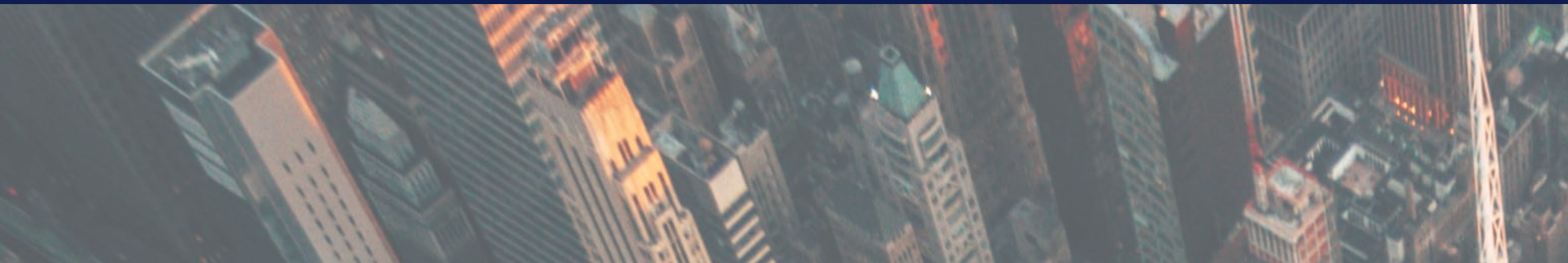
RMA
RISK MANAGEMENT ADVISORS

THE ULTIMATE GUIDE TO CAPTIVE INSURANCE COMPANIES

WHAT IS A CAPTIVE?

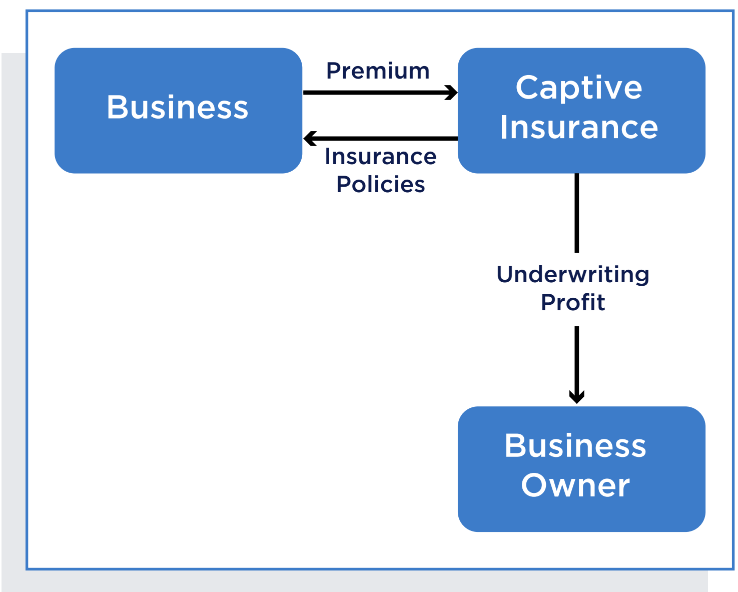


A captive insurance company is a C-Corporation (or a legal entity taxed as a C-Corporation) created for the purpose of writing property and casualty insurance to a relatively small group of insureds. There are additional benefits to creating a captive, but they should be ancillary to the primary purpose of risk management.

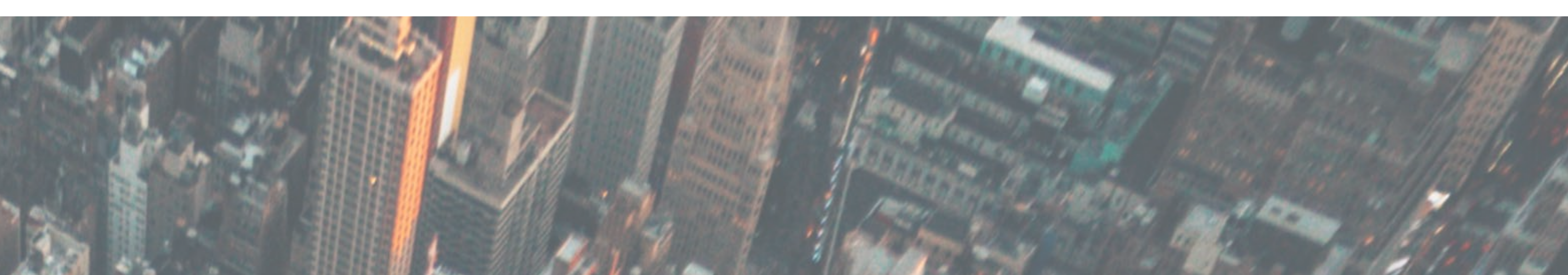
At its most basic level a “pure” captive works like this: A corporation with one or more subsidiaries sets up a captive insurance company as a wholly owned subsidiary. The captive is capitalized and domiciled in a jurisdiction with captive-enabling legislation which allows the captive to operate as a licensed insurer. The parent identifies the risk of its subsidiaries that it wants the captive to underwrite. The captive evaluates the risks, writes policies, sets premium levels and accepts premium payments. The subsidiaries then pay the captive tax deductible premium payments and the captive, like any insurer, invests the premium payments for future claim payouts.

