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CORPORATE RISK FINANCING

BY CAPTIVE INSURANCE

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Thesis submitted for the degree of

Doctor of Philosophy

The City University
Business School

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KJA

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ABSTRACT OF THESIS

A large organisation has the option of making arrangements inside the firm for the financing of risks (Captive Insurance), instead of insuring with insurance companies and at Lloyd's. The main methods of captive insurance are the self-insurance fund and the captive insurance company, the thesis being concerned with such processes only as applied within British corporations.

The thesis opens with an examination of the extent of use of such techniques in the United Kingdom, the conclusions being that about 45 companies had captive insurance companies when the study was conducted and that about 50 of the 250 largest British companies had some involvement with self-insurance. There then follows a study of the reasons why organisations form captive insurance companies, with an examination of the reasons given by companies that had considered the formation of such undertakings but had not done so.

The second main part of the study is concerned with the methods employed in forming and managing captive insurance facilities. The approaches to the assessing

of the feasibility of these methods in particular organisations are discussed and attention is given to the question of whether firms underestimate the possibilities for self-insurance as an alternative to a captive insurance company. However, it was found that self-insurance was rarely used as a major strategy and most of the examination of methods of operation was restricted to captive insurance companies.

In view of the fact that most of the captive insurance companies formed in recent years were found to have been established in tax havens, considerable attention is given to domiciliary factors. The extent of use of tax havens both inside and outside the Scheduled Territories is examined; factors relevant to the various off-shore countries are discussed, together with questions affecting the management of insurance companies in tax havens compared with domestic arrangements. There is comparison of undertakings managed by agents off-shore and self-managed facilities.

With regard to the internal management of captive insurance companies, administrative procedures for

both off-shore and domestic undertakings are examined. The manner in which they deal with the risks presented to them for insurance is also discussed, including the physical examination of properties insured and the calculating of premium rates. Reinsurance strategy is an essential element in the management of a captive insurance company; the methods used and the policies followed are given special attention.

The thesis closes with the presentation of a classification system for captive insurance companies with case studies, and a discussion of developments that might affect captive insurance in the future.

INTRODUCTION

CHAPTER 1

THE NATURE OF CAPTIVE INSURANCE

All business organisations operating under the free enterprise system are subject to risk, that is the possibility of an unexpected contingency affecting the well-being of the business; these contingencies include the risk of readily identifiable happenings such as the physical loss of property, the financial consequences of physical loss and legal liability for accidents involving employees or others, but also extend to losses of less easily identifiable source and consequence such as loss of custom, failure of deliveries of raw materials from home or abroad and economic recession. Textbooks on the subject[1] often offer outline procedures for risk management and these methods have wide acceptance amongst those responsible for such matters in industrial and commercial organisations; typically, a risk management procedure would contain the following elements:-

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[1] See for instance, Greene, M.R., "Risk and Insurance", South-Western Publishing Company, Cincinnati (1968), Chapter 4.

(a) Identification of risk. The system starts with a thorough examination of the organisation in an endeavour to establish all the risks of any consequence that are faced, the suggestion being that organisations are often unaware of many of the risks that they run and will usually benefit from such an exercise.

(b) Analysis of risk. Having identified the risks faced, the next step is to calculate the likelihood of each event arising and the impact upon the organisation if it does. Statistical estimates of loss frequencies and severities are often difficult to arrive at because of lack of data; the question of impact is concerned ultimately with whether the contingency is serious enough to warrant consideration. The two factors have also to be considered in combination, for the contingency with a low frequency of occuring but with high possible severity may be more serious than a contingency with high frequency but low severity.

(c) Elimination or reduction of risk. The common first reaction to risk by managers is to attempt to insure against it and this may occur even before any attempt has been made to estimate the actual extent

of the risk as above. The emphasis of the writers and practitioners involved in risk management is however that organisations should endeavour to reduce or completely eliminate the contingencies before considering insurance. What might be termed "physical risk management" is concerned with the introduction of procedures or the installation of equipment that will reduce the probability of an event occuring or limit its impact if it does, thus the constructing of a building with non-combustible materials will reduce the risk of a fire and the installing of a sprinkler system will restrict the damage that will be done if a fire breaks out. Such methods can extend to having a number of suppliers of raw materials to reduce the impact of disruption at a supplier's premises and with regard to computer risks could involve the arrangement of stand-by facilities.

(d) Transfer of risk. This is an option that applies in circumstances where a risk can be passed on to another party, for instance by way of an exclusion clause in a contract.

(e) Ignoring or financing of risk. At the end of the process there will still be risk to be dealt with because it cannot all be transferred and most efforts at risk reduction will leave residual risk that cannot be totally eliminated. Depending on the estimations made after analysis of the risks, it might be decided that some are insignificant enough to be ignored, but failing that some form of financial provision (financial risk management) must be made to protect the enterprise from the consequence of one of the contingencies arising, the essence of risk management being the security of the organisation.[2]

However, the suggested application of the above processes to all the risks faced by an enterprise would produce a number of questions, for there are different types of risk faced by an organisation which are likely to demand separate treatment. For example, consider the risk of fire and the risk of a strike at a supplier's premises - the former lends itself to statistical calculation, for there will be

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[2]See Haller, M., "The Aim of Risk Management", in Papers in Risk Management No 7, Keith Shipton Developments Limited, London (1977)

data available from the company's own records and from elsewhere, furthermore the possible impact of the contingency before an event and its actual impact if a fire does occur can be calculated; but with strike risks no such calculations can be made for the lack of a discernable pattern with such occurences will destroy any hope of statistical analysis and the effects can neither be calculated before or easily determined after an event.

Although a lack of data may on occasions make accurate estimates difficult and the introduction of physical improvements to risks is not always possible it is generally the case that risks which will produce losses of determinable value are also those that are subject to statistical calculation and may be reduced by physical means. Similarly, the risks where outcomes could not be calculated with precision are usually those where the probability of occurences will be subject to only the broadest estimation and will generally be outside the control of the organisation. This division is also the dividing line for insurers, who are able to consider the insurance of the former type of risk but not the latter.

Risk Management and Captive Insurance

This study is concerned with the alternatives to conventional insurance (insurance placed with insurance companies or at Lloyd's) which are available to an organisation in the financing of its risks, for it is often possible for a large firm to retain the whole or a part of certain risks within the organisation; any process whereby risks are financed within the organisation on which they initially fall will be referred to as captive insurance.

The study is written largely within the boundaries of the normal approaches to risk management and generally within the limits of conventionally insurable risk. Financial risk management procedures are closely related to the other aspects of the subject described above and captive insurance in particular cannot exist except on a firm foundation of statistical analysis of the risks involved and a good level of physical risk management; a certain amount of detail on the non-financial areas is included in the study where directly relevant to the main topic, but such considerations are outside its scope. With regard

to the consideration of risks that are not usually conventionally insurable, the extent to which captive insurance has enabled the organisations involved to finance such risks will be apparent from the results of the research, but because most companies with captive insurance have not used their facilities in that way the study is largely restricted to those risks which can be placed with conventional insurers.

The decision not to insure

An organisation might decide that certain of the risks it faces do not warrant financial provisions because each individual loss will be small compared to the size of the organisation - plate glass losses in a large retailing group, office machinery damage in a major commercial organisation and malicious damage to buildings owned by a big property company are all good examples, but with a very large enterprise such attitudes might extend to total losses by fire of small premises, goods in transit losses of virtually all sizes and accidental damage to motor vehicles. By meeting such losses out of current revenue an organisation will certainly create an administratively simple

system and there can be few companies that do not follow such policies to some extent, but as there is no attempt to actually finance risks the very essence of insurance is missing and such cases must be considered as non-insurance; although no decision is involved, situations where no attempt is made to deal with a risk out of ignorance of its very existence can also be classified as non-insurance.

Simply not insuring small amounts and meeting losses out of revenue when they arise is sometimes considered to have disadvantages because the organisation may lose control of that facet of the enterprise, thus some form of insurance system whereby losses have to be reported centrally may have an important contribution to make in enabling management to check that losses are being kept within reasonable limits, even where there is no need for insurance for financial reasons. For that reason an organisation might consider setting up an internal fund into which contributions are made by the various parts of the firm and out of which losses are paid; in other cases a fund might be established where risks need not be insured in view of the size of the organisation, but small subsidiary

companies might find the losses too heavy to bear without insurance and the company sets up a fund as a service to them. The establishment of an internal fund to meet losses is the essence of self-insurance and is an approach that must be distinguished from non-insurance as many organisations tend to regard the mere decision not to insure as self-insurance.

Self-Insurance Funding

An organisation will often find it beneficial to internally fund the risk of small losses, rather than insure them conventionally, where such losses are independent in nature and occur in quite large numbers so that their incidence is fairly easy to predict statistically from year to year. Where conventional insurance is used in such cases a situation of "swapping pounds" is likely to develop in that the insured will pay to the insurers a high premium at the beginning of each year, only to receive a large percentage back in claim payments, but in view of the fact that the insurers will be able to accurately estimate the outcome in an average year the insured will almost always receive much less than was paid. The only real risk that

insurers will be accepting will be that of total losses substantially exceeding what was anticipated and in such situations the risk is, by definition, very low.

Thus, self-insurance can benefit an organisation by enabling it to retain the profit that would otherwise go to an insurer, but there are further savings to be made in that the firm will not incur all the operating costs of the conventional insurer.[3] In particular, a company with self-insurance will not need the branch networks, sales staff and other services provided by insurers and it is also likely that administrative cost will be saved by an efficient system of dealing with losses within the organisation, as opposed to the rather cumbersome procedures that (perhaps necessarily) have to be followed by insurers. However, in many cases a reserve fund, in addition to the fund made up of contributions from participants, will be needed to ensure that all losses will be met in years when total losses exceed the expected level; because of taxation difficulties this might only be feasible where the fund is held by an insurance company through a funding policy.

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[3]The combined profit and expense ratios of insurance companies often approach 40% of premiums

Self-insurance need not, however, be restricted to situations where there are large numbers of small independent risks. An organisation might, for instance, find it beneficial to insure large risks with a deductible (by which the insurer is not responsible for losses below a certain amount and for that amount of each loss where it is exceeded) and to internally fund the amount of risk retained; the deductible could in such cases be treated in the same way as a small risk. In other cases a company might self-insure the whole of larger risks, either because the rates charged by insurers seem too high or because there is the possibility of savings in administration, but as there will be the risk of a large loss rendering the fund insolvent reinsurance of the fund would be needed.

Captive Insurance Companies

Although in theory a self-insurance fund would be attractive to many organisations, there are difficulties in that transfers to such a fund will not be considered as insurance premiums for tax purposes and this factor alone is probably responsible for limiting the use of self-insurance to special cases, but there is also the possibility of an organisation forming its own insurance company to handle its risks being able to obtain advantages that do not apply to self-insurance funds. An insurance company formed for such purposes is commonly called a captive insurance company.[4]

It would be wrong to think of a captive insurance company as always being a progression from a self-insurance fund, some companies forming captives have used pre-existing funds as bases for the new subsidiaries, but in many cases the decision to form a captive has been completely unconnected with self-insurance. Indeed captive insurance companies

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[4]For the sake of brevity and in accordance with popular usage a captive insurance company will often be referred to simply as "a captive"

are often formed from motives that could not arise with self-insurance. However, on the level of purely conceptualising the options available there are similarities between the two strategies, for in both cases money to finance losses is kept within an organisation although in one case payments into the system are legally "premiums" and payments out "claims". Provided the possibility of quite different motivations and advantages are appreciated a captive insurance company can be seen as a self-insurance fund in corporate form.

There have been quite a number of attempts to define a captive insurance company. Hare and Smetna[5], after distinguishing a pure captive from one which an organisation sets up as a normal enterprise, give the definition "a wholly owned insurance subsidiary of an individual company or industry that has been established to fulfill a complementary corporate need - the financing of some portion of the risks of its owner or owners on a more economical basis, as opposed to an independantly operating company which offers its product to the public". This definition makes a

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[5]Hare, William A.D. and Smetna, Joseph C., "Captive Insurance Companies", American Management Association, New York (1972)

number of points which are essential to an understanding of what a captive insurance company is:-

(a) It may be wholly owned by one company, but may be owned by a number of firms jointly. A number of American companies have joined to form captives, the participants often being members of a trade association, one of the best known examples being Oil Insurance Limited established by the American Petroleum Institute.

(b) It is an insurance subsidiary; a captive insurance company is a properly constituted insurance company which receives premiums, issue policies, pays claims, effects reinsurance etc. in the same way as a conventional insurance company and this is essential if premiums are to be allowed for tax purposes.

(c) It is concerned only with the risks of its owners, this point must be made to distinguish a captive insurance company from an insurance company established, as a wholly own subsidiary of another, to offer insurance to the public. A good number of conventional insurers are owned

in that way, examples being Abbey Life and Excess (I.T.T.), Cornhill (Thomas Tilling) and Bishopgate(Inchcape), these are not captives and neither are the many life insurance companies formed as backing to unit trusts. The distinction is far from academic, the captive relies for its very existence on not being a part of the conventional insurance market and many of its benefits are derived from its independant nature, whereas the other type of insurance subsidiary is formed to be a part of the market.

The definition quoted is typical, but is inadequate in that in one respect is is too wide as it includes insurers owned by individual companies and groups of companies in the one term "pure captive" and in another respect it is too narrow in that it excludes undertakings that have some but not all of the features in the definition. To deal with the first problem, the following terms will be used in this study:-

(a) Pure captive - a subsidiary which only insures the risks of a single parent.

(b) Industry captive - where a number of organisations in a particular industry have formed a captive, often because the industry has a special insurance problem.

(c) Association captive - an undertaking run by, or for, a trade association.

(d) Group captive - where two or more organisations, with no industry or association links, have formed a captive jointly.

In considering undertakings that only have some of the features of a captive as earlier defined, the following forms of operation need to be considered:-

(a) Some insurance companies, although offering their services to the public also act, in varying degrees, as if they were captives to the companies that own them, thus they are hybrids acting as both conventional and captive insurers. An example in the United Kingdom is the Tobacco Insurance Company, owned by the British American Tobacco Company.

(b) Many companies have formed subsidiaries to administer pension funds.

(c) A number of organisations have floated insurance companies to insure the products they sell to customers, examples being insurers established by manufacturers of contact lenses and certain jewellers. Clearly these are not captives in the normal sense, but any process whereby an industrial or commercial enterprise forms an insurance company, without the intention of competing fully in the market, is analogous to the captive concept. In addition the motives are often similar to those for a captive e.g. failure of the conventional market to provide insurance, or to provide it at what is considered a reasonable rate.

(d) Most shipowners place certain risks (not covered by the marine hull policy) with Protection and Indemnity Clubs, which are mutual associations of owners, not unlike mutual insurance companies, excepting that they have the power to raise further levies from members in the event of a deficit which most mutual insurance companies either cannot or chose not to do.

The first two cases can properly be considered as captive insurance companies, although pension fund companies, being in a specialised field, are outside the scope of the study. Subsidiaries coming under the first heading display all the features of captives when dealing with the risks of the parent companies; they are sometimes referred to as "open-market captives" and that term will be used here. As regards the third type, the option could be an important one for companies faced with particular risk problems and although the element of insurance of the parent is lacking it might still be considered as part of the subject of captive insurance; such subsidiaries will be referred to as "quasi-captives".

However, Protection and Indemnity Clubs cannot be seen as captive insurance companies, indeed neither can the many specialist or composite mutual insurance companies that exist. P & I Clubs and "mutuals", although established by and for a limited group of people or organisations, are founded with the intention of insuring outside the original group, the fact that only certain persons/companies may be allowed to insure (say

members of a particular trade association) does not change the fact that the eventual portfolio of risks extends far beyond those of the original founders. Furthermore, anyone insuring with such an organisation usually views it in the same way as a proprietory insurer.

The objectives of the study

This study is concerned with the subject of captive insurance as it affects and is approached by British companies. Its primary concerns are:-

(a) An estimation of the numbers of companies employing captive insurance techniques. The actual totals will be continually changing, the general impression gained being that the number of organisations with captive insurance companies was increasing steadily, but the number with self-insurance funds was fairly static. However, an estimation at a particular date is useful in gauging the size of the subject and serves as an indication of the reliability of data, as information could only be received from a proportion of all the companies involved.

(b) A study of the attitudes towards the subject of the individuals working in industry and commerce who are directly affected by it.

(c) An examination of the motivations of companies that had established such facilities, or which were considering or had in the past considered the possibility of some form of captive insurance.

(d) A study of the methods used by companies in forming and managing their facilities and of the various relevant factors such as taxation and the domicile of off-shore insurance companies.

(e) The production of a classification system for the different forms of captive arrangement.

(f) Consideration of those factors likely to affect British companies employing captive insurance in the future.

The financing of risks within organisations, particularly the method involving the formation of an off-shore insurance company, has been the subject of considerable interest in the insurance industry in the last few years and has received a substantial amount of attention in the insurance press and at conferences dealing specifically with the topic or wider risk management matters; it has also been the subject of academic study and comment. Much of the information available can, however, be criticised on the grounds that it is incomplete, subjective, or applicable only in special circumstances.

Literature on captive insurance

Of particular concern for organisations on this side of the Atlantic is the fact that much of the published work applies to the North American situation. On the grounds of differing tax and exchange control regulations alone the subject is quite different when approached by a British company, but one must in addition consider the differing insurance markets and the size of the average British industrial company compared to its American counterpart; attitudes to risk management also differ, although that may in part be a factor of size of company. The bibliography of captive insurance companies published by the library of the Chartered Insurance Institute[6] contains 65 items, however all but 22 are overseas (principally American) publications or have been written from a foreign viewpoint.

Probably the most important commentator on the subject in North America is Andrew Barile[7], who has

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6 "Select bibliography on Captive Insurance Companies", Chartered Insurance Institute, London (1979).

7 Some of his publications are referred to in the text of this study and others are listed in the bibliography.

written extensively on the technical aspects of captive insurance companies but has not included self-insurance. His work has much in common with this study in dealing (from an American viewpoint) with such matters as the formation and management of captives, taxation and reinsurance, but he has produced little by way of detailed analysis of the methods employed by captive operators and seems to rely on his practical experiences in the area. He has not claimed that his writings are based on a random sample of the organisations involved.

Barile has produced a list of companies with captive insurance companies[8], but has not attempted an estimation of the total number of organisations involved; the British companies on the list are mainly those with well known U.K. based insurance subsidiaries. Similarly, the annual survey of captive insurance companies in the North American publication Risk Management Reports[9], which contains a long list of captives and their owners,

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8 In "The Off-Shore Invasion", Policy Holder Insurance Journal, 19.1.73, p. 120.

9 Business Insurance Inc., Chicago, Report No. 3, 1979.

makes only a general estimate of the number of firms with such subsidiaries and is particularly lacking as regards British companies because it is biased towards Bermudian captives and American operators.

Roy Damary studied the risk management practices of 80 European companies under the auspices of the Geneva Association[10] and included the use of captive insurance techniques in his survey. It was found that only three of the companies (all in the U.K.) had self-insurance funds, but 24% of the respondents had already formed captive insurance companies and a further 13% stated that they had the intention of doing so. However these findings are not translated into an estimation of total usage and the data is not divided between the different countries in the survey. The motivations of organisations are dealt with only briefly, but the findings will be mentioned later. It is unfortunate that Damary makes the error of confusing the Bahamas for Bermuda as the most important centre for captive insurance

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10 "A Survey of the Practice of Risk Management in West Europe Companies", in "The Management of Risk and Insurance", Association Internationale Pour L'Etude De L'Economie De L'Assurance, Geneva (1976).

companies[11], but it must be accepted that internal financing techniques were not a primary part of his study.

There is some literature that deals with the formation and management of captive insurance companies by British firms[12], the published papers of conferences organised by Keith Shipton Developments (now the Risk Research Group) going into some detail with regard to the technicalities involved[13]. However, some other writings are plainly partisan and seem to have been produced merely to promote particular territories as sites for captives; an example is the book written by Harry New[14] which is little more than a treatise on why captives should be formed in Bermuda

Most of the work published in Britain, mainly contained in insurance periodicals,[15] is concerned only

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11 op cit, p. 44.

12 For instance, Dixon,J.A., "Captive Insurance Companies" in "Handbook of Risk Management" Kluwer-Harrap, London (1975).

13 For instance, "Captive Insurance Companies", Papers in Risk Management No. 5, Keith Shipton Developments Limited London (1976).

14 "The Captive Insurance Company", Atlas Risk Management, Hamilton, Bermuda (1973).

15 For instance, "Captives" Policy Holder Insurance Journal, 24.3.78 and "The Captive Scene," Reinsurance, June 1979.

with the general advantages and disadvantages of captives, questions of domicile and taxation issues. Most estimates of the number of companies with captives are very approximate and rarely has any attempt been made to collect and analyse data on the motivations, experiences and practices of the organisations involved.

Writings on self-insurance can be found in many general textbooks on insurance and risk management[16] and in occasional journal articles[17], but as with the literature on captive insurance companies these give little indication of the extent of use and of the practices followed by companies involved. Furthermore, the writers have usually considered self-insurance as a distinct strategy from the captive insurance company, with no examination of the two as alternatives to solving the same problem in particular corporations.

This is,therefore, the first academic study of captive insurance as it applies to British companies.

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16 For instance, Lenz, M., "Risk Management Manual", Merritt Inc., Santa Monica (1976).

17 For instance, Bullock, K., "Self Insurance, a developing Skill", Foresight, December 1975 and January 1976.

Research procedures

To meet the objectives of the study a random survey of British industry was required, which would produce statistically valid data on the extent of usage of the techniques under discussion, that to be followed by detailed questionnaires seeking information required for the later parts of the study from those in a position to supply it. This was the pattern followed and sufficiently large samples were obtained in each case, however with certain aspects (and this particularly applied to the extent of use survey) more information would have made the results far more useful and consequently data was sort, in addition to the basic survey, from a wide variety of sources.

The collection of data took place in the following stages:-

(a) An outline questionnaire (Questionnaire 1 - see Appendix) was sent to the 250 largest U.K. industrial companies, as listed in The Times 1000[18].

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[18] The Times 1000, 1975-6, Times Newspapers Limited, London

The limit of 250 was decided upon for a number of reasons. As regards captive insurance companies, a cursory look at the subject suggested that only the very largest companies were involved, most in fact being in the largest 100. Although self-insurance seemed to be more common amongst the smaller companies in the proposed population and might therefore frequently occur outside it, it was apparent that such techniques were generally used in a limited way, with only a few companies having major programmes; examination of the subject beyond the feasibility limits for captive insurance companies was therefore not warranted. The 250 figure also roughly coincided, at the time, with the £100m turnover boundary, which was considered to be a reasonable place to stop and an examination of the types of company either side of the line suggested that it was the point where the diversified company (that is one with a number of operational sites) becomes less common and the company that is centralised in a few places tends to appear; taking the commonly accepted principle that insurance (and thus even more so captive insurance) needs a wide spread of risk, captive insurance would be far less likely to be used by the latter.

(b) Coincidentally with the commencement of this study the Association of Insurance and Risk Managers in Industry and Commerce (an Association with a membership of over 400, mainly full-time, insurance managers) began a study of captive insurance companies. In view of the mutual interest a questionnaire (Questionnaire 2) prepared for this study was sent by the Association to its members, with a summary of the findings being included in the Association's report[19]. The survey proved to be useful as it provided background attitudes to the subject from a wide range of people; a number had been directly involved with the subject but many drew their replies solely from personal attitude.

(c) Those respondants whose companies had captive insurance companies, or who stated that the possibility of forming one had been considered, who indicated their willingness to provide further information, were sent a detailed questionnaire. Questionnaire 3 was sent to respondants with captives and Questionnaire 4 to others.

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[19] "Captive Insurance Companies", Study Group Report, Association of Insurance and Risk Managers in Industry and Commerce, London (1976)

(d) Captive insurance companies operated in the United Kingdom, rather than from tax havens (domestic captives) have to be authorised under the Insurance Companies Act and make returns to the Department of Trade, therefore where replies to questionnaires were not received such captives could be identified from the list of authorised insurance companies published by the Department[20]. Replies to the outline questionnaire or to further enquiries sometimes made it apparent that particular organisations had quasi-captive insurance companies, but these were usually identified from the returns. Where there was any doubt as to the nature of an operation, that is whether or not an insurer was a captive or whether it was a quasi-captive, the file at Companies House was examined.

(e) Further information was obtained from a variety of contacts that were established during the course of the study, these included interviews with people specialising in the management of captive facilities, discussions with risk managers at conferences and (to a lesser extent) approaches

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20 Insurance Business Annual Report, HMSO, London 1976

from organisations seeking information on the subject. Certain points need to be noted regarding the precautions taken to maintain accuracy and a degree of random sampling with such sources: first, the information obtained in these ways was not used in compiling the list of respondants for the detailed questionnaires thus the data in that respect is completely random, secondly in obtaining information equal stress was placed upon obtaining details about companies that did not have captive facilities as those that did, so that the sample did not become biased in that direction and thirdly, second-hand information (e.g. the insurance manager of one company saying that another has a captive insurance company) was not included without verification from another source.

(f) Consistent reminder procedures were followed in all cases. Where questionnaires were not returned further written requests were sent, with the telephone being used in a final attempt to obtain information and to request details on unanswered questions or where answers were not clear.

PART ONE

Extent of Use of and Motivations Towards Captive Insurance

CHAPTER 2

THE EXTENT OF USE OF CAPTIVE INSURANCE TECHNIQUES IN THE UNITED KINGDOM

Information was obtained in respect of 134 of the 250 largest companies in The Times 1000, but in only 101 cases was information received about self-insurance. There are a number of reasons for the discrepency between the two areas; first, companies with captive insurance companies established in this country (rather than in a tax haven) could be identified, where they did not return the questionnaire, by reference to the Department of Trade's summary of insurance company returns; secondly, the fact that a few organisations have captives is well known in the insurance market and it was possible to obtain information about participants in group and association captives from various publications. Finally, a number of respondents replied to the effect that they did not have a captive insurance company but did not mention self-insurance in their reply and refused to be questioned further when contacted by telephone, this may have been partly due to a misunderstanding of the nature of self-insurance as defined for the purposes of the study, but it must

also be appreciated that this whole subject is generally considered to be a confidential area by organisations and they are often reluctant to divulge information for that reason. However, it is considered that in both cases samples are representative and large enough to make meaningful analysis possible.

Calculations on the extent of use

Table 2.1 contains details of the information received, analysed according to the position of respondents in each group of 50 of The Times 1000. 31 captive insurance companies are owned by respondents in the top 250 as three of the 28 organisations mentioned have two undertakings each; in all three cases one subsidiary is domiciled off-shore and the other in the U.K.

The decision to restrict the survey to the top 250 was found to be justified by the fact that after an extensive investigation of the subject only two companies outside the list were found to have captive insurance companies. One of these was a public corporation, with a U.K. captive, which was large enough to feature in the top 250 had it

Table 2.1

Analysis of the use of captive insurance techniques, by size of parent company

Position in Times 1,000	Captive Insurance Companies			Self-Insurance Funding		
	Number in Sample	Number with Captives	% with Captives	Number in Sample	Number with Self-Ins	% with Self-Ins
1-50	33	13	39%	17	3	18%
51-100	25	6	24%	22	5	23%
TOTAL 1-100	58	19	33%	39	8	21%
101-150	29	5	17%	23	4	17%
151-200	25	3	12%	23	4	17%
TOTAL 101-200	54	8	15%	46	8	17%
201-250	23	1	4%	16	4	25%
TOTAL 1-250	135	28*	21%	101	20	20%

*Two companies with captives appear outside the list

been in the private sector and the other organisation, with an off-shore undertaking, had an unusually high insurance expenditure for its size. Consequently, it is unlikely that there will be other companies with captives outside the top 250 and if there are the number involved will be very small.

Similar assumptions cannot however be made about self-insurance funds, for it will be seen that the extent of use is fairly evenly spread throughout the list and as size is not such a crucial issue as it is with captives it is reasonable to assume that many more companies could be involved. Consequently, calculations on self-insurance usage will only apply to the top 250 and cannot be applied to the whole of British industry.

Captive insurance companies

Simply estimating the number of companies with captives by applying the percentage in the total sample to the whole population would not produce an accurate figure because:-

(a) There is much higher incidence of captives amongst the largest companies, with in particular the five biggest all owning such subsidiaries and indeed having seven between them.

(b) The data displayed in Table 2.1 includes a number of captives formed in the United Kingdom (domestic captives) but the number of such undertakings in the country does not need to be estimated as their total has been discovered by reference to the Department of Trade returns.

The more accurate procedure adopted (detailed in Table 2.2) was to make separate calculations of the likely number of off-shore captives within each group of 50 companies, except for the first group where the five largest companies were isolated. The following calculation could then be made:-

Expected number of off-shore captives	- 36
Number of domestic captives, but deleting those companies (3) that also have off-shore undertakings	- 7
Domestic captives outside top 250	- 1
Off-shore captives outside top 250	- 1
	45

Thus, on the assumption that the one off-shore captive outside the top 250 list is the only one that exists, the most likely number of British companies with captive insurance companies is 45.

