ART COLUMN FOR OCTOBER

The ABC's of captives aren't as simple as they seem

By Allen Taft

In the academic world, instructors for the basic "101" classes tend to be among the younger educators, cutting their teeth on teaching the fundamentals of the subject under scrutiny.

That's not always the way it is in business. Often the most basic education is provided by the more experienced practitioners of the field. Case in point: my presentation partner Richard Wright of Willis HRH Captive Consulting Practice and I joining up to lead the seminar "ABC's of Captive Insurance" at last month's SIIA conference.

What would motivate us to interpret our field to people who have not yet experienced it? Speaking for myself and I believe also for Richard, I seek these opportunities in order to strengthen our industry, not necessarily overpopulate it.

I believe that a realistic view of ART is required – not just the promotional copy on every captive manager's website. In fact, I have listed six misconceptions about ART that I try to dispel in any presentation I make. That wasn't how our SIIA program was structured, but I think all misconceptions were addressed over the course of the seminar.

So here following are my top six reasons NOT to plunge into the ART pool:

No. 6: Forming a captive for vanity purposes – "he has one, so should I." There's a lot of imitation that drives business trends, but ART shouldn't be a result of that. ART's "value proposition" is that it is a vehicle to drive risk management/risk finance efficiencies and lay a foundation of best practices. ART's "vanity proposition," by contrast, include the foregoing "me too" reason, plus the vague "I think we need one" (perhaps as a CYA tactic), or "captives are part of the standard risk management toolkit."

But the reality of a captive is not likely to impress your playing partner at the Country Club. A captive is pretty unimpressive: No buildings, fancy furnishings or any of the trappings of corporate America – even the bank accounts are managed by third party professionals. A captive can be a valuable part of the risk management toolkit…but only if it makes business sense for your unique situation.

No. 5: A captive is a magic pill that will solve all our problems and be financially profitable. Well, maybe. But consider this: If a concern cannot afford to increase its risk retention levels without a captive, then they certainly cannot afford to assume more risk with one. And this: A single-parent captive insurance subsidiary,

covering the risks of the parent and affiliated operating brother-sister concerns, is really just self-insurance in the most sophisticated form.

No. 4: The promised opportunities of a captive are extremely attractive and compelling.

The promised opportunities comprise an "original pitch" that every potential captive-forming client hears. The list of opportunities includes improving coverage with greater control, direct access to reinsurers and leverage with underwriters, warehousing risk in a central location, providing an earnings buffer, increasing tax planning efficiencies and enhancing profitability. Sure, but again, only if things are managed properly.

The real value proposition of a captive includes the benefits of a seasoned insurance company/corporate-wide risk management vehicle to allow non-insurance concerns to opportunistically navigate the insurance and reinsurance arena and nurture long-term relationships. Now that preceding sentence would require an hour or two of explanation because it's much more complex than the "original pitch," but it drills much deeper into the value of a captive.

No. 3: We can hire all the expertise we need. Well, yes. But you need the expertise to be guided by your professional service providers, not be dictated to. You're going to need expertise at very sophisticated levels of corporate risk management, finance and taxation. If you don't have it, get it.

No. 2: A captive is a great tax play. That's like saying Derek Jeter of the New York Yankees is a great celebrity commercial spokesman: it tells the truth, but it completely misses the point of Mr. Jeter's true greatness. The advantage of a captive is that it can deduct loss reserves while a corporation cannot. A corporation can deduct fixed costs, risk transfer premiums and only those losses paid in the policy year. A captive's tax advantage is clear, but forming a captive solely for tax avoidance is a no-no.

And, the No. 1 misconception of forming a captive: It's a turn-key service that requires an insignificant commitment of time and money; once it's underway it doesn't require much effort.

No, no and no. Forming a captive *does* require a significant commitment of time and money, but the real misconception is that a captive is a static entity, unchanging over time. The truth is that captives are and must remain opportunistic entities – more than just a going concern.

You see, the ABC's of Captives aren't so simple, after all.

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