What is a Captive Insurance Company?

Captive Insurance Company Definition and Meaning

A captive insurance company is generally called a “CIC.” In its simplest form, a CIC is a wholly owned subsidiary created to provide insurance to its non-insurance parent company or companies. CICs are established to meet the risk-management needs of the owners or members. They are essentially a form of self-insurance whereby the insurer is owned wholly by the insured. Once established, the CIC operates like any commercial insurer and it issues policies, collects premiums and pays claims. CICs do not offer insurance to the public and it is regulated as a CIC, rather than as a traditional insurer. A CIC can successfully provide coverage for difficult risks that are tailored to fit the exact needs of the insureds, as long as the CIC operates within sound underwriting, actuarial, and regulatory guidelines.

The type of entity forming a CIC varies from major multinational corporations, mid-size businesses, to nonprofit organizations. As an aside, CICs are held by the vast majority of Fortune 500 companies as an alternative method of risk financing. The industries with the greatest number of CICs are finance, real estate, construction and manufacturing. Over the past several years, there has been particular growth in areas such as healthcare and property development. Because few companies are in the business of insuring themselves, most CICs will hire an outside third party administrator to manage the CIC.

The underwriting profits and gains from the invested premiums that would otherwise be held by a conventional insurer are retained by the CIC. Even with conservative tax-sensitive investment portfolios, the dollar amounts are substantial due to the high levels of capital and surplus typically held.

Substantial US tax incentives enacted nearly 30 years ago exist to encourage their formation where a small insurance company is needed to efficiently finance insurable risks. Internal Revenue Code 831(b) offers small insurance companies a very powerful tax advantage that can provide financial resources to pay claims. This benefit assumes that legitimate risk is being transferred. This election makes the premiums paid to the CIC not subject to income taxes. The reserves are accumulated, and the insurance company is only taxed on its investment income. Any properly structured CIC writing less than $1.2 million of annual premium may take this election. Starting in 2017, the maximum annual premium amount to increases to $2.2 million.

IRC 831(b) allows for a property and casualty company to be taxed only on its investment income. The advantage of this structure is that it allows the company to accumulate surplus from underwriting profits free from tax. However, it is important to note that while an 831(b) pays no tax on underwriting profits, its owners are still taxed on dividends and other compensation received.

CICs gained momentum in the mid-to-late 1980s when commercial liability coverage was either unavailable or unaffordable for many businesses. Over the past three decades, there has been significant growth in the CIC market. Today, there are more than 5,000 CICs that do business around the world in a variety of industries, compared to roughly 1,000 in 1980. Almost 3,000 CICs are domiciled in the Caribbean, 1,200 are domiciled in Europe and Asia, and more than 1,000 are domiciled in the United States.

How to Setup, Form, or Start a Captive Insurance Company.

Here are the major steps in designing and forming a CIC:

1. *Complete a Feasibility Study* - this is merely a fact-finding mission to get to know more about you and your company. Knowing what keeps you up at night will help identify the potential risks and exposures that may be appropriate for your CIC. This is a good time to start thinking about how your CIC ownership should be structured to achieve your financial goals and objectives.

2. *Select a Third Party Administrator ("TPA")* - It is vital for your CIC company to adhere to the business and investment plans it has filed with the insurance regulators, and working with the insurance regulatory team is an important responsibility of every third party administrator. The TPA will provide guidance and take responsibility for handling the day-to-day operations of your CIC. Make sure that your TPA can provide the following resources:
    - Legal Counsel
    - Risk Management
    - Investment Management
    - Tax and Audit Counsel
    - Actuarial Advisor

3. *Determine Underwriting and Pricing* - Upon completion of the initial feasibility analysis, you will need to perform a more in-depth review of your unique fact pattern to determine risks appropriate for your company. This includes a review of your existing policies to identify gaps in coverage and uncover additional lines of coverage which may provide meaningful benefits to your operating company.

4. *Select the Domicile* - Domicile selection is one of the most important factors to consider when forming a CIC. Items to consider when selecting the most appropriate domicile will include:
    - Captive statute
    - Regulatory climate
    - Taxation
    - Infrastructure
    - Compliance
    - Investment objectives

5. *Determine the Risks that can be Covered* - The risk management process generally begins with the identification and quantification of all exposures, perils and hazards existing in the organization. The CIC may insure against insurance risks for which commercial insurance cannot be obtained.