Table 2.2

Calculation of number of companies with captive insurance companies:-

(a) in the top 250 of The Times 1000

(b) at July 1977

Position in Times 1000	Companies in Group	Number of U.K. Captives	Off-shore Captives.		Expected number of off-shore captives
			Companies in Sample	Number of Captives	
1-5	5	5	5	2	2
7-50	44[1]	2	28	7	11
51-100	50	2	25	4	8
101-150	50	1	29	4	7
151-200	50	-	25	3	6
201-250	50	-	23	1	2
TOTALS	249	10	135	21	36

Note[1] The company placed sixth in the list is no longer trading

Self-Insurance Funds

Usage is fairly uniform throughout the list of companies and there are none of the domiciliary complications that exist with captive insurance companies. Thus, it was possible to make an estimate from the total data, which produced the figure of 49 as the most likely number of British companies with self-insurance funds.

Clearly, many organisations consider self-insurance to be a feasible alternative to conventional insurance, but in virtually all the cases identified by the survey it was being used as a tool for particular purposes rather than as a general risk management strategy. In only three cases were schemes concerned with major parts of insurance portfolios and even in those cases major catastrophe risks (e.g. fire on large premises, liabilities) were not involved. The uses to which self-insurance was put in the companies concerned are detailed below:-

Motor accidental damage:	6 companies
Deductibles on property insurance:	6 companies
Special perils:	7 companies
Theft:	3 companies
Miscellaneous "All Risks" (e.g. goods in transit, money, office machinery):	7 companies

Incidence of captive insurance amongst different types of company

Significance of size

The high incidence of captive insurance companies amongst the very largest companies in the survey has already been commented upon. In order to test the question statistically the chi-square test[1] was applied to the data in Table 1 and this showed that size was significant, being above the 2½% level at 4 df ($x^2 = 11.96$).

No significance of size could be shown for self-insurance funds.

[1]The chi-square test indicates the extent to which the characteristics of a sample could not have arisen by chance. The chi-square value (denoted x^2) is obtained from the formula:-

$$x^2 = \sum \frac{(O - E)^2}{E}$$

Where O = observed data
E = expected data for a null hypothesis, i.e. that data that would be obtained if the characteristics had arisen by chance.

x^2 results are expressed in terms of "degrees of freedom" which are obtained from the number of columns of data involved and give the point of reference on the statistical table which will indicate the extent to which the results are significant (i.e. not possibly due to chance), thus:-

1% level of significance = highly significant
5% level of significance = significant
10% level of significance = low significance

Intermediate points (e.g. 2½%) indicate signficance between the levels shown above.

Significance of industry

It also seemed likely that companies in certain types of industry were more likely to be involved in captive insurance than those in other lines of business. Table 2.3 shows the data analysed according to the industrial grouping of the parent company. A chi-square test showed industry to be very highly significant as a factor for captive insurance companies, being above the 0.1% level at 4 df ($x^2 = 19.04$).

It should be noted that the "others" group was excluded from the calculations as it consisted of completely unconnected types of industry and cannot be considered an industrial grouping as such. In view of the fact that there are 22 companies in that grouping and none of them have captive insurance companies, their inclusion would have increased the x^2 value still further.

No significance of industry could be shown for self-insurance funds.

Table 2.3

Analysis of the use of captive insurance techniques, by industry

Industry[1]	Captive Insurance Companies			Self-Insurance Funding		
	Number in Sample	Number with Captives	Percentage with Captives	Number in Sample	Number with Self-Ins	%age with Self-Ins
Food, Drink & Tobacco	22	5	26%	14	4	29%
Chamicals[2]	14	9	62%	10	2	20%
Engineering	34	4	12%	28	6	21%
Retailing & Allied	16	1	6%	14	4	29%
Misc[3] Manufacture	26	9	35%	17	2	12%
Others	22	0	-	18	2	11%

Notes: 1. Groupings are those used by the Central Statistical Office
2. Includes oil companies
3. Metal manufacture; Textiles, Leather & Clothing; Paper, Printing & Publishing; "Other Manufacturing".

Interrelation of factors

Given that size and type of industry are both shown to be significant factors with regard to the use of captives it was possible that the two issues were inter-related and that the significance of industry might arise because certain types of industry tend to have more than an average number of large companies, or that the significance of size might partly arise because there are more than an average number of companies in a particular industrial grouping at various points on the top 250 list. The very high incidence of captive insurance companies amongst chemical companies (which tend to be larger than most - 7 of the 14 in the sample appear in the top 50) would appear to be a particularly important factor.

To test the extent to which size of company contributed to the significance of industry, the chi-square test was used with the "expected" figures being calculated as if size were the only factor i.e. a null hypothesis on the question of industry.

Excluding the "others" group approximately 40% of the top 100 and 15% of the rest of the top 250 had captive insurance companies and the calculations of the "expected" number of captives were made on that basis, for example:-

Industry	Captives	No Captives
Food, Drink and Tobacco:		
1-100		
Actual numbers	4	11
Expected according to size (40%)	6	9
101-250		
Actual numbers	1	6
Expected according to size (15%)	1	6
Totals for the group		
Actual numbers	5	17
Expected according to size	7	15

The result was to produce a high significance, being above the 1% level at 4 df ($x^2 = 16.42$), but as this is a lower significance than that obtained without the weighting for size it shows that size was a contributing factor in the very high level of significance found for industry.

However, given that 62% of the companies in the chemical group had captives, this was clearly having a dramatic effect upon the calculations and when they were deleted from the procedure detailed above the significance of industry was reduced to one of low significance, being slightly below the 5% level at 3 df ($x^2 = 7.40$). Whereas, when chemical companies were deleted from the calculations testing the significance of size, the level of significance was reduced but not so dramatically, still being above the 5% level at 3 df ($x^2 = 9.30$).

These testings therefore suggest that:-

(a) Size of parent company is the most significant factor generally determining the use of captive insurance companies;

(b) Chemical companies are more likely to have captive insurance companies than other types of enterprise;

(c) Captives are more likely to be formed by companies in the manufacturing (excluding engineering) and food, drink and tobacco sectors than in retailing

and engineering, but this is to a great extent accounted for by the fact that the former groups have more of the very largest companies than the latter.

Extent of use of Quasi-Captive Insurance Companies

Eight insurance companies were identified which seemed to satisfy the requirements of a quasi-captive, as defined earlier. As they are involved in the insurance of property sold by their parent companies they will need to trade in the United Kingdom and to have obtained authorisation from the Department of Trade under Section 3 of the Insurance Companies Act; it is also unlikely that customers would accept insurance from an off-shore undertaking. Thus, it was a fairly easy matter to identify possible quasi-captives from the list of Department of Trade authorised insurers and then to check with the files at Companies House; the figure of eight such insurance companies is therefore considered to be an accurate one.

Section 8 of the Insurance Companies Act provides the Department of Trade with powers to exempt insurance companies from the provisions relating to solvency margins and minimum capital, where the insurer is "only insuring persons of a limited class or insuring risks of a limited category". Also, the Department regularly uses Section 57 of

the Act to reduce the extent to which small companies have to comply with the regulations for submitting annual returns. These provisions are used mainly for small mutual insurance companies, particularly the many plate glass mutuals, contributory sickness and hospital schemes and protection and indemnity clubs; quasi-captives are seen to be in a similar position and all have been provided with exemptions, although one of them does meet the minimum capital requirements. Common market regulations (discussed more fully in Chapter 8) have brought changes in the solvency margin provisions, but the Department is given powers to grant relief to insurers given exemptions under Section 57 and the undertakings discussed here seem likely to benefit.

A single example should serve to demonstrate the principles involved with quasi-captive insurance companies:-

> The Belgravia Insurance Company Limited is associated with Bravingtons Limited, the jewellers firm. The activities of Belgravia are stated in the latest directors report to be "insuring jewellery

and watches against loss and theft, with particular reference to sales made by Bravingtons Limited".

The company, which was established in 1931, has a capital of £10,000. In 1976 its premium income was £3,386, of which £2,991 was taken up by claims and expenses. The insurer is obviously involved with the insurance which many jewellers provide free, for one year, with sales.

Including the above company, the following table indicates the activities of these quasi-captives:-

Insurance	Insurers involved
Contact lenses	3
Jewellery and watches	2
Ice cream	1
Attack of timber by insects or fungi	1
Goods in transit	1

In most cases the enterprises are providing for risks that are very difficult to insure (e.g. contact lenses) or probably impossible to place

(e.g. timber infestation) with conventional insurers, or are dealing with policies which most insurers would consider too small to become involved with.

CHAPTER 3

MOTIVATIONS TOWARDS CAPTIVE INSURANCE (1) - IDENTIFICATION OF FACTORS

It has been shown that, although a good number of companies use self-insurance techniques, very few of the schemes in operation are concerned with major risks. It would not, therefore, be appropriate to discuss in depth the motivations behind processes which have limited applications and this part of the study will be concerned only with captive insurance companies.

It was necessary to conduct some initial enquiries before detailed questions could be put to organisations involved with captives. Each company approached seemed to have had some special reasons for the formation of its undertaking, but in addition a number of common points could be recognised; the following examples, while illustrating the particular circumstances that the firms found themselves in, also cover the main themes identified in the early stages of the study:-

(a) A company with very large risk exposures found (in the late sixties) that it was unable to insure the whole of its fire schedule and was left as coinsurer of about 5% of its largest risks, which represented up to £5m uninsured. As it was having to insure itself the company decided to incorporate the situation and form a captive, as a result it discovered reinsurance capacity untapped by the previous insurers and was eventually able to transfer all the risk thought to be necessary, leaving what amounted to a large deductible with the captive. Since that time the undertaking has been expanded to take on most of the other conventionally insurable risks of the organisation.

(b) Oil companies that were members of the American Petroleum Institute declared in the late sixties "that there is no longer available to petroleum companies, on terms consistent with sound business practice, commercial insurance covering substantial risks including catastrophe".[1] In 1970 the Institute formed Oil Insurance Limited, a Bermuda based captive.

(c) A company, which had previously never seriously considered a captive, received an approach at Board level from a consultant specialising in the formation and management of off-shore captives. The company admits to having been "sold" a captive by the consultant, the firm's insurance manager was originally hostile to the idea but was eventually won over.

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[1] "Risk Management Reports", Report No 1, 1975, p.20

(d) Another organisation decided to form a captive insurance company because it felt that the insurance market was not providing insurance at reasonable terms, particularly where large deductibles were required. The insurance manager also felt that he could run an insurance operation far more cheaply himself because conventional insurers had high overheads.

(e) A further organisation, having set up a captive in a tax haven, only places with it modest risks, leaving most insurances in the conventional market. Although the stated intention was to expand into other parts of the parent company's insurance portfolio, it was clear that the subsidiary was established largely as a tax avoidance device.

It was also possible to identify at an early stage a number of factors that seemed to dissuade companies from forming captives and some disadvantages that were encountered by organisations that had such facilities. Apart from the fact that many organisations found that the general advantages claimed for captives simply did not apply in their circumstances, the disadvantage factors were less concrete in nature than the apparent advantages and related to such matters as the attitude of the conventional insurance market to the captive concept and the possibility of interference by governments either in the United Kingdom or overseas.

AIRMIC Survey

A further opportunity to make preliminary enquiries arose when the Association of Insurance and Risk Managers in Industry and Commerce agreed to distribute a questionnaire to their 400 members. That questionnaire incorporated all the points mentioned above as well as a further possible motivating factor concerning the improvement in risk management procedures that might be possible in a company that has formed a captive.

65 replies were received, which is a reasonable response in view of the fact that many members work for quite small organisations and would not have a considerable interest in the subject. A detailed analysis of the replies appears in the appendix, but it is possible to gauge a general impression of the factors that are of most concern to insurance buyers, both as regards the reasons why they are drawn to considering captives and the issues that are likely to dissuade them. The replies point to:-

(a) A desire to do better than the conventional market by obtaining more generous terms for deductibles and perhaps placing risks that are not ordinarily insurable.

(b) A wish to take advantage of the benefits of operating in tax havens and to retain the profits made by insurers.

(c) A feeling that captives lead to an improvement in risk management, by providing a spur to the more effective control of risk.

(d) Concern about the political risks of operating in tax havens.

Construction of questions on motivation

The various early investigations and the data from the AIRMIC survey suggested that the factors relevant to organisational motivation in this area could be grouped under seven main headings and these form the basis of the first parts of the main questionnaires used in the study, viz:-

(1) Direct monetary advantage;
(2) Risk management advantages;
(3) The influence of consultants and insurance brokers;
(4) Lack of capacity in the insurance market;
(5) Captives as tax avoidance devices;
(6) Status of the risk manager;
(7) The risks of off-shore operations.

In elaborating on these issues the opportunity is taken to explain the philosophy behind the construction of the first parts of the questionnaires.

Direct monetary advantage

It seemed reasonable to take the view that many of the factors so far identified could be seen as part of one major objective of saving (or indeed making) money on an organisation's insurances. In most cases the subjects placed under this heading are those in the AIRMIC questionnaire which received good support, the exceptions being that the item on tax advantage was divided into two and a general factor referred to as "general inflexibility in the market" was added to allow respondents to comment in a broad way on their attitudes towards the way the insurance market operates. The factors chosen were as follows:-

(a) Fewer insurance regulations in a tax haven.
A captive insurance company does not have to be formed in a tax haven, but most are and a significant result is that the subsidiary escapes U.K. insurance regulations.

The Insurance Companies Act 1974 provides that an insurance company:-

(a) must be approved by the Secretary of State (Section 3).

(b) must maintain a margin of solvency, being the minimum amount by which assets exceed liabilities[2] (Section 4).

(c) will not be authorised unless it has a paid-up capital of at least £100,000 (Section 8).

A captive insurance company, established in a tax haven, will not be subjected to the above requirements, provided it trades off-shore rather than in the U.K. It will have to comply with the laws of the off-shore territory, but they are insignificant. An undertaking will need to have reasonable levels of capital and reserves if it is to function properly, but the parent company will not be bound by the U.K. government's regulations and may thus have advantages over conventional insurers.

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2 Regulations, to comply with Common Market requirements, are contained in The Insurance Companies (Solvency: General Business) Regulations 1977, S.I. 1977, No. 1553 and are disucssed in detail in Chapter 7, post. These regulations will be incorporated in the Insurance Companies (Accounts and Statements) Regulations 1980, from 1st January, 1981.

Off-shore undertakings will also not have to submit the annual returns required of insurance companies in the U.K.[3] This is a small matter at first sight, but the returns are so detailed that considerable expense is involved. The returns will be further complicated in the future by Common Market regulations; for instance, regulations that came into effect on 1st January 1978[4], following an E.E.C. directive, have increased the classes of general business under which authorisation must be obtained from six to seventeen. The change in the classes of business for authorisation purposes did not bring an immediate change in the procedure for accounting returns, which have continued to be required under the six old classes, but they will have to be made in respect of each of the seventeen new classes from 1st January 1981.

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3 Insurance companies have to submit returns under The Companies Acts, but in addition are required to file detailed returns of insurance business under The Insurance Companies (Accounts and Forms) Regulations 1968, S.I. 1968, No. 1408. Insurance Companies(Accounts and Statements) Regulations 1980, from 1st January,1981.

4. The Insurance Companies (Classes of General Business) Regulations 1977, S.I. 1977 No. 1552. Also to be replaced, as above, from 1st January, 1981.

In carrying out its role of administering the insurance regulations, the Department of Trade is particularly strict with new companies, which would include new captives and indeed the Insurance Companies Act gives the Department special powers with regard to companies less than five years old. Discussions with people who had been involved in the formation of insurance companies in recent years revealed that it is not uncommon for quarterly (instead of annual) returns to be required in the first few years of a company's life, with up to 70% of assets having to be kept in trust and restrictions being placed on investments.

Such extra work and the possibility of encountering difficulties with the authorities in the early years of a captive's life could be an important factor in persuading organisations to establish their undertakings off-shore. However, it was also possible that these factors were not considered to be important by most companies because they automatically thought only of off-shore facilities.

(b) Lower taxation off-shore. The more significant advantage of having a captive off-shore

is that it will have to pay either a much lower tax on profits than it would if established in the U.K., or no tax at all excepting for a stamp duty in some countries. Funds will accumulate at more than twice the rate that they would in Britain, at current levels of taxation, if no tax is paid: this can be seen as a straight advantage in terms of extra profit to the parent company, or as a way of building up the funds of the undertaking more quickly and thus enable it to play a greater part in the parent's insurances. The tax question is one of the most widely discussed aspects of captive insurance company operation and attitudes vary widely:-

(a) some seem to take the view that virtually no captives would exist if there were no tax havens[5]

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5 See, for instance, Dixon, J.A. "The Challenge from the Captives", Papers from the Financial Times World Insurance Conference, 6 & 7.3.74.

(b) others stress the disadvantages of domestic undertakings rather than the off-shore advantages; Barile has said that "limited tax advantages (at home) are one of the contributing factors to the increasing growth of the off-shore captive insurance company"[6]

(c) still others point out that the money which is accummulated tax free must eventually be repatriated to the U.K., when tax will have to be paid, thus the undertakings are only engaging in tax deferment.[7]

An off-shore captive could be formed largely for insurance reasons but with tax benefits as an added advantage, or it could be established mainly as a tax avoidance device. There are many shades of emphasis that could exist in various undertakings and the identification of such motives was considered to be an important part of the study.

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6 Barile, A.J., "The Off-Shore Invasion", Policyholder Insurance Journal, 12.1.73. p. 70.

7 Sennett, W.F. in "Captive Insurance Companies", Papers in Risk Management No. 5, Keith Shipton Developments Limited, London (1976)

(c) General inflexibility in the market. This is a blanket factor which could incorporate the next two items, but it has been suggested that insurers are unresponsive in a general way to the needs of their large clients and respondents were therefore given the opportunity to comment accordingly.

This is a particular theme of Hare and Smetna,[8] who write of "ultraconservative attitudes amongst insurers and point to a captive being able to provide a "tailormade answer to a specific problem"; they also suggest that in the area of loss control activities "some industries with special problems have set up captive insurance companies primarily to improve them". It is interesting to note these views from North America, where insurers are often considered to be more flexible than in the U.K.

Similar views have been expressed in the U.K. The report of the Association of Insurance and Risk Managers in Industry and Commerce[9] (the AIRMIC

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8 Hare, William A.D. and Smetna, Joseph C., op cit p.4.

9 "Captive Insurance Companies" Study Group Report, London (1976) To be distinguished from the "AIRMIC Survey" conducted solely for this study.

Report) states that increased flexibility from a captive "is difficult to quantify in terms of overall financial benefits, but it undoubtedly exists". The report mentions such issues as technical exclusions and limitations in cover being imposed unreasonably by insurers and the speedier settlement of losses by a captive, the general theme being that a captive can provide operational convenience for its owners. It also suggests that a captive will be able to deal with "unusual risks", a popular theme amongst a number of commentators[10], but possibly a false hope, for all the indications at the early stages of the study were that most captives were only involved with risks that could not be placed with conventional insurers. It is possible that a captive could be formed with the intention of insuring difficult to place risks after it had been established for a few years and that consequently such intentions had yet to make them-

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10 Barile, in "The Off-Shore Invasion", op cit, mentions the possibility of insuring expropriation, confiscation, strikes, products recall and products guarantee, but it is significant that he states that these have been considered and "sometimes" written and that he only gives one actual example, that of a group of newspaper publishers insuring strikes.

selves apparent, but in drafting the questionnaire it was decided not to include uninsurable risks as a specific item and to see whether respondents would mention it as a motivating factor in their cases.

(d) Attitude of the insurance market to deductibles

Over 327,000 fires were reported in the United Kingdom in 1977[11], but statistics from the British Insurance Association[12] show that of the total fire wastage of £261.7m, only 1,117 fires involved damage over £25,000 and that of those there were only 19 cases where damage exceeded £1m. Major organisations can therefore expect to have a number of small fires each year and the occasional large one, but the small losses will be insignificant in terms of the total assets of the firm and it will be more economic (for the reasons explained in Chapter 1, ante) for such a company to effect insurance only for losses in excess of a certain level of "deductible".

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11 Home Office, Fire Loss Statistics (1977)

12 British Insurance Association Press Release, F 1264, 25.1.78.

However, the insurance market is often accused of being unwilling to co-operate in this area, with fire insurers in particular being frequently criticised for allegedly not providing adequate discounts for the risks being retained by insured. The AIRMIC Survey clearly shows industry's view of the matter and there is even the occasional admission from insurers that discounts are inadequate[13]. With a captive an organisation can have the deductible it chooses and subject to being able to obtain reinsurance at that rate, can fix the discount at what it considers to be reasonable.

Large deductibles are said to produce savings in administrative costs, in that money is not wasted on settling small claims, but a captive will need to reinsure above the level of the deductible (plus any retention of its own) and this will lead to further savings, as excess of loss reinsurance is invariably cheaper than direct insurance with a large deductible;[14] the reinsurance market is

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13 See, for instance, Raley, D., "Financial aspects of risk management - an insurer's view", Post Magazine & Insurance Monitor, 24.6.76, p. 1466.

14 The use of reinsurance for the more economic financing of risk is a regular theme of commentators; see for instance "Captives", Policy Holder Insurance Journal, 24.3.78, P.506.

also generally considered to be more flexible than the direct market. As only bona fide insurance companies can gain access to the reinsurance market, a captive is essential if an organisation is to take advantage of the situation.

This is one of the main non-tax arguments for captive insurance companies, but there are considerable dangers involved. For instance, there were 40 fires over £1m in the U.K. in 1978, compared with 19 in 1977; inflation would seem to be only partly responsible for the increase because the number of outbreaks over £25,000 increased only marginally. Clearly, with such a small number of very large fires, an individual company could, in the short term, suffer losses that were substantially worse than average. Such occurrences would be protected by reinsurance, but the reinsurance market has a tradition for volatility, particularly towards accounts with poor experience. A company that abandoned a captive because serious losses resulted in the cancellation of reinsurance treaties would be in a very weak position when returning to the conventional insurance market for cover.

It is also possible that organisations will underestimate the cost of dealing with their own small

losses - there must be some sort of internal administrative procedure to deal with such matters and the expenses might not be taken into account when costing the effectiveness of a captive, the comparison with conventional insurance therefore being a false one.

(e) Attitude of the market to policy wordings.

It is quite often argued that insurers are far too rigid in their attitude to policy wordings and as a consequence buyers are unable to obtain the types of insurance they need. This too was a matter that attracted comment in the AIRMIC Report, which said that "insurance managers will have experience of the problems of standard policy wordings which the conventional market cannot or will not alter"[15]. Typical areas of complaint are the failure to provide "All Risks" cover, insisting on traditional fire, special perils and theft wordings instead, reluctance to allow replacement values as the basis of settlement and rigid application of universal average clauses. There are also suggestions that insurers are

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15 op cit, p.6.

prepared to provide wider cover for overseas business than for U.K. risks.[16]

A captive would, in theory at least, be able to issue whatever policy wordings it chose, but restraints would be imposed by reinsurers who are likely to be reluctant to become involved in unusual policies. Nonetheless, where moderate sums (not requiring reinsurance) are at risk there will be complete scope for originality, or where a risk cannot be insured at all and was thus falling on the parent company, it would be sensible to place it with the captive as a funding measure even if reinsurance is not available. Despite the possibilities of advantage in this area, the early indications were that, as with uninsurable risks, captives were usually only issuing policies of a type that were available in the conventional market.

(f) Lower operating costs than a conventional insurer. Insurance companies are high cost enterprises, with most insurers spending more than 30% of premiums on operating expenses[17] and

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16 See, for instance, "Captives and Risk Management" Property Correspondent of Post Magazine & Insurance Monitor, 3.11.77, p. 2744.

17 Analysis of the summaries of insurance company revenue accounts published in Policy Holder Insurance Journal in 1977 and 1978 shows that most of the major companies had expense ratios between 30% and 35%

although about 15% is agents' and brokers' commission, that still leaves about one-sixth of premiums going in administration. This is not necessarily a criticism of the insurance industry, which has all the signs of having become increasingly cost conscious in recent years, the issue is not that the money is being wasted but that it is being spent in areas that are irrelevant to the large insurance buyer. Insurance companies spend vast sums on branch networks, sales staff, advertising and public relations; on a smaller scale they pay subscriptions and make donations to a good number of associations (British Insurance Association, Chartered Insurance Institute etc.) and many are members of tariff and semi-tariff bodies. Conversely, a captive will only handle large blocks of business which will reduce costs and it will have no need of most of the foregoing items.

However, a small captive will not enjoy the economies of scale of the major insurance company and there may be further disadvantages in that it will lack the expertise and thus the efficient operation of a well established insurer. To these factors must be added the fact that operations in tax havens are more expensive than those in the

U.K. On balance, therefore, the advantages of cost are not as pronounced as they first appear, but a well run captive with a reasonable level of income (say approaching £1m per annum) could still effect savings.[18]

(g) Saving of insurers profit and investment income. Insurance companies and underwriters are entitled to make reasonable profits, but that does not change the fact that if a company has a captive the benefit will acrue to itself rather than conventional insurers. Although overall underwriting experience has remained disappointing from the viewpoint of insurers, many of them have made profits in the U.K. in the last few years and some have had very good results on U.K. fire business,[19] but even if that were not the case it is possible that insurers could be making substantial profits

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18 Both Barile , op cit, p.14 and Sennett, op cit, p.16 mention captives with expense ratios of only 5%,but it seems likely that in such cases the parent companies would be bearing some of the costs usually carried by insurers.

19 "Insurance Facts and Figures", British Insurance Association (1975 to 1977) show that BIA members overall made profits on U.K.fire and accident business in all years from 1971 to 1975. There was a large loss in 1976,but an improvement in 1977 to show a small loss. Analysis of the results of individual companies suggests that much of the deterioration occured in the accident accounts, particularly with liability and theft business.

on an individual organisation's business and thus a captive would have earned substantial surpluses.

Investment income is probably even more important than profit. It is well known that insurers earnings from investing their funds are an important factor in their well-being and a captive would secure that advantage for its parent company.

Risk Management Advantages

A number of factors that seemed to influence thinking on captives could be grouped under the concept of captives improving risk management techniques, the basic notion being that their formation concentrates attention on risk management, gives those involved greater scope for action and provides general management with a more direct vested interest in keeping down the level of losses. The most commonly heard examples under this heading were included in the questionnaires to indicate what was meant by risk management advantage:-

(a) Greater risk consciousness. It can be argued that the management of a company insuring itself is less likely to be resistant to installing loss prevention and reduction equipment and might be

more active in educating its workforce in safety procedures. This is likely to be a matter that needs attention before a captive is formed and the attitude of Eric Short is typical when he says that "the parent group needs to have its risk management and control organised and functioning efficiently".[20]

It is this question of which comes first, the captive or greater risk consciousness, that makes it difficult to identify the actual motivations in each case. It is possible that some companies are spurred into greater effort before and after a captive is formed, but it is equally possible that most of the organisations that form such undertakings are of a type that already have procedures of a high order, which would be reflected in low loss records and thus the opportunity to benefit financially from a captive. On balance, it seemed that this could be a factor in some cases and should therefore be included in the questionnaires.

(b) Better control of risk. A company with a captive has an integrated physical and risk

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20 Short, E., "Captive Companies", Financial Times, 9.7.75.

management system, whereas with conventional insurance the two areas are separated. The advantage of greater cohesion in these areas is a point made by Marianne Budge[21] and other North American commentators, particularly with regard to the harmonisation of the world-wide insurances of international companies. Such comments rarely appear in the British literature, possibly because many British-owned captives are of more recent origin than their American counterparts and the former would be likely to deal with domestic risks before turning to overseas insurances. It is also apparent that American companies, having lived with the captive concept for longer than British firms, are likely to look at wider areas even with new undertakings.

The motivations of companies are not, however, always fully reflected in the literature and it seemed reasonable to include an item in the questionnaires; it was also possible that companies would form captives with a view to using this particular advantage in the future.

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21 Budge, M., "Advantages of Corporate Captive Insurer Explored", Insurance Advocate, 31.1.71.

(c) More flexible risk management policies.

If the conventional insurance market is inflexible in its attitudes, the insurance buyer will sometimes be unable to obtain the cover that risk management policy dictates. Such factors as policy wordings and deductibles have so far been quoted as monetary issues, but they have an application under this heading also. A company with a captive will be able to take risk financing decisions regardless of the attitude of the insurance market to the issues in question.

It can be seen that the possible risk management advantages are more vague than the monetary issues mentioned earlier. It therefore seemed unlikely that a company would be drawn to form a captive on the strength of risk management factors alone and the questionnaires were worded so as to give respondents the opportunity to comment upon that view.

Influence of consultants and insurance brokers.

Insurance brokers have considerable influence in the placing of the fire and accident insurance of U.K. industrial and commercial firms[22] and independent brokers handle the majority of the business of

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22 Carter,R.L., "Economics & Insurance",PH Press Limited Stockport, p. 17.

the major companies despite some growth in the use of "in-house brokers"[23]. Given their existing contacts with the types of organisation likely to form captive insurance companies, it is not surprising to note that North American brokers became involved in advice on and the management of such undertakings almost as soon as they began to be formed in the 1950s. In more recent years, British brokers have also developed expertise in the subject and there can now be few major broking firms that do not have staff specialising in captive advice, with facilities established in one or more tax havens.