At its core, a captive insurance company is a risk-financing tool. It places more risk management control and financial control into the hands of the owner of the captive than exists in a typical commercial insurer-insured relationship. Unlike what occurs in the traditional insurance market, the risks that are underwritten by the captive are precisely the risks that the insured needs underwritten.

The policy terms are designed to meet the specific needs of the insured and the rates are based on the specific loss profile/loss experience of the insured not the average loss rate of the market.



A TYPICAL CAPTIVE STRUCTURE



BENEFITS OF A CAPTIVE INSURANCE COMPANY

There are many reasons an organization chooses to form a captive. The best way to fully understand the specific opportunities and benefits for your organization is to consult with a risk management advisor who has expertise in the captive, traditional, and the alternative risk transfer insurance markets. Such a professional would likely gather some initial information, evaluate the organization's risk management goals and then, if it appears a captive insurance strategy is at least a realistic possibility, recommend conducting a formal feasibility study.

This process is an essential component of determining the projected return on the investment made to establish and manage a captive. After all, forming a captive is a risk financing strategy. If the benefits are strong enough to meet or exceed the organization's internal ROI requirements, then captive formation warrants serious consideration. Although the package of benefits behind each captive will be unique to the organization it serves, there are certain benefits that are relatively universal.

STABALIZED BUDGETS

One of the primary goals of our consulting practice is helping clients develop a strategy that allows them to take a measured approach to understanding and insuring their risks. Chief among those risks for many of our clients is financial risk; that is, risk of the unexpected interruption of cash flow, decrease in stock price or loss of earnings. Just as there are many types of financial risk, there are a variety of ways to manage them. The methods fall within three primary categories: avoid the risk, retain the risk or transfer the risk. Avoiding the risk through business-process or business-structure measures is always a preferable strategy whenever it is possible. But to the extent that it is not possible to avoid risk altogether, a company must decide whether it will retain the risk or transfer it.

INCENTIVE TO CONTROL LOSSES

While no one who is trying to run a profitable business begrudges a commercial carrier's profit motives, everyone wants to be treated fairly. This is certainly true for any company working to lower costs through careful risk-management planning and practice. If those efforts do not result in lower premium rates, then the insured believes there may be no economic reason to control losses. Through a captive strategy, improving risk management practices will directly impact the insured's cost of insurance.

GREATER CONTROL

The greatest benefit a captive offers companies is significantly greater control over their risk-management program. This occurs in many ways and will be evident in the following discussion of just a few of the specific benefits of captive formation.

IMPROVED CLAIMS HANDLING

The premiums a company pays to a commercial insurer are based in large measure on industry-average claim-processing costs. The claims your company incurs are handled by the insurance company's claim administrators. This will be either the insurer's own administrators or more often, a contracted third-party administrator (or "TPA").

TAILORED COVERAGE

We often compare buying insurance to buying clothing. In our highly simplified analogy, we say buying from a commercial carrier is like buying clothes off the rack and having the choice of small, medium or large; whereas, buying through a captive is like buying clothes through a tailor who custom makes the clothes for one individual to achieve a perfect fit. A captive simply provides an organization with more risk financing options to create the best fit.

