The Hard market – Can a Captive be the Antidote?

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What Is a Captive Insurance Company?

A captive is…

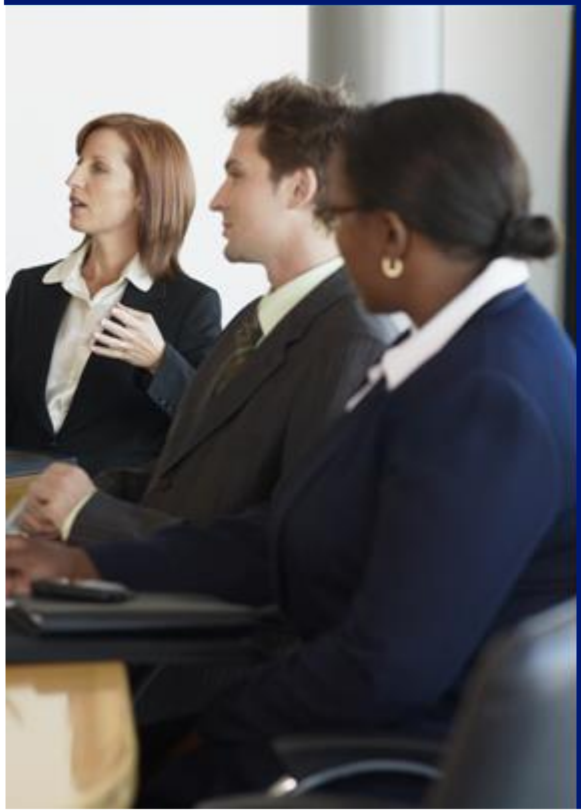
- A separate legal entity created or used by a company

More specifically, it is…

- An insurance or reinsurance company formed primarily to insure its owner(s) and affiliated companies
- A risk management and financing vehicle that offers an alternative to conventional insurance
- A regulated entity within the domicile in which it operates

A captive typically…

- Has no employees so all of the usual “insurance company” functions are outsourced to third parties
- Provides coverages that the owner wishes to retain or that are unavailable in the traditional market
- Does not have its financial strength rated by AM Best, S&P or Moody’s like a traditional insurance company



Why Do Companies Use Captives?

Companies use captives for a variety of reasons, but most often, to improve the cost of and/or control over their overall corporate risk

Risk Management

- Reduce the need for, and reliance on, commercial insurance
- Promote loss control through effective risk management
- Provide coverage for difficult to insure risks
- Offer flexibility in program design
- Access the commercial reinsurance market

Financial

- Reduce total costs of risk
- Investment earnings and cash flow
- Balance sheet protection
- Tax planning opportunities
- Potential profit center

Insurance

- Participate in profitable risks
- Evidence insurance coverage requirements
- Ability to set “own” terms and conditions
- Allow for greater certainty in costs and flexibility through varying market cycles
- Provide coverages either not available in the traditional market or considered too expensive
- Reduce dependency on conventional insurance markets

Strategic

- Integration with long term client strategy
  - Parent company strategies
  - Joint ventures and new geographic territories
  - Capture Insurance related (life/non-life) profits

Types of Captives

- **<u>Single Parent Captive</u>**: An insurance or reinsurance company formed primarily to insure its owner (parent company) and its affiliated companies.
- **<u>Rent-A-Captive</u>**: A client "rents" a portion or segregated "cell" within a sponsored captive facility. Clients without a captive can experience many of the benefits of a captive through participation without having to go the lengths of creating their own single parent captive. These arrangements may also be referred to as a Protected Cell Company (PCC) or Segregated Accounts Company (SAC).
- **<u>Association or Group Captive</u>**: An insurance company which is formed and owned by an industry, trade or service group, or a group of companies strictly for the benefit of its members to meet a shared insurance need.

