

# Captives keep on fuelling industry

*IT'S ONE OF THE SURPRISES OF THE SOFT MARKET*

By Sue Johnston

**F**OR ANYONE UNFAMILIAR WITH THE insurance industry—which is to say most of the world—the term ‘insurance captive’ conjures up a peculiar image. Is this a business in chains struggling to break its bonds? Why is it enslaved? What did it do before captivity? Was it once free? Was it captured in a hostile takeover?

The reality of captives is less exotic than speculation by the uninitiated. Yet, to those in the know, it is no less interesting. Captives brought Bermuda into the insurance business. Captives continue to be an important factor in the Island’s growth as an international insurance centre. And captives are an important and increasingly versatile item in a risk manager’s tool kit.

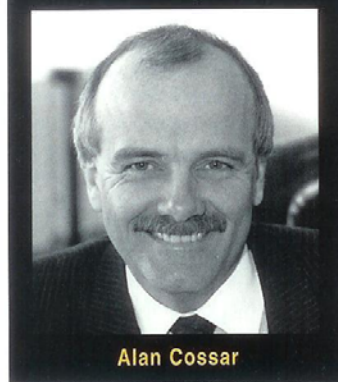
In 1997, according to management and actuarial consultants Tillinghast-Towers Perrin, more than 300 new captives were formed by companies and associations around the world. Of those, 60 were formed in Bermuda, which has the world’s largest share of captives. The Caymans gained 50 new captives, Guernsey and the State of Vermont grabbed 27 apiece, and the British Virgin Islands registered 23. Sixty percent of new captive sponsors were from the US, while 20 percent were European. Last year’s newcomers bring to 3,966 the number of captives, worldwide.

So what is a captive? According to Tillinghast, a captive can be defined as a “closely held insurance company whose insurance business is primarily supplied by and controlled by its owners, in which the original insureds are the principal beneficiaries.” In other words, it’s a company formed to insure the risks of its owners.

Captives developed as an alternative to the commercial insurance market, and



David Ezekiel



Alan Cossar

grew in number during the ‘hard’ markets of the 1960s and 1980s. A large corporation unwilling or unable to place all its insurance business in the commercial market, and pay the corresponding premiums, could form a ‘captive’ insurance subsidiary. It would bypass the commercial insurers, hiring professionals to manage the insurance company in-house or through a management company. The parent could designate and invest large sums to protect

against a specific loss, effectively insuring itself. Or it could, as an insurance company, deal directly with the reinsurance market and place risk there. Forming a single-parent captive was a way for companies to control their insurance costs in a tough market. And they could sometimes reap tax benefits.

**B**UT ‘HARD’ MARKETS ARE HISTORY and tax laws have changed. So why, in 1997, did so many organisations pass up the bargains in a ‘soft’ commercial insurance market and form their own captives?

“It’s one of the surprises of the soft market,” says David Ezekiel, president and managing director of International Advisory Services, the Island’s largest independent captive management company. “But maybe we shouldn’t be surprised. As managers, we’ve been preaching to businesses that they need to plan for their future, take care of their own business, manage their money better. A lot of companies are getting that message. The good thing about a captive is that, even if you put too much money into it, it’s still all yours.”

“In this business, you see patterns developing that grow into mini-waves,” says Andrew Carr, managing director of Johnson & Higgins Marsh & McLennan (J&H/M&M), the world’s largest captive managers. “A project is put together and it’s successful. One broker involved might share the story with colleagues. Before long someone recognises that the same ‘fact pattern’ exists in another industry and the idea can be used in another instance.”

Bermuda’s many captive managers say the ‘hardness’ or ‘softness’ of the commercial insurance market is no longer the →



## Smaller companies are looking to captives

trigger for the formation and use of captives. Captive management companies and the in-house risk managers of large corporations are finding new uses for them.

"We're still seeing captives being formed for the traditional reasons. But, clearly, niche captives are what has kept the incorporation level at the height it's at," says Jill Husbands, vice president at J&H/M&M. "Originally, a captive was something only a large corporation would find of interest. Now middle market companies are forming them, too."

"There is a recognition of captives' value by what we'll call 'Fortune 2000' companies," says Alan Cossar, executive director of Aon Insurance Managers (Bermuda). "Smaller companies are looking at captives as significant risk management tools. It brings a focus to your risk management programme, and it provides additional opportunities to go into the reinsurance market."

"If there's any trend developing, it's that new captives being formed have very clear goals that are specific to their companies," he continues.

"We manage 300 captives," says Husbands. "We interface with 300 corporations or individuals who own these companies. Each has its own needs, and they're all different. They have different philosophies and are looking for different end results."

**I**N THE EARLY DAYS CAPTIVES TOOK ON their owners' property risk. Today, says Ezekiel, "Property coverage doesn't make sense for a captive. You generally collect the premiums and pay out in the same year. Where you can make money with a captive is in risk with a longer tail, such as medical malpractice. You can still be learning about losses 10 years later. If you know you're likely going to have a loss of \$10 million some time in the future, you can charge the insured, your owner, \$6 million. You invest this in the market and, by the time you need it, the \$10 million is covered. Some captives match up the duration of their risks and their investments. The important thing is the predictability of the liability stream."

