Module B Unit 2

CAPTIVES

Purpose

By the end of this unit the participant should be able to demonstrate a thorough understanding of the reasons captives are utilised and the different types of captive that exist and how they may be employed.

Assumed knowledge

None

Summary of learning outcomes
1. Explain what a captive is
2. Explain the reasons for the creation of a captive
3. Describe the different types of captives and the circumstances when use of each type is appropriate
4. Describe the key features of a Protected Cell Company and an Incorporated Cell Company
5. Explain the role of a Joint Interest Captive/Mutual Pool
6. Explain the key benefits that a captive offers
7. Explain the alternatives to using a captive and why a captive may be more advantageous

Module B Unit 2

CAPTIVES

2.0 DEFINITION: WHAT IS A CAPTIVE INSURANCE COMPANY?

A pure captive insurance company has been defined as an insurance company formed by an industrial or commercial group to insure some or all of the risks of its parent organisation. The word ‘pure’ in this context is to signify that the company is writing only the risks of its parent and not those of unrelated organisations. As captives mature, they sometimes underwrite unrelated business risks and these entities have been termed broad captives. As seen later on in this module, captive insurance companies can further evolve and ultimately become a part of the traditional insurance and reinsurance market.

Sydney Pine was a New York lawyer in the 1950s. One of his clients with whom he worked for some 30 years was Fred Reiss (of whom more later) and between them they can be credited with initiating the development of the modern captive and were instrumental in setting the ground rules and encouraging development. Sydney Pine defined a captive as:

> *“A captive insurance company is a bona fide insurance or reinsurance company owned by a non-insurance company and which insures or reinsures the risks of its parents or affiliated companies”*

This is an excellent definition in that it does not limit the activities of the company to solely the insurances of the parent nor does it imply that the captive has to write all of the insurances of the parent. What is equally important in this definition is the use of the term ‘bona fide insurance’ – an overriding principle for best practice in this sector of the Guernsey International Insurance sector. A captive insurance company should certainly be a bona fide insurance operation, appropriately capitalised and managed and operated adopting best practices of the traditional insurance industry.

There are other definitions of captive insurance companies, for example:

> *“A limited purpose, wholly owned insurance subsidiary of an organisation not in the insurance business which has as its primary function the insuring of some of the exposures and risks of its parent or parent’s affiliates.”*
>
> *(Gordon 2003)*

or

> *“A closely held risk channel that is used to facilitate a company’s insurance/reinsurance programme and retention/transfer activities. It is generally formed as a licensed insurance/reinsurance company controlled either by a single owner or multiple owners (often referred to as the sponsor(s)).”*
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> *(Banks 2004)*

The above definitions show that even though captives are typically “limited purpose”, vehicles, they can be formed with multiple owners which may enable the access to, and utilization of, insurance or reinsurance markets with a greater degree of efficiency than that may be possible by purchasing a ‘traditional’ insurance product as individual clients.

Why use the term Captive? The most commonly accepted source takes us back to Fred Reiss. His very first client, for whom he created a subsidiary insurance company in 1957, was the Youngstown Sheet and Tube Company for whom he formed the Mahoning Insurance Company in Cleveland, Ohio. Neither of these companies exists today but it should be mentioned that the subsidiary insurance company was formed onshore. There was no significant development of offshore locations back in the 1950s.

The steel companies in the USA around that time were huge and sourced much of their own electrical power, generated by burning coal. This development had left them owning their own coal mines which, as they only produced coal for use of their parent organisation they termed ‘captive’ mines. It was a natural corollary that any subsidiary insurance company became known as a captive insurance company. This generic name stuck and has been universally adopted. So, whilst we put down the conception of the term to Fred Reiss, it most likely emanates from the American steel industry.

Whilst the term captive insurance company properly is assigned to companies slotting into the Sydney Pine definition, as explained in other Module K in this course there are several different types of insurance and reinsurance entities operating in Guernsey and the term captive should only be applied where it truly fits the definitions mentioned earlier.

2.1. BACKGROUND TO DEVELOPMENT

The primary reason for the initial development of captive insurance companies can be put down to cost efficiency. This is fully explained subsequently where it will also be seen that there are a variety of other reasons for the creation and development of the modern captive, not least as a strategic tool for financial risk management and the 'insurance' of uninsurable risks. But in the early days cost savings were probably at the root of the creation of such a company, with the risks generally related to the insurance of property.

As we shall see, the origins of captives go back 250 years, but the modern captive concept arose out of the development of larger multinational corporates' concerns following the Second World War. The employment of corporate insurance managers, followed by their development into risk managers, lead to a deeper understanding of risk and those companies who were successfully implementing risk management principles saw their loss experience improve. At the same time, they were not receiving the premium discounts from the insurance market they felt their superior claims record merited. Although the insurance market could offer some flexibility in premium pricing in recognition of loss prevention such as the installation of fire protection, there was a fairly narrow band of rates that would be applied to an organisation almost regardless of its loss experience. The risks were typically rated based upon the view that the insurance market took of the risks pertaining to that particular industry sector as a whole rather than recognising individual companies' superior risk management through premium discounts.

Thus, the companies with superior risks were getting the worst of both worlds. They were asked to pay high minimum premiums when their loss record was good, effectively subsidising their competitors in the same line of business, with inferior loss records and yet were then penalised with experience rated premium hikes should their claims record deteriorate.

At the same time, the insurance/risk manager community was mobilising, becoming more sophisticated and sharing best practices. The USA witnessed the creation of the organisation which became the Risk and Insurance Management Society (RIMS) and this was mirrored in the UK with the founding of the Association of Insurance and Risk Managers in Industry and Commerce (AIRMIC). Subsequent years has seen the development of similar associations of risk managers in other countries throughout the world.

The margin retained between claims payments and premium charged was considered too large by insurance buyers. Insurers had been allocating only some 60–65% of premium received to payment of claims, with the balance retained to cover their expenses and profit. Further, with the development of risk management and acceptance of deductibles, as the insured companies grew larger so the amount of risk they could carry themselves became greater.

Insurers were not particularly keen to lose large chunks of premium and so the discounts they gave for companies retaining more risk through greater deductibles were insufficient to reflect the reduce risk assumed. The market discounts also bore little relation to the saving that a company could achieve by accepting its own risk (and associated premium) into a captive and then seeking quotations from the reinsurance market to transfer all or part of the remaining risk. All of this is explained in greater detail later but suffice to say that the retention of risk by large companies began to develop and arising out of that, came the increased usage and sophistication of the captive insurance company model.

2.2 DEVELOPMENT OF THE CAPTIVE CONCEPT

As insurance brokers (who arrange the placement of insurance into the insurance market) recognised this development of self-insurance would reduce the amount of premiums paid to the market (and consequently reduce their earnings as brokerage was typically earned as a commission on premium paid), they rapidly created their own captive management teams to service the growing number of captives (and in turn create a new revenue stream by charging management fees). Had they not done this, one might question whether the activities of Fred Reiss and some entrepreneurial captive managers not associated with insurance brokers, would have given the necessary stimulus to the captive industry to fuel its subsequent development. But the fact is that the use of captive insurance companies has grown to be very significant in corporate risk financing.

2.3 ROLE: WHY NOT JUST SELF-INSURE?

The genesis of captives no doubt came from the increased popularity of internal self-insurance whereby a company would, instead of paying a premium to an insurance company to transfer risk, retain the premiums (and risk) and be responsible for any financial losses that occurred. Given the traditional insurance market product typically returned only 65% in claims payments for each £ of premium, the advantage would be a reduced cost of risk. The self-insurance technique was an ideal solution for insurance coverage that has a predictable number of low value claims (also known as 'burning cost' insurance) and where the insurance market product is financially inefficient.

These self-insurance funding arrangements were relatively crude compared to the benefits of operating a captive.

At the end of each year, any surplus balance (premium less claims) remaining in the self-insurance fund was effectively treated as profit and would not be regarded as a tax-deductible expense.

The overall cost of insurance for that year would have been reduced but the development of such self-insurance programmes was inhibited by the limitation on carrying claims reserves through into future years. Another significant problem was that the funds were often not cash but merely internal accounting transfers within the financial ledgers of an organisation. So again, if the aim was to take the principle beyond very low levels of self-insurance, there would not be the cash available to pay a large claim should it arise. There was also the risk of the Finance Director raiding the self-insurance fund should the company be seeking some additional cash flow.

The creation of a captive insurance company overcame these problems through financial segregation.

In contrast to the self-insurance funds, premiums paid to a legally constituted captive insurance company, set up as a bona fide operation, had a number of fiscal advantages, not least that the premium paid to it would usually be allowable as a tax-deductible expense, just as it would be treated if paid to any other insurance company.

In addition, any profits generated from the underwriting activity and from the investment income earned on those premiums could be accumulated and capital & surplus reserves created and would not be taxable until declared and paid as a dividend to the parent company.

This growth of reserves enhanced the captive's capacity to retain higher levels of risk. Self-insurance could only effectively be operated on a single country basis as the transfer of money across borders for self-insurance is restricted in many countries. Thus, the potential cost savings from self-insurance was greatly enhanced by the creation of an insurance subsidiary company which could accept risks from a range of territories and the advantages could be extended world-wide.

The original tax advantages have been materially (if not entirely) eroded by tighter tax legislation over the years. The captive's position is now pretty much tax neutral, and this is discussed further in Unit 14.

The other advantages, however, such as the ability to create and maintain reserves, tax relief on premiums, access to the wholesale reinsurance market and the capability of writing business for a diverse world-wide group, remain.

Investment income can be a principal area of profit within the captive insurance company. The company has the use of the premium funds it retains until such time as claims arise and even then, payments may well not be made until some considerable time after the incident.

From the date of receipt of premium up to the time of final settlement that money can be invested and earning interest. Additionally, there is the investment income earned on the retained earnings within the captive and generated by the original capital paid in.

Of course, it is recognised that some of this investment income would still be earned by the parent in the event of self-insurance, if only by virtue of the fact that the funds would be retained by not paying the captive. However, the captive facilitates investing the funds in assets that match the profile of the insurance liability rather than being placed in the parent's investment portfolio or being invested in the parent's core business.

2.4 BASIC FEATURES

2.4.1. Operation

The basic principles of a captive's operations are relatively simple. A captive can issue an insurance policy directly to its parent to cover the risks being insured. It can keep part of the insurance for its own account and can purchase reinsurance to protect it against a large individual and/or cumulative aggregate losses. In this case the captive will operate exactly as a traditional market insurer issuing its own policies to the parent group. This is the simplest model, but it is not always suitable for all types of cover and may not be feasible for those captives that are operating on behalf of a world-wide group. This arises out of the fact that many countries require that insurances can only be placed with insurers licensed and regulated in that territory. In these cases, the captive would operate as a reinsurer and partner with a licensed insurer in each territory to act as a 'fronting' company which would issue the local policy, possibly retain part of the risk for itself and then reinsure to the captive. Please note that some counties allow captives to write insurance directly to insureds within their territory. Please see Unit 9 for more information in this regard.

2.4.2. Management

The management of a captive insurance company is usually achieved through the outsourcing of functions to a company providing specialised management services which would manage the captive's activities on behalf of, and under the oversight of, its board of directors.

The board itself would usually comprise representatives from the parent group, being both the shareholder and the insured entity, plus suitably experienced persons resident in the captive's domicile. It would lay down guidelines for the running of the captive by the management company, receive regular detailed reports on its operations from the managers and in general would exercise control over the operation at regular board meetings where the managers would report. It is obviously important that the captive's strategy, business plan and activities should be aligned with those of the person within the parent group responsible for insurance and one way of achieving this would be for the risk manager of the parent organisation to be a member of the captive's board. Composition of the board is discussed further in Unit 16 and the duties of the management company are summarised in Unit 7.

