

# Captives 101 Basics to Help You Choose Wisely

by Adrian Bento

*SilverLink* magazine has presented several articles on the topic of captives. Many people think of the most obvious definition when they hear the word “captive” (something or someone being held or controlled by an outside influence<sup>1</sup>), and they may not have a good grasp of how the word applies to the insurance industry. The time has come to answer these questions:

1. What **exactly** is a captive?
2. Why do captives exist?
3. How can captives be accessed by business entities?

## What Exactly is a Captive?

A captive—at least by the standard, traditional, insurance-related definition of the term<sup>2</sup>—is a licensed insurance company wholly owned and controlled by its insureds, with the primary objective of insuring the risk(s) of its owners, and whose owners ultimately share in the profits generated by its underwriting.

## Did You Get That?

Let’s analyze each component of the definition:

1. A captive is essentially nothing more than a **licensed insurance company**. The primary feature distinguishing it from a traditional insurance carrier is that the entity is **owned by its insureds**.
2. The objective is to **insure the risk(s) of the captive’s owners**.
  - As a licensed insurance entity, the captive acts in the same way that a traditional insurance company does, in that it underwrites the risks presented to it, issues policies, receives premiums, pays claims, buys reinsurance, provides risk management services, etc.
  - Like a traditional insurance company, a captive can elect to insure one or more of the risks to which an entity is exposed. This is one of the decisions that the owners make when they initiate the captive.
  - By limiting the pool of insurers to these same owners, many of the concerns normally faced by a traditional carrier regarding adverse selection and asymmetry of information are lessened, if not entirely dispelled.
  - This leads to a more homogeneous concentration of insureds whose level of risk is statistically narrower,

and this translates into more sensitivity when pricing the exact exposures assumed and more predictability in the underwriting results produced by the captive.

- A captive is regulated as an insurance entity in the jurisdiction in which it is incorporated. Most of the jurisdictions that have flourished as captive domiciles (“domicile” means “the *location* where a captive is formed”) tend to be offshore in such desirable destinations as Bermuda, the Cayman Islands, the Channel Islands, etc. Aside from being in a beautiful part of the world, these areas offer an extremely favorable tax and regulatory environment for the operation of captive organizations.
  - Along with the above-named locations, there are also a number of states in the US that have enacted captive legislation and are successfully attracting new entrants. Most of these, however, including Vermont, the District of Columbia and Hawaii, are relatively new entrants compared to the Caribbean domiciles.
  - At this point, it should be noted that the locations outside of mainland United States have enjoyed a relatively benevolent, hands-off environment. The same may not be true for mainland captives, as the state of Colorado (one of the first states to accept captive insurers) discovered when state regulators had a change of heart regarding the formation of captives. The state of Colorado implemented stringent regulations and removed much of the incentive that was originally offered to potential captives. As a result, at this time, no captives exist in Colorado.
3. Owners share in the profits. Like a traditional insurance carrier, a captive also assumes risk,<sup>3</sup> which means that the captive requires risk capital. This capital is typically provided by its owners. The corollary of risk, of course, is reward. In this case, financial reward—in the form of profits generated by the underwriting of the owners’ policies and shared by the owners of the captive.

“Ownership and control” means that the owners make all decisions regarding the operation of the captive. The following are types of decisions the owners may make:

- Electing the level of risk they are prepared to assume in the captive
- Deciding which coverages will be provided by the captive
- Controlling who may or may not participate in the captive
- Determining the type of approach they wish to assume regarding the management of claims
- Deciding whether the captive distributes dividends



### Why do Captives Exist?

The first insured-owned entities came into being before legislation created a dividing line between a *traditional insurer* and what is now known as a captive. One may assume that the original entities, such as the one owned by Imperial Chemical Company (ICC) of the United Kingdom (and established in the dawning years of the twentieth century) were formed simply as an exercise in vertical integration.

Captives as we know them today came into being in the 1960s, the brainchild of Frederick Reiss (who became the founder of a captive management firm called International Risk Management Group) and Sidney Pine (an attorney with a law firm now known as LeBoeuf, Lamb, Greene, and MacRae). Together, they persuaded the government of Bermuda to institute laws that would ease the formation of captive insurance companies.

At first, these entities were almost the exclusive province of Fortune 500 companies. But as insurance regulatory agencies began to tighten their grip on traditional insurance agencies, carriers found themselves dealing with increasingly inflexible and innovation-sapping bureaucracy.<sup>4</sup> Coupled with an increase in litigation and the creativity of plaintiffs' attorneys in extracting money from insurers, carriers found themselves reacting defensively—ultimately introducing a “culture of risk aversion” into the industry. The pressure on traditional insurance carriers began in the early 1980s, with the end result that certain types of coverage are now totally unavailable.

Business entities that needed to remove some of the risk from their balance sheets began to look for alternative sources of insurance. At first, this produced a trickle of new participants to the captive world. As the number of traditional coverages declined, however, the captive industry found more adherents.

One of the latest supply restrictions, considered by some to be a crisis in coverage unavailability, involves medical malpractice insurance. The country's current highly litigious environment has led to spiralling malpractice insurance premiums, with a resultant increase in consumer pricing. To counter the threat of potential litigation, physicians may err on the side of caution, ordering more tests or procedures than may actually be necessary, which then leads to over-consumption of medical services. And the vicious circle continues with no end in sight.

This situation led not only to the wholesale formation of new medical malpractice captive carriers as a response, but also to captive domiciles (remember, “domiciles” are “places where captives are located”), who structured their licensing and regulatory environments to accommodate the specific needs of the newly formed carriers. One such domicile was the Cayman Islands, a British Protectorate that forms part of what is known as the British West Indies. Of the 745 captives in existence on the islands, 278 cater specifically to the healthcare industry, with premiums of almost \$3 billion annually.

### How Can Captives be Accessed by Business Entities?

With the wide (and often confusing) array of insurance coverages available, an organization may have questions about which type of coverage—traditional or captive—is more appropriate for its risk. Insurance industry experts recommend that any business or private individual with complex exposures should find a reputable agent or broker whose expertise can be relied upon when placing coverages. The best way to find answers to questions about traditional and captive products is to consult an insurance expert who has experience in both worlds. SilverStone Group's Captive Risk Management division has that experience and is available to help answer all your questions.

<sup>1</sup> Merriam-Webster Online, <http://www.merriam-webster.com/dictionary/captive>, accessed October 22, 2007.

<sup>2</sup> This definition certainly applied to the original captive entities that were formed and essentially still holds true for the vast majority of those in existence today. However we must add that there are - as these entities have evolved over the years - a number of structures that are recognized as captives that would not fit under the exact terms of this definition.

<sup>3</sup> Although the level of risk assumed is carefully balanced to meet the risk appetite of its owners.

<sup>4</sup> The insurance industry, after banking, is probably the most regulated of the financial sector.