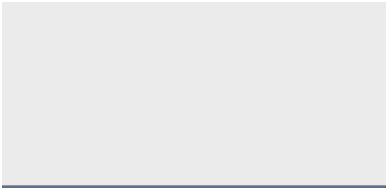


Captive insurance: An overview of the market today



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Today, captives are a fixture among Fortune 1000 companies but, not surprisingly, many smaller companies and even groups of individuals have discovered the effectiveness of captive insurance structures.

Once considered to be a “cutting edge” risk management tool, captive insurance has now found its way into the mainstream of corporate risk planning. Captive insurance companies (generally defined as “wholly owned subsidiaries created to provide insurance to the parent company”) make up 2% to 3% of the commercial insurance market and have been growing steadily in popularity since the 1960’s when the first captives were being formed in Bermuda.

Today, captives are a fixture among Fortune 1000 companies but, not surprisingly, many smaller companies and even groups of individuals have discovered the effectiveness of captive insurance structures. The proliferation of competition among both vendors and domicile regulators has fostered structural innovations and driven down captive formation and operational costs to the point where captives have become a realistic option for even relatively small organizations.

While competition has been good for the captive industry and has allowed for widened access to the marketplace, captives are still not for everyone. Savvy risk managers and C.F.O.’s realize that the decision to form a captive should not be taken lightly. Captives are relatively easy to form but can be much more difficult to shut down. For those risk managers and C.F.O.’s who are not intimately familiar with the intricacies of captive insurance, an unbiased captive feasibility analysis is always a prudent first step into this arena.

Companies that meet minimum practical requirements (i.e. pay \$750,000 or more in standard market commercial insurance premiums and have a better than average loss history) can realistically entertain the possibility of utilizing a captive insurance structure. In many cases, the standard insurance market has already forced the insured company into a heavily self-insured position. Increasing premiums tend to push insureds toward larger SIR’s and high deductible programs. Higher risk assumption may keep short-term insurance costs relatively stable but it increases long-term liabilities and drives up the ultimate cost of risk.

By formalizing its self-insurance program through a captive, a company can begin to regain control of its insurance program. The advantages of a captive include:

- **REDUCED DEPENDENCY ON COMMERCIAL INSURANCE** - for lines of insurance written through a captive, insureds shortcut the insurance renewal process and reduce exposure to the often unforeseeable whims of the commercial insurance market;
- **DIRECT ACCESS TO REINSURANCE MARKETS** – captives are able to bypass the conventional insurance market and, as an insurer, di-

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Insurance market fluctuations have considerably less impact when pricing is based on the insured's individual loss history rather than the loss history of large and in many ways, unrelated, base of insureds.

rectly access reinsurance markets. By doing so, markup costs from the primary insurance market are avoided;

- **LOW OVERHEAD** – captives generally have no employees, no marketing expense, no physical property and minimize necessary administrative overhead through careful outsourcing of needed services to professional captive service providers;
- **STABILIZATION OF PRICING OVER TIME** – insurance market fluctuations have considerably less impact when pricing is based on the insured's individual loss history rather than the loss history of large and in many ways, unrelated, base of insureds;
- **CUSTOMIZATION OF COVERAGE** – where coverage is unavailable or unaffordable, a captive is able to manuscript its own customized policy to cover a specific or unusual exposure;
- **IMPROVED CASH FLOW** – investment income from unearned premiums can be realized over the full duration of claim exposures;
- **REDUCED GOVERNMENT REGULATION AND INTERFERENCE** – proper domicile selection can result in a shift of regulatory authority to a less onerous and restrictive jurisdiction;
- **MORE CONTROL OVER CLAIMS HANDLING** – a captive establishes and controls its own claims handling policies and procedures and has full access to all claims data;
- **CREATION OF A PROFIT CENTER** – if desired, a captive may selectively write unrelated third party business thus creating a new source of revenue for the parent company;
- **POTENTIAL TAX ADVANTAGES** – captives can provide a tax-advantaged vehicle for accumulating underwriting and investment income
- **ABILITY TO DIRECT INVESTMENT OPTIONS** – captive reserves and surplus are invested at the direction of the captive owner (subject to regulatory liquidity guidelines) and can include not only traditional investment vehicles but also certain investments back into the parent company.

Of course, captive structures can present some difficulties as well. The disadvantages include:

- **CAPITAL COMMITMENT** – In addition to initial captive formation costs, a parent company will have to meet the mandatory minimum capitalization requirements of the domiciliary jurisdiction. These costs vary widely depending upon the captive domicile and service providers chosen.

