

## Captive Companies

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Article abstract

Voici la deuxième partie des travaux présentés au dernier *Rendez-vous de Septembre*. Nous soumettons cette étude à nos lecteurs qui y trouveront matière à réflexion. M. Mayes est, en effet, très bien placé pour voir ce qui se passe dans le milieu des assurances aux États-Unis. Il assiste à l'essor assez extraordinaire des compagnies captives, ces belles esclaves, avons-nous dit, dans notre dernier numéro, en empruntant le mot à Jean de la Varenne, qui l'appliquait, il est vrai, à bien d'autres choses. M. Mayes ne peut et ne veut pas s'opposer à l'expansion des sociétés captives. Il en voit les inconvénients et, parfois, les graves défauts. Ce n'est pas une mise en garde qu'il nous présente, mais une étude assez approfondie du problème que pose la dernière née d'une famille nombreuse. A.

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## Captive Companies

by

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*Voici la deuxième partie des travaux présentés au dernier Rendez-vous de Septembre. Nous soumettons cette étude à nos lecteurs qui y trouveront matière à réflexion. M. Mayes est, en effet, très bien placé pour voir ce qui se passe dans le milieu des assurances aux États-Unis. Il assiste à l'essor assez extraordinaire des compagnies captives, ces belles esclaves, avons-nous dit, dans notre dernier numéro, en empruntant le mot à Jean de la Varenne, qui l'appliquait, il est vrai, à bien d'autres choses. M. Mayes ne peut et ne veut pas s'opposer à l'expansion des sociétés captives. Il en voit les inconvénients et, parfois, les graves défauts. Ce n'est pas une mise en garde qu'il nous présente, mais une étude assez approfondie du problème que pose la dernière née d'une famille nombreuse. A.*



In short time that has elapsed since the *Rendez-vous* of 1971 there has been a marked increase of interest in the philosophy of "captive" companies, and during this interval not a few captives have been formed and activated. The subject has been paramount in seminars held in Bermuda, the United States and Canada, and it has found itself on the agendas of meetings in the United Kingdom and Con-

tinental Europe and has even been publicized from the New Hebrides Islands.

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There are various categories of a "captive company", ranging from the subsidiary of a parent owning an automobile finance company or similar consumer credit company, a company formed to write personal lines for employees of its parent or one the object of which is to insure the exposures of its parent and in which all of its shares are held by the parent. For the purpose of this discourse, we shall consider a captive as a wholly-owned insurance company subsidiary with the primary function of insuring exposures and risks of the parent organization. We shall also deal here only with "off-shore" companies formed and domiciled outside of the country of residence of the parent and concerned with the assumption of exposures of overseas or "home-foreign" property and loss of profit risks of its U. S. based multi-national manufacturing parent.

Since we last met here in 1971 there has been a marked proliferation in formation of captives following the definition we deal with to-day. At present count there are estimated to be 145-150 captives registered, with some 25-30 in Bermuda along with seven or eight captive management offices.

We are concerned here with three basic forms of captives.

1. *The Flow-Thru Captive* — which might involve a captive management firm and under which admitted policies are issued by fronting companies in various countries of risk location. An agreed amount, generally around 90%, is ceded back to the captive from each country. Usually the fronting company would retain a share of 10% or less. The amount ceded might be controlled by local regulations. Some risks might be directly insured non-admitted by the captive.

The entire amount ceded would then run or flow through the captive's books. A retention, usually first loss ranging from \$25,000 to \$100,000 is assumed by the captive. This is equivalent to a deductible with the credit in the form of reinsurance premiums. A reinsurance treaty already established by the management firm receives the surplus over the agreed first loss amount. The captive may receive a reinsurance commission and also participate in the pool treaty of other captives for a small percentage. Under this form brokers are generally eliminated in direct placements.

