

## ADVANTAGES AND DISADVANTAGES OF USING A CAPTIVE INSURANCE PLAN

Because it is usually a hybrid risk financing plan, a single-parent captive insurance plan has many of the advantages and disadvantages of both retention and transfer. The degree to which these advantages and disadvantages apply to a specific single-parent captive insurance plan depends on the design of the plan—that is, the amount of retention versus transfer built into the plan. The same is true of a group captive.

### Advantages of Using a Captive Insurance Plan

There are many reasons to use a captive insurance plan, particularly when compared with other risk financing plans. The following are some of the more prominent advantages to forming or joining a captive insurer:

- Reducing the cost of risk
- Benefiting from cash flow
- Obtaining insurance not otherwise available
- Having direct access to reinsurers
- Negotiating with insurers
- Centralizing loss retention
- Obtaining potential cash flow advantages on income taxes
- Controlling losses
- Obtaining rate equity

### Reducing the Cost of Risk

A captive insurance plan can reduce an organization's cost of risk over the long-run when compared to guaranteed-cost insurance because it involves retention; saves acquisition costs of obtaining insurance; reduces underwriting expenses; specializes claim adjusting functions; saves the cost of the commercial insurer's overhead and profit; and allows for investment income from premium, loss reserve, and collateral investment dollars. In addition, a group captive, if operated efficiently, can reduce a member organization's cost of risk by distributing the cost of administering the captive insurer among several members. Risk management professionals often consider reducing the cost of risk, and thereby preserving the resources of an organization, to be the most important advantage of a captive insurance plan.

### Benefiting From Cash Flow

A captive insurer allows the insured(s) to benefit from the cash flow available on losses that are paid out over time because, under a funded plan, the captive earns investment income on premium funds that have not yet been paid out for claims. This includes investment income on loss reserves and unearned

premiums. The insured benefits because it is part of the same economic family as the captive insurer.

However, the investment income earned by the captive is likely to be less than the insured's cost of capital. This constitutes an opportunity cost for the insured organization because it would realize a net savings if it could invest some or all of the cash tied up in the captive in its main business. The insured organization can retain some of the cash it would otherwise pay in premiums to the captive insurer by using a paid loss retrospective rating plan when paying premiums to its captive insurer. Also, some jurisdictions allow a captive insurer to lend funds back to its parent (the insured). This arrangement also overcomes the opportunity cost problem.

### **Obtaining Insurance Not Otherwise Available**

Another advantage of a captive insurance plan is that its parent organization can obtain insurance coverage that is not available from commercial insurers. Such coverage includes liability insurance for environmental, products, and professional loss exposures. To obtain these kinds of coverage, the parent pays a premium to its captive, which then issues an appropriate insurance policy.

One could argue that using a single-parent captive to insure hard-to-place coverages does not constitute insurance because the parent owns the captive and, therefore, retains the premium and losses arising from its own loss exposures. However, in such cases, the captive may be able to negotiate a favorable reinsurance arrangement, which, in effect, transfers the parent's loss exposures just as a traditional insurance arrangement would.

### **Having Direct Access to Reinsurers**

A captive insurer provides the insured organization direct access to the international market of reinsurers, which can be more flexible than insurers in terms of underwriting and rating. A captive insurer that uses reinsurance can capture any ceding commission on the reinsurance that would otherwise be paid to a commercial insurer. In addition, by removing the primary commercial insurer, the insured organization saves substantial markup costs. However, this advantage of gaining direct access to reinsurers is not as significant as it once was, because risk management professionals can often now deal directly with reinsurers, even in the absence of a captive insurance arrangement.

### **Negotiating With Insurers**

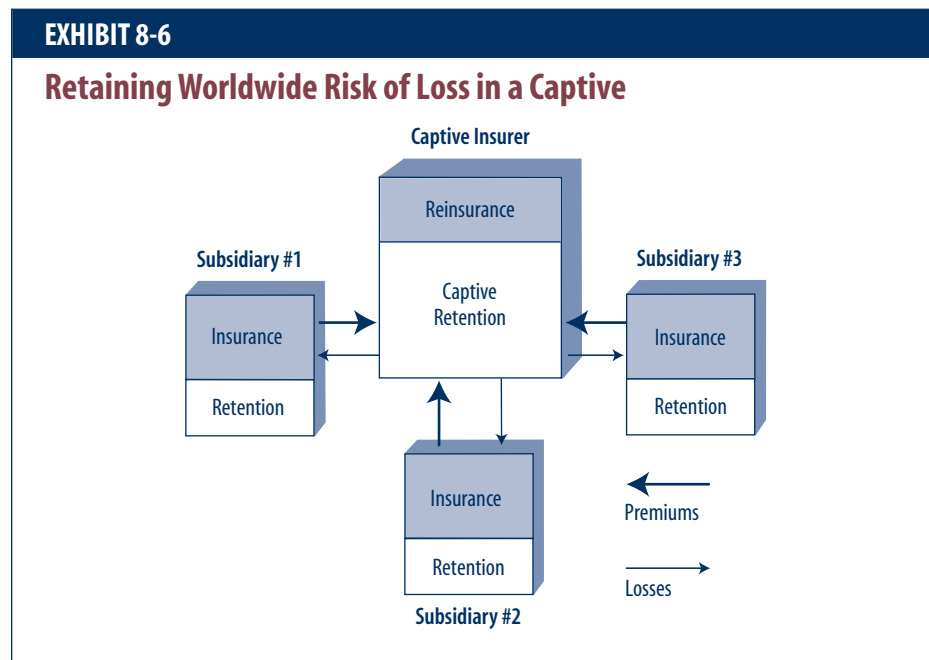
The existence of a captive insurer can improve an insured's negotiating power with commercial insurers. Assume, for example, that an airline forms a single-parent captive insurer to retain a quota share percentage of its aircraft hull insurance. If premiums increase in the aircraft hull insurance market, the airline might increase the share it places in its captive. However, the fact that the airline has this option might increase its bargaining power with its

commercial insurers, who might lower the airline’s premium so as not to lose business to the captive.

### Centralizing Loss Retention

Another advantage of a captive insurance plan is that the insured organization can use it to centralize retained losses that are spread throughout its subsidiaries. Centralization can result in savings to the insured organization because of the lower long-term cost of retention.

For example, if the management of a large multinational corporation wants to retain a significantly higher level of loss than each of its subsidiaries, it could use a single-parent captive to pool its losses on a worldwide basis and retain more losses than each of its subsidiaries, which purchase insurance from the captive. Exhibit 8-6 illustrates the operation of this type of plan.



### Obtaining Potential Cash Flow Advantages on Income Taxes

Generally, a parent company may only deduct from its taxes the associated losses and other expenses that are paid by its captive insurer. In some cases, however, a parent company can achieve an even greater tax advantage by deducting from its taxes the premiums that it pays to its captive insurer. The Internal Revenue Service’s (IRS) determination of whether premiums paid to a captive insurer are tax-deductible is based primarily on the following two factors:<sup>2</sup>

1. **Risk shifting**, which is the transfer of risk of loss to an insurer
2. **Risk distribution**, which is the sharing of risk by an insurer among its insureds

**Risk shifting**

The transfer of risk of loss to an insurer.

**Risk distribution**

The sharing of risk by an insurer among its insureds.