

INTRODUCTION: ALTERNATIVE RISK FINANCING MECHANISMS

The study of captive insurance begins with an understanding of the purpose of alternative risk transfer (ART), which is to find more efficient ways of financing risk. Alternative risk financing mechanisms are legal entities used to accomplish ART, and may be regulated differently from risk financing mechanisms that are used for traditional risk transfer purposes. One distinct type of alternative risk financing mechanism is the captive insurance company (captive). The difference between a captive and a commercial insurance company is best understood by examining the essential elements of captive insurance, which show that there are two basic types of captives: those owned by insureds and those owned by risk financing service providers.

Risk financing is the process of providing funds or capital for payment of losses. A common way of financing risk is to transfer it to an insurer. As will be explained in Chapter 4 of this text, the question of whether risk can ever be really transferred in the long term is an important one, but certainly the short-term goal of many risk financing programs is to transfer responsibility for paying losses from the entity that incurred the loss to another entity.

Traditional risk transfer (TRT) programs are provided by commercial insurers or reinsurers.¹ For reasons that will become clear later in this text, commercial insurers, or those that sell insurance to the general public, work within the constraints of an extensive insurance regulatory system. The alternative risk transfer (ART) industry is a response to TRT programs that, either for regulatory or business reasons, do not respond quickly and efficiently to

the ever-changing risk environment of commercial and nonprofit enterprises. In the ART market, sophisticated risk takers, including both buyers and sellers of insurance, and their professional advisers work together to develop nontraditional methods of financing risk.

CAPFAQ #1

What is captive insurance?

Defining Alternative Risk Transfer

Defining ART, however, is a challenge. One approach is to define ART in terms of innovation. This would mean that a risk financing program is ART only if it has not been done before. ART may also involve the use of noninsurance risk financing techniques. Recently those who utilize *risk securitization*² and other noninsurance risk financing techniques assumed the mantle of ART, having developed innovative risk financing programs for credit enhancement, cash flow protec-

¹A reinsurer is an insurance company that insures an insurer, not the original insured. See Chapter 9 for details.

²Financing risk using hedging or other capital market techniques.

tion, and price hedging. The student of captive insurance may be left wondering whether the captive is still part of the ART industry. It may be an alternative structure from a regulatory perspective but certainly can no longer be viewed as innovative, except to the insured who has never used one before.

While innovation is certainly the hallmark of an ART program, most practitioners would agree that the definition of ART should include the fact that utilization of ART risk financing programs requires risk retention by the insured. For this reason, many commercial insurers still classify retrospectively rated policies and high deductible policies as ART techniques. Historically, ART market focus has been on the design of products and services that can be used by insureds with the net worth to allow them to assume significant amounts of risk. While this appears contrary to the concept of risk transfer, it is not. Risk can only be transferred if there is adequate *risk capital*, which is the capital at risk if losses exceed the expected amount of loss that is to be financed. Seeking alternative, and more efficient (i.e., less expensive and/or more dependable/easily accessible), sources of risk capital to support risk financing is the fundamental purpose of ART.

In the TRT market, risk capital becomes available if those assuming the risk understand enough about it to be able to quantify it and price it. The process of quantifying and pricing is what is understood by underwriting risk. TRT underwriters try to calculate premium rates to provide adequate funds to pay expected losses. When they are dealing with a new type of risk, as may occur when they are asked to underwrite an ART program, TRT underwriters may be reluctant to commit capital to finance that new type of risk.

If the insured, who is the source of the risk, is also willing to contribute capital, this creates *underwriting capacity*, meaning that there is more insurance available for those wishing to transfer risk. This is why captive insurance, which allows insureds to participate in the risk underwriting process and utilize their own risk capital in financing risk, is quite properly considered to be

part of the ART market, even though it is not a new technique.

The distinction can be seen between the innovative use of risk financing techniques to structure an ART program and utilization of an alternative mechanism to finance risk. While those who use captives may also be structuring ART programs, the two terms are not synonymous. An ART program does not require the use of a captive, may be underwritten by an insurer or reinsurer that is regulated as a traditional commercial company, or may involve the use of noninsurance risk financing techniques. The captive, on the other hand, may use TRT techniques, using the same underwriting methods and perhaps even the same policy forms, as a noncaptive insurer. The captive is not an ART program but rather an *alternative risk financing mechanism*.