2. A second method involves the captive only for the amount of its retention. Under this system, the direct underwriters cede by arrangement an agreed amount of each risk to the captive and probably in the form of a first loss retention ranging from \$25,000 to \$100,000 or higher. The captive premium is based on the equivalent of the deductible credit if a first loss retention is involved. Since the captive's liability is a controlled amount on each risk, reinsurance may be limited to a stop-loss protection.

3. A third practice is quite straightforward and sets the captive up as a reinsurer of a proportional share of each risk. This form is more unique and applicable to the large industrial firm. Under the first two examples, the captive might be incorporated with the minimum capital of \$120,000 as required in Bermuda. Larger concerns assuming a proportional line would be capitalized at several million dollars. The amount of risk assumption or retention of the latter type captive could range from \$100,000 to several million. With such significant shares of each risk fire protection and engineering are of paramount importance. Reinsurance facilities may entail a complete treaty arranged and operated by the captive's own management.

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Corporate consideration of formation of a captive is generally related to capacity, premium costs, earnings which may accrue to a newly created profit center thru accumulation of off-shore tax exempt funds, availability of reinsurance with a resulting turn in commissions, the possibility of writing classes or exposures not available in traditional markets and to achieve uniformity of world-wide covers. Taking these considerations in order, we first refer to capacity.

Any lack of capacity is largely due to the decline in world-wide underwriting profitability of industrial risks. Depressed and inadequate rate levels for this class, introduction of new and more hazardous processing and manufacturing methods, inadequate fire protection and inspections and substantially higher values have all contributed. With any consistent return to profitability the alleged capacity problem would diminish if not disappear (as witness the aviation market). The mere formation of a captive will not eliminate capacity difficulties so long as these deterrents exist. There is no question that a captive accepting an important share of a single account can reduce the degree of the problem. However, few captives as yet appear willing to assume substantial amounts of liability for their own account.

Premium costs may be reduced depending upon the credits which the direct or lead underwriters are willing to concede, the cost of reinsurance or stop-loss protection, management fees and administrative expenses incurred in a self-managed program. It is to be assumed that reinsurers will expect a modest profit and their charges will follow the experience.

Additional earnings thru an off-shore domiciled profit center and resulting accumulation of tax free funds has been a positive result for captives. How long this will continue is a matter of conjecture.

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Over a year ago the U. S. Department of Justice issued a list of several major U. S. multi-national companies whose captive insurance companies were under investigation. The Department was concerned lest such corporations inflated their premiums to enable them to accumulate unrealistic sums of tax free dollars in overseas tax havens. Corporations with ethical management and using proper premium charges were not subject to investigation. I know of no action actually taken by the Department but should a serious offender be discovered all may be tarred with the same brush.

More importantly, a recent release by a highly respected trade association cited a directive from the U. S. Internal Revenue Service to its field auditors regarding captive off-shore insurance companies. The tenor of the directive could spell trouble for such companies even where they were carefully conceived and organized and prudently managed. The basic theory of the Internal Revenue Service appears to be that these companies simply represent an incorporation of self-insurance reserves. Accordingly, they may be treated as sham transactions which could result both in the disallowance of deductions for premiums paid and the possibility of constructive dividends being imputed to the parent company. A ruling is expected in the near future.

Where reinsurance is placed directly by the captive, or thru its own management, the commission turn is an important contributor towards reduced net premium costs. This is an advantage as long as major losses, which fall to the account of reinsurers, do not occur.

There is no question that a captive is in a position to provide its parent with cover on perils not generally available in traditional markets and to arrange for uniformity of an insurance program applying to multi-locations in many countries.

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A development not often considered but affecting both captive and underwriter (be it direct or reinsurer) is the proliferation of nationalism.

Every year additional countries join the growing list of those requiring that insurance on property of national domicile be placed with companies licensed in the country of risk location. Subject to certain exceptions, such regulations currently exist in fifty-nine countries. One might say from A to Z, Angola to Zaire. Violation of local laws or regulations eliminates the advantages of expensing premium against local earnings and can result in penalties ranging from fines to loss of business license to jail sentences for officials of the insured.

