Perspectives

# Captives 101:

## Managing Cost and Risk

TOWERS WATSON

Although many people think captive insurance companies are a relatively new phenomenon, they have existed in some form since the 1870s, when the first protection and indemnity clubs were created. However, growth of the captive market was slow, and only about 100 captives were formed until the 1950s. The real growth of captives began in the 1960s in the Bermuda market. Fred Reiss, who coined the term “captive,” formed a management company in Bermuda in 1962 and convinced many of his corporate clients to form captives. The 1970s and 1980s represented a period of tremendous growth in captives in response to a hard insurance market and difficulty obtaining product liability coverage. There are roughly 5,400 captives in existence today compared to just over 1,000 in 1982 *(Figure 1)*.

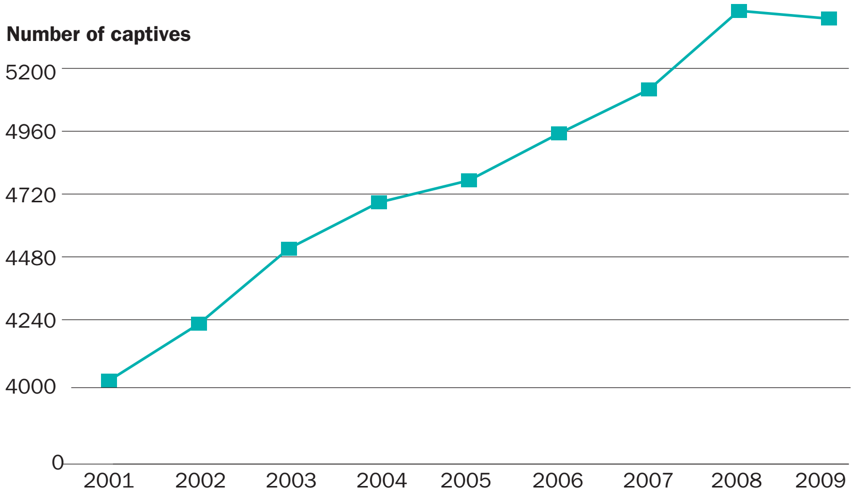
Captive insurance is big business. More than 40% of major U.S. corporations and many multinational companies own one or more captives.

*Business Insurance* estimates there to be 5,390 captives at year-end 2009. Fifty-three percent of these are in five domiciles as shown below.

| Domiciles | Number of captives |
|---|---|
| Bermuda | 885 |
| Cayman Islands | 780 |
| Vermont | 560 |
| Guernsey | 355 |
| British Virgin Islands | 285 |

This primer on captives defines them and discusses the forms they can take.

**Figure 1. Recent Growth in Captives**




Source: *Business Insurance*

We also describe captive operations, and explore the reasons for forming a captive and the issues to consider in determining whether a captive is right for your organization.

## Captive Insurance Company Defined

A captive is a bona fide insurance or reinsurance company. Its business is primarily supplied by and controlled by its owners, which are also normally the principal insureds. These owners/insureds participate in controlling the underwriting, claim and investment decisions of the insurance company. A number of different types of captives exist:

- Single parent or group
- Direct writing or fronted
- Onshore or offshore
- Agency captive
- Risk retention group
- Property/casualty only or life/benefits only (sometimes a mix of the two)
- Writers of related business or some unrelated business
- Primary or excess layer captive
- Stock, mutual or reciprocal
- Rent-a-captive, cell captive or sponsored captive

All entities called “captives” are not the same. In fact, some are not considered captives in the strict sense, including:

- **Agency (or program business) captives:** Sometimes called producer-owned reinsurance companies (PORCs), these captives are frequently offered by insurance companies to keep their better agency clients or are formed by insurance agents and industry associations to align the financial interests of their groups with insurers. The owners and the insureds are not the same — in fact the insureds may not even know that their risk is reinsured by a PORC.
- **Special-purpose or transformer vehicles:** These are entities that transform insurance exposures such as catastrophes into marketable securities such as investment-grade bonds. These vehicles use the capital markets, not the insurance markets, to finance risk.

