Captive Basics – Why Form a Captive?

What is a Captive?

In its simplest form, a captive is a wholly owned subsidiary created to provide insurance to its non-insurance parent company (or companies). Captives are established to meet the risk-management needs of its owners. Once established, the captive operates like any commercial insurer—it issues policies, collects premiums and pays claims. It does not offer insurance to the public (although in some cases, it may insure risks that are external to its parent).

A captive is different from a commercial insurance company because it usually just serves its parent company. As a result, captives are regulated separately from commercial insurers that serve the public, but usually by the same regulatory body as for commercial insurers.

While a captive is typically owned by its parent company, one can also be owned by a group of companies or entities with similar exposures, for example, trade associations. Captives can be used to provide insurance cover either directly or as reinsurance of a primary or fronting insurer.

Why Form a Captive?

There are many reasons to form a captive and these can be different in each case. Many multinational public and private corporations own captive insurance companies in order to mitigate their exposure to a wide range of risks.

They have found that ownership of a captive improves their ability to reduce insurance costs, streamlines the administration of insurance, achieves tax benefits and can be a highly effective risk management tool. Practically every risk underwritten by a commercial insurer can be provided by a captive. Sometimes, too, a captive can provide access to hard-to-find commercial insurance.

However, a note of caution: it is important to distinguish between the benefits of self-insurance, or risk retention, and the benefits of captives. Some of the literature promoting captives does so on the benefits of self-insurance which of course can exist or be organised without the need for a captive. The same literature can also invent or exaggerate benefits (e.g. access to wider markets, extra commissions).

A well run captive functions as an insurance company. It is organized to meet internal and external tax and compliance audits. It uses rigorous processes, and the owner is able to feel confident that initiatives undertaken with its captive will deliver long term value.

We have listed below some, but not all, of the reasons captives are formed.

- Reduce the Total Cost of Risk
- Risk Management Reward – more focus on the cause and amount of losses being incurred, which leads to greater emphasis on loss prevention programs
- Direct Reinsurance Market Access
- Funding exposures that would otherwise be self-insured or for which commercial insurance is unavailable or too costly.
- Flexibility in Program Design – tailored cover, premium and retention requirements
- Retention of underwriting profits and investment income on unpaid loss reserves
- Information and Control
- Possible tax planning advantages depending on the parent's domicile

- As the captive grows and reserves increase, it will have greater capacity to retain risk and be less affected by commercial market cycles.

Traditional insurers do not meet every risk management need for every business and, as risks evolve, responses to managing these risks must change. For both of these reasons, a captive comes into its own.

How Palm Can Assist

Palm can assist with feasibility work to help you decide whether forming a captive is the right path for you. Our speciality is the provision of insurance underwriting and analytical advisory and support services that are the core of captive operations. Using such services, a captive can both function and be seen to function as a Barbados insurance company and the captive owner is able to better understand and optimise captive value.

Palm provides advisory services in the areas of underwriting, risk management, governance, planning and development of new products.

We also have a network of non-affiliated expert resources in the areas of captive management, tax, investment management, accounting and actuarial, legal, and claims.