15 Things to Do Before Forming a Captive

Article By:

Risk Management Magazine

There are many benefits to forming a captive, but they can vary based on the company's individual needs and circumstances. A company's size, risk appetite and risk exposures all play a role in determining whether forming a captive is the right answer. And while the final decision is ultimately subjective, conducting a captive feasibility analysis will help management make the right choice.

Be sure to consider the following before you begin.

1. Begin the Analysis
First, look closely at the lines of insurance, deductibles, limits and premium spent in the company's current insurance program to see where a captive could reasonably help mitigate risk. Be sure to include the lines of coverage and the amount of expected loss to be insured. Property and casualty lines are the foundation of most captives since they account for the majority of insurance premium expenditure. The new captive owner should understand the implications of insuring third party business since the captive may unknowingly take on risks that are unacceptable.

2. Identify Premium by Business Line
The flow of premiums to the captive can drive taxes, fronting/regulatory fees, collateral requirements and administration expenses. A potential owner should determine if premiums should be paid to the captive in the form of a deductible reimbursement contract, through a fronting company or directly from the insured subsidiaries. Risk professionals should also review whether the captive will be a net retainer of risk, reinsurer of risk to third parties or a combination of the two.

3. Review Management Options
Capital is used to secure the risk written by the captive. Companies seeking to limit the amount of cash in a captive can be selective about insurance lines and premiums written and use qualified reinsurance or employ direct insurance instead of a fronted arrangement. The captive insurance company may invest its premiums and capital by purchasing assets from within the organization or entering into loan arrangements with affiliates. It is also possible to use letters of credit in lieu of cash to fund a large portion of the capital base. The cost of capital versus the cost of letters of credit should be compared.

4. Obtain an Actuarial Analysis
The premium written and the losses incurred should be actuarially determined where possible. Many domiciles require an actuarial analysis as part of the incorporation packet.

Before a company embarks on a captive, analyze the cost of capital from three perspectives: (1) internal rate of return, (2) borrowing rate, and (3) investment return equality. Determine which capital measure is most relevant to management for application to the feasibility study. Here is an explanation of each term:

Internal rate of return: the investment return on funds, such as a capital investment, can be as high as 30% or more and can be expressed as the minimum investment return to justify a capital expenditure; if the company uses an internal rate of return criterion for capital investments, use of a captive is often very difficult to justify financially as the investment returns in a captive are often at a highly liquid rate

Borrowing rate: the rate at which a company could borrow funds to invest in the captive

Investment return equality: no cost of funds because cash in a captive is viewed at the same liquid investment rate as if it were at the parent

5. Perform a Tax Analysis
The tax impact of a captive insurance arrangement must be evaluated, both from the perspective of the captive insurance company and the insured. Due to the unique nature of the insurance business, insurance companies are frequently subject to a different taxing scheme than other businesses. In many instances, these differences are favorable to the insurance company while in others the differences may be detrimental.

6. Determine Captive Structure
Review the various options for the structure of the captive that can drive capital, taxation, capacity and costs. There are four primary choices for a large corporation: "wholly owned" (also known as "single parent"), "group or association," "rent-a-captive" or "cell company." A wholly owned captive is, as you would imagine, an insurance company owned by one company, typically the insured, while a group or association captive is one shared by multiple businesses (either through a formal association or an informal relationship in which the risk is homogenous). A rent-a-captive, on the other hand, is not owned by the company using it to mitigate risk. Rather, the company uses another owner's captive and shares the liability. A cell company captive is very similar to a rent-a-captive-the potential for the sharing of liability with other members does not exist.

7. Review Possible Domiciles
For U.S. insureds, the key differentiator is the management perspective regarding onshore versus offshore. Domicile choice is a consideration that can also affect capital, types of insurance that can be written, premium taxes, federal excise taxes, regulatory ease and so forth. There are about 75 captive domiciles around the world (see page 34 for the top 25 domiciles), and the most mature domiciles have thriving service provider communities (captive managers, lawyers, actuaries, accountants and brokers) capable of managing all aspects of the captive.

8. Identify the Costs
Capital, reinsurance costs, federal excise taxes, direct placement taxes, captive management fees, attorneys' fees, audit, actuarial and domicile fees can add up quickly. Identifying the costs and keeping them in mind when making a captive feasibility decision will reduce surprises.

9. Model the Alternatives
It is important not to regard the premium savings gained by increasing captive retention as a benefit provided by the captive because such savings could also be achieved through insurance program restructuring alone. The model should take into account all the relevant variables and produce a bottom-line net present value of each option. Creating a financial model outlining the current program, a guaranteed cost program, a high deductible program and several captive options is an effective way to compare alternative captive and noncaptive structures. It is often recommended that all captive feasibility model inputs include funding, tax deductibility, taxes (income, premium, state, federal excise), premium required, cash flow, capital (cash and letters of credit) and other identified costs.

10. Quantify Access to Reinsurance
There may be savings in using the captive as a vehicle to access the reinsurance market directly (often the same reinsurers that the primary insurance companies would use). Using a captive can allow the frictional costs that insurance companies charge to be avoided. However, many feasibility studies lack a direct comparison of the two alternatives. In essence, the company should compare the premium cost difference of using an insurance company versus going directly to the reinsurance markets.

11. Assess Time Commitment
Seldom reviewed is the time it will take the risk manager and those selected as captive board members to manage the entity. The more complex the captive, the more time-consuming it will be. This is critical if senior management is on the captive's board of directors or in key supporting captive management positions.

12. Compare Captive Managers
The selection of service providers for the captive will normally occur after the feasibility decision is made, but understanding the level of management that will be delivered by the captive will give insight into internal resource requirements.

13. Create Financial Projections
Cash flow and income statement projections are critical to determining if funding levels are correct. They will also show how a captive responds under several loss scenarios. Inputs should be taken from the actuarial work, modeling alternatives and agreed upon key metrics, and all financial statements should be vetted and reviewed with accounting, finance, tax and strategic planning professionals.

14. Evaluate Indirect Benefits
Many of the benefits of a captive are qualitative in nature. Be sure to also consider these advantages:

- Captive use as an organizational tool to concentrate insurance
- Use of funded captive to smooth budgets in cases of severe uninsured losses
- Flexibility to retain more risk in hard markets and transfer risk in soft markets
- Enhanced control over claims
- Tailored insurance programs for the parent
- Reductions of onerous state self-insurance regulations
- Employee benefits
- Captive risk pooling with other insureds
- Estate planning for privately owned corporations
- Finite risk solutions
- Loss portfolio transfers
- Joint venture insurance
- Warranty insurance

15. Consider Shutdown Options
Captives are licensed insurance companies so the long-term nature of the liabilities and financial capital commitments can be difficult to wind down if the structure entails the use of a front company or reinsurance or if the captive acts as a reinsurer of third party business. Typically, all liabilities must be extinguished and the proof of a "clean captive" must be demonstrated to regulators. This is relatively straightforward with short-tail coverages, but can be problematic with longer-tailed lines, such as casualty coverages.

Written by James Bulkowski:

***James Bulkowski** is an executive in the insurance and actuarial advisory services practice of Ernst & Young LLP's Financial Services office.*

An unabridged version of this article was originally published by the Risk and Insurance Management Society, Inc. (RIMS) and Ernst & Young as part of RIMS' Risk Insights whitepaper series.

The above article is reprinted from the August 2010 on-line edition of Risk Management Magazine.

National Law Review, Volume , Number 225