## Reasons to Form a Captive Insurance Company

There are many reasons for starting or continuing to use a captive insurance company. These reasons tend to change in priority over time as the needs of the owners evolve. For example, during hard insurance market cycles, cost and capacity are key drivers for the use of a captive insurance company. Owners have started or continue to use a captive in order to:

- **Reduce or stabilize cost:** Typically, financing risk in a captive lowers overall costs and helps an organization to stabilize costs over the long-term because it is less susceptible to the vagaries of the insurance market. Cost savings include no profit load, elimination or reduction of broker commissions, and lower administrative costs. The owners share in all earnings through policyholder dividends or shareholder dividends. Another element of savings is the avoidance of costly insurance regulations, including payments into residual market pools and state premium taxes. Loss-cost savings might also be achievable where the captive serves to heighten risk management and cost awareness of senior management and operating management. These savings often exceed the cost of setting up and running the captive.
- **Increase capacity and provide access to reinsurance:** Captives by themselves offer only limited capacity. Captives can, however, access the capacity of the reinsurance markets and may be able to offer more limits of coverage than are available in the retail market. For example, multiple reinsurers may participate on a "slip" to offer millions of dollars of additional capacity that would not otherwise be available.
- **Exert control:** Captives were originally formed by insurance buyers who were tired of the vagaries and cycles of the insurance market. They sought control of underwriting, rates and forms, as well as control of claim settlements and investments.
- **Provide coverage:** Captives can provide coverage to subsidiaries and members that would not otherwise be available. These include professional liability, punitive damages and business risks.
- **Provide freedom of rate and form:** A direct-writing captive can offer specially tailored wordings, which reinsurers may then follow.
- **Establish better-than-average claim experience:** The claim history of the captive's insureds may be better than the overall class of business for a commercial insurer. If so, there is a good argument for retaining the risk in a captive rather than subsidizing the poor claim experience of competitors.
- **Recapture investment income and accelerate/manage cash flow:** Corporate treasurers like captives because the investment income that usually stays with commercial insurers may be wholly or partially recaptured in a captive.
- **Take advantage of insurance accounting:** Insurance companies get special tax treatment; they can accrue tax-deductible reserves for unpaid claims, whether known or estimated, and in the case of life insurance reserves, pay no tax on inside build-up of interest income. Furthermore, tax accounting for non-insurance companies with captives has been trending toward a similar treatment.
- **Take advantage of tax deductibility:** There are still tax advantages to be gained by using captives, especially those with multiple owners or insureds and those where the insureds and the shareholders are not the same. Deductibility of premiums and deferred taxation of insurance income are the two principal advantages. Tax issues can be a major driver, but they should not be the only reason for forming a captive. If they are, the captive might not stand up under the scrutiny of tax authorities and regulations. Before considering a captive, a company should seek the advice of qualified legal counsel.

"We formed a captive because of reduced capacity in the property insurance market. We were well on our way when 9/11 happened and would have otherwise been exposed to serious coverage gaps for our physical property around the world."

*— Richard Sarnie, former Director of Risk Management, Engelhard Corporation*

> "There are clear-cut financial reasons for using captives as well as nonfinancial reasons — and sometimes the nonfinancial reasons turn out to be more important in the long run."

- **Offer perceived "safety" of formalized services:** Captive books and records are audited; the reserve for claims is reviewed by actuaries; their investments are managed by investment professionals, and their accounts are maintained by independent managers. All of these services formalize the risk financing process. In many cases, formalized services are perceived by captive owners to be superior to unformalized in-house services, unallocated funding or no funding whatsoever.
- **Take advantage of favorable regulations:** Some captives are formed offshore to escape unnecessary insurance solvency regulations. Offshore captive insurance solvency regulation, like onshore captive solvency regulation, is designed to protect policyholders. Some believe captive regulation is weak. However, in well-regulated domiciles, such as Bermuda and Vermont, regulation is not lax and permissive.
- **Provide administrative tool to fund retentions:** Large organizations often create and maintain captive insurance companies to fund the difference between their large corporate deductible or retention and the relatively small deductible or retentions sought by the organization's individual business units. By using a captive, the central organization can offer fixed-cost insurance to the business units above modest deductibles while retaining the potential variability for losses within the overall organization's risk-bearing capacity.
- **Support risk management:** The financial "stick" provided by the captive can be combined with a reward "carrot" to influence operational behavior. It also gives the risk manager more leverage in the organization than an annual cost allocation process does by itself.
- **Increase access to innovative deals:** A captive can help provide access to certain deals. Some of the more innovative arrangements include loss portfolio transfers and relief derived from transferring liabilities from one balance sheet to another.
- **Warehouse data:** A captive can provide the organization with a tool for collecting more and better data to support its cost management efforts. For example, a captive can serve as a central information repository for common disability cost management purposes as an organization finances select employee benefit risks (e.g., short-term or long-term disability) along with its workers compensation risks.
- **Support strategic partners:** Organizations can make coverage available for their various business partners, such as key suppliers or customers, independent contractors or attending physicians, when the traditional market's price or terms are unfavorable. This approach might also provide profit and tax management advantages to the captive's parent.
- **Make a profit:** Some captives are formed specifically to underwrite a customer's risks or offer third-party insurance. Although they should not be called captives, they sometimes are. These entities can add value to an organization by tying customers to the owner and offering a stream of profits.

