Things to Know about Captive Insurance Companies

Those of us who toil in the alternative markets sometimes lose perspective on reality. We assume that everyone we talk with has a basic understanding of the various alternative risk financing techniques. In some cases, this is true, but in the majority of cases, we're met with blank stares.

You know what I mean. You're a proud member of the insurance industry; a broker, an underwriter, etc., who perhaps would benefit from at least a rudimentary understanding of how, for example, captives operate. But you've never really devoted the time to research the subject because, truth be told, you haven't had to do so.

So, you're out at a local watering hole with friends from work and someone says, "Hey, we just put ABC Company into its own single-parent captive!" Your response? "That's nice." However, you're thinking, what if some of my clients could benefit from a captive, and I've got no clue how to help them? Well, friends, you've come to the right place.

This brief article will give you a "CliffsNotes"-style understanding of captives and their uses. No, you will not become an instant expert on captives, but as one of the senior underwriters at the Royal Globe Insurance Company told our class of underwriting trainees exactly 30 years ago this month, "In this business we don't have to know everything there is to know; we only have to know *where to find* the information."

What Is a Captive?

First, let's start at the very beginning. You might be asking yourself, "How can a company insure itself?" Good question. You've been trained to understand insurance as a contract that transfers risk to another entity—an insurance company. Well, the definition of insurance has not been rendered moot; for captives to be considered real insurers, there must be some degree of risk transfer. Captives that do not satisfy the risk transfer tests are nevertheless captives, but not for tax and accounting purposes. More on this later.

Most captives cover casualty lines such as workers compensation and general liability, and are fully or partially funded to cover "expected losses" for each line of coverage. An actuary determines expected losses based on a company's historical loss amounts and payout characteristics. Captives usually only cover losses within a specific deductible or retention amount; $250,000 per occurrence is a typical captive limit. This means that the actuary's expected losses only include losses falling at $250,000 and under.

For example, let's assume that your company's historical general liability losses are, as we say, all over the board. You've got many small losses, of course, but you also have several large losses exceeding $250,000. Your actuary will only use the losses falling under $250,000 to calculate expected losses, assuming that all future losses over $250,000 will be transferred into the commercial insurance markets.

The strict definition of a captive is an insurance vehicle that is owned by its policyholder(s). Many of the world's captives do not satisfy the IRS definitions but remain captives because of the role they fulfill for their parent companies.

Captives must be formed in a special U.S. state or foreign country, known as a captive domicile, that has special enabling legislation. Bermuda is the most well-known offshore domicile, and the largest, and Vermont is the preeminent onshore domicile. As of this writing, 28 U.S. states have captive enabling legislation.

Captives and Taxes

You, however, are mainly interested in captives that take the place of commercial insurance. In doing so, premiums paid to the captive must be deductible from your (or your client's) U.S. federal income taxes—just like the premiums paid to any insurance company. So how does a captive achieve premium deductibility for its parent company(s)?
Two IRS tests—risk shifting and risk distribution—provide the answer.

A series of IRS revenue rulings beginning in the late 1990s replaced what we used to call the "mother of all captive- related revenue rulings," the venerable Rev Rule 77-316. 77-316, the 316th revenue ruling of 1977, defined the Internal Revenue Service (IRS) position on captive premium deductibility for over 25 years. It's called the "economic family" doctrine, which said that since a captive is just another subsidiary of its parent company, it falls within the company's economic family. This means that premiums paid to such a captive are tantamount to nothing more than a transfer of assets (so-called premiums) from one part of the company to another, hence, no risk transfer, and certainly no risk distribution (also known as risk sharing).

Today, there are two ways for a captive to achieve insurance company status per the IRS:

> (1) It must insure third-party business equal to 50 percent or more of the captive's total business, or
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> (2) The corporate structure must resemble a holding company with an array of subsidiaries or operating units that generate their own financial statements. This is described in IRS Revenue Ruling 2002-90, and it's known as the "balance sheet" theory because each subsidiary is independent of the others—the failure of one does not affect the others.

There are a variety of other requirements needed to satisfy the IRS insurance company tests, but these two are the most important. If your captive manages to pass one of the two tests noted above, satisfying the rest can be relatively easy, (but don't take my word for it, look it up in IRMI's *Risk Financing*).

Types of Captives

Captives take various forms. They can be wholly owned by their parent companies or they can rent space, called a cell, from a third-party-owned captive. Ah ha, you say! If a company rents a cell from a third-party captive, doesn't that constitute a real insurance contract based on the discussion above? Well, the answer is yes and no.

It is generally accepted that use of a cell captive constitutes risk transfer, but the question of risk sharing remains open. IRS Revenue Ruling 2008-08 sets forth the conditions in which cell captives may be considered insurance for tax purposes; they're basically considered to be self-contained single-parent captives. Now, *group captives*, as opposed to single-parent captives, generally tend to satisfy the risk shifting/distribution tests by virtue of the fact that there are multiple independent policyholders/shareholders, each owning a minority interest in the captive.

Minimum Premiums

Any owned captive—that is, any captive that is *not* a cell rented from a third-party captive—must begin life with at least, in my humble opinion, $2.2 million in premium. This applies to both group and single-parent captives. Some people think that $5 million should be considered the minimum premium threshold, but I've seen (and formed) captives with $2.2 million as the opening premium.

Startup Costs

Single-parent captives may be launched for roughly $250,000 in startup capital costs. These costs do not include the consultant (or broker), the actuary, the attorneys, and the captive manager. Group captives can cost far more than this if the group decides to have a private placement memorandum (PPM) written by an attorney. A PPM is tantamount to a securities offering document. Groups are not required to have PPMs, but they provide a solid legal foundation for the captive in the event one or more members initiates legal action against the captive for whatever reason.

Capital and Surplus

Like any company, every captive must be capitalized. Bermuda, for example, has specific capital and surplus minimums depending on the amount of written premium. For premiums up to $6 million, a Bermuda captive must adhere to a 5:1 capital and surplus-to-premium ratio. For example, a captive that starts out with $3 million in premium must have at least an additional $600,000 of capital and surplus. For premiums in excess of $6 million, Bermuda requires a 10:1 ratio. New captives, regardless of domicile, usually begin life with a solvency ratio between 3:1 and 5:1.

Captive Benefits and Drawbacks

So, now that we've covered some of the structural issues, let's talk about why you or your client might want to investigate a captive. Space prohibits a thorough recitation of all of the various benefits and drawbacks. The major consideration, however, is only tangentially related to the often-incidental reasons (both for and against) for forming or joining a captive.

What is the major consideration? It is this: Is your company (or client's company) amenable, economically and culturally, to creating an on-balance sheet asset (the captive) designed to manage your risk capital? If not, you will continue to transfer insurable risk into the commercial insurance markets, with or without a significant amount of passive risk retention (unfunded deductibles, etc.). If the idea of building an asset devoted to managing event risk is attractive, then and only then should you investigate the benefits and drawbacks of captives.

The question is really one of capital management—keep a large portion of your event risk on-balance sheet, allocating the necessary capital, or allocate your risk capital through insurance premiums and retain whatever amount of passive (unfunded) risk demanded by the insurance providers. Answer these questions, and then proceed to the next logical step.