TAKEN CAPTIVE

The secret to capturing your piece of America's multi-billion dollar insurance industry

R. Wesley Sierk, III

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Chapter 1: What is a captive?

A captive insurer (or "captive") is a special-purpose insurance company formed primarily to underwrite the risks of its parent or affiliated groups. It is quite similar to a traditional, commercial insurance company in that it is licensed as an insurance company, it sets insurance-premium rates for the risks it chooses to underwrite, writes policies for the risks it insures, collects premiums and pays out claims made against those policies. The biggest difference between a captive insurer and a commercial insurance company is that a captive cannot sell insurance to the general public. It can only underwrite the risks of its parent organization or related entities. Another key difference is that the regulations governing captive insurance companies are typically less onerous than those regulations governing traditional commercial carriers.

At its most basic level a "pure" captive works like this: A corporation with one or more subsidiaries sets up a captive insurance company as a wholly owned subsidiary. The captive is capitalized and domiciled in a jurisdiction with captive-enabling legislation which allows the captive to operate as a licensed insurer. The parent identifies the risks of its subsidiaries that it wants the captive to underwrite. The captive evaluates the risks, writes policies, sets premium levels and accepts premium payments. The subsidiaries then pay the captive tax-deductible premium payments and the captive, like any insurer, invests the premium payments for future claim payouts.

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Like most innovations, captive insurance companies were created to solve a set of problems; in this case, risk-financing problems we didn't know we had until we started thinking about managing and financing risk. To be sure, however, we were introduced to these problems long before we began our professional careers. For most, that introduction probably came around the time we turned 16. Beaming with unfounded confidence, we burst into the house announcing that we passed our drivers' test and were officially ready for our own personal freedom. At some point soon after our little declaration of independence, one of our parents asked how we expected to pay for the insurance.

> "Insurance?" we asked.
>
> "Yes, we've added you to our auto insurance policy and we'd like you to help pay for the additional cost.
>
> "No problem," we said thinking, *What's the big deal? How much could it be?*

If your experience was typical, then you will remember the shock as you tried to comprehend how you—let alone *any* 16-year-old—could possibly afford such a staggering amount. And if you are male and you happened to have an older sister, your shock was eclipsed only by outrage when you learned you were being charged at least 50% more for the same coverage.

"That's not fair!" you protested as you came face to face with one of the risk-financing problems captives were developed to address: insurance rates are not based on the specific risk profile of any one particular insured or the loss history of the family or group or company. They are based on the anticipated

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loss frequency and severity of a population that may well *not* reflect you or your experience.

Imagine the following scenario. Let's say you grew up in a family of safe drivers who rarely or maybe even never had a reason to make a claim against your auto insurance policy. Wouldn't you have preferred to pay premiums based on your actual loss history and risk profile? And, wouldn't it have been better if instead of paying your premium to an insurance company, you could have put it in a bank account that your parents opened so the premium dollars could at least earn you some interest while they sat there waiting to cover a claim that wasn't coming? Of course!

This simple example illustrates a powerful incentive captives offer their owners: the ability to sidestep the broad strokes commercial carriers use when writing rate policies. Why not simply retain the risk inside the captive and let someone else subsidize the broader risk pool's poor experience? We address this and other benefits of forming a captive in chapter 2.

A brief historical perspective

The concept of captive insurance is not new. In fact, by some accounts, the basic concept can be traced back hundreds of years to the days when ship owners would share, exchange or otherwise transfer risk with one another in situations where commercial insurance was not available. Then, in the 1870s, the first Protection and Indemnity clubs were created. Growth of the captive insurance concept was slow however, and up until the 1950s, only about 100 captives were formed.

It wasn't until the 1970s and 1980s that the captive industry saw significant growth. This growth was partly facilitated by new legislation. In the 1970s, three states—Colorado, Tennessee and Vermont—passed laws favorable to captive formation. Then in the 1980s Congress passed federal

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products liability legislation making it easier to operate similar-interest captives. A hard insurance market and interest rate anomalies were the other significant forces driving the dramatic growth of the 1970s and 1980s.

