Nothing ventured, nothing gained

As the captive insurance industry grows in the US, so does its wider reputation as the go-to strategic risk-management tool. Why are more and more US companies venturing into the captive arena?
It has been noted that only one third of US captive owners treat their captives as insurance companies for US federal income tax purposes—have you seen this trend?

Gary Osborne: I would note that there are many reasons for forming a captive, and taxes, while always important, are rarely the first reason. Many businesses do not have either enough entities or third party risk to meet the risk distribution tests and are unwilling to enter into pooling arrangements with other parties.

Some of the primary drivers of captive formation include: (i) insurance being expensive or unavailable; (ii) dissatisfaction with the carriers claims process; (iii) internal allocation amongst various sized enterprises; (iv) group purchasing power; (v) need for evidence of insurance; (vi) state regulatory issues; and (vii) tax benefits. Clearly many religious groups, non-profit healthcare and public entities have formed captives where tax was not part of the motivation to form.

The old standard of the ‘Three Cs’—cost, control and capacity—are still valid. When you are forming a captive you will firstly address the risk and business issues and then you will look to see if a beneficial tax structuring can be achieved.

Jason Flaxbeard: Captives are being created to allow their parent to control their total cost of risk. Swapping dollars with a carrier does not provide any return on equity to a company. We see captives being used to capture third party business, develop relationships with vendors and clients and to deliver on enterprise risk management (ERM) strategies.

Michael Serricchio: According the Marsh 2014 Captive Benchmarking Report, only 37 percent of US companies with captives actually achieve insurance company federal income tax status, and there are a few ways to look at this trend. Although Marsh manages more than 1240 captives, many of those captives are not 831(b)-sized entities. Therefore, our statistics should be looked at with this limitation in mind, especially relative to federal income tax status of captives generally.

Frederick Turner: While I agree that a captive should only be formed for risk management reasons, I also believe that the tax advantages to a captive foster the risk management benefit. Of course, tax and wealth management benefits should not be the standalone reasons for captive formation. The need for the captive to facilitate better organisational risk management is the key and foundational consideration to the question of whether to form a captive.

Kimberly Bunting: Historically, the trend was to domicile captives offshore and not elect to be taxed as a US corporate taxpayer. The benefits of avoiding US taxation have been viewed as outweighing the risks that the Internal Revenue Service (IRS) would challenge the insurance premium deductions being taken by those companies.

That trend is shifting due to increased scrutiny by the IRS and even IRS undercover investigative efforts to show such companies are illegal tax avoidance or evasion schemes. A business owner considering domiciling a captive insurance company offshore without subjecting the company to US taxation should seek expert advice on the issue before proceeding.

Operational and risk management value seem to be more important to the majority of owners—what is it about the modern captive that allows these to be generated?

Flaxbeard: Companies are looking for capital appropriate vehicles. If an insurer’s cost of capital is greater than a captive owner’s cost of capital, risk should be retained. When insurance vehicles become a cheaper cost of capital than retention, companies should buy risk transfer policies. In this arbitrage scenario, captives play a major part. They are concertinas that contract and expand based on a number of issues—availability of capital, wording flexibility, access to reinsurance including the Terrorism Risk Insurance Act.

Turner: Operational and risk management value is best generated by and supported through the way the captive can write policy lines. Captives can be very creative and flexible in terms of how they write the risks they cover. Commercial carriers have no such flexibility in their underwriting since their policies often have to be filed and approved by the regulators.

From a commercial underwriting perspective, it can be hard to write the coverage from a standardised perspective, though standardisation of forms is indeed how commercial carriers typically write—it’s the way they have to write lines. When you have a standardised, one-size-fits-all policy form, you still need that form to somehow also fit the insurance needs of a diverse population of differing insureds, covering all the various ways risk or loss can manifest itself. But, when you are underwriting say, for a pure captive, all that matters is the risk of the parent, affiliated company or controlled unaffiliated entity (the only types of insureds a pure can have).