There are clear-cut financial reasons for using captives as well as nonfinancial reasons — and sometimes the nonfinancial reasons turn out to be more important in the long run.

## How Captives Are Structured

Captives have three primary components: financial, operational and people.

The financial resources of captives include premiums, capital and investment income. Premiums or capital may be contributed in non-investment instruments, such as a letter of credit. These financial resources must be sufficient to:

- Finance the legal obligation of the captive as part of its insurance or reinsurance agreements
- Finance a reasonable level of adverse development
- Fund the ongoing expenses required to operate the captive

To the right, we present a graphic representation of the financial resources and obligations of a captive *(Figure 2).*

The operations of a captive are somewhat similar to those of a traditional insurer. A captive issues direct policies to its insureds or reinsures a fronting insurance company, collects the premiums and pays the claims. It also sets aside reserves to pay its legal obligations arising from the insurance or reinsurance agreements, pays for its operating expenses and pays dividends to insureds/owners. In addition, it earns investment income on the invested assets. *Figure 3* shows the operational framework of a group captive.

Three related groups operate a captive: outside service providers, the captive's officers and a board of directors. Few captives have their own employees. Instead, most use captive management companies to perform the day-to-day operations, maintain a set of books and records, and serve as liaison with the board and regulators. Captives also use specialty service providers, such as accountants, actuaries and legal counsel. Service providers report to the board of directors, which sets captive policy. The board may establish committees (e.g., claim, underwriting, audit/finance, executive) to help set policy, and it delegates the execution of policy to officers, such as the president or secretary *(Figure 4).*

## Examples of Captives

The following three examples illustrate the financial and operational framework of captives.

### Example 1: Property/Casualty Coverage in a Vermont Captive

**Problem: Availability of reasonably priced insurance for loss of service or failure of equipment.** A U.S. telecommunications company insures its own property and casualty risks with a traditional insurance company. However, the policy has a deductible feature for the first $500,000 of each claim. Operating divisions and locations are simply too small to absorb a single large claim, so the company has established a captive to indemnify and reimburse the operating divisions and locations for their legal obligations relating to the deductible. Corporate-wide premiums for the deductible indemnification are equal to $5 million, based on actuarial analysis of the exposure. The

