Captive
Insurance Companies

NNA ADVISORS
Asset, Tax & Risk Control

National Network of Accountants
6900 Jericho Turnpike
Suite 300
Syosset, NY 11791
rroth@nnaplan.com
516.458.6545

What to Consider When Establishing and Operating Captives

PATRICK THERIAULT, CPA, CPCU, AIAF
Vice President and Director, Client Services
Wilmington Trust SP Services (Vermont), Inc.

The use of alternative risk transfer vehicles, which includes captive insurance companies, has almost become the norm rather than an innovation for larger organizations, following the recent hard commercial insurance market cycle. These vehicles represent roughly half of the U.S. insurance market; yet captive insurance companies, or captives, are still somewhat of a misunderstood alternative for organizations that do not currently operate one.

Most risk managers or financial executives of mid to large corporations know the term "captive insurance," but they are still often unfamiliar with how these entities are formed and how they affect a company's day-to-day operations. Therefore, these executives often rely on their insurance agents or brokers to present them with the best available alternative. Unfortunately, while most insurance agencies and brokerage firms of a certain size have captive specialists on staff, many of the agents and brokers in the field are uneasy with recommending the captive as an alternative risk transfer (ART) vehicle, or are not fluent enough to identify when a captive should be considered. The following discussion will provide some basic information about captive insurance companies, the steps required to determine whether a captive might be an attractive solution, and information on how a captive is formed and managed.

What is a captive?

There are many definitions used to describe a captive insurance company. This is primarily due to the different ways in which a captive can be structured and utilized by its owners or insureds. The American Institute of Certified Public Accountants and Towers Perrin provide the following definitions:

- "Wholly owned subsidiaries created to provide insurance to the parent companies." (AICPA Audit and Accounting Guides)
- "A closely held insurance company whose insurance business is primarily supplied by and controlled by its owners, and which the original insureds are the principal beneficiaries. A captive insurance company's insureds have direct involvement and influence over the company's major operations, including underwriting, claims management policy, and investment." (Towers Perrin)

By reading between the lines, one can deduce that at the end of the day a captive is really one form of alternative risk financing, or in other words, a formalized form of self insurance. Previously restricted to large corporations, the recent creation of new captive structures, clarification around tax and accounting implications of captive participation, and the insurance market cycles have led organizations ranging from publicly traded companies, to mid and large privately held and tax exempt entities, to groups of individuals, to look to captive insurance companies as a possible solution to their insurance problems.

Formalized Form of Self Insurance

Just like other self insurance mechanisms, such as policy self insured retention (SIR) and large deductible programs, a traditional captive arrangement allows an organization to retain part of its risk internally. However, unlike these common risk management tools, a captive insurance program will require pre-funding of the risk. Once formed, a captive will operate more or less just like a commercial insurer, issuing an insurance policy and therefore assuming the risk of its parent/owner in exchange for the payment of a predetermined insurance premium. The captive will be licensed as an insurance company in its “domicile” and, though not unlike commercial insurers subject to insurance regulation, will have a more flexible regulatory environment. In this era of Sarbanes-Oxley and increased emphasis on internal controls and transparency, the regulatory environment in which captive insurance companies operate can bring a significant additional level of comfort to executives across all industries, ensuring that their retained risks are accounted for properly in their financial statements.

Why Form or Join a Captive Program?

So why do so many companies now have a captive subsidiary? What are the key reasons or benefits of forming a captive?

- **Reduced insurance costs:**

During the recent hard market, many companies saw double digit increases in their insurance premiums even though their loss experience remained virtually unchanged. By using a captive they were able to continue charging themselves a premium equal to their historical loss experience.

- **Stabilized insurance budgets:**

While the use of alternatives such as large deductible programs and SIRs helps to reduce overall insurance costs, it may also subject the users to large year-over-year swings in their insurance budget, depending on their claims experience. By using a captive, an entity may be able to set insurance reserves equal to ultimate expected losses, therefore providing for some consistency in insurance expense. From a subsidiary’s perspective, the captive provides for more consistent year-over-year insurance premiums, as retained earnings in the captive are used to absorb worse-than-expected results in bad years.

- **Coverage availability:**

The recent medical malpractice and other industry crises have resulted in several commercial insurers pulling out of certain states or lines of coverage altogether, leaving insureds with no insurance options. Many of these insureds have grouped together and formed captive insurers to step in and replace the commercial market.

- **Direct access to the reinsurance market:**

A captive provides insureds with direct access to a market they could not access otherwise, or at least not in a very efficient basis—the wholesale reinsurance market. Since reinsurers have lower costs of operation and regulatory barriers, they can often provide coverage at more affordable rates.

