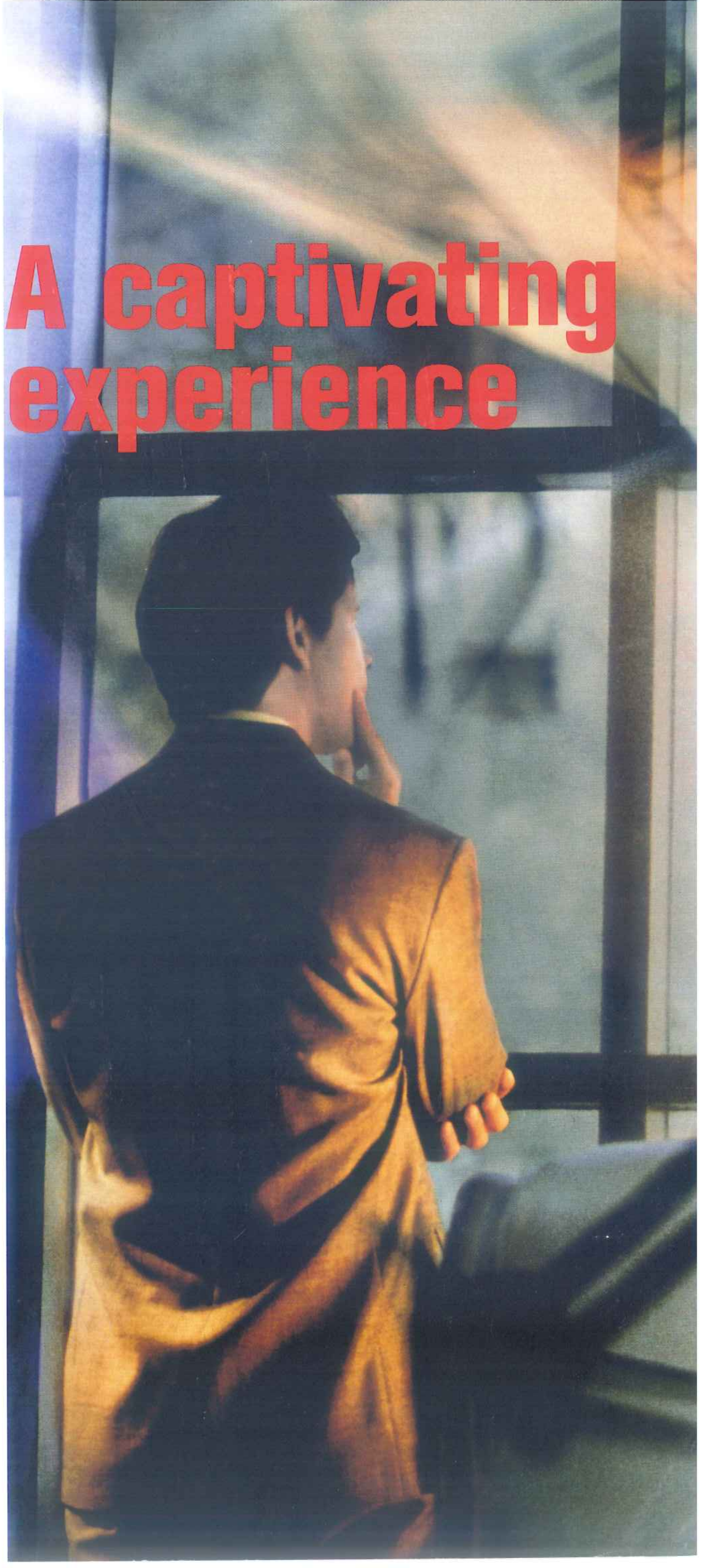
A captivating experience

Are captives the answer to the hard market? Mark D. Harris *looks at their uses.*

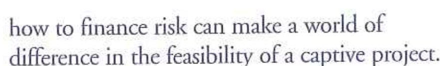


Your broker is having difficulty finding affordable insurance for all the exposures your company faces. Possibly you have locations in disaster-prone areas. Maybe somebody else, an underwriter, classes your risk profile as distressed in spite of the efforts you have demonstrated to control losses and your excellent track record. If this sounds familiar you could be a good candidate to form a captive.

Captives are a form of alternative risk transfer (ART) that provides insurance buyers with the coverage they need outside of the traditional marketplace. Captives aren't for everyone. The initial process requires careful analysis of your needs and how they will be addressed, long term, by a captive. The growth of ART in the US marketplace over the last ten years is remarkable, when one considers the just-ending 'soft market' cycle that prevailed during the period. It is estimated today that more than one-third of the potential US property/casualty marketplace has ventured into some form of ART and that few will return to the traditional marketplace in the foreseeable future.