Alternative Risk Financing Mechanisms

At the time the Coalition of Alternative Risk Funding Mechanisms (CARFM)³ was formed, there was debate as to which term should be used to describe the different types of entity to be represented by that organization. Alternative risk transfer entities was one of the titles considered. However, while some mechanisms are used strictly to facilitate the transfer of risk from the insured to the commercial insurance or reinsurance markets, others are used only to retain risk. Since it was thought that “risk financing” could be understood to mean premium financing, i.e., lending money to insureds who need to purchase insurance, “alternative risk funding mechanism” was the curious and cumbersome term CARFM selected to describe the function of all entities, whether incorporated or unincorporated, that finance risk outside of the TRT insurance regulatory system. In this text, risk financing, rather than risk funding, will be used to describe the activities of captives.

³CARFM is an association of trade associations that represents nontraditional risk financing entities. Its primary purpose is to provide a vehicle for dealing with regulatory or legislative issues impacting captives.

The *American Heritage Dictionary* defines mechanism as “the means by which something is done or comes into being.” A risk financing mechanism is a legal entity that is the means by which funds are made available for payment of losses. An entity is simply something that exists, that existence being separate and independent of the existence of other entities. The student of captive insurance must understand how and why risk financing mechanisms work, both those that are separate legal entities dedicated to ART, and those that are regulated traditionally but provide ART risk financing programs.

Certainly a savings account can be a mechanism used for paying losses. But a legal entity is something that has independent existence, which means the entity itself has decision-making and executive authority. For this reason, a trust, but not a bank account, would be an alternative risk financing mechanism, if it were used instead of buying commercial insurance to pay future losses.

The purpose of this text is to describe how alternative risk financing mechanisms function in the entire risk management process. To do this, we must also discuss the types of programs captives write. Although the text is about alternative risk financing mechanisms, it will deal with alternative risk transfer programs if they involve the use of a risk financing mechanism.

As the title suggests, the focus is on captive insurance companies. As the trust example shows, not all alternative risk financing mechanisms are captives, and not all use insurance techniques. Risk purchasing groups and self-insurance pools are examples of ways in which risk can be financed in alternative ways, working within the world of insurance but without the entity itself being an insurance company. By understanding the way in which some of these frequently used noncaptive alternative risk financing mechanisms work, we come to a better understanding of the true definition of a captive.

Risk Purchasing Groups

The federal Risk Retention Act was passed by Congress in 1981 in response to the *hard market*, i.e., a shortage of underwriting capacity that left

many U.S. insureds unable to obtain or afford product liability insurance. The purpose of the Act was to allow groups of insureds to join together to form *risk retention groups (RRGs)* and *risk purchasing groups (RPGs)*. The Act was amended in 1986 to allow entities authorized under its powers to write or purchase not only product liability insurance but all types of liability insurance.

The Risk Retention Act is a valuable piece of legislation. RPGs allow smaller insureds (those without the financial strength to retain risk or assert economic strength in the marketplace), to attain bulk buying power in the purchase of liability insurance. It also allows them to avoid the “fictitious group” laws passed in some states to prevent groups forming solely for the purpose of buying insurance. It was also the intention of the federal Risk Retention Act to make it easier for insurers to handle multi-state filings for rates and policy forms,⁴ thereby encouraging risk capital to enter the market. This creates underwriting capacity for insurance of difficult-to-place risks. Since it is more efficient for an insurer to underwrite a group of similar risks, rather than separately underwriting each insured entity, it was hoped that the federal legislation would reduce insurance costs. There are estimated to be nearly 800 RPGs currently operating.⁵ This makes the liability purchasing group a significant element of the alternative risk financing industry.

Another type of risk purchasing group is the multiple employer welfare arrangement (MEWA). Like the Risk Retention Act, the MEWA legislation was a federal initiative designed to respond to the insured’s need to find an alternative to state-regulated commercial insurance. MEWAs allow unrelated employers to jointly purchase health and other state-regulated employee benefit insurance.

Even though purchasing groups are not captives, insureds in a purchasing group have many of the

⁴Commercial insurers are required to use premium rates and policy language that has been filed and approved by the insurance regulator in the state where the insurer is domiciled. This is known as rate and form filing.