- **Improved claims handling and data collection:**

Under a fully insured or large deductible program, insureds often rely, or are required to rely on, their insurer to keep a historical database of their claims activity. Insureds too often discover several years later that the information was not kept in a very useful format or is very difficult to access, especially if they are no longer doing business with the insurers. By using a captive, insureds can often un-bundle claims administration services to Third Party Administrators (TPAs), who specialize in the lines of coverage insured and take control internally of when, what, and how information is reported.

- **Possible tax benefits:**

Captive insurance taxation is a very complex topic, but in short, there are some tax advantages available only to insurance companies. Under the right sets of facts and if structured properly, these advantages may be available to a captive program.

- **Profit center creation:**

While captives are typically used to insure the risk of its parent(s), under the right circumstances and depending on the risk appetite of the captive owner, the entity could be used to insure third party or controlled unrelated risk such as risk of customers, vendors, or franchisees. If managed properly, insuring unrelated risk could become a very profitable endeavor to a captive owner.

- **Negotiation tool:**

Once formed, the greatest benefit of owning a captive is probably the additional negotiation power it provides during discussions with the commercial market. An insured can easily and rapidly decide to insure a risk or a portion of a risk in its captive if it is in a situation of being overcharged by the commercial market. It is not unusual to see an insurer adjusting its rates downward when faced with the likelihood of losing a piece of business to a captive, since once a risk is insured in a captive, it very rarely returns to the market.

Who should consider a captive?

A risk manager of a large organization recently said the following to a group of his peers at a conference, while explaining what a captive brought to his organization: "Just like a carpenter, a risk manager must have all the right tools in his tool box in order to be able to build the best risk management program. A captive is one of those tools." What he meant is that most organizations can benefit from having a captive today or at some point down the road; not having such a facility available when the need arises is like having a tool missing from a tool box.

That being said, since a captive does require a commitment of time and resources, a captive program may not make perfect business sense in all situations. There are a few key variables a prospective captive owner should analyze when evaluating the feasibility of a captive program. The more of the following variables that are present, the more likely a captive will bring material benefits to its owner:

- **Premium size:**

While there are specialized captive structures that may provide interesting benefits for smaller programs, in order to overcome the start-up costs and ongoing operating expenses most captive programs will require annual premiums of $1 million or more.

- **Good historical loss experience:**

While most insurance buyers feel they are being overcharged by the commercial insurance market, it is surprising how often a detailed

> **"Just like a carpenter, a risk manager must have all the right tools in his tool box in order to be able to build the best risk management program. A captive is one of those tools."**

analysis of their loss experience actually shows that this might not be the case. An insured with a good historical loss experience, who is experiencing premium increases resulting from the commercial insurance market cycles, is an ideal candidate for a captive program.

- **Commercial market availability:**

Lines of insurance or industries that have become disfavored by the commercial market are good candidates for captive insurers. Disfavored industries, such as medical malpractice insurance in recent years, suffer from a supply and demand misbalance and are typically overcharged or not provided the amount of insurance required to properly operate the business. A captive can help bring back the balance.

- **Risk retention appetite:**

While captives are real insurance companies, at the end of the day they are really a formalized form of self insurance, especially in the case of single parent captives. Adverse results at the captive level will negatively impact the results of its parent. Therefore, if your organization is risk averse, a captive may not be right for you.

- **Dedicated project leader:**

A captive is a complex entity subject to accounting, tax, and regulatory guidelines that may be unfamiliar to the organization considering the captive. While a captive might make sense, many captive projects will not get off the ground or evolve without the presence of a dedicated project leader within the prospective captive owner's organization. This project leader should have senior management credibility.

Domiciles

Historically, captive insurance companies have been associated with various offshore locations such as Bermuda, the Cayman Islands, and Barbados. However, recent events such as September 11th, the Enron debacle, and the recent medical malpractice crisis have resulted in onshore locations gaining in popularity. This is so much true that the United States has recently replaced Bermuda as the number one captive domicile in the world, with over one thousand active captive insurance companies. This recent trend of favoring onshore locations has resulted in an explosion of the number of states allowing the formation of captives, and in a level of competition between domiciles never seen previously. There are now roughly 25-30 states with some form of a captive statute on their books. Vermont remains the true onshore leader with more active captives than all other states combined, but a handful of other states have reached a level of credibility with more than 50 active captives and a dedicated regulatory staff.

With the number of options continuing to increase, what are the key factors to consider when choosing a captive domicile? The first step of the domicile analysis is probably to narrow it down between offshore or onshore locations.

Why Offshore?

An offshore domicile would most often be retained for three leading reasons: third party risk; regulatory flexibility; and tax benefits.