Don't make the mistake of assuming you have to be one of the Fortune 500 to get into the captive business. Emerging companies are the source of most activity for captive formation in today's marketplace. Usually buyers have a unique problem which the traditional marketplace spurns the alternative market offers tailored solutions. There are various types of ART mechanisms, such as pooling, risk retention groups and a host of self-insurance programs in addition to captives, many of which are viable options that should be considered. Once the captive approach has been decided upon the type of captive mechanism needs to be chosen.

There are single entity captives, rent-a-captives, group captives and broker captives and each program must be designed to meet the precise requirements of the client. The particular solution for a specific company may be a hybrid combining varied characteristics of alternative risk transfer. Creatively assessing



how to finance risk can make a world of difference in the feasibility of a captive project.

Corporations with a reliable pattern of predictable losses generally create their own, single entity captives. However, they must commit the capital to form what is in effect their own 'private insurance company'. They use the captive to provide coverage or a portion of the coverage they need, and protect themselves against unforeseen losses with reinsurance. The upfront costs to establish a pure captive can be formidable, and there are times when traditional self-insurance or a different form of captive makes more sense. There are tax issues, along with local requirements of the proposed captive's domicile, fronting and reinsurance issues to deal with in the initial phase. Captive management companies provide professional advice on these issues, which when coupled with the opinion of tax counsel makes the entire process clearer and relatively straightforward.

IRS scrutiny

Starting in 1977, with revenue ruling 77-316, the deductibility of premiums paid to a foreign insurance subsidiary have come under intense scrutiny by the IRS. Since then, the issues have been tested and retested in the courts. The upshot is simply that captives should not be set up to take advantage of perceived tax advantages, as they probably don't exist. On the other hand, captives should be set up as professional insurance operations in business to profitably underwrite risk.

Rent-a-captives are formed using someone else's captive and capital. They are organised and operated by captive managers, often offshore. A fronting company – an admitted carrier in a given state – cedes a portion of the risk to the rent-a-captive and to its reinsurer(s). A fronting company will require the rent-a-captive to post a letter of credit, which it will book as an admitted asset, in the amount of the unearned premium reserve and any incurred losses.

Reinsurers require the captive to participate in losses in a ratio agreed upon by the parties. Typically, they desire the captive to bear enough risk to foster responsible pricing and loss prevention.

Many emerging companies begin with a rent-a-captive to avoid the higher capitalisation costs of sponsoring a single entity captive. After a few years of favourable experience they move into a captive of their own. Cell rent-a-captives allow a company to form a captive that is managed along with other captives in separate cells. A firewall protects each participant of a cell rent-a-captive from exposure to losses incurred by the participants of other cells.

Broker captives have emerged over the last ten years as a popular formula. The broker creates a group captive, choosing multiple clients to provide enough premiums to create a stable platform. The captive, acting as the reinsurer of a front company, retains a layer – usually the primary layer – of losses. The broker, in effect, becomes the insurer and is exposed to losses between the captive's retention and the attachment point of the aggregate reinsurance. Proper set-up considers all risks and requires the broker to collateralise its exposure, so that no client is inadvertently exposed to unknown risk. The broker also stands to share the profit in the event the losses are contained within the captive's retention. Good loss control, safety programs and claims management services provided by the broker can substantially contribute to the captive's profitability.

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Role of reinsurance

Reinsurance plays a critical role in any captive's financial picture. Typically, reinsurance is used to limit the exposure of any one loss to an amount that the captive can comfortably withstand. Often reinsurance is also purchased to stabilise the captive's results over time (or its aggregate exposure to all losses in a given period of time). Beyond these two common types of protection, myriad combinations of other types of reinsurance can be used to enhance the performance of a captive. The use of finite risk (or a blend) may allow a captive greater flexibility and/or stability. Skilful layering and the use of caps on certain exposures may make a deal more palatable to professional reinsurers, which might explain how a deal can be accomplished in the alternative market when the traditional market is unable to respond. Regardless of the type of captive, the ultimate aim of purchasing reinsurance is to provide the captive with a financially secure and stable base from which to grow.

My associates in the U.S. RE Group offer captive insurance facilitation through U.S. RE Holdings in Bermuda and its subsidiaries – Uni-Ter International Insurance Co and Uni-Ter International Management. We work with commercial insurance brokers to help analyse captive options for their clients and provide direct access to the reinsurance market. My company, AMG/Quadrant Insurance Managers, works directly with buyers and agencies to structure captive solutions and can, where warranted, provide underwriting support.

The language of captives may sound arcane to those not accustomed to dealing with the insurance marketplace. No question, captive formation can be complicated. However, if you're having a tough time finding the coverage you need at a price you can afford, maybe it's time to talk with your broker about captives. **GR**

By Mark D. Harris

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