There are very good reasons for the employment of a specialist outsourced Management Company.

If the parent of the captive manages the company itself, it is likely to incur considerably higher costs because the economies of scale available to a management company, handling the activities of a number of captives, are not available to it.

Specialist underwriting and accounting staff would be required. There would be numerous other technical aspects such as reinsurance, the making of statutory returns, secretarial matters, investments, that would be difficult to handle without the specialist and comprehensive facilities that a management company would provide. Thus, the costs would be considerably reduced by using a management company, who would typically operate for a fee based upon hours worked, compared to employing one's own staff on a full-time basis. Apart from the cost differential, which could well be significant, one's own staff would not usually have the depth of experience to assist in the management and development of the captive. Outsourced managers are typically regulated by the local regulator and so are incentivised to deliver quality client service by qualified and experienced staff.

However, there are a limited number of captive insurance companies that are large enough to justify employing their own staff. They are not, however, using parent company staff but employ their own dedicated and specialist staff for the operation of their captive. It has to be stressed that this only becomes an economic proposition for the very largest captives and by far the vast majority of captives use the services of a management company.

2.4.3. General Economic and Administrative

The main reason for forming captives is to reduce insurance cost by eliminating the on-costs of the traditional insurance market for those risks within one's risk appetite that can be carried by the insured itself and creating access to the wholesale reinsurance market to buy the cover needed. In excess of the risk appetite. Additionally, there is the attraction of improved cash flow and additional income derived from the investment of premium and reserves funds.

Historically, most captive insurance companies were domiciled offshore and whilst this may have produced taxation advantages, these should never be the raison d'être for captive formation. Indeed, over the years, the taxation advantages of an offshore location has, and continues to be, eroded. The taxation issues are discussed in detail in Unit 14.

Unit 3 goes into detail about the choices of captive domicile, but an offshore location can offer advantages from a variety of aspects quite apart from taxation.

Regulatory procedures in the parent domicile can be administratively onerous and are usually not proportional for an insurance subsidiary of a major group concerned primarily in insuring its own risk. Local insurance regulations are predominantly designed to protect against customer detriment and financial system failure. By comparison, offshore legislation is designed for the operation of captives and recognises the B2B nature of the captive model.

The setting up procedure, which can take a matter of several weeks offshore, can be many months onshore. Set up and ongoing running costs would usually be much lower offshore because of the reduced levels of regulatory oversight and consumer protection. This is by no means to imply that the regulatory authorities in offshore domiciles are lenient and a captive can be created there that would not otherwise be approved. Rather the contrary is true. Because of the scale of their operations and an understanding of the specific requirements of captives, the regulators offshore have developed regulatory regimes that, whilst meeting international standards, are aligned to the unique characteristics of the captive model.

There are good sound commercial reasons for the creation of a captive insurance company but they are nevertheless on occasion viewed with suspicion by certain Revenue/Tax Authorities. Most countries now have various rules and regulations regarding the treatment of controlled foreign corporations (which is what a captive is typically identified as) which were effectively created with the aim of consolidating the financial activities of offshore companies into those of the parent. Certain commentators have suggested this growth of Revenue oversight as, if not the death knell of captives, at least a curb to future development. Despite this, the growth of new captive formations has continued, which supports the argument that a captive is not be formed solely for tax reasons.

The main economic benefits of corralling underwriting profit from improved risk management activities, removing commercial market financial inefficiencies and capturing investment income continue, regardless of the domicile of a captive or the Revenue rules. Ultimately corporation tax can only be incurred on profit; a profit that would not be generated without the creation of the captive. The consolidation of a captive' profit within the parent financial results does not remove this profit from the tax net. Just as the economic activities of the parent organisation are to make profits, on which tax is paid, so the activities of the captive are designed to reduce external expense within the parent organisation and thereby increase its profit. And in turn tax liability.

2.5 TYPES: ASSOCIATION, JOINT INTEREST, PROTECTED AND INCORPORATED CELL COMPANIES

So far, much of what has been discussed relates to single owner captives, albeit that in many respects (such as management accounting) the aspects are just as relevant for multi-owner captives. This Section, however, reviews the applications, uses, structures, advantages and challenges of joint owners' captive companies. This is presented in four sections.

Firstly, Association Captives (which, in earlier days, might have gone under the title of mutual) are discussed. These would be a group of companies (possibly members of a trade association) or an ad hoc grouping in a particular industry segment, who are facing a common insurance problem. Either they are individually too small to form their own captive or there are advantages in joining together with others.

Joint Interest Captives are reviewed next. These are similar to association captives but the distinction is that they refer to groups of companies which may come from different business segments but have a mutual problem or opportunity, which can be solved by a joint approach.

We then move on to discuss Cell (either Protected or Incorporated) Company which have delivered solutions to some of the structural drawbacks previously encountered by mutual, association and joint interest captive facilities.

2.6 ASSOCIATION CAPTIVES

The majority of association captives are groups of companies in the same line of business facing common risk challenges. Members may be too small to create their own captive but, by joining with others, they create scale and are able to secure the advantages of a captive. Sometimes association captives are created and owned by a trade association and other times by individual owners as shareholders.

2.6.1. Applications

Association captives have been formed by a broad range of industry segment associations including engineering companies, auto dealers, fast food retailers, energy companies, lawyers, banks and builders. The main reasons for getting together typically would arise out of one or more of the following:

- Common Exposures/Perception of Risk

The names of the groups themselves invariably indicate a common business and accordingly, the captive will be covering similar exposures arising out of their trade. The members will have a deep understanding of the risks they face and have a different perception of the risk compared to the commercial market.

- High premiums

For example, a captive for the Association of Oil Distributors was created because the insurance market were rating their insurance on delivery trucks in the same way that they were rating the major oil companies who had much larger vehicles covering high mileages on motorways.

So far as the insurers were concerned oil delivery truck loss statistics were demanding a particular average rate whereas the local oil distributors had smaller delivery trucks doing relatively low mileages in limited areas.

Probably of more significance was the fact that in many cases they were owner drivers or family drivers and keeping the vehicle on the road maintained their income. It goes without saying that their experience was good. A local insurance broker handling the business of their local Association perceived the solution to the problem as the creation of a mutually owned captive and this was successful enough to spread the concept over three different countries.

- Combined buying power

The individual small business typically has little market leverage. By joining together with others, a more attractive and diversified package of risks can be created producing competitive pricing and better terms for the participating companies.

- Economies of scale

Whilst the cost of operating an association company is certainly higher than the cost of managing a single owner captive, when overall cost is shared across the members of an association the cost per individual member is relatively small.

2.6.2. Advantages

- Optimal risk financing programme and efficient use of market capacity

Individual companies insuring on their own would likely have a low deductible or excess on any insurance placement with the market. When it comes to buying greater levels of cover, excess insurers require minimum premiums which can make the cost onerous and economically unviable for an individual insured. Under an association arrangement, capacity can be increased and cost reduced at both ends. At the bottom, in addition to the small deductibles which each member can carry, there will be the additional retention retained by the association captive. Thus, the attachment point of insurance purchased from the market could be significantly higher than it would be under an individual arrangement, with more of the burning cost of predictable claims and related premium retained rather passed to the market. When it comes to purchasing excess layers of cover, the combined risk is now being placed on behalf of the association captive, i.e., on behalf of the group of owners. Whilst there will still be a minimum premium demanded by the market and this will certainly be a higher one than for an individual purchaser, it will be more palatable given the financial strength of the association captive and more in line with the risk profile.

The overall effect is that both the lower and higher levels of cover can be bought at reduced cost, with external premium leakage reduced and capacity deployed in higher layers of coverage, if required.

- Wider cover

With the cover placed in the market now being in excess of, possibly, a significant retention, assuming that the association captive is retaining the bulk of the burning cost it should be possible to mitigate market driven exclusions.

The association members can themselves decide the breadth of cover their captive will write and, indeed, the whole purpose may be to write certain covers which were previously uninsurable but which they agree between themselves would make sense to be shared.

- Profit potential/superior risk management

It would be normal for any association captive to assess and vet its membership to ensure that poor risks were not accepted.

Obviously, any company can experience a temporary poor loss record for a variety of reasons, but it is assumed that the creation of the association captive is because the members feel they possess superior risk management capabilities, yet they are being unfairly treated by the traditional market.

The market rate charged may well represent the price required to insure an insured with an average loss experience. So, if the captive is more selective as to membership, and imposes stringent risk management standards on those with an inferior loss record, its loss experience should be superior to the market average. Even if the loss ratio is the same as that enjoyed by the market, there will be the reduced expenses of a captive and this, combined with a positive premium margin over loss experience, should produce profits in the captive. There will also be the investment income generated on the premium flow, loss reserves and accumulated capital. and surplus. All of these profits will ultimately be distributed to the members thus producing an additional income to each member whilst effectively reducing insurance cost.

- Developing an asset base

Part of the profit described in the preceding paragraph can be retained to expand the asset base enabling the captive, over time, to offer greater capacity to bear risk and increase its retention or the range of business it writes thereby providing greater flexibility such as additional facilities and further reduced insurance cost to its members. Any increase in the asset base of the captive also increases the value of the original investment of any member.

- Common problems

Although there are many successful association captives in existence there are equally a large number with feasibility studies that confirm the viability of the vehicle but never actually get established. The reasons for this can be that there are many practical issues which need to be overcome. All of these need to be considered and be documented in a Shareholder Agreement before any company is formed.

- Setting up costs

It is assumed that initial contributions will have been received from members, on an agreed basis, to fund any feasibility studies. The basis of the allocation of any set up costs should be agreed in advance. For example, are the setting up costs to be by way of individual contribution and on an equal basis from members or are they to be taken out of any amounts contributed as share capital?

- Raising capital and allocating shares

Many companies are keen to get involved in discussions about association captives but then display reluctance when it reaches the stage of asking for financial contribution. It often then transpires that a lot of the initial interest stems from organisations who were seeing a solution but are not prepared to offer financial support. Before the request for capital raising is made, a decision has to be made as to whether each member will be an equal partner, putting up equal amounts of capital regardless of how big they are, or whether there should be some proportional shareholding calculation, according to corporate size, amount of insurance or just a willingness to contribute more share capital.

- Corporate structure

Is the company to be a Limited company, where the shareholding is the limit of each member's liability or a mutual company which, whilst possibly limiting the initial capital need, represents an open-ended commitment on each member to contribute to any future losses? Should the company be formed on a mutual basis or be limited by guarantee? It is fairly certain that there will be strong opinions on the relative merits of each option and a consensus will need to be achieved.

- Entry requirements

These, together with the following comments on exit requirements, are probably the greatest challenges to overcome. It is not usually a problem at the formation of the captive as, assuming agreement is reached on the corporate structure and the capital allocation, all shareholders start off on the agreed basis. However, as soon as the company begins trading, its capital & surplus base will change as a result of any profits and losses generated. What makes an insurance company's worth difficult to assess is the uncertainty associated with large amounts of claim reserves on the balance sheet. One assumes that these are conservatively estimated and should be adequate to meet eventual claim payments but regardless of whether they are over or under stated there is a danger of new members arguing that, with hindsight, the value of the shareholding to which they contributed was ultimately different to that which was actually assumed. Apart from this difficult calculation there could be other requirements.

