Captives 101: a primer

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The world of captive insurance can be confusing, with so many different structures available, and so many different factors that need to be taken into consideration.

John Talley of the Missouri Department of Insurance runs through the key points to keep in mind.

I have been a captive insurance regulator for a number of years. The question I am asked most often is: “What is a captive?” The simple answer is a captive is a company created by the parent organisation to insure its risks and those of any affiliated entity. Most captive statutes in the US generally follow this definition.

Other definitions given are:

- An insurance company that is wholly owned and controlled by its insureds, whose primary purpose is to insure the risks of its owners. The insureds can benefit from the captive's profits.
- "An insurance company that is a subsidiary of the parent company that provides risk mitigation services for the parent company or a group of companies": National University of Kyiv.
- "A captive insurance company is a subsidiary company established by one or more commonly owned businesses to insure the risks of the controlling entity and/or its individual owners": PwC.
- "A wholly owned subsidiary of a multinational group of companies which exclusively insures or reinsures the risks of companies that belong to the group. A captive insurance company is usually established in a low-tax country": OECD.
- "A captive insurance company is a special purpose insurance company established to provide risk management for a parent company": Erin Robbins, CLA Ontario.

Anyone who has operated, or worked in, a business knows that business risk is the antithesis of a profitable business. Business risk is the exposure a company or organisation has that will lower its profits or lead it to fail.

It is a sound business practice to adopt internal procedures to manage (eliminate or mitigate) these risks. However, the business owner will be obliged to pay losses that arise from those risks (self-insure). Alternatively, the owner can transfer that risk and the obligation to pay any losses arising from the risk to a third party.

Risk transfer

The traditional way to transfer the risk, and the obligation, has been through the purchase of insurance through a commercial insurer. Most individuals understand this process as (1) money (premium) is paid for an insurance policy; and (2) the policy states that the insurance company promises to pay a loss covered under the terms of the policy. The process is simple, but as businesses have found, many issues can make the process onerous.

Some of those issues are:

- Premiums continue to rise, but your losses decline.
- Particular losses are excluded under the language of the policy.
- Coverage cannot be found in the traditional market.
- The cost of coverage is so expensive as to be prohibitive.

The concept of owning and operating your own insurance company was formed as an alternative.

From the definitions above, one can see that a captive insurance company is different from a traditional insurance company in that the insured is also the owner of the insurance company. In that respect, a captive is a form of self-insurance.

However, a captive is an insurance company, subject to domicile statutes and regulations just like a commercial insurance company. A captive’s main purpose is to fund the owner’s risk, while allowing the owners to participate in the operation of the company. As an operator of the insurance company, owners may share in the profits of the company.

Types of captives

There are many different types of captive insurance companies that can be established under the various domiciles’ laws and regulations. The most common types are pure captive; association captive; industrial captive; segregated cell (ie, protected cell) captive; series limited liability company (LLC) captive; rental captive; and branch captive.

Agency captives; special purpose captives; special purpose reinsurance captives; and risk retention groups are excluded from this discussion. These companies are creations of state insurance laws and regulations whose functions are specific to those laws. Their operations are outside the scope of this article.

For each type of captive above, the premise of self-insurance remains constant, but the form changes.

- A pure captive, sometimes called a single parent captive, is an insurance company owned by a single parent that provides insurance to cover the loss exposures of its parent company and other affiliated companies.
- An association captive is a company owned by an association whose primary purpose is to insure the risk of the members of the association.
- An industrial captive insures risks of the industrial insureds that comprise the industrial insured group and their affiliated companies.
- A segregated cell captive has a structure in which the core insurer is owned by a third party (ie, a third party administrator or insurance broker) and assists in the creation of cells within itself. The cells are owned by the insured. Most jurisdictions have enacted protected cell legislation that is similar in operation.
- A series LLC captive exists in domiciles that will allow a limited liability company to be licensed as an insurer and that insurer is then able to establish independent series business units (SBU) to legally separate participants. Series LLC captives allow the individual SBU to be treated as a separate corporation for corporate law and tax purposes.
- A rental captive is a captive insurance company that can be used by unrelated insureds for a fee (rent). It allows insureds to gain the benefits of a captive insurance arrangement without actually participating in the captive insurance company’s ownership or management.
- A branch captive is a foreign (other state) or offshore captive insurance company licensed by the chief insurance regulator to transact the business of insurance in the given state through a business unit with a principal place of business in said state.

Although the form of a captive insurance company has greatly changed and diversified, the typical structure is the pure captive (Figure 1).

The business owner may share in the profit made by the captive through the form of dividends or loans to the owner. Under most domicile statutes and regulations, all distributions from the captive to its owner must have prior approval from the regulator.