- **Third party risk:**

Onshore domiciles typically limit their captives to insuring the risk of their owner(s) and risk from controlled unrelated business. Controlled unrelated business would be limited to risks such as joint ventures or customers where the parent has a significant amount of influence on the risk management or loss control process. Any risk that would not meet the definition of controlled unrelated business would most likely have to be insured in an offshore captive.

- **Regulatory flexibility:**

Offshore is usually synonymous with increased flexibility in the captive arena. This flexibility is sometimes real but at times just a perception. Flexibility might arise in terms of the ownership structure, operation, and allowable investments, but the two main drivers are usually capitalization and regulation. Offshore domiciles tend to have lower minimum capital requirements and do not typically perform regulatory examinations, relying instead on the work of Certified Public Accountants. As stated previously, in this era of increased focus on internal controls and Sarbanes-Oxley, some companies may actually favor the slightly higher level of regulation offered by onshore domiciles.

- **Tax benefits:**

While most of the tax benefits that fueled offshore captive formation in the early days have now been greatly reduced or eliminated, some possible advantages may still exist and should be considered. While the premium tax rates charged by most onshore domiciles are very low[1], large captives might nevertheless be able to obtain tax savings in excess of $100,000 by locating their operations in an offshore domicile that has no premium tax. Some carefully designed offshore captives might also provide income tax advantages to tax exempt organizations or help individuals reduce the effects of double taxation of profits. Captive insurance taxation is a very complex subject matter and as such, owners should seek advice from their tax advisors early in the structuring and formation process.

Why Not Offshore?

- **Lines of coverage:**

Some types of risk cannot be insured in an offshore captive. For example, the Department of Labor (DOL) recently provided that corporations wishing to insure employee benefits regulated under the Employee Retirement Income Security Act (ERISA) in their captive must locate the captive in an onshore jurisdiction.

[1] A couple of onshore domiciles such as Arizona and Utah do not currently charge any premium tax, instead charging a slightly higher annual license fee. Other domiciles such as Hawaii also do not charge premium tax on premiums that have already been subject to a premium tax (i.e. assumed reinsurance).

- **Access to Federal programs:**

Some benefits offered through Federal Government programs or laws are only available to onshore insurers. Two examples are the Terrorism Risk Insurance Act of 2002 (TRIA) and the formation of risk retention groups under the Liability Risk Retention Act.

- **Tax disadvantages:**

While offshore domiciles are associated with tax benefits, they may actually result in higher taxes in some instances. For example, premiums paid to an offshore captive may be subject to the Federal Excise Tax (FET)[2]. FET is charged, when applicable, at a rate of 4% or 1% for direct and reinsurance premiums, respectively, a rate much higher than the premium tax charged by onshore captive domiciles. Captives electing to be taxed as U.S. entities should be aware of the "Dual Consolidation Loss Rule," while those choosing not to make this election could subject themselves to significant punitive taxes if deemed to be doing business in the U.S.

- **Higher cost of operation:**

Operating expenses can vary significantly from one domicile to another, but it is not unusual for the cost of services such as captive management, audit and legal fees, and others to be as much as 10-20% more in some of the more established offshore domiciles.

[2] Offshore Captives may avoid being subject to FET by, if available to them, making an election to be taxed as an U.S. insurance company (i.e. 953(d) election).

- **Accessibility and ease of operation:**

Depending on the location of the captive's parent and its management, it can often be time consuming and expensive to travel to many of the offshore locations, although the same can be said for the two leading onshore domiciles, Vermont and Hawaii. Now that at least half of the states have captive laws on their books, it may be possible for a corporation to form a captive in its own backyard.

- **Reputation/perception:**

Whether real or not, there is still a tax haven stigma attached to many of the offshore jurisdictions. Several of the leading offshore domiciles have long established reputations as insurance or financial centers, while others are more known as exotic tourist attractions. Corporations need to evaluate this based on their own internal philosophy and industry particulars.

The bottom line is that there is no one "right" domicile. Every prospective owner should perform a domicile analysis as part of the captive feasibility study. The domicile should be selected in light of the organization's particulars and specifics by ranking the various options available using pre-determined, weighted variables. The most common key variables used during the domicile selection process are: reputation and perception, regulation and infrastructure, cost of operation, tax implications, and logistics and ease of operation.