It is therefore possible that brokers sometimes persuade clients, that would not otherwise have done so, to form captives, but in addition there are a number of organisations (independent of broking houses) that specialise in the establishment and management of such subsidiaries. A few firms of the latter type were actually responsible for most of the first off-shore undertakings and

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23 Garrett. T., "The broker in the middle", Financial Times, 9.7.75. An "in-house broker" is one established as a subsidiary of an industrial company to place the parent company's insurances in the market. Garrett mentions such undertakings being formed in co-operation with the parent company's independent broker, but that is not always the case.

those and others like them are now active on both sides of the Atlantic in selling the concept to industrial and commercial companies. One case has been cited earlier[24] of a British company's original motivation towards forming a captive being not a perceived insurance need, but an approach from a consultant and this factor clearly needed to be investigated in the survey.

Lack of capacity in the insurance market.

It is common to think in terms of insurers being able to accept risks from their insured because they can pool large numbers of similar risk exposures, thus obtaining the benefit of the law of large numbers[25]. However, an insurer will need to restrict the amount of insurance on any one risk, so that it is unlikely to be faced with the situation where a single loss affects the stability of the undertaking. The main factors determining the amount that any particular insurer will retain of a certain risk being:-

(a) the amount of business of that type which the insurer has, the law of large numbers indicating

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24 p. 67 ante

25 See, for instance, Greene, M.R., op cit. Chapter 2.

that the larger the account the greater is the amount which can be safely retained[26]

(b) the severity of the risk; insurers are usually prepared to retain larger amounts of insurance where hazards are low (as for instance with houses) than where they are high (as with burglary risks involving valuable property in inner city areas).

In practice these factors mean that an organisation proposing substantial sums for insurance will have to place proportions with a number of different insurers, a system known as co-insurance. Those insurers will have reinsurance facilities which enable them to pass on large parts of their acceptances to the reinsurance market, but those facilities will not be large enough to allow even the biggest insurance companies to handle the whole of a major industrial risk. It is not possible to give examples of sums insured that would require the participation of more than one insurer, as the factors vary widely, but it can be taken that none of the organisations

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26 Insurers will, to some extent, take into account the amount of other types of business that they have, but usually attempt to achieve a balance for each major class of insurance.

discussed in Chapter 2 are likely to be able to place their industrial fire risks without recourse to co-insurance.

A "capacity problem" arises where, despite approaching virtually every insurer in the market, an organisation (or in most cases its broker) is unable to place the whole of a major risk. This would seem to be an unusual situation, but pharmaceutical companies[27], banks[28], and petrochemical firms and other organisations with high risk exposures have been cited as examples of businesses which have experienced capacity problems and captive insurance companies have therefore been suggested as a means of providing further insurance facilities, as with the British case quoted earlier [29].

It is apparent that during a period of unprofitable business in the 1960s, the fire insurance market retracted to the extent that a number of organisations experienced capacity problems, but that the situation had improved by the early 1970s[30], when

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27 Barile, A.J., "Study Underlines Important Factors in Management of Captive Companies", The National Underwriter, 10.11.72.

28 Hare, W.D., and Smetna, J.C., op cit, p.3.

29 p. 68 ante

30 See, for instance, Groves, C.H., "Using a Captive to Insure Hard-to-place Risks", Best's Review, June 1972 p.16.

most of the captives under discussion were being formed. It is possible that some organisations were motivated by earlier experiences, although it must be concluded that few of the sample of British companies covered by the study were likely to be affected.

A major difficulty with the idea of a captive being used to provide extra capacity is that such an undertaking would (even with substantial reinsurance) be able to take only small amounts of insurance. A single-company captive will be of only modest size and if it is to operate safely will have to follow the principles discussed above for the restriction of retentions. However, an alternative view would be that an organisation that was unable to place all its insurance in the conventional market would be well advised to put the remainder with a captive, rather than carry the risk internally. Thus, there was a danger that respondents would misconstrue any question about capacity and it was decided not to include one in the questionnaire, but to see whether the factor was volunteered and also to follow up the matter during interviews.

Captives as tax avoidance devices

All of the factors mentioned so far have been purely

insurance matters, with the question of possibly operating a captive in a tax haven being seen as relating to the faster accumulation of insurance funds and the avoidance of irksome insurance regulations. However, it is possible that organisations could be influenced by the opportunity of building up funds off-shore for other than insurance purposes; having accumulated money tax free it could be used to finance projects either in the tax haven itself or in a country to which funds can be moved without incurring tax. Even if the main objective of a captive was to operate as a genuine insurance company, the benefits mentioned would arise as a spin-off and could be taken advantage of if the organisation needed finance in an appropriate territory. In the most extreme cases, a captive might be established with little intention of it operating fully as an insurer, or the parent company might artificially inflate the premiums charged by the subsidiary in order to get more money into the tax haven; in such cases the parent company would be involved in illegal tax evasion.

Taxation questions probably cause more dispute between commentators on captive insurance than any other factor. Some consider that the funds of an

off-shore captive should be seen as an important part of a company's financial planning; Becket,M., suggests that they can be used for "currency hedging" and to "move currency across frontiers with a minimum of government interference"[31]. The opposing view would be that insurance should not be mixed with tax avoidance and that "if a company is being set up purely for tax reasons it should not be set up at all"[32].

There is also a possible middle view taken by some practitioners who state that, although tax advantages do exist off-shore, their possibly transitory nature should mean that they are not taken into account when deciding whether a captive would be beneficial for a particular firm. Thus, the tax advantages should be seen as a possible bonus rather than a real motivation[33].

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31 "Safeguards with freedom in Bermuda", Policy Holder Insurance Journal, 13.4.79, p.31.

32 Vaughan, D.B., quoted in "Captives", Policy Holder Insurance Journal, 24.3.78, p. 513.

33 See, for instance, Sennett, W. F., "Advantages & Disadvantages of Captives" in "Captive Insurance Companies", Keith Shipton Developments Limited, London (1976)

A question was therefore included in the questionnaire asking whether the respondent companies had been influenced by the possibility of building up funds in a tax haven for other than insurance purposes. In the case of companies that had considered the formation of a captive but had not proceeded, a further question asked whether the respondent thought that companies that had formed captives were so influenced.

Status of the risk manager.

Another possible motivating factor concerns the personal reasons why a risk manager might want the company to have a captive insurance company. This factor was mentioned during a few of the interviews conducted at the beginning of the study and the AIRMIC Report states that "the next captive established in the pursuit of the promotion of the position and status of the parent company insurance manager will not be the first"[34].

The information available on the status and role of risk managers in the U.K. is rather limited.

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34 op cit, p. 9.

Damary[35] found that, in the 80 companies he investigated, 38% of the risk managers reported to the company secretary or administrative director and 45% to the financial director; 56% of the people were concerned solely with insurance matters, that is they were not involved with broader risk management issues such as risk reduction. It is, however, difficult to apply the findings to British industry and in particular to the quite wide spectrum of firms covered by this thesis, because only a minority of Damary's sample were U.K. based and all were very large organisations.

An earlier investigation by what was then known as the Association of Insurance Managers in Industry and Commerce[36] found that 41% of respondent risk managers in British industry reported to the company secretary, 27% to a director and 20% to the financial controller. In this sample only 20% were involved in risk reduction, the others being concerned almost entirely with insurance work.

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35 Damary, R., op cit, p. 35.

36 "Status and Techniques of Insurance Managers in Industry", Association of Insurance Managers in Industry and Commerce, London (1969)

This limited and partly outdated information does, however, confirm the general view in the insurance industry that, although some risk managers in the U.K. hold important positions in their companies, the risk management function in most organisations is not highly regarded and is usually seen as having the role of placing insurance and little else. Consequently, a risk manager might see considerable personal advancement in pushing the captive concept in the organisation, but it is difficult to see how the person can have much impact if status is lacking initially.

This is clearly a difficult area to research. The topic was therefore dealt with by asking about the manager's role before and after the captive was formed, including a request to indicate any change in job title.

The risks of off-shore operations

The questionnaires needed to take into account the factors that might dissuade organisations from forming captives, with such circumstances being distinguished from those where an enterprise decides that the claimed advantages do not apply to itself, or do not amount to anything

substantial enough to warrant the effort involved in forming a captive.

However, it proved to be difficult to find disadvantages that organisations took seriously, the only factors that appeared to be of concern being the "political risks" of operating in a tax haven[37] that is the risks of:-

(a) The United Kingdom government taking action to prevent the use of captives, either to reduce tax avoidance or to protect the British insurance market; in the former case there is the precedence set by the American Internal Revenue Service, which is discussed later;

(b) changes in off-shore territories caused either by amendments to legislation or social unrest.

The AIRMIC Survey provided evidence that insurance buyers were not over concerned about encountering difficulties with the conventional market, or the questions of cost or possible lack of expertise; thus in the absence of other factors it was decided to suggest in the questionnaires that

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37 See for instance Raley, D., op cit.

political risks off-shore were indeed the only risks taken seriously. However, decision making in this respect appeared to be haphazard, the impression gained being that although political risk was recognised, organisations tended to proceed if the advantages seemed to be substantial without any attempt to quantify the risks; respondents were asked to comment on that view.

CHAPTER 4

MOTIVATIONS TOWARDS CAPTIVE INSURANCE (2) - RESPONDENTS ATTITUDES

Of the 30 companies that were found to have captive insurance companies, 26 had formed one in the last ten years (i.e. after 1968) and it was decided to limit the investigation of motivation to those companies, as respondents could not be expected to recall situations over ten years ago. One of the 26 had formed an off-shore captive after having operated a large domestic undertaking for many years and was excluded because it could not be seen in the same way as an organisation entering into captive operations for the first time. Two further companies, in addition to having their own captives, were members of Oil Insurance Limited; these were also excluded as they would be in a different position to other respondents. This left 23 organisations able to answer questions from the same viewpoint, from which 17 completed questionnaires were received.

Information was received in respect of 107 other companies in the top 250 of The Times 1000 and

of these 38 indicated that the possibility of forming a captive insurance company had been considered. Ten of these companies refused to supply further information and of the remainder, 21 actually returned completed questionnaires.

There is, therefore, data collected on a random basis from 38 companies.

Respondents

This information, as with all other data for the study, was initially sought from the risk managers of respondent companies. These were the obvious people to contact with regard to technical information on the management of captives, mainly required for Part II of the study, but they may not have been familiar with all the organisational motivations involved. It has already been mentioned that risk managers do not always enjoy a high status in British companies and even in some very large firms the role is seen as one of simply placing insurance, rather than covering a wide risk management brief.

However, it was considered to be reasonable to question risk managers on such matters and to

expect them to accurately detail the motivations within the company, at least as far as direct insurance matters were concerned. Other areas, such as taxation and political risk, were more likely to have been dealt with at Board level, or by managers in the Finance Department and thus the risk manager may not be able to answer for the company. It was still considered appropriate to question the risk manager, as the main respondent, on all aspects, as it was likely to prove difficult to gain access to other officials, particularly the directors of international conglomerates; but replies on areas likely to be outside a person's realm clearly had to be treated with caution and other contacts made wherever possible.

Companies with Captives

The questionnaire sent to respondents in companies which had formed captive insurance companies attempted to elicit the information required in a number of ways, each method being that which was considered most suitable for the information required:-

(a) Data on motivations concerned with direct monetary advantage, risk management advantages

and the risks of off-shore operations, were obtained by asking for comments on a statement covering the main areas.

(b) The question of the influence of consultants and insurance brokers was handled by asking about initial instigation and sources of information.

(c) The possibility of an increase in status for the risk manager being a motivation, was dealt with by asking about job title, role and position in the management structure of the captive.

(d) Information on the extent to which an undertaking was used as a tax avoidance device was obtained by a direct question.

(e) As mentioned in the last chapter, there was no question on captives being formed to solve capacity problems, but there was space left for respondents to add comments on that and other issues not dealt with.

Similar questions, where appropriate, were put to the companies that had not formed captives and the replies will be referred to at convenient points

throughout the chapter.

Monetary and risk management advantages and risks of off-shore operations

The questionnaire contained the following statement:-

> "Captive insurance companies are formed with the objective of saving the parent company money in a direct way, 'risk management factors' (greater risk consciousness, better control of risk, more flexible risk management policies etc.) are seen as being important, but are not in themselves critical enough to persuade a company to form a captive where direct monetary advantage cannot be shown. Consultants and insurance brokers play an important role in persuading companies to form captives, but in essence they do little more than draw the attention of potential captive owners to the possibilities. Direct monetary advantage is seen to stem from fewer insurance regulations and lower taxation in tax havens, inflexibility in the conventional insurance market (attitudes to deductibles, policy wordings etc.), the captive being

operated at lower cost than a conventional insurer and the retention of profit and investment income that would otherwise go to the insurer. The main objections to captives come from fear of the possible political consequences of operating in tax havens, but these are largely ignored in the final calculation."

Respondents were asked to:-

(a) Indicate the extent to which their experiences corresponded with the general points in the statement;

(b) Weight the importance to their companies of the various factors mentioned.

The decision to include the statement in the questionnaire, instead of merely asking respondents why their companies had formed captives, was taken so that replies would be obtained to specific points, in order to test the hypothesis on motivation that had been developed from the issues described in the last chapter. It is possible to criticise this approach on the grounds that it might place ideas in the minds of respondents that would not have otherwise

arisen - in an attempt to identify any such bias, respondents were asked on a later occasion to indicate what they thought were the first and second most important reasons why the subsidiaries had been established and the replies were also compared with comments made by the financial controllers in the same companies. These investigations are described towards the end of this chapter.

Replies on general aspects

Comments on the main points in the statement are summarised in Table 4.1. There was general agreement with the stance taken regarding the importance of direct monetary advantage and risk management factors, but with less strong support for the latter. This corresponds with wide support for the view that a captive would not be formed on the strength of risk management factors alone and the replies show that organisations are primarily motivated towards reducing the cost of their insurance budgets when forming captive insurance companies.

Support for the statement on the role of con-

sultants and insurance brokers came from slightly more than half of the respondents. It is perhaps to be expected that companies would have different experiences in this area, for consultants would not have been able to reach every company. If an organisation had decided to look at captives at its own instigation its views would be formed by that, others that were approached (perhaps at random) would clearly have opposite opinions. These replies need to be considered with those on sources of information dealt with later.

There was substantial disagreement with the statement on the question of whether political risks in tax havens were the only disadvantages taken seriously and the placing of values on such factors. This indicates that there are disadvantages considered by companies, which were not apparent when the questionnaire was constructed and is an issue which will also be returned to later in the chapter.

Table 4.1

Showing the attitudes of companies with captive insurance companies to the main points of the statement in the questionnaire

Question	Same	Similar	Dis-similar	Very different	No Reply
Direct monetary advantage	12	5	-	-	-
The view that risk management factors are considered important	6	8	2		1
Would not be formed on the strength of risk management factors alone	11	5			1
The role of consultants and brokers	5	4	5	3	
Only disadvantage taken seriously is the political risk in tax havens	3	2	6	4	2
No attempt is made to place a value on political risk	4	3	3	3	4
No attempt is made to place a value on other disadvantages	3	3	4	3	4

Importance of various factors

The weightings applied by respondents are summarised in Table 4.2. The items on straight monetary advantage and deductibles were all highly weighted, with the saving of insurers profit and retention of investment income being considered very important by nearly all respondents. The strong support for the factor "general inflexibility in the market" must also be noted - this supports the view mentioned earlier that captives are formed partly as a reaction to general dissatisfaction with the conventional insurance market[1].

The replies to the item on lower taxation offshore are perhaps surprising, although it must be noted that three of the respondents had domestic captives and naturally placed it in the "unimportant" bracket. It would be wrong to place too much emphasis on this point, for half of the respondents did place the factor in the highest bracket and only one indicated that it was unimportant, but one might have expected the

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1 See also Elliott, P.C., quoted in "Future Changes", Post Magazine & Insurance Monitor, 26.2.76, p. 437.

matter to be considered a highly important motivator in nearly all cases. There are, however, a number of things operating against such a response:-

(a) It is widely held that captives are not formed unless savings can be shown on insurance costs, before taking into account tax savings[2].

(b) Most companies using tax havens prefer to keep their activities secret, thus their importance will not be stressed.

(c) Risk managers replying to such questions would tend to stress insurance rather than tax aspects.

Thus, a mixed response was likely, but the question is largely one of whether tax savings are a prime factor or just an important secondary motivation and the difference is not crucial, provided tax savings from genuine insurance operations are not confused with the use of captives as deliberate tax avoidance devices.

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2 See Sennett, W.F., "Advantages and Disadvantages of Captives", op cit.

Table 4.2

Replies from companies with captive insurance companies on the importance of various factors

Question	Very Important		Important		Unimportant	NO REPLY
	5	4	3	2	1	
Fewer insurance regulations in a tax haven	4	2	5	1	4	1
Lower taxation off-shore	7	1	5	-	4	-
General inflexibility in the market	7	3	1	2	3	1
Attitude of market deductibles	8	1	3	2	2	1
Attitude of market to policy wordings	1	2	4	4	5	1
Lower operating costs	5	6	3	1	-	1
Saving insurers profit	10	5	1	1	-	-
Retention of investment income	7	9	-	-	-	1
"Risk management advantages"	4	3	3	5	1	-

*Three respondents had U.K. based captives

Companies without captives

Respondents who indicated that their companies had considered the formation of captive insurance companies, but had not done so, were asked to comment on the statement mentioned earlier in a similar way to companies with captives. It will be convenient to consider those replies here and to compare them with those discussed above.

The respondents were also asked to state the extent to which their firms had examined the subject and the data obtained is set out below:-

(a)	In depth	10
(b)	To a more limited degree	6
(c)	Superficially	5

It is significant that more than half of the respondents were replying from a position of limited knowledge, but that their attitudes were very similar to those who had studied the subject in depth. There is also a considerable similarity in attitudes towards the main points in the questionnaire statement between companies that had not formed captives and those that had, as shown in Table 4.3. If the "same" replies are

combined with the "similar" and the "dissimilar" with the "very different" responses for each group, the pattern in Table 4.4. emerges.

Table 4.3

Comparison of the attitudes of companies with and without captives to the main points of the statement in the questionnaire

Question	R*	Same	Similar	Dis-similar	Very different	No Reply
Direct monetary advantage	W	12	5	-	-	-
	WO	15	4			2
The view that risk management factors are considered important	W	6	8	2		1
	WO	8	9	2		2
Would not be formed on the strength of risk management factors alone	W	11	5	-	-	1
	WO	13	6	-	-	2
The role of consultants and brokers	W	5	4	5	3	
	WO	5	4	7	2	3
Only disadvantage taken seriously is the political risk in tax havens	W	3	2	6	4	2
	WO	5	3	6	5	2
No attempt is made to place a value on political risk	W	4	3	3	3	4
	WO	6	4	5	3	3
No attempt is made to place a value on other disadvantages	W	3	3	4	3	4
	WO	2	6	3	6	4

*R: Type of respondent. W = Company with captive
WO = Company without a captive

Table 4.4

Showing the similarity of attitude between those companies that had formed captive insurance companies and those that had considered the possibility but had not done so.

Reply	Same/Similar		Dissimilar/ Very different	
Question	With Captives	Without Captives	With Captives	Without Captives
1	100%	100%	-	-
2	87%	89%	13%	11%
3	100%	100%	-	-
4	52%	50%	48%	50%
5	33%	42%	67%	58%
6	53%	59%	47%	41%
7	46%	44%	54%	44%

Relevance of various factors

The extent to which companies without captives found the factors listed in the questionnaire relevant is shown in Table 4.5.

All the issues had been considered by most respondents and had been judged to be relevant by the majority in nearly every case. Monetary factors, deductibles and general inflexibility in the market were the items considered important by virtually all companies, while the items on regulations in tax havens and policy wordings were irrelevant in half the cases where they were considered.

Table 4.5

Replies on the relevancy of various factors from companies that had considered the possibility of forming captive insurance companies but had not done so.

Question	Relevant to the company	Relevant generally not to company	Not Relevant	Not Considered	No Reply
Fewer insurance regulations in a tax haven	7	4	3	2	5
Lower taxation off-shore	16	2	1	-	2
General inflexibility in the market	12	4	3	-	2
Attitude of market to deductibles	16	2	1	-	2
Attitude of market policy wordings	8	5	3	2	3
Saving of insurers profit	16	-	1	1	3
"Risk management advantages"	13	5	1	-	2

Comparison between companies with and without captives

On the main points of the statement in the questionnaire there is considerable agreement between the two types of respondent, both groups expressing approval and disapproval in much the same way. This consensus leads to the conclusion that the questionnaire has been successful in identifying a number of the factors that motivate organisations towards the formation of captive insurance companies. The agreement between the two types of respondent also indicates that companies that have decided not to form captives have done so, not because they found the claimed advantages lacking in themselves, but because they were not relevant in their particular circumstances.

On the detailed points, however, there is some considerable disagreement between the two types of respondent. The questions had to be put in a different way to the two groups, but it is reasonable to assume that "very important and important" in the questionnaire sent to companies with captives equates closely with "relevant to the company" in the other. A comparison of Tables 4.2 and 4.5

shows some similar responses with regard to questions of tax haven advantages, inflexibility in the insurance market and insurers profit. However, respondents without captives give somewhat more support than the other group to the point on deductibles and have produced very different replies to the questions on policy wordings and risk management advantages.

Overall, respondents without captives have shown heavy support for nearly all the points raised in the questionnaire statement. While it is to be noted that they were merely required to indicate whether a factor was relevant (which would include relevance to just a small degree) it is difficult to escape the conclusion that the limited knowledge of some of the respondents led them to concur with the statement without question.

Influence of consultants and insurance brokers

14 of the 17 respondents from companies that had formed captives indicated that they or their firms had originally decided to examine the possibilities, with two saying that they were first approached by consultants and one giving the credit to the insurance brokers that were already handling the

company's insurances[3]. Of the 21 respondents without captives, 16 replied that the idea of a captive originally came from within the firm, with all the other five saying that their insurance brokers had suggested an investigation; one of the latter said that another broker had also contacted them and one of the companies that originally decided for itself was later approached by a consultant. However, in nearly every case where the company made the initial decision information was sought from more than one source and Table 4.6 summarises the relevant data.

Reconciling the existence of so many specialists with the insistence of companies that they originally think of the subject is difficult and there can be no complete answer. Apart from the possibility of companies being embarrassed by the question and preferring to say that they thought of the matter first, a fuller understanding of the situation might be gained by considering the

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3 Some organisations have subsidiary insurance broking companies (known as "in-house brokers") to handle their insurances. Unless the contrary is indicated, reference to a company's insurance brokers should be taken to mean an independent firm.

history of the subject. Off-shore captive insurance companies were, until quite recently, predominantly an American phenomenon[4] and motivations in British companies probably originated from a knowledge of what was happening in the United States, existing consultancies may therefore have become involved in Britain as a result of a genuine desire for assistance in certain companies, rather than with a view to marketing their services. As for the brokers, they might have established their specialist departments to counter the threat from the consultants. Such a situation would tend to produce a philosophy of waiting for enquiries rather than involving in cold canvassing.

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4 Sennett, W.F., op cit, makes reference to captives being formed by American companies in Bermuda in 1956. The earliest off-shore British-owned captive discovered during the study was formed in 1970.

Table 4.6

Sources of information on captive insurance companies analysed according to whether the initial moves were at the instigation of the company or an outside agency

OWN INSTIGATION			OUTSIDE AGENCY		
Source	With Captives	Without Captives	Source	With Captives	Without Captives
Company's broker	8	13	Company's broker	1	4
Another broker	2	1	Another broker	-	1
Specialist consultant	7	5	Specialist consultant	2	1
Other sources			Other sources		
With Captives	Without				
Accountants (4 times)	Bankers				
"In-house" (4 times)	"In-house"				
Other companies	Other companies (2)				
Conferences	Conferences				
Tax advisers	U.S. subsidiary				
Leading insurer					
Solicitors					

If the above argument is accepted, the results of the survey in this respect would tend to support the view that brokers and consultants do have a considerable part to play in encouraging the formation of captives, but only to the extent of making known the relevant issues. The idea of captives being "sold" to organisations would seem to have little support; risk managers with whom the subject was discussed occasionally spoke of excessive zeal but usually reported that they were not pressured at all.

From the data in Table 4.6 it can be seen that companies generally preferred to deal with either a broking company or consultant, rather than carrying out investigations themselves and that in most cases they chose to be advised by the brokers with which they already had contact. The consulting of an outsider did however happen in a number of cases and it seems that where a consultant was contacted eventual captive formation was more likely. One cannot infer too much from that, but one might surmise that the specialist would be more convincing than a broker or that the latter would be more likely to put forward

arguments against forming a captive; it is also possible that the company which is already convinced that it could benefit from a captive is more likely to be prepared to incur a consultant's fee.

The other sources of information mentioned by respondents are listed in Table 4.6, but it should be noted that these were usually cited where an approach to one of the more normal intermediaries was also quoted. Noteable features are that a number of companies with captives are prepared to share their experiences with those considering such a step and that despite the growing number of conferences held on the subject these were mentioned only rarely as sources of information.

Other factors that encourage captive formation

Replies to questions intended to elicit information on the status of the risk manager, tax avoidance and any other factors that respondents considered relevant, were sometimes inconclusive or incomplete. It was therefore necessary to follow up such issues during interviews with respondents that were also concerned with factors

of relevance to Part Two of the study. The discussions that follow are therefore based on information obtained during such interviews as well as replies given on the questionnaires.

Status of the risk manager

The first point to note, when considering whether risk managers might be motivated towards captives in order to increase their status, is that it was found that most risk managers whose firms have off-shore captives are not directly involved in managing the subsidiaries. This situation arises partly because it was found that most organisations engage managers to operate their undertakings, but also because if an off-shore subsidiary is to maintain that it is not trading in the U.K. (which is essential for tax reasons and to avoid the insurance regulations) it will have to be kept at arms length from the parent.

In the case of domestic captives, risk managers were found to be very much involved in the day to day administration of the subsidiary. However, with regard to deciding what risks to place with the captive, the manager will generally have to

treat it in almost the same way as any other insurer[5].

Role and job title

Despite the absence of a direct involvement in most cases, the formation of a captive will produce a considerable change in risk management strategy, from which the manager might benefit. In 10 of the 16 cases where information was received, the risk manager had been given a seat on the board of the captive, although in only two cases had he been made Head of the operation and in only one instance had the previous Head of a risk management function moved to run a captive in a tax haven. Except in two cases (where the title Insurance Manager changed to Risk Manager) no change in job title had occurred and except for the man who had moved to the tax haven, very few changes in job responsibilities were reported by respondents.

This suggests that there is a good chance that the formation of a captive will lead to a limited

5 This point has been made by a number of commentators, including Dixon, J.A.,in "The challenge from the captives" papers from the Financial Times World Insurance Conference, 6 & 7. 3. 74.

improvement in status for a risk manager, but that the chances of substantial improvement are slight. Even if a risk manager were motivated by the possibilities of improvement, the question still remains whether the person would have sufficient influence in an organisation to bring about such a change. This was a difficult matter to research, for one could hardly ask a direct question and if one did the replies would probably not be reliable. However, casual observation of office environment and replies to questions about their jobs suggested that few of the respondents would have been able to persuade their companies to form captives unless there were strong financial arguments in favour.

It was found that in most cases respondents had been directly involved in the decision making process, but that accountants, tax experts, top management and outside advisers also took part in varying degrees in each company. The influence of the risk manager would vary in each organisation and the others might take into account a possible vested interest when considering his views. Nonetheless, as the risk manager may benefit from the formation of a captive, it does seem likely that the person will be more motivated towards that end than would

be the case if that possible benefit did not exist.

Lack of capacity in the insurance market

The case of Oil Insurance Limited, referred to earlier, where members of the American Petroleum Institute became dissatisfied with the services provided by the international insurance market and formed a captive insurance company, is sometimes quoted as evidence of a lack of capacity for handling very large exposures. However, it seems likely that O.I.L. was largely a rebellion against what were seen as high rates, rather than a failure of the market to absorb all the risks involved[6].

Excluding O.I.L, in only three cases were capacity problems mentioned by respondents as motivating factors. One of these has already been mentioned at the beginning of this chapter, the others are detailed below:-

(a) A major chemical company experienced a number of serious fires which resulted in the existing consequential loss insurers increasing rates very substantially. The company was convinced that it

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6 "Risk Management Reports" (1975), op cit.

had experienced a temporary difficulty for technical reasons, but were unable to persuade their existing insurers and alternative markets were found to be too small to handle all the very large risks the organisation had. A captive was formed, largely to insure consequential loss risks, but whether lack of capacity can be claimed to be the real issue is clearly debatable.

(b) A second chemical company was finding the placing of its fire schedules difficult, but not impossible. However, looking ahead a few years they could see that expansion and development were going to bring even larger exposures which they might not be able to insure in full; a captive was therefore formed in anticipation of capacity problems that did not at the time exist.