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Captives using fronting arrangements may find the local insurer of questionable ability to respond in event of loss. So called "cut-thru" endorsements are of dubious value in event of denial of liability or failure of a fronting company. The fronting policy is the only legal policy document on which interpretations may be determined under local jurisdiction in event of dispute and it is the policy against which policy fees, taxes, unearned premium reserve and such items as brigade charges are applied.

Freedom of convertibility and remittance of reinsurance balances are increasingly difficult to obtain in many countries. Government or pseudo government reinsurance monopolies with compulsory cessions materially reduce the desired cash flow to the captive.

In theory, the captive company concept would appear to be the panacea for all the desires of a multi-national buyer of insurance. In practice, this is not a well founded assumption.

We have looked at the captive company from the standpoint of the insured or the parent company. Let us now consider the positions of the direct insurer and the reinsurer.

There can be no doubt that both direct underwriter and reinsurer are not entirely without blame for the development of and recent surge in the formation of captives. The historic resistance of our industry to large deductibles as desired by corporate insureds which are concerned only with recoveries of substantial losses has been a contributing factor. Two major U.S. underwriting syndicates, one writing industrial property risks and the other petroleum and petrochemicals accounts, and with the same or similar insurers in each pool,



have not been uniform in their application of deductibles. One of these syndicates has recently lost some \$11,000,000 in premiums to a captive formed by a group of U. S. corporations engaged in a related industry. The fact that this has occurred does not of itself affect the pitfalls to which the direct writer or the reinsurer are exposed thru participation in a captive company program.

284 The fronting or admitted underwriter must retain the statutory unearned premium reserve generally 40%, account for premium taxes, policy fees or brigade charges as applicable, cede the bulk of the premiums to the captive at far less commission than either normal treaty or facultative placings generate, apply for and arrange currency conversion and remittance of reinsurance premium and at the same time hopefully make even a slight profit. Here again, the policy issued by the fronting company is the only policy admissible in the courts of local jurisdiction as the legal document expressing the coverage afforded.

Although not necessarily pertinent to the captive, the financing of losses is important to both direct and reinsurance underwriters. The case of the ITT loss at Longuenesse in 1971, and with which I believe the French market is at least conversant, is a case in point. Reserves for all open losses for any calendar year in France must be posted and the money physically deposited in France by December 31st. My company shared with others the exercise in financial gymnastics necessary to move funds to France from almost any available source. It is of interest to note further that my company has still been unable to collect from certain reinsurers. Think, too, of the exchange penalty or loss which may be incurred in financing losses.

The "Smithsonian Agreement" arrived at in Washington from deliberations of the members of the International Monetary Fund, permits currency values to fluctuate 2.25 points on the upside and 2.25 points on the downside, a range of 4.5 against parity. A concurrent revaluation of a major currency could materially increase this swing and the effect of such currency valuation changes could create a sizeable loss for the underwriter putting up the reserves or paying a loss prior to collection from reinsurers. One must also bear in mind that some countries have dual rates of exchange, the "financial" and the "commercial" rates. Funds imported to such countries for conversion come in at the "financial" rate. Funds exported, following

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collection from reinsurers are repatriated at the "commercial" rate, another potential exposure to exchange loss. The following example will illustrate this exposure. I have used a fictitious country which we shall call Euphoria.