⁵Source: *The Risk Retention Reporter*, December 2001, p. 18, Insurance Communications, Pasadena, CA.

same objectives as captive insureds. They want access to coverage in hard markets, lower costs for both insurance and insurance-related services such as claims handling, and customized policy forms.

What the purchasing group insured does not do is transfer risk to an alternative risk financing mechanism. Because the RPG does not assume risk, there is no contribution of risk capital from the insureds to the group, and generally no commitment, contractual or implied, to remain a member of the group beyond the insurance policy anniversary. These are the defining characteristics that help to differentiate risk purchasing groups from a captive.

Self-Insurance Pools

Self-insurance pools have many objectives in common with purchasing groups: to provide a mechanism for joint access to coverage and claims services and to allow the pool members to stabilize loss costs and improve control over purchasing coverage from commercial insurers. They differ in that the function of administering claims payments for losses within each member's retention is assumed by the pool.

Pools can be funded or unfunded. If they operate as a mutual benefit association, the pool can assess members to pay losses as they occur. If funded by its members, a pool may do many things that an insurer does, such as setting up loss reserves and paying losses. As a result, pool members have a longer-term commitment and are required to post collateral to ensure future payment of the pool losses. Pool members also have joint and several liability, meaning that although there may be pool participation agreements stating that each member will pay its own losses, if one pool member defaults, the other members may jointly become responsible for the unfunded losses. When joint and several liability exists, a claimant may sue the members of a group separately, as well as the group as a whole.

Workers compensation (WC) pools are an example of a frequently used type of funded risk financing mechanism. The WC self-insurance pool is regulated under special purpose laws and provides

reports to state insurance regulators. Pool participants must be qualified self-insurers, meaning that they have passed minimum net worth or other tests established by the state where the workers compensation coverage is provided. Public entity pools, which finance liability risk for states, cities, or other governmental organizations, are another frequently used type of self-insurance pool. As legal entities, the pools have the ability to enter into contracts on behalf of their members and will have a board of directors and elected officers.

Federal legislation has also allowed a single employer to form, on behalf of its employees, a Voluntary Employees' Beneficiary Association (VEBA), which is a tax-exempt funded trust or nonprofit organization used to finance employee benefits. Like a self-insurance pool, the VEBA is not a licensed insurer. Organizers are prevented by state insurance laws from selling participation as if it were insurance, although the U.S. Internal Revenue Code provides a VEBA some of the same tax treatment as life insurance companies. Pool participants may transfer funds to the pool for the future payment of self-insured losses, and investment income earned in the VEBA is not subject to taxation. Like a contribution to a pension plan, the contribution to a VEBA may be from pretax income. However, the pool is primarily a mechanism to facilitate adjustment and payment of losses and purchase of excess insurance. The key difference between a self-insurance pool and an insurance company is that the risk of loss remains with the pool members. Like a purchasing group, the pool is a risk financing mechanism that is not a risk taker.

Captive Insurance Companies

The third main type of alternative risk financing mechanism is the captive. A captive is generally defined as an insurance company that is wholly owned and controlled by its insureds; its primary purpose is to insure the risks of its owners; the primary beneficiaries of its underwriting profits are its insureds.⁶ It is necessary to examine these defining characteristics further, to understand first

⁶This definition was developed to define the captives that would be included in the *A.M. Best's Captive Directory*.

what sets a captive apart from noncaptive alternative risk financing mechanisms, and second, the real difference between captive and noncaptive (i.e., commercial) insurance.

The first question, what sets a captive apart from risk purchasing groups and self-insurance pools, is answered by stating that a captive is a licensed insurance company. The objective of the insureds that formed the first captives was to own an insurance company licensed in at least one jurisdiction. The subsidiary company had to be able to do for its owners exactly what commercial insurers do: issue policies, buy reinsurance, and receive commissions from reinsurers. The objectives of insureds forming captives today are no different. When a risk financing mechanism is licensed in one jurisdiction (its domicile), this enables it to operate on a multistate basis,⁷ something that a self-insurance pool cannot do.

An insurance company takes risk. Therefore, it must have risk capital. This again points to a major difference between a purchasing group or pool and a captive. The members of an RPG or pool do not transfer risk to the risk financing mechanism. The insureds remain responsible for payment of their own losses, unless they have purchased insurance or arranged an alternative way to legally transfer their liabilities to another entity.