Companies in the chemical industry, with their very large sums of risk, are more likely to suffer from problems in placing all their insurances than organisations in general; the company originally quoted is also in an industry that is well known for very large accumulations of risk. It can therefore be said that where substantial exposures exist, say where estimated maximum possible losses

exceed £100m, where sums insured are lower but risks high (e.g. plastics), or where there is the risk of catastrophe loss for other reasons (as in pharmaceuticals), risk managers will experience problems in placing their largest insurances and may be concerned about capacity problems in the future. However, except in the one case mentioned, there is no evidence of actual shortage of capacity being a motivation towards the formation of captive insurance companies.

Finally, on the question of whether a small captive would be able to create very much extra capacity, in a case where full cover was simply not available it would be sensible for tax reasons for the organisation to form an insurance company to handle the enforced "coinsurance" rather than to carry it internally. However, the experience of the one company that did have genuine capacity difficulties was that it was able to obtain reinsurance for most of its forced retention and it therefore seems that there is extra capacity available that the conventional market does not always tap. In particular, reinsurance might be found in foreign markets not always used by British insurers or by way

of a captive reinsurance pool and consequently extra capacity could be found.

Captives as tax avoidance devices

Of the 26 companies that were found to have formed captives in the last ten years, 22 had placed them in tax havens. These facts speak for themselves; taxation is a very important consideration for companies thinking of establishing an insurance subsidiary. It has been noted that, in addition to gaining tax advantages, an off-shore captive also escapes burdensome British insurance regulations, but replies to the questionnaire suggest that captive owners do not consider it an important issue. This leaves tax benefits as the only possible reason for forming an undertaking off-shore.

However, it was found that motivations were rarely clear-cut, consider for example the following case:-

> A company has a large number of small premises where total losses are steady from year to year, with total sums at risk at each location being moderate compared with the size of the

organisation. It also has a number of large exposures with mixed experience as far as insurance losses are concerned. In the case of the small risks, conventional insurance was considered uneconomic because it was easy for the insurers to fix the premiums at the level required to cover their costs and make a good profit and consequently the company always paid in premiums far more than it received in claims. The company formed a captive in a tax haven, which it operates virtually as a self-insurance fund for the small risks only; it has no need for reinsurance. Despite quite a modest charge for each risk, the subsidiary was reputed to be making a handsome profit and funds are accumulating steadily. Is this genuine insurance and to what extent are tax considerations an element? The respondent stated that the company was influenced by tax factors for other than insurance purposes, but that the original motivation was basically related to insurance costs.

Thus, one cannot automatically infer that, because most captives are being formed in tax havens, they are being operated as tax avoidance devices, neither does it necessarily follow that tax benefits are an initial motivation when captives are considered. Damary[7] states that most of the companies in his sample that had formed captives claimed to have done so in order to reduce the cost of their insurance and that possible tax savings merely affected decisions on location. The replies by respondents to the question of whether they were influenced by tax benefits for other than insurance purposes therefore make interesting comparison with Damary's findings, the replies being summarised in the following table:-

	Was the company influenced in its decision by the possibility of building up reserves in a tax haven for other than insurance purposes.		
	YES	NO	NO REPLY
Companies with off-shore captives	9	5	3
Companies without captives which had considered them	9	10	2

7 Damary, R., op cit, p. 44.

Respondents in companies that did not have captives were asked the additional question of how they thought others were influenced; 13 respondents thought other organisations were affected by the tax factor, eight of those having said that their own companies had not been so influenced.

Difficulties in identifying motivating factors with regard to taxation

It is therefore clear that many companies do form captives to gain tax benefits, but that still does not answer the question of whether it is such an important issue that most undertakings can be considered largely as tax avoidance devices. There is also the question, in cases where tax was not the main issue, of the extent to which that factor was a motivation.

Where a person involved in the management of a captive states that the undertaking was formed largely for tax reasons, one can be fairly certain one has the truth, but in most cases respondents would probably be reluctant to be candid about what is a delicate issue. This was also an area where it was especially apparent that the risk managers providing information for

the study were not always able to answer for their companies. One can envisage the situation where a risk manager is fully involved in the setting up of a captive, believing that savings in insurance costs and risk management advantages are the main motivations in the company, but at a higher level, or in another department, a captive is in addition to the insurance factors seen as a part of the organisation's international tax plans.

Consequently, it was necessary to attempt to obtain information from other officials in respondent companies, particularly the senior managers or directors in the financial functions who were involved in the decisions relating to the formation of the captives. However, it proved to be extremely difficult to gain access to such people, many of whom are directors of some of the world's largest companies; it was also the case that tax issues were often considered highly confidential. The data that was obtained is considered together with that concerned with primary motivating factors, which is discussed in the next section, but the isolating of those undertakings used solely for tax avoidance purposes was attempted in another way.

Identification of captives used largely for tax purposes

If an organisation's primary reason for forming a captive is tax avoidance, it is likely to avoid situations that could lead to a major loss being insured and will therefore not need the reinsurance protection of a normal insurance company. Thus, it is possible to make inferences about the motivations of captive ownership from the following factors:-

(a) Risks insured. A captive taking all or part of the major risks of the parent company is more likely to be a genuine insurance operation than one that is not.

(b) Reinsurance. Similarly, a captive playing a real part in its parent's insurance will almost certainly need reinsurance.

The main indication as to whether a captive in the sample was being used to share in major risks was taken to be the arrangements for fire, explosion, and consequential losses in respect of the largest premises of the parent company, with theft risks (if particularly valuable pro-

perty was involved) and marine risks, where appropriate, also being considered relevant.

In all but three of the 17 off-shore cases where information was obtained, the captive was taking the whole of such risks or appeared as a co-insurer on scheduled insurances; the three exceptions insured minor risks such as storm, burst pipe damage, travel and credit, or (in the case quoted above) only handled the insurances of small properties. The three were also the only ones of the 17 that wrote 100% insurances without reinsurance. In one of these cases, the respondent admitted that the undertaking was run largely for tax avoidance purposes and another, which had only a modest income, could have had very little purpose unless tax was a major issue; only in the case already quoted in detail above did it appear that insurance was an important aspect.

The conclusion is that, except in a few cases, captive insurance companies do not appear to be used solely as tax vehicles.

Primary motivating factors

The factors that seem to motivate organisations to form captive insurance companies have now been identified. However, a far clearer picture of decision making in this area would be obtained if respondents placed the factors in order of importance. To this end, each risk manager respondent was asked to give the most important reason why his company formed a captive and the second most important reason. As mentioned earlier these further investigations were also undertaken to ascertain whether the statement contained in the questionnaire had led respondents to reply as they did.

Replies were received from 16 companies and these are summarised in Table 4.6. The factors mentioned can be placed under four broad headings: reduction in the cost of insurance, taxation, risk management advantages and insurance market factors (deductibles, capacity problems and inflexibility in the market). All but two replies could be placed without question into one of these four areas; one respondent said that the most important factor was that a captive had been "sold" by a consultant and the reply was not allocated to any of the four headings, the other indicated that "global considerations and long

term stability" was the second most important issue for his company, which was interpreted as a risk management factor. The following table shows the totals under each heading:

	Cost	Tax	Risk Management	Market Factors	Other & No Reply
Most important	8*	3	1*	3*	1*
Second most important	7*	2	3	2*	2*

* One domestic captive in each case

Although the item on cost occurs the most frequently, it is to be noted that the other factors together account for about half of the reponses in both the most important and second most important categories. However, only one respondent failed to place cost either first or second. The emphasis placed on cost savings by most respondents and the importance given to risk management and market factors by a minority of risk managers follow quite closely the replies obtained from the questionnaires and summarised in Tables 4.1 and 4.2.

Table 4.7

Summaries of the most important and second most important reasons for their companies having formed captive insurance companies, given by the risk managers of 16 organisations.

	Most important	Second most important
1.	Insurers insisted on large deductible	To reduce cost of insurance
2.	To reduce expenditure on insurance	No other reason given
3.	*Lack of market capacity forced them into co-insurance	Saving money on insurance
4.	Reduction in insurance costs	Tax savings off-shore
5.	*To reduce cost of insurance	To obtain better terms for deductibles
6.	Tax advantages	To save money
7.	Problems with deductibles and inflexibility in the market	To reduce insurance budget
8.	To provide cover in most economic way	Global considerations and long-term stability
9.	To reduce costs on insurance	Greater control of risk
10.	To save money, particularly on brokers commission	Inadequate cover in market, particularly with deductibles
11.	To reduce insurance costs	Tax savings
12.	*Better handling of self-insurance	No other reason given
13.	Captive "sold" by a consultant	To reduce cost of insurance
14.	Tax benefits off-shore	To get insurance at reduced cost
15.	To utilise existing off-shore funds	To save money on insurance
16.	To obtain cheaper cover	More control regarding pre-cautions against loss

* Domestic captives

Attitudes of Financial Controllers

If the domestic undertakings are excluded, it can be seen that taxation was quoted as a factor in only five of the thirteen cases where such advantages were available. It was with regard to tax questions (and also wider financial matters), that mention was made earlier of the possibility that the Risk Manager might not reflect accurately the motivations in an organisation. It was therefore decided to attempt to contact a senior official in the finance function who was familiar with the captive, in each respondent company; such contacts were also a further way of dealing with the question of any bias in responses to the statement in the questionnaire.

The procedure followed was to ask each of the 17 risk managers who had returned a questionnaire to give the name of the principal person in the finance function of the company who had been involved in the formation of the captive. In some cases it was the Finance Director, in others a person of lower status and the general term "Financial Controller" will be used here; all

such persons were contacted by letter and where replies were not received attempts were made to reach them by telephone. Twelve of them eventually agreed to provide information and although the amount of cooperation obtained varied widely, they were all asked and answered (without prompting) the question:"what was the main reason why your company formed a captive insurance company?" The other information obtained was so varied that it cannot be analysed, but the data obtained in reply to the above question does make interesting comparison with that provided by risk managers and is shown in Table 4.7.

Analysis of the replies shows that there was little difference of opinion between Financial Controllers and Risk Managers. In only one case was there substantial disagreement, that being where the Financial Controller stressed the importance of the fact that the company's North American operations already had a captive. However, differences in emphasis, if not in overall opinion, could sometimes be detected between the two respondents from the same company.

Table 4.8

Showing the most important reason for forming a captive insurance company given by 12 Financial Controllers, compared with that given by the Risk Managers of the same organisation.

	Financial Controllers	Risk Managers
1.	To enable company to obtain insurance at lowest cost	To reduce expenditure on insurance
2.	For insurance purposes, but there were also wider considerations	Reduction in insurance costs
3.	*A cost saving exercise	To reduce cost of insurance
4.	Largely for tax purposes	Tax advantages
5.	Technical insurance reasons	Problems with deductibles and inflexibility amongst insurers.
6.	To effect savings on insurance	To provide cover in most economic way
7.	To improve financial arrangements	To reduce cost of insurance
8.	Reduction of insurance budget, with money making possibilities in the longer term.	To save money, particularly on brokers commissions
9.	Stemmed from North American operations	To reduce insurance costs
10.	*To provide more satisfactory insurance arrangements	Better handling of self-insurance
11.	A part of international financial arrangements	To utilise existing offshore funds
12.	More economic provision of cover for some of our properties	To obtain cheaper cover

* Domestic captives

The Financial Controllers tended to see the issues in a wider context and in particular:-

(a) were more likely to think in monetary, rather than insurance, terms;

(b) tended to regard the captive as a part of more general international arrangements.

It is not really surprising that finance men should think in financial terms, but it does indicate that the direction in which a particular captive moves may depend on who is in control and/or has the most influence. Where an insurance person is almost completely responsible for a captive operation, it might be seen as largely an insurance vehicle, but where a finance person has a lot of influence far wider considerations are likely to be involved.

These wider financial issues were not mentioned by the Financial Controllers involved with the two domestic captives; the sample is too small to make a general assumption, but it seems likely that domestic captives will normally be seen purely as insurance vehicles. If that conclusion is correct, it means that the wider financial considerations with off-shore undertakings arise largely out of their operations in tax havens.

Disadvantages of captive insurance companies

Approximately two out of every five respondents indicated that the only disadvantage taken seriously by their companies was the political risk involved in operating in a tax haven; when the replies from firms with domestic captives were eliminated the proportion making that response was increased to about 50%. Thus, it was necessary to ask further questions of all respondents with domestic captives and about half of those which had off-shore undertakings or where the companies had decided not to proceed with the formation of a captive.

In addition to the question of political risk, which had affected the thinking of nearly all companies when looking at the possibility of off-shore operations, three perceived disadvantages were identified:-

(a) The formation of a captive might cause problems with the conventional insurance market, both immediately and in the future; a factor mentioned by five respondents.

(b) Insurance was outside the organisation's normal

realms of operation; this was mentioned by three companies.

(c) The reinsurance market, upon which captives depend, is very volatile; a problem quoted by two respondents.

Nine companies produced the ten responses quoted above, which means that a number of respondents had said that factors other than political risk had been considered, but did not indicate what they were. This might suggest that the people concerned had either not given proper thought to the answering of the questionnaire, or were not clear in their own minds as to what was involved in the decision making processes. However, further questioning revealed that, in indicating that other disadvantages had been considered, many respondents were referring to the fact that some of the widely acclaimed advantages were found not to apply to their companies for various reasons. We therefore need only to be concerned with the three factors cited.

Effect on conventional market

This was an issue mentioned in the AIRMIC questionnaire, but which only received moderate

support then. The view of respondents who said they were influenced by this matter was that insurers who had previously insured the company would very much resent the loss of business that the formation of a captive would involve and that they might be able to demonstrate their displeasure either immediately or in the future.

As regards immediate action by insurers, it would be unusual for a company setting up a captive to be able to survive without the conventional market. Employers liability and motor third party risks might have to be insured outside the captive if it were off-shore, as it would be unable to obtain authorised insurer status, but even with a domestic captive there might be difficulties in obtaining authorisation, or it might be decided that liability risks generally are not suitable for a captive. In other cases the parent company might still need the conventional market for large fire risks and for insurances that it feels it would be imprudent to place with the captive immediately. The fear is that, having lost most of the business (and it may be seen as the best business) the market will not be inclined to be helpful towards what remains and could even

be vindictive towards it.

Fears for the future would relate to what would happen should the captive cease operation either because of poor experience or as a result of changes in laws here or overseas. A company placing business in the conventional market, having put it with a captive for some years, might find insurers less responsive on premiums and terms than they might hope; there could also be practical problems in producing evidence of claims experience while the business had been with a captive. In support of his fears, one respondent quoted the experience of his company some years ago when it moved its fire schedule from the company to the Lloyd's market; on having to return to the companies a few years later it encountered considerable ill-will from the underwriters approached.

It is not strictly necessary to comment on the credibility of the issue, for it has been shown that a few organisations, rightly or wrongly, have been influenced by it. However, it might be mentioned that insurers would deny any suggestion that they would act in the manner indicated, it is also difficult to believe that insurers

would turn down the opportunity of participating in good business, although there could be problems if a captive collapsed because of adverse claims experience.

Specialisation as a disadvantage

This is a factor that was sometimes said to influence the decision making processes at senior management level. The general argument was that an organisation was established for and was expert at engineering, trading in oil, manufacturing chemicals or whatever and should concern itself with those activities alone. Just as it did not engage in other peripheral activities so it should not "dabble" in insurance. One can readily understand such attitudes on a board of directors used to dealing with questions of manufacturing, distribution or retailing when the suggestion of a captive insurance company is made.

Such attitudes were not generally found amongst risk managers and obviously such objections were overcome in those organisations that had formed captives, but it does seem possible that this issue could be material in stopping some companies from proceeding with the formation of a captive insurance company.

Volatility of the reinsurance market

It has been said that the reinsurance market is very flexible compared with the direct market, it will be more open to suggestions on policy wordings and slightly less usual risks and its general attitude of trying to accommodate clients will be extremely helpful when treaties for captives are broked. One could even mention that many reinsurance companies have developed definite specialisms in handling the accounts of captives and have opened offices in appropriate tax havens partly to facilitate such operations.

However,with flexibility in good times comes the corollary of quick reaction when anything goes wrong and indeed the reinsurance market is sometimes accused of over-reacting when adverse features arise. The captive insurance company is usually completely dependant on the reinsurance market for its survival and if, as a result of a couple of years of poor experience, rates are substantially increased or cover becomes unavailable the operation would have to close down. It should be noted that to an international reinsurance company a single captive's account will be insignificant; compare that

situation with the influence the large insurance buyer will have with a direct insurer.

The aforementioned problems will be real enough where the reinsurers generally have a resonable attitude towards their customers and there is no doubt that major reinsurance companies act in a most proper manner. However, for various reasons, captives sometimes have to deal with organisations that can only be described as "down market" and which may not display the standards of ethics that most insurance buyers in this country have come to expect of their insurers. One respondent quoted his organisation's experiences of reinsurers going to extraordinary lengths to refute payment for a large loss and although it is not possible to comment on the merits of individual cases one can understand the reluctance of some firms to placing even small lines of reinsurance with little known foreign companies.

Many of these problems will be reduced if the captive is a member of one of the reinsurance pools run by certain organisations specialising in captive management.

Why companies do not form captive insurance companies

The final part of the questionnaire to companies that did not have captives asked respondents to provide information on the current situation in their companies with regard to this subject and in particular to choose from a number of possible reasons if a decision not to form a captive in the immediate future had been made. The intention was to ascertain what overall factors lead to a decision not to form a captive.

Respondents were asked to select more than one alternative if appropriate and the replies from the 14 companies answering the question are summarised below:-

(a) Generally the advantages were seen to outweigh the disadvantages; 3

(b) The claimed advantages were seen to exist but were not considered to be applicable to the company; 3

(c) Advantages to the company were seen to exist but were not thought to be

significant enough to warrant a change in the company's approach to risk management; 10

(d) The company was largely dissuaded by the prospect of having to operate in a tax haven. 2

In four cases where no reply was received respondents indicated that reviews or feasibility studies were in progress and in two of these instances the risk manager concerned reported that it seemed likely that a captive would be formed.

Possibily the most interesting feature is that so few respondents chose the item on tax havens, this is not to say that the others did not consider the risks or moral issues involved to be important only that they were not paramount. This finding conflicts with that in the AIRMIC survey, but would reinforce the impression gained from later investigations that the tax question is not the first one that companies have in mind.

It would seem that most of the companies did not form captives because they considered that the rewards from so doing would be unlikely to repay the effort involved. Some comments added to the forms suggested that either the mention of the possibility of a captive had led existing insurers to improve their terms, or the process of examining the subject had brought to light ways of reducing the insurance budget in more conventional ways. But on the whole it seems that companies found they were either too small, or did not have a wide enough spread of risk or simply were not convinced that the arguments for a captive, as applied to their particular company, would save (or make) very much money.

Conclusions on motivations towards the formation of captive insurance companies

The reasons why companies form captives are complex, befitting the complexities of risk management for the large organisations concerned. This part of the study has shown, not only what the main motivations are, but also that they extend beyond purely insurance and risk management considerations in many cases.

The results of the survey suggest that captives are normally formed with the main objective of reducing the parent company's expenditure on insurance. Monetary advantage is seen to stem from:-

(a) the retention of insurers profit and investment income;

(b) operating at a lower cost than conventional insurers;

(c) obtaining better terms (particularly with regard to deductibles) through access to the reinsurance market.

Some captives are often formed, in addition, with a view to improving risk management techniques in the parent organisations. Many companies are also motivated by what is seen as inflexibility in the insurance market.

Not all captives are formed in tax havens, but where they are the parent companies are attracted by the tax advantages, but do not consider these to be the main reason for the existence of the undertakings. Only a small minority of captives appear to be operated solely as tax avoidance devices.

Most companies consider the political risks of operating in a tax haven to be a disadvantage. Some also see disadvantages in the possibility of repercussions from the conventional insurance market, involvement in a specialist sphere traditionally left to experts and the volatility of the reinsurance market.

PART TWO

The Formation and Management of Captive Insurance Facilities

INTRODUCTION TO PART TWO

The second major objective of the study was to obtain information on the manner in which captive insurance operations are formed and managed by British companies with a view to:-

(a) studying and reporting on these areas of risk management generally, thus providing information on the behaviour of major companies and their reaction to risk;

(b) analysing the methods used in a way that might be of use to organisations operating or considering the formation of such facilities;

(c) providing critical comment on the methods used and opinions on the way in which they might be improved.

As with the first part of the study, the intention was to restrict attention to the activities of British-based companies, because some work has already been done from the point of view of North American enterprises and there appear to be insufficient numbers of captive undertakings elsewhere to warrant academic study.

The whole realm of captive insurance is covered, but in view of the limited use of self-insurance funding revealed by the research described in Part One, this part of the study must of necessity concentrate on captive insurance companies. However, self-insurance is included in the opening chapter on feasibility studies and having ascertained that such techniques are largely useful only in special circumstances, these form the main subject of the chapter dealing exclusively with self-insurance.

Collection of data

The basic sources of information were the answers to the later parts of the questionnaire (Questionnaire 3) sent to organisations with captive insurance companies. But in view of the nature of the investigation it was considered to be appropriate to obtain as much further detail on the subject as possible from those companies with captives and from other interested parties such as insurance brokers, captive managers, insurance and reinsurance companies.

Information from captive insurance company operators

Data was eventually obtained from 30 organisations operating between them 33 captives. Having calculated that the most likely number of companies with such subsidiaries was about 45, it was considered that the sample would represent very adequately the general situation. A considerable amount of information was obtained from the 17 questionnaires, but it was decided to attempt to obtain interviews with as many of the risk managers of respondant companies as possible, in order to discuss more fully the decisions to form the subsidiaries and their methods of operation, as well as to clarify (where appropriate) replies given to the questions. It was also necessary to obtain information by interview from companies with old established domestic captives that had not been sent questionnaire forms.

15 of the 17 risk managers returning the questionnaire agreed to be interviewed, as did three with old established domestic undertakings. The 18 organisations interviewed own 21 of the 33 captive insurance companies in the sample and as the table below indicates the distribution amongst the various

types of facility follows roughly the proportions in which they exist in the sample and the information obtained can therefore be considered as representative:-

Captive operators interviewed		No. of type in Sample
Domestic:	6	11
including formed in last ten years:	2	4
Off-shore:	15	22
domiciled as follows:-		
Bermuda:	7	10
Guernsey:	6	8
including domiciled in Guernsey but operated from		
Bermuda:	3	3
Gibraltar:	1	1
Bahamas:	1	1
Other/ Not known:	0	2

In six other cases contact was made and further information was obtained by telephone or extended correspondence, leaving six companies where personal contact was lacking, but as three of those companies had domestic captives and details could be obtained

by reference to the files at Companies House, there were just three cases where only scanty information was received. However, it must be appreciated that information about captive insurance operations is considered confidential by the companies concerned and those respondents that felt unable to answer all the questions differed as to the data which was withheld. Thus, in no case does the data presented cover all 30 organisations and the number of respondents in each instance varies.

Information from other sources

In order to gather as much information as possible on various practices, experiences and opinions, a large number of contacts were made. Wherever possible, at least one leading expert in each major area of the subject was interviewed, with information of a more general nature being obtained from all the types of organisation known to be involved, in particular:-

(a) four organisations involved in the management of captive insurance companies were interviewed;

(b) much of the information on reinsurance was received from an interview with a senior manager of a reinsurance company that has a major

involvement with captives and contacts with two direct offices that are also widely involved;

(c) three firms of brokers with experience in the whole field of captive insurance were seen and information and comment obtained from five other broking firms with some interest in the subject;

(d) details of relevant laws and regulations were obtained by direct contact with the Department of Trade, the Bank of England, the Department of Inland Revenue and the European Commission;

(e) four conferences on various aspects of the subject were attended;

(f) during the course of the research there was involvement in a feasibility exercise for a client of one of the broker contacts.

These contacts, although predominantly concerned with captive insurance companies, also often provided information with regard to self-insurance.

CHAPTER 5

EVALUATING THE COSTS AND BENEFITS OF CAPTIVE INSURANCE

The formation of a captive insurance facility is clearly a major step for any organisation, involving significant changes in policy and in attitude to risk. It is therefore to be expected that a company would not enter into such arrangements without a thorough examination of the subject and of the extent to which the claimed advantages and apparent disadvantages were applicable to the particular organisation. That was found to be the case, for all the respondents interviewed, who had formed captive insurance companies after 1966, indicated that some form of investigation (or feasibility study) had been undertaken in considerable depth - it was considered necessary to restrict investigations in this area to facilities formed within ten years of the year in which the interviews were held as respondents could not be expected to remember what had happened very many years ago and might not have been personally involved at the time, but it should be noted that this only excluded domestic captives, most of which had been formed between 1920 and 1945. Information from

companies who had investigated the subject but had not formed captives is also included where appropriate. With regard to self-insurance facilities, however, feasibility studies do not appear to have been carried out in other than a superficial way in any of the cases investigated and apart from considering the extent to which self-insurance is considered as an alternative to captive insurance companies, the former cannot be discussed here.

Such was the diversity of approach by respondents that it is not possible to compile detailed data for analysis in respect of most of the aspects of this topic; the research did however reveal certain patterns of practice amongst respondent companies and it is possible to discuss these in a general way. It is also possible to consider the various approaches adopted by organisations involved in advising companies on the formation of captive facilities.

Factors affecting feasibility

There was general agreement amongst captive operators, consultants and commentators that two factors were paramount to the feasibility of a captive insurance company:-

(a) the insurance to be placed with the captive must be profitable;

(b) the captive must be able to retain a sizeable amount of premium net of reinsurance.

The need for profitability

If the insurance that is being considered for placing with a captive is not producing a profit for the current conventional insurers, there would seem to be little chance of a subsidiary of the parent company doing any better. However, an insurer will have to pay for its expenses of operation before a profit is made and as a captive would hope to have lower operating costs than a conventional insurer, it could in theory be beneficial to form a captive where the present insurers are making a small loss because of the savings in costs. Nonetheless, there are good reasons for believing that it would be dangerous to form a captive in such circumstances:-

(a) The cost saving items are not as substantial as the profit factor and as has been shown earlier, some items (such as the saving of brokers commission) are largely illusory in most cases.

(b) An organisation whose insurers are making a loss on its account cannot be considered to be in a good risk management position and almost certainly need to examine their loss prevention procedures before forming a captive.

(c) It would probably prove difficult to obtain reinsurance for a captive where the previous insurers had made a loss.

One consultant[1] takes the view that such considerations rarely arise, because the claims records of most major companies tend towards one or other of two extremes. There are those in the "30 minus club" who regularly receive back less than 30% of their premiums in claims and those who are members of the "100 plus club" who often receive more in claims than they pay in premiums. In the latter cases insurers are making heavy losses after allowance is made for expenses and there would usually be no possibility of captives being beneficial, whereas companies in the "30 plus" category would gain considerable advantage from having subsidiary

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1 Bannister, J., quoted in "Captive Insurance Companies", Keith Shipton Developments Limited, London (1976)p.7.

insurance companies. There is a difficulty with this approach, however, in that it seems to look merely at the short term and ignores the fact that a company with an excellent loss record in the past could suffer a single large loss that would eliminate many years profits; indeed Bannister has said that "previous loss experience is at best a crude guide to future losses".[2]

Despite these considerations, a good profit by insurers in the last few years would normally be an indication of an organisation's suitability for a captive, but there was one case amongst the sample of companies with captives where the philosophy was ignored to good effect:-

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2 "The Captive Insurance Company", The Accountant, 5.10.72, p. 421.

A major chemical company had a number of years poor experience with consequential loss risks, largely from fires caused by tehnical problems in their plants. The company was convinced that the problems had been solved and that thereafter loss experience would be satisfactory, but insurers were insisting on very substantial increases in premium; the risks were placed with a captive that was also being considered for other reasons and the business proved to be profitable.

This was an exceptional case, however, the view taken generally was that risks should prove themselves in the conventional market for a few years before being placed with a captive.

The need for net premium volume

The question of whether a company could produce enough premium, net of reinsurance, for its captive was found to be a combination of a number of factors.

The amount of money a company is currently spending on insurance is important, for clearly there will be a level below which a captive would be impractical under any circumstances, however the more crucial issues are the amount of such business that can be placed with a facility (some of the risks at present conventionally insured might be unsuitable for captive insurance) and the proportion of gross premiums that can be retained net of reinsurance, for if it will be necessary for an undertaking to pass large proportions of its premium to reinsurers, the amount remaining will be so small as to possibly render the exercise pointless. The question of which risks can be placed with a captive is best left to the later chapter on underwriting. The amount of premium that will be retained is largely concerned with spread of risk; the captive of a company with a large number of small independant risks (say a chain of retail shops) will be able to keep a large proportion of the gross income, but a manufacturing company with one main site may not be feasible for a captive as a subsidary would only be able to retain a small percentage of the large single risk. Captives do receive commission on reinsurance premiums and that income could be an important factor in feasibility, but the view of the specialists was that a good spread of risk is necessary in nearly all cases.

Bannister, J.,[3] takes the view that a net premium of £500,000 is necessary for a successful captive insurance company. The net premiums of captives shown in Table 5.1 would seem to suggest that his figure is too high, with nearly one-third of the undertakings heaving an income below £400,000, although two of these were recently formed and their premiums can be expected to grow. There was no evidence to suggest that the smaller undertakings were unsuccessful in any way.

