Risk
Management
Advisors, LLC

What are Captive Insurance Companies?

"Captives offer unparalleled benefits for the companies that use them. They allow a company to obtain insurance coverage that is tailored to its unique risks, rather than the standard coverages provided in commercial policies. Captives also allow a company's risk to be judged on its own merit, rather than being charged a premium that is based on the risk of its entire industry. Captives also provide tax benefits for the companies who use them and often provide claims handling services that are substantially better than the service provided by commercial insurers."

- R. Wesley Sierk III, Author of *Taken Captive*

What is a Captive?

A captive is a closely held insurance company established primarily to insure the risks of its parent company and affiliated groups. Day to day operations are controlled by the owners, who will also be the principal insureds. These operations include: underwriting and claims decisions as well as an investment policy of the captive.

The feature that all captives have in common is that the company is formed under specific legislation that is designed for the captive industry. Captive regulations are traditionally more relaxed than the onerous restrictions placed on commercial carriers.

Twenty-one states, the District of Columbia, Bermuda, Guernsey, the Cayman Islands, Luxembourg and the British Virgin Islands have enacted laws that regulate these special purpose insurance companies.

Most common captive domiciles:

Bermuda	1,426 captives
Cayman Islands	642 captives
Vermont	438 captives
Guernsey	408 captives
Luxembourg	260 captives

Captive History

Use of Captive Insurance Companies can be traced back to the 1920s. However, only about 100 captives were formed up to the 1950s when many parent companies began to form their insurance companies offshore. A hard insurance market and interest rate anomalies, led to tremendous growth in captives throughout the 1970s and 1980s here in the United States. Today there are over 5000 captives worldwide. More than 40% of major US corporations own one or more captive. Two-thirds of these are located in five domiciles.

The following is an overview of Captive Insurance Companies. It is designed to illustrate the many forms they can take. We will also discuss the operations, tax considerations and the pros and cons of establishing a captive. This is the first step in determining whether a captive is right for your company.

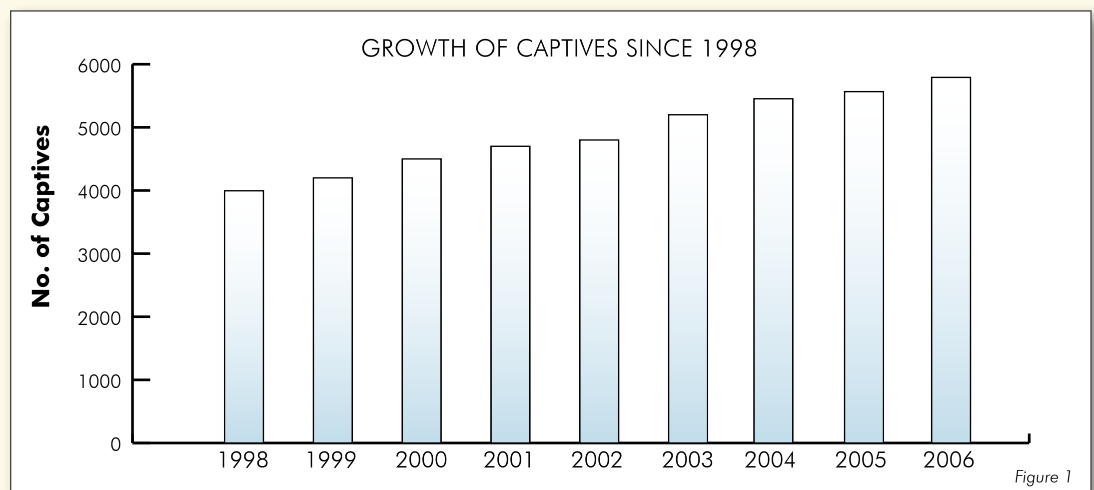

Figure 1

Why Form a Captive?

Corporations utilize captives to assert greater control over their risk exposure. This control generates a wide range of benefits that make a captive insurance company advantageous to the owner.

Additional Benefits of Captives

BENEFITS COMPARISON

Plan Comparison	Retail Insurance	Self Insurance	Captive Insurance
Lower Insurance Cost	no	yes	yes
Provides Protection from Risk	yes	no	yes
Tax Deductible Premiums	yes	no	yes
Policy Design Flexibility	no	yes	yes
Control Claims	no	no	yes

Figure 2

COST REDUCTION/STABILIZATION

Captives are often formed by insureds that have grown tired of the vagaries and undulations of the retail insurance market. Bypassing the retail insurance market can often lead to cost savings through the elimination or reduction of profit loads, broker commissions and administrative costs.