Contrast this with captive insurance. The captive has a contractual obligation for payment of future losses, not just the administrative responsibility for processing payments. This is why captives have capital and are regulated under insurance laws.

At first, because special purpose laws did not exist, these wholly owned insurance companies were formed under the same laws as commercial insurance companies.⁸ In the 1950s, a number of U.S.

⁷The way in which a captive insures risks located outside of its domicile will be discussed in Chapter 9.

⁸The United States cannot claim to have given birth to the first captive of this type. Imperial Chemical Industries has owned an insurance company licensed in the United Kingdom, and FL Smith Industries of Denmark owned one licensed in Denmark, since the early part of the twentieth century.

manufacturing corporations with large property exposures began to incorporate captives. Some early examples were Youngstown Sheet and Tube and Gold Medal, which formed licensed admitted⁹ insurance companies in Ohio and Minnesota, respectively.

In the 1960s, Fred Reiss, founder of the captive management firm that did business as the International Risk Management Group (now mostly part of AON), joined forces with Sidney Pine, an attorney with the law firm now called LeBoeuf, Lamb, Greene and MacRae. They approached the government of Bermuda to discuss passage of special purpose laws that would facilitate formation of such “captive” insurance companies.

This little bit of captive history is helpful since it points toward the answer to the second and more difficult question, which is our first CAPFAQ, “What is captive insurance?” Identifying certain essential features of captive insurance will help to clarify our definition of a captive insurance company.

The Elements of Captive Insurance

Captive insurance is utilized by insureds that choose to put their own capital at risk by creating their own insurance company, or utilizing an existing special purpose insurer, working outside of the commercial insurance marketplace to achieve their risk financing objectives. There are certain distinct elements to this general explanation of captive insurance that improve our understanding of the characteristics of a captive insurance company.

Standard captive definitions typically focus on the fact that the captive is owned and controlled by its insureds. While both of these points may have been historically true, they do not now help to distinguish the captive from, for example, a non-captive mutual insurance company. It may be fac-

⁹An “admitted” insurer is one licensed to write insurance in the state or country where the insurance is purchased.

tually correct to state that a mutual insurance company (for example, Liberty Mutual) is owned and controlled by its policyholders. The insured that purchases insurance from a mutual insurer may be asked to vote on matters requiring policyholder action. Usually, the insured will be presented with a proxy and advised by the board that runs the company as to how to exercise its vote.

But no one who is simply insured by a commercial mutual company really exercises control of the company. Being an “owner” is not a very meaningful concept, since as soon as the insurance ceases, so does the ownership status. The policyholder has not invested any assets in the insurance company and does not actively participate in running the company. It is true that a mutual company insures only the risks of its owners, and in their early years, mutual insurers operated more like group-owned captive insurance companies. However, they evolved into commercial insurance companies and now are regulated as such.¹⁰

Choosing To Put Capital at Risk

So the real distinction between a commercial insurer and a captive is found in the first part of the description of captive insurance. Purchase of captive insurance requires the insured, or a party affiliated with or connected to the insured, to be both willing and able to contribute risk capital. This is the first essential element of captive insurance. Those who form or use a captive have made a choice, have analyzed their risk financing options, and have the financial ability and will to invest their own resources to benefit from this type of risk financing program. This is far more relevant than whether the insured has ownership or control

¹⁰Some captives evolve in time to become commercial insurers. For example, Medmark Insurance RRG in time became licensed as an admitted (noncaptive) company. The company was formed to respond to the crisis in product liability markets. The need for rapid response to lack of capacity meant that the risk financing objectives of the insureds were initially best met by being outside of the traditional insurance regulatory framework. Changing markets meant that ultimately a noncaptive structure was superior. The factory mutuals were examples of property insurers that underwent a similar evolution.

of the management of the captive or whether the company insures only the risks of its owners.

Financial risk, of course, has as its corollary financial reward. The other part of the standard captive definition states that the insured in a captive must not only have ownership in and control of the company but will also be the beneficiary of its profitability. Again this is true, but does not eliminate a commercial mutual insurer from the captive classification. A policyholder in a commercial mutual company is entitled to receive dividends if the company makes a profit. In theory, the surplus of a mutual is supposed to be distributed to its members. The reality is that surplus accumulation, rather than distribution, is typically practiced by commercial insurance companies. This is because the companies’ managers are rewarded in part based on their ability to increase market share, which in the traditional regulatory system requires an insurer to have additional surplus.

