Growing Interest in Captive Cells: Who and Why?

David White is Assistant Director of Global Risk Solutions’ U.S. Captive Management Services group headquartered in Burlington, Vermont. David joined AIG in 2001 and is responsible for services related to the feasibility, structuring, formation, and management of captives.

Large companies have been able to experience the benefits of captive insurance programs for decades. Now, companies not owning a captive are looking to do the same, and captive cells may be the answer, says David White of AIG’s U.S. Captive Management Services.

At AIG, we are seeing a growing interest in captive programs from smaller and mid size companies that are often new to the captive concept. Committing resources and capital needed to form and manage a standalone captive might not be the right first step for these companies. The right answer may be a rent-a-captive cell where their risk is retained in an account that is legally and contractually segregated from other companies.

Bermuda originated the cell concept over 20 years ago and permits a segregated accounts company (SAC) to create and rent out segregated accounts. Other jurisdictions have implemented similar structures such as the sponsored captive insurance company (sponsored captive) in Vermont and other parts of the U.S., protected cell companies (PCC) in Guernsey, and series limited liability companies (Series LLC) in Delaware and other U.S. domiciles. Also effective in 2013, existing Vermont captives have the option to establish separate accounts (SA) in their current structure which may alleviate the need for relicensing as a sponsored captive.

As you can see, there are varying names and locations, each having different legislation and rules that may need to be analyzed prior to selecting a facility. For all of the varieties, the industry often refers to these types of facilities as “rent-a-captive” structures. I like to use the term ‘captive cell’ when referring to a rented segregated account.

What is a captive cell and how does it work?

A captive cell provides many of the benefits of a standalone captive insurance company, including features that allow the insured to retain a certain proportion of its risks and better manage the associated costs, without the full operating costs of a standalone captive. The key features of a captive cell are listed below.

**Formation and Capital:**

- Cells can be formed quickly with minimal start-up costs as compared with a standalone captive.
- Participants sign a participation or similar agreement defining the rights and obligations of the cell.
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- Assets and liabilities of each cell are legally segregated.
- The owner of the cell facility generally maintains the minimum core capital as required by the local regulator.
- Participants have no ownership interest in the cell facility but may need to post collateral to a fronting company and/or contribute funds to its cell.

Underwriting:
- Similar to a standalone captive, premiums from the insured are written by or ceded to the participant’s cell, thereby providing the potential for underwriting and investment profits.
- Annual operating expenses can be significantly less for a cell than for a standalone captive.
- As with a standalone captive, there is potential for enhanced management and control over losses.
- Cells are available for most lines of business, such as general liability, professional liability, workers’ compensation, property, warranty, trade credit, cyber risk and medical stop loss.
- Depending on the line of coverage, a traditionally licensed insurance company may be needed to provide fronted policies on rated admitted paper, program coordination, claims handling and reinsurance services.

Reporting and Regulations:
- Local regulatory requirements and administrative tasks are carried out by the owner of the cell facility.
- Unlike a standalone captive, a rented cell does not require a separate board of directors which means less management time.
- Separate reporting is available to the participant that accounts for income statement activity such as premiums, losses and expenses as well as the balance sheet position of the cell including assets, liabilities and surplus of the segregated account.
- Individual cells may or may not receive their own audit report; this depends on the domicile, the cell facility and/or the needs of the insured participant. Typically, the entire facility is audited annually by an independent firm.
- For income tax purposes, each cell is typically treated as a separate entity from the cell facility. Depending upon the facility, its domicile, the location of the insured participant, or the insured risk, the participant may be responsible for filing applicable federal tax returns and paying any taxes resulting from the operations and assets of its cell.

More Captive Cell Benefits:
- A cell facility may provide participants with the opportunity to manage risks more effectively so that excess surplus can be distributed to its members. The cell’s profit equals premium plus investment income, less claims and expenses.
- A cell may be a stepping stone to forming a fully owned captive, as cells are easily converted into standalone captives.
- Exiting a cell is quicker and easier than winding down a standalone captive.

Who might be interested in renting a captive cell?
Companies seeking an alternative risk management solution, without the costs or commitment associated with a standalone captive, are showing an increasing interest in captive cells.

