RMS Solutions

Captive Insurance Company FAQs

What is a Captive Insurance Company?

A captive is a closely held company in the business of insurance owned and controlled by one or more entities that are the exclusive or primary insureds. The captive model is one of many alternatives to the traditional insurance market. Captives can act as a direct insurer where the insuring agreement is drafted between the captive and the insured or as a reinsurer (indirect). In the latter case, the insuring agreement is between the insured and a fronting carrier and the captive reinsures the fronting carrier. Captives can be classified into two basic types: Single Parent (or "Pure") Captives and Group Captives. Captives can also be classified as on-shore (or domestic) or off-shore based on where they are domiciled.

What is a Fronting Carrier?

Because insurance transactions cannot be legally executed by certain types of captives, an insurance company registered to transact business in the jurisdiction(s) where coverage is to be provided must be the direct issuer (front) of the insuring agreement. In such cases, the fronting carrier then transfers all or a portion of the risk to the captive through a reinsurance agreement.

What are the different types of Captives?

The following represents a brief survey of the most common forms of captive insurance programs. References to minimum capitalization requirements were extracted from the District of Columbia's Department of Insurance, Securities and Banking website and are presented as benchmarks only.

***Pure Captive*:** A pure (or single parent) captive provides insurance coverage exclusively to its parent, affiliated companies or controlled unaffiliated businesses. Day-to-day operations of a pure captive are typically the responsibility of the risk manager or financial officer at the parent company. Most off-shore captives are managed by a captive management company, located within the jurisdiction of domicile. At last review, the District of Columbia required minimum paid-in capital and surplus of $250,000 for certificate of authority approval.

***Association Captives*:** An association captive provides insurance coverage exclusively to risks of the member organizations of an established association and affiliated companies of those members. Ownership rests with the association or individual members. In general, the association must have been in existence for at least one year prior to formation of the captive. Day-to-day operations of an association captive are typically handled by an employee at the association level, or outsourced to a management company, broker or consultant. At last review, the District of Columbia required

minimum paid-in capital and surplus of $500,000 for certificate of authority approval.

***Agency Captives*:** An agency captive is a captive insurance company owned by an insurance agency, brokerage or group of insurance agents formed to provide insurance coverage to their clients (i.e., policyholders) and capitalize on favorable underwriting results. At last review, the District of Columbia required minimum paid-in capital and surplus of $600,000 for certificate of authority approval.

***Rental Captives*:** A rental captive is a captive insurance company formed to enter into contractual agreements with associations or groups of policyholders to offer insurance coverage to their members or affiliates. Certain companies 'rent' their surplus to entities wishing to establish a self-insurance program but not their own captive. At last review, the District of Columbia required minimum paid-in capital and surplus of $600,000 for certificate of authority approval.

***Sponsored Captives*:** Sponsored captives (a.k.a. segregated cell captives or "protected cell" captives) are essentially rental captives with multiple participants that are allowed to shield their capital and surplus from other participants as long as the sponsored captive remains solvent. At last review, the District of Columbia required minimum paid-in capital and surplus of $600,000 for certificate of authority approval.

***Risk Retention Groups*:** A risk retention group is a group captive formed under the requirements of the Liability Risk Retention Act of 1986. The risk retention group need only be licensed in one state in order to write commercial liability coverages except personal risk liability, property, employee benefits liability, employer's liability and workers compensation in all fifty states. Under District of Columbia laws, risk retention groups are considered a type of an association captive.

What is an "on-shore" Captive?

An "on-shore" (or domestic) captive is one that is domiciled in a U.S. jurisdiction. The most common domiciles for on-shore captives are Hawaii, South Carolina and Vermont, however, recent legislation has attracted many new captive formations to Arizona, the District of Columbia and Montana.

What is an "off-shore" Captive?

An "off-shore" captive is one that is domiciled outside of U.S. regulatory jurisdiction. The most common domiciles for off-shore captives are Bermuda, Grand Cayman, and the Isle of Guernsey.