**Figure 2. Financial Resources and Flow of Funds**

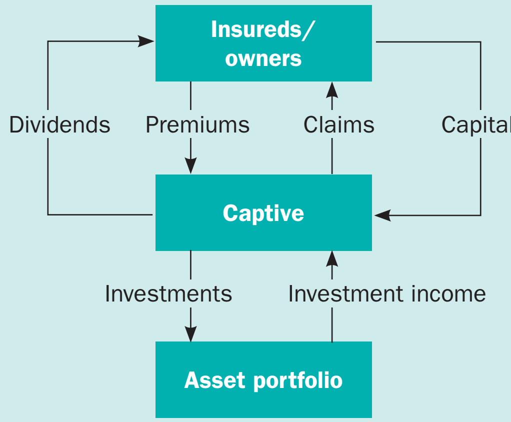



**Figure 3. Group Captive Operational Schematic**

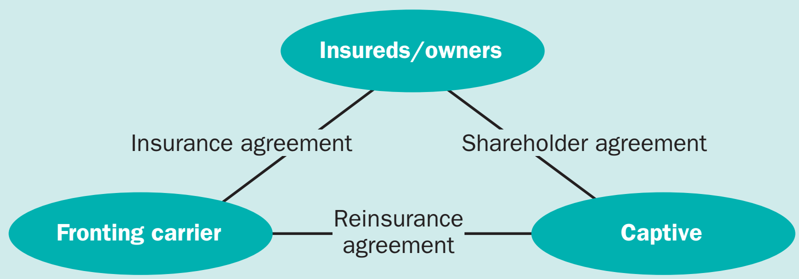
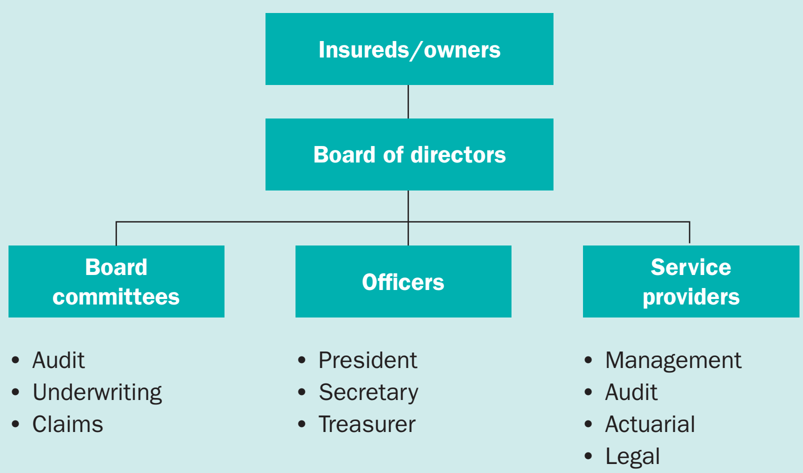



**Figure 4. Organizational Framework**




> "Synernet Re formed a captive to ensure access to insurance and reduce costs. As the board understood the market better, we've seen our way to taking on all of the risk and operating as our own insurance company."
>
> *— Russell A. Peterson, President, Peterson & Associates*

"Where an actuarial study has established the confidence level of the estimates, a captive insurance program will make a better impression on regulators, reinsurers and tax advisors."

captive indemnifies the telecommunications company for its legal obligations under the deductible agreement. As claims are paid by the telecommunications company, it is reimbursed by the captive.

The captive also reinsures warranty claims from the telecommunications company's customers that arise due to loss of service or failure of equipment. The "fronting"* insurer executes a reinsurance agreement to transfer the first $250,000 per claim to the captive. The premiums for warranty coverage amount to $2 million, of which $1.5 million is transferred to the captive through the reinsurance agreement. The warranty program is considered unrelated business and has a net benefit regarding the tax position for the premiums relating to the property/casualty deductible program. (Refer to the "Tax Issues" section for more on the reasons why unrelated business can be beneficial.)

Underwriting is performed by the risk manager of the telecommunications company. Claims are handled by a third-party administrator, subject to the oversight of the risk manager and claims committee of the captive board. Operations are handled by a Vermont-based management company. The parent company's independent audit firm also conducts a captive audit. Investments are handled by the treasury department of the parent. Actuarial services are provided by an independent actuarial consulting firm.

### Example 2: Group Medical Professional Liability Coverage in a Cayman Captive

**Problem: Lack of affordable medical malpractice insurance.** A group of 12 nonprofit hospitals within a single health care system retain the first $10 million of each claim for their medical professional liability exposure. A captive domiciled in the Cayman Islands provides an indemnification policy to pay for the claims arising under the $10 million self-insured retention. The captive is said to operate on a gross-line basis as it secures reinsurance in layers for $9 million excess of $1 million per claim. The captive retains the remaining $1 million per claim, referred to as a "net line."

Annual premium charged by the captive for the hospitals' liability exposures is $10 million a year. The hospitals contribute their share according to a formula based on revenues, bed count and past loss experience. The reinsurance cost is $2 million, so the net premium to the captive is $8 million. The loss projections indicate the captive will pay between $9 million and $10 million for the claims within its $1 million net line. Although it appears that claims will be higher than premiums, the consulting actuary has determined that investment income from assets will be sufficient to cover the premium deficiency.

The member hospitals also sponsor a program for their attending physicians. The physicians are insured by an A-rated insurance company — licensed and authorized by insurance regulators. The insurance company issues policies to the doctors and handles their claims. The captive executes a reinsurance agreement with the insurance company to reinsure the individual liability for attending physicians. The physicians receive an insurance policy from the insurance company, not the captive, and they do not participate in the good or bad results of the captive. The physicians' program is considered unrelated business. However, in the case of the nonprofit hospital group, there may be adverse tax consequences for the captive.

