Purpose and Characteristics of Captive Insurance Plans

Activity 1—Describing Captive Insurance Plans

Questions	Answers
1. What is a captive insurer?	
2. What tasks does a captive perform for its parent company?	
3. Why would captive insurers purchase reinsurance, usually on an excess of loss basis?	
4. What are some of the characteristics of a common captive insurance plan?	

Answers for Activity 1—Describing Captive Insurance Plans

Questions	Answers
1. What is a captive insurer?	A subsidiary formed to insure the loss exposures of its parent company (or companies) and affiliates whose primary purpose usually is to reduce the parent's cost of risk.
2. What tasks does a captive perform for its parent company?	• Collects premiums • Issues policies • Pays covered losses (both first-party and third-party losses) • Captive insurers often retain losses to a certain point and transfer losses to a reinsurer beyond that point.
3. Why would captive insurers purchase reinsurance, usually on an excess of loss basis?	To transfer some of their loss exposures to another insurer. Reinsurance provides a captive insurer with the ability to cap the losses paid by the captive.
4. What are some of the characteristics of a common captive insurance plan?	• Usually contains aspects of retention and transfer (hybrid plan) • Covers low to medium loss severity • Losses are usually funded • Substantial administrative requirements

Types of Captive Insurance Plans

Activity 1—Describing Types of Captive Insurance Plans

Questions	Answers
1. An arrangement under which an organization rents capital from a captive to which it pays premiums and receives reimbursement for its losses.	
2. A captive insurer owned by a group of companies, usually operating similar businesses, rather than a single parent.	
3. A captive insurer owned by one company that insures all or part of the loss exposures of that company or its subsidiaries.	
4. A type of group captive that is owned by insurance agents or brokers rather than by the organizations insured.	
5. A group captive formed under the requirements of the Liability Risk Retention Act of 1986 to insure the parent organizations.	
6. A corporate entity separated into cells so that each participating company owns an entire cell but only a portion of the overall company.	

Answers for Activity 1—Describing Types of Captive Insurance Plans

Questions	Answers
1. An arrangement under which an organization rents capital from a captive to which it pays premiums and receives reimbursement for its losses.	What is a rent-a-captive?
2. A captive insurer owned by a group of companies, usually operating similar businesses, rather than a single parent.	What is a group captive?
3. A captive insurer owned by one company that insures all or part of the loss exposures of that company or its subsidiaries.	What is a single parent (or pure) captive?
4. A type of group captive that is owned by insurance agents or brokers rather than by the organizations insured.	What is an agency captive?
5. A group captive formed under the requirements of the Liability Risk Retention Act of 1986 to insure the parent organizations.	What is a risk retention group?
6. A corporate entity separated into cells so that each participating company owns an entire cell but only a portion of the overall company.	What is a protected cell company?

Advantages and Disadvantages of Using a Captive Insurance Plan

Activity 1—Advantages and Disadvantages of Captives

Give a brief description of the advantages and disadvantages of captive insurance plans.

Advantages	**Disadvantages**

Answers to Activity 1—Advantages and Disadvantages of Captives

Give a brief description of the advantages and disadvantages of captive insurance plans.

<table>
<tr><th>Advantages</th><th>Disadvantages</th></tr>
<tr>
<td>
Reducing the Cost of Risk

Captive insurance plans eliminate insurance expenses such as acquisition costs, underwriting expenses, insurer overhead and profit.
An efficiently operated captive distributes the administrative costs across multiple members
Allows investment income from the cost savings and on funds held as loss reserves

Benefitting From Cash Flow

Captive earns investment income on premiums not paid to the insurer

Obtaining Insurance Not Otherwise Available

Can obtain insurance coverage that is not available in the commercial market

Having Direct Access to Reinsurers

Direct access to reinsurance markets creates flexibility in underwriting and rating
By removing the direct commercial insurer, the insured organization saves substantial markup costs

Negotiating With Insurers

Existence of a captive insurer can improve an insured’s negotiating power with commercial insurers

Centralizing Loss Retention

Centralization can result in savings to the insured organization because of the lower long-term cost of retention

</td>
<td>
Capital and Start-Up Costs

A captive insurance plan involves a commitment of capital and start-up costs not incurred with other risk financing plans
Return on capital invested in a captive are typically less than the cost of capital
Capital must be committed for many years

Sensitivity to Losses

Captive insurance plans involve retention of losses, a potential disadvantage of their use
If the losses retained are higher than forecasted and exceed allocated funds, the financial solvency of the captive and the payment of the parent company’s losses is jeopardized

Pressure From Parent Company Management

Captive insurers must insure the risks required by their parents, even if the risk is not desirable
The reinsurer of the captive will likely be sensitive to overt pressure from the parent’s management that may cause the captive’s underwriting standards to be too lenient or premiums too low

Premium Taxes and Residual Market Loadings

The losses retained by a captive insurer are paid for by the parent company as a premium on which premium taxes and residual market loadings are levied

</td>
</tr>
</table>

Potential Cash Flow Advantages on Taxes • General rule is that premiums paid to commercial insurers are deductible, but only paid losses by captives are deductible • May be able to deduct premiums paid by parent to captive if there is risk shifting and risk distribution • Many tax advantages from offshore arrangements have disappeared in recent years **Loss Control** • Because a captive insurance plan involves retention, an insured organization that controls its losses is able to save payments for losses and loss expenses • Captive insurers can offer specialized risk control services that are similar to other commercial insurers **Obtaining Rate Equity** • A captive insurer has the rating flexibility to charge premiums that may more accurately reflect the predicted losses of its parent(s) and affiliates • If the captive has sufficient loss experience, it can better evaluate commercial insurance premiums that are being offered	