PROVISION OF COVERAGE NOT OTHERWISE AVAILABLE

Captives can often provide coverage for unique or specific risks that would not otherwise be transferable in the retail market.

CAPITALIZING ON A BETTER THAN AVERAGE CLAIMS EXPERIENCE

Why subject yourself to the brutal rate making policies of commercial carriers? Often, the parent company is better served retaining the risk inside the captive as opposed to subsidizing the broader risk pool's poor experience.

TAX TREATMENT

Captives are able to accrue tax deductible reserves for unpaid claims, whether known or estimated.

ACCESS TO REINSURANCE

A captive alone is subject to capacity limitations. However, captives can often access the reinsurance market to provide increased limits. Under certain circumstances, captives can offer more coverage than that which is available in the retail market.

RECAPTURE UNDERWRITING PROFIT AND INVESTMENT INCOME (FIGURE 3)

Hard markets can be extremely onerous on insurance buyers. Large premiums create a drag on parent company profitability. To a company with better than average claims experience this equates to a sunken cost, never to be recaptured.

A captive can mitigate this burden. Underwriting profit and investment income that typically stays with commercial insurers can be recaptured by the parent company.

PROVIDE COVERAGE FOR STRATEGIC PARTNERS

Assuming it is actuarially sensible, captives can write risks for industry peers, wholesalers, contractors or any other area where the traditional market's rate is undesirable.

IMPROVE RISK MANAGEMENT

Captives will positively influence operational behavior and enhance loss controls. The tremendous amount of data housed in the captive will help the parent company identify areas for improvement.

Captives have traditionally been formed by companies seeking to recapture lost income due to high premium dollars. Subsidizing the poor claims of the larger risk pool or increasing retail insurer profits can create a drag on a company's bottom line.

INCOME RECAPTURE MODEL

First Year Premuim	$1,000,000
Second Year Premium	$1,000,000
Third Year Premium	$1,000,000
Total Premium	$3,000,000
Total Claims (ratio subject to experience)	($200,000)
Investment Income	$252,000
Total Cash - Fourth Year	**$3,052,000**

Figure 3

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Who else is using captive insurance companies?

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Today there are over 5000 captives worldwide. Over 40% of major US corporations and many of your smartest competitors have one or more captives. Verizon, UPS, Centex Homes as well as many others utilize these unique companies. The strongest periods of growth for captives occur as businesses respond to hard market insurance environments.

"My lenders require my insurance to come from a rated carrier. How can I issue coverage from my captive and still secure my financing?"

For a fee, a rated carrier will provide what is known as a "front". The fronting carrier provides their name for the policy to satisfy the lender's requirements. The premium and the risk are "ceded" to the captive through a reinsurance agreement.

The Real Power of an Insurance Company

Income and profits that would normally benefit the retail carrier and its stockholders are now income and profits to the captive owner.

Incurred But Not Reported Losses (IBNR)

Insurance companies get special tax treatment. Loss Reserves, whether known or estimated can accrue on a tax deductible basis.

This is a very powerful leveraging tool and indicative of why insurance companies are some of the most financially powerful companies in the world.

In figure 4, a captive has taken $21,782,038 in premiums over a five year period. It was actuarially determined that reasonable loss reserves would be 60% (this number is higher in many instances). Therefore, the captive was able to deduct the entire reserve amount against premiums.

If the captive in figure 4 maintains effective loss control, it will be able to earn investment income on tax free premium income.

DEDUCTIBLE LOSS RESERVE

	Premium	Ratio	Deductible Loss Reserve
Year 1	$3,942,000	60%	$2,365,200
Year 2	$4,139,100	60%	$2,483,460
Year 3	$4,346,055	60%	$2,607,633
Year 4	$4,563,358	60%	$2,734,015
Year 5	$4,791,526	60%	$2,874,915
Total	**$21,782,038**		**$13,069,223**

Figure 4

What Types of Captives are There?

Single Parent Captives (Figure 5)

Single Parent Captives are seperate legal entities that insure the risks of its parent and affiliated companies. They may also accept business from third parties if appropriately licensed and capitalized.