Types of Captives and Risk Insured

The forms and types of captive structures available continue to evolve every year. A new trend is also to combine existing forms into more complex single or multi captive structures or to explore potential benefits of using atypical corporate legal structures in captive arrangements. That being said, most captives still fall under one of three main groupings:

- **Single Parent or Pure Captives:**

Single parent or pure captives represent the great majority of active captives (probably somewhere around 70% - 80% or more). They are typically stock corporations owned 100% by their insured parent. Their sole purpose is to insure the risk of the parent, affiliates, or subsidiaries. A recent subset of the pure captive is the branch captive. Branch captives are formed and regulated in more or less the same manner as a pure captive in the domicile where they are licensed, but are more like a division of an existing captive (i.e. not a separate corporation). The most typical use of a branch captive is in situations where a parent of an offshore captive would like to insure employee benefit risk regulated under ERISA. Since the Department of Labor requires that the risk be insured in an onshore captive, the parent creates an onshore branch captive rather than forming a new pure captive in order to achieve capital and cost of operation efficiencies.

- **Group Captives:**

Many group captives operate much in the same manner as single parent captives except, as the name implies, they are owned and insure a group of entities or individuals. This captive form is typically chosen because the participants are not large enough to form their own single parent captive, to achieve a higher level of buying power with the reinsurance market or other providers by aggregating their risk, or to achieve a certain level of true risk transfer[3]. Group captives encompass many different structures, including: Industrial Insured Captives, Association Captives, Risk Retention Groups, and Reciprocals.

- **Rent-a-Captives:**

In certain respects, rent-a-captives are a relatively new type of captive and have grown significantly in popularity in recent years. They are comprised of a combination of the characteristics of both the single parent and group captives. They typically consist of a stock company owned by an insurance company or other large provider of insurance products. As the name implies, rent-a-captives allow third parties to insure their own risk in the captive

[3] Since single parent or pure captives are wholly owned subsidiaries of their parent insured, their results would typically be consolidated with the results of their parent. Group captives however, depending on their legal structure and the ownership level of the insured or captive participant, may be treated as off-balance sheet transactions, therefore resembling more the purchase of insurance from the commercial market from an accounting perspective. This topic is outside the focus of this paper. Please contact Wilmington Trust SP Services for more information.

for a fee. The rent-a-captive owner provides the upfront capital and surplus required for the underwriting of risk and also typically provides many of the services required for the administration of the program. They are ideal for entities too small to form their own captives or for entities interested in getting their feet wet before deciding to form their own program. The biggest advantages of rent-a-captives are: ease of access, as they are typically turnkey operations; lower start up costs, as no capital infusion is required; and possible lower ongoing cost of operation from pooling of services. However, rent-a-captive users are relinquishing a large part of the management control of their program to the rent-a-captive owner, and there is very little case law around the tax treatment of these structures, if challenged. Also, while no start-up capital is required, the rent-a-captive owner may require significant levels of collateral or guarantees against insurance losses being worse than expected.

– *The late 1990's introduced a new form of rent-a-captive referred to as protected cell, segregated cell, or sponsored captives. They operate virtually the same way as their rent-a-captive siblings except that the risk of the participants or users is kept separate from one other. As such, the assets of one participant cannot be used to pay the losses of another in the event of adverse results. It should be noted that while most experts believe that the segregation aspect would hold if tested, this has yet to be challenged in the courts.*

Flexibility in Insuring Risk

The type of legal structure available varies by domicile, but generally, captives can be formed as stock corporations, as mutual insurers, as limited liability corporations, as non-profit organizations, or as reciprocals.

One of the greatest benefits of a captive is its ultimate flexibility as to the type of risk it can insure. Basically, the sky is the limit and anything that makes good business sense could most likely be approved by the domicile regulators and as such, insured by a captive, if structured and financed adequately. That being said, the great majority of captives are still used to insure standard property and casualty risks such as all risk property, workers compensation, general and auto liability, professional liability, and product liability. More recently, large captive owners have begun using captives to insure some employee benefit risks such as group life, long term disability, and medical stop loss. Many believe that pension and postretirement benefits are just around the corner.

It should be noted that while there is little restriction per se, the type or location of a captive vehicle used may limit the type of risk that can be insured. For example, risk retention group captives can only insure liability risks as defined under the Liability Risk Retention Act and, as stated previously, ERISA employee benefits can only be insured by an onshore captive program.