Pure captive underwriters need only concern themselves with understanding the risk of insureds that are in the same ‘family tree’—they don’t need to be mindful of the risk to some larger and unrelated population of insureds that all happen to need the same form of coverage. There is great flexibility then in how the coverage can be tailored to fit the risk when a captive is writing the coverage.

Serricchio: Modern day captives that are being formed tend to be either in the large middle market space, or smaller private company sector. Setting aside small captives, we are seeing a dedicated focus to compliance, discipline, control, and governance. This means that since most Fortune 1000 companies tend to have at least one captive, the growth is in this middle market sector.

Therefore, if we can demonstrate value, keep costs low, with perhaps the ability for a client to enter a protected cell captive (PCC) structure or ‘rent-a-captive’ to save costs, we make that recommendation. Furthermore, there are far more service providers out there now than there were 20 years ago that focus on market captives from a cost savings and competitive pricing perspective. That all equates to more resources, better service at cheaper rates for captive owners or would-be captive owners.

Osborne: A captive is a licensed and regulated insurance company, it can enter into contracts of insurance and reinsurance, and it can issue certificates of insurance. More often than not, these simple facts are at the core of why captives are a successful risk management tool. The use of a captive usually combined with a rated carrier can mean the companies can manage a more appropriate level of risk but still meet the insurance requirements in their business and government contracts.

In addition, ‘dollar trading’ with insurance companies is a very inefficient process, so larger companies often use high deductible or self-insurance to retain working layer losses. A captive can be an effective allocation and management tool to monitor, control and allocate these primary losses and access insurance or reinsurance protection for severity losses.

Bunting: A captive provides a unique opportunity for a company and its owners to operate ‘on both sides of the fence’ as both insured and insurer. This arrangement highlights risk factors embedded in a company’s operations and the benefits of developing tools and holding people in the company accountable for failure to minimise such risks. It also provides a direct reward mechanism that is quickly visible to the stakeholders for successful loss reduction and mitigation.

Micro or 831(b) captives buck this trend—how do you see the rise of micro captive, and why?

Osborne: 831(b) captives are not new. What is new is the ‘overselling’ of the vehicle as a tax planning opportunity. A small captive insurance company still needs to meet all the risk transfer and risk distribution tests and the major trend has been the rise of specialised ‘pools’ for esoteric risk being written in these new companies. If the captive is set up to address a business risk issue and supplemented
by funding for black swan type events then it is probably going to pass muster. If there is $1.1 million of premium with minimal to no losses and 50 percent is ceded to a pool that also has no or minimal losses, I would be concerned if this will meet risk transfer tests.

The boom is because there is a real potential to create entities that make a lot of business sense and are potentially very tax efficient. For companies with unfunded deductibles for high severity, low frequency type covers (such as wind, earthquake and pollution), this can be a very attractive option to prefund in a tax efficient manner for these damaging events. If the claims do not arise then the funds can be taken back or often passed on to the next generation at the capital gains tax level.

**Turner:** Any captive, no matter the size, evaluates the risks it writes the same as any other insurance company. Captive underwriters evaluate the risk and the risk is appropriately priced, in the form of arms-length premiums. When claims happen, they are evaluated and when covered, they are paid. This process has nothing to do with a tax election. Small captives fit a certain marketplace (ie, small-privately held companies) because they are suited to cover certain levels of risk inherent to this marketplace, such as high frequency/low severity risks.

As long as there continues to be a strong insurance need for these structures, they will continue to flourish. Let’s play this out by way of example: all insurance companies are taxed as ‘C’ corporations under federal income tax law. The Internal Revenue Code 831(b) election allows the captive to exempt premium income if its annual premiums are no more than $1.2 million per year. A client has 12 tax regarded entities each of which owns a building along the gulf coast. None of these entities have coverage for wind damage. The buildings are spread over a wide geographic area. In effect, the client has been self-insuring wind risks for these entities as the total risk.

Each of the entities has significant rental income that is not covered by depreciation. The client then forms a captive that covers first dollar wind coverage for each of these entities and each of the entities gets a tax deduction for these premiums. Let’s say the total premiums are $1 million, spread fairly evenly among the entities.

