The purpose of this paper is to summarise what is a captive insurance company, why one might be formed, the advantages and disadvantages and the various risk carrying options available.

People forming their own insurance companies to insure the risks of the owners dates back to the dawn of the modern insurance industry. From the 1920’s more and more larger corporations established their own insurance companies, but the term “captive” (as we know it today) was first used by Frederic Reiss, who coined the term while he was bringing his concept into practice for an industrial client in Ohio in the 1950’s.

The Youngstown Sheet & Tube Company had a series of mining operations and its management referred to the mines whose output was put solely to the corporation’s use as captive mines. When Reiss helped them incorporate their own insurance subsidiaries, they were referred to as captive insurance companies because they wrote insurance exclusively for the captive mines. The term also made sense as the policyholder owns the insurance company i.e. the insurer is captive to the policyholder.

Today the captive insurance industry is still growing with over 5,500 captives established in excess of 60 jurisdictions around the world. The rate of captives traditionally develops in response to “hard” insurance markets, although they are to be regarded as part of a longer term risk management strategy, rather than short term cost saving vehicles.

Vantage Limited are Jersey’s first resident specialist insurance management company who can advise on and provide management services for captive insurance companies and alternative risk transfer vehicles.
What is a Captive?

In short, a captive is a special purpose insurance company established to insure specific risks. It allows an entity (a company or individual) to form its own insurance company to “self-insure” and thus obtain greater control over the insurance purchase. In most cases a captive insurer’s owner and its customers (the Insureds) are one and the same, which results in captives being different from commercial insurance companies. Captives can however also write “third party” risks. Contrary to the understanding of many, captives are not purely for the benefit of PLCs or multi-nationals.

A captive is a registered and authorised insurance company established to write all or part of the risks of a company, its affiliates, or for the members of a group. Traditionally they are subsidiary companies of their parents (whose risks they underwrite) however there are now numerous additional uses for such vehicles - including the writing of third-party risks. Captives are used by PLC’s, private companies, the public sector, trade associations, not-for-profit organisations and high net worth individuals, as well as by insurance brokers (for their client insurance risks).

Commonly located in an offshore domicile, the captive will be licensed by the local regulator to operate either as an insurance or reinsurance company (or perhaps both).

Generally an insurance company must be licenced to write risks in the country in which it issues its policies. In such circumstances, the captive will write insurance directly. In some jurisdictions however the parent company or its subsidiaries may not be permitted (by local legislation) to insure certain classes of business directly with the captive and in these circumstances the risk is often initially insured with a local commercial insurance company. That commercial insurer will then reinsure the risks into the captive. (see Fronting)

A captive may also transfer some or all of the risk to commercial reinsurers. (see Reinsurance)

A captive can write a wide variety of risks, including Property and Business Interruption, Liability, Transit, Professional indemnity, Credit and Warranties, as well as Employee Benefits (such as healthcare or death-in-service).

Why Offshore?

Historically captives were often established in offshore jurisdictions for favourable taxation treatment, however these days the tax benefits have been largely eroded. The major benefits of an offshore located captive now are the reduced capital requirements (when compared with an onshore insurance company) and the more accessible, and generally more flexible, regulatory bodies.
Why Form a Captive?

Generally captives will be formed under the following situations:

- The insured loss record is better than average and a desire exists to reduce premium expenditure and / or participate in the underwriting profits, or
- The insured loss record is particularly poor and insurance coverage in the conventional marketplace is either considered too costly or is not available.

The object of a captive is to provide a self-insurance programme that will fund predictable losses and both reduce and stabilise the cost of the insurance to the Insured. In addition, in a carefully managed programme, profits will be earned and a return on capital will be achieved.

**Reinsurance**

Invariably the premium level paid into the captive is insufficient to cover the overall aggregate amount of risk exposure insured within it (for example, large individual losses, such as property damage or liability claims, or perhaps the accumulative effect of a large number of smaller losses). A reinsurance programme is therefore assembled to protect the solvency of the captive.

