

# Captives

In recent months, as insurers have faced increasing deductibles, restricted coverages and higher prices for the risk transfer that is available, the focus on *alternative risk finance* has increased. This term includes captive insurance companies, finite risk "insurance," catastrophe bonds, contingent equity/debt, derivative risk transfer and other non-standard approaches to dealing with hazard risk. Captives are clearly the most common form of alternative funding now being evaluated.

Definition: The simplest form of captive is a wholly owned insurance subsidiary that writes predominately the risks of its owner. In this form, the captive is a way of pre-funding the cost of retained risk in a formal vehicle. This is useful for the control and management of the risk, as a way of allocating the cost of risk among corporate entities and as a way of gaining access to reinsurance markets. It also presents a tax advantage for profit-making corporations.

The tax advantage results from the ability of insurance companies to take a current tax deduction for the present value of loss reserves. Non-insurance companies, on the other hand, are only able to deduct uninsured losses when they are paid. Accordingly, retentions that are insured in a captive present the opportunity for an accelerated tax deduction for incurred but unpaid losses. Of course, a business purpose for setting up and operating a captive must be present, but a tax motive is certainly permissible. There are significant tax issues associated with the use of a captive insurance company that must be analyzed.

The disadvantages of using a captive include the need to capitalize the captive (which would not be required with a self-insured retention) and the fact that funds held in the captive will likely earn a lower rate of return than funds available for investment in the parent's business. Accordingly, a cost/benefit analysis is needed.

Lately, we see captives being used to plug holes in property placements. It is not unusual to complete, say, 90% of an excess property layer under favorable terms at a "reasonable" price. To fill in the last 10% layer, it may be necessary to contract with a carrier offering narrower coverage at a significantly higher price. If this 10% is accepted, all participants in the layer will receive the higher price and will also similarly restrict their coverage. In addition, the pricing of risk layers above may be adversely affected, as their prices may be a function of what lies below. Finally, because of treaty restrictions placed on the participating insurers, it may not be possible for the panel to accept 10% coinsurance from the insured.

The captive can write the 10% layer, thereby protecting the pricing and terms received from the other 90% participants. Some organizations have saved significant amounts using this approach. Incidentally, it may be possible for the captive to find reinsurance protection for its portion of the risk without affecting the original pricing.

One major misconception is that a captive will help smooth its parent's earnings because the retention is "insured". Actually, because it is wholly owned, a captive will be consolidated with the parent for book purposes. as a result, inter-company transactions are eliminated and the consolidated books appear as if the risks that are insured in the captive are self-insured by the parent.

The inability of a captive to smooth earnings has given rise to a significant interest in finite risk insurance, where commercial insurers combine risk shifting and risk funding to achieve income smoothing for the buyer. Such programs are also receiving renewed attention.

*Risk Management Notes Number 199 with permission of "Practical Risk Management" : 1901 Main Street, 4th Floor; Irvine, CA 92614-6507 Tel: 949-608-6505*