Any shareholder investing after the creation of the company would not have contributed, either in cash or time, to the original feasibility studies and establishment. How best to recognize this mismatch? There will also need to be joining criteria put in place that define who can and who cannot become a member, i.e., their business, falls within maximum or minimum sizes and, importantly, risk management loss experience and other underwriting features meet certain standards.

- Exit requirements

Whilst every shareholder forming an association captive may assume that they are going to remain committed to the association captive model, inevitably at some time in the future, a shareholder will wish to exit. This may be because they have been subject to M&A activity, they have themselves grown and wish to form their own captive or the shareholder is in liquidation, or restructuring. But whatever the rational there is going to be complexity in assessing the value of the shareholding to be redeemed.

Again, this valuation is going to be subject to the estimation of reserves held by the company. If these reserves are over-stated then the exiting partner will not be getting the full value of their shareholding. If the reserves prove to be inadequate or additional claims arise, the exiting partner will not be there to contribute their ratable share.

Will the company have the liquid resources to redeem a shareholding? Even if it has the cash resources to repay one exiting partner what if there are a large number of partners who wish to leave at any one time? This could undermine the whole integrity of the company.

A solution could be that if more than two shareholders wish to leave at any given time, an extraordinary general meeting of the members has to be called to consider the requests. If withdrawal requests have been received from more than a stated percentage of the membership, it may be that the company has to be put into liquidation. Whatever the solution, it requires careful consideration at incorporation and needs to be very clearly laid down in the bye-laws or shareholder agreement of the company.

- Uneven size of partners

There are inevitably going to be members of varying sizes and structures within the original association. This problem may have been addressed during the original raising of capital and allocation of shares but even if it is pre-agreed that all members will have equal shareholding and therefore equal voting rights, there is still a danger of the larger company becoming dominant. If it is decided that the shareholding should be proportional according to size of member and thereby allocating members different numbers of votes, but what happens if a member company becomes smaller or gets larger? Does its shareholding have to change every year? If it does, how is the value of any shares being exchanged calculated given all the attendant uncertainties discussed above?

Regardless of the shareholding, larger member companies will presumably be contributing larger proportion of premium and that premium will be earning investment income. Is it then fair to allocate profits in accordance with shareholding when some member companies may have contributed more than others to profits, ignoring loss experience?

- Uneven loss experience

The original intention of the association captive may be for everybody to share their insurance risk, share their losses and allocate profits to members evenly. That is fine in theory. However, at the end of any year, a company experiencing no losses may feel poorly treated in receiving the same dividend as somebody who may have shown a poor loss experience. More importantly, what if the losses of a few put the whole company into an overall loss situation? Is this to be dealt with by future premium adjustments for all members or just the members with poor loss experience? Whatever remedial actions may have been considered and set down at the beginning of the association captive, experience shows that unforeseen factors (such as the impact of COVID 19) will come along over time that will create the potential for unrest.

- Profits split

Investment income will be earned on premium funds, which will vary according to the contribution of each partner but it will also vary according to the amount of premium funds applied to the payment of claims. Effectively a member who experiences claims is reducing the investment income from the premium of the member who doesn't have claims. This issue gets to the very essence of an association captive; are the members prepared to share the aggregated pool of risk rather than retain their own risk recognizing the outcome may not always be positive for them but will benefit the group as a whole?

- Financial stability of partners

What happens if the financial situation of any of the members deteriorates? It is one thing to agree exit requirements of a shareholder leaving the fold voluntarily but what if they are going into liquidation or administration? A member may be asked to leave by other members, possibly as a result of a deteriorated claims experience or breeching membership criteria? Should exit rules be strictly applied on a forced sale? Are the rules within the company clearly stated as to when a member is obliged to leave?

- Experience prejudice by one member

We have referred to the uneven loss experiences of the members which is certain to occur but there could be a situation where one member significantly prejudices the overall experience and, possibly, the viability of the company. Can they be forced to leave and on what basis? If they are forced to leave, what might their ongoing obligations be if the ultimate loss experience proves adverse to that reserved?

- Long-term commitment

Any group of entities getting together to form an association captive has to recognize that it is a long-term commitment. The terms and conditions of the shareholder agreement should make it clear that a long-term commitment is required but recognize there may be valid reasons at some point in the future for a member to wish to exit the arrangement, albeit not to the detriment of the remaining members

- Guarantee of future financing

If the association captive requires additional capital will every member be able and willing to contribute? If not, and the original decision was that everybody should be equal shareholders, how will this be managed? If the company is formed on mutual basis, how will any possible future contributions be guaranteed?

- Board committees

Not every member can appoint its representative on the board of directors of the association captive, certainly this is the case for the larger association captive. Even in the situation where every member is a director, for effective direction of the company the appointment of an Executive Committee is often established. How will these directors be chosen and how regularly will they rotate? How long will they serve? What authority will be delegated to the Executive Committee? There may also be the need for other committees to be formed such as audit, underwriting and investment. How will these members be chosen and under what terms of reference will they function?

- Underwriting control

Ideally the underwriting parameters should be set initially by the Board and the management, or the Underwriting Committee should be given the authority to underwrite business within those parameters. However, there is a distinct possibility that when uneven loss experience begins to show, members may want greater oversight of underwriting decisions if so, how will confidentiality of each member’s information be preserved? What if the underwriting terms offered are not acceptable to a member? Are they obliged to exit on a voluntary or a forced basis?

- Claims handling

Claims handling may be shared between any fronting insurer involved, appointed loss adjusters or lawyers and the insurance manager. But dependent on the type of risk, some association captives may devolve claims handling authority to the individual members, which could lead to the adoption of differing claims’ handling procedures. This risk can be mitigated by members being required to adopt common standards and processes and these being audited to ensure compliance.

- Exit/Run off challenges

Whether individually for exiting members or collectively because it is desired to close down the association captive, solutions will be required to address challenges arising from run off. If liability business has been being written, it can take many years to achieve finality and during this time members may wish to monetise their shareholding to support short term cash flow.

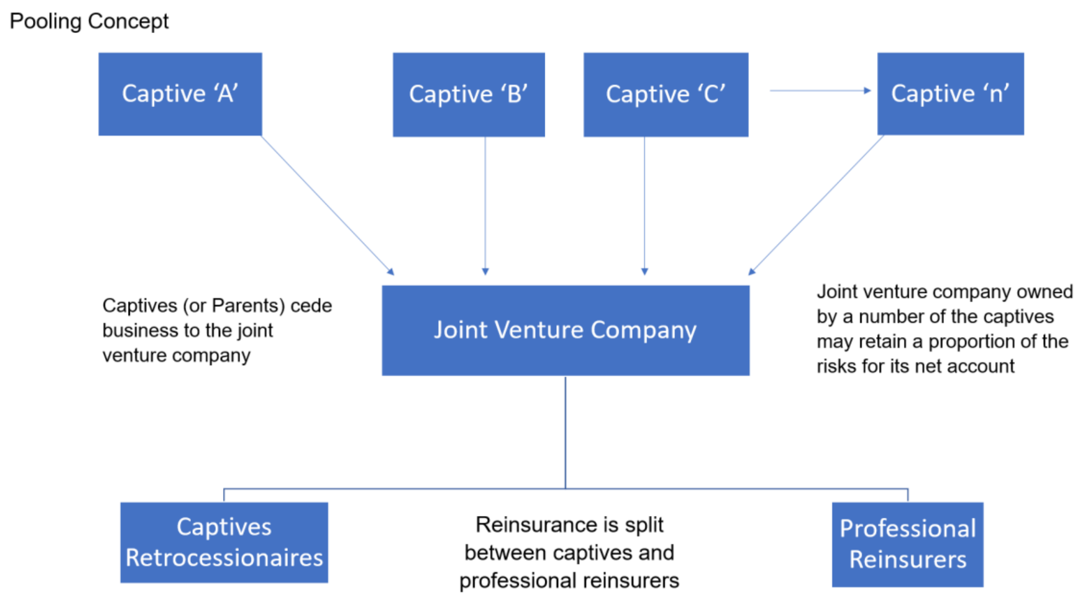
2.6.3. Confidentiality

Whilst this has been alluded to in a number of the above paragraphs, maintaining individual members’ information confidentiality is one of the biggest tests of an association captive. A great deal of authority will be delegated to the management company, and it should have robust information management policies and processes in place to t preserve confidentiality. Members may not wish to have their claims revealed to other members, particularly if the company is writing commercially sensitive covers such as product liability or professional indemnity. Underwriting information is equally going to reveal confidential factors. What information (and does it need to anonymised) is going to be made available to the board or any other executive committee of the members?

With this list of potential practical problems, it might seem surprising that any mutual/association captive ever sees the light of day! But they do and, as has been stated, the vast majority are successful. What is important is that these potential problems are assessed, discussed and agreement reached how to manage them before the company is formed. Failure to do so inevitably leads to tension between members because vested interests will already have been created.

2.7 JOINT INTEREST CAPTIVES AND MUTUAL POOLS

This heading refers to those joint interest captives that do not demonstrate the same homogeneity of risk and the members are not in the same business segment as would be the case with an association captive. Some of these entities have been formed for reinsurance pooling purposes where captives under the management of a particular insurance manager may decide that they want to participate in writing each other risks unrelated to their core business. By getting together, they may feel that they can accept larger lines (given the increased diversity of risk) and participate in a share of well-managed (and profitable) business risk. It may be, indeed, be a tactic employed in order to increase the overall retention of risk within their captives and secure better reinsurance terms, particularly in times of restricted capacity. A possible example of this is shown below:



In the above example each captive would have its own retention and would then cede any business risk in excess of that to the joint venture company. The joint venture company will likely then retain a portion of that business, either a fixed amount or a percentage and then purchase reinsurance to transfer the remaining risk.

The captive shareholders will therefore be sharing in each other’s’ risks above their captives’ retention.

An example of the application of joint interest captives arose in 1985 as a result of an excess liability market capacity shortage. This gave rise to the creation of 2 new pooling entities called A C E and XL formed and capitalized by 40 or so major corporates that were unable to secure cover in the commercial market. These were both successful and have evolved way beyond their joint interest captive origins. They are now part of the established market (having been acquired by Chubb and Axa respectively) writing a wide range of other business.

Their speed of growth and profitability was remarkable and indicates what good business a joint interest captive can be. This is a perfect example of the captive market producing an alternative solution to a traditional market problem.

Many of the common challenges outlined above in relation to association captives will also apply to the mutual pools and the joint interest captive, but the incentive to find solutions to these is easier to be reached when all participants face a common problem (e.g., lack of conventional market capacity).

2.7.1. Operating Procedures

In many respects the formation process and operating procedures of an association or joint interest company is very similar to that of a single owner captive. Both are insurance companies and the number and rights of shareholders should not make much difference until distribution of profits is considered. Nevertheless, there are factors which do need to be taken into account.

Perhaps the most important relate to the features – and in particular the common problems – referred to above. Before a promotor makes an insurance licence application and forms a new company, time should be considering the various aspects mentioned in detail and then formalising the outcomes in a Shareholders' Agreement to be signed by all shareholders. This generally takes some time as each point could well be the subject of lengthy discussion. However, this is time well spent and a necessary prerequisite to the creation of a successful joint venture company.

Thereafter, the licence application can be submitted to the regulator who will need to conduct due diligence on all the proposed shareholders. The regulator will examine the governance of shareholding, the financial stability of the partners and will likely expect the business plan to address many of the aspects raised as common problems and how they have been resolved in any shareholder agreement. Where there is a single owner captive writing only parent group business, the regulator can adopt regulatory oversight proportionate to the risks associated with a B2B relationship and little chance of customer detriment. A multi-owner company, on the other hand, is more akin to an ordinary commercial insurer and each member is, in effect, writing unrelated business to the extent of its participation in the accumulation of risks of the other members. The regulator is therefore going to look very closely at the business to be written, the potential liabilities and the adequacy of solvency. Any commitment given for future financing, such as in a mutual situation, would almost certainly need to be backed up by some security such as letters of credit.