Hard Market

A hard market occurs when insurance premiums increase and capacity decreases. In a hard market, insurance companies are less flexible on coverages, terms and rates.

Go to www.takencaptive.com/glossary to find more definitions.

By 1995, there were just over 3,000 captives and today the number exceeds 5,000. Not surprisingly, some of the largest and most sophisticated organizations were the first to explore, develop and refine the modern captive market. In fact, more than 40% of major U.S. corporations operate at least one captive. These organizations discovered that through forming a captive, they could obtain greater flexibility and control over their risk-financing needs without relying exclusively on the traditional insurance market.

When an organization decides to establish a captive insurance company, one of the key decisions it must make is to determine where the captive will be legally domiciled. Although the organization may be familiar with establishing a subsidiary company, setting up a captive is different. As mentioned, certain jurisdictions have developed favorable legislation to attract companies interested in establishing a captive model while others have established legislation that is decidedly unfavorable.

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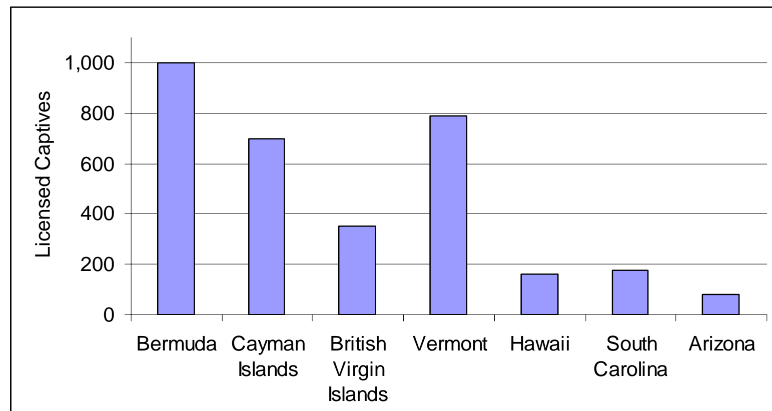
Today, the leading offshore domiciles are Bermuda, the Cayman Islands and the British Virgin Islands. In the U.S., the leading domiciles are Vermont, Hawaii, South Carolina and Arizona. We explore the issues around evaluating and choosing a domicile in chapter 4.

Figure 1.2 - Leading captive domiciles



Addressing Risk: Captive vs. Traditional Market

The problems that are addressed today by captive insurance companies are problems that most organizations face in one form or another:

- unavailability of coverage
- coverage that is too expensive
- coverage that can't be tailored appropriately for an organization's needs
- premium rates that do not meet a particular organization's loss profile

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- inflexible policies
- inflexible terms
- inability to estimate loss frequency or loss severity
- lack of a tax benefit for retaining risk

Like any good business venture, the companies that make up the traditional insurance market are motivated by making a profit. They are in a sense investment companies. They assess market risk, determine what risk they are willing to take based on market averages, take premium payments against those risks, invest the premium payments and ultimately they hope to pay out less in claims than they were able to earn in premium payments and investment income.

Within this business strategy, there is little room for any significant deviation from broadly established principles of acceptable levels of risk and the projected amount of premium payment required to cover those risks. This means opportunities to negotiate better-than-average market rates and opportunities to negotiate customized coverages are limited—even if the company negotiating better rates has a risk profile that is substantially better than average. In fact, insurance companies are counting on these low-risk companies to offset the risk associated with higher-risk companies who are in effect paying less than they should.

At its core, a captive insurance company is a risk-financing tool. It places more risk-management control and financial control into the hands of the owner of the captive than exists in a typical commercial insurer-insured relationship. Unlike what occurs in the traditional insurance market, the risks that are underwritten by the captive are precisely the risks that the insured needs underwritten. The policy terms are designed to meet the specific needs of the insured and the rates are based on the specific loss profile/loss experience of the insured—not the average loss rate of the market.

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You can think of it in terms of buying clothing. While the traditional insurance market offers small, medium or large, a captive insurer measures a precise fit for its insured. However, unlike the choice between custom-tailored and "off the rack," a well–planned, well-structured captive strategy will most likely cost the insured *less* than the traditional commercial-insurance route. The combination of custom-tailored and less expensive is the reason captives have become so prevalent today.