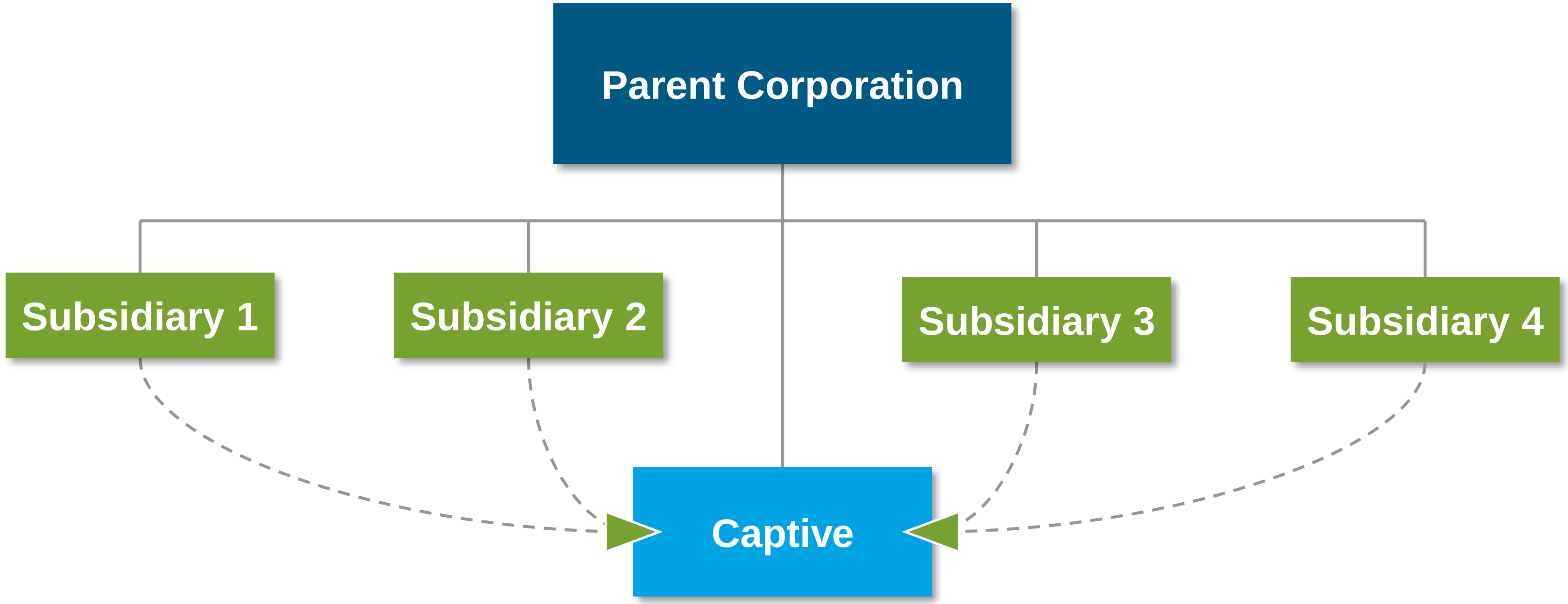
Types of Captives

	Sponsored / Rent-A-Captive	Group	Single Parent
Ownership	Owned by sponsoring agency	Parent would be a shareholder	Owned by Parent
Flexibility			
Investments	May be limited by sponsoring agency	Not at direction of parent	Broad but limited by regulatory approval
Limits	May be limited by sponsoring agency	According to group structure	Flexible
Coverages	May be limited by sponsoring agency	Limited (typically WC, GL, AL)	Nearly unlimited
Vendors	Preferred or exclusive vendors	Preferred or exclusive vendors	Per choice
Program structure	May be limited by sponsoring agency	According to group structure	Nearly unlimited
Potential of Subsidizing Third Parties	None	Possible	None
Volatility of Results	Can be significant based on limits written and predictability of losses	Protections exist to mitigate volatility and provide annual budgetary stability.	Can be significant based on limits written and predictability of losses
Deductibility of Premium	Based on advice of tax counsel but requires compliance with IRS fact patterns (risk sharing, risk distribution).	Based on advice of tax counsel but likely based on assumption of third party risk.	Based on advice of tax counsel but requires compliance with IRS fact patterns (risk sharing, risk distribution).
Cost for Reinsurance/Excess	Based on unique profile	Priced as a group - economies of scale	Based on unique profile
Operating Costs	Shared (approx. $70-80K)	Shared (approx. $70-80K)	Own (approx. $90-100K)
Capitalization	Provided by sponsoring agency	Purchase of share in captive - may vary according to structure.	Depends upon limits written, predictability of losses and payment pattern.
Administration	Limited	Typically two meetings per year	Annual captive board meeting and on-going adminsitration
Exit costs	Relatively simple. Structure is intended as a stepping stone to other options.	Additional complications	Can be significant depending on coverages written