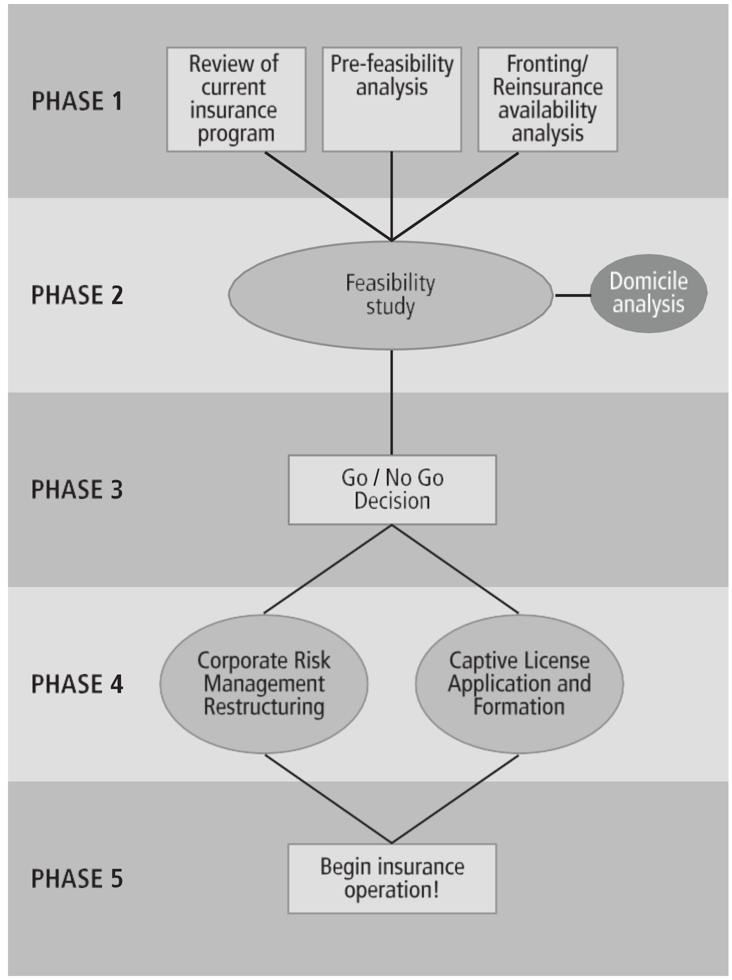
Captive Design Life Cycle

All new captives will go through some form of program design life cycle. The actual number of steps required and how long each phase will take to be completed vary depending on the complexity and severity of the issues faced by the organization considering the captive. In some very severe situations where a captive might be the only available solution, all five phases may be completed in 45 to 90 days. In the case of very complex organizations evaluating a range of viable options, the process could take as much as 12 to 24 months.

It is worth expanding on three key steps :

- **Pre-feasibility analysis:**

The pre-feasibility analysis consists of a back-of-the-envelope assessment of the viability of a captive program. Normally performed by a captive manager or a captive consultant, it is a quick review of the issues being faced, the current insurance program, historical loss experience, corporate structure, and organization/industry hurdles. Typically completed in a few days or weeks at no or limited cost to the prospective captive owner, its main goal is to eliminate obvious obstacles that would not make a captive a viable vehicle before embarking into a time consuming and often expensive full blown captive feasibility study.



- **Feasibility study:**

Captive feasibility studies are often mistaken to be an actuarial analysis. While an actuarial review of the lines of coverage considered for the captive is a very, if not the most, important part of the analysis, a captive feasibility study would not be complete if it did not also incorporate a financial and operations evaluation of the proposed captive and its parent(s)/insured(s).

—Actuarial study. The actuarial study, performed by a third party actuary, consists of a detailed review of the prospective captive owner's loss exposure information, historical loss patterns, frequency and severity of loss activity, and schedule of large losses. In order for the analysis to provide credible information, the actuary must have access to a minimum of three to five years of very detailed loss information. The actuary will complement the information available with related industry data.

The product of the actuary's work is a report typically providing four main products: per occurrence and aggregate stop loss retention evaluation; coverage premium determination; confidence level analysis; and capitalization requirements. In other words, the actuarial report will provide the actuary's best projection of the premium to be charged and ultimate incurred losses under various different scenarios. At a minimum, the analysis will project the numbers under both an expected and an adverse scenario. This range of possible outcomes will be used to compute the appropriate amount of capital required for the captive to assume the risk contemplated.

The actuarial report will also be a very important component of the captive application filed with the domicile regulators, if a decision is made to form the captive.

—Financial and operations evaluation. The financial and operations evaluation, normally performed by a captive manager or consultant, will focus on reviewing financial and industry information of the prospective captive owner including, but not limited to: an organizational chart and most recent available annual report or financial statements; industry specific regulatory hurdles or barriers; scheduled or anticipated insureds and their current deductible or self insured retention levels; current accounting and tax situation; and philosophy.

This analysis should provide the potential captive owner with pro forma financial statements for the captive; a net present value cash flow analysis of the captive compared to alternative options and status quo; a report showing the effects of the captive on consolidated earnings before income tax, interest, depreciation, and amortization (EBITDA); and a schedule of operation and other non-financial benefits or shortcomings of the captive program.

In short, while the actuarial analysis will identify whether the prospective captive owner is being overcharged by the commercial market, therefore suggesting a higher retention of risk, the financial and operations review will determine whether the higher retention of risk can be best managed within a captive structure.

