Captive Primer

An Introduction to Captive Insurance

This "Captive Primer" is designed as an introduction to captives to inform those looking to for an introduction to and basic understanding of captives.

In today's business environment, there are a litany of options available to risk management professionals to control, hedge, or eliminate risks. These options include:

- Purchasing insurance;
- Self insuring;
- Accessing reinsurance/multi-year/finite coverage; and
- Approaching capital markets.

Collectively referred to as risk financing, one, all, or a combination of these programs have become the standard for forward thinking risk managers. The focus of this Primer is to highlight the use of captive insurance subsidiaries in relation to these alternatives. The captive can provide the organization a comprehensive risk management tool to facilitate one or more of the above methods and ultimately achieve risk reduction for both traditional and non-traditional risks.

RISK MANAGEMENT OVERVIEW

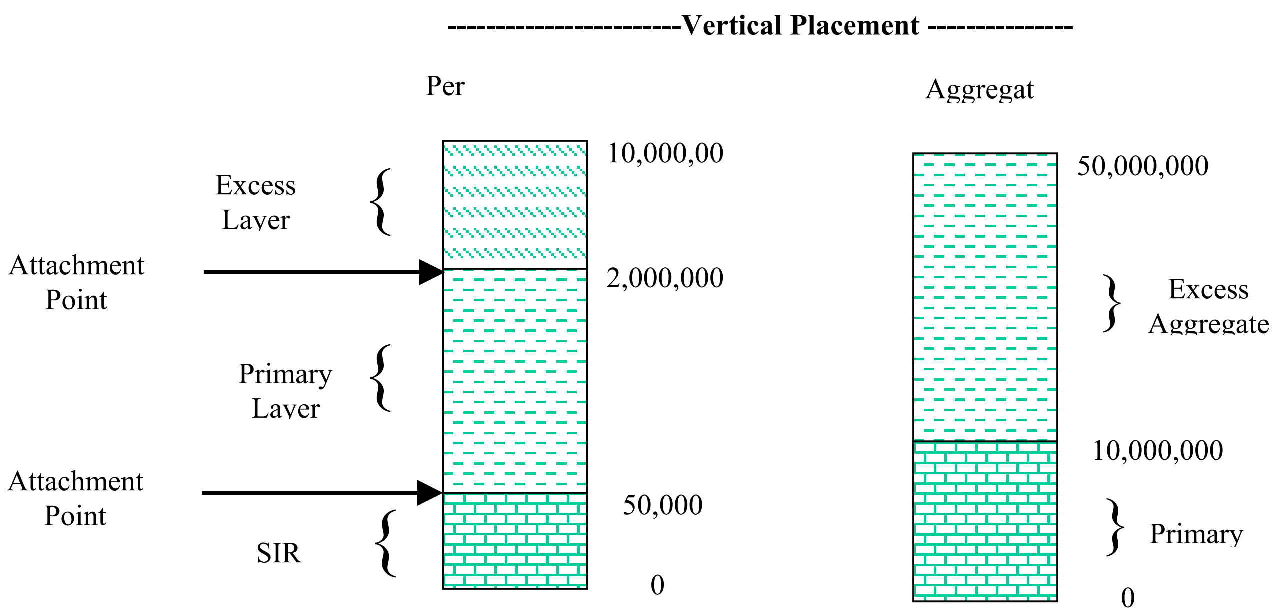
Risk Management is defined as a rigorous and coordinated approach to assessing and responding to all risks that affect the achievement of an organization's strategic and financial objectives.

The risk management function has historically addressed what can best be described as "traditional" insurable risks. These are insurance coverages that are normally purchased from established insurance carriers and include such risks as fire, property, workers' compensation, general liability, and auto. Other "non-traditional" risks, such as financial risks which include product and service pricing, interest rates, and business risks such as asset utilization and inventory procurement are usually the focus of finance/treasury and operations respectively. However, from a risk management perspective, this approach lacks the ability to measure risks on a common basis, assess the interrelationship between the risks and analyze the potential impacts of these risks across an organization. To pursue these interrelationships, the concept of risk management has changed dramatically over the past several years to include risk which were once thought outside the realm of insurance and risk financing.

