CAPTIVE INSURANCE COMPANIES

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A captive insurance company is, in its simplest form, a closely held insurance company whose insurance business is primarily supplied, and controlled, by its owner, who is the principal beneficiary. Captive insurance company insureds have direct involvement and influence over the captive's major operations, including underwriting, claims management, policy form, and investments.

In the last 20 years, there has been extraordinary growth in the number of captive insurance companies so that today, there are well over 4,000 captives worldwide, writing more than $20 billion in premiums. To a certain extent, the primary reasons for using a captive as opposed to commercial insurance have taken some twists and turns over the past 20 years or so.

In the 1980s, the primary rationale for captive utilization was tactical and caused by high commercial insurance prices, availability and restrictive terms and conditions. As the market became "soft," the primary rationale for captive formation and utilization in the 1990s was strategic, consisting primarily of the following:

- As a strategic business tool
- Better overall financial planning
- Integrated approach to minimizing all types of company risks
- More direct control of claims management
- Better loss prevention and safety
- Organizational placement and increased sophistication of the risk management function
- Critical review of the perceived value added by property/casualty insurers
- Federal and state tax efficiency

Since 2001, we have seen a return to some of the problems of the 1980s with high prices, restrictive terms and reduced capacity, driving new or expanded captive use. As a result, in many large corporations, captives are now part of a holistic approach to risk management and business risk.

Captives are established on a direct basis, when the captive sells its parent insurance directly; or, on an indirect basis, when the captive provides reinsurance of a fronting insurer which provides insurance directly to the parent. The latter arrangement is required in two main situations. First, where the insurance sought is mandatory and may only be issued by an insurance company licensed in that state, such as automobile liability and workers' compensation. Second, where the captive's owner needs to evidence financial responsibility to third parties and those third parties have mandated that the insurance must be provided by an insurer meeting minimum ratings from an insurer rating organization. Since most captives do not have ratings and cannot get them in the early years, a front may be required in those circumstances.

Captives are most typically categorized according to ownership and structure, as follows:

- Single owner, or pure captive
- Multi-owner/Multi-insured
    - agency captive
    - homogeneous association/group
    - risk retention group
- Protected cell

Pure Captive. A pure captive or a single parent captive is owned by a single entity, and exist primarily to underwrite the risks of its parent and affiliated companies. They may or may not also underwrite risks of affiliated but tangential parties. In Arizona, that is called "controlled unaffiliated business" and it requires that the risk management function be performed under contract by an affiliate of the captive.

Agency Captive. An agency captive is owned by one or more licensed insurance agencies or producers and only insure risks or policies placed through its owners.

Association Captive. Association captives have multiple owners and are typically homogeneous, i.e., they underwrite roughly the same types of risks for companies in similar or related industries. Association captives typically engage in risk sharing, with each insured responsible for the losses of other captive members, subject to corporate governance documents.

Risk Retention Group. Risk retention groups are a subset of association captives. They are formed pursuant to the provisions of the Liability Risk Retention Act of 1981, as amended, and operate under a limited federal preemption of the regulatory prerogatives of state insurance commissioners. Like association captives, they are homogeneous and engage in risk sharing. Unlike association captives, they are limited in the risks they are permitted to insure.

Protected Cell Captive. Protected cell captives are sponsor-owned facilities that permit companies to retain their own losses in a formal insurance environment. The risks of separate participants are insured through a contract.

Captives may be formed for any number of reasons, some of the more common are as follows:

Cost. The "cost" reason has three components, as follows:

1. All things being equal, captives should be expected to have lower transaction costs than commercial insurance companies. When compared to commercial insurance transactions, captive premiums generally do not include loadings for acquisition cost and shareholder profit. Having said this, captives which act as reinsurers of fronted programs do attract considerable transaction costs, and these frictional costs may drive up the net after tax cost beyond the cost that would be associated with self-insurance.

2. To the same degree as commercial insurers, premiums paid to captives have the ability to generate investment income until claims are paid.

3. The presence of a captive may allow the parent to negotiate better terms from commercial insurers if those commercial insurers are aware that the captive owner has a readily available risk financing vehicle that can be pressed into service if it views the insurance terms being offered as unattractive.

Coverage. Captives have few limitations on their ability to offer specific policy terms and conditions. This typically results in a better match of needs to coverage.

Capacity. The dedication of capital to a captive creates capacity that heretofore did not exist in the world insurance market. Since insurance is a leveraged business, each dollar of capital supports more than one dollar of premium underwritings.

Control. While there is a tendency to think of the insurance contract as primarily providing coverage against fortuitous losses, the insurance contract contains a number of other obligations including claims adjusting, engineering and loss control. In a captive environment, owners select all their service providers individually, and therefore do not have to "settle" for the ones assigned to them by their insurer, picking and choosing the best providers for each service.

Coordinating International Insurance Program Retentions. A captive can be an attractive mechanism to coordinate international insurance programs to ensure that retentions are consistent worldwide. In a typical multinational program, retentions vary based on the operations resident in various countries. These operations are often differently sized, and retentions that are appropriate at the parent level are often inappropriately high for operating units, especially those in non-headquarter countries. Permitting operating divisions to purchase local insurance typically results in excess insurance coverage because the local operating unit tends to purchase deductibles that are appropriate for the operating unit given its size, but too low overall considering the enterprise wide risk-bearing capacity.

This is a particular problem where the compensation plan of the local manager is at least partially a function of profitability, and where under-deductible losses are charged back. In this situation, captives can be used to ensure a consistent, company-wide retention by offering deductible buy-down coverage. This coverage permits local operating units to purchase lower retentions appropriate to their risk-bearing capacity, but because the captive provides coverage, there is no premium leakage. Alternatively, the local manger can elect to purchase insurance locally and reinsure it to the captive, which can retain what it wants and reinsure the balance.

Access to Reinsurance. In the event that the captive owner wishes to engage in risk transfer but the ideal program is provided by a reinsurer who, by virtue of its charter or regulation, can only offer reinsurance, the use of a captive insurance company allows the parent of the captive to deal with that reinsurer, even if only on an indirect basis. In such a case, the captive functions as a direct insurer of its parent, but all or virtually all of the risk is immediately reinsured with a professional reinsurer.

Access to TRIA. Captives domiciled in the United States are included in the definition of "insurer" within The Terrorism Risk Insurance Act of 2002 (TRIA). TRIA is a cost-sharing program between the U.S. Government and the insurance industry.

While in the past many captives have been domiciled offshore, this is rapidly changing. The usage of onshore captives has increased markedly due to state law changes that have made on-shores as attractive as offshores. In fact, in some cases there are benefits offered by a domestic captive that can't be matched by an offshore captive, such as employee benefit risk. Arizona enacted the Captive Insurance Act in 2002 that has thrust Arizona to the forefront of captive domiciles. Most significantly, Arizona has a regulatory environment designed to make it an attractive domicile state, with no premium taxes and a low cost capital structure.

All in all, captive insurance companies are becoming increasingly popular and for good business reasons!

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