IMPROVED CASH FLOW

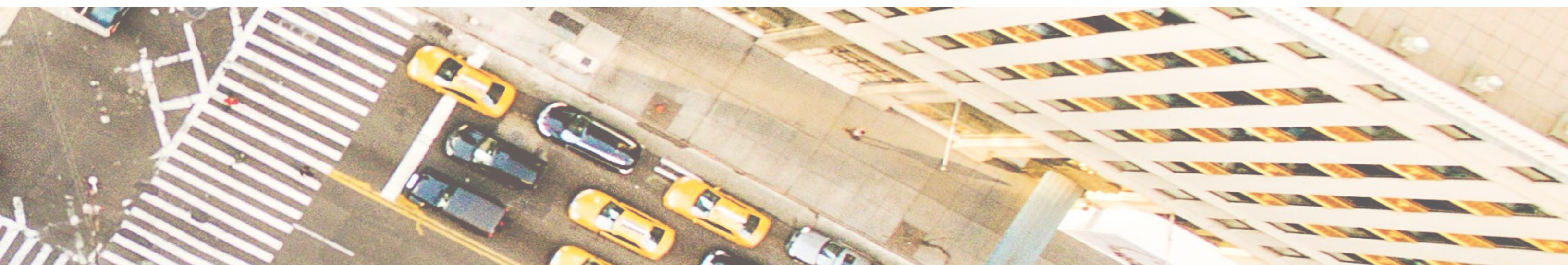
Beyond achieving lower premium costs, the use of captives can benefit organizations by improving cash flow. This can be achieved through developing precisely tailored coverages, improving claims handling and stabilizing insurance budgets.

DIRECT ACCESS TO WHOLESALE REINSURANCE MARKETS

Reinsurance is purchased by insurance companies at what amounts to wholesale rates. Because a captive is an insurance company, it can go directly to the reinsurance market and purchase coverage at the wholesale rates. The captive eliminates the commercial insurer as the middleman and allows a business direct access to global reinsurance markets. For many companies, the savings can be substantial. The direct access to reinsurers saves all of the fees paid to agents, wholesalers, and brokers, as well as the profit markup that the first-level insurer would normally earn.

There are many other benefits to having a captive insurance company in an overall risk management strategy. Some of these include:

- Flexibility with funding and underwriting
- Reduced deductible levels for operating units
- Better allocation capabilities
- Additional negotiating for underwriters
- Additional investment income to help fund losses
- Greater stability in coverage and pricing
- Reduction in the cost of insuring certain high-quality risks
- Reduction in expenses associated with transferring risk



TYPES OF COVERAGE THAT CAN BE PUT INTO A CAPTIVE INSURANCE COMPANY

At this point hopefully you are thinking a captive sounds great, but are wondering exactly what kinds of coverage can be written and what are the limitations? First, it's important to understand that there are certainly types of coverages that are better suited for a captive. The type of risks that can be put into the captive are:

LOW FREQUENCY/LOW SEVERITY CLAIMS

Sometimes it doesn't make sense to carry traditional insurance for claims that rarely occur and even when they do occur, they are always of low-severity. Traditional insurance might not be available, or it may be expensive since the carriers may charge a minimum amount for the coverage. In this case, an appropriate captive policy can balance the need for coverage and the need for appropriate premium pricing based on the individual organization's risk profile.

HIGH-FREQUENCY/LOW SEVERITY CLAIMS

Some companies experience a high number of low-severity (or low-cost) claims. Purchasing insurance coverage in the traditional market for this type of claim can be expensive because of the high-frequency nature of the loss history. A captive can make appropriate adjustments thereby reducing the overall cost of financing the risk.

LOW FREQUENCY/HIGH SEVERITY COUPLED WITH A STOP-LOSS STRATEGY

When claims related to a particular risk occur very infrequently, but the potential loss is severe, companies often find themselves paying very high premiums for events that rarely if ever occur. For those companies who have programs or procedures in place to reduce or eliminate the risk of such claims and who wish to reduce the cost of financing whatever underlying risk exists, a captive is often a good alternative. This works, however, only when there is a sound stop-loss strategy in place to ensure that if a severe claim does occur, there is appropriate excess coverage to handle it.

RISKS WITH LARGE ESTABLISHED CLAIMS DATA AND EXISTING MARKET OF RE-INSURERS

Most captives rely on reinsurance to handle much of the risk shifting. When there is an existing strong market for the reinsurance sought and there is well-established claims data, there is a good chance that the reinsurance will be very competitively priced and easy to secure. In this case, there is a good chance the overall program to underwrite these risks using a captive will be more financially attractive to the insured than simply buying traditional insurance.

RISKS WHERE PREMIUMS TO POLICY LIMITS ARE VERY CLOSE

If you are purchasing coverage from a traditional carrier and the premiums you are paying are not too different than your policy limits, you would likely benefit from having the captive underwrite that risk. First, the captive coverage will be less expensive because even for the same policy, the captive's overhead is much lower than the traditional carrier. Second, you are getting almost no benefit from the traditional insurance if you are paying out about as much as you would hope to get back in the event of a loss. You are much better off paying the premium to yourself (i.e., to your captive) taking the deduction and then investing the money according to your captive's investment policy.