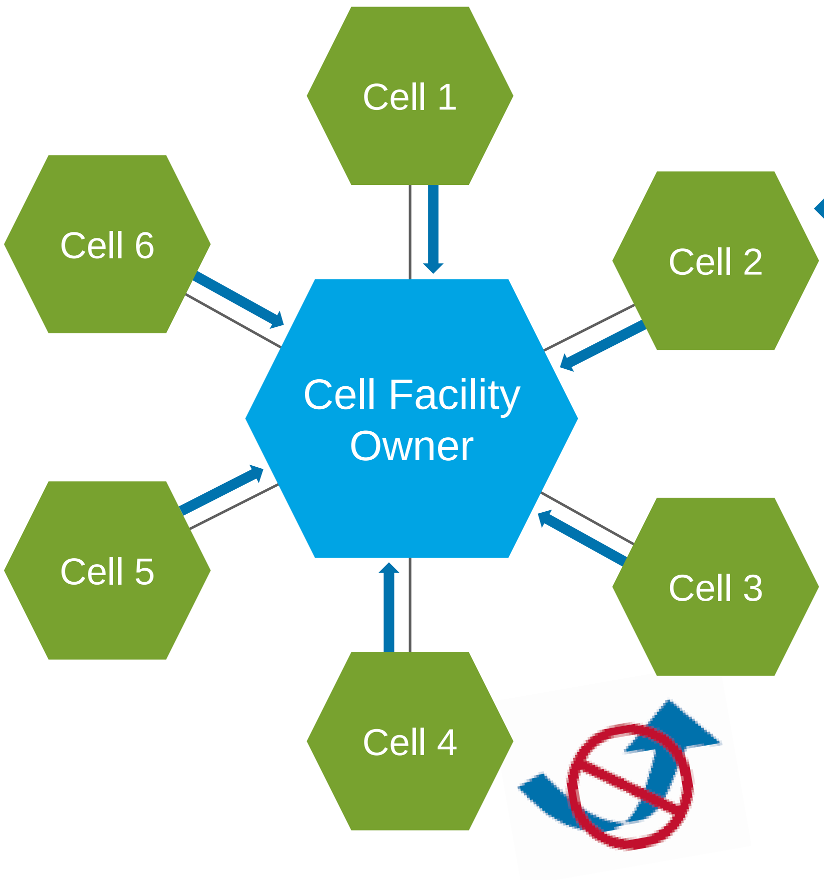
Single Parent Captive

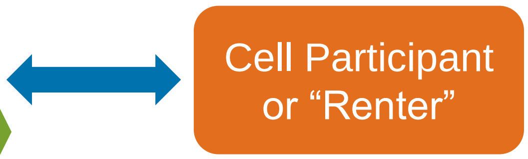
This is the simplest, and most common captive arrangement.

- Captive is a separate legal entity that insures the risks of its parent or affiliated entities.
- Capital is provided by the parent who maintains control over underwriting, reinsurance and investment policy decisions.