6. *Implement and Manage the CIC* - The decision to form a CIC should closely resemble the prudent decision making process for the establishment of any new business enterprise. The insurance regulators in your chosen domicile will require that you enlist a team of specialists to provide the expertise needed to help develop a long-term plan which includes initial implementation and ongoing management of your CIC.

What are the Benefits of a Captive Insurance Company?

The CIC was originally created to solve a problem of rising commercial insurance costs and the difficulty in obtaining certain types of insurance coverage. Most companies now establish CICs for microeconomic reasons such as cost reduction, risk management, or risk control.

CICs have become a popular risk-management tool for organizations seeking greater control over managing their insurance needs. Two main drivers for forming CICs are risk management and risk financing. A CIC allows the parent company to respond quickly to changes in the commercial insurance market and to identify the most efficient way to finance an identified risk. This could mean a lower cost of coverage than conventional insurance markets. The parent also could use a CIC to obtain coverage for risks that would otherwise be quite costly or unattainable.

Companies establish CICs to mitigate their exposure to a wide range of risks. Practically every risk underwritten by a commercial insurer can be provided by a CIC. The majority of CICs provide mainstream property and casualty insurance coverage such as general liability, product liability, workers' compensation, director and officer (D&O) liability, auto liability, and professional liability.

CICs also provide specialized coverage for unusual or hard-to-insure risks such as credit risk, pollution liability, equipment maintenance warranty, employee benefit risks including medical benefits, personal accident and, in some cases, whole life insurance.

What are the Pros and Cons of Captive Insurance?

Before you go down the road of establishing a CIC, it's important that you understand the pros and cons and how it will impact your business.

Pros	Cons
Lower Premiums Traditional commercial insurance companies must price premiums based on many factors such as the cost of claims, overhead, and profit for future investment. An owner of a CIC can bypass many of these expenses and use it as an opportunity for investment.	*Still Need a Third-Party Plan* There are still insurable risks you are better off leaving in the hands of third-party insurance companies. If the possibility of catastrophic loss is too high, or there are typically many claims on a loss for that particular insurable risk, setting up a CIC for that risk can be too risky to remain beneficial. Third party insurance still offers much larger risk pooling, so it remains an attractive and necessary option in many circumstances. A CIC is a supplement for your traditional insurance program, not a complete replacement. Any hopes of completely disposing of third-party insurance plans are misguided.
More Risks are Covered When the commercial market is unwilling to cover certain risks, or charge far too high for such coverage, CICs fill in the gap. Keep in mind that your company is already in the insurance business as any risk uncovered by a traditional third-party plan is still an insurable risk you must cover with your profits should there be a claim. A CIC allows you to create an investment fund for insurable risks and should there be smaller claims than expected, you retain the profit instead of an insurance company.	*It Takes a Big Initial Investment* Starting your own CIC is a major commitment requiring a large investment and deferment of revenue. Covering unfunded risks means protection against unanticipated losses, which can be of the catastrophic variety. The initial administrative cost of shifting assets and setting up an entire new business can be a substantial cost. The benefit, of course, is the significant cost savings down the road.
Risk Management Becomes Profitable Many companies consider risk management a drain on the bottom line. It's a cost center, and its expenses must be constantly evaluated to remain minimized. A well thought out CIC makes you money. While risk management remains an area of your business in need of regular attention, a CIC turns it into a profit center.	*Inadequate Premiums* If your risk management team underestimates the costs necessary to cover unfunded risks, premiums might be too low, and you could lose revenue from the start. Without a substantial base of capital to work with right from the beginning, a poorly executed plan could put you in a difficult financial position. You need an honest appraisal to determine the cost of premiums to ensure your CIC. Leaving the formation and execution of a CIC in the hands of someone inexperienced is dangerous to the financial health of your company.

What are the different types of Captive Insurance Companies?

There are various types of CICs, depending on the needs of the parent company or owners. The vast majority of CICs insure only the risks of its parent. Over the years, variations have flourished as companies come up with more sophisticated and innovative ways to use CICs. The types of CICs in use continue to evolve to address the growing need for alternative risk transfer.

The types used most often include Single-Parent, Series, and Cell CICs. While they can be similar in design and effectiveness, there are several distinct differences.

