

## A Captive can Increase Profits

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Chief Financial Officers and Risk Managers will recognize the syndrome: the premiums quoted by insurance companies are too high, or maybe cover is not available at all. Perhaps the insurance company is over-stating the risk, or perhaps it is quoting from an off-the-shelf policy which covers risks that do not apply, or perhaps the risk doesn't suit its portfolio. Whatever the reason, this is the time to investigate whether a captive insurance company might solve the problem.

### **Case Study**

XYZ Co is a multinational chemical company with plants in various states and countries whose largest insured risks are fire, explosion, environmental damage, reputational damage, and injury to third parties or employees. Insurance premiums exceeded \$10 million, and were increasing, due to its insurance company's underwriters' perception of the risks that the company faced. This perception was influenced by the experience of other chemical companies, which had received negative publicity. Compared to other companies of the same type, XYZ's claims record is good due to effective risk management. After forming a captive in the

Cayman Islands it was able to reduce its premiums by 35 percent and still pay a dividend out of the captive following several years of operation.

Xyz Co was particularly suited to successfully forming a captive: it was paying a substantial premium, had a good claims record and effective risk management, its risk was spread over several plants in different locations, it had a risk manager who understood and championed the concept of a captive insurance company, and senior management was comfortable with assuming a certain level of risk and took a long term view of their investment. This article sets out the steps that such a company would need to follow to participate in a captive.

### **Feasibility Study**

A thorough feasibility study should be carried out in advance of participating in a captive, covering *inter alia* the justification for forming a captive, the type of captive proposed, corporate governance, management, taxation, choice of domicile, compliance, licensing, fronting, historical and projected claims record, claims handling, copies of current policies, investment policy, reporting requirements, cash flow forecast, business plan, and assumptions. The feasibility study is often referred back to in the future, by regulators, tax authorities, and management. Typically, it is an extensive document, drawing on the expertise of company management, underwriters, tax experts, and actuaries. It is an expensive exercise, but well worth the cost, in mapping the right way forward.

## **Types of Captive**

Captive insurance companies have been in existence for more than half a century. A captive insurance company is one where the insured puts its own capital at risk to provide cover for its own claims, outside of the commercial insurance market. It may be wholly or partly owned by the insured, or it may be owned by a third party. Types of captive insurance companies are facilitated by the jurisdiction in which they are licensed, and include Pure Captives (which have as their primary business purpose the insurance of the risks of their shareholders and affiliates), Group Captives (which are formed by a group of entities that come together to jointly own a captive), Risk Retention Groups (where the risk is homogeneous and all the insureds are owners), Sponsored Captives (which are not formed by their insureds, who may have no ownership interest in or control of the captive), and Association Captives (which are formed by an association for the benefit of its members), with variations on these. (For these definitions, I am indebted to Kathryn A. Westover, *Captives and the Management of Risk*). Most captives are companies limited by shares, and segregated cell companies are also used. A captive typically has no employees, but is managed by a Captive Manager.

## **Risks that can be covered**

Every organization faces risks. These may arise from nature, or from technology, or from hazards, or from legislation, or from the economy. They may affect property, or finance, or third parties, or employees.....and, usually, profits. An important management task is to identify and take measures to protect against risks that threaten

the continuity of the organization. One current methodology used for this is Enterprise Risk Management (ERM). Once a risk is identified, management might choose to mitigate it with risk management techniques, or to transfer the risk to an insurance company, or a combination of both. Risks that can be insured are those where a loss has occurred which is 'determinable and measurable, definite as to cause, time, place and amount' (Kathryn A. Westover, *Captives and the Management of Risk*). Typically, the types of risk that can be insured in a captive insurance company are wider than those that can be insured in the commercial market.

A company's historical insurance claims record will usually fall into three broad categories. It is useful to analyze at least five years' claims history into these categories.

The first category is comprised of small losses which are regular and predictable. There is probably little point in paying an insurance company to process these, since the cost of the premium is more than what it would cost the company itself to deal with them. Under a commercial policy, these would fall below the deductible.