Rent-A-Captives/Segregated Cell Captives



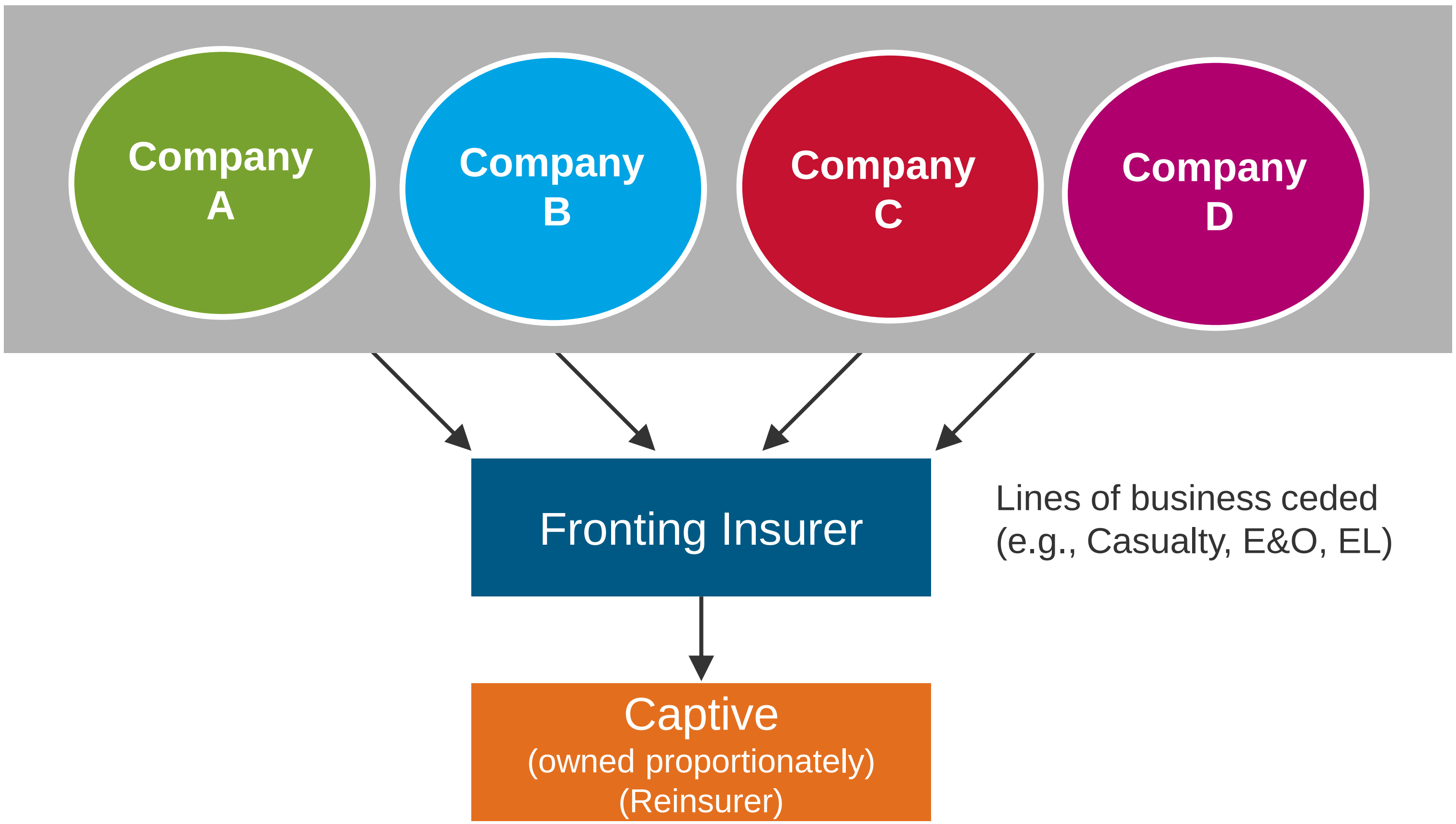


- The cell facility owner creates and capitalizes the core facility and rents its capital and insurance license to cell participants
- Built around that central core account, each cell essentially functions as its own captive for its participant (“renter”)
- Each cell insures the risk of a different participant/renter and its assets and liabilities are legally segregated
- There is no risk sharing between the cells
- Often fronted and reinsured into a client’s cell

Benefits: Lower cost, easier/faster start-up, no separate capitalization requirement

Group Captive

A number of heterogeneous, but more often homogeneous companies come together to form a group captive to collectively insure a portion of their business, e.g., primary casualty.



Common Misconceptions about Captives

A captive is an immediate money saver

Captives are formed primarily because of the tax benefits.

A captive is used instead of commercial coverage.

Captives are subject to far less regulation than traditional insurers.

Misconceptions Explained

“A captive is an immediate money saver.”

A captive may help companies save money over time, but they should not be counted on to save money immediately. Savings can come from (1) self-insuring a risk more cost effectively than what the market would charge to insure it; (2) acceleration of deductions for claims; and/or (3) the implementation of a more comprehensive and rigorous risk management program which allocates losses to company subsidiaries, therefore incentivizing greater loss prevention measures.

“Captives are formed primarily because of the tax benefits.”

A captive may have tax benefits but that is not typically the reason they are formed. The most common tax benefit is that a captive may be able to deduct loss reserves, while non-insurance entities cannot do so. This results in the captive accelerating the deduction for claims, which can be significant for long-tailed lines of business.

“A captive is used instead of commercial coverage.”