Table 5.1 also attempts to draw a comparison between net premiums and the total amounts spent by the parent companies on insurance, the most typical percentages of total insurance expenditure retained being around 40% to 50% with the facilities that had low percentages being mostly either newly formed or those used for special purposes. Assuming, from the table, that a net income of £100,000 is the absolute minimum, that would mean that a company must have an insurance budget of at least £200,000 before there is any likelihood of a captive being feasible, but in fact none of the companies in the sample supplying that information spent less than £500,000 per annum on insurance.

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[3] In "Captive Insurance Companies", op cit, p.29

Table 5.1

Showing the premium income, net of reinsurance, of 23 captive insurance companies in the last available financial years and (where available) the precentage that net income bears to the total expenditure on insurance of the parent company in the same financial year.

Net Premiums £000s	% of Parent's Expenditure
19,300	Not known
6,500	See Note (1)
5,250	35%
2,000	25%
2,000	See Note (1)
1,500	50%
1,500	50%
1,250	50%
1,100	50%
1,000	35%
900	80%
760	36%
750	15%
700	Not known
500	Not known
450	43%
310	58%
300	30%
250	40%
200	8%
170	4%
140	5%
100	9%

Note (1)

These companies have two captive insurance companies each and comparison is not, therefore, possible.

Variations by type of industry

The type of industry in which a potential captive owner is engaged is likely to affect the amount of premium generated and the spread of risk, for certain industrial processes are more hazardous than others and will attract higher premiums, while some industries are more likely to have a very high sum at risk at single locations and thus a restricted spread of risk. These two factors are connected for the hazardous industry (say plastics) is likely to be one with a high degree of technology demanding major items of plant; other industries (such as chemicals) may have very large concentrations of property which are generally considered to be good risks, but which are subject to catastrophe loss. Conversely, the company in a less hazardous industry (say electrical engineering) is more likely to operate on a number of sites in small units.

Thus, in terms of feasibility for captive insurance, the hazardous industry is likely to produce the necessary large premiums but large sums at risk at single locations could make retentions low. The low

risk industry might seem more suitable because of the low incidence and severity of claims (and perhaps wider spread of risk), but as the business will be attractive to insurers, rates charged could be very competitive and leave little room for improvement by a captive. The consideration of the significance of industrial groupings in Chapter 2 suggests that low risk industries may indeed find it difficult to show savings through captive insurance, with the predominance of use amongst chemical and oil companies (although also a factor of pure size) showing that catastrophe hazard is not an obstacle to captive operations for the major company.

Procedures for feasibility studies

The complexity of the factors mentioned above lead to the conclusion that such matters cannot easily be considered in abstract but must be related to the situation of each particular company considering a captive.

There are two options when it comes to deciding how the study is to be conducted:-

(a) The risk manager of the organisation could be asked to carry out an investigation, drawing on the persons own knowledge and experience and

that of professional colleagues (e.g. lawyers and accountants); existing outside advisers (e.g. taxation specialists) might also be called upon.

(b) A consultant could be instructed to make the necessary enquiries, that is either a specialist consultancy (a firm involved only in captive management) or a firm of insurance brokers with experience in the area.

The use of consultants

It would seem that very few companies feel able to conduct feasibility studies without outside assistance. Of the 38 respondents providing such information (including 21 which had considered the matter but had not formed captives), all but five had approached consultants at some stage; two of the five were largely interested in forming domestic captives, a third was a very large international organisation and the remaining two only engaged in brief enquiries before deciding that a captive was not feasible. The following reasons for taking outside advice were apparent:-

(a) Lack of expertise within the company. In some cases risk managers personally accepted that they did not have the knowledge or expertise to carry out a study and to interpret the results, in other instances senior management insisted that outside advice be sought either because they were not satisfied that their risk manager had sufficient experience or to obtain a second opinion.

(b) Lack of time. A busy risk manager is unlikely to be able to find the time to do justice to an investigation, unless extra staff are allocated to the department, in which case an "in-house" investigation could be more costly than a feasibility study by an outside firm.

(c) An approach from a specialist consultant or broker. Where the idea of a captive insurance company is first put to an organisation by outside interests they are likely to be engaged to conduct any feasibility study that results.

However, in many of the cases where outside advice was obtained, that was only a part of the process, because risk managers themselves often made additional enquiries and contributed their knowledge and views before a decision was made.

No respondent company reported being influenced by the cost of obtaining outside help, the general view being that the importance of the subject fully justified the expenditure. A specialist consultant or broker could be expected to ask for a fee of about £500 for an initial investigation (an outline feasibility study) to decide whether a full study was justified; thereafter charges would depend on the precise nature of the work which the consultant is asked to carry out, but fees of around £4,000 were typical, rising to as high as £25,000 where the consultant was asked to incorporate a full risk management appraisal into the investigation. Where a company's existing insurance broker is consulted there is unlikely to be a charge for the initial investigations and in virtually all cases a firm will waive the fee for the feasibility study if it is appointed to manage the facility.

Respondents seemed aware of the dangers of a specialist consultant having a vested interest in the outcome of a study; it can be readily appreciated that a firm operating from Bermuda would almost certainly recommend that a captive be formed there if such an undertaking was at all feasible, whereas one established in Guernsey would naturally prefer that island. Most risk managers with whom the matter was discussed seemed satisfied that none of the well known consultants would recommend that a captive insurance company be formed if it was impractical to do so, but they were able to imagine the situation where in a marginal case a consultant might be influenced by the possibilities of substantial reward should their clients decide to proceed. A basic distrust of specialist consultants, for reasons of vested interest but also because they would be unlikely to be known to the organisation considering a captive, would probably explain why most respondents preferred to deal with an insurance broker and usually the firm that was already handling the company's insurance. The preference may on occasions be wrongly directed however, for the research revealed instances where insurance brokers appeared to give unwarranted negative advice on captives, often in circumstances where they lacked the expertise

to give proper advice to their clients and could be considered to have a vested interest in the insurance staying in the conventional market.

Main considerations of a feasibility study

The results of the research dealt with this far suggest that there are four alternatives for a company to consider:-

(a) A self-insurance fund, with the possibility of a funding policy and excess of loss re-insurance;

(b) A captive insurance company established in the United Kingdom;

(c) A captive insurance company in a Scheduled Territories tax haven;

(d) A captive insurance company in one of the tax havens outside the Scheduled Territories.

It was apparent that a specialist engaged solely in the management of off-shore captives would be unlikely to be able to provide genuine advice on

self-insurance, nor on the possibilities of forming an insurance subsidiary in the United Kingdom. With both specialist consultants and insurance brokers, the fact that most only have offices in one or two territories means that the majority of firms are unable to give adequate consideration to all likely places of domicile. In practice, feasibility studies were usually found to be little more than an investigation of one or a few possibilities rather than an examination of all the options open to a company.

Respondants did not, however, seem over concerned that certain possibilities were not considered fully in their feasibility studies. In particular most were aware of the alternatives of self-insurance and a domestic captive, but had automatically assumed that they were not appropriate to them.

Boundary conditions arising from corporate attitudes

Where a certain procedure would conflict with the principles laid down by senior management for the running of the business, that option will be rejected without question. It would seem to be wise for a consultant or risk manager to establish these "boundary conditions" before commencing the study,

but in practice they are normally encountered as the investigation proceeds; as an organisation rarely lays down such principles in detail it will be difficult to identify them at the outset, but as it was clear that so many proposals are rejected on those grounds it is surprising that so little attention seems to be paid to them. With regard to captive insurance companies, two factors seemed to dominate; companies attitudes to risk and the extent to which they are prepared to operate in tax havens.

(a) Risk aversion. This relates to the reaction of organisations to areas of risk and uncertainty. Captive insurance, even when organised on the soundest of grounds will involve certain risks that do not exist where insurance is placed in the conventional market, thus an organisation that usually prefers the less risky of two alternatives is more likely to be influenced by the disadvantages of captive insurance discussed earlier than the advantages. It was found that some companies were most unwilling to take any chances with their insurance procedures, which they felt should be completely safe.

(b) Attitudes to tax issues. This is a feature that will also be affected by the risk aversion tendancies of an organisation, for operation in a tax haven does have risks that do not arise with domestic captives or conventional insurance. In addition some organisations would consider tax avoidance to be inconsistent with their business ethics, although it must be said that this was not found to be a widely held view.

The investigation

The general view was that the main purpose of a study was to cost the various alternatives strategies and to place the most likely ones before management for a final decision, the main issues being to decide what risks a facility could handle, the amount of premium that could be channelled into it and the amount of that which could be safely retained net of reinsurance.[4]

In choosing risks for a potential captive, investigators usually had regard to the types of risk currently insured, but did not normally limit themselves solely to those. A study sometimes revealed the need for insurance that was not previously apparent or dealt

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[4] See Brockmeirer, W.G., "What to look for in captive company and self-insurance feasibility studies", Risk Management, May 1974, p.22

with risks that could not be insured conventionally; more commonly recommendations were made that a captive facility should insure risks previously thought more appropriate for non-insurance.

For the purposes of estimating rates and retentions, the following information was usually called for:-

(a) for material damage and pecuniary loss risks:-

(i) the sums at risk at each location;
(ii) the type of property at each;
(iii) insurable losses, typically over the last five years.

(b) for liability risks, details of the nature of the risks, the organisation's accident record typically over the last seven years and information for rating purposes, such as turnover, wages and number of premises;

(c) for all types of insurance, details of existing premiums and policy covers.

Where reinsurance was necessary, it was generally considered that the premiums charged by a captive

would have to approximate to market rates, in order that reinsurers could be persuaded that they would receive adequate remuneration. However, investigators sometimes concluded that it was more sensible to start with estimates of claims costs and to add loadings for expenses, taking the view that reinsurers would be satisfied if it could be shown that the matter had been approached in a scientific way.

The question of how much of a risk a captive should retain before reinsurance is largely a technical matter, with past experience showing what losses are to be expected in the future and statistical tests indicating the probability of such loss levels being exceeded and thus the risks run by accepting various types of reinsurance protection. It was found that normal practice did not import a particularly high degree of precision into such matters, most companies being content to choose a retention that seemed appropriate in the circumstances; it was however apparent that most organisations went to some lengths, usually through their brokers, to ascertain the cost of various types of reinsurance scheme, often before the amount of the captive's retention had finally been decided upon.

Decisions regarding precautions against loss and risk management engineering in general also have to be covered by a feasibility study. Some studies proceeded on the assumption that precautions were in order and that little change was to take place, others included an investigation of the situation with a view to making recommendations on what improvements would be needed if a captive facility were formed. The former course was found to be the most common, companies probably taking the view that the inclusion of physical risk management factors might detract those involved from other issues. Although the different skills involved would possibly require two sets of investigators, there is no reason in theory why the two features should not be investigated at the same time; however the fact that consultants have stressed that only companies with good loss records are suitable for captives would naturally lead organisations to the conclusion that all matters of physical precautions against loss should be settled before the financial aspects of risk management are dealt with. A study will nonetheless be concerned with the procedures to be taken for the maintenance of a good level of physical risk management, after formation of the captive,

including the handling of new and adapted risks, for these are important features in the costing of a facility.

The feasibility study report

A typical report will cover the following areas with regard to each alternative presented:-

(a) The amount of capital required, with information on any special arrangements for moving the funds to an overseas territory;

(b) The insurances to be placed with the undertaking, with an indication of any special terms that are recommended;

(c) Projections of premiums, claims, expenses and profits;

(d) Details of reinsurance arrangements and their cost;

(e) Details of the proposed management of the facility e.g. whether the company should manage it itself, engage a specialist firm or insurance broker, or make arrangements with accountants or lawyers;

(f) Proposals for investment and dispersal of funds.

Outline contingency plans for moving to other territories might be provided where an undertaking would be relying on a tax haven, but these are not usually included.

The emphasis will almost always be on comparing the proposed procedures with present insurance arrangements, in an attempt to show that a captive insurance programme will produce savings in cost, for this will invariably be the dominant factor. Proposals concerned with such matters as the insuring of risks at present uninsurable and the improvement of cover and policy wordings will usually be considered secondary, unless the company has a serious problem in such an area; the provision of insurance arrangements more closely suited to the needs of the organisation may be included in the recommendations and are often looked upon as important selling points, but reductions in cost in addition will nearly always be looked for.

It was common to find reports with various alternative proposals, although in most cases these did not go

beyond an examination of the various sites for the domicile of off-shore captive insurance companies and the alternative methods by which a facility could be organised. Where a company's existing broker had been involved careful consideration was often given to stressing the alternative of continuing with conventional insurers, possibly with proposals for improving existing arrangements; other firms were more likely to ignore such matters.

The conclusion from the examination of feasibility procedures is that the studies are often far from well done. The typical approach can be criticised on the grounds that it pays insufficient attention to considering all the possibilities open to a company and is particularly lacking in its consideration of domestic captives and self-insurance funds. There is probably a need to recognise that a specialist consultant is not equipped to provide advice beyond the firm's particular sphere of operation and with insurance brokers there is the possibility that they will lack the expertise for any form of study; whatever type of consultancy is used further investigation may be necessary to determine whether other strategies to those dealt

with are appropriate. It is also to be noted that there is likely to be a lack of precision brought to the various calculations necessary for establishing future loss levels and thus the profitability of any facility that is formed.

CHAPTER 6

THE SELF-INSURANCE ALTERNATIVE

The survey of the 250 largest companies shows clearly that self-insurance funding is not widely used in this country and it does seem that such strategies are rarely even considered by organisations looking for alternatives to conventional insurance. On a number of occasions respondants being interviewed stated that self-insurance had been considered but had been quickly dismissed as being completely unfeasible, although the impression often gained was that little attempt had been made to check whether adaptions of the traditional self-insurance approach would be practical. On the few occasions where self-insurance was used as an extensive risk management tool the organisation seemed very satisfied with the system that had been devised and there was nothing to suggest that the companies had unsual features which made them particularly suited to a self-insurance approach. It is therefore possible to suggest that companies considering captive insurance companies may not be giving adequate consideration to self-insurance as an alternative.

The advantages of self-insurance over captive insurance companies

It would be wrong to always think of self-insurance and a captive insurance company as alternatives in solving the same problem, for in many cases captives are used in situations where self-insurance would not be suitable and in current practice self-insurance funding is generally limited to special cases which might not always be suitable for the formation of a captive. However, by way of an introduction to the whole subject certain advantages compared with captive insurance companies can be put. In most cases self-insurance will be:-

(a) Administratively simpler; there need be no corporate form for a self-insurance scheme as the whole system can be administered through an insurance department. There will be none of the problems involved with managing a captive off-shore, or in comparison to a domestic captive no insurance regulations to comply with as the Department of Trade does not consider self-insurance to be insurance for the purposes of the Insurance Companies Act.

(b) Less expensive to operate; most of the savings accruing from a scheme will arise from it being operated at far lower cost than a conventional insurance company, as has been seen captives gain substantial benefit in the same way, but with a self-insurance fund the advantage is even greater. Compared with an off-shore captive there will be none of the expense involved in engaging an agent to manage the facility or the many other costs arising from off-shore operations and compared with a home-based insurer the cost of complying with government regulations will not arise. The experience of firms with self-insurance schemes shows that they can achieve very considerable savings over both conventional insurance and any form of captive insurance company.

(c) More flexible; this is a major advantage, self-insurance funds can be increased, varied, diminshed or wound up with the minimum of formality and thus can very closely follow the needs of the organisation.

(d) Feasible at lower levels of premium; to be practical and worthwhile a self-insurance scheme must be of a good size, but can be operated at a far more modest level than can a captive insurance company. The latter has substantial costs to cover (which do not arise with self-insurance) and is therefore only feasible for major insurance schemes, whereas self-insurance could operate quite successfully at levels of income in tens, rather than hundreds, of thousands of pounds.

Disadvantages of self-insurance compared with captive insurance companies

There are, however, serious obstacles to the use of self-insurance methods for major items of risk, which largely concern questions of taxation and protection against catastrophe.[1] Taking first the question of taxation, consider the position of a company which decided that it wanted to fund losses that on average total £100,000 per annum and where it was considered that for safety reasons an initial fund of £50,000 was needed. The position at the end of the first year might be:-

[1] See McNally, P., "Self-Funding Techniques and Captives", Reinsurance, June 1979

	£
Initial transfer	50,000
"Premiums"	100,000
Interest	15,000
	165,000
LESS losses	95,000
	70,000

However, in making the initial transfer this will in reality cost the company £104,000 at the current rate of corporation tax of 52%, as such internal movements of funds are not allowed as insurance premiums for tax purposes and the money would have to be found from post-tax profits. As for the premiums, they will not be allowed as a business expense either, but losses will be deductible and the end result will be a liability for tax on the "underwriting surplus" of £5,000 plus the investment income.

There will also be a problem with losses that occur very near to the end of an accounting period, as the tax authorities will not allow an estimate of the cost of settlement as a pre-tax expense, that is outstanding claims will not be permitted before tax. Although the loss could be charged to the next year

this would still result in tax being paid on an enhanced surplus in the current year.

The availability of funding policies

If a company wished to provide, by means of self-insurance, for anything approaching substantial risk the initial transfer to set up the fund would have to be large and if it were intended to build up the fund to enable it to cater for even larger risks, or to become less dependant on reinsurance in the future, significant surpluses would have to be budgeted for and as a consequence the tax liability would be very heavy. Self-insurance funding for major risks is, therefore, only feasible if a funding policy can be arranged with an insurance company.

A funding policy is in essence a self-insurance fund held, for the insured organisation, by an insurance company. The procedure is that the two companies enter into an agreement whereby:-

(i) A policy is issued in respect of certain risks, in the normal way, but the liability of the insurer is limited to the amount in the fund i.e. premiums paid, plus interest, less claims paid.

(ii) Contributions to the fund, being paid to and insurance company, will have the nature of premiums and be allowed as a business expense.

(iii) When losses arise payment from the fund will be claimed and such payments will attract no tax liability as they will be adjudged to be normal insurance claim payments; outstanding claims reserves will be carried in the insurance company's accounts and will not attract tax.

It must not be assumed, however, that the tax authorities will allow a large payment, in addition to normal premiums, to provide for the setting up of the fund in the first year. Only reasonable levels of premium are allowed to be set against tax[2] and the company would have to build up the fund over a few years (relying on underwriting profit, interest and savings in administrative costs) and gradually incorporate major risks into the schemes as reserves grow. Any surplus, after claims and reserves and investment income on the fund, will produce a profit in the insurer's accounts and will be taxed.

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[2] Premiums slightly higher than market rates would go unnoticed, but would be illegal.

With regard to the practicalities of operating such a scheme, an insurer would probably be prepared to offer surveying, claims settling and other facilities as required and it would be for the insured organisation to decide the extent to which it preferred to carry out such functions itself. The services of the insurance company's investment department would be an integral part of the arrangement. The insurance company will charge a fee for its services, depending on the facilities required.

If arrangements of this nature are made a self-insurance fund becomes virtually the equivalent of a captive insurance company and there are good grounds for believing that many organisations would prefer such a system, which has most of the advantages of a captive, but none of the risks and costs of operating off-shore or the difficulties of obtaining authorisation for and complying with the regulations relating to a domestic insurance subsidiary. There would, of course, be none of the tax advantages that stem from operating off-shore, reflected in the tax that must be paid on the surpluses, but given the extra expense and the possible risk aversion of companies to such

enterprises, self-insurance might be preferred. Such arrangements might also be feasible at a level of premium below that which is needed for a captive.

However, insurers are most reluctant to enter into funding policy arrangements. The eight largest composite British insurance companies control over 85% of the country's fire and accident insurance and given the size of the risks involved in organisations that might seek funding policies, it would prove difficult to arrange a programme without the co-operation of one of those insurers. The fire managers of the eight companies were asked to provide information on the extent to which their organisations were involved in the management of such facilities and all but one of them replied; all of the seven respondents stated that they were not involved in such matters and generally indicated their unwillingness to consider approaches from clients. Only one respondent revealed any real knowledge of the subject while another stated that his company had never heard of funding policies; a third, the Fire Manager of a very large tariff office, wrote that his company has no interest in the subject because "our primary concern is to undertake the full insurance requirements of our clients"!

It is obviously difficult to gauge whether organisations are actually being dissuaded from seeking alternative strategies to captives because of the lack of cooperation from insurers, or whether the scarcity of such arrangements reflects a lack of interest amongst insurance buyers, who prefer the advantages of off-shore operations. Only one of the respondents in the survey of the 250 largest companies had a funding policy and further investigations (amongst brokers and consultants) revealed that such facilities could usually only be negotiated in this country by organisations that had links with an insurance company, for instance at board level and especially as a major shareholder. A few firms of insurance brokers were found to have off-shore insurance company subsidiaries that were sometimes made available to major clients for these purposes.

Self-insurance for special purposes

Given that funding policies are virtually unobtainable, the extent to which self-insurance can be used depends on the extent to which organisations are prepared to incur the tax liabilities, or on whether there are circumstances where such matters can be circumvented. It has been shown that there are three problems:-

(a) initial transfers have to be made from post-tax profits;

(b) surpluses at the end of the year will be taxed;

(c) outstanding losses cannot be provided for in the current year.

It is perhaps surprising to note that a number of companies do have modest self-insurance schemes that would seem to be subject to these disadvantages. In some cases funds were described as "book provisions" which indicated that the risk manager may not have fully appreciated the fact that it does not matter how the money is reserved, surpluses that arise will produce a liability for tax in one form or another; it also seemed likely that some self-insurance schemes were not being charged the tax that the system brought upon the company and this cannot be a satisfactory state of affairs. In general, however, self-insurance can only be used in circumstances where the above mentioned disadvantages do not apply or at least are substantially reduced. For instance, one respondent, the risk manager of a company with transport interests, described their self-insurance arrangements as follows:-

The company has a number of operating divisions, which are faced with a large number of goods in transit losses every year, each of which is limited in amount by its very nature and total losses are fairly predictable from year to year; as a consequence insurance premiums would always exceed claims by a considerable margin. A self-insurance scheme has been established for goods in transit losses, whereby the parent company is paid premium by the subsidiaries at the beginning of each year and pays for losses when they arise; at the end of each year any surplus is repaid to the subsidiaries and there is no fund carried forward. This system results in losses being financed at very low cost, administrative expenses being well below what an insurer would require by way of profit and to cover operating costs.

There are no difficulties with taxation because no money was transferred initially to establish a fund and nothing is left

at the end of each year; any surplus repaid would add to subsidiary company profits for tax purposes but proper forecasting (aided by the nature of the risk concerned) keeps them to a minimum. The types of loss involved can be dealt with very quickly and outstanding claims are not a problem.

The company has also been able to negotiate a satisfactory excess of loss reinsurance for the fund. In this case the company was reasonably happy with the insurance arrangements for its other risks, did not want a captive insurance company because of uncertainties surrounding off-shore operations and may not in fact have been large enough.

The application of self-insurance amongst respondents, reported in Chapter 2, shows that the above approach can also be used for motor accidental damage risks, special perils and in other circumstances where individual losses are modest and exposures are of sufficient quantity to provide steady loss experience

from year to year. It is however reasonable to ask why, in such cases, any form of financial provision for the losses should be needed, for if the real risk (that is the chances of a variation from expected experience) is so small the losses could easily be met out of current revenue and administration costs would be saved totally. There are two possible reasons for a company preferring some form of funding to a "non-insurance" approach, both of which applied to the above company.

First, where all semblance of insurance is lost the company could lose control of the situation; self-insurance through the parent company will provide some incentive amongst subsidiaries or divisions to keep losses down and to obtain replacement or repair at reasonable terms. Even if there was no funding the parent organisation might still want some reporting of losses as a check on what was happening and having a funding system would cost little more. Secondly, although from an organisation-wide viewpoint certain losses may seem too small to be worth insuring, if subsidiaries are expected to act as virtually autonomous units, which is often the case with decentralised or diversified enterprises, the same

losses may not appear so small to the subsidiary companies which will therefore feel the need for insurance. In such cases the parent company will provide a useful service by setting up a self-insurance scheme for the group, also saving money in the process.

Financing of deductibles

Self-insurance funding might be useful, not only for small total losses, but also where an insured accepts responsibility under an insurance contract for the first part of every loss of a certain type in return for a discount on the premium.

There are two ways of looking at deductibles[3]. There is the attitude that small losses (say up to a few hundred pounds) should not be insured by a large company because it is quite able to bear them without insurance, the insurer will as a result be released from the burden of handling numerous small claims (in many cases the expense of settling being nearly as high as the payments themselves) and will be able to offer a discount that should more than cover the losses themselves

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[3] The term "deductible" is taken here in a wide sense to mean a large retention on property insurance (in which it is most frequently used) and smaller retentions commonly called "excesses" in such areas as motor and "All Risks" insurance.

and the expense to the insured in dealing with them. This was the approach followed by the six respondents who financed deductibles through self-insurance funds.

The alternative approach is to say that only catastrophes need to be insured by major organisations and that very large deductibles (that is amounting to many thousands of pounds) should be carried. Large organisations could safely carry such large amounts of their own risk without the need for internal funding (but which might again be used for control purposes or to aid subsidiaries), but in certain cases it ought in theory to be cheaper to carry deductibles at an even higher level and for an organisation to protect itself by self-insurance with reinsurance backing. Advanced forms of risk management demand that risk financing be seen as the joint role of both insurer and insured, with the most beneficial systems being seen as those which adequately provide for risks at the least cost; however it appears that the attitude of insurers makes it difficult for a company to arrange a programme with more than a modest deductible. A number of respondents interviewed claimed that

insurers (particularly in fire insurance) had refused to give them proper consideration when fixing the levels of discount and on occasions had refused to even consider deductibles at high levels.

Insurers seem to take the view that rates for deductibles are difficult to calculate from available statistics[4] but it also appears that problems arise mainly from the Fire Offices Committee, which has very considerable influence in the fire market not only because all but two of the major offices are members but also from the 65/35 rule[5] and the fact that most non-tariff insurers follow the Committee's philosophies. Indications are that an FOC rating might be realistic at medium levels of deductible (say up to £10,000), for anything larger the insurance buyer might get slightly more help from non-tariff insurers and Lloyd's underwriters, but large risks cannot be placed without tariff participation because the other companies do not have sufficient capacity. In other classes of insurance the position appeared to be somewhat easier, with insurance buyers being far more satisfied with the discounts that could be negotiated.

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[4]See for instance, Raley D., "Financial aspects of risk management - an insurer's view", Post Magazine & Insurance Monitor, 24.6.76, p.1466

[5]No tariff office is permitted to participate in a collective policy unless at least 65% of the insurance is placed with tariff companies.

Reinsurance of self-insurance funds

Reinsurance would be necessary where:-

(a) there was the probability of total losses over a period exceeding what was expected;

(b) large single risks have to dealt with.

The fact that all but three of the respondents with self-insurance funds had only modest arrangements explains why most ~~the~~ facilities in the sample were run without reinsurance protection. Two of the three had excess of loss cover and a third a stop loss arrangement; the only other case was a company with a fund providing for motor accidental damage risks, which occasionally arranged reinsurance on a surplus basis for the most valuable vehicles dealt with.

However, the existence of four funds with reinsurance cover does demonstrate that the need for such protection does not have to prevent a company from devising a self-insurance scheme; there is thus scope for organisations to produce programmes of at least the sophistication of the major schemes discussed here and which could in certain circumstances rival the benefits of captive insurance companies.

Reinsurance has to be placed with direct insurers as specialist reinsurance companies only deal with insurance companies; it was apparent that the four respondents were tending to rely on existing connections with insurers in order to get the facilities they required, in one case the reinsurer was a major tariff office with which the company placed a substantial amount of other business. This shows that although the cover needed can be obtained, insurers are rather reluctant to cooperate.

Discussions with the Inland Revenue revealed that the Department would be prepared to consider money expended on reinsuring a self-insurance fund in the same way as a direct premium for tax purposes.

CHAPTER 7

DOMICILIARY CONSIDERATIONS

A basic choice to be made by a company intending to form a captive insurance company is whether or not to place the undertaking in a tax haven and for the moment tax havens as a whole will be considered although there are substantial differences between the various territories available.

Domestic captives

Only four of the 26 captive insurance companies in the sample formed after 1966 were established in the U.K. whereas all seven formed before that year were domestic captives. The companies forming the facilities in the earlier era did not generally have the attractions of tax havens before them, but they also formed their subsidiaries in times when insurance regulations were not nearly as complex or far reaching as they are today.

The problem that made itself immediately apparent to those respondent companies that had formed domestic captives related to obtaining authorisation from the Department of Trade for the formation of an insurance

company, as required under Section 3 of the Insurance Companies Act 1974 (or earlier legislation) and subsequently complying with the regulations for the supervision and control of insurers. The provisions for insurance companies are intended to protect the public from possible fraud and malpractice of insurers and the current position has its roots in the collapse of a number of companies in recent years, but although these matters have little relevance to a captive only insuring its parent company's risks the regulations do not permit any differentiation between captives and those insurers that offer their services to the public, excepting that the Department is prepared to allow limited accounting exemptions for small captives.[1] In the past captives have sometimes been permitted to operate with less than the minimum capital and solvency margin but new captives must now meet the full requirements.