The creation of a multi-owner company should take not any longer than that of a single owner but it should be recognised it is likely that each member is going to want to review a draft copy of the Memorandum and Articles of Incorporation and many will probably offer their comments and suggested amendments even though they may have already approved the shareholder agreement. These governance reviews by members can extend the time needed to form the company.

From an operating point of view, the management company needs to recognize there are a number of stakeholders. All activities will have to be performed following pre-approved policies, processes & procedures and within delegated authorities. Any variation to these will need to be approved by an executive committee or the board as appropriate. For the larger joint venture company there might even be a case for a chief executive to be appointed and through whom exception items can be channeled and who can act as the focal point for stakeholders.

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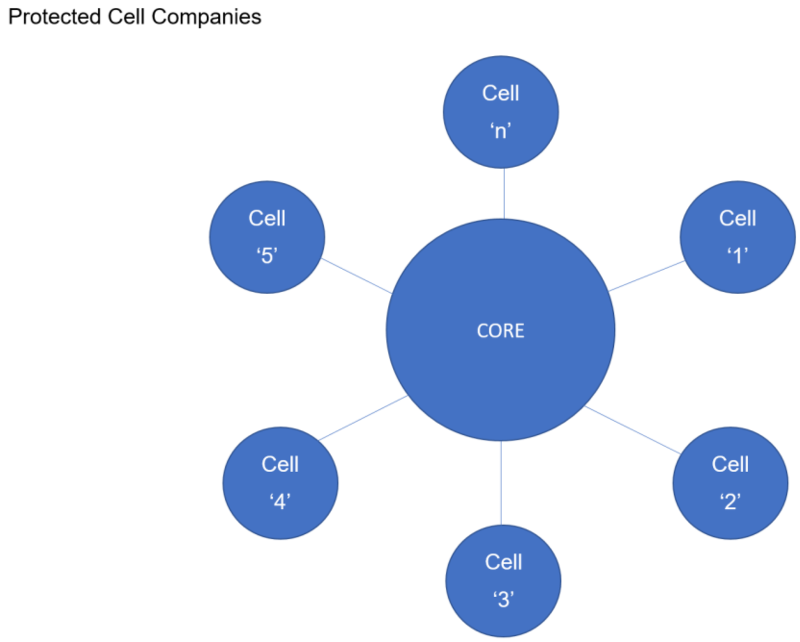
2.8 PROTECTED CELL COMPANIES

In 1997, Guernsey became the first domicile to introduce dedicated protected cell company (PCC) legislation. This facilitated the creation of a new corporate structure company which provided limited liability on a sub company scale through the legal segregation of assets attributable to each cell within that company. The structure of a PCC is demonstrated in the following diagram:



2.8.1. PCC Structure

The company, which is required to have the letters PCC in its name, would be formed by the promoter with authorised and issued share capital and its own board of directors. The business then written for each client would be put into a separate cell. Each cell may or may not have its own capital according to the business it was writing, its exposures and, possibly, the risk appetite of the shareholders of the core who may themselves be an insurance or reinsurance company forming the facility for the use of their clients. The structure is best described by example and two possible schematics are shown in the following pages. These use small premiums and risk limits but it is purely for explanatory purposes and it should not be assumed that PCC are usually used for such low limits. On the contrary, in most PCC formats, cell premiums can be large but the principles are the same. In the first example each cell is fully funded and there is no risk to the capital. In the second example each cell has a potential deficit which puts a theoretical exposure on the core capital of £66,000. If this were to be the situation it is certain that the regulator would either want the deficit eliminated by additional reinsurance or additional core capital to make sure that it would always be above the statutory minimum. In practice one would most likely see a mixture between the two scenarios with some cells being fully funded and others not. There is no detriment to the cell owners because each cell is entirely separate and protected from whatever may happen in the other cells. It is for the shareholders of the core company to decide the extent to which they are prepared to allow any individual cell to be under funded and presenting an exposure to their own capital. Where they are an insurance or reinsurance company, they may charge a reinsurance premium to eliminate the deficit or charge a fee and be prepared to accept the risk to their capital. Obviously, they would assess very carefully the likelihood of potential deficits actually arising.

Essentially, a PCC consists of a core and of separate and distinct cells. The assets and liabilities of one cell are segregated and protected from those of the other cells. Similarly, the assets and liabilities of the core are segregated and protected from those of the cells.

Insurance companies have found the PCC structure attractive for use by rent-a-captives, transformers and a wide range of other alternative risk transfer solutions. There have also been a number of catastrophe bond issues and the securitisation of life business within individual cells of a PCC.

The principle is that where any liability arises that is attributable to a particular cell or to the core, the cellular assets attributable to that cell or the core assets attributable to the core, should be used in satisfaction of the liability. Thus, when considering a liability attributable to a cell, the core assets and the assets attributable to any cell other than the cell to which the relevant liability is attributable, are “protected assets”.

Separation of Assets

The directors of the PCC must keep cellular assets separate and separately identifiable from the core assets and also keep cellular assets attributable to each cell separate and separately identifiable from cellular assets attributable to other cells. Nonetheless, the assets of a PCC may be collectively invested, provided that they remain separately identifiable. The assets of a PCC may also be held by a nominee or underlying company, the capital of which forms cell or core assets (as the case may be).

Attributing Liability and Recourse Against Assets

Subject to the terms of any recourse agreement, the cellular assets attributable to a cell must be used in satisfaction of any liability attributable to that cell. In the same way, the assets attributable to the core are liable in respect of liabilities attributable to the core.

Unless excluded in writing, it is an implied term of every transaction to which a PCC is party that no party shall make or attempt to make liable any “protected assets”.

Liabilities of a PCC not otherwise attributable to any of its cells must be discharged from the PCC’s core assets. A recourse agreement is a written agreement between a PCC and a creditor which provides that “protected assets” may be subject to a liability owed to a creditor. Prior to entering into a recourse agreement, each director of the PCC who authorised entry into the recourse agreement, must make a declaration that he believes on reasonable grounds that no creditor of the PCC will be unfairly prejudiced by the agreement. The declaration must also state that a resolution has been passed by the core members or the members of the relevant cell (as appropriate) approving the recourse agreement, unless memorandum and articles of incorporation provide otherwise. A director who makes a declaration without grounds is guilty of an offence.

On the application of a PCC, the Court may issue a declaration if there is a dispute as to whether a right, liability or creditor is or is not attributable to a particular cell or as to the amount to which any liability is limited.

Information Obligation

A PCC must inform any person with whom it transacts that it is a PCC and identify or specify the cell in respect of which that person is transacting that the transaction is in respect of the core (as appropriate). If a PCC fails to provide the transacting party with this information then the directors become personally liable to the counterparty to the contract. Unless the directors were fraudulent, reckless, negligent or acted in bad faith, they have a right of indemnity for that liability out of the core assets of the company. Only the Court can relieve the directors from this liability for grounds set out further in the Law.

Transferring Cellular Assets To Third Parties

With the approval of the Court, the assets of a particular cell, but not of the core, can be transferred to another person wherever resident or incorporated. Note that this transfer mechanism is not intended to cover the investment or divestment by the cell of cellular assets or the payment or transfers from cellular assets in the ordinary course of the PCC’s business. Such ordinary course transactions do not need Court approval.

The Court will only approve a transfer of cellular assets if it is satisfied that the creditors of the cell concerned have consented to the transfer or would not be unfairly prejudiced by the transfer. The GFSC has a right to make representations to the Court in respect of the transfer. A transfer can be approved by the Court even though the PCC is being wound up or it or any of its cells is subject to an order for receivership or administration.

Arrangements Between Cells Affecting Cellular Assets

A PCC may in the ordinary course of its business, or the business attributable to any of its cells, make an arrangement where it deals, transfers, disposes or attributes cellular or core assets between any of its cells or between the PCC and any of its cells. If necessary, the PCC must adjust its accounting records and those of the affected cells to reflect the arrangement. The PCC itself, its liquidators or administrators, or the receiver or administrator of any cell may apply to the Court to make an order in respect of the execution, administration or enforcement of an arrangement.

Liquidation of a PCC

The general rule that on liquidation of all of a company's assets must be applied in satisfaction of the company's debts and liabilities pari passu is modified in relation to PCCs. The liquidator may apply a cell's assets only to those creditors entitled to have recourse to them.

Tax

The Guernsey tax treatment of a PCC is intended to reflect that the PCC is a single legal entity but at the same time protect investors in and creditors of one particular cell from the tax liability attributable to the profits of other cells. If eligible the PCC as a whole may elect for tax exempt status and the fee payable is not dependent on the number of cells comprised within the company. A single tax assessment will be raised on the PCC. However, the liability will be apportioned between the different cells and the core according to their entitlement to the profit.

Foreign Recognition

Since their introduction in Guernsey in 1997, a large number of jurisdictions have introduced the same concept – including notably many US states and the UK. This suggests a growing acceptance of the segregation of assets and liabilities created therein. Nonetheless, we are unaware of any case in which the mechanism by which assets are segregated through a PCC have been challenged by a foreign court.

However, as a matter of comity, a foreign court ought to apply Guernsey law in determining questions concerning the segregation of the assets and liabilities of a PCC.

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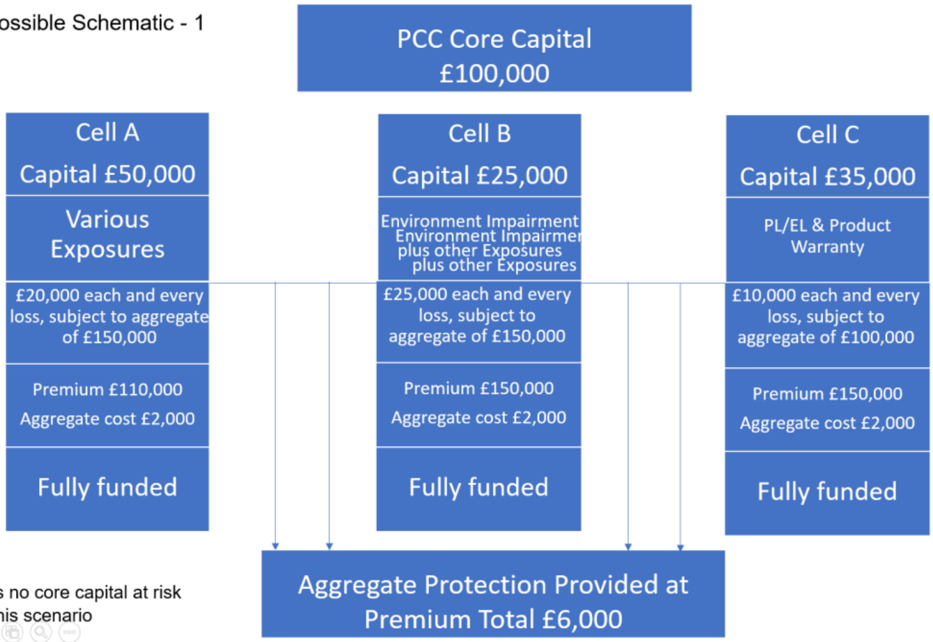
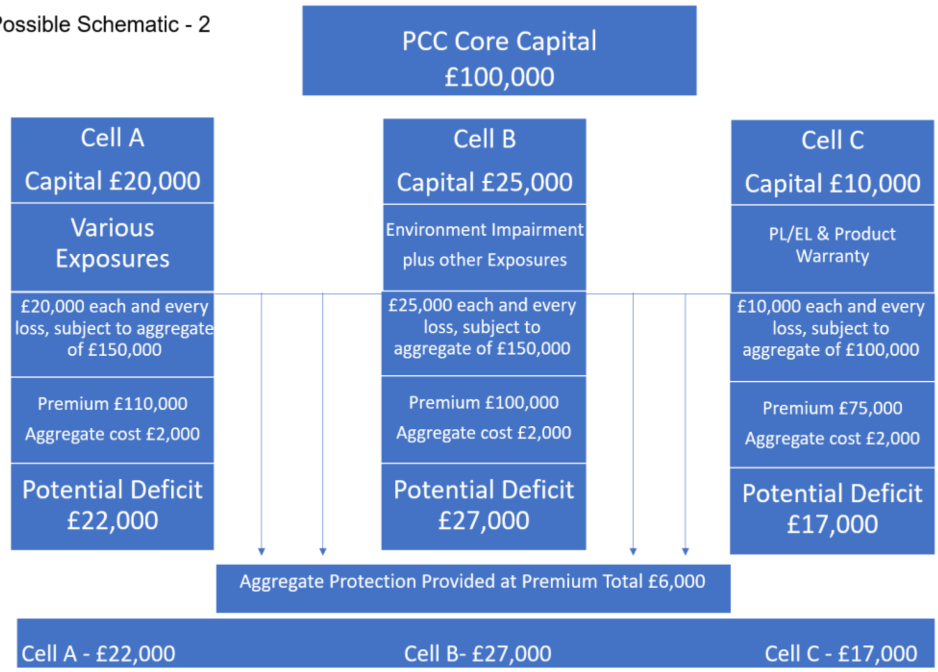
PCC Possible Schematic - 1