Each year the client can make these premiums payments to the captive. Since the policies run off each year, if there is no wind event the reserves for the policies are eliminated and couple this with an 831(b) election, the captive can steadily increase its capacity unlike a captive that does not make such an election. The client has improved the overall risk management of this economic family.

**Serricchio:** For many of our clients, a small captive is a stepping-stone, and a simplistic and easy way to test the waters and have the potential to grow the captive in the future. We have formed a few of these ‘starter’ captives in the last year.

We urge our clients that embark on a small captive to start right from the very beginning with a comprehensive feasibility study, arm’s length derived premiums, coverages that are appropriate for the company and industry, require an actuarial study, and adequate and appropriate capital. We turn down many clients that come to our door, because our reputation and their’s are on the line.

**Where does the pooling approach fit in to US companies’ methods, and where do you see these arrangements going in the future?**

**Bunting:** Pooling provides a mechanism for captives to spread and smooth risks and claims costs. It is also making it increasingly possible for the middle market to participate in captives either through group captives with pooling or small captives with pooling which
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is almost always required to meet the risk distribution requirements for an insurance company set forth by the IRS.

Osborne: Pooling is another example of when everything old becomes new again. It has come to the fore again because of the ‘need’ to achieve risk distribution for entities that may not be able meet risk distribution tests independently. It is a well-tested concept that should perform as advertised if correctly established to actually share losses and allow for the possibility of losing money. I am not convinced that pools that run for years with zero losses or that advertise stop-loss attachment points below the premium level ceded to the entity will stand up.

I see a more traditional pool model emerging where companies will share more predictable programmes such as self-insured health or warranties. The down side to these types of coverage is that the underwriting profits will be reduced by having losses flow through the captives. It again comes back to why the entity is being formed. If a small captive is being formed to address a risk issue then these types of pooling arrangements to qualify the programme will be more readily accepted. If the ‘sale’ is to move $1 million of loss-free premium into a captive to lower the taxes, then the current pooling will continue to be pushed.

Sericchio: Pooling is a hot topic for discussion in the current captive landscape, both as it relates to small captives and also for traditional captives. Pooling is by definition, third party risk. One way to include third party risk in a captive is through participation in risk pools.

Through a pooling mechanism, participating captives ‘share’ their loss experience by transferring a portion of their risk in exchange for assuming a percentage share of the risks of other treaty participants. By accepting other participants’ risks, captives can diversify their underwriting portfolio by writing third party premium. Pooling may result in a reduction in the variability of expected losses for individual members as each member will be writing a smaller portion of a large pool of losses.

The reduction in loss variability produced by the pool is designed to stabilise cash expenditures on losses assumed by participants. Pooling also provides a source of third party risk, which may assist with US federal income tax treatment. To contrast this, the captive also assumes other participants’ risk, which it does not control or have risk management oversight over. We found that the most common lines of coverage found in these pools are workers’ compensation, general liability, and auto liability. Marsh’s Green Island Reinsurance Treaty (GIRT) is an example of this. With GIRT, participating captives’ premium volume has grown over the last 16 years from $59 million of premium in 1997 to $631 million of premium in 2013.

With the growth of pooling over the years and because of the increasing number of small captives, there are also numerous small captive pools that in some cases may allow for proper risk shifting and risk distribution. These small pools typically are not for very predictable primary casualty losses. Rather, they are catastrophic coverage pools, with lines such as excess liability, product liability, product recall, environmental, cyber liability, supply chain, and terrorism, among others. We expect significant growth in small captive pools in the next several years, but as a caveat, owners must examine the pools, review formation and participation documents, audits, actuarial studies and make a determination that risk transfer results from the pool and that the pool actually experiences losses, there may be issues related to tax matters down the road.

Turner: In Active Captive Management’s experience, captives with a pooling component are only ever created to facilitate risk distribution. Granted, there are tax concepts underneath the notion of proper risk distribution, but pooling does not in and of itself create any tax advantage. Risk distribution is all about ensuring against the possibility that any single claim will cause catastrophic loss to a captive and exceed the captive’s premium/reserves. This isn’t a tax concept, it’s an insurance concept. Marsh’s GIRT is an example of a pooling structure that has been in operation for 17 years. There is a continuing longevity to the need for pooling. I believe that this pooling structure is used by large pooling clients of Marsh, which shows that pooling arrangements are used by both large and small captives in the US.