The application procedure is not a simple one but seemed well within the capabilities of the average insurance manager of a major organisation aided by a good company lawyer. Those interviewed who had dealt with applications made in recent years took the view that the procedure is not over-burdensome, although the first application is likely to be followed by

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[1] Those with a premium income below £1m, net of reinsurance.

requests for still further information; their experience was that discussions with the Insurance Division proceed with reasonable speed and that ... the whole procedure does not generally take more than a year. With regard to the types of authorisation granted, one very large company had experienced no difficulty in obtaining immediate authorisation to write all classes of business, but it appears that this may not be so easy with smaller organisations; another company deliberately applied for authorisation for just a few classes initially and asked for and obtained permission for other classes as the captive developed.

A company would be unlikely to want to begin operations within less than a year of taking the decision to proceed and consequently the authorisation procedure will probably not cause actual delay. Given that the procedure is somewhat protracted, this may produce a lack of motivation in some companies, but the matter was not considered a serious obstacle by respondents with domestic captives formed recently. The general supervision and filing of returns following authorisation may, however, be a more serious difficulty; respondents did not express too much concern about the trouble and expense involved with

the provision of the voluminous returns required of an insurance company[2], but it was apparent that these regulations could adversely effect the viability of a small domestic captive. It is also to be noted that the Department has now very wide powers for the control of insurance companies (particularly those less than five years old); one captive has had restrictions placed on its investments under Section 30 of the 1974 Act.

Particular attention was paid to the question of relationships with the Department's Insurance Division when interviewing and corresponding with operators of domestic captives. Attitudes were mixed but relations seemed fairly harmonious most of the time; respondents had occasionally experienced problems where an individual civil servant had decided that he or she was not satisfied with an aspect of the operation, or where regulations and instructions were poorly drafted and open to different interpretations. The difficulties of dealing with civil servants who have no practical experience of insurance (and sometimes little experience in the Insurance Division) were frequently

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2 Nothing more than a cursory look at The Insurance Companies (Accounts and Forms) Regulations, S.I. 1968, No. 1408, is needed to appreciate the problem.

stressed and captive operators considered it necessary to know, on as friendly a basis as possible, the officials responsible for their companies.

Effect of the regulations of the European Economic Community

It must be noted that most of the contact with owners of domestic captives took place before the full impact of British membership of the European Community on insurance regulations was known; the changes that have occured can only have increased the burden on captive owners and reduced still further the desire of organisations to establish insurance companies in the United Kingdom.

The Department must now apply minimum solvency margins equally to captive and conventional insurance companies[3], whereas in the past they have been able to grant exemptions to any undertaking insuring persons of a limited class or risks of a limited category. Further provisions (following the same directive), which came into

[3]Following the "First Council Directive on insurance other than life assurance", Official Journal of the European Communities, No L228/3, 16.8.73.

effect on 31st July, 1978[4], amended the solvency margin requirements for insurance companies, which until the date required assets to exceed liabilities by 20% of the first £2½m of premium income, net of reinsurance, (with a minimum of £50,000), plus 10% of the excess. The new regulations require the Department of Trade to insist upon:-

(a) a plan for restoration of a sound financial position being submitted where an insurer's solvency margin falls below the minimum;

(b) a short term finance scheme where the solvency margin falls below the guarantee fund or minimum guarantee fund, whichever is the greater.

The Department must withdraw authorisation to trade where a restoration plan or short term finance scheme is not fulfilled in the time allowed.

(a) Solvency margins

These are now to be calculated on the higher of either a premium basis or claims basis as follows:-

[4]The Insurance Companies (Solvency: General Business) Regulations 1977, S.I. 1977 No 1553. Most quasi-captives will probably be exempted under Section 10 of Schedule 5, whereby they have to maintain the guarantee fund but not the minimum guarantee fund.

	Premium Basis	Claims Basis
1.	Based on premium income before reinsurance	Based on the average amount of claims paid per annum over the last three years (seven years where more than half the premiums are in respect of storm, hail or frost insurance), plus the difference between claims outstanding at the year end and the amount pertaining three (or seven) years ago if the former is higher or minus that figure if lower.
2.	18% of the first 10m units of account (UOA)[5] and 16% of the excess are aggregated	26% of the first 7m UOA and 23% of the excess are aggregated
3.	In each case the figure obtained in 2. is multiplied by the following ratio:-	

[5]Unit of Account is currently valued at 65p.

Outstanding claims at the year end, plus the difference between that figure and the amount pertaining at the beginning of the year if the former is higher or minus thatfigure if lower, after deducting reinsurance recoveries

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The same calculation before reinsurance recoveries

But the ratio is not to be less than 50%.

It would seem that the premium basis would apply, except in circumstances where an insurer has suffered very poor claims experience.

(b) Guarantee funds and minimum guarantee funds

The guarantee fund is set at 1/3rd of the solvency margin but is subject to minimum levels depending on the types of business transacted. An insurer writing fire (but not liability) business must have a minimum guarantee fund of 3000,000 UOA; if liability insurances are undertaken the minimum is 400,000 UOA.

It is difficult to state the effect the new levels of solvency margin will have because they have to be calculated on premiums before reinsurance, whereas previous legislation was based on net income and as insurance accounts in the U.K. have traditionally shown net figures gross incomes are not freely available. However, as the minimum guarantee fund for companies writing fire business is equivalent to £190,000 which exceeds the former solvency margin for companies with a net income below £950,000, it seems that all the smaller domestic captives are certain to be affected; where liability risks are written the new minimum exceeds the old figure in all cases where the net income is below £1,300,000.

Although the financial implications are probably not serious, for most companies have solvency margins well in excess of the former minima, the above provisions do show that membership of the E.E.C. has made the administration of a domestic captive more complicated. The task of filing returns can also be expected to become more complex, following regulations which came into effect on 1st January 1978[6], which replace the six classes of insurance formally used for authorisations by the 17 classes in

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[6]The Insurance Companies (Classes of General Business) Regulations 1977, S.I. 1977 No. 1552.

the Common Market directive; at present these classifications do not apply to accounting returns, but changes to harmonise the position are to be introduced soon.

The operator of a domestic captive is faced with the possibility of even more community regulations, as it is the intention of the E.E.C. to harmonise insurance laws throughout the common market area. Mainland European countries have traditionally had more stringent insurance regulations than this country and if tighter controls are incorporated into community-wide provisions it could make the situation very difficult for the small captive insurer.

However, at least one company has decided that proposed E.E.C. regulations may in fact be of advantage in the forming of a domestic captive and this respondent had formed one recently in addition to continuing to operate an existing off-shore facility. Draft regulations[7] provide that any insurance company authorised in one member state will be free to operate in any other E.E.C. country, without having to obtain authorisation from the authorities in those other territories. This is of

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[7] Draft of second insurance directive on non-life insurance, E.E.C. Reference XV/206/74-E.

use to captive operators because three community countries (France, Italy and Ireland) do not permit insurance of their risks to be placed overseas, thereby making it difficult for, say, a British company to insure its French risks with either a British or off-shore captive, but when the regulations come into force insurance will have to be permitted with the undertaking domiciled in this country but laws forbidding payments outside the community (i.e. to an off-shore captive) will still be allowed.

It should be noted that, although protocols exist between them and the E.E.C., those parts of the Scheduled Territories that are often used as tax havens (the Channel Islands, Isle of Man and Gibraltar) are not members of the community and the insurance regulations of the common market are unlikely to affect captives established in those territories in the foreseeable future.

Consideration of the domestic alternative

It is difficult to say whether the problems involved in operating domestic captives are actually causing organisations not to form them, or whether the alternative is simply not normally considered because

of the distinct advantages of having a captive in a tax haven. The results of the research into organisational motivation have shown that companies are attracted by the tax benefits off-shore and that avoiding domestic regulations by going to a tax haven was an important but not a major factor. Some respondents were conerned about the political risks that arise with off-shore operations and organisations will recognise that there are costs that arise overseas that will not be incurred here. Whatever the motivations, it was apparent that many of the companies interviewed had not made a thorough examination of all the options available when contemplating a captive and that consequently the possibility of a domestic captive was often not fully considered. The advantages that may accrue when a company does make an effort to look for alternatives is ably demonstrated by one organisation that found it could fulfill its needs with a home-based captive established as a mutual company.

Mutual captives

A major company has established its captive insurance company as a mutual undertaking of the parent company

and its subsidiaries, the main advantage being that a mutual insurance company is not liable for any tax on surpluses, although it is liable for tax on investment income. Apart from the technical matter of setting up the company as a mutual, the main issue that concerned the company was the negotiating of the tax question with the Inland Revenue; the proposed scheme was put to the Department at an early stage and clearance was obtained before proceeding further. The only major stipulation the tax authorities made when giving approval was that premiums charged were not to exceed normal commercial rates, which would be precisely the criteria applied to an off-shore captive when deciding whether to allow premiums as a business expense.

The main problem with this type of operation would seem to be the question of how the organisation is to obtain the benefit of its enterprise. A mutual insurer is entitled to share out a surplus amongst participants, either in a direct manner or as a rebate of premiums, but such sums will then be liable for tax; there is nothing to prevent the mutual captive reducing premiums in order to diminish any surplus but that would simply enhance the profits of participants and lead to higher tax in another way.

This is not a problem peculiar to mutual captives however, for as will be discussed in more detail later, the remittance of the profits of an off-shore operation to this country will produce a tax liability, but the off-shore captive does have the possibility of diverting funds to another territory, which the home-based mutual cannot do. Another disadvantage would be that a mutual undertaking would be unable to take on business from outside the organisation and although most captive owners take the view that it is best not to be involved in "open market" operations it is sometimes beneficial to take modest inwards reinsurance or to participate in a reinsurance pool with other captives.

A mutual captive would also have the disadvantage of paying tax on investment income and the expense of complying with insurance regulations, but those factors apart would be in the same financial position as an off-shore undertaking intending to remit profits to the U.K. If the operation is modest the extra cost of management off-shore may exceed the savings made and it would certainly seem sensible for any organisation deciding that it does not want a tax haven captive (perhaps for moral reasons or because of the political risk) to consider mutual status for a domestic enterprise.

Off-Shore Captives

Table 7.1 in setting out the domiciles and years of formation of the captive insurance companies in the sample demonstrates quite clearly the part played by tax havens in the recent growth of interest in such facilities. The impact of tax havens is in fact even more pronounced than the table suggests, for the eleven domestic undertakings shown are all those that exist; the estimated most likely number of fifteen British-owned captives outside the sample will all be off-shore operations.

Provided the subsidiary is formed and managed in the manner to be indicated herein, the legal position of an off-shore captive should not cause difficulties to its owners. British companies are free to place insurance anywhere in the world and provided the undertaking is a bona fide insurance company, the Inland Revenue will allow premium payments to an off-shore subsidiary as a tax deductible business expense, in the same way as it allows premiums to domestic captives. In the latter respect, no respondent company seems to have experienced difficulties to date in persuading the tax authorities that their captive is a properly constituted insurance company.

Table 7.1

Showing the domiciles and years of formation of the 33 captive insurance companies in the sample

Year of Formation	U.K.	Bermuda	Guernsey	Others
1920 to 1966	7	-	-	-
1967 to June 1972	2	8	-	4*
July 1972 to 1977	2	2	8	-

*One each in the Bahamas, France and Gibraltar; the domicile of the remaining captive is not known, but it is off-shore.

Tax havens for Captives

A tax haven is a country which has a lower rate of tax than the territory in which the company or individual concerned is ordinarily resident, this means that in theory if a country like Italy happened to have a lower corporation tax rate than the U.K. an organisation might be tempted to transfer some of its operations to the former, in which case Italy would be used as a tax haven. Such manipulations do in fact occur from time to time and prevailing tax rates would be a material issue for an American company starting a new European venture for instance, but in general practice tax haven activities are concerned with those territories, normally smaller countries, which either have very low rates of tax or none at all and which actively encourage organisations to move some of their operations into the territories for tax reasons.

A company which sets up its captive insurance company in a tax haven will achieve two things:-

(a) It will pay a lower rate of tax than it would in the United Kingdom, or in some cases no tax at all and with a current rate of corporation tax

of 52% that will obviously make a substantial difference. It is important to note that tax savings are not just a matter of gaining an advantage in a particular year, for the cumulative effect of earning interest, tax free, on untaxed profits will be quite dramatic over just a few years. Assuming an interest rate of 10% a profit of £100,000 will accumulate to over £360,000 tax free in three years, whereas with a tax rate of 52% only about £180,000 would accrue. Thus, in a tax free situation the faster accumulation of funds will mean that the captive will be able to take on larger risks much sooner or with less capital and therefore become a far more effective risk management tool in a shorter time, making a lot of money for the parent company in the process. Clearly, the larger the organisation that owns the captive the greater will be the advantage.

(b) It will avoid the British insurance regulations; most tax havens have far more lax systems of control than this country,particuarly where the insurance company concerned is not insuring risks in the territory, which will be the case with captives. The savings in expense may make the

operation more feasible, but there will be the added advantage of avoiding the need to obtain authorisation initially, not having to worry about possible intervention by the Department of Trade in the future and being free of the need to keep abreast of changes in regulations.

There are a large number of tax havens around the world[8] but many were considered, by those involved, to be unsuitable for insurance operations. A particularly important technicality was found to be the manner in which the government of the country had created the tax advantages, for in many cases the tax laws differentiate between local companies transacting business in the country, which have to pay a certain amount of tax and those domiciled there but only trading outside the territory (usually referred to as non-resident companies), which have very little tax to pay. For most tax havens purposes non-resident status is sufficient as the actual business can be transacted elsewhere, but an insurance company must trade off-shore in order to achieve the remoteness from the parent company that is necessary if the premiums are to be allowed as an expense before tax;

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[8] 19 tax havens are listed in "Grundy's Tax Havens", Bodley Head Limited, London (1974) and these are merely the better known territories.

a captive that could not show that it was being operated at "arms-length" from the parent would be treated as a self-insurance fund by the revenue authorities and any insurance transactions in this country (regardless of the domicile of the insurer) would render the captive subject to insurance regulations; certain practical aspects of the need for remoteness will be discussed in a later chapter. The result is that those tax havens that have little or no tax for non-residents but do tax companies trading there are of less use for captive insurance purposes than those that have low rates overall.

Certain physical factors are also important, the concensus amongst those involved in the management of off-shore facilities[9] being that for a particular tax haven to be used for insurance purposes with a good degree of safety and ease, the following factors needed to apply:-

(a) Good communications systems. Ease of travel to the territory will help but is not essential, whereas good telegraphic and postal links will be needed, for the parent company will want to have regular contact with its representatives; one must not assume that all tax havens meet these basic requirements.

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[9] See, for instance, Barile, A.J., "Locating, Managing The Captive", The National Underwriter, 16.3.73, p.3

(b) Stable government. A captive insurance company will be a medium to long-term venture and should only be established in a country which has a long standing record of political stability with, preferably, a government that actually encourages the territory as a tax haven and welcomes insurance companies.

(c) Familiar language and legal system. It will be a distinct advantage if the language and laws of the country are the same as that of the parent company, failing that another common language and reasonable and easily understood laws will be essential.

Above all, considerable stress was placed by commentators on the need for a territory chosen for a captive to have the necessary expertise available to manage the facility and provide the ancillary services. It was generally considered that captives should only be formed in places with well established management agencies, or at least substantial banking and investment facilities. However, although the advantages of territories with such facilities could be readily appreciated it was sometimes apparent that those involved in managing captives put forward

such arguments in an attempt to ensure that potential clients only considered countries where the former had offices. But, in view of the obvious lack of expertise amongst companies forming captives, most organisations being too small to warrant the establishment of their own arrangements off-shore, even those few organisations that did look for alternatives usually concluded that their subsidiaries had to be placed in territories which could provide most of the facilities required, although that did not necessarily have to include insurance expertise.

Finally, the aspect that affected location decisions in very many cases was whether an organisation was able to move the capital required to establish the undertaking to the territory that it decided was most suitable. Before October 1979, British exchange control regulations prevented the movement of funds from the Scheduled Territories (which since June 1972 have consisted of the United Kingdom, Republic of Ireland, the Channel Islands, Isle of Man and Gibraltar) to other parts of the world, without central bank [10] approval. As such per-

10 Exchange controls were administered locally in Ireland and Gibraltar, but on similar lines to the U.K. The Bank of England had control in all other areas.

mission was unlikely to be given, British organisations could only form captives within the Scheduled Territories (and four of the territories are limited tax havens) unless they could provide the necessary funds from elsewhere, i.e., from a subsidiary in another country with less stringent exchange controls. An international organisation will often have money in an appropriate territory and a few British firms financed the establishment of captives outside the Scheduled Territories in that way, particularly from North American subsidiaries; a few others had funds in a suitable tax haven before a captive was perceived and an insurance company proved to be a good way of putting the money to use. This is not to say that respondents always preferred a captive insurance company outside the Scheduled Territories, for in some cases firms had stayed within the Territories when it seems that they could have gone elsewhere.

Despite the removal of exchange controls in October 1979, the Scheduled Territories do still exist and as the previous situation had such a dramatic effect upon location decisions it is necessary to continue to distinguish between tax havens outside and inside the Territories. This is particularly

the case as companies have had little time as yet to fully appraise their situations following the removal of exchange controls, but a discussion of likely developments as a result of the change is contained in the final chapter of the study.

Captives outside the Scheduled Territories

In view of the desirability for certain facilities and expertise in a tax haven, if it is to be suitable for captive insurance operations, it can be seen that the pioneers in the field, who set up captives before the said facilities existed anywhere, would attract others to their chosen territories. Once a few tax havens were seen to possess expertise, organisations would be attracted to them to the exclusion of all others. This theory is supported by the fact that captives have mostly been formed in a small number of territories, with the British colony of Bermuda being the most popular of all.

Bermuda

It is not difficult to see why Bermuda was one of the places originally chosen. Captives, at least so far as their incorporation in tax havens is concerned, were the inventions of some Americans

in the early 1950s,[11] who needed a territory with all the geographic and political advantages mentioned and which was close, for communication purposes, to the United States. Bermuda (just 600 miles east of Florida) was able to fulfill the requirements to an extent which other countries could not match. It was a very stable area politically and being under British control was beyond the direct reach of U.S. authorities, it had the added advantage of being a small country (population about 45,000) which consequently might avoid the unrest that was already apparent in certain other places. The Bahamas (at one time perhaps the most used general tax haven of all) and the Cayman Islands were also used, but these have become less suitable in recent years[12] and the result has been to increase the dominance of Bermuda still further.

Bermuda seems to be considered an elite type of tax haven, possibly because very few people have used it as a residential tax haven in view of the

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11 Sennett, W.F., "What is a Captive?" in "Captive Insurance Companies", Keith Shipton Developments, London (1976)

12 Barile, A.J., "Managing, Locating the Captive", op cit.

shortage of land (only 20 square miles) and its consequent high price,[13] but its reputation for stability and integrity is probably due largely to the controls placed on the admission of new businesses by the government and it is this relative safety that makes it so attractive to the insurance fraternity. An indication of the extent of control over the affairs of the tax haven enterprises is the fact that until 1970 new companies required an Act of the Bermuda parliament and although the situation has been relaxed as regards procedures for company formation, the authorities still impose a vetting system.

With regard to a new insurance operation, the government wishes to be satisfied as to the integrity of its owners and the level of expertise available to them before giving approval. Applicants have to submit:-

(a) full bank references;

(b) details of:-

(i) classes of business to be written;

(ii) who will be insured;

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13 See for instance, Spitz,B., "International Tax Planning", Butterworth London (1972) p. 84.

(iii) who will manage the company;

(iv) reinsurance arrangements;

(c) estimates of premium income and reinsurance premiums for the first two years.

The authorities also insist on a minimum paid-up share capital of B$ 120,000 for insurance companies, but until quite recently there was no supervision of insurers once they were established. That situation has changed with regulations that came into effect on 1st July 1979, under The Insurance Act 1978. The main provisions require the making of annual returns of audited accounts and the maintenance of solvency margins, with loans to affiliate companies and investments in unquoted securities not being counted as assets for solvency purposes.

There is no tax on profits in Bermuda, but insurance companies have to pay an annual fee of B$1,000 to the government.

A major disadvantage is the high cost of living on the Island[14]. Salaries are typically two to three

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14 This factor is commented upon by a number of writers including Himsworth, C., in "Building up the personnel" Policy Holder Insurance Journal, 24.3.78, p. 517.

times the level of the United Kingdom (despite the fact that earnings are tax free) and the provision of accommodation both for staff and business use is very expensive; as a consequence fees charged by consultants are high compared with elsewhere and a company deciding to manage its own captive would have to produce a good level of premium income to make the exercise worthwhile.

Scheduled Territories captives

Table 7.1 shows that until 1972 British companies forming captives were content to follow the practices of North American companies and nearly always established their operations in Bermuda. The change to favouring Guernsey occurred with the contraction of the Sterling Area on 23rd June 1972; until that date a large number of countries (including some tax havens, such as Bermuda and the Bahamas) were included in the Scheduled Territories and money could be transferred to them without breaching the exchange control regulations. In practical terms this meant that as British companies could form captives in Bermuda with ease and obtain the benefits of tax free operations, there seemed little point in considering territories nearer home, such as the Channel

Islands, which levied tax at a fairly high level by tax haven standards. In fact, such was the extra cost of operating at a considerable distance from the parent company and in an expensive country, that some companies might have done better in, say, Guernsey but the dominant position of Bermuda seems to have held sway.

The imminent reduction of the Sterling Area led to a scurry of activity in 1971 and 1972, with a number of British companies forming captives in Bermuda before the deadline. Since 1972 a few organisations (two in the sample) have been able to form captives outside the Scheduled Territories, by transferring funds from other parts of the world, but on the whole attention from Britain has been concentrated on those territories with tax advantages that are still part of the Scheduled Territories, namely Guernsey, Jersey, Gibraltar and the Isle of Man.

Jersey law forbids the formation of new insurance companies of any type and until 1977 the authorities in Gibraltar were usually unwilling to allow insurance companies to be established. Of the two remaining territories, Guernsey has generally

been preferred and most British-owned captives formed in the last few years has been set up there; one commentator has said that as many as ten captives may "possibly" have been formed in the Isle of Man[15], but none were discovered during the survey carried out for this study.

Guernsey

The abandonment of exchange controls in October 1979 means that British companies are once again free to form captives in Bermuda and indeed can now establish them anywhere in the world. It is not yet clear what effect the change will have on the domicile of captives, but the Baliwick of Guernsey has established itself as the first choice amongst British companies for the incorporation of such undertakings and it is significant that a number of American companies have formed captives there[16] when they could have gone to Bermuda. It therefore seems likely that Guernsey will retain its position as a major captive centre.

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15 Becket, M., "Safeguards with freedom in Bermuda", Policy Holder Insurance Journal, 13.4.79, p.29.

16 Risk Management Reports, op cit.

The Island would seem to fulfill all the requirements of a site for captives mentioned earlier. It has a long history of political stability, well established financial facilities and for British companies an advantage over most tax havens suitable for captives of easy access, being only an hours flight from London. The development of reinsurance and management facilities for captives has undoubtedly been encouraged by the desire of the authorities to create a captive insurance centre.

A disadvantage of Guernsey compared with most tax havens outside the Scheduled Territories is that income tax at a rate of 20% is payable on all company profits and investment income. However, a "pure" captive will be treated as a mutual trading organisation and will only pay tax on investment income so long as profits are retained within the organisation. The Commercial Relations Adviser of the Guernsey government, a person appointed to encourage use of the Island as a commercial centre, also indicated that similar treatment could be negotiated, with the Administrator of Income Tax, for multi-parent

captives and for that part of an "open market" captive's business that relates to the parent.

Until quite recently virtually the only controls over insurance companies were minimum capital requirements where an undertaking used "insurance" or "assurance" in its name, but legislation that came into effect towards the end of 1979 now requires of all insurers:-

(a) Annual registration and the annual filing of accounts, although the accounts will not be available for public inspection;

(b) The declaration of risks insured and of interests in the company by third parties.

(c) The control of the company from Guernsey with sufficient Guernsey based directors to form a quorum.

Companies using "insurance" or "assurance" in their name will in addition be required to have a minimum paid-up capital of £100,000, but otherwise there are no provisions on minimum capital and solvency margins, although the authorities are given the powers to attach conditions to registrations.

The Guernsey "Corporation Tax" Company

Companies that are incorporated in Guernsey, but carry on a substantial part of their activities elsewhere can be registered as non-resident and gain exemption from all income tax, they do however have to pay corporation tax (hence the name) of £300 per annum. It is to be noted that corporation tax has a different meaning to that charged on the mainland and that resident companies pay income tax on profits. A company will not be treated as a resident merely because it has a registered office in Guernsey, where only administrative business is carried on to comply with company law.

The corporation tax company could until recently be used as a means of operating a captive outside the Scheduled Territories, that is in a tax haven with little or no tax, without having to deal with the problem of moving money outside the Territories to capitalise the subsidiary. The capital would be moved to Guernsey in the normal way, but the company would be registered as non-resident and managed elsewhere, typically in Bermuda which in common with many tax havens allows an insurance company to operate there, although domiciled in

another country, in return for the normal insurance company fee of B$ 1,000 per annum. Thus, capital was not needed outside the Scheduled Territories and all tax was avoided save for the annual fees charged by the two governments.

The non-resident company is a feature of most tax havens, but concern had been expressed in Guernsey in recent years about its use for insurance purposes and the new legislation mentioned above has effectively prohibited the establishment of Insurance Companies as corporation tax companies, as it requires that all insurers established there should also be managed from the Island.

Existing undertakings have been allowed to continue for the time being, but the matter is now largely of historical interest only as the abandonment of exchange controls removes the barrier that the corporation tax company was formed to overcome. Organisations with such arrangements are now free to wind up their Guernsey companies and move the capital to the territory where the captive is managed. Three of the captives in the sample compiled for this study were formed as corporation tax companies and at present remain in operation as such.

Other territories

A number of other territories are used as sites for captives and brief details of most of them are contained in the appendix.

The vast majority of captives in the world are, however, domiciled in either Bermuda or Guernsey[17], with virtually all the captives in this study's sample being based in one or the other. Despite the advantages of the substantial facilities for captives that such concentration has brought, one respondent took the view that other sites could be beneficial because of the greater secrecy that can be maintained. The publication of lists of captives and their parent companies by various writers[18] does suggest that it is becoming increasingly difficult to keep captives in Bermuda and Guernsey from public notice; some captive owners would consider secrecy important (for reasons to be discussed later) and might therefore choose one of the lesser known territories. Companies that have non-insurance tax haven operations other than in Bermuda or Guernsey at the time a captive is formed, might also go elsewhere, using their existing facilities as a foundation.

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17 Risk Management Reports, op cit.

18 See, for instance, Becket, M., op cit.

Tax haven contingency plans

Such are the risks of operating in a tax haven that one would expect owners of off-shore captives to have contingency plans to deal with any emergency that may arise which would effect the status of their subsidiaries. This was not, however, generally found to be the case.

There are a number of indications of the type of event that could occur, which can be divided between changes in the host country and action by the authorities in which the parent company is domiciled.

The host country

It would be a simple matter for a government to introduce legislation which would result in the territory ceasing to be a tax haven or being no longer suitable for captives. Although the governments of territories now commonly used as sites for captives are firmly in favour of maintaining their present position, there is always the possibility of a change of attitude or the election of a government opposed to the off-shore

community. In certain territories, changes in the domestic climate making the situation unpleasant for foreigners and even violent revolution cannot be ruled out entirely.

Changes in the Bahamas since independence and alterations in government policy in Guernsey and the Isle of Man are indicative of the fluid situations that exist in tax havens.

The parent company's country

In this study possible action by the British government is the primary concern, where it would seem that any action by the authorities would almost certainly be aimed at tax avoidance and exchange control features.

It is possible that the situation in Britain could follow the United States pattern, where the Internal Revenue Service have been in dispute with a number of companies over their captive operations for some time. The I.R.S. have issued a ruling[19] that premiums paid to wholly-owned off-shore insurance subsidiaries are not to be allowed as a business expense for tax purposes, although

[19] Ruling 77-316

premiums passed to reinsurers would be allowed if the ruling, currently being challenged, is accepted by the courts. The ruling applies specifically to off-shore undertakings, but commentators have taken the view that the arguments followed in reaching the decision apply equally to domestic facilities.[20]

The introduction of such measures in Britain would not be serious for captives with a substantial amount of reinsurance. Of more consequence than these or similar tax measures would be action under the exchange control regulations.

Attitudes to contingency planning

The matter of the extent to which organisations had advance plans for dealing with any such changes was discussed during interviews with operators of off-shore captives, but on the whole respondents were found to be apathetic. It sometimes seemed that this was an area beyond the responsibilities of the average risk manager, but there was little evidence of decisions in this area being made higher up the companies.

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[20] Pine, S.R., Stanger, A.M., and Wright, P.B., "IRS Ruling 77-316: Avoiding its Consequences", Risk Management, April 1978, p.11.

Some of the enterprises with Bermudian captives had outline plans for moving elsewhere should their subsidiaries become unviable, but the normal view was that organisations would have advance warning of legal changes and that any major civil unrest would be foreseen. The impression given was that the existence of tax havens in the Sterling Area, to which the undertakings could be easily transferred, made contingency planning unnecessary. While it was apparent that the owners of captives in the Sterling Area were aware of the risks of political decisions affecting their operations, there was little evidence of planning to deal with such contingencies. In virtually all cases where off-shore facilities existed and in every case where a domestic captive was established, the risk of British government action against them seemed to have been completely discounted.