A few years ago, Congress passed legislation regarding the requirements a captive insurance company must meet to be verified as underwriting legitimate insurance for tax and accounting purposes. The Protecting Americans from Tax Hikes Act of 2015 ("PATH Act") passed December 18, 2015 and took effect January 1, 2017.

'If structured properly, you only pay tax on your investment income'

-Wesley Sierk

TYPES OF CAPTIVES

The types of captives designed and managed by Risk Strategies are varied. The most common type of captive is the single parent captive. A single parent captive primarily insures risks of the parent company, subsidiaries, and its employees, and may be formed as a subsidiary company. There are two main types of captives that most clients consider. Although very similar, the two main types of captives vary on the size of the premium and the taxation of the insurance company itself. The two main structures of captives are: 831(a) & 831(b).

831(A) CAPTIVES- REGULAR INSURANCE COMPANIES

Captives that are treated as insurance companies are taxed for federal income tax purposes just like any other C-corporation. Thus, these regular captives are subject to taxation as a C-corporation at the corporate level on their premium and investment income. All taxable income of a C-corporation receives only ordinary income tax treatment and not capital gains tax treatment. Although regular captives are taxed on their premium income, they can deduct legitimate reserves and other expenses, and may be able to avoid taxation of premium income if they have sufficient deductions. These captives are also called 831(a) captive insurance companies.

831(B) CAPTIVES- SMALL INSURANCE COMPANIES

Code Section 831(b) permits captives that receive less than $2.8 million of premium income each year to be taxed only on their investment income, and not taxed on premium income. The investment income of 831(b) captives (also known as small or "mini" captives) is taxed at ordinary income tax rates, with no capital gains tax rate available due to their C-corporation status. Section 831(b) treatment applies only if the total premiums received by the captive is less than $2.8 million in a given year, as opposed to the first $2.8 million of premium received.

QUALIFYING AS INSURANCE FOR TAX PURPOSES

For a captive to obtain the tax benefits of a captive (e.g. amounts paid to the captive are deductible as insurance premiums), it must be considered an insurance company. The IRS has indicated that a corporation qualifies as an "insurance company" for a particular year if more than half of the corporation's business during that year consists of activities that, for federal tax purposes, constitute "insurance." For an arrangement to constitute insurance, two requirements must be met: *there must be risk shifting and risk distribution.*

RISK SHIFTING

Risk Shifting occurs where a party facing the possibility of an economic loss transfers some or all of the financial consequences of that risk to another party, so that a loss does not affect the insured, i.e. party that shifted the risk. With an insurance arrangement, the loss is offset by the insurance payment. Risk shifting is generally the easier of the two requirements to meet.

RISK DISTRIBUTION

Risk Distribution occurs when the party assuming the risk distributes its potential liability among many insureds. Risk distribution incorporates the statistical phenomenon known as the law of large numbers, and allows the insurer to reduce the chance that a single claim will exceed the amount of premiums taken in.

FREQUENTLY ASKED QUESTIONS

Q: My lenders require my insurance to come from a rated carrier, how can I issue coverage from my captive and still secure my financing?

A: For a fee, a rated carrier provides what is known as a "front." The fronting carrier provides their name for the policy to satisfy the lender's requirements. The premium and the risk are "ceded" to the captive through a reinsurance agreement.

Q: If I have a catastrophic claim, can I lose all of the money in the captive?

A: You decide how much risk you want to retain. Through reinsurance agreements and excess policies, Risk Management Advisors can tailor your insurance company's exposure to meet your comfort level and objectives.

Q: Who is else is using captives?

A: Today there are over 8,000 captives worldwide. Over 40% of major US corporations and many of your smartest competitors have one or more captives. Verizon, UPS, and Centex Homes, as well as many others, use these unique companies.

program to design, implement and manage your insurance company. This allows you focus on running your company, while we fulfill your objectives for entering the alternative risk transfer market.

Q: Do I need a Feasibility Study?

A: Feasibility studies are important because they answer the essential question: What is my return on investment by using a captive? Prospective shareholders of the captive should have a clear understanding of what to expect when their capital is used to establish an insurance company. Once the strategic purpose for a captive has been established, we conduct the feasibility study to determine the payback period and rate of return on capital deployed, and to answer the key organizational and operational questions that have an impact. The study later becomes the business plan for the captive with actuarial support for the loss assumptions, a description of how reinsurance functions behind the captive, and how much capital is required to make the captive financially viable.

RISK MANAGEMENT ADVISORS

riskmgmtadvisors.com