# Coverage Insights

Brought to you by: ToughComp - a Trucordia Company




# Are Captive Insurers Right for You?

Captive insurance companies, which are established to finance the risk of a parent group or groups and sometimes these groups' customers, can provide advantages in risk management, insurance savings, wealth transfer and taxes. They are a form of alternative risk transfer used by major corporations, nonprofit organizations and medium-sized businesses.

## How Does a Captive Work?

The owners of a group of businesses may decide to retain some of their own risk and form their own insurance company, called a "captive insurer," instead of purchasing insurance from a third party carrier. This is an attractive option for companies who find a limited availability of certain types of insurance coverage in the commercial market or find that those coverages will be a significant expense. In some cases, the captive insurer may decide to insure the group's customers as well. The primary jurisdiction in which the captive insurance company is organized is called a "domicile."

## Benefits of Captives

Captives can bring many benefits as alternatives to other risk financing plans. Properly structured, captives can bring the following advantages:

- Reduced cost of risk
- Cash flow benefits from captive
- Coverage not available from commercial insurers
- Direct access to the international market of reinsurers, which can be more flexible
- Increased bargaining power with commercial insurers (if the captive holds a percentage of insurance)
- Centralize retained losses spread throughout subsidiaries
- Cash flow advantages on income taxes—premiums paid to a captive insurer can be tax-deductible, depending on several factors:
  - The transaction is a bona-fide insurance transaction under a defensible business plan
  - The captive's owner is organized such that subsidiaries pay premiums to the captive
  - The captive writes a substantial amount of unrelated business, e.g., employee benefit business
  - Ownership is arranged such that insureds are not the same as shareholders.

## Is a Captive Right for You?

Captives can be valuable strategic risk management tools, but they are not the best approach for every organization. For some risk profiles, they are not feasible, and could ultimately cost more than traditional insurance. If your business is considering setting up a captive insurer, you must first clearly establish the financial and business goals and objectives of the company through effective communication between senior management, including CFO, risk manager and business unit heads. Together, consider the follow aspects of your company:

- Background and financial goals
- Actuarial or data issues, including loss data or exposure information needed, insurance company expense loads
- Reinsurance marketplace potential
- Tax and regulatory issues
- Desired captive design

Several parameters can assist you in determining whether a captive is a viable option:

- You must be financially stable and have a good loss history.

- Captive expenses should be below 20 percent of premium, unless there is a compelling reason for a higher ratio.
- You must be able to demonstrate your ability to pay for claims and secure future losses.
- You must be able to dedicate considerable attention to the operation of the captive.

## Feasibility Study

Having concluded that a captive may be a good fit, take the following steps to more carefully study the appropriateness of a captive insurer for your organization:

- Review relevant background information
- Discuss financial implications of captive formation
- Generate projections of expected loss experience
- Estimate operational expenses associated with the captive to determine premium
- Determine appropriate capital levels or margin of risk to support the written exposure, considering local legislation
- Describe qualitative factors including location, ownership, support or other issues
- Prepare financial statements with balance sheets and income statements for the captive over a five-year period under different scenarios
- Compare the captive with the status quo on both financial and nonfinancial criteria

## Issues to Consider

Consider the following issues when examining captive insurers:

- Align your investment policy to the assumptions used to set premiums. Consider whether to use the time value of money based on the captive's assets—for example, letters of credit do not generate investment income, so premiums should not be set considering the time value of money.
- Consider state or domicile premium taxes, U.S. federal excise taxes, U.S. income tax and 953(d) election (for foreign insurance companies).

## Expert Assistance

Having determined that a captive is right for your organization, seek professionals experienced in actuarial, accounting, tax and legal issues to help you set it up. They can assist you with the following additional steps:

- **Selecting the Domicile**: Select an onshore (within 50 states) or offshore (outside the United States) domicile. Here you must consider ease of regulation in the area and the quality and quantity of support services. A visit to the domicile may assist.
- **Selecting Partners**: Selecting the right risk-sharing partner is critical to the success of the captive. This is the entity responsible for claims, generally a U.S. licensed and admitted insurance company. The partner could be your current, traditional insurer or you could have time to form a new relationship—the partner will likely have strong opinions on your plan, and may have restrictions or requirements on practices and procedures.
- **Operating a Captive**: The captive will be an operating insurance company. It must receive funds immediately and invest them prudently so they are available to pay claims. This can be a source of revenue for the captive, but can also cost the owner substantial sums if improperly managed. Assigning roles and responsibilities and conducting frequent analyses on the captive's financial health is essential to ensuring it is bringing the desired benefits to the organization.

## ToughComp - a Trucordia Company

The insurance professionals at ToughComp - a Trucordia Company are committed to helping you implement the best risk management solutions for your business. Contact us today for more information.

---

This Coverage Insights is not intended to be exhaustive nor should any discussion or opinions be construed as legal advice. Readers should contact legal counsel or an insurance professional for appropriate advice. © 2011-2012 Zywave, Inc. All rights reserved.