In addition to the above, a captive feasibility study should, if it reaches the conclusion that a captive program would best achieve the goals and objectives previously identified, provide for consideration of one or a few proposed structures, including a comparison of captive domiciles and available ownership configuration. The feasibility study report will be the building block of the Executive Summary to be provided to upper management leading to the Go or No-Go decision and, if it is decided to go forward, to the captive application and its formation.

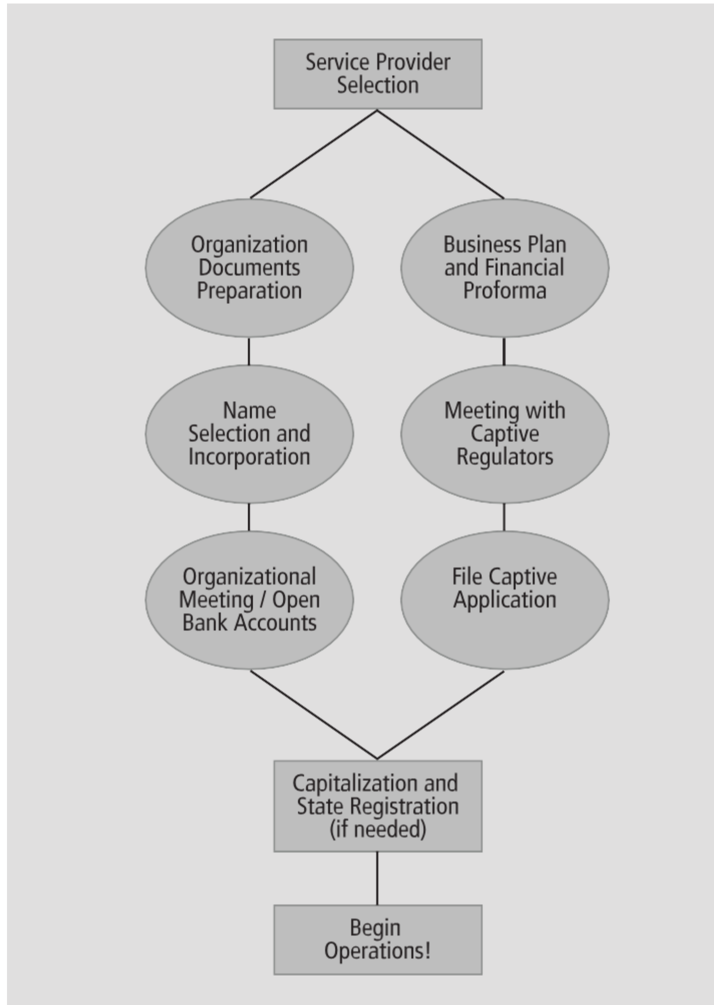
Many variables such as the number of lines of coverage under consideration, the number of parties involved, the quality and accessibility of loss and financial information, and the level of commitment of the prospective captive owner to the project will affect the time and expense of the feasibility study. Very simple studies could cost as little as $20,000 and take roughly six weeks. More complex studies could take 12 months or more and cost in excess of $100,000.

- **Captive application and formation:**

Service providers can be broken down in two main groups: the required providers and the suggested providers.

REQUIRED PROVIDERS. Most captive domiciles require their captive owners to retain a captive manager, an actuary, a financial auditor, and a bank.

—*Captive Managers.* The captive manager, individually or as a firm, must typically be either approved or licensed by the domicile where the captive operates. The captive manager will generally



maintain the books and records of the captive, will manage the work of the other service providers, and will be the primary contact for the domicile regulators.

—*Actuaries.* The actuary, also typically approved by the domicile, will prepare the annual reserve certification required by the domicile and/or the financial auditors. The loss certification is a confirmation that the reserves carried in the captive's financial statements are appropriate. The actuary will also often prepare an annual report used as basis for the setting or the renewal of premiums.

—*Financial Auditors.* The financial auditor will issue an opinion on the adequacy of the financial information issued by the captive under Generally Accepted Accounting Principles, or other approved basis of accounting. An annual audit, and corresponding opinion, is required by all captive domiciles. The financial auditors will also often prepare the captive's income tax returns.

—*Bank.* All domiciles will require that the captive's capital and/or operating funds, if held in the form of cash, be deposited in a bank account in the name of the captive.

SUGGESTED PROVIDERS. Depending on the type of captive program and the domicile chosen, a captive may be required, or would greatly benefit from the services of a domicile or consulting attorney, an (re)insurance broker or intermediary, a third party administrator (TPA), an investment manager, and a tax advisor or other consultants.