The hospitals participating in the captive share in the bottom-line results according to a formula that takes into account how much they paid in and their cumulative loss experience. Investments are managed by an independent investment advisor that charges a fee, and are generally in a mix of U.S. and non-U.S. investment-grade, fixed-income instruments.

### Example 3: Employee Benefit Coverage in a Bermuda Captive and a Vermont Branch Captive

**Problem: Needed more efficient ways to finance employee benefit risks.** A large industrial company uses its captive to reinsure death, disability and lump sum benefits of its non-U.S. employees. It has also obtained a Department of Labor (DOL) waiver to reinsure some of the benefits of U.S. employees in a U.S.-domiciled branch of the Bermuda captive.

The company has operations in 12 countries outside the U.S., with a total of 15,000 non-U.S. employees. A pooling insurer has agreed to issue policies covering death, disability and survivors' benefits to local

**Fronting company:* An insurer serving as a front, for a predetermined price, will issue a policy written on its paper to cover a risk, sometimes insuring only a small percentage of it and reinsuring the majority or all of the risk to a captive. For example, a fronting company may be used where the captive needs evidence of insurance from a recognized insurer. The front usually provides insurance services on behalf of the captive.

employees in all these countries, collect premiums, and handle claims. In doing so, it is providing the same service as the fronting company in the previous example. The risk is reinsured with the captive in Bermuda. The captive takes as much of the risk as possible, usually 90% or more. Since the amount per claim is relatively modest, up to $250,000 per person, the captive only needs to buy catastrophe reinsurance protection. The annual net captive premium is estimated to be about $3 million. Annual claims are expected to be $2.5 million to $3.25 million.

The U.S. owner has licensed a branch of the Bermuda captive in Vermont. The branch captive applies for permission from the U.S. DOL to reinsure benefits for the company's U.S. employees. This structure requires that a licensed, A-rated fronting insurance company issue policies to employees, collect premiums and pay claims. (ERISA exemptions and other issues are discussed in more detail later in this paper.) The annual premiums and losses for the U.S. business are not expected to be more than $2 million. Investments are managed by an external manager, as in the previous example.

> "Our captive puts us in the driver's seat for managing costs and provides even greater incentives for us to control our risks."
>
> *— Russell A. Peterson*

## Major Issues for Service Providers

The issues associated with captives fill many books, are the subject of numerous annual conferences and create full-time jobs for service providers. Captive owners and participants, as well as their service providers, need to be acquainted with these issues or know someone who is. The main issues are discussed briefly below.

### "Numbers" Issues

- **Actuarial projections:** Most jurisdictions require actuarial analysis as part of a feasibility study. Premiums and losses for business plans should be based on this analysis. Where an actuarial study has established the confidence level of the estimates, a captive insurance program will make a better impression on regulators, reinsurers and tax advisors. Ongoing actuarial analysis is also required in most domiciles, particularly when a professional opinion is required on the captive's reserve position.
- **Expenses:** A captive should operate more efficiently than a commercial insurance company. Captive expenses should be below 20% of premium, unless there is a compelling reason for a higher ratio (e.g., strong dedication to loss control).
- **Investment results:** Most captives set premiums to reflect the time value of money. The implicit assumption is that investment returns will at least equal the amortization of the discount in premiums over the course of time. Some captives use letters of credit as assets — and these assets do not generate investment income. The investment policy should be aligned with the assumptions used to set premiums.

### Tax Issues

Since the subject of taxation is vast and ever-changing, it is important for companies to get advice from qualified tax counsel. There are four areas of taxation of particular importance to captives: state or domicile premium taxes, U.S. federal excise taxes, U.S. income tax and the 953(d) election.