Real estate investment trusts’ use of captives to access the Federal Home Loan Bank system has attracted much attention of late—what is your position on this? Should the regulator be concerned?

Bunting: This is a relatively new development that will no doubt attract regulatory attention due to the funding opportunities and risks. Captives for real estate investment trusts (REITs) make sense to cover the risks associated with their business operations, but it remains to be seen whether regulatory entanglements will permit funding opportunities to continue to be available through a captive mechanism. From a regulatory standpoint, one of the risks is that a captive has more flexibility for customised coverage, which could create risk if high-risk coverages are provided and funding available based upon such coverages.

Osborne: I don’t see any issue with captives being used in this fashion if the Federal Home Loan Bank (FHLB) does their job and ensures...
Is it enough to be thorough?

We don’t think so. Thorough is what you expect. Thorough is industry standard. At Carey Olsen, we view every instruction as a chance to surpass your expectations, to set new standards and reaffirm our position as leading offshore lawyers. We haven’t been just thorough for a very long time.

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that the entities involved meet their requirements and will help to support the objectives of FHLB. I think the attention is being driven by the same regulators that think all captives are ‘shadow’ insurance and a general anti-captive attitude from several large states that don’t want to understand their legitimate use as business and risk tools.

There are many strings to the modern captive’s bow—what other innovations do they have in store for US owners?

Turner: The most innovative thing about a captive is always how it writes its policies. The policies are the past, present, and future of captives—the centre of any captive’s universe. As the commercial market cycles through hard and soft markets in around how the US economy is performing, a captive will of course change how it is writing policies to fill in the gaps created by any commercial market coverage or cycle. Captive innovation follows commercial market cycles and captives take their lead from watching that market.

But there is great freedom on the back end of watching how the commercial market is trending—where captives can innovatively write coverage for trending risk that it is impossible or cost prohibitive for a captive’s commercial brethren to write in any particular market cycle.

Bunting: Small captives are emerging as one of the most powerful risk management tools available to the middle market. This market will continue to grow, especially as more legitimate insurance and risk management captive managers begin to enter the market and educate the middle-market business owner. This is already occurring and should help to remove the negative impression for this tool as a tax ploy and not a true risk-management opportunity.

Our company is one of the new breed that are working in this market to elevate the reputation and bring risk management to the forefront as the primary reason for setting up and operating a small captive. There are many legitimate arrangements that can be made with a successful small captive to augment and complement the middle market company that it insures.

Osborne: I think the proliferation of domiciles is going to create more direct writing opportunities for companies to issue policies in their home states and reduce frictional costs, such as state premium taxes and carriers’ frictional loads.

Structural innovations such as the series limited liability company are making captive utilisation more accessible for smaller organisations for which captive ownership may not have been financially viable in the past. I also expect the use of captives in the benefits space to continue apace and not necessarily as much health insurance as some anticipate. The short tail nature of that cover means that self-insuring is already efficient and the captive benefit is more nuanced.

Flaxbeard: Captives will be used to access capital markets and securitising balance sheet risk of the parent. These deals will allow for efficient access to capital to assist with corporate enterprise risk management strategies and allow companies to think outside the traditional market when renewing their business.

Serrichio: The top risk being looked at and asked about at the moment is cyber. The Marsh Cyber Risk Group released the Cyber IDEAL Model, which provides a facility to assess a firm’s exposure to the risk, and captive owners may make use of the tool when exploring the feasibility of covering cyber.

Writing cyber through a captive is still relatively rare. In Marsh’s Captive Benchmarking Report, only 17 out of 1148 captives reported writing the risk. However, that number will most definitely grow as more and more brokers are talking with more clients of all sizes, since cyber risk affects all companies, all networks, all computing and phone devices, banks, data banks, private identifiable electronic data, and the entire connected world.