"This whole employment liability area is very big," says Ezekiel, "gender and age discrimination, sexual harassment. Again, people are using captives to fill this insurance need." Clearly, a corporation's employment practice is an area of risk over

which it has a larger than normal amount of control. It can assume the risk with some confidence.

"You keep in the captive only the risk that is very predictable," says Ezekiel. "You know just what you will have to pay out when you have a loss. The rest goes into the reinsurance market. One large loss could blow the captive away, but the reinsurers can handle it, because of the law of large numbers."

Companies are discovering the ability of a captive to help them strengthen customer relationships by offering related insurance products. Says Cossar, "One area

### WHERE YOU CAN MAKE MONEY WITH A CAPTIVE IS IN RISK WITH A LONGER TAIL

where we are seeing growth—and it was just talk three years ago—is the area of controlled third-party business. It makes sense where there is an insurance element in the relationship."

He cites, as examples, retailers who make credit card insurance available to their customers, car dealers who offer automotive warranties, or companies shipping merchandise who can offer insurance against damage. "Because you have control over the process, itself, you know it's good business," says Cossar.

"You're also participating in the reinsurance market. And because you're assuming some of the risk, yourself, you can influence the terms and pricing on behalf of the customer. This enhances your relationship."

Multiple-owner captives, such as association and industry captives, are also being used in relationship building. Captive insurance companies have been formed by groups, such as professional, sporting, or industry associations. "The National Basketball Association might be an example," Ezekiel says. "Each entity, on its own, is not large enough to have a captive, but as a group they can do it. The captive is usually owned by the members of the association. Industry captives are owned by members of the same industry, for example groups of structural engi-

neers, architects, supermarkets, doctors."

Their purpose may have been to cover the risks of the organisation, itself, yet many association captives have discovered they can put together insurance packages with the sort of terms and pricing their members want. It adds to the list of membership advantages, while contributing to the bottom line.

Corporations may also find benefit in controlled third-party business. Though it is less of an incentive than it used to be, companies who write a significant amount of third-party business through their captives can still receive some shelter from tax.

Husbands describes a time in the 1980s when some captives, particularly those owned by oil companies, wrote a great deal of unrelated third-party business strictly to take advantage of tax breaks, "with disastrous results. We don't recommend to clients to develop third-party business unless there is a specific relationship in which it makes sense, such as extended warranties on their products or credit card insurance."

"Clients are beginning to recognise the opportunity that can be developed by using a captive as a profit centre," says Carr. "Years ago, you would form a captive to control losses more effectively or improve a pricing structure. A percentage of new companies formed have found ways to produce a profit through their captives."

"For example, a company might offer a certain kind of insurance to clients or suppliers through a captive. It can make a profit on the placement of a piece of business for a number of insureds. And at the same time, it's good at bonding the business relationship by offering them a good insurance product."

The development of Bermuda's reinsurance market has been a benefit to captives, as local reinsurers, seeking new markets, are reaching out to captive insurance companies. Ezekiel says favourable rates in today's reinsurance market allow captive owners to place much of their risk there. "You can pay what is considered a rational premium into your captive, then lay it off in the reinsurance market. In a 'hard' market, a captive will retain more of the risk."

**C**APTIVES HAVE BEEN, FOR YEARS, the backbone of the Bermuda insurance industry. It's still probably the largest employer [in insurance], says Carr. "From that base, people in Bermuda ➔

have learned the industry and moved into important roles in excess liability companies and catastrophe and property insurance."

"Bermuda started out with captives and developed a ton of expertise in the 1980s," Ezekiel says. "We've evolved into an insurance centre where captives represent just one piece. Bermuda has separated itself from competing domiciles and is much more akin to London or New York as an insurance centre. Our expertise and the variety of business have been sustaining features as a place for captives."

Captives fuelled Bermuda's development as an international insurance centre. In return, being an international insurance centre is a major reason Bermuda continues to attract captive business. The Island has built a substantial pool of insurance expertise, in captive management, brokerage, insurance and reinsurance.

Says Ezekiel, "Our regulatory climate is another sustaining feature. Our regulations have teeth, but they are put in place with

## THE ISLAND HAS BUILT A SUBSTANTIAL POOL OF INSURANCE ENTERPRISE

the company's needs in mind. People know they are coming to a jurisdiction that knows their business."

What, if anything, threatens this picture of Bermuda as a captive haven? "Tax threats are always there," says Ezekiel, "though for UK or US captives there are a limited number of tax benefits left."

"In terms of a threat, it's difficult to see anything other than a very sustained soft market. We're in the middle of the longest soft market there's ever been but we're still growing. I don't see major threats. Captives are here to stay. They have shown that they are not just creatures of a 'hard' market."

"The [captive] business is huge," says Husbans, whose job is new business development. "I really believe what we need to do now is develop more ways to use captives, so we're not just developing captives. If we can create new products, it solidifies relationships. The more you have to offer, the more likely you are to keep a client happy."

That's as true for Bermuda as it is for the captives. **BB**