- **Premium taxes:** When premiums are paid to an insurance company, local state premium taxes are due. Sometimes these take the form of self-procurement taxes. Although some captive owners find ways to avoid paying these state taxes, most captives must pay them. These taxes generally approximate 3% to 4% of premiums. Some captive domiciles, such as U.S. domestic domiciles, apply a premium tax to premiums as well. This rate is usually less than 1%, but it can be a significant amount in large transactions.
- **Federal excise taxes (FET):** An insurance or reinsurance agreement with offshore insurance companies, including captives, is viewed as the "importation" of a service and subject to FET. Premiums for property/casualty exposures paid by U.S. payers to offshore captives are subject to FET, which is 4% for insurance transactions and 1% for reinsurance transactions. All life business, whether direct or reinsurance, is subject to 1% FET. These taxes do not apply to countries with which the U.S. has a tax treaty, such as Ireland and the U.K. However, premiums sent to those treaty countries must not then be transferred to non-treaty countries; if they are, then FET applies.

- **U.S. income tax:** There are two key issues regarding U.S. income tax: deductibility of the premium and taxation of the captive's income. Premiums paid to captives are not deductible unless some or all of the factors below exist:
  - The transaction is a bona fide insurance transaction, with the captive taking some risk, under a defensible business plan.
  - The captive's owner is organized such that subsidiaries, not the parent, pay premiums to the captive under a "brother-sister" relationship.
  - The captive writes a substantial amount of unrelated business. (Thirty percent is sometimes mentioned as "enough.") Some employee benefit business is considered "unrelated" if structured properly.
  - The captive's ownership is arranged so that the insureds are not the same as the shareholders.

The good news is that premiums paid to multiple-owner or group captives usually are deductible. Owners of nonprofit captives are less concerned with tax deductibility. In fact, they seek to structure the transaction with their captives as self-insurance, rather than insurance, to optimize their tax position. Deductibility of premiums paid to rent-a-captives or cell structure captives may or may not be deductible, depending on the situation and evolving tax treatment. Advisors sometimes differ in their views on the tax treatment of these vehicles. When there is disagreement or doubt, the tax authorities make the final determination.

Taxation of the captive's income varies by domicile. If the captive is domiciled offshore where income tax rates are usually zero, it pays no tax directly. However, the U.S. owner of the captive has to declare all its profits as if earned in the current year and include that amount in its taxable income through Subpart F of the IRS tax code. If the offshore group-owned captive is owned by U.S. entities, then each of them has to include its proportional share of the current income in its own tax return. If the captive is domiciled onshore, its earnings can be consolidated with the single-owner parent for tax purposes. If it is a multiple-owner captive onshore, it is treated as a taxable entity in its own right.

Owners of nonprofit offshore captives are generally not concerned about taxation of the captive's income unless the captive writes too much unrelated business income (such as the doctors' insurance in Example 2). Unrelated business income can "taint" the whole captive's income, or be segregated into a separate captive by nonprofit owners.

Non-U.S. owners of captives writing U.S. risks such as employee benefits are not governed by the same rules and therefore sometimes have a decided advantage over U.S. owners of captives.

- **953(d) election:** Under Section 953(d) of the Internal Revenue Code, certain foreign insurance companies (e.g., captives) can elect to be treated as domestic companies for U.S. federal tax purposes. These companies are then subject to U.S. federal income tax directly, rather than subjecting their U.S. shareholders to tax on income (Subpart F) earned by the companies. There are several advantages to making an election, including exempting premiums paid to an electing company from federal excise tax and branch profits tax generally, and simplifying compliance and administration. There are also disadvantages to making an election. The primary disadvantage is that the election is irrevocable, unless IRS consent to revoke is received.

## ERISA Issues

It may be advantageous to both companies and their employees to finance employee benefit plans with captive insurance. Plans that are candidates for this type of financing include group term life, short-term and long-term disability, and retirement plans.

In order to protect workers and their benefits, the Employees Retirement Income Security Act of 1974 (ERISA) prohibits fiduciaries of ERISA benefit plans from executing financial transactions with "parties in interest" that involve "plan assets." Captives that are more than 50% owned by the employer-sponsor of employee benefit plans are considered parties in interest, and assets set aside to finance employee benefit plans are plan assets. Therefore, captives are generally prohibited from insuring or reinsuring benefit plan liabilities unless they qualify for an exemption from the DOL, which administers ERISA.

> "Captives are not for everybody, but for the companies out there that really understand how to manage risk and are not just looking to buy insurance."
>
> *— Richard Sarnie*

The DOL has granted waivers or prohibited transaction exemptions (PTEs) to plan sponsors and captives to allow them to insure benefit programs. There are two types of exemptions available — class exemptions and individual exemptions.