A captive is a vehicle for retaining risk, but rarely would a captive completely replace traditional commercial coverage. Clients will typically use a captive to retain the primary, or “frequency” layer, of their insurance program. But the client will typically buy traditional insurance above the captive layer.

“Captives are subject to far less regulation than traditional insurers.”

As a form of self-insurance, captives are subject to different regulations than traditional insurers. But captives are still carefully regulated by the insurance regulators in their domiciles and are subject to regulatory requirements including financial reporting, capital and reserve requirements.

Captive Trends –Tax Issues

1. Accelerated Deduction of Premiums

	Previous	Current
Captive Premium	$1,000,000	$1,000,000
Avg. Payment Duration	2.5 Years	2.5 Years
Return on Investment	5.0%	2.0%
Corporate Federal Tax Rate	35.0%	21.0%
Accelerated Deduction Benefit	**~$45K**	**~$11K**

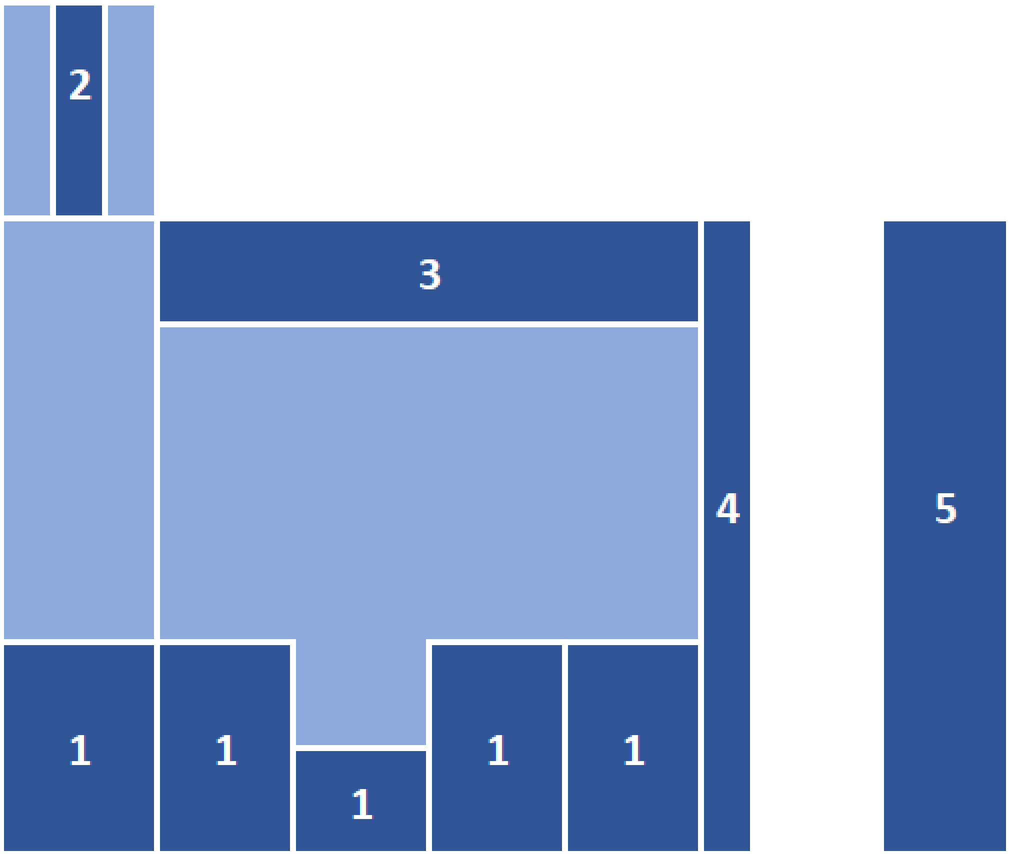
2. IRS Scrutiny of Micro Captives

- Settlement offers include disallowance of deductions, liquidation

3. State tax positions

- Washington (register as surplus lines carrier or use front)
- More to come?