Equally, the principal shareholders in a publicly traded commercial stock insurance company, who very likely will be insured by that company, receive financial gain if that company has good results. And both mutual and stock company insureds may be entitled to financial benefit through some form of return of premium if their loss experience is favorable. But that doesn’t necessarily mean that their respective insurers are captives.

Working Outside of the Commercial Regulated Marketplace

To answer the question “What is a captive?” we have to go back to the essential elements found in the description of captive insurance. The first element is that insureds in a captive choose to put their own capital at risk. In what way? By working outside of the commercial insurance marketplace. This is the second essential element of captive insurance.

Ironically, everything in the traditional insurance regulatory environment is done to eliminate risk for the insured. The regulators try to ensure that the insured is “protected” from the insurer. Some-

times the medicine is worse than the illness. Regulations are expensive to implement, costly to monitor, and sometimes fail. Their main thrust is to restrict what an insurer may do and how it may be done. It is not only the regulatory environment that restricts an insured. Commercial insurers' internal business strategies and external market forces contribute to the restrictions imposed on those who wish to use ART to reduce their risk financing costs.

Inevitably, insureds wishing to improve control over the way that insurance is used to finance their risks seek to increase their control over the insurer. This explains why the second essential element of captive insurance is that it involves financing risks using special purpose insurers, companies that operate or provide programs outside of the traditionally regulated commercial marketplace.

These insurers often have significantly less capital than commercial insurers and no protection for the insureds from state guarantee funds. But those who use captive insurance choose to participate in the risks and rewards associated with using their own risk capital, rather than paying to use the capital of commercial insurers. The choice is made in the belief that captive insurance offers something superior to the commercial insurance alternative, if there is one. That "something superior" is what this book is all about. We will try to understand why insureds are willing to invest capital, take risks, and incur direct and indirect costs to use a captive insurance company.

Achieving the Insured's Risk Financing Objectives

The third essential element of captive insurance is that it is used by insureds to achieve their risk financing objectives. This clarifies an important piece of the standard definition of a captive insurance company, which states that the captive's purpose is to insure "related" risks, i.e., the risks of its owners. As previously discussed, whether the owners of an insurance company are its insureds is not the key distinction between captive and commercial insurance. Not all of the risks insured in a captive may be

related. The captive could be insuring nonowned or unaffiliated risk. Sometimes the nonowned risk is connected or related by virtue of some aspect of the captive owner's business. This provides the captive owner the ability to exercise management control or oversight of the insured risk. Sometimes unaffiliated risk in a captive insurance company is unrelated and not controlled by the captive owner; the source being the open market.

The important point is not the source of the risk, but that the purpose of captive insurance is to satisfy the risk financing objectives of the insureds that are also risk takers. The meaning of risk will be discussed in Chapter 2. What must be explained here is that in captive insurance, there are two types of "risk takers." The first is the source of risk, meaning the operating companies or entities that undertake activities that generate risk. Second is the owner of the risk, meaning the entity that bears the ultimate financial impact of the risk, and is the source of capital required for risk taking. The source of the risk and the owner of the risk may be the same legal entity, but often, in captive insurance, they are separate entities within the same organization (affiliated by ownership and control). We use the term "insured" loosely when discussing captive insurance to refer to both the insured entities that are the source of risk (the "insureds" in a captive program) and the ultimate risk owner (referred to as the "parent," in some captive legislation).

In this sense, ownership and control by its insureds are indeed what sets a captive apart from commercial insurers, but this is not the type of ownership or control evidenced by a nominal percentage share in the company's surplus. It means ownership in the company's strategic business purpose. Although the many benefits of captive insurance can be debated, the dominant factor that motivates insureds to finance their risks outside of the commercial insurance marketplace is clear. It is done to improve the insured's control over the purchase of insurance. Even though the insured may not participate in the day-to-day management of the insurance company, by purchasing insurance from a captive insurer, insureds intend to increase control over their risk financing programs.