Traditional Risks

Traditional risks include coverages such as general liability, auto, workers' compensation, and industry specific coverages, as well as umbrella and employee benefits. These risks are typically financed in the traditional insurance markets where insureds make an educated bet that the cost of insurance premiums over time plus the time value of money are less than the ultimate benefits received through claims settlement. In addition to the financial aspect of these coverages, insureds also gain claim settlement support, regulatory compliance and ultimately, piece of mind.

These risks are generally priced in the commercial market utilizing "vertical" placement. Typically, this vertical placement includes a self-insured retention ("SIR" or Deductible), a primary layer and an excess layer. When placing these coverages, insureds look to pricing[1], per occurrence and aggregate limits[2], exclusions, and their own financial position when accessing the appropriate SIR or "attachment point" for the cover[3]. Of course, depending on pricing, many different insureds may participate in the various layers of coverage.



Non-traditional Risks

The non-traditional market has grown to such a size that a comprehensive review of all the available programs is well beyond the scope of this Primer. However, risks such as earnings fluctuations, bad debts, performance completion, contract indemnifications, materials and labor price fluctuations, price hedging and warranties have found niches in the alternative market. The programs can be placed in a multitude of ways; some of the more popular include:

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[1] The insurance market, like many markets, is cyclical in nature. A market with increasing prices is typically referred to as "hard", while an affordable market is "soft". The utilization of captives for traditional risks tends to increase as the markets harden forcing insureds to retain larger SIRs.

[2] A per occurrence limit relates to the maximum amount that will be paid for any one loss event or accident whereas an aggregate limit relates to the total losses in any given time period regardless of the number of loss events.

[3] The SIR or attachment point is typically stated on a per occurrence basis, however, aggregate covers also have an attachment point. For example, the SIR may be $50,000 per loss event up to an aggregate maximum of $10,000,000 at which point all losses are covered, including the SIR, up to the aggregate limit ($50,000,000 in this example).

<u>Retro ratings</u>	Premiums are refunded or demanded based on loss experience;
<u>Prospective ratings</u>	Premiums increase or decrease annually depending on loss history and investment return on assets;
<u>Multi-year or Finite</u>	Aggregate retentions are based on multiple years. In addition, premiums tend to be retro or prospectively rated and often will contemplate as much as a ninety-five percent (95%) return of premium upon program completion.

More recently, enterprises have moved toward evaluating and managing risk in the aggregate. This approach, often described as "enterprise," or "holistic" risk management, allows a company to efficiently analyze how various risks interact and enables the risk management function to provide management with a better perspective on the financial statements impact of risk. In turn, the company is better equipped to quantify and manage the full spectrum of threats these risk cause to earnings, cash flows and operations. Many times the combination of non-correlative risks will permit the insurance markets to provide coverage on a more economical basis.

CAPTIVE INSURANCE OVERVIEW

There are normally two characteristics that distinguish a captive insurance company. First, a captive is generally owned through a common interest which is not primarily engaged in the business of insurance. This interest may be single-parent shareholder or a group of shareholders. Secondly, as the name implies, all or a significant portion of the risks written are "captive". These captive risks can be separated into two basic types: (1) First party risk to its shareholders, parent corporation or brother/sister company; and (2) Third party risk, which is risk unrelated to an organization, but in some cases, the organization has some ability to control.

The growth of the captive insurance industry has been steadily increasing. Although there are no official records regarding the number of captives, it is estimated that there are approximately 4,200 worldwide. Current estimates of premiums written or reinsured by captives are $28 billion and alternative risk management programs are estimated to be 40% or more of the U.S. market.

The risks being underwritten by a captive will vary based on the objectives involved in its formation. The coverage may include such risks as workers' compensation, property, liability, employee benefits or malpractice and may be for SIRs, primary or excess layers of risk. Examples of first party risk include: deductibles for property and casualty, workers' compensation, and general liability. Captive third party risks include: extended warranty programs, credit life, and credit disability and various employee, customer, vendor and supplier programs.

A captive can legally assume risks as either a "direct writer" or a "reinsurer". A direct writer is defined as a primary insurer that sells insurance directly to the insured. A reinsurer is defined as an organization who assumes the liability of a direct writer (or in the case of multiple reinsurance agreements the reinsurer can assume risk from another reinsurer) for a consideration, and then agrees to indemnify the direct writer or "ceding company" against all or part of the loss which may be sustained under the policy or policies. As a reinsurer, the captive assumes business from an admitted direct-writing company called the fronting company or "Front". A variety of transaction costs and state laws must be considered in determining whether a captive should utilize a fronting company or insure the risks on direct basis.

