FILTER OUT THE NOISE: THE REAL ISSUE IS INSURANCE

The captive insurance industry has experienced phenomenal growth over the last decade, and continued growth seems likely. The insurance industry cycles between hard and soft markets, as global and domestic events are shaping the fluctuating costs of insurance.

Meanwhile, too many business owners (insureds) have experienced insurance companies dead set on using their 'denied' stamp when a claim crosses the claims adjuster's desk. By way of a recent example, we have seen AIG/Chartris delay payment for an obvious oil & gas pollution claim attempting to write mythical coverage restrictions into the policy after the fact, rather than expeditiously settling a five-year-old claim. This is the single greatest reason that captives exist in the marketplace. The uncertainty of whether the conventional carrier will properly and timely respond undermines the very purpose of conventional policies.

Taking all of this into account, why wouldn't middle-market business owners seek out alternative methods to mitigate their risk and control operating costs overall?

They are. Business owners who have developed a greater understanding of how risk affects all aspects of their businesses take control of their risk management and seek out alternative risk financing decisions beyond what is available in the conventional insurance market.

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How can greater control over risk be gained?

A viable risk management alternative is a captive insurance company. Properly designed and operated, a captive can provide benefits that include risk management, cost control and most importantly, a higher degree of certainty. To this end, the US Internal Revenue Code statutorily provides benefits that go beyond risk management—albeit, these benefits come with its own set of rules. The public policy objective inserted into the Internal Revenue Code a hundred years ago was that small businesses and our country's economy would benefit from mitigating uncertainties through captive insurance arrangements. One of the common vehicles needed to satisfy IRS (Internal Revenue Service) imposed conditions for risk distribution has been pooling arrangements.

Current captive market

The current climate for new captive insurance companies is healthy, but as with anything new, there exists sceptics and fear mongers tied to conventional insurance arrangements. After all, every dollar put into a captive insurance program is viewed – at least by some – as 17cents out of the P&C broker's pocket. The IRS was most recently seen peddling fear by naming captive insurance as one of the 'Dirty-Dozen' tax schemes, pointing fingers at 'unscrupulous promoters' in efforts to deter the growth of a legitimate industry, statutorily rooted in the Internal Revenue Code itself. After failed attempts to rewrite existing captive legislation that remains to this day on the books, the IRS has taken to the streets, citing to its own Dirty Dozen characterisation, but saying little else. Essentially the Service's position is that if not properly carried out, captive planning can be abusive. The same inane comment can be applied to every

government program, ranging from the military to the police to food stamps and Medicare. Yet the collateral damage intended by these scare tactics is an unwarranted attack on captive insurance companies operating in a tax-compliant manner under the statutory provisions of the Code.

Insurance - defined

By simply removing the word 'captive', captive insurance's focus rightfully shifts to the actual issue – insurance. The threshold question is whether the captive insurer at issue is writing true insurance that is properly priced. The essence of insurance is simply exchanging certainty for uncertainty. Insurance is an arrangement by which a company provides a promise of compensation for an uncertain and fortuitous, specified, possible future loss. Without insurance policies, uncertainty of is a needless cost imposed on businesses. Without insurance, a single occurrence could bankrupt a company, leading a company to retain otherwise unneeded capital 'just in case' which could otherwise be used for productive business purposes.

Insurance companies must meet specific criteria to pass the insurance 'sniff test': (i) risks covered must meet the definition of an insurable risk as commonly understood, (ii) risk transfer or shifting must have occurred, and (iii) the insured risks must have been satisfactorily distributed (in reference to the 'law of large numbers').

More specifically, in the case of bona fide captives, the insurers must issue what is commonly understood as insurance. Examples of coverages are directors' & officers' liability, business interruption, errors & omissions coverages, and cyber risk.

Risk transfer or shifting occurs when one exchanges a certain premium for an uncertain loss to the insurer. This is implicit in an insurer's issuing policies and receiving premium payments. Finally, insurance companies must meet the criteria of risk distribution or pooling in that the insurer is distributing the risk over a large number of events, none of which is particularly likely to occur. The requisite number or method of distributing the risk is not a bright line test and itself is often a matter of scrutiny.

Risk pools seeking to distribute and diversify risk

The concept of risk pooling dates back to the days when Ancient Chinese transported their goods over the dangerous river ways of the Yangtze. In order for an individual merchant to reduce the total loss of the goods, he would distribute goods across many vessels. Fast forward to the 17th century where Lloyds was formed to distribute the risk of loss of ships as their cargo travelled back and forth to India from England around the Cape of Good Hope. Exposure took the form of a shipwreck or a pirate attack. These forms of insurance still exist today, albeit with a few refinements. For example, many large insurance companies, such as State Farm, are mutual insurance companies where insureds share their losses through common ownership of the insurance company.

But ultimately, what does this mean for the captive insurance owner? A captive insurance company is required to have a material level of risk distribution so that the risk of loss is spread among multiple occurrences. One method for obtaining the required levels is through risk pooling arrangements in which an insured's risks are combined or pooled with risks of other insureds under similar, identical, or disparate policies. The law of large numbers is a key factor that drives risk pooling and therefore insurance arrangements; the larger the pool, usually the more predictable the losses are, especially where the individual loss exposures within the pool are either uncorrelated or negatively correlated to one another. Accuracy also increases as losses are spread over more participants. The very purpose of risk distribution is to reduce risk. When the properly designed pool is large, the captive benefits from significant risk reduction with the increased number of exposure units.

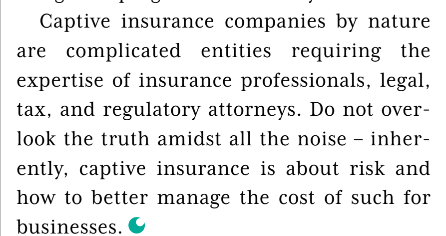
Important pooling considerations

An important consideration in differentiating a simple transfer of risk from bona fide insurance is the extent of risk distribution. The underlying concept is that insurance involves the sharing of risk among many risk exposures, which increases the predictability of losses. Multiple strategies should be used to obtain risk diversification. Among the strategies, a risk pooling arrangement could be used to help captive insurance companies gain greater risk distribution and to provide stop-loss protection for direct written policies. At the same time, policies should be designed with multiple exposure units. The result of the pooling is a more diversified book of insurance, with greater predictability, held by each captive insurer as an advantage of being in the pool.

Conclusion

Whether in context of a captive insurance company or a large insurance company, the criteria for an insurance arrangement remains same: (i) coverages which meet the commonly understood notion of insurance; (ii) risk transfer or risk shifting and (iii) risk distribution. These criteria apply to insurance companies across the board. Despite industry scrutiny and expressed IRS concern, captive owners whose intentions are rooted in mitigating their risks and reducing overall costs of risk should continue to operate their captives without concern. Recognise, however, alternative risk financing/captive insurance planning has many moving parts, requiring an experienced team to design the program and to carry it out.

Captive insurance companies by nature are complicated entities requiring the expertise of insurance professionals, legal, tax, and regulatory attorneys. Do not overlook the truth amidst all the noise – inherently, captive insurance is about risk and how to better manage the cost of such for businesses.



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