Types of Captive Insurance Companies

These three essential elements of captive insurance help us to see which types of alternative risk financing mechanisms are properly called “captives” and which are not. They also make it possible to see that, in spite of the different definitions of types of captive used by the different captive domiciles, captives fall into one of two main groups. First, there are captives that are 100 percent owned, directly or indirectly, by the insureds. Second, there are captives owned and controlled by parties unrelated to the insured. These parties may be risk financing service providers, such as insurers, reinsurers, agents, brokers, and consultants, and are called captive “sponsors.” With this type of captive, the insureds still invest risk capital, allowing for control of their risk financing program. But the insureds have either none or a limited ownership in the captive company.

By looking at the different types of captives within these two main groups, the distinction between a captive and other alternative risk financing mechanisms, and between captives and commercial insurers, becomes clearer.

Pure Captives

It is not unusual to see captives classified as “single owners” and “group owned,” but the single or group owner distinction is not in itself very useful. After all, a service-provider-owned captive is a “single parent,” i.e., one-owner captive, but may be a very different type of captive from an insured-owned captive.

Whether a captive is “pure” is a more important distinction to make when looking at types of insured-owned captives. The term “pure captive” is generally used to describe captives insuring only the risks of their owners.¹¹ However, as was ex-

¹¹Some captive laws allow a pure captive to insure a limited amount of unrelated risk, without losing the “pure” classification.

plained in the discussion on the essential elements of captive insurance, a single-parent captive may write a third-party risk to satisfy the risk financing objectives of the owner. Should it then remain under the “pure captive” definition?

While not all captive domicile laws have the flexibility to distinguish between what is pure and what is not, those who understand captives, and the defining elements of captive insurance, can. What makes a captive pure is not whether it writes 100 percent related risk or up to a certain percentage of unrelated risk. What makes a captive pure has to do with the purpose of writing the unrelated risk in the captive: whether it is written to allow the insured owner of the captive to more effectively manage its own risks. If there is a commercial purpose, i.e., to sell insurance to unrelated parties for the purpose of making a profit from the third-party risk, then the captive could indeed be regarded as other than pure.

A well-known example of a noncaptive single-parent insurance subsidiary was Allstate, owned by Sears. When it was a wholly owned subsidiary of Sears, it was not a pure captive because its purpose was to sell insurance to Sears’s customers although it did insure the risks of Sears and Sears’s employees. Allstate’s goal was to increase Sears’ revenues, not more effectively manage Sears’s own risks. Allstate was a commercial insurer, not a pure captive.

Industrial Insured Group Captives

An industrial insured group captive is one that is formed by a group of individuals or entities (profit or nonprofit) that come together to jointly own a captive. Industrial insured group-owned captives typically insure only insureds in the same industry group, or with homogeneous risk, which creates group buying power and other risk management efficiencies. The industrial insured terminology is used in insurance to signify that the members of the group are all *sophisticated insureds*, meaning that they have sufficient size (based on net worth and number of employees) to qualify under state insurance laws for the purchase of nonadmitted insurance.

Another kind of group-owned captive is one that allows a group of insureds from entirely different industry groups to own a captive jointly. This type of group captive may be called a *reinsurance pool*, indicating that its purpose is the pooling of risk, and that it does not provide direct insurance. Even if the captive shareholders are from different industry or service sectors, the risk financing objectives of the owners of the captive are aligned, the captive being used to underwrite a particular line or lines of business. Provided the insureds are of sufficient size and financial stability, they may reinsure their risks to the pool, which may purchase reinsurance or provide other risk management services for the pool members as a whole. Not all reinsurance pools are captives; indeed, the traditional insurance industry uses reinsurance pools to respond to the difficulty of underwriting statutory coverages, i.e., the types of insurance that are required by law.

Group-owned captives are required under most domestic (U.S.) captive domicile laws to remain entirely pure, writing no unrelated business. Regardless of domicile laws, it is also not unusual to find that owners of a group captive establish in their bylaws or members agreements that no unrelated risk can be introduced into the risk pool.¹²

Risk Retention Groups

Risk retention groups are alternative risk financing mechanisms authorized under the same federal legislation as risk purchasing groups. The clear distinction between an RRG and an RPG is that the retention group is licensed as an insurer, i.e., it insures and/or reinsures the risks of participants. The Risk Retention Act did not address whether the RRG should be licensed as a commercial insurer or under special purpose laws designed for captives. It defines the RRG as a company owned by “persons ... who are provided insurance by such group” or “an organization which has as its members ... only (persons) ... who are provided

insurance by such group” and “whose members are engaged in businesses or activities similar or related with respect to the liability. ...” Therefore, an RRG insured is not required to be an industrial insured, but homogeneity of the risk is mandatory, and all insureds must be owners.

