ONE CAPTIVE, TWO CAPTIVE, THREE—

The Benefits of Multiple Captives

By Karrie Hyatt

Captives have financial and risk management benefits for their parent companies, as has been well proven. Could there be more benefits with more captives? The short answer is yes and no. Owning multiple captives has its uses and benefits, but it is not for every company. However, it is a frequent practice and is continuing to grow.

The Benefits

The primary benefit for a company to own more than one captive is to segregate risk. Whether it is by preference, for regulatory reasons, or, in some cases, by chance, multiple captives can help their parent company mitigate their exposures. "Multiple captives are helpful when underwriting different risks," according to Karin Landry, managing partner with Spring Consulting Group. "As businesses grow, they may want to add additional lines of coverage but keep them separate from what they originally wrote into their captive… An additional captive is also valuable for underwriting third-party risk, such as warranty coverage, or for new lines of business, like reputational risk."

If a company with a pure captive wants to add another captive that doesn't mean that they have to form another pure captive. Companies can look to many different types of captives to help them segregate risk, including group captives, cell captives, and special purpose captives. David Provost, deputy commissioner of the Captive Insurance Division, Vermont Department of Financial Regulation, said, "I've seen quite a few captive owners that have their own pure captive and participate in a group captive. In at least one instance, I've seen a pure captive reinsured by a group captive."

Segregating risk can help companies reduce exposure from subsidiaries or affiliated entities. "[A] company might want to separate its fronted business from its direct lines," Provost added. "Some organizations use separate captives to segregate their for-profit and not-for-profit businesses."

Another benefit of owning multiple captives is to separate long tail and short tail insurance coverages. Long tail coverages—such as medical professional liability, workers compensation or environmental liability—are exposures generally not reported before the end of a policy and can take years to settle. Short tail coverages, such as stop-loss or property, are reported soon after the exposure and can be settled relatively quickly. By putting these types of exposures into two different captives, a company can better manage the intricacies of each risk.

The rigors of regulatory requirements can make having two or more captives an appealing solution to meeting those obligations. "In some cases, two captives are needed to meet regulatory requirements," said Provost. "For example, a bank may own a captive for reinsurance of mortgage guarantee insurance (PMI), which must be in a mono-line company, therefore other P&C lines would have to be in a separate captive."

But as multiple captives can help mitigate risk, it comes at a price. The primary downside with owning multiple captives is the additional costs, both initial and ongoing. There are other disadvantages as well.

"Drawbacks include greater complexity, the need for more management time, and additional frictional expenses (legal, accounting, auditing, actuarial and consulting services) that would be increased versus a single captive," said Landry. *"Compliance is also harder as you'll likely have to reconcile with different domiciles and their respective regulations."*

There would be some economies of scale, especially in terms of management. However, each captive is an individual company and will have to comply with the regulation by its domicile. Provost said, "Not everything will be doubled necessarily, but there will be two annual reports, two audits, more work to juggle, etc."

Multiple Captive Motivations

There are as many reasons for owning multiple captives as there are types of captives. Owning more than one captive can be a boon for companies operating internationally or companies that find it useful to have both an offshore and onshore domicile. Dealing with multi-state regulations is another reason to form multiple captives. According to Provost, "From what I've seen, it's most often a case of necessity, but sometimes it's management's preference to separate things. Often, it's more like an accident—many companies with two captives got them by merger and acquisition activity, not by design."

He related that the most captives owned by one entity peaked at 13 Vermont-domiciled captives—during the economic downturn a bank acquired many smaller entities, each with their own captive. Eventually, the captives were consolidated.

"[Mergers and acquisitions] can spark the formation of additional captives, as an organization's risks and goals may change as a result or may be pooled with those of another entity, calling for another captive," said Landry. "They may decide to keep or close an existing captive based on the circumstance."

Companies that operate globally often use multiple captives as a strategy to meet the needs of their subsidiaries or clients in different countries. Having captives in different jurisdictions maximizes the benefits that captives offer and can help ease compliance issues.

Landry offered this example, "In order to get a prohibited transaction exemption in the US, your captive must be domiciled in the U.S., and typically workers' compensation is underwritten by an admitted carrier which must be admitted in the state of the insureds. In this instance, it would be advantageous for an organization to set up a captive in the U.S. even if its base was in another country, and vice versa."

"If you have an offshore insurance company," continued Landry, *"You may decide to start a branch captive to fund a line of coverage, such as employee benefits risk, on-shore to be subject to the U.S. course instead."*

This set-up is not restricted to international companies. Even U.S.-based companies can make use of the multi-captive strategy to minimize taxes and effectively deal with excess and surplus lines requirements in different domiciles. Landry said, "If an organization's home state is different from its captive's domicile state, a client may decide to start a captive as the 'fronting company' for the out-of-state captive to pay a lower premium tax versus an excess and surplus lines tax."

Growing in popularity are the use of cell captives by owners of established captives. Cell captives, with their quick start-up time and lower capital requirements, are a way that many companies can make use of

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the multiple captive structure. According to Landry, "Cell captives will be a strategy that will continue to grow in popularity."

Size Doesn't Matter

Reasons for owning more than one captive are varied and the benefits that multiple captives provide are equally unique. It might seem, due to cost and management considerations, that owning multiple captives would only be under the purview of large companies and corporations, but that is not the case at all. Small to medium-sized companies can also benefit from segregating their risk through multiple captives. It really depends on the nature and volume of their business. With the rapid growth in cell captives, and more and more domiciles enacting legislation to allow for them, smaller companies can take advantage of the benefits in risk segregation offered by multi-captive structures.

"Large companies would certainly be more able to take advantages of economies of scale," said Provost, "But the benefits should be the same if you can overcome the extra costs."

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.

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