- **ADMINISTRATIVE DUTIES** – While the day-to-day operations and technical aspects of operating an insurance company are generally contracted out to a captive manager and other professionals, the captive owner does have to dedicate time and effort to oversight responsibilities;
- **MERGERS AND ACQUISITIONS** – Ownership of a captive insurance company may complicate merger or acquisition activity;
- **VOLATILITY OF THE REINSURANCE MARKET** – while captives escape the volatility of the primary insurance market, to the extent that they have transferred risk to reinsurers, captives remain susceptible to broader market fluctuations in reinsurance pricing;
- **CLOSURE AND RUN-OFF** – Depending upon the nature of the risk insured by a captive, liabilities may remain on its books for years thus making the captive difficult to shut down. An exit strategy should be developed as the captive is being formed so as to minimize this potential problem.

Developing a captive structure that maximizes the advantages and minimizes the disadvantages as outlined above, is critical to the ultimate success of any program. The first step in determining whether a captive is appropriate for a given company or group is the production of a Feasibility Study.

A Feasibility Study should be a combination of (1) an actuarial analysis performed by an accredited actuary and (2) a financial, structural and operational analysis performed by an experienced captive consultant. Through a review of a potential captive owner's individual claim exposures and historical loss patterns as well as related industry data, the actuary will apply statistical models to the risk to make an educated prediction as to how future claims will develop. Working hand-in-hand with the actuary, the captive consultant will then employ financial modeling and industry knowledge to project operational expenses, isolate the most appropriate captive domicile and design a structure that allows the captive to retain the optimal level of risk and related premium.

Because broker commissions are tied to premiums, there is an inherent tendency for brokers to place as much risk as possible in the traditional insurance market. Meanwhile, the point of the captive is to get out of the traditional insurance market.

Captives most often need some level of protection from catastrophic losses through reinsurance or excess liability coverage. To avoid potential conflicts of interest, the consultants performing the Feasibility Study should be completely independent of the captive owner's insurance broker. It is important to remember that, when risk is insured through a captive, less premium dollars are paid into the traditional insurance market. Because broker commissions are tied to premiums, there is an inherent tendency for brokers to place as much risk as possible in the traditional insurance market. Meanwhile, the point of the captive is to get out of the traditional insurance market.

Depending upon the parent company or groups' specific risk profile and needs, the captive consultant may recommend one (or some hybrid) of the following captive legal structures.

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- **PURE (OR “SINGLE PARENT”) CAPTIVE** – is an insurance or reinsurance company formed primarily to insure the risks of its parent company or affiliates.
- **GROUP CAPTIVE** – is an insurance company, jointly owned by a number of similarly situated companies, created to provide a vehicle to meet a common insurance need.
- **ASSOCIATION CAPTIVE** – is an insurance company owned by a trade, industry or service group for the benefit of its members.
- **SEGREGATED CELL CAPTIVE** – is a captive insurance company that creates legally segregated accounting silos or “cells” within its facility and then rents those cells and the related operational services of the captive to other parties. The main purpose of a segregated cell captive is to provide ease of entry into the captive market and freedom from administrative burdens for those companies that want to avoid the ownership and maintenance responsibilities that are required of pure captive owners.
- **RISK RETENTION GROUP** – is a liability insurance company that is owned by its members. Pursuant to the Federal Liability Risk Retention Act (LRRRA), RRG’s must be domiciled in a U.S. state. Once licensed by its state of domicile, an RRG can insure members in all states. Because the LRRRA is a federal law, it preempts state regulation, making it much easier for RRG’s to operate nationally.

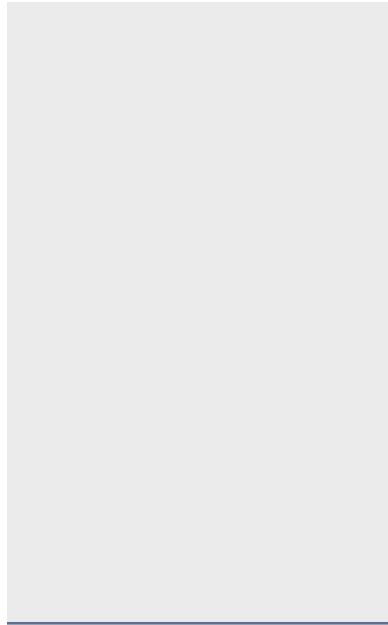
Once formed and licensed, a well-organized captive can produce immediate and quantifiably positive results for the parent company. Careful selection of captive advisors and service providers is the key to that success.