As with RPGs, the objective in creating this new type of risk financing mechanism was to make it easier for an insurer to offer product liability coverage by eliminating the process of filing rates and forms in all states where the insurance is to be provided. The federal legislation established that an RRG would only be licensed in its domicile state, with notification simply being sent to other states of the intent to write business in that state. Provided the RRG remains in compliance with the laws of its domicile, other states are prevented from exercising regulatory oversight, such as performing examinations. The purpose was to avoid cumbersome multistate regulation.

The RRG was also envisioned as a way to create new underwriting capacity, encouraging insureds to put their own capital at risk to form group-owned risk pooling companies. In this sense, the federal Risk Retention Act encouraged true ART, which explains why it is still viewed by such suspicion by many state insurance regulators, who live in a TRT world.

Sponsored Captives

The second main type of captive is one that has many of the same elements as a pure captive. Those who utilize it are required to put their capital at risk; risks are financed outside of the commercial regulatory environment; the purpose is to achieve the risk financing objectives of the captive’s insureds. The distinction is that a sponsored captive is not formed by its insureds, and the insureds may have no ownership interest in or control of the captive. The insureds whose risks are underwritten by the sponsored captive are called *participants*.

A sponsored captive may be set up by an insurance-industry-related entity to be used by their clients, or there may be no previous connection, business or

¹²The question of what kind of unrelated risk a captive can underwrite will be addressed in the final chapter of this text as CAPFAQ #13.

otherwise, between the sponsor and the participant. The *sponsor* contributes the captive's statutory capital (sometimes called core capital). Because many sponsored captives do not require insureds to pay in capital in return for ownership of the captive, but simply pay an access fee, they are referred to as "rent-a-captives" in some domiciles.

A second distinction to be made between pure and sponsored captives is that the sponsored captive does not necessarily pool the risks of its insureds. It may keep a separate underwriting account for each insured participant. In some domiciles, these accounts are legally separated or protected, and the term *cell captive* is used, meaning that the assets in one participant account may not be used to pay liabilities in another, unless the respective participants have entered into an agreement to do so. This is a key difference between participating in a pure group captive such as a risk retention or industrial insured group and a sponsored captive. The sponsored captive can be structured to maintain legally separate underwriting accounts, whereas an insured that is a member or owner in a pure group captive shares risk with the other captive insureds.

This means that insureds who are shareholders or members of the industrial insured group captive not only have to contribute capital to access the captive insurance program, but their capital is at risk based on the performance of the group as a whole. In a sponsored (rented) segregated cell captive, the insured's risk capital is typically only exposed to the risk of its own underwriting performance.

If required under domiciliary law, the sponsor's core capital may be at risk. This would mean that if one insured becomes bankrupt or otherwise defaults on its obligations, producing an insolvent cell or underfunded underwriting account, liabilities of the cell would become liabilities of the sponsor. In domiciles that do not have the legal requirement that the sponsor's core capital is at risk, the cell participant may be required to sign an agreement that losses paid under policies issued or reinsured by the captive are limited to the assets in the participant's cell.

The term *captive facility* is sometimes used to describe a commercial insurance or reinsurance company that provides captive programs. As with the sponsored captive, the participants in a captive facility have a captive underwriting account, although there may be no legal segregation of cells. The facility provides an insurance program similar to those offered by companies licensed as a sponsored captive. The sponsored captive elements are as follows.

- The insured is a participant and puts its own capital at risk.
- The insured uses the facility for the management of its own risks.
- Participants do not have ownership or control of the facility, although control over the structure of their insurance program may be given to an insured.¹³

Sponsored captives may be used by insureds that are too small to own their own captive. In these cases, the captive cell program acts like an incubator for small insureds to begin a captive program. When sufficient surplus has been accumulated, the insured has the option of using those funds to set up its own pure captive insurance company. It is also quite common for larger insureds, even those who already have a pure captive, to use a sponsored captive, since the "nonowned" captive facility, i.e., one owned by parties other than the captive insureds or their affiliates, can be used to insure or reinsure risks that the insureds wish to finance off balance sheet. (As will be discussed in later sections of the text, the financial results of the captive are consolidated with its shareholder for financial reporting purposes. If a captive is owned by an entity affiliated with its insureds, risks transferred by insured operating companies to the captive remain on the balance sheet of the shareholder.)

