

# An Introduction to Captives



Sophisticated organisations are continuously looking to develop successful risk financing strategies, and many utilise a captive to accomplish this goal. In this article, Adrian Sykes explains captives, their benefits, the typical profile of their owners and more.

## A captive: what exactly is it?

Whilst numerous definitions of a “captive insurance company” abound, essentially it is an ‘in-house’ insurance or reinsurance company, formed primarily to insure its owner and affiliated companies. It is a risk management and financing vehicle that offers an alternative to conventional insurance as it enables the parent/affiliates to essentially ‘selfinsure’ or ‘retain the risk’ through its captive. The captive provides the owner or its affiliates with insurance coverage for risks that the owner wishes to retain, and the insured entities pay premium to the captive. Any profits made by a captive are retained within the parent company’s group rather than being ‘lost’ to the insurance market.

Typically, a captive has none or very few employees requiring some or all of the usual ‘insurance company’ functions to be outsourced to third parties. The majority of them do not have a rating issued by a credit rating agency. It is possible for an organisation’s captive insurance company to write non-parent exposures (third party risks), but this is dependent upon the jurisdiction and its rules for captives.

Captives have been in existence for over half a century. Today, there are over 6,000 captives about operating in 59 territories worldwide and writing premium income of over US\$70bn per annum.

## Why retain risk in a captive?

A company may choose to retain risk in a captive for a variety of reasons including:

- It may be more cost efficient than transferring the risk to the commercial insurance market.
- Over time, it may provide greater certainty of insurance spend by insulating the company against the market cycle of insurance premiums, so as to ‘smooth’ the peaks and troughs.
- The traditional insurance market may not provide any available solutions to the company due to:
  - lack of cover for a difficult to insure risk
  - restricted capacity as regards coverage, limits, or policy terms.

As a licensed insurer, a captive has the ability to directly access the reinsurance market, with all the attendant benefits that go with it.

## To be (or not to be) a captive owner

### A long term view

Every organisation has its own specific approach to assuming risk, but often those companies that want to maintain a large degree of control with regard to their group risk and insurance spend seek to form a captive. The most successful captives are those where the parent views the captive as a long term strategy. This has been borne out by those companies who have operated captives for a number of years, as typical in the energy sector.

### Size of the group's insurance premiums

When deciding whether to form a captive, companies need to consider whether the group's insurance premiums are sufficiently large to justify the investments that needs to be made in terms of the:

- time and resources required to establish and operate the captive, and
- capital investment in the captive needed to comply with the regulations of the jurisdiction in which the captive is domiciled.

If these investments don't seem prudent in view of the premium levels, a Protected Cell Company (PCC) or similar rent-a-captive type structure may provide clients with a simpler, more cost effective alternative for retaining risk. These structures enable clients to enjoy many of the benefits of a captive but without the same level of investment.

### Claims history

Remember, a captive is a means for the organisation to retain risk rather than transferring the risk to the commercial insurance market. Since the commercial insurance market pricing reflects the industry's loss trends and the organisation's claims history, companies may benefit by retaining risk in a captive when they have a:

- claims history that is better than its industry (or is improving), or
- risk management processes that improve the organisation's overall risk profile.

Conversely, we have seen examples of where a poor loss history has resulted in either a captive being formed by the parent or an existing captive assuming an additional deductible layer at the level above the local deductible. The rationale for this is to enable the overall program to remain in force in compliance with either compulsory insurance requirements or the requirements of regulators, clients or other counterparties, or so as not to increase the local operating deductibles. This is an example of where a captive shares the risk with an incumbent market carrier in order to 'smooth' the deductibles across a program.

## So, a captive might work. What's next?

Once a company has decided a captive might be right for it, a feasibility review would be the next step. Typically, the parent engages an outside consultant to conduct a feasibility review. Generally (though not exclusively) the consultant is an insurance broker or insurance company with experience in captives. The objective of the feasibility review is to determine the potential value of a captive to its owners and, ultimately, to evaluate whether the captive is a viable strategy for a particular organisation to pursue.

The review will focus on the financial aspects of a captive formation, but will also look at areas such as choice of domicile, lines of business, insurance or reinsurance (or both), limits to be written, and whether a fronting carrier is needed in order to provide front end policies in territories where local insurance is required, for example to meet compulsory insurance requirements or because the territory falls outside the captive's licence.

### Which risks to insure?

In principle, virtually any risk can be covered through a captive structure. At entry level, one or all of commercial property, casualty and marine are most common. For more mature captives or where the principal exposures of the parent may be more financial in nature (for instance, banks) coverages such as Crime and Professional Indemnity may be written.

Under the provisions of Solvency II in Europe, which impacts captives as well as the commercial insurance market, there is an incentive to a captive owner to diversify their portfolio of exposures. For example, by insuring Trade Credit insurance in the captive, in addition to say Property and Casualty, this creates an additional risk diversification which may support the captive's capital requirements, particularly in a Solvency II environment because the additional line is not correlated to the other business. This may have the impact of reducing proportionately the amount of capital that the captive needs to hold in order to maintain the minimum solvency levels.



## What's the role of a fronting carrier?

Generally, there will be a limited number of jurisdictions in which the captive can write risks on a direct basis. For example, an EU domiciled insurance captive can write coverages across the EU and EEA by a single policy issued on a Freedom of Services basis. In addition, non-compulsory coverage in other territories where non-admitted insurance is permitted may also be written by the captive.

A parent with risks outside of the scope of the captive's licence may seek an insurance carrier to front those exposures in order to obtain locally admitted insurance policies and benefit from the carrier's own multinational licences and network. In order for the arrangement to operate as efficiently as possible, it is important that any fronting carrier considered has a global network presence to match the "footprint" of the insured. The captive will then assume the exposures (either in part or in full) from the fronting insurer via a contract of reinsurance between the parties.

## The captive is up and running for a number of years. Now what?

For a mature captive, it makes sense to periodically assess the functionality and financial effectiveness of the existing programme, as well as to consider additional lines of coverage for the captive. This review should evaluate the captive's:

- performance in meeting the objectives of its original business plan
- actual vs. planned experience in terms of writings, premiums, losses, etc.
- operation including data flows and internal controls
- service providers' role and performance
- opportunities for writing new risks; and
- capital position and any additional capitalisation needed if it is to expand.

## Is the captive way the only way?

No. A captive vehicle is just one of the risk financing options open to a company. Other options for retaining risk include choosing to be uninsured, increasing deductibles and structured solutions.



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