Reinsurance provides a number of beneficial factors for a captive. Primarily it increases the underwriting capacity of the captive by allowing it to insure risks in excess of the premium paid in. In addition, reinsurance stabilises the underwriting results and provides protection from catastrophic losses.

Reinsurance is purchased on a wholesale basis and is therefore generally cheaper than buying primary, or direct, insurance. A reinsurance company does not have the same overheads, staff, or marketing costs as an insurance company.

**Fronting**

Fronting is a term that describes a particular form of reinsurance frequently employed by captive insurers. Commonly, a commercial insurer licensed in the jurisdiction from which the risk emanates issues a policy to the Insured. Subsequently, the risk is transferred to a captive insurance company by way of a reinsurance contract, also known as a fronting agreement. The insured (policyholder) receives a policy written by the licensed commercial insurer, but the economic risk of that policy transfers into the captive insurance company. In some jurisdictions, it is a legal requirement for either all or certain classes of business to be written by a local insurer. Hence, if the captive is established in a domicile other than that where the risk resides, then fronting arrangements are mandatory.

Fronting insurers, who are fully regulated and supervised in their home jurisdictions, may retain an element of the primary risk they insure, or may cede 100% of the risk into the captive (re)insurance company.
It is well known that the conventional insurance market can frequently fail to adequately meet the needs of the buyer. Criticism usually falls into one, or more, of three categories – price, cover, and service.

The primary motives for creating a captive are to:

- Help match insurance costs to the experience of the company (or group) such that a good loss experience is rewarded;
- Retain more risk and thereby reduce external insurance costs: At the lowest level this takes the form of retaining, financing and managing predictable losses in a cost effective manner. However most captives assume a greater level of risk;
- Pricing stability: Provide a degree of insulation from the insurance market cycle which is often unconnected to the performance of the company or group;
- Enhance risk management strategy: greater corporate awareness of the overall cost of risk
- Market leverage: A mechanism to provide pressure on traditional insurance markets;

**Principal advantages**

- Potential underwriting profit
- Premium costs related to own loss experience as opposed to the insurance market’s view of the industry segment in question
- Access to reinsurance markets not available in the retail insurance market
- Investment income on premium and loss reserves
- Cash flow benefits
- Possible improvements in policy wording / coverage not available in the conventional market

**Possible disadvantages**

- Exposure to potential losses which can erode capital
- Capital and solvency requirements
- Running costs / Management time
Types of Risk Carrying Vehicles

Essentially there are three main types of formal insurance vehicle through which self-insurance or reinsurance can be conducted:

**Captive Insurance Company**
Referred to as “pure” captives, these are invariably wholly owned subsidiaries of their non-insurance parent company. When first formed, a pure captive for a large organisation will usually begin by participating in the high frequency/low severity element of an overall insurance programme. As the captive becomes more established, with a stronger balance sheet, it may look to write a wider range of risks, ie, those with medium frequency / manageable (or high) severity.

**Protected Cell Company (‘PCC’) / Incorporated Cell Company (‘ICC’)**
A cell company can be described as a standard limited company (referred to as “the core”) that has been separated into legally distinct portions (or cells). The assets and liabilities of each cell are kept separate from all other cells. An ICC involves the formation of separate, legally recognised cells within the overall structure, with each cell established as a separate incorporated company. This is in contrast to the traditional PCC where all the cells combine to create one legal entity and each cell is not treated as a separate legal personality. Some larger organisations have sponsored their own cell company (as opposed to a pure captive) and segregate their different classes of risk in separate cells.

**A cell within a PCC or ICC**
The use of a cell within a cell company can provide a means of entry into the captive insurance market to entities for which it was previously uneconomic. The overheads of a protected cell captive can be shared between the owners of each of the cells, making the captive cheaper to run from the point of view of the insured. Each cell has its own separate portion of the PCC’s overall share capital, allowing shareholders to maintain sole ownership of an entire cell while owning only a small proportion of the PCC as a whole. A number of insurance managers and brokers sponsor their own cell company to permit access to self insurance vehicles for use by their clients.

All of these vehicles can achieve specific risk financing and / or risk sharing objectives depending on the needs of the sponsor and specific structuring requirements.
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