CAPTIVE FORMATION: THE ROAD TO SUCCESSFUL RISK MANAGEMENT

Hartley Hartman, of Johnson Lambert, talks to *Captive Review* about where to start in the captive formation process

After a plethora of brain storming sessions you decide that the most efficient and cost effective way to insure your select business risks is to form a captive. Now what?

The first step towards captive formation will be to choose various knowledgeable providers such as captive managers, actuaries, legal counsel and tax advisors to help you on the road to a successful formation. This process can essentially be broken down into four distinct phases: conducting a feasibility study, choosing a domicile that best suits your needs, completing a captive application and implementation. For the purposes of this analysis we will take an in-depth look at the formation steps of a 'pure captive', where the captive insures the risks of one group of related entities. There will, however, be slight differences in this process depending on the type of captive to be established.

Captive law in most domiciles requires that the applicant submit a captive feasibility study as a component of their application. The goal of a feasibility study is to determine whether or not the risk financing and risk management program of your organisation is, in fact, a viable option with a legitimate business purpose. The scope of a captive feasibility study can take many different shapes, however, for the purpose of forming a captive this study should contain at a bare minimum an actuarial analysis and an operational and financial evaluation of the captive. These are the two areas that regulators of each captive domicile will analyse when determining whether or not to accept a captive application.

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The actuarial analysis portion of the study usually include loss projections at three scenarios: projected, optimistic and pessimistic. The base of the projections may be different depending on the availability of your historical data. You may not have sufficient loss data or are unable to obtain this information from your past insurance carriers. In these instances the actuary may mix historical data with industry data or just rely on industry data. The actuary can also assist you in determining the premium pricing for the proposed insurance risks to be covered under the captive.

The second component of this feasibility study will focus on an evaluation of the proposed financial projections and operations of the pending captive. Regulators will pay close attention to this part of the feasibility study. This portion of the study will most likely be conducted by a captive manager, as they are in the business of administering captives on a day-to-day basis and are highly qualified to assist with this type of report. This evaluation will help determine how a captive can best manage its potential risk, however, it is imperative during this process that 'real' insurance risks are identified as being insured by the captive as there could be potential tax implications if the captive does not qualify as an insurance company.

The end result of the financial and operational evaluation of the feasibility study would produce an initial captive business plan, which would include a schedule of the anticipated insureds and type of coverage to be provided, program philosophy and pro-forma financial statements. A well-executed feasibility study will provide the framework for a successful captive business plan and will validate the benefits of foregoing the commercial insurance market to assume business risks within a self-funded captive.

The selection of a domicile for your captive should be conducted concurrently with your feasibility study, as there may be particular sections of the study that may need to be fine-tuned for the domicile of your choosing. In determining the domicile that best fits your captive you must first establish the overarching goal of your captive and then determine which domicile will help

you best meet that goal. There are five focal points that most owners consider when choosing between domiciles: regulation, infrastructure, reputation, logistics and tax.

Regulation

The regulations of the chosen domicile should be recognised and understood by all parties involved with the captive (parent, insurers, and reinsurers). There are differences in capitalisation, premium taxes, investment restrictions, annual compliance and reporting requirements amongst various domiciles which will play a role in determining which domicile is more suited for your particular captive.

Infrastructure

It is crucial to select a domicile that has a well-established infrastructure that will support the functionality of a captive. This includes an abundance of qualified service providers and a regulatory body that is adequately trained in captive management. Choosing a domicile with proven infrastructure can lead to a shorter response time when submitting business plan changes and various other submissions as there is less of a need to educate regulators on the specifics of your captive.

Reputation

The reputation of your potential domicile is another important factor to consider. There are some domiciles that have established a reputation for being particularly attractive to certain types of captives or industries and others that shy away from certain types of captives. Choosing a domicile that specialises in the type of captive seeking to be formed is highly beneficial for its growth and success. One distinct advantage that a reputable domicile can provide is the tendency to obtain more favourable rates from reinsurers.

Logistics

Most captive regulation require an annual meeting to be held within the selected domicile. Ease of travel plays a crucial role in selecting the proper domicile. There tends be greater interaction with senior management of the captive when the domicile is in closer proximity to the parent company. Although logistics is an important factor to consider, the overall infrastructure and knowledge of regulators and service providers should be of a higher concern as those factors will contribute to the success of the captive, whereas, logistics is more-or-less a commodity.

Tax

Tax compliance is a general concern when choosing a captive domicile. The choice of onshore or offshore domicile is heavily dependent on the physical location of the business risk the captive will be insuring.

For example, a US captive may be subject to various federal excise and local taxes on premium paid to non-US insurance companies. As such, captives that insure both US and international risk who are domiciled outside of the United States will often file a 953(d) election, which will allow them to be taxed as a US company for federal income tax purposes; minimising the perception that the offshore domicile was chosen as a form of tax evasion.

Premium taxes typically vary from domicile to domicile and are taxed at a much lower rate than premiums paid to traditional insurers.

Now that the most sensible domicile has been selected to meet the needs of your captive and the feasibility study has been completed, the captive application is ready to be submitted to the regulators of the selected domicile. Application requirements also vary from domicile to domicile, but will typically include:

- Application for admission (Certificate of Authority)
- Business plan outline
- Biographical affidavits for all directors and officers
- Listing of all authorised service providers
- Corporate documents (draft)
- Articles of Incorporation
- Bylaws
- Organisational chart
- Minimum capital and surplus guidelines
- Proforma financial projections
- Actuarial feasibility study
- Financial statements of parent company
- Insurance policies to be written and process documentation

The planning and formation phases of captive development can be involved and surrounding yourself with knowledge service providers will ease the process. As the industry advances the number of captive domiciles continues to grow as the captive marketplace is becoming more and more commonplace.

The creation of a captive insurance company is not always a reality, as evidenced by a pre-formation feasibility study, but can provide substantial risk management and tax benefits to those who are successfully able to obtain licensure.