The cost of retaining the above service providers can vary significantly depending on the type of captive, the size and complexity of the captive, the domicile chosen, and the frequency and timing of financial reporting. The table below provides a rough range of what most captive owners should expect during the early years of operation of their captive.

The information required for a captive application varies slightly from domicile to domicile, but will consist generally of the following components:

- Domicile application form signed by a director of the captive

SERVICE PROVIDER	LOW END (US $)	HIGH END (US $)
Captive Manager	$25,000	$150,000
Actuary	$5,000	$50,000
Auditor	$10,000	$50,000
Bank (Letter of Credit)	25 basis points	50 basis points
Investment Manager	30 basis points	50 basis points
Attorney	$250 per hour	$500 per hour
TPA	Per claim charge; varies based on risk insured	
Consultants	Project specific	

- Certified copy of certificate of incorporation, articles of association, and bylaws
- Biographical affidavit or resumes of all directors and officers
- Feasibility study or actuarial report
- Captive business plan and financial pro forma
- Listing of service providers with description of fee arrangement
- Parent company audited financial statements
- Shareholders'/members' agreement for group captives
- Copy of proposed insurance policy/reinsurance agreement
- Applicable filing and application review fees

The three main key documents that will determine whether the application/business plan is approved by the domicile regulators and a captive license is issued, are the feasibility study, as previously discussed, the captive business plan, and the financial pro formas.

—Business Plan. Normally drafted by the captive manager, the business plan should depict in great detail the proposed structure and the lines of business to be covered by the captive at inception or soon after. It should describe the type of captive and its proposed ownership, the program rating methodology or how premiums will be derived and allocated, the loss control and safety programs to be established, whether the program will be fronted or written direct, the type and amount of reinsurance protection if any, and the proposed capitalization. The business plan should also detail the proposed management of the captive and provide a listing of the proposed service providers, including a description of how they will be compensated. Finally, the business plan should include a narrative summarizing the findings of the feasibility study and the projected financial results.

Once approved, and when the certificate of authority has been issued, any departure from the original business plan will generally have to be pre-approved by the domicile regulators before it can be implemented. This process, referred to as a change in business plan, is typically much simpler than the original captive application review and can sometimes be approved in as little as a few days.

—Financial pro forma projections. The financial pro formas, typically prepared by the third party actuary or the captive manager, consist basically of the standard financial statements (Balance Sheet, Income Statement, Cash Flow Statement, Financial Statements Notes) projected over a period of five years under both an expected and adverse scenario. The loss information presented under both scenarios should be consistent with the underlying feasibility study or actuarial projections. The pro formas should also present the basis for growth over time of premiums and operating expenses including inflation factors. Investment income should be calculated using conservative and realistic rates of returns for the type of risk to be insured and based on projected invested assets. Any unusual amounts and management response to the adverse scenario (i.e. premiums increased, recapitalization, etc.) presented in the pro formas should be explained in the captive business plan.

Application Cost, Review, and Licensing

The cost of preparing the captive application, generally prepared by the captive manager with the help of a domicile attorney, can sometimes be included in the cost of the captive feasibility preparation. If contracted separately, preparation of the captive application will range between $5,000 and $20,000 for the captive manager and between $5,000 and $15,000 for legal work depending on the type of captive, the complexity of the program, and the components to be completed.

Captive application filing and review fees will range between $3,000 and $10,000 depending on the domicile chosen. Offshore domiciles tend to have higher application review and annual license fees. Most domiciles state that an application will be reviewed in no more than 30 to 60 days. The actual amount of time required will depend on the following variables:

- **Complexity of the captive program:**

  A single parent captive writing one line of business should be reviewed in no more than 30 days. A group captive or risk retention group writing several lines of business will most likely take at least 45 or 60 days and possibly more.

- **The time of the year:**

  Most domiciles tend to be very busy in the fourth quarter as many prospective captive owners are trying to have their program implemented for the January 1 insurance renewals. An application that could be reviewed in 30 days early in the year may take much longer during busy periods.

- **Market cycles:**

  The number of captives formed often increases significantly during hard market cycles. Most domiciles have limited staff dedicated to the captive division and can get overwhelmed during hard market cycles.

- **The domicile chosen:**

  Be aware of what is happening in the domicile you favor. Does the domicile review the full application internally or do they hire out some of the review? Have they experienced significant growth recently? Have they been subject to recent staff turnover? Does the domicile have a history of preferring certain captive structures over others? Prospective captive owners with tight deadlines should inquire with local service providers regarding their domicile of choice to make sure they are in a position to review an application under the time frame they advertise.