- **Class exemption:** Under DOL PTE 79-41, an employer-sponsor can insure benefit plan liabilities with a captive without explicit DOL approval if several conditions are met, including but not limited to the following:
  - The insurance is issued on a direct basis.
  - The captive is licensed in at least one U.S. state or territory.
  - 50% or more of the captive's premiums are unrelated.
  - The captive has at least one year of audited financial statements.
  - The transaction includes no commissions.
- **Individual exemption:** The DOL grants individual PTEs if, after reviewing an application, it finds that the exemption is protective of the rights of plan participants. There are two ways to gain an individual PTE:
  - Individually, where the applicant presents its own facts and circumstances for captive insurance. The review process can be lengthy and difficult, taking up to a year, depending upon the complexity of the transaction.
  - Under the DOL's expedited procedure rules (EXPRO), where the applicant follows the structure and process established by the Columbia Energy and Archer Daniels Midland exemption requests. In this case, the review process will take 77 days or less. The applicant's proposed transaction must meet the following to qualify, including but not limited to:
    - The insurance is issued on a reinsurance basis and fronted by an "A" or better rated company.
    - The captive is licensed in at least one U.S. state or territory to write employee benefit insurance.
    - The captive has at least one year of audited financial statements.
    - The transaction includes a benefit enhancement for the employees.
    - An independent fiduciary has been appointed to opine on the substance of the reinsurance and the fairness of the premiums.

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### Issues on Ratios and Regulations

Regulation of captive insurance companies in captive domiciles often takes the form of monitoring certain leverage ratios or amounts. The more important ratios include:

- **Risk gap:** The difference between the captive's net retained limit and the sum of premiums plus capital is viewed as the amount at risk and is called the "risk gap" in some domiciles. Owners and managers have to demonstrate that the captive has reinsurance protection for the risk gap, or guarantees of more premiums (or capital) in case they are needed.
- **Solvency ratio:** This misnamed ratio is the maximum level of premiums a captive is supposed to write net compared to its capital and surplus position. In Bermuda, it is 5:1 up to $6 million in premium and 10:1 above that for most captives. This same limitation does not apply to life insurance in Bermuda. Onshore, and in some offshore domiciles (Cayman Islands, for instance), a ratio of 3:1 is used as an unofficial maximum. The solvency ratio is meaningless for most captives because their risk profile is quite different from the profile of the kind of insurers this ratio was designed to regulate. In fact, most large captives write to a ratio of less than 1:1.
- **Loss reserve ratio:** The proportion of loss reserves to capital and surplus is important to some regulators, especially if they think there is the possibility that the reserves are understated. The proportion of 4:1 for property/casualty captives is sometimes used, although in Bermuda up to 10:1 is permitted.
- **Retention ratio:** From a financial ratio perspective, this is the amount of per-occurrence risk retained net by the captive compared to its capital and surplus position. Captives, especially start-ups, generally expose 10% to 25% of their capital and surplus to a per-occurrence loss. This is higher than for traditional insurers, which cannot expose more than 10%. Some captives operate at ratios of 50% to 100%.

Captive risk-transfer partners think of the retention ratio in another light, namely the amount of risk retained in the captive compared to the amount reinsured or left with the fronting company. One fronting company requires 25% risk retention in the captive. While this ratio does not appear in regulations, it is often looked at with interest by domicile regulators. While some believe that the "amount of risk" is just the proportion of the total limit or proportion of premium, it is more than that. It is the proportion of expected loss and the variability of the expected loss.

> "A captive is a great tool for true risk managers to have in their toolbox for managing the cost of risk."
>
> *— Richard Sarnie*

## Evaluating Whether a Captive Makes Sense for Your Organization

To examine whether a captive makes financial and/or strategic sense, a feasibility study should be conducted. If the results of the feasibility study are positive, a more formal business plan is then developed.

### Feasibility Study

A feasibility study is a rigorous quantitative and qualitative assessment of the key aspects of a captive's business in relation to current operations and costs. The quantitative features of a feasibility study include coverage offering, premiums, capital and surplus, claim projections, reserves, expenses, reinsurance, investment income and taxes. The qualitative features include ownership, governance, domicile, structure of the transaction and management.