Capital is provided by the parent of the captive insurance company. The Parent maintains complete control over underwriting terms, policy wording, reinsurance decisions and the investment policy.

There is an initial cost of set-up and long term commitment is required to be fully effective.

Rent-a-Captive (Figure 6)

The policyholder is insured by the captive, but has less control over captive operations. The captive facility typically "rents" its capital and surplus to the policyholder and will provide administration and reinsurance services.

Evolution of the Rent-a-Captive scenario involves the use of protected cell legislation.

Protected Cell/Segregated Cell

Legal segregation exists between each of the accounts or cells within the captive and between the insured and the owner.

Segregated cell companies can be either single parent captives, rent-a-captives or group captives. The capital provider is usually in charge of underwriting guidelines and investment decisions.

The primary advantage of this structure is a smaller barrier to entry. Capital requirements for cells are less than that of single parent captives.

Risk Retention Groups

Risk Retentions Groups (RRGs) allow businesses with similar insurance needs to pool their risks and form an insurance company that they own and operate under state regulated guidelines.

Federal statutes allow groups to be chartered in one state, but engage in the business of insurance in all states. Federal law preempts state law and has many significant advantages. The primary advantages are the avoidance of multiple state filing fees and the ability to create a more stable market for risk and rates.

Additional Captive Structures

- Agency Captives
- Excess Layer Captives
- Trade Group or Association Captives

Captive Regulation

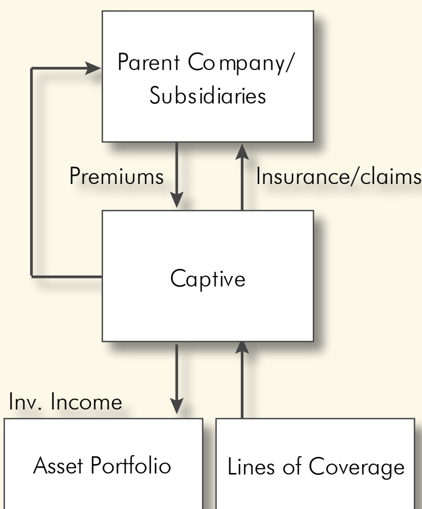

Figure 5

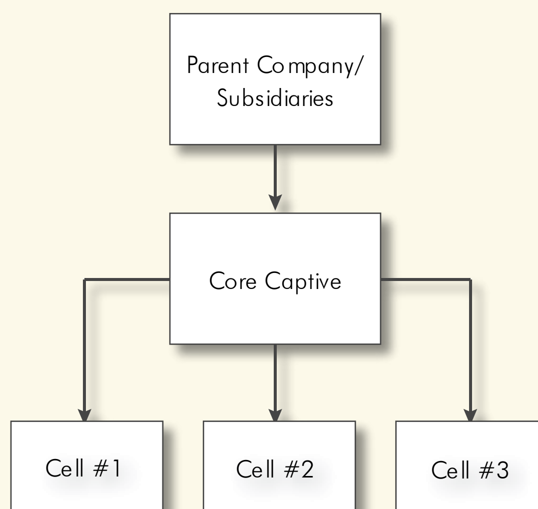

Figure 6

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"If I have a catastrophic claim, can I lose all of the money in the captive?"

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You decide how much risk you want to retain. Through reinsurance agreements and excess policies, Risk Management Advisors can tailor your insurance company's exposure to meet your comfort level and objectives.

Captives are regulated by the Department of Insurance in the domicile of incorporation. The captive will be classified as one of 2 types of insurance companies for tax purposes.

- 831(b) Small Insurance Company
- P&C Insurance Company

831(b) Small Insurance Company

Internal Revenue Code 831(b) provides a very powerful tax advantage through small insurance companies to provide them with additional financial resources to pay claims. This benefit assumes that legitimate risk is being transferred. It is available to both onshore and offshore captives. The offshore captive must choose to be taxed as a US company by making the 953(d) election.

WHAT THIS CODE SECTION MEANS

IRC 831(b) allows for a P&C company to be taxed only on its investment income. Under this structure the significant advantage is that the company is able to accumulate surplus from underwriting profits free from tax.

It is important to note that while an 831(b) pays no tax on underwriting profit, its owners are still taxed on dividends and other compensation received.

USE OF THE 831(b) ELECTION

The application of the 831(b) election is fairly straightforward. Any properly structured insurance captive writing less than 1.2 million of annual premium may apply for this election.