Once the application has been approved and a license has been issued, captive owners should never forget the following:

> *Once licensed, a captive is only authorized to do business in its location of domicile.*

As such, a Cayman or Vermont captive, for example, once licensed, cannot open an office in Illinois and begin selling insurance in Illinois. This does not mean that a Cayman or Vermont captive cannot insure Illinois risk, but it may only do so under specific situations such as by using a licensed commercial insurer as front. The captive manager and/or consultant should review the various alternatives available with the prospective captive owner during the feasibility study process.

Successful Captive Insurance Program Attributes

The success of a captive program will be judged at its onset against the goals and objectives identified early in the feasibility study process. However, due to its often somewhat high start-up cost and the level of regulatory oversight it will be subject to, very rarely should a captive be formed solely to solve a short-term problem. A captive will provide its greatest benefit if it is designed with a focus on mid- to long-term objectives with an emphasis on its ability to adjust.

If looked at carefully, most successful captive programs will have a few or most of the following attributes. Some can or should be identified at inception while others should be managed and achieved over time.

- **Spread of risk with predictable losses:**

Most captive owners are experts at things other than insurance. This is a big reason why several captives failed miserably some years ago when they attempted to compete against their commercial insurer counterparts, and began insuring significant amounts of true third party business. Successful captive owners will remain focused on the risk they understand the best—their own—insuring the “working” layer where extensive data is available and premiums and losses can more easily be actuarially determined. Successful captives will also have a good spread of risk either by having a sizeable enough exposure base for the law of large numbers to operate,, or by incorporating a number of lines of coverage with limited correlation.

- **Good loss experience and loss control program:**

The success of a captive program can only be as good as its underlying loss experience. The best way to manage underwriting results is via targeted and rigid loss control and safety programs. Poorly managed risk programs are probably better insured by the commercial markets, no matter how over-priced the market might appear.

- **Fronting and reinsurance support, as required:**

Some captive programs cannot operate or grow without adequate fronting and/or reinsurance support. As such, captive owners should look to identify fronting insurers or reinsurers with whom they can partner and enter into a long-term relationship, even if this might mean paying slightly more in any given year. The captive owner needs to be comfortable that the front or reinsurer will be there next year and the year after, through good and not so good years.

- **Financially stable parent(s):**

Most successful captive programs have financially strong or stable parent(s)/insureds that are able to pay the amount of premium required for the risk insured year after year, and that are in a position to provide the additional capital required to allow the captive to grow or to weather bad years. A captive should not be viewed as a piggy bank that can be plundered whenever a new pet project comes along or other divisions are experiencing difficulties.

- **Good non-tax business purpose:**

Captive programs formed solely for tax reasons very rarely stick around for very long. Successful captives are formed for true and identified risk management reasons. Tax benefits obtained, if any, should be viewed as a bonus.

- **Strong business partners:**

Very few captives are self managed. As stated previously, captive owners are very rarely in the business of insurance in the first place. As such, it is crucial that a prospective captive owner retain the right business partners. Strong business partners should have a good understanding of the captive industry in general and how it is evolving, as well as the industry of the captive's parent. They should be innovative and focused solely on the success of the captive itself.

- **Long-term commitment from management:**

The true success of a captive program cannot be ascertained until after it has been in existence for 5, 10, or more years, depending on the lines of coverage insured. The captive should be managed in a manner consistent with other subsidiaries or affiliates and viewed as an ongoing concern entity. With the current narrow business focus of meeting next quarter's budget targets, this can often be a difficult proposition.

- **Positive financial return to the corporate family:**

While many captive programs are primarily cost centers, they should be constantly evaluated against the financial or cash flow benefits they provide to the organization as a whole, and these benefits should be material. If opportunities to convert the captive as a profit center become available, they should be evaluated very carefully. Only captive programs with positive financial returns will be able to achieve full support from upper management and be provided the resources needed to reach their full potential.

- **Continuous re-evaluation of business purpose and growth opportunities:**

Corporations of all sizes constantly change and evolve. Similarly, the captive program should also be constantly challenged and re-evaluated by its management to assure it continues to fulfill its primary purpose: to more efficiently manage organization-wide retained risk. Risks originally retained by the captive could possibly now be more economically insured by the commercial markets. Alternatively, risks previously non-existent or deemed immaterial might have arisen or grown and are now ideally positioned for a captive structure. This could not be identified without frequent strategic planning exercises for the captive program.

Conclusion

Captive insurance is now part of every good risk manager or executive officer's vocabulary. In the right situation a captive can provide significant benefits to its parent(s) organization. Its review and implementation should, however, not be taken lightly as they are complex structures subject to rigorous regulatory environments. Only a well planned and managed captive program will achieve full potential and be in a position to adjust to its parent(s) needs.

Captive insurance is now part of every good risk manager or executive officer's vocabulary. In the right situation a captive can provide significant benefits to its parent(s) organization.