There is no core capital at risk under this scenario

PCC Possible Schematic - 2



Core capital is at risk as follows:

2.8.2. Advantages of a PCC

- PCC is a single legal entity

The PCC as a whole is considered a single legal entity and it follows that only one set of accounts is prepared, audited and submitted to the authorities each year. Only one regulatory fee is paid but there will be an addition for each cell, recognizing the work of the regulator, according to its individual size. Each cell, however, is not considered a legal entity whether it contains capital or not.

- Each cell has legal separation

A cell owner can put business in, with appropriate premium, plus any other supporting assets, in the knowledge that his cell has complete legal separation from other cells. These assets (and of course, liabilities) in the cell are totally segregated from the other cells, thus there is no danger of any loss arising out of the activities of other cell owners.

- No limit to number of cells

Once established the PCC can grow without limit. Where a PCC is formed to segregate the various subsidiaries or sub groups of a parent group, additional cells can be incorporated without problem.

- Can be converted to/from conventional company

Conversions

There are a range of conversions possible with PCCs. The process to effect a conversion is the same regardless of the particular transaction being considered: the consent of the GFSC is always required as well as a special resolution of the shareholders of the entity (or cell) which wishes to convert. The conversions which are possible are:

- a non-cellular company may convert into a PCC;
- a PCC may convert into an incorporated cell company;
- a PCC may convert into a non-cellular company; and
- a PCC cell may convert into a non-cellular company.

A number of PCCs have been converted from a conventional company where, perhaps, a traditional captive had a wish to segregate its business. This has occurred in a takeover or restructuring situation where a cell could be created for the old business with new business, possibly split into various subgroups, forming other cells. Companies may also want to segregate various classes of business to keep the funds for short tail business separate from long-term liability or financial business. The PCC is also an ideal solution for parent companies who have subsidiaries not 100% owned by the parent as a cell can be formed for each subsidiary, produce its own profit and pay dividends. A cell can also mature to a size where it wishes to float off and be created as a separate captive. As everything is isolated in the cell, this can be done without the attendant exit difficulties under a traditional association or joint venture company.

– *Limitations on recourse of creditors*

It follows from what has been said that the creditors of an individual cell have no recourse to the assets of any other cell or to the core assets unless a recourse agreement has been entered into by the PCC and the relevant creditor with the approval of the shareholders in the core. The approval of the relevant shareholders. They also will not have recourse to the core assets unless a recourse agreement has been mutually entered by the Cell User and the Core shareholder.

2.8.3. PCC Solvency

Although the PCC is a single legal entity the share capital supporting the statutory solvency provisions may be within the core itself or divided between the cells or a combination of each. The regulator will assess solvency on the total share capital and the risk mix of the PCC as a whole, i.e. he will weigh up in a risk gap situation the potential surpluses and deficits. Having said that, although each cell as it is added will need to be approved, it is not likely that each will have to go through a full registration process and can, in effect 'borrow' capital to support its operation from any surplus that there may be in the core. Thus, in the two example schematics the regulator would be happy with the first but would almost certainly ask for additional capital in the second above the minimum of £100,000, in order to support the potential deficit.

2.8.4. Actual and potential uses of a PCC

PCCs have been extremely successful risk financing vehicles. Actual and potential uses of a PCC can be summarized as follows:

- Providing a rent-a-captive facility with each renter's assets segregated

- In life assurance the PCC can legally separate the assets of individual policyholder funds, particularly useful for those companies involved in respect of the provision and administration of pensions and life assurance of very high net worth individuals.

- A composite insurer, which could be a captive, where the assets of life business need to be legally separated from those of general business. Equally it can be used to segregate short tail business from long tail business on the general side or to segregate the business of individual subsidiaries within a parent group.

- Member Associations where members are able to access mutual insurance arrangements offering better cover and prices than in the conventional market whilst at the same time being offered legal protection for their individual assets by placing them in separate cells. Earlier in this chapter the potential problems of association and joint interest companies were outlined and the PCC could well produce a solution to many of these problems.

- Insurers, reinsurers and most Insurance Managers have formed PCCs to accommodate the needs of individual clients within their particular cells.

- Reinsurance PCCs can have securitisation contracts for different clients segregated into different cells.

New uses for PCCs are being created all the time.

It would not be stretching a point to suggest that the invention of the PCC has been the single most significant development of the captive business model.

2.8.5. Incorporated Cell Companies (these exist in Guernsey and some other domiciles)

Unlike a protected cell company, an ICC's cell ('Incorporated Cell' or 'Cell') is a separate corporate entity with its own legal personality. It is not, by virtue of its incorporation, deemed to be a subsidiary of the ICC.
A cell is created though registration at Companies house in Guernsey following the approval of the formation of the cell by the shareholders of the ICC by special resolution.

Each Incorporated Cell and the ICC itself has its own memorandum and articles of incorporation. The ICC and each cell has a separate board of directors. One director of each cell must also be a director of the ICC but subject to that requirement the directors of the cells and the ICC can be different persons. The ICC and each cell also share the same registered office. The directors must ensure for any transaction entered into that it is clearly stated whether the transaction is entered into on behalf of an Incorporated Cell or the ICC itself, and if the transaction is entered into on behalf of an Incorporated Cell, which Incorporated Cell. A combined annual return is completed for the ICC and the Incorporated Cells.

An incorporated cell company may prepare consolidated accounts for itself and all or any of its incorporated cells as if it were a holding company and its incorporated cells were its subsidiaries.

The ICC must include the letters 'ICC' or 'Incorporated Cell Company' in its name and the Memorandum of Incorporation of the ICC must state that the company is an ICC. Each Incorporated Cell must include the letter 'IC' or 'Incorporated Cell' in its name.

The directors of an ICC must keep assets and liabilities of the ICC separate and separately identifiable from the assets and liabilities of its cells and the assets and liabilities of each cell separate and separately identifiable from other cells. The Law allows the assets of the ICC or any of its cells to be collectively invested or managed, provided that they remain separately identifiable.

It is possible to convert a company or a PCC into an ICC. (Normally by special resolution of shareholders approving the conversion, together with the revised Memorandum and Articles of Incorporation.

An ICC that is being wound up cannot be dissolved until the winding up of each of its cells has been concluded. Alternatively the cells may be converted into independent companies, transferred to another ICC, or expelled from the ICC. The powers of the directors of each cell are not affected by the appointment of a liquidator to the ICC.

One important distinction between PCCs and ICCs in Guernsey is the tax treatment of cells. For Guernsey tax purposes a PCC is a single entity and is taxable as such, whereas for an ICC each cell will be assessed for tax separately.

Protected Cells can be established more quickly than Incorporated Cells. Model agreements can be put in place for the administration and custody applicable to the cells. Regulatory consents can be obtained more quickly. This means that Protected Cells can be established at a fraction of the cost of an independent company. Cells can also be centrally administered as one entity, with, potentially, only one board of directors to pay.

As each Incorporated Cell is a separate legal entity, the legal complexity of transacting with third parties is reduced, as is the ability of the cells to transact with each other. The ring fencing qualities attributable to cell companies are enhanced. For securitisations and structured products, ICCs are likely to be favoured by rating agencies over Protected Cell Companies (PCCs).

2.9 BENEFITS / ADVANTAGES

The reasons for forming captives are many and varied and depend upon the size and type of the business of the captive owner, their philosophy on insurance and risk acceptance. Having said that, the key reasons can be grouped under three main headings.

The first and probably the principal reason for the majority of captives would be to reduce the cost of risk. As we shall see, the cost of using the traditional market system can be expensive.

The second reason is that of lack of insurance capacity. In one sense this can be coupled with cost in that premium increases as capacity reduces and vice versa. For traditional covers such as property insurance, capacity can be eased by the insured carrying the first part of the risk and seeking reinsurance rather than primary insurance. However, for risks like pollution, professional indemnity or product recall, capacity may be so limited for some professions as to make a captive the only viable solution.

The third reason is as a business strategy and whilst probably the minority of new captives have this as their main reason, cost and capacity being the usual initial incentives, many captives as they mature realise the uses to which this unique operation within their group can be put for the advantage of the whole business. Under the business strategy heading, would be the wish to eliminate the insurance market cycles and to take more control over the insurance process, something particularly valuable for a major international group. More particularly, however, there would be the ability to protect against uninsurable risks. As we shall see, some companies are forced into this by the withdrawal of the traditional insurance market but conversely there are examples of captives beginning to write an uninsurable risk then ultimately seeking and obtaining support from the reinsurance market.

THE COST OF TRADITIONAL INSURANCE

- **Insurers' Expenses**

A major part of any insurance premium goes to cover insurers' expenses – what might be called the 'frictional cost' of insurance. Looking at the annual results of the traditional insurance market it will be seen that, on average, not much more than 60% of premium is used to pay claims. Ignoring brokerage, as the majority of clients would wish to have their advisers close at hand whether they were using a captive or the traditional market, the average of insurers' expenses is around 20%. The insurer has to pay for the maintenance of buildings, marketing and staffing costs to provide the service expected both by individual clients and major industry. Many of these services provided by the traditional insurer are not required by the major corporate buyer or, if they are required, are needed possibly in a different or more specialist form and can often be purchased separately at lower cost. Just about all of the services required by a captive are offered either directly or by sub-contract through captive insurance company managers.

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By comparison, the cost of a captive operation is typically 5 to 10% of premium

Typically the higher the premium the lower the percentage of the operating costs. The captive will have certain minimum costs to cover and these costs would vary little regardless of the type of business written. The main difference is in what might be generally called the underwriting activities but again the cost would only increase where administratively burdensome lines of business are undertaken .

