THE CAPTIVE/OFFSHORE INSURANCE COMPANY, AN EMERGING PROFIT CENTER – REVISITED 38 YEARS LATER

by Andrew J. Barile, CPCU

Andrew J. Barile, CPCU, with 50 years of experience in the insurance industry, has been retained by corporation owners to perform captive feasibility studies, has implemented agent-owned captives, has negotiated on behalf of captive owners both their "fronting fees," and reinsurance structure. In 1978, he put Bermuda on the map by co-founding the first publicly held Bermuda Reinsurance Company. He is on the Board of Insurers and Captives.

It's been just more than 38 years since we did the first public offering of a Bermuda insurance company … the insurance environment, as respects captives, has certainly changed in 38 years. The corporation owner has come to recognize that a captive insurance company should be part of the entire risk management perspective, with some 6,000 captives.

THE FEASIBILITY STUDY

The feasibility study has shown that a captive insurance company would be beneficial to the parent organization, and a domicile has been selected. The legal considerations have been reviewed and the implications fully understood. Now the organization is faced with the task of starting an insurance company with a very limited product line. The parent organization has three basic options:

a. It can use its own existing internal facilities to incorporate, staff, and manage the new subsidiary.

b. It can hire independent specialty firms to perform some of the services under its management direction.

c. It can delegate the responsibility to a professional captive management company, which will perform these functions or subcontract them out to specialty firms. Often, the captive management company chosen is the consultant that made the feasibility study.

Obviously, a combination of the above can also be used.

The selection of the most suitable approach is an individual corporate decision, and the costs and benefits of each must be thoroughly analyzed. The insurance business can be very complex, and many neophytes may feel that they are out of their element. Even experienced executives might have difficulty mastering the vagaries of the business. Many insurance practices violate orthodox business procedures. In addition, the extensive insurance jargon must be learned so that the captive will not be at a disadvantage when it does business with other members of the industry. If the parent does not possess this specialized knowledge and has no inclination to acquire it, a captive management firm should be employed.

Some of the domestic (those with parent corporations domiciled in the United States) captives are managed by the parent corporation's insurance department. The corporate risk manager, formerly in charge of the insurance department, usually becomes president of the captive and is responsible for the operating decisions of the insurance subsidiary, with a board of directors comprising the financial officer and the treasurer of the parent corporation. Overall management goals and objectives come under the jurisdiction of the parent's chief financial officer with prior approval of the board of directors. All of the conventional insurance company functions are performed by the staff of the insurance department or are purchased from specialty firms.

In-house management and administration of the captive could create problems because of the Internal Revenue Service requirement that it be operated as an individual entity dealing at arm's length with the parent. If this were not the case, the IRS would disallow deductions for premiums paid to the captive, and reinsurers would be reluctant to get involved in an incestuous relationship between the parent and its captive offspring. Such a relationship might very well occur if the parent's employees operated the captive. For instance, underwriting standards may become lax, rates may be inadequate, or loss payments may be too liberal. The whims of the parent will be indulged and uncooperativeness too easily forgiven.

On the practical side, using the parent's employees might very well increase costs, since they are probably not as skilled and experienced as people who make their livelihood at managing captives. This should not be construed as a derogation of the corporation's insurance department or an endorsement of management firms. Remember that the captive must perform or obtain all of the services formerly provided by the corporation's broker and insurance company, and at less cost. If this is not the case, the captive may not made economic sense, and consideration should be given as to whether or not to go forward with the captive.

Many corporations will continue to form captives as the owner understands the advantages of owning an insurance company.