In more general fields of international tax operations it seems to be widely accepted that tax haven enterprises can only be considered (at the most) as medium-term undertakings and that companies must be prepared to change their strategies as various situations develop; as such operations are concerned with taking advantage of whatever opportunities present

themselves in the shorter term, planning in advance for any changes is unnecessary. In the case of off-shore insurance however, its longer term nature and the fact that it is intended as part of the security arrangements of an organisation, would seem to make contingency plans essential. These might involve plans to:-

(a) move operations to another tax haven should the present host territory become unsuitable;

(b) negotiate with the British authorities for the formation of a domestic captive, in the event of changes making that the only option a company has;

(c) rearrange the facility to comply with possible new regulations;

(d) wind up the captive and return to the conventional market should such a move become necessary.

In the event of political action rendering the current facilities of respondents inactive they would probably be forced to return to conventional insurance, simply because they had no alternative

strategies planned. Other types of captive operation may not be feasible, but one would perhaps have expected companies to have made definite decisions about such matters and to have available plans for an orderly return to the conventional market. In other cases it is possible that the benefits of feasible alternative captive facilities would be lost solely through lack of forward planning.

CHAPTER 8

FORMATION AND ADMINISTRATION OF CAPTIVE INSURANCE COMPANIES

This chapter is concerned with the establishment and management of captive insurance companies solely with regard to administrative aspects, those issues concerned more directly with insurance management being dealt with in the next chapter.

Capital requirements

The amount of capital a captive needs will be determined by:-

(a) Any requirements imposed by the government of the country in which the subsidiary is to be domiciled. Domestic captives will have to comply with the provisions of the Insurance Companies Act, while those in Bermuda will need a minimum capital of $ 120,000.

(b) The size of the operation. Even if there are no minimum requirements the undertaking will need enough working capital to be able to function effectively and there is also the necessity of

persuading reinsurers that the enterprise is sound.

With regard to the capitalisation of off-shore undertakings, many of the practitioners involved in the management of captives that were interviewed took the view that the same capital should be provided as would be considered appropriate for a domestic insurer of similar size. Such an approach would generally mean providing more than the statutory minimum capital of £100,000 as such a figure would be low by current standards for conventional insurers; in the case of the bigger captives, which have a larger income than many smaller conventional insurance companies, capital substantially in excess of the minimum required by law in this country would be called for.

Information was obtained regarding paid-up share capitals in respect of 26 of the captives in the sample, but only 15 of the 22 respondents with off-shore facilities provided the information, this being a subject on which a number of companies were very secretive. Table 8.1 lists the information obtained, together with years of formation and premium income. It will be seen that (excluding the very small captive which is a special case) all but

Table 8.1

Showing years of formation, paid-up share capitals and premiums net of reinsurance in the last available financial years of 26 captive insurance companies

Years of Formation	Capital	Net Premiums
	£000s	£000s
*1920	5,000	19,300
*1925	(£100)	25
*1926	1,000	6,500
*1928	210	700
*1937	100	5,250
*1945	100	900
*1965	250	500
1970	100	1,500
1971	50	350
1971	50	1,000
*1971	200	2,000
1972	50	450
1972	100	1,250
*1972	150	760
1972	200	170
1973	60	2,000
1973	250	250
*1973	250	2,000
1974	200	750
1975	250	100
1975	250	1,100
1975	250	Not known
1975	500	1,500
1975	500	Not known
1976	250	1,000
*1976	500	200

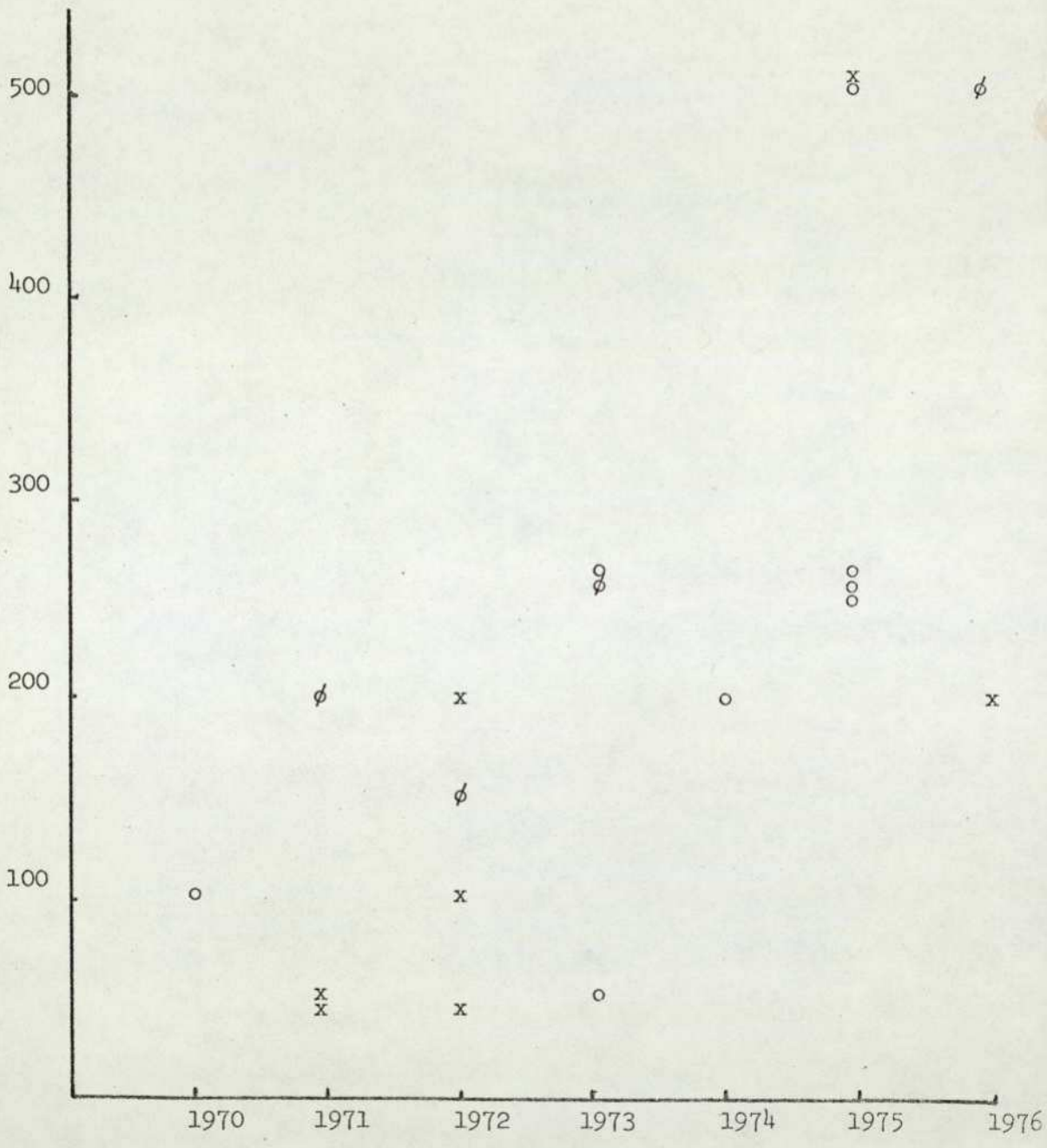
* Domestic captives

one of the domestic undertakings have capital in excess of legal requirements and in two cases the amounts involved exceed the minimum by a substantial amount.

Many of the off-shore facilities have quite low capital bases, which might appear to refute the view mentioned above that they should be funded at the level which would be considered appropriate for British based insurers, but there has been a definite trend towards larger capital foundations in recent years, which exceeds anything that can be explained by inflation. Whereas in 1971 £100,000 would have been considered quite adequate and a number of captives were formed with only £50,000 of capital, more recently £250,000 has become typical with some having £500,000. Table 8.2 is a scatter diagram showing the relationship between capital and years of formation of 19 of the 26 captives formed in the last ten years, the data

Table 8.2

Showing the paid-up share capitals of 19 captive insurance companies, related to their years of formation



Key to domicile: x Bermuda
o Scheduled Territories tax havens
ϕ United Kingdom

having produced a very high rank correlation[1] value of .82, with a standard error of .07. The trend would seem to be the result of the increasing attention paid to captives by off-shore governments and of a desire by captive operators to manage their undertakings on a sound footing.

The general impression gained from respondents was that the final decision on how much capital to put into a captive will often be a compromise between a wish to provide only the minimum that is necessary and the realisation that higher capital will produce a far sounder operation, provide more credibility with reinsurers and produce tax benefits.

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[1]Rank correlation is a simple but adequate method of showing the relationship between two columns of data, the correlation coefficient (r) being obtained from the formula:-

$$r = 1 - \frac{6(\ d^2)}{n(n^2 - 1)}$$

Where d^2 = the sum of the difference in rank for each pair of values, squared

n = the number of pairs of items

In determining whether the value obtained provides sufficient evidence of correlation, a standard error can be calculated from the formula:-

$$SE = \frac{1 - r^2}{n}$$

The correlation coefficient needs to be at least three times the standard error before an hypothesis can be accepted.

Increases in capital

It is common practice to increase the capital base of an insurance company as its income grows and some of the domestic captives in the sample have done so, although in a few cases it may have been forced on them by increases in the legal minimum. In the case of off-shore undertakings, however, this seems to happen very infrequently and has not occurred with any of the captives in the sample about which information under this heading was received. Captive owners, both domestic and off-shore, seem to take the view that provided the accumulated reserves of subsidiaries are at a suitable level there is little point in converting some of the funds into capital; off-shore authorities have little concern for the matter and at home the Department of Trade looks for adequate solvency margins rather than capital in excess of the minimum.

With conventional insurance companies one would expect to find some correlation between capital and premium income, the former being increased as the latter grows, but in the sample of captives there is none, the data producing a low rank correlation of .24 (standard error .23).

ADMINISTRATION OF OFF-SHORE CAPTIVES

At this point it is necessary to consider captive insurance companies managed in tax havens separately from domestic undertakings.

It must be possible to show that the enterprise is being run from the tax haven rather than simply being a paper operation off-shore which is in reality managed from Britain.[2] The consequences of not operating the captive at "arms length" from the parent are very serious - being seen as an insurance company trading in the United Kingdom would render the undertaking subject to the provisions of the insurance legislation (with the likelihood of an order from the Department of Trade to stop trading) and would make the profits liable for tax, or otherwise the whole arrangement could be treated as a self-insurance scheme and the premiums would not be allowed as a business expense.

The necessity of keeping distance between the parent and the captive means that at the very least the subsidiary must have a representative resident in the tax haven who goes through the motions of managing the facility, it is permissable for the parent

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[2] See Barile, A.J., "Criteria for a Captive", Policy Holder Insurance Journal, 12.1.73, p.72

organisation to "advise" its subsidiary on what action to take in various circumstances so long as it permits off-shore personnel to make their own decisions in the light of that advice, although in practice of course what the parent company says will always be followed. For instance, it is normal for new business to simply be "offered" to a captive at a certain premium. Good communication channels between parent and captive are obviously essential; one respondent insurance manager had worked hard to persuade some brokers to place some reinsurance business with his firm's captive, but due to a misunderstanding the agent off-shore refused to accept the business when presented at his office.

Agency facilities

A company forming a captive in a tax haven can, if it wishes, engage its own staff to work in the territory concerned, but it is more likely to appoint an agent. The following types of agency company were identified:-

(a) Specialist firms, involved only in the management of captives, these include the pioneers of off-shore captive insurance, but a number of other firms have been formed more recently.

(b) Insurance broking organisations which have developed an expertise in the subject; although some have gained experience in North America over many years, most British brokers have only become involved in the present decade.

(c) Insurance companies, which either have a risk management subsidiary that will form and manage captives, or have become involved because of an interest in captives by a few major clients.

(d) Firms of accountants and lawyers who handle captives in special circumstances.

Advantages of agents

The main arguments for using an agent would seem to concern simplicity, a shortage of expertise and cost[3]:-

(a) Simplicity Although probably not beyond any company large enough to have a captive, the trouble and risk involved in finding local advisers, obtaining premises, appointing staff, arranging reinsurance (possibly having to use intermediaries who have little experience of captives) and actually running the subsidiary are considerable. However,

[3] See Bannister, J.E., "The Operation and Management of Captives", in Papers in Risk Management No 5, Keith Shipton Developments Limited, London (1976), P.37

it will be a fairly simple matter for an agency which has formed several captives and has gathered the relevant expertise in managing them, in particular having established the necessary facilities in an appropriate territory.

(b) Expertise What expertise there is remains in the hands of a surprisingly small number of people and hiring suitable personnel for a self-managed undertaking could prove difficult. There is the problem of selecting a good agent from amongst the many firms offering their services, but it is not an impossible task. Some agencies have reinsurance pools for the captives they manage, which make the cover easier to obtain and usually provide better terms than are available elsewhere.

(c) Cost Both the above factors would probably contribute to savings in cost from engaging an agent, but there is also the point that there may not be sufficient work to justify the employment of a manager for one captive, resulting in a highly paid person being under-worked or involved in routine matters; agencies might therefore be a more efficient method of utilising off-shore personnel.

In circumstances where a very large company is able to place considerable amounts of business with the undertaking it is possible that a self-managed captive will be more economical, but in this and in other cases the matter must be carefully investigated during the feasibility study. In some cases it is possible to make arrangements whereby the facility is basically self-managed but an agent assists in setting up the captive and provides a certain amount of continuing management on a fee basis.

There are, however, certain disadvantages to consider. The agency will usually want to arrange reinsurance for the captive as part of the management agreement and although the existence of a reinsurance pool mith make the cover cheaper, the agent will recieve the reinsurance commission that would otherwise go to the captive. It was also apparent that each agency tends to produce a stereotyped form of management for each facility under its control which can only make the arrangement inflexible and lead to less control by the parent company; in particular virtually all the firms involved operate in just one territory, which means a restricted choice with little possibility of moving to another territory to suit changing circumstances without changing agency.

Extent of use of agents

Table 8.3 sets out the management arrangements of 19 of the 22 off-shore captives in the sample, divided between those in the Scheduled Territories and elsewhere. Very few organisations chose to manage their undertakings themselves, two of those that did being very large international companies with larger than average captive facilities in Bermuda.

It will also be seen that the specialist firms have only been used in Bermuda, while companies with Guernsey operations have nearly always entrusted their facilities to insurance brokers. The explanation for the difference between the two territories is probably that the specialist firms in Bermuda rely on the large number of American companies with captives for their livelihood and the much smaller number of British companies that could form captives is seen to make the formation of Guernsey operations by such firms as uneconomic.

The three captives in the sample formed as Guernsey corporation tax companies and managed from Bermuda are shown as domiciled in Guernsey in the table.

Table 8.3

Showing the management arrangements of 19 off-shore captive insurance companies

DOMICILE	MANAGEMENT					
	Self-Managed	Specialist	Insurance Company	Insurance Broker	Accountant	Lawyer
Scheduled Territories	1	-	1	5	1[a]	-
Non-Scheduled Territories	3	6	1	-	-	1[b]

Note: All Scheduled Territories captives are domiciled in Guernsey and all the others in Bermuda, except:-

a: Gibraltar
b: France

In one case an American broker, with substantial interests in Bermuda, is involved at both ends; in a second a British broking house with a subsidiary in Bermuda manages the operation and in the third case a British broker handles most of the administration but relies on a specialist firm in Bermuda for resident personnel.

Criteria for selecting an agent

If the agency method is decided upon, the selection of the organisation that is to manage the undertaking is obviously a crucial issue and there was plenty of evidence of companies going to considerable lengths in checking the credentials of various firms before making a decision. Respondants found that the various insurance companies and broking houses that offered their services were usually well known and that their financial and general stability could not be doubted, even if sometimes their experience in the area was somewhat limited; in the case of the specialist firms however it had often proved difficult to identify the best organisations as they were virtually unknown entities. Discussions with respondents suggested that the following were the factors that should be looked for before appointing

an agent:-

(a) Good experience over a reasonable time scale. This might be a rather limited factor compared with other aspects of insurance, as even the oldest established firms have not been in business for more than 15-25 years, but except in very special circumstances it is considered unwise to trust a captive to someone who has had no previous experience, however someone who had previously been employed by another organisation could be suitable and a newer organisation might provide a cheaper and more conscientious service.

(b) A well established organisation. In particular one would want to be satisfied with the firm's financial standing and be convinced that the death, incapacity or retirement of one person would not lead to the collapse of the organisation.

(c) Ability to provide the facilities required. What a company needs from its agent will depend on what the objectives of the captive are and how the owners wish to arrange its management. The extent to which the agent is to be involved in risk management (including the assessment and improvement

of risks), underwriting and claims work are particularly important in this respect.

The indications were that the best agency organisations are excellent, but that there are others which are poor and likely to cause problems; typical criticisms heard were that some firms were making excessive profits or gave less than satisfactory service in attending to their clients needs, the first being more often applied to the well established firms and the second to newer entrants into the field. However, respondents generally indicated that they were satisfied with the service provided by their management agents, with only one raising serious complaints:-

> The company concerned, which has major interests in the food industry, established a captive Guernsey corporation tax company in 1974, the subsidiary being managed from Bermuda. An American company, known to be experienced in such matters, was engaged to manage the facility, but the insured company was unfortunate enough to suffer a serious marine cargo loss in only the second year of the captive's existence.

The handling of the claim led to the discovery of shortcomings in the management arrangements and the parent company has now decided to form its own management company when the current three year agreement ends.

Management by the parent company

As there are only four self-managed captives in the sample it is not possible to speak of "typical" arrangements, but the following is an outline of the procedures adopted by the organisations concerned:-

(a) All the undertakings were established in their tax havens with the assistance of local lawyers; it was found to be essential to have someone with local experience to handle the registration procedures and compliance with whatever regulations applied. The person retained for that purpose was in most cases also retained to act for the undertaking in fulfilling annual requirements, such as the filing of returns and the payment of stamp duties. Although it is often sensible to hire a lawyer to deal with such technicalities, it would

seem that captive operators are open to exploitation; one respondent mentioned receiving a large account for services from their Bermuda lawyer, the sum being substantially reduced when the matter was challenged.

(b) The extent to which off-shore staff are engaged in the management of the undertaking is a compromise between the need to prove that the captive is being run at arms length from the parent and the desirability of having as much work done at home for cost reasons. The captives in the sample had between one and three management staff off-shore, plus secretarial support.

(c) As far as could be established, each captive had at least one person off-shore who could be considered to have substantial insurance experience, however as indicated earlier in only one case was the person previously employed as the firm's risk manager given a position in a tax haven.

(d) With regard to the actual division of responsibilities between the off-shore territory and Britain, the extent of the captive's operations were found to be material; where the captive

handled risks of some complexity experienced staff were needed off-shore and were required to have substantial responsibilities to justify their existence, whereas simpler operations could be handled almost completely from home. However, in most cases the work handled off-shore by the staff of self-managed facilities is similar to that done by agency firms and the administration of both types can be considered together.

Administration factors

Investigation of the manner in which the captive insurance companies in the sample were administered led to the identification of five main areas:-

(a) Legal and financial services;
(b) Risk management;
(c) Underwriting management, that is the organisation of rating processes, policy issue, endorsements and renewals;
(d) Reinsurance management, involving the making of decisions on what protection is required and the placing of cover with reinsurers;
(e) Claims investigation, adjustment and settlement.

It proved to be difficult to quantify most of the information under this heading as each operation tends to have slightly different arrangements.

Legal and financial services

In most cases a lawyer in the off-shore territory was engaged to handle formation and regulatory procedures, excepting that the largest agency companies had their own lawyers.

Banking and investment was usually supervised by off-shore staff or the agency, but the actual authority vested in them varied widely. In some cases investment decisions were taken in the tax haven but more commonly the parent company had close control or took complete responsibility.

Accounts have to be kept in the off-shore territory and most captives engaged local firms for this purpose, but with the larger agency firms using their own staff; some undertakings used local auditors while others appointed British based firms, with those in the Scheduled Territories more likely to use the latter.

Risk Management

Where risks are conventionally insured there will be certain risk management aspects which the insured will usually conduct for itself and others with which insurers are directly involved. In the former category are such matters as risk identification and analysis, risk management involvement in the design of new products and plant and general improvements in risk unconnected with underwriting requirements; in the latter case there is the surveying of risks and the stipulation of requirements for improvement before they can be insured. Where a company forms a captive it could in theory continue the division, but in practice they are combined for the sake of ease of operation.

This was a subject that was found to have considerable diversity of treatment between the various captives in the sample. Some organisations arranged for the managing agency to provide a full risk management service, this being more typical where an insurance company or large broking house was acting as agent; others shared the tasks between their risk management staff and their agents;

still others used a combination of agency, in-house and consultant expertise and a final group did everything themselves. Distinguishing features seemed to be the complexity of the risks involved, their spread throughout the country and the world (help being needed for foreign risks and those distant from in-house specialists) and the manner in which the risks were insured, for where a captive writes a line on a coinsurance schedule it is able to rely upon the leading office in many respects.

Underwriting and Reinsurance Management

These factors can be considered together as they are closely linked, both being areas where there was usually substantial involvement by the parent company's risk management staff, although decisions would have to be passed to the subsidiary by way of "advice" in order to maintain arms-length dealings.

In nearly every case underwriting decisions involved the risk manager of the parent company; where an agency managed a subsidiary the extent to which the owners relied on it for assistance varied, in the

majority of cases the risk manager took most of the decisions unless the agency's expertise in the technical aspects of underwriting was especially necessary; however in some cases the agency was substantially involved. It was the particular firm involved rather than the type of agent that was found to be the determining factor, both specialist managers and brokers acted in various roles as required by their clients, but some firms seemed more likely than others to be involved in the underwriting. There was only one case in the sample where the parent company allowed most decisions to be taken off-shore, that being where a self-managed captive had a strong management team in the tax haven.

In most cases reinsurance was placed through brokers in the London market (both companies and Lloyd's); decisions generally involved the parent company but management agents were usually substantially involved too. Non-British reinsurers were frequently used through their London offices, but only on a few occasions was their recourse to foreign markets and then mainly by captives outside the Scheduled Territories.

Claims

Captives usually follow the pattern of conventional insurance companies in appointing adjustors for all but smaller claims. It is therefore a fairly simple matter to show that the subsidiary is acting remotely from the parent, but it is also essential that the undertaking be able to demonstrate to reinsurers that it is acting properly.[4] In practice, however, it will be impossible for those engaged in managing the captive off-shore to be closely involved and it is usual to leave the claimant (in the form of the parent company or one of its subsidiaries or divisions) and adjustor to settle property claims without much reference to the insurer; where liability risks are insured the parent company will often act as if it were the insurer in dealing with claimants. Much will depend on the relationships between the parent's insurance department, the captive and operating companies or departments making claims; in most cases the claimant will be able to treat the insurance department in the same way as it would an insurance company and the department will be able to act properly for the captive, but where the insurance department acts as claimant that will not be possible.

[4] See Bannister, J.E., "The Operation and Management of Captives", op cit, p.34

Investments Off-Shore

Income from the investment of reserves and insurance funds is an important source of revenue for conventional insurance companies; non-life insurers generally exclude such income from their premium calculations[5], but have often relied upon it in order to produce a profit after making underwriting losses. Consequently, a captive insurance company will be a less viable alternative to conventional insurance if the returns on its investments do not at least approach those of insurers in the parent company's domestic insurance market. Also, as much of the benefit of off-shore operations stems from tax free (or low tax) investment income, careful attention to investments would seem to be essential.

It is, therefore, surprising that little attention is paid to investment policies by commentators on captive insurance companies. Carter, R.L.[6] has produced an analysis of the risks involved in investment captive funds and there is the occasional reference in the literature to the rates

5 Carter,R.L. "Economics and Insurance",op cit, p. 121

6 "Handbook of Risk Management", Kluwer-Harrap, London (1975), p.8. 3-05

of return on investments that a captive might achieve[7], but discussion on the methods to be employed is largely lacking. Investment procedures have also rarely formed the basis of major discussion at the various conferences held on the subject of captives since the inception of the research for this study.

It is possible that the shortage of information stems from practitioners wishing to keep their methods secret because they are very special, or because returns are embarrassingly low, but it seems more likely that the average captive operator knows very little about investment because most rely almost wholly on advisers in outside firms or banks.

Investment policies

Table 8.4 summarises the replies received to the questions on Questionnaire 3 relating to arrangements for the investment of finds and responsibilities for investment decisions; unfortunately information could not be obtained from over a third of the sample of off-shore captives, thus being a subject that respondents considered to be particularly confidential. About half of those that did reply stated that they relied on outside investment advisers, most of the others using existing parent company investment staff or personnel of self-managed captives, with only a few leaving investments to management agencies.

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7 See for instance, Bannister, J.E., "Captive Insurance Companies" op cit. p.30

Table 8.4

Showing the investment arrangements and those responsible for investment decisions in respect of 14 off-shore captive insurance companies.

DOMICILE	MANAGEMENT	INVESTMENT ARRANGEMENTS	INVESTMENT RESPONSIBILITIES
Bermuda	Self-managed	Deposits with local banks	Captive management
Guernsey	Insurance broker	Merchant bank as investment managers handle investments	
Bermuda	Specialist	Short-term investments	Advisers in Bermuda
Bermuda	Specialist	British govt. stocks	Captive management
Guernsey	Insurance broker	British stocks and shares	Parent company
Bermuda	Specialist	Short-term investments	Investment advisers
Bermuda	Self-managed	No reply	Captive management
Bermuda	Specialist	Short-term investments	Investment advisers
Bermuda	Specialist	Wide portfolio	Parent company
Guernsey	Insurance broker	Deposits with local banks	Investment managers
Guernsey	Insurance broker	All investments are in the form of loans to the parent company	
Guernsey	Insurance broker	Deposits with bankers	Captive management
Gibraltar	Accountants	No reply	Captive management
Bermuda	Self-managed	Wide portfolio	Parent company

Conventional insurers tend to keep large amounts of their non-life funds in investments that can be readily realised should the need arise and generally are cautious about providing high-risk capital. The latest statistics available[8] indicate that the average insurance company keeps only about 20% of such funds in property and related investments, around 25% in ordinary shares, as much as 40% in government and fixed interest stocks and has large amounts of money on short call. The captive insurance company, because of its modest size, will usually need to be even more cautious than the conventional insurer, perhaps leaving out property and other equity investments completely; this is borne out by the fact that the majority of respondants supplying information on their captive's investments had their funds only in short term investments, mostly on deposit with banks. In 11 of the 14 cases where such information was supplied, investments were held in Sterling, in the remainder they were in U.S. Dollars.

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[8] "Insurance Facts & Figures 1978", British Insurance Association, London (1979)

Where the table shows short-term investments or bank deposits these were (with minor exceptions) the only investments the captive had, in other cases investments in stocks, shares etc. were the main avenues used but in all cases substantial bank deposits were held in addition.

Most respondents and practitioners interviewed were of the opinion that the actual securities representing the assets of captive insurance companies established outside the Scheduled Territories should be held outside the territories concerned, to avoid the risk of seizure by the authorities. Share and stock certificates can be held in Britain, but where funds are deposited with banks off-shore it will be for the bankers to take appropriate precautions for the protection of its assets. The manner in which it would be intended to repay depositors in the event of a revolution or government action would be a subject for a contingency plan, but was not usually considered.

Lending back

A form of investment well known to the practitioners interviewed, but which only appeared once amongst the

survey sample, involves the captive lending money back to the parent company. This will be permitted by most tax haven governments and might be considered for a number of reasons:-

(a) the parent company may not be able to afford the full cost of capitalising the subsidiary and will need to receive the money back once the captive is in operation;

(b) the parent might consider that the return to be obtained on the money will be higher when placed with itself than if invested elsewhere;

(c) the parent might genuinely be a good investment for the captive's funds;

(d) the captive might have accumulated funds that it no longer needs and the device might be used to make funds available to the parent without incurring the tax liability on repatriation.

As the only reason the parent organisation can have for wanting the money back is to use it for working captial such arrangements will affect the liquidity

position of the subsidiary and will be detremental to its operation as an insurance company, unless the lending back is very modest or the money is genuinely surplus to requirements. However, where the captive is only being used to insure smaller risks and/or is largely a tax avoidance device little damage is likely to result and the strategy may in fact fit in quite closely with the organisation's objectives, but in other cases it is difficult to see how the captive can be effectively used as a risk financing tool when much of the finance will simply not be available if it is needed to cover a large loss. Lending back is also certain to damage the credibility of the captive in the eyes of reinsurers and tax authorities.

If the captive is to lend money to the parent organisation it will have to charge a commercial rate of interest, otherwise the arrangement will amount to tax evasion and liability for tax on the money lent would arise as if it has been repatriated in the normal way. This is the main reason why the device is not a particularly useful one for getting funds into the country, although there might be a marginal advantage in that slightly generous rates might go unnoticed.