It is important to understand that there are some fixed costs in operating a captive and as such the more business put into the captive, the lower those costs as a percentage of premiums written.

- **Investment Income**

  Insurance premiums are generally paid annually in advance and the insured therefore loses the use of the money immediately that premium is paid. Conversely, the insurer gains that money which can immediately be invested.

  A second major area of investment income comes from the retention of that part of the premium set aside, often over many years, to meet claims. These reserves can be substantial. Property insurance, looked on as short tail business, can still have claims outstanding for up to five years. With liability insurance and other long tail business, this investment income from reserves can be very substantial in that the claims tail can go on for up to ten years and longer. This investment income means that such insurances can still be written profitably at loss ratios in excess of 100%. Investments are discussed further in Unit 13

  The third area of investment income arises from the investment of retained profit, again something that would not have been earned if the captive had not been created. Obviously the size of the retained earnings within the captive is dependent upon the dividend policy of the company.The investment income can be a valuable part of the annual profit of a captive.

- **Trade Rating**

  Most insurance companies determine the premiums to be charged principally based upon the activities of the insured business. This is not to say that no relevance is given to loss experience but for many types of insurance there is a range of base premium rates largely dependent upon the parent company's business. By comparison, regardless of the original rating, the net cost of an insurance policy written through a captive is principally the cost of claims.

  Usually the premium charged by the captive is similar to market rates. Whatever, the profits earned on the premium flow through to the bottom line of the captive and will ultimately be returned to the parent thus reducing the net cost to the losses occurring plus expenses, less whatever investment income is earned on the premium and loss reserves.

- **Underwriting Profit**

  With all insurance underwriting one aims to make a profit. With traditional insurance that profit goes into the general insurance pool either for the profit of the insurer or, more commonly, to pay the losses of other insureds who do not have such a good loss experience possibly because they are not spending so much on risk management. With a captive the loss prevention activities of the parent are directly rewarded in a better loss experience and more profit in the captive. In the traditional insurance market this can be a very long-term process of gradual premium reduction as the market wishes to ensure effective and ongoing risk management is being applied by the insured. The captive knows this first hand by way of direct contact with its parent.

- **Reinsurance Commissions**

Insurers buy reinsurance to protect their book and the small to medium size companies buy more than the larger companies. Reinsurers would generally pay a ceding commission to the insurer which they retain. When the insurer is a captive these reinsurance commissions are retained by the captive and therefore contribute to potential profits

- **Reduction of Insurance Market Capacity**

Globalization of businesses means that the average insured group is significantly larger than it used to be and therefore is in need of more capacity. The ability of the insurance market to provide that capacity has not increased anything like to the same extent. Indeed, for some lines of business it has been significantly reduced at various points in the insurance market cycle, or even removed altogether and this has had a marked effect in pushing people towards the captive solution. Shown below are examples where the insurance market has historically withdrawn capacity.

- **1985 Excess Liability Crisis**

Prior to 1985 insurance rates for high limits of liability cover had been reducing and it was relatively simple to buy limits of several hundreds of millions of dollars. Suddenly, in 1985, the market dramatically reduced the limits that they were prepared to provide. In many cases it was not even a matter of cost but a withdrawal from the excess liability market. On the other hand, the insured companies had been getting larger and their operations more sophisticated hence their purchase of high liability limits. A solution had to be found. Groups of insureds got together and a variety of captive solutions came into being. The main ones were ACE created by clients of Marsh and XL created by Johnson & Higgins for their clients. The concept was relatively simple in that whereas a company might be paying, for example, $1 million per annum for cover of $100 million for their once in a hundred year risk, if 25 of them got together that risk became once in four years but the group had $25 million to put towards it. Of course, uncertainty of timing was the problem but by getting more people together and by the use of reinsurance, ACE and XL prospered to the extent that they are both now major players in the traditional market. Whether ACE and XL would have been formed without insurers withdrawing excess liability capacity is questionable but if they had subsequently been formed it is unlikely that their success would have been as dramatic as it turned out to be.

- **Terrorism**

After providing cover for terrorism losses within the traditional property insurance, suddenly the London market withdrew such cover claiming that it was being withdrawn by their own reinsurers. They did ultimately, in conjunction with the government, provide a solution by the creation of Pool Re but this was, initially at least, very expensive, particularly for people with risks within the main metropolitan areas. It was also administratively onerous. But there was really no need for this dramatic action. In no year have terrorist losses exceeded 5% of total property losses and, on average, all that insurers needed to do was to add, say, 2½% to their property insurance premiums to more than cover the terrorism risk. Pool Re charged rates of premium according to the situation of the risk and the highest of these often exceeding the premium cost of traditional property insurance. In this particular case, however, it can be argued that a more overall rating was appropriate rather than the specific risk rating traditional with the insurance market. A bomb placed by a terrorist in a building in London was not an attack on the owner of the building or on London but an attack on the United Kingdom government. It follows that everybody in the United Kingdom should bear the terrorism losses rather than those people who just happen to have properties within London or the other metropolitan boroughs which subsequently commanded high rates. This brings us back to the fairly obvious original solution of just putting a surcharge on all property insurance premiums as it is unlikely that anybody, even the man in the street with his household insurances, would have argued about a nominal surcharge which is all that would have been required both on past and what has proved to be, subsequent loss experience. The elimination of UK terrorism as a standard risk was not solved by creating a captive solution per se but what it did do was indicate even more clearly that the traditional insurer could not be relied upon, long-term, to provide the protection required.

Having had some years of reducing risk (and Pool Re rates) in the UK, on 11th September 2001, the terrorism risk escalated and assumed multi-national proportions following the attacks on the twin towers in New York. The market reaction was fairly typical in that terrorism cover is now extremely difficult to obtain at a reasonable price. In the US it is fairly generally excluded on property risks but this could be overturned by some States on legal grounds. A further development after 11th September was the Terrorism Risk Insurance Act (TRIA) creating a US government backed reinsurance facility for insurance companies against acts of terrorism. Originally, this Act was intended as a temporary measure to establish confidence and was set to expire on 31st December 2005. It was extended by another two years to expire on 31st December 2007 but on 26th December 2007, the US President signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2007.

In other countries like France and Germany schemes have developed that combine private insurance with government assistance.

- **Pollution**

Whilst a problem to industry over many years, no significant insurance solution has been provided by the market. There are pollution schemes around but they tend to provide cover up to the equivalent of £10 million as a maximum whereas, for most insureds, this is what they would be prepared to accept as a deductible and they are really looking for £100 million in excess of the £10 million. Even this low level of cover is usually only offered after very detailed surveys and investigations. It is not to be implied that pollution risks are negligible but it is disappointing that a solution has not been found by the very market designed to accept premiums and spread risk. There have been pollution claims but when set against losses arising from storm and tempest, from fires, from marine losses or liability losses, they have not been large and it should not have been beyond the insurance market's capability to provide a solution. This has been left to the individual insured and it frequently forms part of financial reinsurance packages.

- **UK Mortgage Indemnity**

After years of profits from this line of business, insurers did suffer very significant losses over the period 1988 to 1992. This was caused by a variety of economic factors in the UK that we have no need to go into here but it is true that insurers did have to face losses on this line of business of the order of 400% on average – some individual insurers suffering even more. What is true however, on examination, is that insurers, because of the earlier profits, were writing a cover which was far too wide and which, frankly, in many cases they did not fully understand. More particularly they were not earning the premium over a sufficient period of time; on average a two to four year earning pattern had been used when experience has shown that the true risk here runs over eight to ten years. The upshot was that they did not have sufficient premium reserves available in those years to meet the claims, hence the substantial losses posted in their profit and loss account. The reaction of the insurers was to substantially increase the premiums, reduce the cover and invoke an element of co-insurance with the lender. They saw it no longer as attractive business and often required other lines of business like the household buildings' account, before they would continue to write the mortgage indemnity. Regardless, the new terms meant that a substantial portion of the risk remained with the lending financial institution and this despite substantially increased premiums. The solution was for the lenders to create captives. It has to be stated here that one or two of the banks had already written mortgage indemnity within their captives from the mid-1980s and one at least, went through the period of 1988 to 1992 without anything like the trauma suffered by the market; they did suffer losses but at an acceptable level and when averaged over the ten years life of this risk, the overall experience was quite acceptable. Thus, a very substantial volume of premium left the insurance market and went into captives and after some eight years, those who formed these captives made very substantial profits. Certainly, we can expect, in the normal cycles of this business, to have periods of loss in the future but those financial institutions with captives are well placed to meet such losses. What is particularly significant is that the traditional reinsurers stayed out of the market, having had their fingers severely burned via the insurers but the captives were able to conclude very satisfactory reinsurance arrangements largely with the financial reinsurance markets and usually on a long-term basis. Mortgage indemnity is a perfect example of the insurance market virtually pulling out of the business, forcing the insureds to create their own solution through the creation of captive insurance facilities. This proved to be profitable and successful, just as happened in 1985 following the excess liability crisis.

- **Professional Indemnity**

This has never been particularly attractive business for the insurance market but up to the mid-1980s, whilst expensive with limited capacity, premiums were acceptable. However, from the mid-1980s substantial losses started being reported and the market reaction was the usual one of increasing premium, reducing cover and invoking very high deductibles. One quotation was offered of £650,000 in premium for an indemnity limit of £1 million when, with the tail on the business, the premium would just about have reached the limit of indemnity by the time any claim was paid. The result was that the auditing and other professions began to create captive insurance facilities. It is not to say, following the creation of these facilities, that the loss experience has got better; indeed, the loss experience has gone dramatically worse but the accountants have found that the creation of their own facilities has to be the cheapest long-term approach to what has become a significant trading expense. It was really the actions of the insurers in the first place which encouraged the insureds to look at alternatives such that, as the risk got worse, their captives were maturing and able to develop and take on the additional risk that was required. Over time changes in policy terms and increasing premium levels made this class of insurance profitable again. As a result more capital was attracted to the market to write this business and the market cycle began to undermine premium levels to the extent that insurers once again began to incur substantial losses. Capacity once again started to be withdrawn and in 2020 there was yet again another crisis of capacity within the insurance market for PI cover. This has led to the creation of another wave of captives writing Professional Indemnity insurance.

Holistic view of risk

Fortuitous Loss		Financial Risk	Pure and Other Risk
First Party	Third Party		

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Property Fidelity P.A. Etc.	Public Liability WCA/EL D. & O. E. & O. Etc.	Credit Interest Rate Currency Forex	Professional Indemnity Pollution Product Recall Product Trials Product Failure Terrorism Cyber Risk Government Action Technology Change Market Change

Those risks in the fortuitous loss category are traditionally insured. As we move across the risks become less insurable, certainly at economic cost. Credit insurance is available but is certainly not purchased by the majority of companies. There is also some capacity for such as Product recall or Pollution but it can be expensive and has limited capacity. The overall picture is that those risks which are insurable in the traditional manner are not only in the minority but tend to be the least catastrophic.

Most financial institutions write off, each year, an amount for bad debts far exceeding any recoveries they make from insurance policies. In the motor industry, Mercedes suffered larger losses in the redesign and delay in the introduction of their A Series car than they had ever suffered in insurance losses. Some years ago Volkswagen suffered serious losses on forward foreign exchange transactions. The daily financial press frequently reports of huge losses suffered by a variety of industries, none of which are insured or could be insured traditionally.

