulation and Taxation

REGULATION

A fundamental purpose of insurance regulation is to protect the insurance consumer by monitoring insurers' solvency, pricing and claims handling. Generally, captive insurers are exempt from many insurance regulations because they do not market policies to the public at large. This fact provides captives with great latitude in the lines of business they can write. However, an offshore captive insurer may be prohibited from writing certain lines of business. For example, some countries require employee benefits and terrorism insurance to be written only within their borders, thereby prohibiting offshore captive insurers from doing so.

For organizations considering an offshore captive, domicile accreditation and tax treaties are key considerations. For example, an offshore domicile that is both accredited by the International Association of Insurance Supervisors (IAIS) and a party to a Tax Information Exchange Agreement (TIEA) with the home country of the captive's parent is likely to be more attractive than one without these attributes.

In recent years, regulatory focus on captives has increased. The 2008 financial crisis only heightened the level of regulatory concern, not only for captives, but for all types of financial institutions. In 2011, the IAIS updated its Insurance Core Principles, increasing capital requirements for captives; now many domiciles comply with the IAIS standard. This helps to strengthen the role of captives in the international insurance market.

Number of Captives Worldwide

2,833: Captives in 1991
6,876: Captives in 2014

Sources: Business Insurance, Swiss Reinsurance Co., Insurance Information Institute

TAXATION

A captive may be able to take an immediate expense deduction against taxable income for the amount of its claim reserves rather than wait until the claims are paid out, in effect providing its parent with an after-tax cash flow advantage over other types of risk retention plans. (With a wholly owned captive, the captive's financial accounts are consolidated with those of its parent, so the after-tax cash flow advantage is reported on the parent's consolidated financial statements.) For the parent company to realize this benefit, its captive must be recognized as an insurance company for tax purposes, enabling the parent to deduct the premium it pays to the captive.

There are two major ways for a captive to be recognized as an insurance company for tax purposes. One is through risk shifting (the transfer of risk from the insured entity to the captive) and distribution (the sharing of risk among the captive's insureds), with recent court cases helping to clarify these two concepts, favoring taxpayers. The other is through writing sufficient third-party business, which includes controlled unaffiliated business, unrelated-party business and business generated through a captive reinsurance pool.

A special U.S. tax provision exists for small insurance companies, including captives, with "small" defined as companies with gross premium currently not exceeding $1.2 million and rising to $2.2 million on January 1, 2017. Such companies can elect to be taxed only on investment income, thereby avoiding income tax on any underwriting profits. Many recently formed captives with U.S. parents have taken this election.

Most captives are subject to a premium tax by their domicile. This tax is usually much lower than the premium tax for commercial insurance and can vary depending on whether the captive is operating as a reinsurer or a primary insurer.

Continued Growth

Over the past several decades, captive insurance has become an increasingly valuable tool for organizations' risk management programs. Indications are that the number of captives will continue to grow, with most of the increase coming from medium-size and small organizations looking to solve particular risk management problems.

The captive industry will continue to see regulatory and tax challenges. It will need to be vigilant by monitoring proposed regulations that may have unintended consequences. Furthermore, the U.S. Internal Revenue Service will challenge certain captives, particularly some of the small ones, to determine whether they are operating as true insurance companies.

An area of robust growth for captives is stop-loss coverage for employer-provided health insurance. Under the U.S. Patient Protection and Affordable Care Act, insurers are no longer allowed to exclude coverage for preexisting conditions or place lifetime caps on claim payouts. Employers that self-fund their employee health insurance benefit will increasingly look for ways to cap their out-of-pocket costs because of this expanded risk. Many currently place this risk in a wholly owned or group captive. These transactions will continue to grow. In addition, existing group captives formed for other reasons will increasingly consider providing employee health insurance stop-loss coverage as a service to their individual members.

Cyber risk will be another growing area of coverage in captives. As companies assess their cyber risk management needs, many will conclude that there are advantages to funding some or all of this risk in a captive. Furthermore, centralizing the management of cyber risk in a captive facilitates the development of appropriate protocols for controlling the risk throughout the organization.

Other nontraditional risks will continue to be placed in captives, including political, supply chain, wage and hour, crime, surety, pension liability, disability and post-retirement medical risks.

Captive insurance is growing as a risk management tool and provides many advantages for an organization's risk management program. The ability of a captive insurer to help solve risk management problems is increasingly limited only by one's imagination.

New areas of captive growth:

- Enterprise Risk
- Terrorism Risk
- Customer Risk
- Cyber Risk
- Healthcare Capitation Risk
- Physician Risk Retention Groups
- Medical Stop-Loss

Sources: Business Insurance, International Risk Management Institute, The Institutes

To learn more:

Solidify and demonstrate your understanding of captives by completing The Institutes' Captive Insurance Fundamentals course. This self-study, online program takes three to four hours of study time, qualifies for CE credits, and helps insurance professionals:

- Understand terminology, concepts and how to form and operate a captive insurer
- Confidently explain to current and prospective clients the benefits of a captive insurer as a risk financing tool
- Identify when a captive insurer can meet an insured's specific needs, such as underwriting a unique risk or participating in a multinational insurance program

To learn more and get started, go to **www.TheInstitutes.org/Captives**

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(610) 644-2100

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