¹³The term captive facility can also be used to describe a captive reinsurance pool. Therefore, it cannot be assumed that a captive facility keeps segregated underwriting accounts, or that the participants are not owners of the company.

As previously discussed, laws governing captives have been developed based on the general principle that captive owners are insureds, but most domicile laws do not preclude either pure or sponsored captives from writing unrelated risk to support their risk financing objectives. Certain domiciles allow a captive to insure up to 100 percent unrelated business. In these cases, the captive could be owned by an investor (generally an insurer, insurance agency, or broker). Such captives are used to reinsure “program business,” meaning selected preferred risks from the insurer’s, agent’s, or broker’s book of business, from one particular group of customers. The original insured is not a party to this reinsurance arrangement. The purpose of the captive is to allow the agent to earn underwriting profits if it produces good business.¹⁴

Going back to the essential elements of captive insurance, it is possible to see why this form of captive is considered a form of commercial insurance. The only captive element is that the transaction takes place outside of the commercial insurance regulatory environment. The insured has not made a choice to put any capital at risk; the transaction is not undertaken to satisfy the insured’s risk financing objectives. The risk financing mechanism used may be a captive insurance company, but it provides commercial, not captive, insurance and reinsurance. On the other hand, special purpose vehicles (SPVs), which provide insurance in the risk securitization process, are alternative risk financing mechanisms that may properly be called captives. Their purpose and operation therefore are appropriate subjects for discussion in a course

¹⁴Antirebating laws in some states limit the amount of commissions that can be paid to agents. Agency captives were a way to increase income to agents, instead of paying commissions. The “captive” would be sponsored by an insurer or reinsurer, with a cell rented to each agent. In time, agents saw the advantage of owning their own “single-parent” captive—not to insure their own risks, but to share underwriting profits from business they produced. These became known as *producer-owned reinsurance companies (PORCs)*.

that explains how captives participate in the management of risk.

Association Captives

A captive may be formed by an association for the benefit of its members. Does this make it a “sponsored captive”? The answer is, not exactly! In an association-sponsored captive, the risks of some or all of the association members will be pooled. Association members will typically have representation on the captive’s board and actively participate in decisions relating to the captive’s use. The association captive is “pure,” meaning that it insures only the risks of its owners. An association captive is owned by its insureds. The sponsoring association may contribute 100 percent of the required capital, but since the association is owned by its members, its members indirectly own and have voting control over the captive.

In some cases, an association captive may actually function as an industrial insured group captive. Association members choosing to be insured by the captive are required to make a direct capital or surplus contribution. The association’s “sponsorship” is nominal, acting like an endorsement for the program, rather than there being any legal or financial commitment between the sponsor and the captive.

DISCUSSION QUESTIONS

XYZ Liability Assurance Co. is licensed as a Delaware insurer under the federal Risk Retention Act and has registered to do business in all states. It writes general and professional liability insurance and over the years has been so profitable that new insureds are no longer required to make a surplus contribution but are given preference (nonvoting but dividend-paying) shares in the company. The board of directors and officers are composed of the original group of insureds that formed the company and contributed start-up capital. New insureds are not allowed to sit on the board or be-

come officers. To increase its market share, the company advertises widely and has broadened its coverages to allow it to reach a wider group of insureds.

1. Based on what you know about the essential elements of captive insurance, would you say that XYZ LAC is a captive? Why, or why not?
2. If this is a captive, what type of captive is it? Explain your answer.
3. Based on the information given here, is XYZ Liability offering “ART” programs to its insureds? Discuss why or why not.

KEY WORDS AND PHRASES TO UNDERSTAND

alternative risk financing mechanism
alternative risk transfer
captive cell
captive facility
hard market
industrial insured group captive
participant
producer-owned reinsurance company
pure captive
reinsurance pool
risk capital
risk purchasing groups
risk securitization
self-insurance pool
sophisticated insured
sponsor
underwriting capacity