Captive Hard Market Trends – Alternative Uses



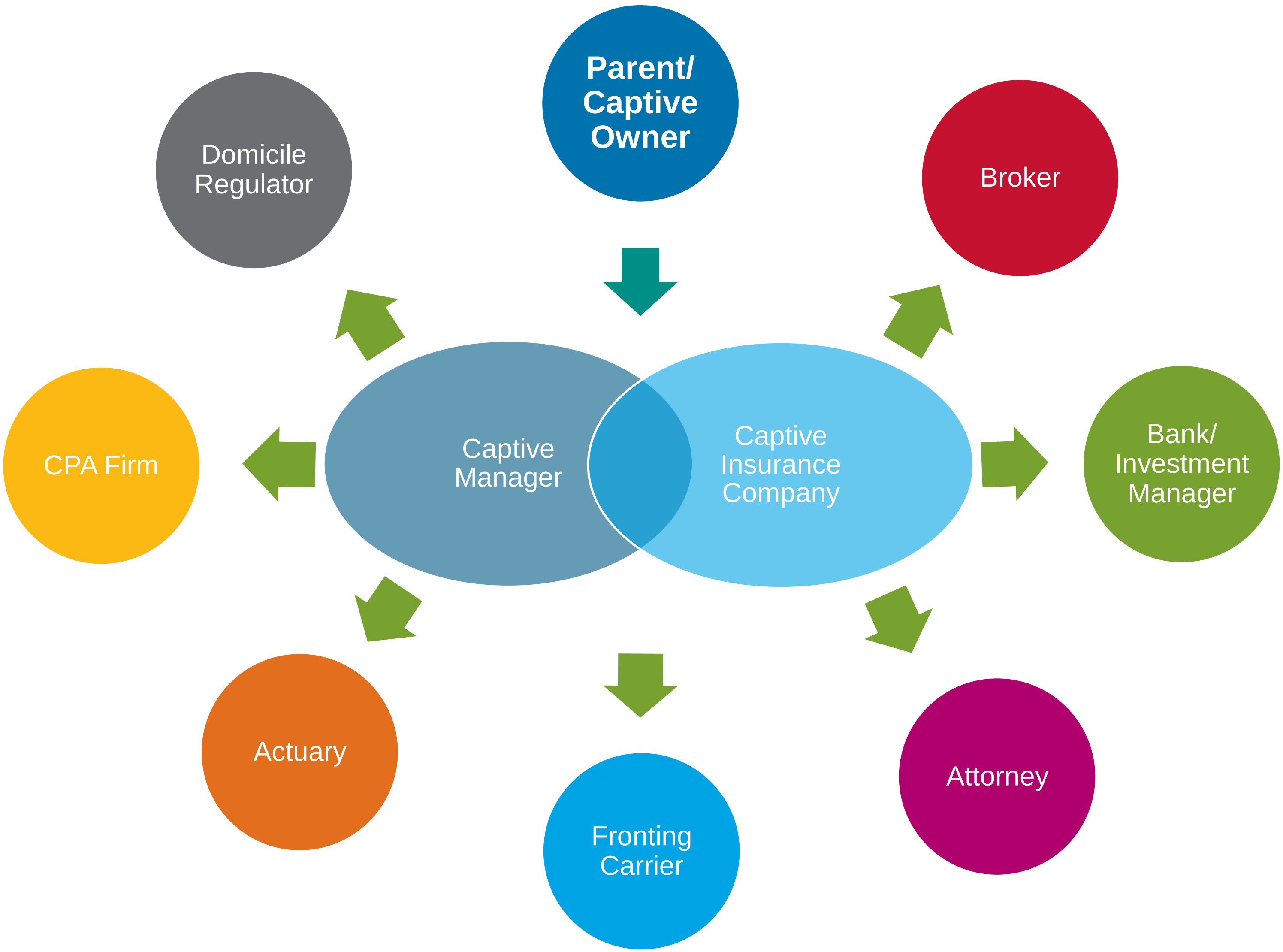
Captive Opportunities

1. Funded deductibles/retentions - most common usage
2. Gaps in excess - due to capacity constraints or to maintain layer pricing
3. Increased excess limits
4. Broadened coverage - funding for exclusions or non-competitive terms
5. Currently self-insured risks or third party business

Potential Program Structure

- Most common captive structure for global business
- Enables company to purchase risk transfer at consistent level in market while varying what is retained in-country
- Captive takes “working layer” losses; deductible helps manage insurance premium tax costs