Is forming a Captive right for my business?

Forming a captive insurance company is a long-term risk management strategy that can be set up relatively quickly, but, requires consideration of numerous issues including taxation, reinsurance, regulatory and exit strategy among others. However, if insurance costs for your business risks exceed $1 million and, it is becoming increasingly difficult to obtain adequate insurance coverage, or to budget for insurance costs, then incorporating a captive into your risk management strategy may be worth investigation. The first step in this process should be to obtain a captive feasibility study performed by a qualified actuary to assist you in quantifying the costs associated with your company's program.

What Advantages are created by forming a Captive Insurance Company?

Forming a captive insurance company can create many advantages including cost stability, coverage availability, direct access to reinsurance, increased control, and improved cash flow. The following provides a brief explanation of these advantages.

Cost Stability**:** Many agree that the primary advantage of forming a captive is to stabilize the expenses related to insuring the risks associated with operating a business. A combination of self-insurance through a captive and reinsurance can insulate insurance costs from the volatile nature of the commercial insurance markets thus stabilizing the budget process.

Coverage Availability**:** As a result of the volatile underwriting cycles, adequate protection against business critical events is periodically unavailable in the commercial insurance marketplace. Utilization of a captive insurance company can ensure the availability of adequate protection against known risks, as well as provide a mechanism to respond to emerging risks that commercial markets have not yet addressed. Captives can also be used to fill in gaps in coverage as a result of changing insurance programs or policy forms.

Direct Access to Reinsurance**:** Because the existence of a captive provides reinsurers with a formal structure from which to assess risk, direct access to worldwide reinsurance markets can be completely unavailable in the absence of a captive. In addition, captives can be employed to adjust self-insured retention levels to respond to changes in the reinsurance market.

Increased Control**:** Another primary advantage of captive formation is the ability to control the underwriting results and the claim management process. Under a captive program, underwriting profits and investment earnings generated remain with the captive providing the ability to expand

coverage offerings or reduce premiums to its participants. By establishing specific policies and procedures focused on loss prevention, captive program participants can assert significant control over the claims settlement process.

Improved Cash Flow: The ability to generate investment income from premiums received is another advantage of forming a captive. When premiums are paid in advance and loss payments are made over an extended period, significant cash flow benefits can be accrued. Further, if investment income accumulates in a tax-free environment, additional funds may be available to pay losses and support capital growth.

What Challenges can result from forming a Captive Insurance Company?

Forming a captive insurance company can also create challenges that should be considered including complexity, organizational costs and minimum capitalization costs. The follow provides a brief explanation of these challenges.

Complexity: Captive formation and operation requires a good understanding of such complex considerations including accounting, actuarial, legal, regulatory, reinsurance and taxation among others. Time spent working through the complexities of these issues can be a significant undertaking for a company's management staff.

Organizational Costs: The costs associated with initial formation and continued operation of a captive can be substantial, especially if the captive to be formed is other than a pure captive. Depending on the size of operations and type of captive formed, annual operating expenses can range between $100,000 and $500,000 for a group captive.

Minimum Capitalization: Most jurisdictions require minimum capitalization from $250,000 to $1 million to obtain a certificate of authority for a captive insurance company. One rule of thumb requires that the captive's per loss retention be no more than 10% to 25% of total capital and surplus at any given time. For example, a captive that retains $500,000 of each loss requires $2 million to $5 million be held in the capital and surplus account at any given time.

What is a Feasibility Study?

Because there is no one-size-fits-all captive structure, prospective captive owners should engage in a comprehensive study of the many advantages, challenges and variables involved in forming and operating a captive insurance company. This analysis should explore such considerations as which type of captive best meets the owner(s) objectives, which jurisdiction should the captive be domiciled, who will managed the captive's daily operations, what risks should be insured through the captive and how much

liability should the captive retain, among others. The result of this study will provide the basis for constructing the business plan to guide the formation of the captive.

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