How integrated are captives in today's market?

Based on the existence of more than 5,000 operating captive insurance companies and more than three decades of mainstream market and regulatory acceptance, the captive insurance model can be considered, by nearly all measures, a well-accepted risk-management option in today's market.

This was certainly not always the case. State and federal insurance regulators and tax authorities have scrutinized, analyzed and challenged from many angles the use of captives. In the end, the captive market is better for it. What stands in the market today are captive options that have been clarified and refined. The long-term value of a well-structured captive is now much more clear and predictable.

To say that the captive insurance model is well accepted does not mean that there are no longer any challenges from a regulatory perspective. It is true that there are standard captive structures that have become well accepted. But the market continues to evolve and new captive structures and innovative uses for captives are being designed all the time. As you would expect, any new business methodology that either impacts the Internal Revenue Service's standard of living or runs afoul of an insurance regulator's standards of acceptable

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practice will be subject to some degree of scrutiny. Nevertheless, the fact that the debate has moved from "should a captive be permitted to exist at all" to whether certain customized versions should be permitted is another strong indicator of market acceptance.

Captive Insight

Do you know the name of the major commercial insurance company that started as a captive for one of America's longest-standing retailers?

Go to www.takencaptive.com and enter the phrase: "retail captive" in the **"Captive Insight"** box for the answer.

There is no question that one of the most important drivers for market acceptance and long-term market integration of captives was the recognition in the mid 1990s that in proper circumstances, premiums paid to captives would be deductible. The IRS recognized the deductibility of premiums paid to a captive by a captive owner's subsidiary. Premiums paid to a captive directly by the parent were not deductible (see Figure 1.3).

Once the premium deductibility issue was settled to the point where tax professionals could confidently plan on premium deductibility, captives started forming in record numbers.

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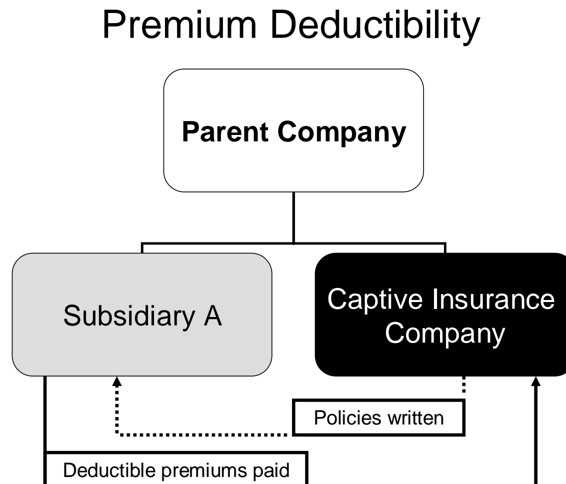
Figure 1.3 - Captive structure for premium deductibility



In the 15 years between 1991 and 2006, the total number of captives in the world market rose from 3,000 to 5,000 – a 167% increase. During the same period, Vermont, the leading captive jurisdiction in the U.S., saw a nearly 340% increase in captives formed from 234 to 791.

One reason for the significant jump in numbers of captives is that smaller companies have discovered the captive benefits. Initially, the captive market was shaped by the largest corporations with complex risk-financing issues to manage. Once captives became commonplace, opportunities for their use became more obvious and available to smaller companies looking for flexibility and greater control. For example, captives are frequently used today by a variety of small-business professionals ranging from contractors to physicians. These professionals have discovered the distinct advantages of using a captive as a key component of their overall risk-financing strategy.

New applications for captives are being developed all the time and are worth evaluating for your particular risk-management

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situation. Consulting a professional risk management advisor with captive expertise will provide insight into options for your specific needs.

Captive Insight

For examples of how captives work in specific industries, go to www.takencaptive.com and enter the phrase: "industry" in the **"Captive Insight"** box.

Reserve your copy of *Taken Captive* today by logging on to www.takencaptive.com or calling Risk Management Advisors at 562.472.2846.

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