Risk Management Bulletin

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Understanding Captives

In today's day and age business owners are constantly on the lookout for ways to save money and ensure the long-term viability of their organization. To that end,specifically in the insurance world, more people are looking to the alternative insurance market for solutions.

Alternative insurance vehicles are often misunderstood by those who are not familiar with the insurance industry. They might think that alternative insurance options are only available to large organizations or that "anything based in the Cayman Islands can't be legal." We will discuss some of these misunderstandings and hopefully provide you with a clearer understanding of an alternative insurance option, *captives*.

A captive is essentially an insurance company that is established and owned by one or more parent companies with the intent to insure the loss exposures of that parent or parents. The captive insurance company operates primarily to provide the same sort of risk financing tool that a normal commercial insurance would provide to the company. So, to put it more simply, one or more companies get together and form their own insurance company, conduct actuarial analysis of their own losses, and determine what their own premiums would be. They pay themselves a premium and run the insurance company just like any other insurance company – paying out losses, managing claims, etc. Once all of the claims have been paid and expenses taken care of, anything left over is given back to the company that created the captive. Granted this is a very simplified explanation, but it really is structurally as simple as that. There are many different types of captives with different benefits and risks, and we will talk about some of them here. As you can probably guess, there are extensive regulatory requirements and tax implications both within the United States and in foreign domiciles, so an extensive analysis is necessary to ensure that the captive model is right for your specific company. If that model does fit your situation, however, there may not be a better way to finance and transfer risks for your company.

Common Types of Captives

The term "captive" is more than just one singular type of insurance option. It is actually an umbrella term that encompasses quite a few different types of insurance tools that have been created to address specific needs. There are almost as many different types of captives as there are rules that regulate this subsection of the insurance world. We'll talk about a few of these types in detail. A quick search online of any of these common types will give you much more detailed descriptions than we have included here.

Pure Captive or Single-Parent Captive

Pure captives or single-parent captives are wholly owned by a single-parent organization, and this type of captive is run for the benefit of that single parent. It provides insurance for no other entity except the organization that it belongs to. This may be one of the most common types of captives in use and is present in just about every industry in the world. It is typically used by larger organizations that can absorb the costs of creation and management of the captive on their own.

Group Captive

The group captive is, as its name suggests, a group of companies who have collectively created the captive to insure their own losses. These types of captives can be much more complicated than a pure captive in that there is more than one owner and each of those owners may have different values and objectives. The group captive can be both homogeneous or heterogeneous, (homogeneous means that all of the companies within the captive are similar in that they are within the same industry, and heterogeneous means that the companies are not necessarily similar), and there are benefits and risks to each of these types of group captives.

In a group captive, depending on the specifics of how it is set up, there is typically some sort of risk sharing aspect of the loss funding (typically a small percentage of the total loss fund). Therefore, if some of your loss funds that you have set aside to help pay for your losses are being shared with another company's exposures, it may be helpful from an actuarial standpoint to have similarly-situated (homogenous) companies sharing that loss fund. Homogeneous captives can be created through particular industry or professional associations. It is typically intended to be a benefit of membership of the association. If you agreed to be a member of the association, your company can be considered to be admitted into an industry-specific group captive.

Conversely, a heterogeneous captive may not have the advantage of having similarly-situated companies sharing their loss fund, but it may have the advantage of having a diversification of loss exposures by having many different types of companies participating in the captive. A heterogeneous captive can also benefit from having more companies participating in the captive which spreads the risk over a wider area. More people participating in the captive means a smaller percentage of risk is shared.

Rent-a-Captive

In some situations an existing captive may be willing to "rent" their captive program and structure to another organization that wants the benefits of a captive but that doesn't want to incur the expenses of forming a captive and putting up the initial operating capital that is required. For a fee, the existing captive will agree to let one or more "renters" participate in their captive arrangement as if they were one of the primary parents. This arrangement can obviously create revenue for the captive but also potentially exposes the captive as a whole to new loss exposures from an organization that may not be completely committed to the process. The fee that is paid to the captive by the "renter" would reflect the increased costs of underwriting, claims management, accounting, and other financial management costs associated with running the captive.

Managing Captives

When talking about how a captive operates, it can be relatively complex depending on the type used. Decisions need to be made at the outset about the form of the organization, what types of coverage will be provided and how they will be provided, initial capitalization, and even where the captive will be domiciled. After making the determination as to form, domicile, types of coverage, etc., the captive must construct a general management framework that gives the structure of executive and support personnel for conducting its day-to-day operations. Often a captive management consultation firm will be used to help establish and, many times, run these day-to-day operations. The presence of these independent management team members, none of whom are employed by the parent, helps support the independent at an arm's length status (this is important for tax purposes).

Generally when a captive involves more than one member, a governing body of members (typically a board) is responsible for its general operations and financial condition. In a typical group captive situation, the members will elect board members and then establish subcommittees of members to address typical responsibilities and decisions that need to be made by the group. Examples of these subcommittees might be an underwriting committee, marketing or new business committee, finance committee, and/or a claims and loss control committee. Each of these committees will be responsible for establishing rules and responsibilities for members to follow during the normal course of operating the captive. Remember, the captive is essentially a standalone insurance company with all of the rules, regulations, and responsibilities associated. The table below outlines what some of the standards and rules developed by the members of the captive might be.

