



Evaluating the Single-Parent Captive Alternative: Part 1

As clients consider the various captive options currently available in the marketplace, one question that they need to ask is, “*Should I be considering a single-parent captive?*”

Some clients may be frightened by single-parent captives (“*Those are only for the really big boys!*”), and others may be too eager for them (“*I pay \$100,000 a year in premium. I want my own captive, no matter what!*”). Our role should be to help our clients evaluate whether they ought to truly consider a single-parent captive as a viable alternative.

Single-Parent Captives: Advantages

Single-parent or “pure” captives can offer unique and fully customized solutions. It’s important to keep in mind that pure captives generally do not transfer risk outside of their owner’s organization, and they are not a panacea for all insurance woes. A pure captive complements rather than replaces the client’s current insurance program, by providing a funding mechanism for existing self-insured or retained risks.

The simplest form of self-insurance does not involve a captive – the client just takes a higher deductible or self-insured retention and pays losses as they occur. *So why do people form and operate captives?* The clients that find significant value from pure captive ownership are generally looking to:

- Smooth the cost of retained risk over time through actuarial loss reserving methods.
- Provide an alternative to off-balance-sheet funding (of, say, a high deductible program) where such off-balance-sheet approaches are out of favor in today’s post-Enron environment.
- Save portions of their operating cash over time to pay for unexpected or “shock” losses.
- Pass through insurance costs to their customers, utilizing the captive to support reimbursable expenses related to total insurance costs.
- Lower the retained loss limit of their individual business units by offering “deductible buy-down” coverage through the captive.
- Smooth costs at the business unit level by charging a “guaranteed cost” premium via the captive, rather than charging business units for self-insured losses as they occur.
- Address situations where there is either a regulatory or a contractual requirement to demonstrate funding of certain retained liabilities.
- Operate their captive as a profit center, by participating in insurance products sold to their customers or other business affiliates
- Improve their overall net worth by consolidating captive assets on their balance sheet.
- Potential accelerated tax deduction by turning the loss fund into a tax deduction



A pure captive's chief advantage over other types of captives can be boiled down to one word: *flexibility*

- The captive owner is in full control of all operational aspects, such as lines of coverage, limits, service providers and captive domicile location.
- Virtually any line of coverage can be handled through a captive.
- Any surplus in the captive can be used to address the client's immediate needs, such as increasing captive retentions, insuring new lines of coverage, or reducing future premium requirements.

Single-Parent Captives: Challenges

Participation in any type of captive is a long-term undertaking. While many of the following issues would be encountered in any captive (in some shape or form), no single-parent captive discussion would be complete without mention of the possible drawbacks:

- A captive, like any other investment, requires an internal commitment in order to be successful:
 - Setting up a captive involves initial start-up capital and start-up expenses.
 - The captive's business plan must be put together and then approved by the selected captive domicile.
 - A captive has certain minimum annual operating costs.
 - If the loss experience is greater than expected, the captive may require additional funding.
 - The captive must be regularly monitored and evaluated by upper management.
- The tax complexities associated with captive ownership should be thoroughly discussed and evaluated.
- As a sole captive owner, the client will be 100% "on the hook" for all losses. There is no risk sharing as exists in a *group captive*. This is a double-edged sword. Although the client does not bear the burden of another participant's poor loss experience, the client also does not have the benefit of sharing its own large losses with others.

The Pre-Qualification Process

Before leaping into the time and financial commitment of a captive feasibility study, you can pre-qualify the client by asking certain basic questions, such as:

- What facets (if any) of the current insurance program are of greatest concern to the client?
- Is the client uncomfortable about any uninsured or underinsured areas?
- What are the current retained loss levels, loss history, premium-to-loss relationships, and the forecast for insurance market conditions for the client's class of business?
- What is the client's range of risk tolerance?
- What is the contractual or regulatory environment related to the client's insurance requirements.
- What is the client's current and future business growth profile?



- What factors would provide the most motivation for the client to move forward into a captive structure? Possible goals could include:
 - reduce cost by increasing retentions
 - fund for self-insured losses in a tax-efficient manner
 - smooth earnings impact
 - facilitate buy-down of corporate deductibles for operating units / subsidiaries / international operations
 - manage risk financing funds in a more controlled environment (i.e., pre-fund for retained losses)
- How important is the tax-deductibility of risk financing costs?
- What organizational or program elements are already in place to facilitate a tax-efficient captive structure (brother-sister relationships or third-party business)?
- As a general guideline, a client should have a minimum premium in the \$3 to \$5 million range in order to best rationalize a single-parent captive. However, many pure captives operate at premiums well below this level. If the insured's objectives include long-term cost smoothing, pass-through of insurance costs, or managing a program experiencing unjustified, market-driven increases, then reaching the above premium threshold becomes less of a factor.

The goal of this process is to identify the “burning” issues, goals of captive ownership, and possible benefits or barriers of captive participation. Once these issues are discussed, the client and agent can more easily evaluate whether a feasibility study would be of value. The mechanics of the actual captive feasibility study process will be covered in future installments of this publication, so stay tuned!

Comparison of Captive Alternatives – Supplement

Which captive alternative is right for me? Should I consider a single-parent, group, or rent-a-captive? While each client situation is unique, just as each captive program has its own distinctive features, one can refer to the following general guidelines. This is not meant to be an exhaustive list of all considerations.

Group captives:

- Are suitable when a client's premium volume is not large enough to warrant owning and operating its own single-parent captive.
- Are suitable when the entity is not in a high-risk class of business.
- Offer ease of entry and turnkey processing (?).
- Are generally structured to be tax efficient.
- Require only a nominal initial contribution of capital to join (in addition to the required premiums, of course).



However, the group captive may not appeal or apply to all clients for one or more of the following reasons:

- Difficult classes of business may not be eligible for group captive participation.
- The client may be uncomfortable with the risk-sharing aspects of the group.
- The dynamics of the group environment require decision-making by committee.
- The client is uncomfortable with sharing its private financial information.
- The client is looking for solutions to unique risks. Group captives tend to offer pre-set lines of coverage (Workers' Compensation, General Liability and Automobile Liability).

Rent-a-captives fall into two categories: RAC products and customized RAC solutions.

RAC products are similar to group captives, where the operating structure (such as fronting carrier, reinsurer, classes of business, lines of coverage, and limits) is already set in place. Because of these similarities, RAC products offer many of the same advantages and disadvantages as group captives, with the following differences:

- No initial capital contribution is required; rather, each participant is assessed an annual RAC fee.
- The RAC organizer, not the RAC participants, drives the decisions on services offered and service providers.

Customized RAC solutions are just what their name implies – the program structure is customized to fulfill the individual client's situation. Since this is similar to building a program from scratch (selecting lines of coverage, retentions, fronting carriers, reinsurers, and so forth), it is very similar to forming a single-parent captive, sans the initial capital contribution and the regulatory formation process. For a customized RAC solution, you and your client will need to develop your own program structure, find a suitable RAC to "house" your program, and satisfy any particular requirements of the selected RAC.

Single-parent captives offer the most flexibility of any captive alternative. But before pursuing this alternative, conduct a feasibility study, and an associated pre-qualification process to evaluate whether a single-parent captive will meet the goals and objectives of the captive organizer.

For more detailed information about single-parent captives, refer to the attached article, or contact Artex's captive management group:

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