Another characteristic of companies that would benefit from retaining risk in a captive cell is a loss history that is better than their industry’s average. Similarly, if traditional market pricing does not yet reflect a company’s improvements in loss control, a captive cell may be a more cost effective solution to managing that risk. Ultimately, a company will benefit when premiums charged by the traditional insurance market are higher than fees and losses the company must pay when retaining risk in the captive cell.

Groups of small companies sometimes rent a cell together. We have seen groups assume portions of their premiums and losses related to their medical stop loss policies. This is often part of an overall strategy that involves self insurance, along with wellness programs to control losses, and cost reduction initiatives.

We often think of retaining risk in a captive structure as a way to save on the cost of insurance, but there are ways to use a cell as a new profit center. For example, a company might sell products that customers are likely to insure. The company might arrange for an insurance carrier to make that coverage available for purchase to its customers, and then reinsure that risk back to their captive cell. That cell then receives premiums and pays losses, so the company ultimately shares in the underwriting profit on the insurance product. The captive cell becomes a profit center capturing additional revenue from existing customers.

Captive cells may also benefit companies that:
- Already own a captive, but would like to segregate a portion of risk from their existing standalone captive program.
- Need a short-term risk management solution (e.g., a transition for captives in run-off or a loss portfolio transfer).
- Have a risk that is difficult to address in the traditional insurance market and an appetite to share in the risk in order to achieve additional capacity and program flexibility.

Where will captive cell formations come from?
There has been plenty of discussion about the saturation of the captive market and how most large U.S. companies already have one or more captives. Despite that sentiment, we believe there is growth opportunity, and that growth is likely to come from three areas:
- Large and mid-sized European and U.S. companies looking to retain more of their P&C risks such as their workers compensation, general liability and property deductible layers.
- Small and mid-sized employers in the U.S. grouping together
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with like minded employers to share in a portion of the medical stop loss layer as part of an overall self-insurance strategy.

• Large companies in new emerging markets where they are not yet as familiar with captives but popularity is gaining due to the advantages captives can offer and the existing sophistication of these large companies. AIG looks forward to working with more Latin American and Asian companies to develop captive programs.

What are some common alternatives to renting a captive cell?

For larger companies, a standalone captive might be more attractive than renting a cell because there is more control over the investments and operations. A standalone captive might also offer a corporate structure that is more familiar to the parent company. For smaller companies, joining a group captive can be appealing. A small company may be concerned about risk distribution and volatility of results when going it alone, and group captives can help stabilize results by having strength in numbers. Group captives often provide the added advantages of experiencing a healthy level of peer pressure and the sharing of best practices for controlling losses.

Group captives involve sharing risk and that means being subject to the underwriting results of the entire group. While a company can take actions to directly impact its own loss results it may only have indirect influence at best on the loss results of an entire group. This uncertainty may drive larger, more sophisticated and mature companies to rent their own captive cell or form their own standalone captive. While group captives may be right for certain companies, renting a captive cell may be a better choice for companies that already keep losses low, don’t need additional pressure or tools from peers and/or value the confidentiality of their program. It is generally best if companies renting their own captive cell have a corporate structure that supports sufficient risk distribution and enough size to achieve the law of large numbers which provides stability and predictability of future losses.

Of course, a group captive can also rent a cell. AIG is home to numerous medical stop loss group captive programs that rent captive cells. We have the rare experience and capability of fronting for both P&C risks as well as medical benefits coverage. AIG Benefit Solutions provides rated medical stop loss policies and can reinsure a portion of the risk to a captive cell that is being rented by a group of employers. In the past two years, this has been a significant area of cell formation growth at AIG. Captive structures are known for focusing management attention on reducing losses. To see more focus on employee wellness initiatives as part of a captive and self insurance strategy is a true aligning of everyone’s best interests.

Summary

A captive cell program is a relatively simple and inexpensive way for a company that is new to captives to gain experience and enjoy many of the benefits of retaining risk in a captive structure. We are excited about the business’ opportunities for growth—both from new geographic markets and new types of companies in existing markets. For years, our sponsored captive insurance company domiciled in Vermont has been providing captive cells to the alternative risk market, and we recently launched Grand Isle SAC Limited, a segregated accounts company in Bermuda. Renting captive cells to our clients offers a great deal of synergy with our fronting and captive management business. We believe the process becomes stronger when the fronting carrier, cell facility and captive manager are all working together as one team.

For more information, please contact David White at 802.419.1211 or david.white@aig.com or visit www.aig.com/captives.