### U.S. Insurance Underwriter doing business in the Country of Euphoria

Local currency is euphors

Loss Euphoria	Euphorian Euphors 60,000,000	Euphors 60,000,000	
Net Retention	2,500,000		
Treaty Reinsurance	<u>17,500,000</u>	<u>20,000,000</u>	
Non-Admitted Reinsurance		Euphors 40,000,000	

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In this particular case we have assumed a loss of 60 million euphors of which amount 40 million represents the liability of non-admitted reinsurers. Under existing regulations in Euphoria the Company writing the business must cover the gross loss reserve with cash or securities as of December 31st of the year of loss occurrence, with credit only for that portion of the loss applicable to admitted reinsurance. Reinsurers by and large are not eager to fund loss reserves and here is where the exchange exposure lies. If all of the non-admitted reinsurers would send in their proportionate share of the loss reserve immediately in cash, no exchange risk is assumed by the policy issuing company. For the proportionate share of the loss reserve not funded by the non-admitted reinsurer, the policy writing company must finance that share and assume a substantial exchange risk resulting from the potential fluctuation of as much as  $4\frac{1}{2}\%$ - $2\frac{1}{4}\%$  on either side of fixed parity between the Euphor and the Dollar and the potential of financing the reserve at the Euphorian financial rate and repatriating the recovery from non-admitted reinsurers at the commercial rate.

Assuming that reinsurers representing 50% of the non-admitted reinsurance refused to finance the loss reserve, the primary underwriter would be required to finance Euphors 20,000,000 through its parent. If we assume the "financial" Euphor was .4050 U. S. at the time, the cost to the U. S. parent underwriter would be \$8,100,000.



Subsequently the loss is paid, the non-admitted reinsurer agrees to pay, and the Euphor 20,000,000 is received. The primary underwriter is called upon to reimburse its U. S. parent. The debt to the parent underwriter is in dollars not Euphors. Conversion and remittance is at the "commercial" rather than the "financial" rate. The spread between these two rates is assumed to be .4020¢ vs .4260¢ or 5.97%. Conversions of the 20,000,000 Euphors for remittance at .4020 results in U. S. \$8,040,000 or a loss to the U. S. parent underwriter of U. S. \$60,000.

**286** Should this occur, we might change the name of our fictitious country from Euphoria to Epitaph and inscribe the words "Here lies the unwary underwriter".



I would not infer from the foregoing that my company avoids the captive like the plague. We do participate and in varying degrees in several captive subsidiaries of U.S. multi-national corporations. Certain ground rules, however, have been established which may be of interest to this audience.

1. Risks in countries, in which free flow of outward reinsurance premium is prohibited or impeded by legislation prohibiting reinsurance abroad or with restriction through exchange controls, shall be excluded.

2. In countries where compulsory quota share reinsurance must be placed with government reinsurance groups or local reinsurance bodies, the compulsory percentum share shall be excluded.

3. In countries where a percentage must be reinsured in the local market such percentage share shall be excluded.

4. For countries where delays in remittance of reinsurance premiums are common due to exchange controls or lack of exchange, my company will only be obligated to pay reinsurance premium to the captive when remittance is received at Head Office.

5. In countries requiring that the unearned premium reserve on that portion of the reinsurance ceded out of such country must be withheld, we will deduct such percentage of the reserve from cessions to the captive.

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6. On risks excluded from the captive program because of conditions described in (1), (2) and (3), the direct placement must be offered to the company.

7. Adequate guaranties are to be obtained from the parent of the captive company to guard against impairment of its capital and to insure prompt reimbursement for its share as a reinsurer or self insurer on losses paid.

8. Advance commitment is to be obtained providing for prompt remittance by the captive at our request of its share of any outstanding loss in such country as requires setting up of deposits to cover outstanding loss reserves.

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And we should perhaps add, "such business considerations as may be deemed appropriate".



In conclusion, I trust that my remarks have not been offensive to my several friends here whose companies actively support the captive company concept nor overly encouraging to those who hope the concept will quietly vanish through controls or legislations. I have attempted to paint both sides of the picture. At the same time, I shudder to think of the cost of insurance to the smaller commercial and industrial risk if millions of dollars, pounds, francs, guilders, lira, yen, bolivars, pesos, rand, or other major currency premiums disappear from traditional markets.