A graphic depiction as follows:

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Types of Captives

Captive insurance companies can be categorized in a number of ways. The main delineation is between group-owned and single-parent captives. Single-owner captives, by far the largest category, are owned by a single parent or sponsor. Group-owned captives have more than one shareholder. There are several diverse types of captives:

- Single-parent captives., Underwriting risks only of related-group companies (first party risk).

- Diversified captives. Underwriting risks of unrelated companies in addition to risks of the relayed group of companies (a so called "mixed" captive with both first and third party risk).

- Association captives. Formed by members of a common industry or trade association in order to share the risks of that industry or association among its members.

- Agent captives. Sponsored by one or more independent agents to write high-quality risks that they control. These programs may be both agent-responsive and insured-responsive; that is, both the agents and the insured may benefit from profits based on their contribution.

- Captive pools. Formed for the exchange of insurance business among captives in order to spread their risks and enhance their participation in non-related business.

- Rent-a-Captives. A captive owned by unrelated parties, which provides captive facilities to others for a fee. Multiple classes of stock and special regulatory statutes permit the segregation of risks among insureds. Often used by programs too small to justify incorporating their own captive or where separate ownership may be important for other reasons.

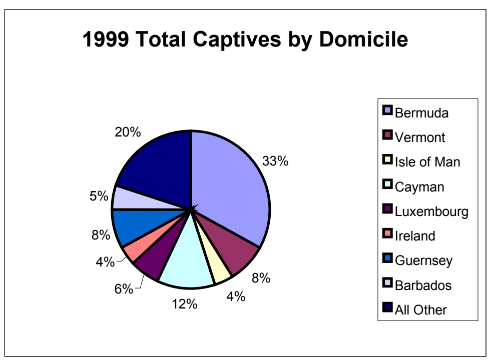
- Risk Retention Groups (RRG). An RRG is a type of group captive arrangement formed either under the U.S. Product Liability Risk Retention Act of 1981 or under the U.S. Federal Liability Risk Retention Act of 1986. RRG are all domestic and licensed in one state but doing business in more than one state. Many times an RRG is utilized to efficiently access insurance coverage for a large group of similarily situated companies of persons that are otherwise too small to access such coverage (e.g. all doctors in a particular geography).

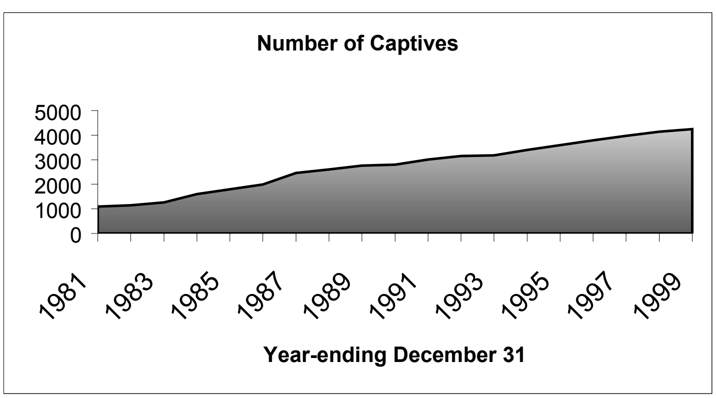
Domiciles

A captive may be domiciled as either a U.S. corporation or a foreign corporation. If a company is incorporated in a foreign domicile, it will operate from that location even though it may underwrite U.S. risks. If such a corporation is also owned by U.S. persons there are a number of complicated laws that guide its U.S. taxation. The rules may be further complicated where foreign risks are also insured by the captive.

While the captive industry is centered in Bermuda, the Cayman Islands are a favorite home for association captives, and the Bahamas are becoming increasingly popular among new captive organizers. Other offshore jurisdictions that are seeing significant activity include Guernsey, Isle of Man, Hong Kong, Panama, Turks and Caicos, U.S. Virgin Islands, the British Virgin Islands, Luxemburg and Ireland.

Thirteen states within the United States have passed captive insurance legislation. Colorado is the senior and Vermont is the most popular domestic jurisdiction. The more recent additions to the list are Tennessee, Virginia, Florida, Georgia, Hawaii, Illinois, West Virginia, Delaware, Kansas, New York and Rhode Island.