1. *Single-Parent CICs* - is a separate legal entity formed as a subsidiary of another legal entity referred to as the "parent." The CIC is formed to insure the risks of its parent and parent-affiliated companies. If appropriately licensed and capitalized, a single-parent CIC may also insure the risks of third parties. The capital required to form and operate a single-parent CIC is provided by the parent. The parent will maintain complete control over underwriting terms, policy language, reinsurance decisions and investment policy. Single-parent CICs are often referred to as "pure" captives.

2. *Series CICs* - are owned by a parent company with individual CICs or cells. A series CIC allows those individual members of the series to be treated like a CIC. Some notable advantages of series CICs:
    - Not subject to the minimum premium tax requirement or a standard minimum capitalization.
    - More flexibility to define its governance mechanisms.
    - Can be designed for simpler administration.
    - Series entity law protects the assets of one business from the debts & obligations of the other businesses.

3. *Cell CICs* - are structured to allow a legal segregation of underwriting accounts (or "cells") from each other. Segregated cell companies can be single-parent CICs or group CICs. The formal requirements for structuring a segregated cell CIC will be defined by the domicile in which the CIC is licensed to operate. Capital requirement and bankruptcy protection are two reasons CIC owners choose this structure.

What is Captive Reinsurance?

When it comes to business and operational risks, having multiple layers of coverage protection can minimize financial losses. Captive reinsurance serves as one of these layers, providing additional risk coverage on top of those written through your CIC. Risk transfer to a CIC and to captive reinsurance companies can fortify businesses against financial losses from any number of risk exposures. Diversification of risk liability through captive reinsurers ensures that businesses remain operational and resilient, despite large losses.

Captive reinsurance companies can be an excellent choice for business owners who need to cover industry-specific or non-standard risks. Reinsurance companies can also insure risks with

high-limit coverages if a CIC's capacity for offering these protections is limited by capital, regulatory rules, or other factors. For example, a CIC may wish to insure the excess professional liability risk exposure of its affiliate company, but has been prevented from writing the policy by its regulatory domicile due to the high coverage limit. Partnering with a reinsurer to accept this particularly high risk allows the CIC to provide lines of coverage under limits that are acceptable to regulators.

Some business losses are inherently unpredictable, fluctuating from year-to-year. As a result, it is difficult for business owners to forecast the profitability of a particular line of business. Captive reinsurance can provide better financial predictability and stability, because it tempers the CIC's loss experience by assuming more risk liability.

What are the tax benefits and strategies of captive insurance?

A properly structured and managed CIC could provide the following tax and non-tax benefits:

- A tax deduction for the parent company for the insurance premium paid to the CIC.
- Various other tax savings opportunities, including gift and estate tax savings for the shareholders and income tax savings for both the CIC and the parent.
- Opportunity to accumulate wealth in a tax-favored vehicle.
- Distributions to CIC owners at favorable income tax rates.
- Asset protection from the claims of business and personal creditors.
- Reduction in the amount of insurance premiums presently paid by the operating company.
- Access to the lower-cost reinsurance market.
- Insuring risks that would otherwise be uninsurable.

Do I need a captive insurance agent or manager?

CICs can be very complicated and are heavily regulated. It's very important that you hire a captive manager to serve as the administrator of your CIC. At its highest level, a captive manager focuses on four key areas:

1. *Underwriting* - The process of reviewing and evaluating risk for potential coverage, setting premium rates, reviewing coverage applications and writing policies. The initial critical step of the underwriting process is defining the insured. The underwriting process also requires the establishment of underwriting policy which is necessary to ensure that the CIC is indeed operating as an insurance company.

2. *Claims Management* – An established process to handle the claims that result from the policies written. In fact, this step should be carefully considered before any risk is underwritten given that the claim management system must be capable of handling the volume and type of claim that could result from the underwritten risk.

3. *Financial Management* – This is the most important function of the CIC. The CIC is a financial management tool and will likely involve more of the CIC owner's internal resources than any other operations management function. The CIC will influence risk

financing decisions, tax decisions, capitalization decisions, cash management decisions, and capital investment decisions.

4. *Compliance and Reporting* -The reporting and compliance issues for a CIC are not as onerous as those for a traditional insurance company. This is because the CICs are not offering insurance to the public. Each domicile has specific reporting requirements and the domicile's captive regulations will identify the type of reports it requires and the frequency of those filings.

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