CAPTIVE INSURANCE COMPANY CONSIDERATIONS

Gary Osborne of Risk Partners determines the key questions that should be asked during the formation phase of a captive

What are your principal objectives relating to the consideration of forming a captive insurance company?

This question is to determine what is generating the interest in a captive. The answers range from cost savings to greater control to market conditions and many other factors such as profit and compliance. This allows a consultant to understand the drivers and look at the current insurance programme with a view to building a captive that can address the concerns. We can already identify considerations such as a need for a front, whether a specific domicile is more practical or whether a captive is even practical.

How do you believe a captive will create value for you?

This question can generate discussion around the realities of what a captive can do. Those looking into captive formation commonly state that they are doing so to "save money or taxes". In this case, we are then able to know what the next set of questions to pose should be. Our aim here is to see if the company structure can achieve insurance tax treatment, and if there are opportunities to lower costs; and if lower cost comes from greater risk, is that a good risk to reward ratio based on their prior history and market trends.

When we hear the answer "fill coverage gaps" or "build capacity", the conversation centres more on whether the coverage can be written by a captive, and whether there are rating, lender or government insurance requirements we need to be aware of. Finally, we'll look at whether the coverage being dropped by the market has ever been offered before, or whether it is brand new.

Gary Osborne

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What initial lines of coverage do you want to consider?

This question can help us think about the other support the captive may need such as fronting, reinsurance, claims adjusting, actuarial, legal compliance, domicile legal. For example, if a warranty programme is being considered, we need to dig into this to understand the regulatory treatment in different states.

It also makes a difference if the programme will write direct or behind a front. Can we insure a warranty provider or are we selling to the public? There are many restrictions on auto and home warranties, for instance, but a lot less on others such as golf clubs, cell phones and household goods.

Do you intend to use the captive for other lines of coverage in the future?

If the company has future plans for other lines such as medical stop loss or workers' comp, we then have to evaluate domiciles to address not just the initial considerations, but the options that may be added in the near future. Cayman, for instance, may be a great option for a fronted commercial auto risk, but if we add general liability or surety bonds, the home state of the owner, such as Tennessee, could have some advantages in that a captive formed there is considered an admitted carrier in its own state.

What is your appetite for risk? Are you willing to pay actuarially determined premiums even when those premiums may be higher in some years than what is available on the commercial market?

For the first time in many years we are experiencing a hard market for multiple lines of coverage and especially property and auto. A captive should be viewed as a long-term tool and here we are trying to ascertain if the motivation is only short-term pain or a willingness to lessen reliance on the commercial market for the long term. That is not to say that market pricing should be ignored because there have been many examples over the years where pricing was lower than expected. In such cases, claims and captives were mothballed for a year as the risk managers took their opportunity but kept the captive around for when the market realised its mistake.

Would a captive insurance company provide access to insurance/reinsurance markets not otherwise available to you?

Access to the reinsurance market is traditionally seen as an advantage of a captive, but as captive consultants, we may know that the support needed for a new programme is not readily available or will be written in a manner that provides inadequate support to the captive. This can involve explaining the structural differences that reinsurance policies can have such as loss caps, inner aggregates, reinstatements and swings.

Would having a captive insurance programme help foster strategic alliances with unrelated entities or non-controlled affiliates?

This comes up more often than you would expect, especially with the healthcare industry, companies with transportation needs and franchise companies. This is probably going to be considered third-party risk and that drives many more questions and domicile considerations around the likes of capital levels and control of the programme. Hospitals may want to include non-employed physicians, logistics companies may need to offer coverages to their independent contract drivers, and franchise operators may need to offer programmes to their franchisees when markets harden or drop coverages.

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What is the public and internal perception of operating a captive insurance company? Does it matter?

This is often viewed as onshore vs offshore but it can also be about contractual obligations. For instance, some Risk Retention Group (RRG) failures meant car manufacturers would not finance warranties written by RRGs, and some commercial trucking failures meant railroads would not except them for intermodal risks. It can also be important with property management companies who can have different pools of investors in each new managed property.

In most cases, captives are not rated by AM Best or others and thus an important question to be addressed is the following: are we aware of any contractual obligations that the captive cannot address or is actually obtaining a rating a cost-effective option for a captive to address this need? For large corporations, the annual rating cost could be less than paying for a fronting company to issue a policy.

Are there other entities with similar risks which could participate in the captive and offset overhead expenses?

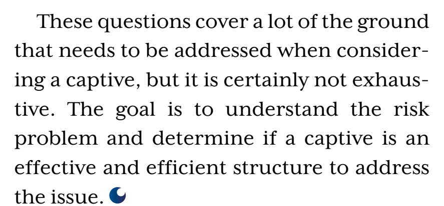
This is exploring whether the captive solution is for a single risk. If not, some kind of group or sharing mechanism may make more sense. Often a group might be the better approach, but it can be difficult to get competitors in the same room. However, companies that do come together to form a group are often geographically diverse so they are not direct competitors.

Are the historical losses significantly better than industry expectations and will the savings be sufficient to offset the operating costs of the captive?

Many captive prospects think they have low losses but don't understand that 70% loss ratio is break even for the commercial market. They also don't necessarily 'develop' their losses and can be surprised when an actuary gives them a loss pick substantially higher than what they believe their history should indicate. This area kills off many prospects when they fully understand how losses develop over many years.

Are you prepared to fund the projected capitalisation and start-up costs in terms of financial and human resources?

It is often a shock for prospective captives to see the combined capital collateral requirements that long-tail insurance coverages will require. For instance, it is quite likely that a $10 workers comp premium will necessitate $9m in capital and collateral to be posted at $3m annually for the first three years. This can be even higher if the chosen domicile does not recognise collateral as capital. It is also important to remind prospective owners that they are forming a new company and there is a required time commitment to oversee the new entity if it is to be successful.



These questions cover a lot of the ground that needs to be addressed when considering a captive, but it is certainly not exhaustive. The goal is to understand the risk problem and determine if a captive is an effective and efficient structure to address the issue.