The core purpose should be using the captive as a tool to aid in the financing of its owner's risk and to become an essential part of the overall risk management plan. It gives more risk management and financial control to the captive owner/policyholder than the traditional commercial insurer-insured relationship.

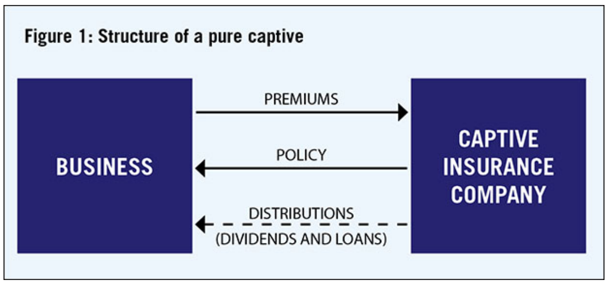

Figure 1: Structure of a pure captive

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As indicated above, prospective captive owners seek to pay less than the premiums historically paid to a commercial insurer. If the owner's claims decline through effective risk management protocols, the premiums for the insurance coverage should decline also.

However, in many instances, with a commercial insurer, the owner who is effectively managing their business risk may be funding the claims for owners who are poorly managing their losses. By using a captive, only the owner's risk will be underwritten. This can stabilise the cost of insurance in the future.

If the owner's business has a good risk management programme and a low claims history, the cost of financing a particular risk can be much lower than a corresponding commercial coverage. Additionally, the captive owner controls the operating expenses and the profit component of the premium, which factors into the development of premium cost. The captive owner can make use of a lower overhead expense ratio than most commercial insurers and reduce or eliminate the profit component of the calculation.

In addition to lowering the overall cost of risk financing, a captive offers the following:

- It can tailor the specific language of the policy to cover previously commercially unavailable coverage. Most domicile statutes allow a captive to develop its own policy language, taking into consideration the specific risks of the owner. This will allow the captive to offer coverage that may not exist in the commercial insurance industry.
- It allows the owner/insured to control its claims process. A commercial carrier controls the claims process, from appointing a claims adjuster to determining the law firm to defend a suit arising from the claim. Sometimes the insured may not feel that the outcome of the process is in its best interest. With a captive insurer, the insured/owner controls the entire claims process.
- It can work with the commercial insurer rather than replacing the commercial coverage. Many businesses have commercial coverage that require a deductible amount—the insured is required

to pay an initial amount on a claim prior to the insurer paying the claim.

Increasing the amount of the deductible will lower the cost of the coverage because the insurer is paying less for the claim. The captive can then issue a policy that reimburses the owner the amount paid on the deductible, usually at a premium rate that makes the whole transaction less than the original amount with the lower deductible.

Domiciles

The captive insurance company must be formed in a domicile that has appropriate legislation. At the time of writing, 39 US states and territories and 39 countries have passed captive legislation. Once the owner determines to form a captive, an application must be prepared and submitted to the chosen domicile regulator for review. Prior to filing an application, a prospective captive owner should obtain a feasibility study, determine the form of the captive, and select a captive manager.

As the regulator of a nationally recognised US domicile, we have designed our application process to quickly review the applications submitted for new captive insurance companies. However, our review does not skip over the fundamentals of sound insurance company operation.

- Risk transfer: defined as a risk management technique, whereby risk of loss is transferred to another party through a contract (eg, a hold harmless clause) or to a professional risk-bearer (an insurance company). The application must illustrate that the business risk of the owner will be transferred to the captive which will have the obligation to pay when the risk matures to a financial loss. We use the preferred method of having outside actuarial consultants to conduct the licence review in conjunction with our highly trained regulators.
- Soundness of projected solvency and liquidity: an insurance company cannot successfully pay an insured claim unless it maintains solvency. Solvency is the ability of a company to meet its long-term debts and financial obligations. In addition, the company must show that it will have current assets above current liabilities to pay any current obligation.
- Types of coverage to be offered: a captive can, and often does, offer coverage that cannot be obtained in the commercial insurance market. Coverage should be rationally related to the business of the owner and the risk being transferred.

The Missouri Department of Insurance Captive Program is in its 12th year of operation in 2019. It has established itself as a pre-eminent captive domicile in the Midwest of the US.

Missouri’s captive programme is specifically designed for, and dedicated to, the promotion and regulation of captive insurance. We have the experience and flexibility necessary to provide the expertise required in nearly any situation. We have learned what the captive companies expect from their regulators and we are building a stable domicile and attracting more service providers to service the companies we license.

We are open for business for captives that have a solid business plan and quality operations.

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