Standards and Rules

Underwriting

- Development of an underwriting policy for the captive.
- Rating and pricing proposals for prospective members.
- Management of underwriting support services (i.e. underwriting surveys, acturial, etc.).
- Maintenance of coverage documents.

Claims & Loss Control

- Conducting pre-inception reports for prospective new members.
- Conducting loss control assessments of current members.
- Development of safety standards.
- Development of loss control workshops for members.

Finance

- Production of financial documents for the captive.
- Filing with appropriate regulatory agencies.
- Performing periodic loss reserve analysis.
- Management of external auditors.
- Pursuit of subrogation.

New Business

- Number of educational seminars.
- Type and development of promotional materials.
- Service complaints.

Benefits and Risks

Some of the world's largest and most successful companies have used captive insurance strategies for risk management and asset protection. Participating in a captive oftentimes is one of the foundational stages a company goes through when formalizing their risk management program and occurs when an organization's management realizes that preventing incidents is profitable long-term. Essentially, the primary purpose of the captive is to save money, and to this end captives have many strong benefits. One of the benefits is that an organization gets to retain underwriting profits that would ordinarily go to a commercial carrier. When the company pays its premium to a carrier, performs wonderfully, and does not have any losses, that premium stays with the carrier. In a captive situation, the company essentially owns the carrier and the premium that the company paid to the captive could ultimately come back to the company (minus operating costs) as a dividend. Therefore, the profits that would normally go to the commercial carrier would stay within the company that is participating in the captive insurance program. Another benefit is that in certain cases a company participating in a captive would be able to customize their coverage to find their perfect mix of deductibles, exclusions, or coverage limits that may not be available to them for a multitude of reasons. As you can see, the captive model allows a company to retain risk in an effort to make every coverage dollar spent meaningful.

While retraining risk is good, it forces an organization to focus on claims management and loss control much more vehemently. When the opportunity exists for a company to re-acquire the money they spend on insurance premium by simply not having incidents, a responsible business owner will actively increase the focus on preventing those incidents. The term, "that's what insurance is for" essentially goes out the window because every loss will come off of the company's bottom line. If the company is preventing the losses, the company is retaining the profits and not letting them flow out the back door. In addition, it gives the company much more control and authority over claim management decisions since the company will be managing its own claims either in-house or through a third party administrator hired by the captive. Increased focus on loss control and increased control of claims management efforts are enormous benefits in and of themselves, but when you add in the cost reductions realized through bypassing the retail insurance market that has sales commissions, marketing and advertising costs, and other overhead costs borne by the commercial carrier, the benefits of the captive model are tantalizing.

As with everything else with the word "risk" attached to it, there can be a significant downside. With all the benefits associated with the captive there are also risks (and sometimes significant risks) associated with this type of endeavor. The insurance industry is heavily regulated not only inside the United States but all over the globe. If the captive is not properly designed and operated, the captive itself can be exposed to sanctions and fines. The vast majority of captives are formed and managed by captive management companies specifically because of this reality. These consulting companies work for the captive and help develop, organize, and run the day-to-day operations to ensure proper structure and compliance. To be sure, this does not mean that the member companies can be "hands off." All of the member organizations must be committed to the operation of the captive. This includes research and education on the part of all of the owners as well as a commitment of time that can be significant. Many group captives require participation in conferences and board meetings in far-off locales (especially for captives that are domiciled offshore).

Captives are a long-term solution to financing a company's risk exposures. Often times there are significant upfront initial capital expenditures. Letters of credit or cash collateral are quite often required in a group captive environment. Establishing the initial capital operating outlay in a single-parent operation can be significant, and an organization may not see an overall cost savings for the first few years.

One of the biggest risks associated with captives is the same risk that is associated with any insurance company: losses. The captive model is wonderful when losses are low and members are receiving capital in the form of dividends because there are excesses in their loss fund. However, if losses prove to be much larger than anticipated, the captive will require significant reinvestment of capital by the members or parent company to make sure the captive does not face insolvency. Just like any other insurance company, normal ongoing insurance costs such as loss control, claims handling, underwriting, and financial management costs may be higher than initially anticipated and create a drain on the captive's resources. In certain circumstances, such as an organization that does not have control of its losses or is not financially fit, the captive model may not be a good fit as much of the risk entails potentially significant capital outlays.

Deciding if a Captive is Right for Your Organization

When an organization has determined that they would like to explore the alternative insurance market and specifically look to captives, they have decided to retain much of the risk associated with their company. Retaining that risk and deciding to fund their own losses using captive insurance gives that organization an opportunity to not only save money, but gain an incredible amount of control over their own destiny. There are risks involved and a careful analysis must be done to make sure that a captive is the correct decision, but in the right situation using a captive program could be one of the best financial choices that an organization could make.

If you would like to know more about this or other safety topics, please contact:

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