

Why may Captive insurance companies decide to write non-related business?

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If we agree that a captive should be, in every sense, a bona fide insurance vehicle and is used primarily for the transfer of risk; and if we look at three main reasons why a parent may establish a captive i.e. risk management, profit centre and tax benefits, these are all logical reasons for incorporating a captive. However, what must be considered and what is apparent, is the priority given to these reasons. Using the following, can we be sure that the parent of example A has the same consideration for the captive as a bona fide insurance vehicle as example B?

Example A.		Example B.	
% Priority to:-		% Priority to:-	
Risk Management	10%	Risk Management	70%
Profit	45%	Profit	15%
Tax benefits	45%	Tax benefits	15%

Granted, the above examples are simplistic, however it is possible to observe where the first decisions to write non-related business may appear.

Many of the known companies to suffer difficulties writing non related risks, were American parents with captives established in Bermuda in the 1980's. This brings us to one of the other main reasons why non-related business for a captive would be contemplated. Many countries' tax authorities have written into their requirements, that in order for captive insurance premiums to be assessed as fully tax deductible, the captive must be writing at least 50% non-related business. An example of this is the United States.

So we have two main reasons which are also closely linked reasons, profit and tax, why a parent may decide to write non-related business. Why would taking this decision necessarily mean that the captive may then experience problems?

There are at least two ways a captive may write non-related business, it may

- a) write the same class of business but for a different client, or
- b) it may write a totally different class of business for the same and other clients.

With regards to a) this is especially true where highly technical risks are involved. Where the Captive is obliged to provide expensive technical skills - engineers, surveyors and claims facilities, these skills may not be cost effective for the business of the parent alone. In highly specialised classes, there may not even be a large enough skill base for a single entity to equip itself with the right resources. Examples are Nuclear energy, the Pulp and Paper Industry, and specialist environmental issues.

In relation to b) for example, a parent company who builds articulated lorries may, through their captive, underwrite property damage cover for all their warehouses and manufacturing plants. They may subsequently look at a new area for their company and decide to underwrite warranty cover for second-hand lorries, both their own and other manufacturers.

In addition to this with regards to a) a captive may write credit risk cover for a parent that trades in precious metals, the same captive may then offer the same cover to another totally separate company but who also trades in precious metals.

Procedure.

In establishing the working plan for any captive, there should be close dealings between the parent and the captive manager, in so far as the parent should have some experience of what is insured, self-insured, their claims history etc. This provides the captive manager with a framework on which to build, adding or changing elements wherever necessary. Once the framework has been built, the parent together with the captive manager, must set the necessary standards as to the capital required for the business to be underwritten, the quality of assets, the adequacy of reserves, and the quality of the reinsurance programmes together with the reinsurers.

Going back to the articulated lorry builder, the following scenario **although simplified**, is an example of what **may** happen;-

The articulated lorry parent company decides that as an additional profitable business they will offer warranties on non-related second hand lorries. Neither the parent nor the captive manager have particular expertise in this area, but they concur that as they have a low faults rate on their own lorries and they build in room for higher fault rates from other manufacturers, this should be sufficient with regards to capital and reserves adequacy.

What may happen;

- This is a product not yet widely offered on the market and it sells well.
- A number of different design faults appear but in different lorries from different manufacturers, once the lorries are at least two years old.
- The cost of spare parts and repair becomes extremely expensive, far in excess of the premium income.
- The reserves initially built up by the original captive business are used to fund the warranty business.
- The captive owner tries to correct the problem, by making the warranty conditions more restrictive, but sales diminish, although there are still the costs of marketing and sales people to be covered.
- It may come to a point where the parent may have to decide whether to run off the warranty business and inject new capital to save the property damage business or to run off both classes of business.
- In addition to the above, little known reinsurers may have been used with poor security, who subsequently may not pay claims.

The problems outlined above may also be compounded by:-

1. The relevant authorities being unconsciously too lax, or too eager to gain further business. Some captive jurisdictions do not permit captive insurance companies to write non-related business.
2. Overconfidence of the parent. Parents of captives in the past have written non-related business on the basis that other companies have equal risk management standards to their own, this is often not the case.
3. It is the argument of some regulatory authorities that if an insurance company employs different individuals for their expertise in different classes of business, i.e. motor, property, long term business etc. then so should a captive insurance management company – or at least have access to the different areas of expertise.

Conclusion.

There is no doubt that there are many real and beneficial reasons for setting up captive insurance companies; the transference of risk that goes beyond self funding through contingency reserves. However, to sum up in one sentence, “When considering establishing a captive insurance company, especially one that may be intending to write non-related business, extreme care and research must be taken at every step of the procedure”. Although the problems encountered are usually the same, the combinations can be different in each and every case. It may be that the risks of the non-related parties being reinsured are not as well known as well as their own. It may also be a break down in communication and responsibilities. In other cases it may be poor management or insufficient build up of reserves, or weak reinsurance protection. In putting any structure together (like a car), all the parts have to be of the highest quality and standard, so that the structure functions smoothly as a whole - it must also be maintained on this basis continuously. Therefore each part must be investigated: firstly; the reasons for establishing the captive; the nature of the risk(s), the cost; the people involved; the location; the reinsurance programmes; the management; the financial configuration i.e. solvency margins and reserves and the auditing.

Although the need for caution is emphasised, this is not to say there are not any captives writing non-related business. On the contrary, there a number. Those which are particularly known, are either manufacturers or retail chains selling household electrical goods, writing successful extended warranty business on both their own products, and those of associated companies.

In the last 10-15 years many lessons have been learned in the captive industry and there are many reputable “experts and managers” in this industry. To reiterate, in proceeding with establishing a captive, whether intending to write non related business or not, quantify all the necessary steps, take each step carefully and safeguard against those who may not be as careful!

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