So, You Want to Start A Captive?

Written by Karrie Hyatt

Captives are a useful tool in managing risk, but there is a lot of time, group effort and money that goes into starting a captive. Here are some tips and considerations from experts involved in the launching of new captive insurance companies.

First Considerations

Starting a captive is a complicated undertaking. It requires effort and input from a number of parties from both within a company and from outside. As you think about starting a captive, make sure that organizing your company's risks under a subsidiary fits in with the philosophy and long-term goals of the company. Jarid S. Beck, a director with Risk Management Advisors, Inc., suggests that companies considering forming a captive should conduct an internal evaluation or audit to make sure that company goals will be best served by a captive and that the company has the resources – both financial and staff – to effectively run their captive.

A captive insurance company brings a company's risk in-house and can help reduce costs while providing better and more stable coverage for those risks. Captives are not a tax shelter or wealth transfer mechanism. Any service provider that is trying to sell them as such are likely not legitimate managers. As the Internal Revenue Service and other regulatory bodies continue to examine the legitimacy of captives, using a captive in a way that it is not intended could have serious consequences.

Financials and Risk, Organizing Your Ducks

The first thing that most people think of for start-up captives is capital requirements. Minimum requirements are required by all domiciles. Jarid Beck pointed out that, "People new to captives often focus on the minimum amount of capital required by the domicile. However, minimum shouldn't be confused with proper amount. Depending on the types of risk being written, capital requirements are often more than the domicile's minimum."

Sandra A. Bigglestone, director of Captive Insurance at the Vermont Department of Financial Regulation, agrees, "The amount of minimum capital required by a domicile's law is merely a floor. Actual capital should be commensurate with the risk in the captive's program. Premium and loss estimates should drive capital requirements, as should the variability and timing of the expected loss payments."

Beck related an example of captive his company has worked with. It was formed for a Southern California-based company that owned several multi-family real estate properties which was seeking Earthquake coverage. "The buildings were older and highly appreciated so it was nearly impossible to get sufficient coverage. Earthquake [insurance] as a risk is low frequency, but has a big payout. The minimum capital requirement in many domiciles is $250,000. If a substantial earthquake were to occur in early years of the program $250,000 wouldn't provide any sort of meaningful support." Using actuarial recommendations, the company wound up putting several million into their captive to fund it. Beck continued, "For a captive covering a different exposure, a lower capital amount may be just fine. It depends on the client's risks."

According to Anne Marie Towle, senior vice president and senior consultant with Willis Towers Watson, "It may not necessarily be a requirement, but it's important to look to the parent company to see how healthy its balance sheet is. Particularly with pure captives since they are insuring the risks of the parent company."

The financial health of the captive owners is a key indicator of how healthy the captive will be and is often considered by domiciles when assessing a new captive. "The financial strength of the captive owner(s) should be considered," said Biggleston, "To support a strategy for recovering capital in a stressed environment and to support any loan back obligations to the captive under a plan to maximize investment returns."

Most companies that are considering captives are well-established, with a history of historical data and a more developed risk management program. Beck said that, "This isn't a hard and fast rule, but we often find captives to be more feasible for established companies with proven track records.... Also, new companies that are still re-investing every dollar into growing their business may not have the excess funds to capitalize a captive. Or, they may not be willing to part with the funds as they'll see a larger ROI by growing their business over establishing an insurance subsidiary."

A company-wide risk management program is essential to getting the most out of a captive and many domiciles will look into the parent/owners' to see how it is managed internally. Additionally, according to Biggleston, domiciles consider other information, such as loss prevention programs and initiatives. Also, she said, "A start-up captive should articulate how the insureds intend to prevent losses from happening and to mitigate those that do occur, thus providing surplus protection."

For Towle all financial elements have to be considered. "Looking at a captive's potential solvency it's important to consider all the financial information combined. Domiciles will really want to understand the parent company, even going so far as to look at the financial health of individual owners. They also want to understand growth strategies, mergers/acquisitions and the leverage on their balance sheet."