P&C Insurance Company

Property and Casualty companies are the more traditional arrangement for captive owners. There is no limit to the amount of premium that can be written and income is only taxable to the extent it exceeds the actuarially determined reserve requirement.

Example:

ABC Captive

Total Premiums:	$10,000,000
Reserve Requirement:	$ 7,000,000
Taxable Income:	$ 3,000,000

The reserve requirement is largely contingent upon the type of risks being covered, the probable timing of claims and an experience pool from which the actuary can draw reasonable conclusions.

CAPTIVE REGULATION GUIDELINES

Designation	Premiums	Corporate Taxation
831(b)	Up to 1.2 mil	Investment Income
P&C Co.	Unlimited	Premium Less Reserves

Figure 7

Additional Structure Components

In addition to the structural and regulatory considerations, captive owners must also be cognizant of the financial and operational aspects of running an insurance company.

The financial resources of a captive include premiums, capital and investment income. Premiums or capital can be funded through letters of credit. A captive's financial resources must be sufficient to:

- Finance the legal obligation of the captive as part of its insurance agreements
- Sustain a normal amount of adverse claims experience.
- Fund the day to day operations of the company.

Captive Insurance Companies are responsible for:

- Collecting Premiums
- Issuing insurance or reinsuring a fronting company
- Setting aside reserves sufficient to pay potential claims.
- Issue dividends to insureds (mutual) and owners.
- Manage the investment policy of the captive.

These responsibilities are typically too involved and beyond the scope of the owner's expertise. Because of this, Captive Managers play an integral role in the alternative risk transfer process.

The Captive Manager

RISK MANAGEMENT ADVISORS, INC. (RMA)

Most captives do not have their own employees. The captive management company (RMA) facilitates the day to day operations of the captive.

RMA is responsible for keeping accurate books and records and contracting specialty service providers. This typically includes accountants, auditors, actuaries, legal counsel and claims managers. (figure 8)

RMA will assemble a service team to help captive owners fulfill their objectives for entering the captive insurance market. Every scenario is different and requires its own special considerations. By having a cohesive service team RMA can make the captive solution a seamless process.

RELATIONSHIP OF CAPTIVE MANAGEMENT COMAPNY

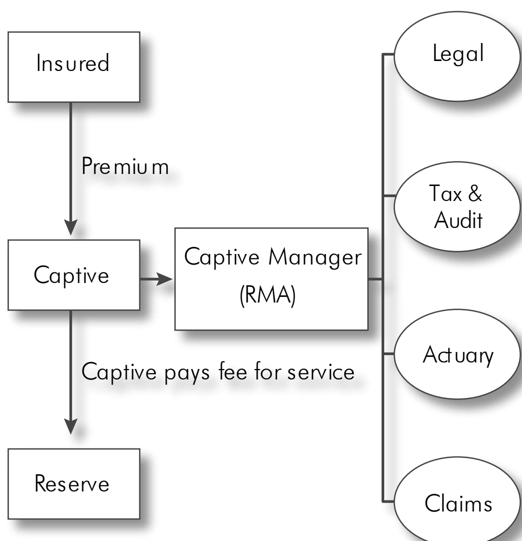

Figure 8

Does a Captive Make Sense for you?

A Captive Insurance Company is unquestionably an attractive alternative risk management tool, but does it make sense for your organization? It is important to examine both strategic and financial considerations before electing to adopt this approach. To do this, a feasibility study should be conducted.

Feasibility Study

A feasibility study is a qualitative and quantitative evaluation of the captive's primary business aspects in relation to the current operations and costs of the parent company.

More specifically, the study will provide:

- Coverage Options
- Claims projections
- Reserves
- Taxes
- Projected Expenses
- Reinsurance
- Investment Income

Through this study you will also gain a thorough understanding of the preferred structure, domicile, governance and ownership.

If the feasibility study yields a positive result and the case to form the captive is made, RMA will help the company craft a business plan. Captive owners will then visit their captive's domicile, meet with regulators and finalize the application process.

Upon regulatory approval the owners of the captive will meet any capitalization requirements and initiate operations as an insurance company.

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"Sounds like a lot of work. How much of my company's re sources will I need to allocate?"

A

Risk Management Advisors will provide a comprehensive program to design implementation and management for your insurance company. This will allow you to focus on running your company, while we help you fulfill your objectives for entering the alternative risk transfer market.

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