Thus, a company looking at its risk in totality realises that insuring traditional lines in the traditional manner is expensive both financially and in administration when they are forced to carry far more serious risks on their balance sheet without protection. This is not to say that the 'insurable' risks are to be ignored altogether but a large part can certainly be carried by the insured with little or no impact on their profit and loss account or balance sheet. The most efficient way of dealing with this is the formation of a captive insurance company which gives access to the reinsurance market; thus, the organisation can be protected from the major insurable losses at an optimum cost. For example, whilst the value of largest building owned by a bank may only be the equivalent to one month's earnings it would not want to lose those earnings if there is a means of insuring at a cost which represents the optimum cost of transferring that risk off its balance sheet. This cost optimization can be achieved by retaining a level of risk within a captive that drives down the cost of transferring the balance to the reinsurance market to a level considered acceptable to the bank. A bank will have a sophisticated model for the risk that it exposes its capital to and will be able to determine if the best use of that capital is, carrying otherwise insurable risk, or if it is better utilized in its core businesses.

Overall risk mapping also reveals to an organisation those losses that they are carrying without insurance protection. If they have a captive insurance subsidiary, their thinking about these risks is widened such that sometimes they can carry them risk within the captive.

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Disparity Between the Wishes of the Buyer and Those of the Insurer

In a number of ways, the desires of the large corporate buyer are at variance with the aim of the traditional insurer:

- The large corporate buyer wants to buy less conventional insurance. They can carry large parts of the risk themselves and they only want to insure, that part of the risk that is going to hurt their profit and loss account, at minimum cost. Conversely, when the stock market reviews the accounts of insurers they look to premium growth and a company with a lower growth of premium would be seen to be losing market share and marked down accordingly. Thus, the insurers would like their customers to buy more insurance to maintain volume and cash flow.

- The large corporates require a stable, reliable and long-term level of catastrophe cover. By comparison most insurers still write the coverage on an annual basis. Some insurers may offer cover for up to three years with for selected clients, but this is still relatively short-term to some insureds who would like to see insurance capacity guaranteed cover for up to ten years. This would remove the market cycle effect and avoid the need to renegotiate every year with potential variations in annual premium cost, often due to market forces rather than individual experience.

- For large corporate buyers it is economic for them to maintain skilled risk management departments such that they no longer require to buy all of the services offered by the traditional insurer. What they want is a reduced level of primary cover and a long-term catastrophe cover at minimal cost and they may not want this to include any additional services.

- The large corporate would, given the choice, like very standard and simple policy wordings. Indeed, although somewhat utopian, many would like to see one policy covering all fortuitous risks. The average insurer is coming from the opposite extreme and still tends to be compartmentalised such that they want to issue multiple policies for traditional product categories. This arises from the fact that they are still looking at traditional ground-up cover whereas there are reinsurers who will consider offering multi-line multi-year long-term protection for the corporate buyer who can then use the captive for the primary levels.

- Summarising the above, the corporate buyer is looking to lower the cost of spreading over time and the elimination of burning cost insurance whereas the insurer is still looking to provide the traditional cover which, by its nature, is expensive in premium and administration and of short duration.

There are insurers who come closer to meeting the needs of the buyers but the fact remains that most of the market is still very traditional in its approach. By comparison, the major reinsurers are moving in the direction that the buyer wants. Thus, the corporate buyer realises that the creation of the captive is providing access to the reinsurance market for catastrophe cover is a better fit.

Insurance Market Limitations

- **Uninsurable Risks**

As we see above, taking the holistic view of risk, there are many losses faced by the large corporate buyer which are uninsurable in the traditional market. These uninsurable risks can be larger than the traditionally insured risks so if a company is going to spend money in long-term risk protection they should consider these uninsurable risks. Apart from saving money on traditional insurance, a captive can certainly help with the long-term funding of what might otherwise be uninsurable risks.

- **Inadequate Cover Availability**

For many risks, the cover provided by the market is inadequate for the buyer's needs. A good example for this would be pollution where there are a number of schemes available around the world but the limits are nowhere near large enough for the majority of corporate buyers. Liability insurances are, more often than not, full of exclusions leaving the insured still exposed to a range of circumstances where coverage will not apply.

- **Claims Arising After Coverage Period**

Despite apparent full insurance in the past, the corporate buyer of today can find that, what they thought was adequate, does not meet today's needs. This could be particularly apparent relative to products' liability insurance where the limits of, say, 40 years ago are very much less than limits bought today. There are a lot of reasons for this: one is pure inflation but on top of that there have been increases in the number and the size of claims over and above the general level of inflation. Also, the corporate buyer is an amalgam of companies which, 40 years ago, were very much smaller. This is not to say that the smaller company does not have the same risks, in a products' liability sense, but it was a fact that smaller companies tended to buy smaller limits.

Now that the corporate buyer is faced with claims such as asbestosis, going back many years, they are finding that even when they can trace the insurers, the limits are inadequate. This is one problem for the buyer which is not of the insurer's making: it is a matter of fact brought on by inflation over the passage of time, the growth of the buyer, greater sophistication of claimants and the willingness of the courts to make substantial awards against corporations. The end result is a corporate buyer, without adequate cover, left with the mind-set that having bought what they thought was full and adequate cover over many years, when it comes to meet the claim, it has proved to be inadequate.

It needs little further thought to come to the conclusion that one might as well have written the risks oneself in the first place, bearing in mind that many of the old limits are little different from what is carried today by the corporate buyer as a deductible or as a retention within the captive.

- **Disappearance of Market as Risks Become Manifest**

Rather than adapting to meet the needs of the buyer, the traditional market tends to disappear when the risk against which the corporate buyer was seeking protection proves to be worse than the insurer had anticipated.

- Financial and currency risks

These risks could, to some extent, come under the heading of the uninsurable risks but they are picked out as there are features about them which could make them insurable and, indeed, in many cases they are effectively insured by hedging or protection often provided by the banks. Business interruption policies are, in effect, insurance against financial loss but they are usually geared to the need for property damage having to have arisen to trigger the business interruption cover. Loss of turnover without property damage tends not to be insured but there are many instances where fortuitous occurrences can trigger consequential loss. The material damage warranty in business interruption insurances can operate unfairly and can be a source of friction between insured and insurer. This has proven to be the case with the Covid Pandemic and lead to substantial court rulings mainly in favour of the insured.

- Market Cycle Effects

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There is no doubt that the traditional market is cyclical in premium cost, coverage and capacity. From the latter half of the 1990s through to 2019 there was a constant reduction in premium rates for such as property insurance, brought on by competition. The need to maintain premium volume accentuates the problem in that as rates come down market share has to be increased. When rates start to increase it can be dramatic. The problem is that a 50% reduction requires a 100% increase to get back to the starting point. The corporate buyer likes stability and is hard to persuade that premium increases are justified when their own loss experience may have been perfectly reasonable. Usually, this hardening market and premium increases are coupled with a reduction in capacity, sometimes because of the need to maintain solvency margins. This reduction in market again tends to have an increasing effect on rates. There is no doubt at all that the development of captive insurance companies can be directly associated with market cycles. What the buyer wants is long-term stable cover at a steady cost and the captive insurance company tends to provide this.

- **Long-Term Financial Security**

For many long-term risks such as products' liability the security of the insurer is an important feature in the arrangement, yet it is often the case that the financial security rating of the insurance buyer is higher than that of the insurer from whom the buyer is seeking long-term security. What sense is there in an AA rated corporate buying product liability insurance for a risk with a potential ten year life – from an insurer with a lower rating. This is equally true, of course, of security bought from reinsurers so that the creation of a captive insurance company does not remove the problem. What helps is that much of the premium, to cover the burning cost element of the risk, is retained and the multinational reinsurers tend to have a higher rating than primary insurers. This is in no way to imply that insurers with BBB ratings are in any way suspect but they certainly cannot be as secure as an AA company. Whatever the financial security position, when looking 10 or 20 years into the future, today's current rating may have no relevance whatsoever. The security rating of insurers and reinsurers is something that needs to be constantly assessed. Suffice under this particular heading to suggest that where the financial security of the insured is higher than that of the insurer, there is a good argument for suggesting to the insured that it makes sense to retain their own risk particularly when one is looking at long-term security.

2.10 SUMMARY OF CAPTIVE ADVANTAGES

Some of the following have been covered in the above paragraphs but the advantages of a captive can be summarised.

- **Lowering Costs by Eliminating the Acceptable**

With the attendant on-costs of the traditional insurance market it makes no sense for anybody to insure what is inevitable and what is acceptable. Just as the man in the street can happily accept a deductible of £50 when relating the average person's assets with the assets of major units of industry and commerce, these larger buyers can happily accept deductibles of £1 to 5 million or more with the same effect on their assets as £50 has to the average individual. At this level, insurance merely increases the cost of claims to the insured and it makes sense not to insure these losses in the traditional manner and thereby reduce cost to the cost of the claims themselves, as well as retaining the funds otherwise paid in premium and securing the cash flow therefrom.

- **Appropriate and Convenient Funding Vehicle**

For long-term risks, reserves can be created in a captive insurance company, as they can with any other insurance company, for risks which cannot conveniently be reserved in the parent company's accounts. For example, employer's liability claims can arise over ten years and premium should be earned over that period. The captive insurance company can do this as a matter of course whereas the parent company would find it difficult, if not impossible and would certainly face problems with their tax inspector. Using a captive rather than having an internal self-insurance fund also takes the funds out of the parent organisation and real money, rather than an internal book transfer, is available in the insurance subsidiary to meet losses as and when they occur. Should the losses not occur then the money comes back to the parent by way of profit in the captive and dividend to the parent.

- **Direct Access to the Reinsurance Market**

Reinsurers are the insurance market's wholesalers. They are cheaper than the primary (retail) market because they operate to much lower expense ratios. They do not have the branch offices, large staffs for service and expense of the retail market and operate at levels in excess of the burning cost. Reinsurers do not expect to be called upon to pay claims on an annual basis; they are there to meet the unusual loss and are spreading their risk costs over time, generally up to ten years. As the name implies, reinsurers deal with insurers and, whilst it is wrong to say that they will never deal directly with the insured, they would do so only with the largest of clients excess of significant deductibles. They are much happier dealing with insurance companies and therefore with captives. The creation of the captive assists with access to this wholesale market.

- **Access to Expanded Capacity**

To a limited extent the captive itself creates additional capacity to the insured but this is governed by the level of capital in the captive. It is also remarkable how the very existence of a captive can have a marked effect on cost and capacity in the insurance market as insurers seek to maintain their share and make the captive less economic.

- **Less Impact of Market Cycles**

With the captive writing the primary risk, premium rating tends to be more stable in that the captive is not necessarily following the insurance market down to its lowest common denominator. Equally this means that when the market hardens, the captive's premium does not go up to the same extent. This gives more stability in the budgeting of insurance premiums and, even when the captive profits are taken into account, greater stability in the net cost of risk.

- **Reduction in Volatility**

It is often thought that the reinsurance market produces greater volatility of cost and capacity than with traditional insurance. Nothing could be further from the truth. The primary market moves much faster and much further than does the reinsurance market and there are many examples of this. The underlying reason is that the primary market is looking more short-term, on a one to three year time horizon, whereas reinsurers look to more like a ten year 'pay back' and, as their cover excludes burning cost, it does tend to be more stable.

- **Higher Degree of Experience Rating**

Insurers operate to the basic principle of insurance using the premiums of the many who insure to pay the losses of the few. The upshot is that the large insurance buyer never receives full benefit of good experience and expenditure on risk management. By comparison, with a captive, the net cost of risk comes closer to the net cost of claims the only difference being the much lower level of operating costs which are partly covered by investment income earned. With captives (and therefore the captive owner group) paying the losses, a much greater emphasis is placed on risk management, providing advantage to the insured, the captive and the economy generally.