Captive Partners and Coordination From Captive Manager

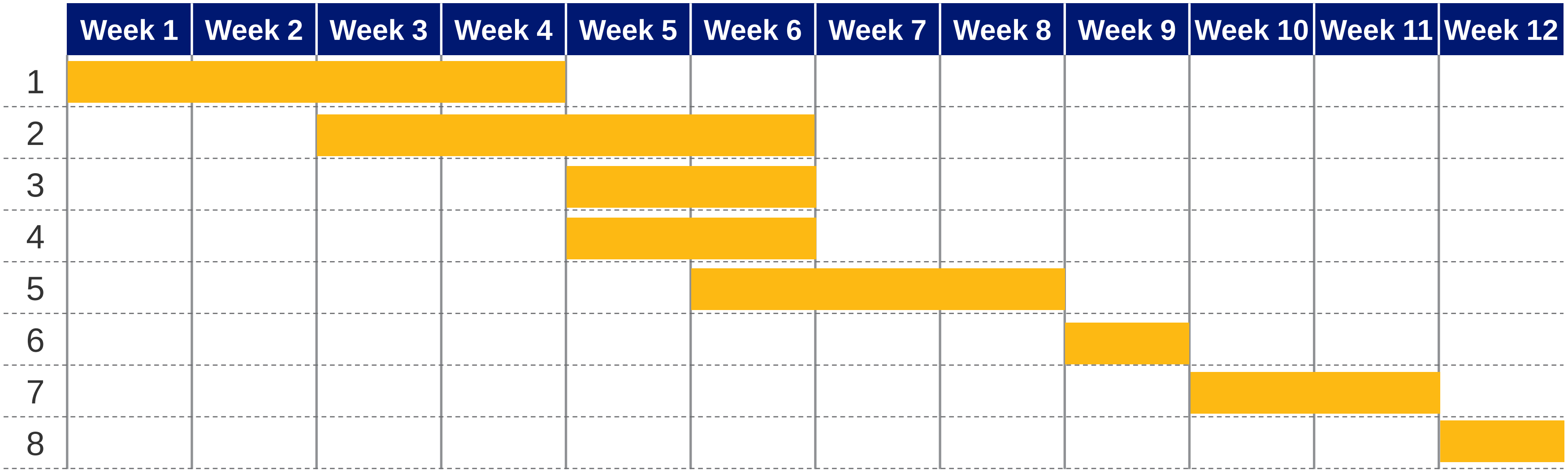


Captive Feasibility Studies

A comprehensive feasibility study should include:

- Discussion of the advantages and disadvantages of a captive
- Analysis of proposed retentions and coverages assumed by the captive
- Estimates of loss experience and capital funding requirements
- Domicile comparison with recommendation, including regulatory requirements
- Preparation of five-year financial projections for the captive based on preferred structure
- Written business plan for the captive with proposed coverages

Formation Timeline – Wholly-Owned Captive



1. Review domiciles; begin business plan and analysis of financial statements and loss history.
2. Prepare feasibility study; begin drafting business plan and proforma financial statements.
3. Authorize attorney to begin bylaws, articles of incorporation, and name reservation.
4. Finalize domicile; identify service providers: auditors, banks, actuaries, etc.
5. Submit completed license application and liaison with regulator during review process.
6. Petition for certificate of general good and incorporate captive.
7. Work with client to finalize operational details.
8. Receive license, capitalize captive, establish bank accounts, order checks, and begin operations.

- **Establishing a rent-a-captive takes considerably less time, typically 4 -6 weeks**

Domicile Selection – *Where to Locate a Captive?*

Think of taking a "TRIP"

- **T**axes – both state/domicile taxes and Federal issues should be considered
- **R**egulation – balance of flexibility and certainty
- **I**nfrastructure – established domiciles typically have stronger available infrastructure (audit firms, law firms, actuarial resources)
- **P**ricing (and **P**olitics) – cost of doing business, political support

A captive manager should be neutral to choose

Among the world's largest captive domiciles are Bermuda, Vermont, Cayman and Utah

Characteristics of a Strong Captive Opportunity

Weak — **Strong**

Premium Size

Under $500,000 — Over $5 Million

Loss Ratio

Over 125% — Under 50%

Data Quality

Little or no data available — 10 years loss/premium history available

Motivation

Taxes or “my buddy has a captive” — Risk management or long term cost savings

Owner Financial Strength

Private company w/ concerns about capital/cash flow — Fortune 500 company/major public entity

Project Leader

Tax advisor — Broker — Risk Manager