The feasibility study has three main components. The first is the design and structure of the coverage and the transactions for insurance and reinsurance. This component also includes discussion of the domicile and governance. The second component is a determination of the financial commitment required to support the design. Last is a comparison of the aftertax cost between alternative programs and an evaluation of qualitative issues.

The feasibility study should follow a methodical process and include the following major steps:

1. Collect and review relevant background information including descriptive background literature (e.g., marketing/service brochures, annual reports, audited financial statements), schedule of insurance (e.g., coverage lines, premiums, limits, retentions, insurers) and summary of historical annual risk financing costs

2. Hold a strategy session with management and outside experts (e.g., actuarial, tax and regulatory) to review information, confirm objectives/goals and discuss probable financial implications of captive formation. The agenda for this meeting typically includes:
   a. *Background and goals:* background information on history, ownership, organizational structure and governance; overall mission and goals; financials; insurance program; risk financing issues
   b. *Actuarial or data issues:* actuarial techniques to be used, additional loss data or exposure information needed, insurance company expense loads, other issues and concerns
   c. *Reinsurance marketplace overview:* review of market, future expectations, reinsurance options, issues and concerns
   d. *Tax and regulatory basics:* federal income taxes, federal excise taxes, state premium and self-procurement taxes, state income taxes, domicile taxes and fees, regulatory issues, insurance company structure options
   e. *Design:* discussion of possible relevant options and targeting of best option
   f. *Summary and next steps*
3. Develop projections of expected loss experience for relevant exposures
4. Estimate operational expenses associated with the captive and determine the captive premium
5. Advise on appropriate capital levels or margin for risk to support the written exposure
6. Describe qualitative factors that need to be considered relative to the formation of a captive, including:
   a. Comparison of domiciles and recommendation of location
   b. Discussion of structural parameters of a captive, including ownership, governance and control
   c. Review of ongoing management issues and required support services
   d. Discussion of whether a captive addresses other issues

> "Once you've decided to form a captive, hire the best professionals you can, whether that's legal counsel, tax counsel, the captive manager, investment advisor or actuary. All of these players have an integral part in the program's success."
>
> *— Russell A. Peterson*

7. Prepare pro forma financial statements presenting the balance sheets and income statements for a captive over a five-year period on an "expected case" basis and under alternative scenarios
8. Compare the proposed captive program to the current program, based on financial and nonfinancial criteria
9. Prepare and present findings

Once the decision to form a captive insurance company has been made, a company needs to develop a business plan, visit the selected domicile to meet with regulators and interview service providers, and prepare and submit an application. In addition, the company needs to secure reinsurance support and select service providers. Finally, the company needs to capitalize and fund the captive.

### The Business Plan

A well-thought-out business plan is the foundation of a successful company, and a captive is no exception. The components of a captive's business plan should be derived from its feasibility study, although the business plan may be organized and presented in a different format. The business plan will serve as a basis against which the owners/insureds can measure the performance of their insurance company annually. A modified version of the business plan will likely be provided to the regulators of the chosen domicile and will also serve as their benchmark for measuring the operations and performance of the company. A good business plan typically includes the following elements:

- Overview and purpose
- Program design and structure
- Structure of governance, including board representation, ownership and corporate form
- Coverage and limits offered, including underwriting policy
- Financial resources — premiums, capital and investments
- Reinsurance and risk management
- Claim management
- Safety and loss prevention programs
- Management and service providers
- Pro forma financial highlights, including "what if" alternative models showing the result of one or more bad loss years, unfavorable investment outcomes and any other likely downside scenario

## Conclusion

There has been tremendous growth in the popularity of captives over the past 25 years. However, while captive insurance companies can be valuable strategic tools, they are not always the best approach for every organization. In fact, in about one in four cases, they are found not to be feasible. Therefore, an organization considering a captive should follow a methodical approach to determine whether a captive is the right solution. In addition, it is important for any organization considering a captive to hire professionals experienced in actuarial, accounting, tax and legal issues.

If you would like to know more about forming a captive insurance company, or would like to learn more about Towers Watson's risk and brokerage services, please visit www.towerswatson.com/rab.

**Learn More About Captives**
Towers Watson Recognized and Accepted Captive Standards (TRACS) was developed by Towers Watson to help captive owners prudently manage and benchmark their captive operations. To learn more about this important management tool and other captive resource tools, such as the Captive Glossary, go to www.towerswatson.com/rab.

## About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.


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