A Captive Domicile, Not Just a Destination

"When the domicile discussion comes up, prospective captive owners often joke about choosing based on the best tropical locale to hold a winter meeting," said Beck. "In truth, we work with several domiciles and what it really comes down to for us is accessibility to the staff and the domicile's commitment to the program. We need to have a good response time from the domiciles we work with."

Regulators for a domicile need to be available to provide answers and guidance with a short turnaround, so a well-trained staff is important. So too, are domiciles that have experience with the types of risk the prospective captive is covering. "We look for the domicile that best understands what our client wants to do and has experience regulating the type of risk or type of captive our client is setting up," continued Beck. "Once our client's captive is up and running, we want to know that the domicile will be accessible and responsive to our clients' needs."

Anne Marie Towle uses a unique approach when working with clients to select a domicile. "I like to break it down into three parts – strategic, operational and financial. With these three parts there are different components and criteria that can help answer questions about the domiciles under consideration."

She describes strategic as "domicile location, length of time they've been a domicile, looking at its growth, whether or not they have expertise in the lines of coverage, captive lobby groups to support the domicile, etc." Operational considerations are for when a captive is up and running, but important questions to know ahead of time are, "whether or not their examiners are in-house, the process for evaluation, invasiveness of those evaluations and operations from a day to day perspective." The operations part also assesses whether a domicile requires the captive to operate remotely or in state. The financial part delves into questions regarding taxes and accounting, whether or not the domicile taxes premium (onshore domiciles) or excise tax (offshore domiciles) and fees charged (if any).

From the regulator perspective, Bigglestone suggests that when prospective captives are in the process of selecting a domicile that their "captive manager or consultants should be neutral to the choice." She also suggests looking at the politics of the state or country of the domicile. "The political environment of a prospective domicile should be stable, with adequate history and support from state leaders and lawmakers."

An active domicile-centric captive industry association is an important aspect to consider when selecting a domicile. As Biggleston said, "Captive industry associations are an important element to a successful domicile's infrastructure, serving as an advocate for captives at the state and national level and offering education and networking opportunities unique to the industry."

A captive domicile is more than its captive law requirements. Prospective captive owners need to thoroughly research both the regulators and regulations, as well as the political mind-set and associations supporting captives in the domicile.

Team Building

So you're starting a captive, which service provider should you start with? Accounting, legal, management? It's a chicken and egg scenario. According to Beck,

"When initially considering a captive, a business can start with any service provider as the lead consultant. This could be a captive attorney, accountant, actuary, manager or broker. Often though, the captive manager is the logical choice. They tend to function like a quarterback and can help marshal together the accountants, attorneys, brokers and other providers."

He continued, "Choosing the captive manager first will help smooth out the process since they will be able to coordinate the feasibility study to determine if starting a captive is viable. They'll also be able to help you find the other service providers you'll need and facilitate implementation if you elect to move forward."

"When the right professionals are hired, their role will help drive the success of the captive," said Bigglestone. "Domicile regulation typically requires captives to contract with a captive manager. Captive manager listings can be found on most domicile's website and managers can be found in person at various industry conferences throughout the year."

She recommends that the owners of a start-up captive should interview a number of captive managers and meet with the staff that will be involved in the day-to-day operation of managing the captive. A captive owner should understand what kind of experience the captive manager has managing similar captives or in similar industries.

Along the same lines, Towle said that "When [captive owners] are vetting captive managers the most important thing is not that they manage multiple captives around the world, it's that their industry experience is similar to the parent company and the proposed captive business plan. That they understand what the needs of the parent company are. It doesn't matter if they have 1,000 captives if they don't have the experience."

According to Beck, "A good manager should also help you see the bigger picture for your captive. Your primary focus might be identifying a Workers Comp solution, but your manager should also be able to look at your whole program and offer other suggestions. For example, it might make sense to integrate group medical stop loss into the captive as well."

Whatever order you put together the team for your start-up captive each component needs to be ready to help to get the captive going. "It's important early in the feasibility study to bring everyone to the table," said Towle. "The accountant or lawyer who suggested a captive, the in-house risk management team, captive consultants/managers, brokers and individual owners, everyone needs to be involved in getting the captive off the ground."

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at www.karriehyatt.com.