Forming a licensed and regulated insurance company is a relatively complicated process but it is one that an experienced captive consultant can help navigate. To secure licensure, most domiciles will require that the prospective captive owner provide regulators with a formal “application package” that includes background information for the parent company, an actuarial analysis of the risk to be insured by the captive, a formal captive business plan, pro-forma financial statements for the captive, reinsurance arrangements, list of proposed captive service providers, investment strategy, biographical information (both business and personal) for the involved principals, source of funding and other such information. If properly coordinated, this information can usually be produced and compiled within 60 to 90 days.

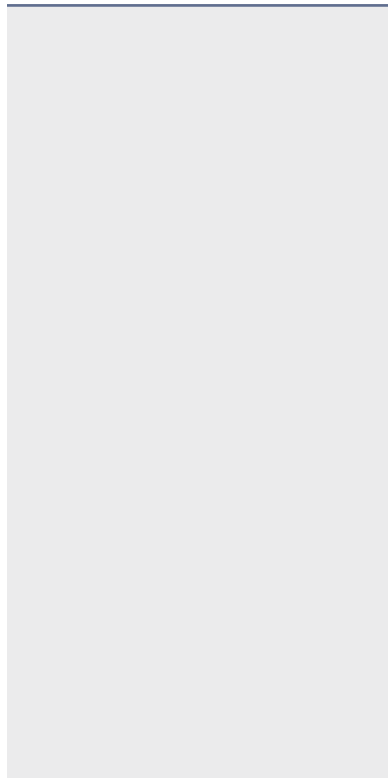
In an effort to successfully compete for business, both domestic and international captive domiciles have worked to streamline the captive application approval process in their respective jurisdictions. While there are still many regulatory hurdles to clear, standardized forms, processes and procedures make it possible for formal captive applications for licensure to gain approval in 30 days or less in many jurisdictions.

Once formed and licensed, a well-organized captive can produce immediate and quantifiably positive results for the parent company. Careful selection of captive advisors and service providers is the key to that success. Because most captive owners are not insurance experts (nor do they want to be), they

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Captives are an increasingly viable risk financing alternative for companies of all sizes – particularly as traditional insurance market pricing has begun to harden.



must rely on their team of captive professionals to provide them with sound advice.

Now that the captive industry has matured, several common features of successful captives have emerged: (1) They preserve a wide spread of risk either by maintaining a large exposure base within a single line of business or by diversifying risk exposure along multiple lines of business; (2) They are formed for legitimate insurance driven purposes rather than for perceived tax advantages; (3) They establish and follow strict loss control and risk management protocols; (4) Their financial stability is protected by parent companies that refrain from routinely drawing out any accumulated surplus; (5) They foster long-term fronting and reinsurance relationships since changing these partners can result in costly “collateral stacking” difficulties; (6) They are formed by parent companies with a long-term commitment to operating the captive; (7) They maintain the operational and philosophical flexibility to adapt to the changing needs of the parent company; and finally (8) They recognize that every captive has a natural life cycle and that there should be an exit strategy in place for when the captive no longer serves the purposes of its owner.

After more than 40 years of development, the captive industry enjoys a stable regulatory and service provider structure. Furthermore, intense competition in this industry has resulted in a wide selection of domicile choices, innovative captive structures, well-tested regulations and lowered captive formation and operational expenses. Captives are an increasingly viable risk financing alternative for companies of all sizes – particularly as traditional insurance market pricing has begun to harden.

ABOUT THE AUTHOR

Christopher Ridge is the Manager of Alternative Risk Finance at Perr&Knight. He is responsible for oversight of the firm's Alternative Risk Finance business unit and has extensive experience in the captive and self-insurance arena with specific expertise in the areas of: captive feasibility analysis, domicile selection, program design, legal structuring, formation and licensure, captive management, corporate governance, regulatory compliance, collateral relief strategies, program run-off and captive closure solutions. Chris has established and worked with a wide variety of captive insurance companies, risk retention groups, purchasing groups and self-insured entities over the course of his career and has served on the Board of dozens of captive insurers - both onshore and offshore. He brings twenty years of industry experience to Perr&Knight and its clients.

Prior to joining Perr&Knight in 2011, Chris headed the captive management and consulting operations of several organizations including a large Fortune 100 insurer, an insurance broker and a regional captive manager. Chris has also practiced law exclusively in the field of alternative risk finance concentrating in captive corporate governance, loss portfolio transfers and captive acquisitions. Chris enjoys a unique industry perspective gained through his work with captives throughout their full life-cycle.

Chris graduated from the University of South Carolina with a double major in Marketing and Organizational Management. He also holds a Master's Degree in Risk Management and Insurance from Florida State University and a Juris Doctorate Degree from Loyola University School of Law.

ABOUT PERR&KNIGHT

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