Captive Insurance Basics

Captive insurance companies have been around for many years. Those who have been in risk management fewer than 10 years may not have heard of them, nor probably ever had to concern themselves with learning about captive insurance. The main reason that captives have not been talked about much is because risk managers lived in a "soft" insurance market world for so long. In the pre-2002 market, insurance brokers were breaking down doors to give the best rates seen in 20 or 30 years.

Today's risk management world is seeing a significant change. The market has "hardened" for many reasons. Now the insurance brokers aren't breaking down the risk managers' doors to quote low rates. They are only coming to the doors to write up rate increases, higher deductibles and more policy exclusions – if they choose to knock at all.

Risk managers, CEOs and CFOs need to know their options. One option to explore for potential fit is formation of a captive insurance company. The following Qs & As may assist risk managers in determining if a captive is a viable option for their situation.

WHAT IS A CAPTIVE?
A captive is an insurance company whose primary purpose is to supply insurance coverage to cover its owners' risk.

WHAT TYPES OF CAPTIVES ARE THERE?

- Pure captive is a wholly owned subsidiary established primarily to insure the risk of its parent company.
- Associate captive (risk pool) has two or more parent companies with similar risk exposures.
- Group captive has two or more parent companies that do not have similar exposures.
- Risk retention group (RRG) is a purchasing group consisting of many owners created to obtain insurance for all owners of the group through a commercial market.
- Domicile is the home (place of incorporation) of the captive and where the tax laws apply.
- Onshore captive is located within the United States.
- Offshore captive is located outside of the United States

WHEN SHOULD THE RISK MANAGER CONSIDER SETTING UP A CAPTIVE?
A captive must be thought of as an actual insurance company. It is important to make sound decisions on what risk to invest in as well as to determine if the risk exposure being considered can be controlled. Risks that cannot be controlled or managed may be better handled by transferring them to a commercial carrier.

WHAT ARE THE BIGGEST ADVANTAGES OF A CAPTIVE ARRANGEMENT?
The captive arrangement has many advantages. It gives the risk manager the sense that he or she has control of the insurance premium dollars. Premium dollars are spent to manage the risk and not spent to add a profit margin to a commercial insurance company. It can prove to be a return on investment over time. If the claim experiences are as expected, the captive will be capable of performing very well financially.
In most captive arrangements, the parent company can receive dividend returns and obtain loans from the captives.

The biggest plus in owning a captive is the ability to tailor the coverage for the risk to be covered. It is easier to include coverages that may not be available with commercial insurance companies.

WHAT ARE SOME DISADVANTAGES OF A CAPTIVE ARRANGEMENT?
Managing a captive means taking on a significant risk. The decision to form a captive must be a longterm commitment. Starting a captive calls for access to capital dollars to establish the captive and be available for claim liabilities. It does not make sense financially to set up a captive with the idea of reverting to a commercial policy when the market turns around.