- **Development of Reserves**

A captive enables a company to carry reserves both for claims reported which may not be settled for some years into the future and for claims incurred but not reported (IBNR). The latter would be impossible and the former difficult to reserve within the parent company's accounts. This ability to create reserves tends to stabilise the cost of risk over time and as they earn investment income, the ability of the captive to carry even more risk is increased.

- **Cash flow**

The investment earnings on premiums and reserves makes a contribution to the captive's income. Premiums are usually paid at the commencement of cover and the captive secures the cash flow advantage of these until such time as they are used to pay reinsurance costs or to meet claims and expenses. That money which is set aside to meet reserves for future claims is invested along with the capital and retained earnings from past profits. Whilst captives generally aim to make an underwriting profit, the investment income helps to increase the earnings.

- **Controlling Multinational Programmes**

There can be no better way of controlling a multinational programme than through a captive insurance company. A good global programme can be aided by a captive. Even though there may need to be a traditional direct insurer fronting the risk in the majority of territories, the captive can be used to provide risk management incentive. Profits earned can either go back to the centre, or be used for risk management projects. Obviously, the tax implications of redistribution have to be addressed but it is a problem that would not be there with traditional insurance. More importantly is the control which the risk manager has with the captive as an integral part of the global programme. Whatever percentage of risk written by the captive, the risk manager is aware of what is going on in subsidiaries, something he might have difficulty in ascertaining in the normal course of events, relying on people telling him.

- **Group Size Retention**

Most corporate insurance buyers are organised in a way whereby each subsidiary is separately accountable for its profit. Thus, deductibles have to be commensurate with the size and the financial capacity of each subsidiary. A much larger group size retention can be held in the captive thus increasing the group's ability to retain risk.

- **Broader Coverages**

Insurance policies differ country by country whereas it is possible to have a global programme through a captive, having a single language wording in very wide form and agreed by the global fronting insurer, regardless of the cover and language of each underlying policy. Captives can offer broad coverages to the extent of their own retention but often these coverages can extend to higher limits in that reinsurers, seeing that the insured is prepared to carry significant portions of the risk themselves, may be happy to support a broader coverage within their reinsurance.

- **World-Wide Fronting**

The introduction of a global insurer can happen with or without a captive but it can be difficult to introduce where a subsidiary has had a long standing arrangement with an alternative local insurer. Where a captive is created, this provides another argument that the risk manager can use to concentrate the risks on one insurer who is ceding business through to the captive to the benefit of the group and, indirectly at least, the subsidiary. Where there is group financial advantage, it makes it harder for a subsidiary to argue against the move. It is even better where the captive advantage, in part at least, can be passed down to subsidiary level through lower premiums or contributions to risk management initiatives from the captive's profits.

- **Claims Control**

Where the captive is involved in the losses, either directly or as the principal reinsurer of the fronting company, the risk manager can see exactly what is going on and can control the claims process. Loss trends can be identified and monitored and risk management procedures can be brought to bear where appropriate.

- **Simplified Policies**

Whilst it will be argued that policies can be simplified in any global programme, with or without a captive, the fact remains that the creation of a captive makes this process easier in that the captive will be writing a large part of the lower end of the risk. Thus, the complications of detailed terms and conditions on smaller claims can be diminished.

- **Customer Business**

It is surprising, upon examination, how many companies have access to insurance business emanating from customers. The mere selling of a product including the cost of insurance and freight (c.i.f.) as opposed to free on board (f.o.b.) gives access to marine cargo insurance for the goods being transported. Risk management, in the way of haulage procedures and packaging, can reduce losses and whilst the buyer may be paying a market rate for the insurance, profits on the business, enhanced by the risk improvement, can remain with the seller. Extended warranty insurance is another example of profitable customer business. Certainly, many companies retain substantial commissions on customer business placed with insurers but there is also generally a large underwriting profit element which can be retained by a captive reinsuring a fronting insurer.

- **Spreading the Cost of Fortuitous Loss**

Many companies may be prepared to accept loss up to certain levels over time but may not want to suffer the variability in their annual profit and loss account. For example, a professional firm may be prepared to carry the first, say, £5 million of their professional liability risk, something which they estimate might happen once in every five to ten years. With a captive they can pay a premium of, say, £1 million per annum to meet the once in five year event rather than possibly have to meet a loss of £5 million in any one year. Furthermore, because of the length of time it takes to settle professional indemnity claims, there might be more than one loss for settlement in any one financial year whereas using the captive, reserves can be created and the cost to the organisation can be spread evenly over time. Whether experience is good or bad the cost can be stabilised by the use of reinsurance.

2.11.1. Advantages Compared to Internal Self-Funding

A self-insurance fund cannot provide all the advantages available to a captive. For one thing a self-insurance fund is not an insurance company and there would be the difficulty of reinsuring with the reinsurance market. The difficulties of creating reserves in the parent company for IBNR loss, remains. With most internal self-funding no 'real' money is involved in that transfers to the fund are generally by a book entry and the fund merely forms part of the total bank balances of the group to be used for all sorts of purposes and may not be available when it is needed. The cash flow advantages i.e. the interest earnings, would tend not to be included in the fund. The discount available from the insurance market for what would be a deductible would likely be considerably less than the credit given by the reinsurance market against a similar captive retention. There is the very real danger of the Finance Director, at the stroke of a pen, eliminating the accumulated self-insurance fund and incorporating it within the profits of the group. Finally, self-insurance funds can only be used in a single country whereas the captive enables risk retention to be extended and harmonized world-wide.

- **New Profit Centre**

The captive becomes a profit centre within the group. It can be argued that as this profit comes from the premiums paid by the parent organisation, it is a reduction in expense rather than a profit but without the captive, such profit would not have been created. There is also the additional income gained from the investment of premium and loss reserves which is certainly new income. Finally, there is the potential of extra profits which may be earned by writing third party or unrelated business.

- **Tax Effective**

This item has purposely been left to the end simply because no captive should be formed solely to secure tax advantage. Any company formed to take advantage of tax rules can just as easily find these rules changing and its advantages eliminated. All captive insurance companies should have sound commercial advantage as their base and enough of these have been described in this chapter so far. Having said that, the captive insurance company should be tax effective, certainly as compared with a self-insurance fund. Usually, premiums paid to the captive would be deductible as an expense just as they would be deductible if paid to a traditional insurer. Reserves can be created against future claims and premium deferred over the life of long-term risks, something that would be impossible or difficult within the parent company. As and when profits are declared in the captive and dividends paid back to the parent, tax would be paid but this could be some time after the initial payment of premium. As commented upon earlier, bearing in mind the profit of the captive is additional income, any tax paid is additional tax to the Revenue authorities. From the parent company's point of view, tax can only be paid on profit and therefore nobody should have a problem in paying tax on the profits arising from a captive insurance company. The principles of tax, insofar as they apply to captive insurance companies, are discussed in detail in Unit 14.

2.12 OTHER ALTERNATIVES TO TRADITIONAL INSURANCE

Captive insurance companies are not the only means of self-insurance and reducing the cost of traditional insurance and this Unit would be incomplete without a summary of some of these.

- **Non-Insurance**

A decision not to purchase any insurance cover at all, provided it is done knowingly, can be a valid alternative to insuring. Generally, this is suitable only for the smaller and regular losses easily treated as a business expense as they arise and the business has the risk appetite and cash flow to manage such losses.

- **Deductibles**

The carrying of a deductible (or excess) on an insurance policy has a twofold advantage. Not only does it reduce the cost of the risk transfer by moving the insurer further from the risk, but it also provides a real risk management incentive on subsidiaries. The fact that they (or the group's balance sheet) may have to bear the first part of each loss can have a salutary effect on their risk management awareness discipline and operations. To be most effective, the deductible amount has to be at a level that the business unit can tolerate in the event of a loss and for which there is a reasonable and worthwhile premium reduction.

- **Balance Sheet Provisions**

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It is perfectly possible for a company to make provision in its balance sheet for potential losses. As an example some banks will do this for general bad debt provisions as opposed to the specific bad debt provision which they will book in their profit and loss account. On the balance sheet they can make this general provision against unspecified losses they feel might arise in the future, based on past lending experience. There is no reason why such provisions cannot be made by any organisation and relating to any type of loss. This provision can only be made, however, out of retained earnings or unallocated capital surpluses. Such provisioning typically does not generate any fiscal advantage, but what it does achieve, however, is set aside sums out of profit that are non-distributable to shareholders.

- **Retrospective Rated Programmes**

These are programmes where it is agreed with the insurers that the ultimate premium shall be directly related to claims experience. A deposit premium is assessed at the beginning of the policy period based upon an expected loss outcome. When the ultimate loss experience for the policy is known, the premium is retrospectively recalibrated to reflect actual loss experience. Better than anticipated loss experience will lead to a premium credit and an adverse experience will result in an additional premium charge. Effectively, the policyholder is self-insuring and paying the insurer a margin to handle losses under the guise of an insurance policy. This could well be a good solution for risks such as employers' liability insurance, which tends to be experience related anyway, but involvement of an authorised insurance company to produce an insurance certificate, is legally necessary.

- **First Loss Covers**

Although known by this name, this is really a misnomer in that it is effectively the purchase of insurance protection to the value of the maximum perceived loss. It could be applied on covers such as theft insurance where, regardless of the total value of goods in a warehouse, the insured might consider that the maximum value that could be stolen at any one time was somewhat less and so insures up to that amount. It may save a little in premium because the insurers also recognise that the risk of a total loss is remote and it is only the elimination of that small element of risk which is recognised in any premium discount.

- **Credit Lines**

Rather than insure, a company might decide to arrange a credit facility with its bankers to provide it with contingent financing, in the event of a material loss. The bankers will then provide funds to be repaid by the company over a defined future period at an agreed rate of interest. Whilst this may save insurance premiums, it has a number of disadvantages. Although premium cost is saved there will be the annual cost of the facility charged by the bank. Also, this facility may reduce the overall amount of any credit line granted by the bank, which may inhibit the raising of funds for other purposes. Not least, however, after a significant loss, the ability of the company to generate sufficient funds to repay the loan plus interest, might well be reduced. Banks can be fickle in the provision of credit, facilities and the company might find credit lines reduced or withdrawn when least expected.

- **Derivatives**

Derivatives are financial market instruments and can be considered as an insurance alternative by acting as a hedge to mitigate risk. In its simplest form, a party is able to free itself of a specific risk, typically linked to its commercial activities. For example, instead of a company insuring against crop failure, it could buy forward options on the purchase price of that same crop. If the crop failed then the market price of the crop would increase and in theory the profit made on the exercising of the option would cover the crop failure cost. The challenge is to remove basis risk and find a hedge that closely matches your financial risk at a cost below that of transferring the risk to the insurance market.

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Self-test questions
Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text. 1. What is Sydney Pine's definition of a Captive? 2. Discuss three reasons why Association captives might not succeed? 3. Discuss three key benefits offered by a captive over traditional insurance? 4. Discuss two alternatives (excluding captive) to purchasing traditional insurance? 5. Why must the assets of each PCC cell be kept in separate bank accounts? 6. How does an ICC differ from a PCC?

Summary of learning outcomes
1. Explain what a captive is
2. Explain the reasons for the creation of a captive
3. Describe the different types of captives and the circumstances when use of each type is appropriate
4. Describe the key features of a Protected Cell Company and an Incorporated Cell Company
5. Explain the role of a Joint Interest Captive/Mutual Pool
6. Explain the key benefits that a captive offers
7. Explain the alternatives to using a captive and why a captive may be more advantageous