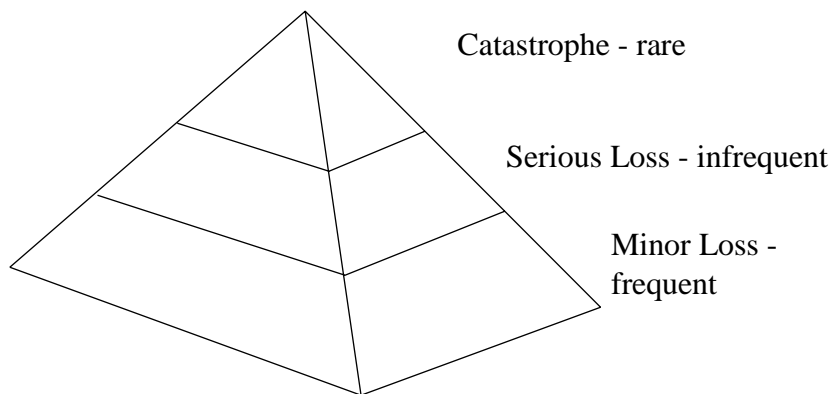
The second category is larger losses which will probably occur less frequently, whose timing is not predictable. If these losses were not insured, their cost would distort the company's results. This is the layer which might profitably be covered by a captive, if the cost of premiums charged by a commercial insurance company exceeds total claims.

The third category is substantial, infrequent losses which would be difficult, or even catastrophic, for the company to bear when they arise. This layer would typically be insured with a traditional insurance or reinsurance company.

Such an analysis is often carried out by an actuary, and would form the basis for projections of future claims.

A diagrammatic representation of such a layering technique is as follows:

## Risk Profile



What size of loss would really hurt?

*(thanks to Conor Jennings of Caledonian Insurance Services for assistance with this diagram)*

## **Economies of Scale**

A captive insurance company should only be considered where the total premiums that the organization pays are large enough to cover the costs of running the captive. The usual rule of thumb is that they should exceed \$1 million. The running costs of the captive will include administration expenses, licence fees, and possibly fronting costs. A fronting insurance company may be necessary, depending on which jurisdiction the risk is located in, and the type of risk. The fronting company would cede risk to the captive. The fronting company may request a Letter of Credit in its favor, since it bears the primary risk.

## **Taxation**

If tax deductibility of the premium paid to the captive is important, the captive needs to be recognized by the tax authorities as a *bona fide* insurance company. There are several pointers to this, among which is whether risk distribution is achieved, through a sufficient spread of risk: one of the underlying principles of insurance is that the claims of the few are met by the premiums of the many. Also, risk should be demonstrably transferred from the insured to the captive: there must be a 'reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed....,' (*FAS 113*). Tax laws will affect different organizations in different ways, and it is important to take good tax advice before venturing into a captive. For example, the deductibility of loss reserves is accelerated if the captive is recognized as an insurance company; but that is only a benefit if the insured is a tax payer; not-

for-profit organizations have different objectives with regard to tax. There are various tax elections which can be taken, and their benefits will be different, depending on the objectives of the insured.

### **Long term Commitment**

A captive is a long term commitment. The senior management of the insured need to recognize that participating in a captive requires investment, and that no dividends should be expected from the captive until it has several years of successful operation under its belt. It needs to have built up sufficient reserves to cope with any claims that may arise. As reserves build up, which they hopefully will if claims are kept under control, management need to decide between taking on additional risk or paying dividends.

### **Keys to Success**

There are several keys to the success of a captive insurance company: willingness on behalf of the parent company's management to accept risk, and to commit capital; management's commitment in the long term; good risk management policies at ground level; and effective communication.

### **Benefits of Having a Captive**

The benefits of a successful captive are substantial: more stable pricing of premiums, and less reliance on the commercial insurance market (the conventional insurance market will often set prices in relation to broad industry classifications, and thereby

fail to reflect key differences in loss experience among individual insureds); greater control over the payment of claims, and a reduction in the time taken to process and pay claims; cover over risks that previously could not be covered, and the ability to customize insurance programs (from time to time, the conventional market is unwilling to provide cover for certain risks, especially for liability and casualty loss); not being penalized for the poor risk management of other organizations; accelerated tax deductibility of reserves; the opportunity to earn investment income, which provides improved cash flow benefits. All the benefits of a successful captive insurance company mentioned above provide the opportunity to increase profit.

In conclusion, participating in a captive insurance company can provide an advantage over a company's competitors. If management believes that its risk management procedures are better than those of its competitors and that it is being penalized by the excessive claims of others, then it may well be worth undertaking a feasibility study to see if a captive is appropriate. The first step in doing this would be to seek advice from its insurance consultant.