Economic Incentives

Captives are formed to provide necessary coverage at acceptable prices, to stabilize earnings, and to provide a regulated method of insuring risks which would both isolate funds for the settlement of claims and satisfy interested lenders, mortgages, and securities analysts. The more common economic reasons include:

a. **Cost reductions.** One of the most common reasons for establishing a captive is to minimize the costs of risk management by creating a captive profit center. The price of insurance purchased in the conventional market obviously includes a portion of the insurer's acquisition costs, overheads and profits, and they may be as much as 40% of the premium. Although establishing a captive does not avoid all these costs, it may reduce them, and, if the captive's own loss experience is no worse and claim handling costs are no greater than the average of the conventional insurer's business, there may be substantial underwriting profits available to the captive.

The rising premium costs of certain high-risk or 'long-tail' insurance (such a product liability or medical malpractice) has been successfully contained by some association or industry captives, which were formed to avoid the volatility of market cycles.

b. **Unavailability of coverage.** The insurance industry is subject to considerable cyclical changes in which excess capacity leads to competition resulting in decreased premium rates and poor underwriting results. This in turn causes a market reaction resulting in dramatic increases in premium rates and restriction on the availability of some types of coverage. In some cases, premium rates may be set unrealistically high as the insurance sector attempts to recover some of its losses from the previous cycle of depressed rates. This is particularly the case with liability lines, excess covers and catastrophe risks. Many captives have been formed to provide coverage, which was otherwise not available due to the cyclical process of the market. Many of these have remained in place providing ongoing coverage at more stable premium rates than is available in the market.

c. **Insuring the Uninsurable.** Captives can provide coverage in areas such as new or potentially hazardous products, hazardous waste, nuclear risks or environmental pollution. Wherever protection is either unavailable in the conventional market or available only at an unacceptably high price, there is an opportunity for a captive.

d. **Cash flow benefits.** The insurance industry has traditionally relied upon high investment income to supplement modest or even negative underwriting results. Such investment income is generated primarily from funds represented by unearned premiums and unpaid losses, since premiums are usually paid in advance, often annually, while claims tend to be paid out over a much longer period, depending on the type of business insured. The captive and its parent company, rather than the conventional insurer, can therefore derive the benefit from investment income which can be substantial. In other words, the "interest credit" by the insurer can be far less than the "cost of capital" of the insured.

e. **Access to the reinsurance market.** A fundamental benefit of establishing a captive is the ability to gain direct access to the international reinsurance market, considered the wholesale market for insurance. Captives can often obtain reinsurance that is less expensive than conventional direct excess and umbrella coverage; especially in a hard market. In addition, a captive has the opportunity to reduce costs by combining two or more lines of risk, and may also earn ceding and/or profit commissions and therefore, diminish the risk to the reinsurer.

f. **Diversification into a profit center.** Another reason for establishing a captive is to diversify into open market insurance operations and operate as a separate commercial profit center. Whereas the primary reason for forming a single parent captive is usually to reduce insurance costs, an ancillary benefit may be the generation profits from third party unrelated business.

g. **"Unbundling" of services.** A company may not be satisfied with the technical services provided by its conventional insurer and may wish to "unbundled" risk control and claim handling services form the actual purchase of insurance cover. This is usually an ancillary reason for forming a captive.

h. **Reduction of government regulations and restrictions.** The insurance industry is heavily regulated, with minimum capital and surplus requirements, solvency margins, specific ratios of premiums written to net and, in some cases, restrictions on investments. An offshore location for a captive insurance or reinsurance company can, if properly established within the legal requirements of the domicile, provide a less onerous regulatory environment, widen investment opportunities and facilitate legitimate international movement of funds, all of which may be of vital importance to the commercial interests of the multinational corporation.

i. **Tax Planning.** Due to the complexity of the tax laws, any captive arrangement must consider tax costs as well as tax planning opportunities.

<u>Is a Captive Necessary?</u>

A feasibility study is the most effective way to compare all the alternatives in both financial and non-financial terms and to determine whether a captive is the best means for the company to achieve its risk management objectives and other goals. The feasibility study should encompass a global review of the company's existing insurance cover, premium costs, loss history, values at risk and overall objectives. The study should also assess the adequacy of existing or planned accident prevention measures and possible reinsurance costs. STRATEGIC RISK SERVICES can provide the actuarial, tax and economic services to prepare the feasibility study.