ADMINISTRATION OF DOMESTIC CAPTIVE INSURANCE COMPANIES

All the captives established in the United Kingdom are managed by the parent companies themselves,[9] although assistance with certain aspects is in some cases obtained from insurance brokers. The main reasons for self administration are that most of the undertakings are old established captives formed before management on an agency basis existed, the majority are operated by the very largest companies which are more likely to be able to run their own insurance companies and the small number involved means that there can be little possibility of expertise for hire being available. Of the four domestic captives formed within the last ten years, one is owned by a multi-national conglomerate which already had a self-managed off-shore captive and a second is a small enterprise established on a mutual basis.

Most aspects of the formation procedure have been dealt with under domiciliary considerations, but the following additional points with regard to dealings with the Department of Trade's Insurance Division are to be noted:-

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[9] Carter, R.L., in "Economics and Insurance", op cit, p.22, mentions the management of some domestic captives by an insurance company, but the firm concerned has indicated that those operations have been discontinued.

(a) There is no known official opposition to captives within the Department, but the insurance legislation and the main powers of the Secretary of State are directed particularly at new companies and the captive is likely to be subject to very close scrutiny during formation and its early years.

(b) Authorisation is likely to be more difficult to obtain where a company is to transact liability and/or life business, as the authorities are naturally concerned to protect the interests of the public.

(c) The Department may place restrictions on the company when granting authorisation, such as forbidding investments of a certain type and requiring that assets representing liabilities be kept in the United Kingdom - this would seem to be a quite common procedure for new conventional insurers and should not be taken as an indication that the authorities are particularly suspicious about the company.

Administrative procedures

Although there were minor points of detail that varied from one undertaking to another, each domestic captive was administered as a part of the parent organisation's insurance department. The arrangements for underwriting, reinsurance and claims were the responsibility of the firm's Risk Manager; in the case of larger captives there were assistants engaged only in the administration of the subsidiary, while in the smaller undertakings it was impossible to distinguish those working for the captive from those working directly for the parent companies.

Legal and financial services were, however, usually handled by the specialist departments of the parent organisation, investments being arranged as a part of the firm's general portfolio with some special provisions regarding liquidity and cash flow pertinent to an insurance company.

Most organisations made their insurance decisions centrally and business was placed with the captives on the basis of management policy, for instance that

fire insurance was to be put with a captive but liability risks were to be insured conventionally. In one case, however, the insurance department was seen virtually as an insurance broker for the divisions of the organisation, each insurance requirement being treated on its merits and only being placed with the captive where it was considered that the subsidiary was able to take the insurance at a lower rate than the conventional market and still make a profit.

CHAPTER 9

UNDERWRITING AND RISK MANAGEMENT POLICIES

Study of the use made of captive insurance companies by their owners and of the procedures followed with regard to underwriting and internal treatment of risks led to the identification of four main decision areas; these concerned:-

(a) The risks to be insured;
(b) The procedures for acceptance of insurances;
(c) The manner in which the risks were to be rated;
(d) The arrangements for the examination of physical risks and loss control.

The risks insured

Table 9.1 shows the types of insurances written by 28 of the 33 captives in the sample and the numbers of undertakings involved with each type.

The typical captive insurance company is concerned mainly with property insurances (largely fire, special perils[1] and theft) and with consequential

[1] Explosion, Storm, Flood, Earthquake, Burst Pipes, Impact by vehicles, Aircraft, Riot, Malicious damage

Table 9.1

Showing the number of captive insurance companies insuring various types of risk

Number in Sample	Fire & Special Perils		Misc.[1] Property	Damage to Motor Vehicles	Motor Third Party	Employers Liability	Public Liability	Personal Accident	Marine	Others[2]
	Material Damage	Con. Loss								
Domestic captives 11	9	7	5	4	4	3	3	5	8	-
Off-shore captives 17	15[3]	12[4]	10	5	-	2	2	4	5	4

Notes:

[1]Theft, glass breakage, "all-risks" to minor items of property, travel

[2]One captive insured fidelity guarantee risks and performance bonds, a second products recall and credit risks, a third credit risks and commodity losses and the fourth consequential losses from strikes

[3]Two of these insured special perils only and one fire only

[4]One of these insured fire only

loss following damage to property by fire and special perils. Some of them are involved with marine insurances (this being more common with the domestic captives) and a smaller number with motor accidental damage risks. Most captives do not write liability type risks, although the practice is more common with domestic captives.

The above mentioned data and interviews with respondants suggested that the basic intention of captive owners is to use the facilities largely for those insurances that represent major items of expenditure, but to avoid risks that are likely to produce delayed claims run-offs and cause settlement problems.[2]

Insurances against damage to property and consequential losses

The main item of insurance expenditure for most industrial organisations is for material damage and consequential loss fire risks and that explains the concentration in that area amongst the sample; there was rarely any doubt that fire insurance was the main consideration when respondants were looking at the feasibility of captive insurance.

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[2] Vaughan, D.B., quoted in "Captives", Policy Holder Insurance Journal, op cit, p.513, has suggested that property insurances are also preferred to other types because the losses in the former cases are more predictable.

Having decided to form the captive on the basis of fire risks, most operators took the view that it was only sensible to include other perils,particularly the special perils conventionally dealt with as an adjunct to a fire policy. None of the undertakings in the sample insured all the perils mentioned above, but most insured a wide range of them, with only one captive having no special perils placed with it. Where captives were used to insure material damage but no consequential loss risks, the latter were either not insured because the parents' spread of risk made the cover unnecessary, or the captives were only recently established and may expand into the field later.

Commentators sometimes suggested privately that some captive owners place as many miscellaneous perils as possible with off-shore captives so as to boost tax advantages and that it is quite common for risks to be insured, that either were left uninsured before an undertaking was formed, or should not be insured by major companies. (It should be noted that it is common practice for very large companies not to insure minor risks such as burst pipe damage, theft of non-hazardous property, glass breakage and motor accidental damage, because the spread of risk makes non-insurance more economic). If such tax avoidance philosophies were being followed generally one would

expect to find most off-shore captives taking insurances under the headings indicated and the proportion of off-shore undertakings so involved to be higher than that for domestic captives. It will be seen that nearly 65% of the off-shore facilities and 45% of the domestic handled insurances under the "miscellaneous property" heading, with the proportion of domestic captives (36%) taking motor accidental damage risks being higher than for off-shore companies (29%). Of the off-shore captives writing miscellaneous property risks, only two insured glass breakage and only one other "all risks" on minor property; two further captives insured special perils and not fire and must be primarily considered as tax avoidance devices in that respect. The tax avoidance case cannot, therefore, be taken as proven from this data.

Marine risks

One captive in the sample wrote both hull and cargo risks, all the others involved with marine risks being almost wholly concerned with cargo only. In six cases marine insurance was considered by parent companies to be a major part of their captive

operations and in a further case the captive operated purely as a marine insurer but was very small.

Personal accident

Some respondents placed employees personal accident and/or sickness insurances with their captive and as the benefits provided are likely to be modest and risks widely spread, such insurances would seem to be suitable for a captive facility. However, it was widely considered that it was best for a company to restrict its captive to insuring its own risks and that there might be claims settling problems with the firms own employees.

Liability insurance

Liability risks are here taken as employers' liability, public liability and motor third party.

The opinion of almost all the owners and managers interviewed was that captives should not insure liability risks. The reasons given can be summarised as follows:-

(a) Only authorised insurance companies can write employers liability and motor third party insurances arising in this and most other countries and as off-shore captives cannot be authorised because they do not wish to be seen as trading here, they cannot handle such insurances unless it is fronted by an authorised insurer and reinsured to the captive. With regard to domestic captives, it seems that the Department of Trade is stricter with the authorisation of insurers transacting liability business than with those which do not, looking far more carefully at the companies and being more likely to impose restrictions.

(b) Indemnities on liability policies are either unlimited or very high, necessitating substantial reinsurance; however where unlimited liabilities are concerned (principally on motor and employers' liability) very high excess of loss protection will still leave a catastophe risk as it is practically impossible to obtain treaties with unlimited cover. One parent company had agreed to a limit on the amount it could claim from its captive, but that would seem to defeat the object of having insurance.

(c) The handling of claims will be time consuming and often highly technical, involving such matters as the collection of witnesses statements, medical evidence, the application of law and the consideration of legal opinion. A lawyer might be engaged on a consultancy basis for difficult cases but the captive might still need to employ a liability claims specialist, which will increase costs.

(d) Liability insurance accounts are subject to protracted run-offs, as claims can arise long after the end of a period of insurance and large claims take many years to settle, it is consequently difficult to know the precise position when estimating profits and if inflation exceeds general interest rate levels, original premiums and reserves for outstanding claims will prove inadequate. There is also the danger that factors apart from inflation will effect settlement levels, changes in the rules for calculating damages (e.g. adding interest to court awards) and general changes in the law (e.g. amending the limitation rules) being examples.

(e) Dealing with third parties can itself be difficult, in that the discovery by a claimant that the company claimed against and the insurance company

involved are part of the same organisation might lead to the claimant being more intransigent than would otherwise be the case; in practice the insured company will have to handle as much of the negotiating as possible (particularly if the captive is off-shore) and only involve the insurer when liability is established.

Unconventional insurances

The fact that very few of the undertakings in the sample handled risks that cannot be insured in the conventional market supports the views contained in the first part of the study that captive insurance companies are not generally formed as vehicles for unusual risks.

The captives insuring products recall risks, commodity losses and consequential loss following strikes were the only cases where unconventional risks were being taken. In the first case, a components manufacturer insures the risk of defects in products necessitating their recall from purchasers; such insurance can be obtained in the conventional insurance market but it is expensive and extremely difficult to place; the respondent concerned had not insured products recall before the captive was formed, partly because of difficulties

encountered in placing the cover. In the second case the captive issues a widely worded policy in respect of losses on commodity dealings arising from various contingencies including cancelled contracts; losses from changes in market prices are not insured. The consequential loss strikes insurance issued by the third captive is a conventionally worded loss of profits arrangement, but the peril is a stoppage of production by strike action. There is no doubt that the commodity losses and strikes contingencies could not be insured in the conventional market.

Acceptance procedures

Coinsurance

A conventional insurance company will usually have reinsurance arrangements which enable it to accept quite large amounts of risk on a 100% basis, placing amounts surplus to that which it can safely retain with its treaty reinsurers. Where a risk is too large for a particular insurer, even with its reinsurance treaties, a number of insurers will share the risk on a coinsurance schedule, it being normal practice for an insurer deciding how large a share it can accept to include an amount to place with its reinsurers, the actual amount accepted being called the "gross line" and the amount finally retained by the insurer for its own account the "net line".

Captive insurance companies were found to be following different procedures to conventional insurers, both with regard to the extent of use made of coinsurance and the manner in which it was used; in particular a few undertakings were operating solely on a coinsurance basis, that is they never issued policies to their parent companies,

restricted themselves to sharing in coinsurance schedules, had no reinsurance treaties and consequently only wrote net lines. The procedures varied between the different types of captive, the general pattern being as follows:-

(a) Off-shore captives arranged sufficient reinsurance to enable them to issue 100% policies to their parent companies for virtually all insurances, with the occasional very large risk being placed in the conventional market without any participation from the captive. In only three cases were off-shore captives found to be participating in coinsurance schedules (two of these also being reinsurance captives mentioned later); in one case the undertaking operated solely on a coinsurance basis, in a second the captive occasionally took smaller insurances 100%, while in the third coinsurance was engaged in for one class of business only.

(b) The old established domestic captives, that is the seven formed before 1967, generally had reinsurance facilities to enable them to act as conventional insurance companies, but tended to write net lines where risks were too large to enable the captives to take 100%. In one case a very small

captive operated solely on a coinsurance basis.

(c) The procedures of the four recently formed domestic captives varied; one operated solely on a coinsurance basis, another did the same but had a stop loss treaty to protect its net lines, a third was able to issue 100% policies with the backing of its treaties and the fourth had a mixed arrangement similar to that described for the older established undertakings.

Fronting

Fronting is where, instead of placing insurance direct with its captive, an organisation arranges for a conventional insurance company to issue policies in respect of certain risks but then to reinsure most of the insurance with the captive.

Two main reasons for fronting were identified[3]:-

(a) Most countries only recognise the policies issued by insurers authorised under their domestic insurance regulations as valid in complying with compulsory insurance requirements; thus in the United Kingdom only companies authorised under the

[3] See, for instance, Sennett, W.F., "Preconditions for Successful Operation", in "Captive Insurance Companies", Keith Shipton Developments Limited, London (1976)

Insurance Companies Act can issue policies to satisfy the requirements of the statutes making employers' liability and motor third party insurances compulsory. Authorised insurers are generally referred to as "admitted insurers" and others as "non-admitted" and those terms will be used here. There are, however, no regulations as to where British insurers may reinsure such compulsory business and a captive that is non-admitted (that is one in a tax haven) could handle those risks of its parent if a fronting arrangement is made. It has already been mentioned that liability insurance is not a popular class of business with captive operators for reasons other than difficulties with authorisation and consequently the fronting of employers' liability and motor third party risks did not occur frequently in the sample, with only two undertakings involved with employers' liability fronting and none transacting motor third party insurance off-shore. One of the domestic captives did have what was virtually a fronting arrangement for employers' liability insurance because of difficulties encountered with obtaining authorisation to transact the business.

(b) Largely as an attempt to reduce the loss of foreign exchange, but also in an endeavour to create their own insurance markets, a number of countries do not permit any insurance on risks within their territories to be placed with non-admitted insurers, but most do permit the placing of reinsurance outside the country; the position regarding most of the countries of the world is shown in Table 9.2. Captives would not generally be eligible for authorisation overseas and would probably not wish to be subject to the regulations of foreign governments, but where there are not restrictions on the placing of reinsurance (those with restrictions are indicated by Notes 4 & 7 of Table 9.2) a company with a captive could arrange for its risks in such a country to be fronted by a locally authorised office and then reinsured with the captive; this would not however be possible in countries with nationalised insurance systems (Table 9.3). Fronting of this type would only be likely to be engaged in by well established captives and it is known that a number of American owned undertakings have such arrangements; however most of the captives in the sample were either operated specifically for the British risks of the parent or it had been decided that the subsidiary would not handle foreign risks until it was more established.

Table 9.2

Indicating whether the governments of the countries named permit the placing of insurance with non-admitted insurers

Angola	NO	Gambia	NO
Argentina	NO[1]	German Federal Rep.	YES
Australia	YES	Ghana	NO[4]
Austria	NO[1]	Gibraltar	YES
Bahamas	NO	Gilbert Islands	YES
Bahrain	YES	Greece	NO
Barbados	YES	Grenada	YES
Belguim	YES	Guadeloupe	NO
Belize	YES	Guatemala	NO
Bermuda	YES	Guyana	YES
Bolivia	NO	Haiti	NO[5]
Botswana	NO[2]	Honduras	NO
Brazil	NO[3]	Hong Kong	YES
Brit. Solomon Is.	NO	Iceland	NO
Brit. Virgin Is.	YES	Indonesia	NO[7]
Brunei	YES	Iran	NO
Burma	NO[4]	Ireland	NO[6]
Cameroun	NO	Israel	NO[3]
Canada	YES	Italy	NO[6]
Cayman Islands	YES	Ivory Coast	NO
Central African Rep.	NO	Jamaica	NO[8]
Chile	NO[5]	Japan	NO[1]
Colombia	NO[2]	Jordon	NO
Cook Islands	YES	Kenya	YES[4]
Cyprus	YES	Korea, South	NO
Denmark	YES	Kuwait	NO[2]
Dominica	YES[3]	Lebanon	NO[9]
Dominican Republic	NO	Lesotho	NO[2]
Ecuador	NO[1]	Liberia	YES
El Salvador	NO	Luxemburg	NO[1,6]
Ethiopia	NO[1]	Malagasy Republic	NO[9]
Falkland Islands	YES	Malawi	NO
Fiji	NO	Malaysia	YES
Finland	YES	Malta	YES
France	NO[3,6]	Martinique	NO
Gabon	NO	Mauritania	NO

Table 9.2 continued

Mauritius	NO[9]	Sierra Leone	NO
Mexico	NO[1]	Singapore	YES
Montserrat	YES	Spain	NO
Morocco	NO	South Africa	NO
Namibia	NO	Sudan	NO
Nepal	YES	Surinam	YES
Netherlands	YES	Sweden	YES
Netherland Antilles	YES	Switzerland	YES
New Zealand	YES	Taiwan	NO
Niger	NO[9]	Thailand	NO[2]
Nigeria	NO	Togo	NO
Norway	YES	Tonga	YES
Oman	YES	Trinidad & Tobago	YES
Pakistan	NO	Tunisia	NO[9]
Panama	NO[10]	Turkey	NO[4]
Papua New Guinea	NO	Tuvalu	YES
Paraguay	NO[1]	Uganda	NO
Peru	NO[3]	Upper Volta	NO[9]
Philippines	NO	Uruguay	NO
Portugal	NO[3]	United Arab Emts.	YES
Puerto Rico	NO	United Kingdom	YES
Qatar	NO	U.S.A.	YES
St Christopher etc	YES	Venezuala	NO[1]
St Lucia	YES	Western Samoa	NO
Saudi Arabia	YES	Yemen Arab Rep.	YES
Senegal	NO	Yugoslavia	NO
Seychelles	YES	Zaire	NO

NOTES

General Notes: (a) Most countries only permit insurers established there to write compulsory risks

(b) Countries with nationalised insurance systems have been excluded (see Table 9.3)

1. Insurance can only be placed outside the country if the authorities give permission.

Table 9.2 continued

2. Home-foreign placings are possible under certain circumstances.

3. Insurance can be placed outside the country if the local market cannot insure the risk, subject to approval by the authorities.

4. These countries have compulsory reinsurance cessions to State companies.

5. Regulations do not prevent the placing of insurance outside the country, but there is a prohibitive tax for so doing which is often waived or reduced if the local market cannot insure the risk and the consent of the authorities is obtained.

6. E.E.C. directives will eventually require freedom of access for insurers in other member States.

7. No more than 25% of premiums may leave the country by way of reinsurance on any one risk.

8. Approval (usually given for large risks) must be obtained from the authorities.

9. Except for marine risks.

10. Permission to place reinsurance outside the country must be sought from the authorities.

Table 9.3

Countries with nationalised insurance systems.[1] They generally require all insurance arising in the country to be placed with the State office.

Albania
Algeria
Bangladesh
Benin
Chad
Congo
Costa Rica
Cuba
Egypt
India
Iraq
Libya
Mozambique
Nicaragua
Sri Lanka
Syria
Swaziland
Tanzania
Zambia

[1] The communist countries of Eastern Europe and Asia all have State monopolies in insurance and have been excluded from the list.

Sources (Tables 9.2 and 9.3)

"International Insurance Directory", Royal Insurance Company, Liverpool (1977)

"International Insurance Industry Guide", Coopers & Lybrand, London (1977)

"Worldwide Insurance Guide", AFIA, Wayne, New Jersey (1975)

Press cuttings in the Library of the Chartered Insurance Institute

20 of the captives in the sample are known to be only involved in British risks, six others are known to take foreign risks but these made only limited use of fronting facilities; however a number of respondants indicated that it was their company's intention to expand their captives into worldwide operations and that they therefore expected to use fronting in the future.

Reinsurance captives

A reinsurance captive is a total fronting arrangement. The parent company arranges for all the insurances that are to be handled by the captive to be placed with a conventional insurance company and then for all but a small percentage to be reinsured with the captive.

Respondents involved in the management of captive insurance companies took the view that a number of British owned captives had been set up in the manner indicated and that others were being considered;[4] a major British insurance company was mentioned as being involved in such matters and this was confirmed by the company concerned. However, only three of the sample were found to be

[4] The practice has been said to be "common amongst Guernsey captives" - "Captives", Policy Holder Insurance Journal, op cit, p.509

operated as reinsurance captives and in only three cases was insufficient information obtained to ascertain whether the undertakings were being run in that way. With one undertaking, the fronting office accepted only what the captive could retain by way of net lines, that is no reinsurance above the small retention of the fronting office was arranged. In a second case the arrangements were similar but the captive was also involved in writing certain smaller insurances direct on a 100% basis, so that the facility could not be considered a reinsurance captive in a total sense. In the third, the captive's insurances were fully fronted but risks received into the undertaking were then reinsured in what is a normal way for a captive.

The main disadvantages of this type of facility would be that the organisation would tend to become locked into one insurance company, producing inflexibility in risk management and might lose some of the scope for making administrative savings over a conventional insurance company. Conversely, a reinsurance captive could have an advantage in that most of the burden of operating an insurance company, particularly as regards surveys, loss control and underwriting could be removed from the

parent company and handled by the fronting office, but that does not seem to be the normal pattern. The three relevant companies in the sample handled most of such work themselves, although there was some evidence of slightly more reliance on the fronting office than one would expect from an operation being run completely independantly. The main motivation for such arrangements was in fact found to be, not administrative, but a reaction to political risk. One respondent in particular stated that a reinsurance captive had been formed because the parent company feared that there might be action from the U.K. revenue authorities against captives in the near future; the organisation considered that the arrangements they had made were safer because:-

(a) a fronted undertaking would be more difficult to discover;
(b) it might be possible to defend it against a ruling that a captive insurance company was not a bona fide insurer;
(c) reinsurance captives might not be an early target for the authorities who would be more likely to take action first against the more obvious direct captives, thus giving them a few more years in business.

Some captive managers and insurance brokers interviewed mentioned that potential captive operators were increasingly expressing concern at the political risk and took the view that the majority of captives formed in the future would be reinsurance captives.

Methods of calculating rates of premium

The captive operator has two options when deciding how to calculate the premiums to be charged to the parent company:-[5]

(a) an attempt can be made to assess what rates would be charged by the conventional market for the risks involved, or

(b) rates can be based on previous loss experience, plus a loading for expenses of operation.

Market rate basis

By "market rate" is meant what would be charged to the particular company, for large organisations will be rated on previous experience to a considerable extent. At the outset of the captive

[5] See, for instance, Bannister, J.E., "The Operation and Management of Captives", op cit, p.32

enterprise the organisation will have a good idea of what the market rates for its risks are, or at least for those that have been insured if previously uninsured risks are also to be placed with the facility. There are good arguments for initially basing a captive's premiums on what has been charged by insurers previously, although some increase might be added over an earlier years figures to allow for increases that might have been required by insurers to cater for inflation and other factors. The system is simple and obviously needs little actual calculation on the part of the organisation and it will also be a safe level of premium, first because captives are usually only formed by companies whose previous insurers were making a profit on their business and second because the lower operating costs of a captive should produce a surplus. A further major advantage is that the charging of market rates makes the whole system more easily explainable to reinsurers who will obviously want to know that they are receiving a share of an adequate level of premium.

However, the estimation of the "market rate" after the captive has been in operation for a number of years will not be so easy, the risk manager will tend to lose touch with current rates for the organisation's risk and such factors as loadings for inflation, increases in operating expenses of insurance companies, higher court awards affecting liability insurance and changes in loss experience of certain industries will be difficult to gauge both generally and as they apply to the company. It is quite easy to obtain the rates of the Fire Offices Committee and certain published statistics and premiums will also be an aid, the experience of any insurance broker involved in managing the facility might be called on too; but the extent to which the company would have been able to negotiate better than average terms for good experience might still be overlooked. The result may therefore be that by following this method a company will pay more in premiums, after a few years, than it would have paid to a conventional insurer because the risk manager is conservative in the estimating of market rates, or takes insufficient account of the bargaining skills of the insurance department or of brokers that might have acted for the company.

Pure risk plus expenses basis

The alternative system of rating may, therefore, be preferred. Typically, a company following such a rating basis will estimate future losses on its experience in the last five years (possibly up to ten years for liability risks) and in order to arrive at correct premiums will add loadings to cover:-

(a) management and other expenses;
(b) an allowance for inflation;
(c) an allowance for safety;

These factors will, however, only provide a rate for risks that have been in existence in virtually the same form for the whole of the relevant time. Loadings will be required for extra hazards (such as new processes) that have arisen, or discounts might be permitted for improvements. Where completely new risks are involved the risk manager will be thrown back to using his experience to calculate the premium, or perhaps in trying to guage the market rate for the risk. In practice, such situations are unlikely to form a major part of the portfolio of risks and most

organisations involved in the study found that they have adequate histories to provide at least a base for rating most of their insurances.

This will generally be the more satisfactory approach to underwriting, provided reinsurers can be persuaded that they will receive adequate premiums for the risks transferred to them. In particular, it provides management with criteria for measuring the efficiency of the administration of the subsidiary, in that the expenses element can be readily checked with actual expenditure, that is not to say that a captive operated under the other system will not be able to use the normal methods of budgetary control, but there is the danger that costs will be lost to a certain extent where there is no specific allocation in the rating system that must be justified in advance.

However, such a system causes problems with regard to the calculation of the other loading factors, which are automatically included in the 'market rate'. The inflation factor needs to be calculated with care and one must be careful to appreciate its true nature; with property insurance, sums insured should keep pace with inflation and in theory at least

rates should be able to remain static so long as there are no other changes actually affecting the probability of loss occuring. But, particularly in times of high inflation a lag is apparent which the condition of average cannot adequately deal with, for instance a partial loss of several hundred pounds on property insured for many thousands might be paid in full, even though the loss is affected by inflation and the sum insured has not been increased, simply because of the difficulties of calculating the precise total value. Captive insurance companies are often under pressure to be more generous in settling claims than conventional insurers. If the undertaking writes liability insurance, the problem is that court awards and legal costs are constantly increasing and therefore rates (perhaps based on wages or turnover) have to be revised frequently because court awards and the factors used in rating rarely increase in line with each other; furthermore as very large liability claims are settled many years after the incident, reserves from premiums to cover outstanding claims will not be adequate if the interest earned on the reserves is less than the general increase in damages and costs.

Underwriting and tax havens

An organisation will want to have good underwriting procedures in order to achieve a degree of management control, but it can be argued that a high level of precision is not needed with off-shore captives. Should a domestic captive charge premiums that are later shown to be too high this will result in a tax liability on the surplus, but the profits of the client companies will have been correspondingly reduced and they will therefore have paid less tax in the past; however in the case of an off-shore facility there will be an actual advantage in the captive producing a surplus because the funds will have been moved from a high to a low or nil tax area. But there are several provisos.

First, it is important that underwriting practices are strict enough to ensure that the undertaking does not make a loss, as the parent company will prefer not to have to provide further capital. A loss will also mean that subsidiary company profits have been enhanced (by paying lower premiums than could have been charged) and consequently their tax liabilities will be increased.

There are also limitations preventing a captive from charging what is seen to be in excess of market rates. Subsidiary companies of decentralised organisations, which will generally have a fair degree of autonomy, will not want to pay more than what they would be charged by a conventional insurance company and will probably not be impressed by the argument that excessive premiums enhance group profits off-shore. Further, there is a danger that premiums in excess of normal commerical rates will be seen by the Inland Revenue as a form of tax evasion and the premiums would not then be allowed as a business expense

It would be unfair to suggest that most off-shore captives are principally other than bone fide insurance vehicles, but it seemed that parent companies were nonetheless alive to the advantages of manipulating the premiums. Such a vague topic cannot be quantified, but the impression gained was that the majority of off-shore captive owners were, at the least, generous in their rating calculations with a view to enhancing tax benefits.

Summary of underwriting practices

The problem of rating for captive insurance companies was found to be less pronounced in practice than had been anticipated. Table 9.4 shows the methods used by the 28 captives about which information was obtained in this respect, the reasons for the analysis system used being as follows:-

(a) Coinsurance. The six captives that operated only by participating in coinsurance schedules in respect of all or most of their business would not have to be concerned with rating because that would be done by the leading office on the schedule.

(b) Old established domestic captives. Of the seven operations formed before 1967, information on underwriting procedures was received from six; one of these was the small captive writing net lines on coinsurance schedules, but the others rated the risks presented purely on the basis of past experience. These facilities could not be considered in the same way as other captives as the length of time they had been in existence meant

Table 9.4

Analysis of the rating procedures used by 28 captive insurance companies

RATING PROCEDURES	DOMESTIC CAPTIVES	OFF-SHORE CAPTIVES
Captives involved in coinsurance schedules only, or for most classes of business, including reinsurance captives	3	3
Domestic captives formed before 1967 and rating on the parent company's own experience	5	-
Captives writing small risks only based on past experience	-	3
Other captives rating on the parent company's own experience, but with regard to the market rate	2	12

that they had acquired considerable amounts of statistical data and could be seen as being in the same position as conventional insurance companies when fixing rates.

(c) Captives only writing small risks. Three captives in the sample were only concerned with certain minor risks of the parent company; two were largely restricted to special perils and small property risks and the third provided insurance for a large number of small properties owned by the parent but did not insure its larger premises. In the first two cases the captives were virtually tax avoidance devices and they brought very little precision to their underwriting, in one of these the parent company's insurance broker was asked to estimate the amount of premium that would be required by the insurance market and in the second the respondents claimed to be following market rates. In the third case there was such a large number of small risks, over 5,000 units being involved and few having a sum insured of over £100,000, that it was quite easy for the captive to calculate accurate premiums on the basis of past experience.

(d) Captives using the parent company's previous loss experience. This group contains two of the recently formed domestic captives, the remainder being off-shore. To this number must be added two undertakings listed under the coinsurance heading which handle some business on a 100% basis. The general policy followed in all these cases was to underwrite risks according to the firm's past experience but to have regard to the market rate; it will have been noted that fire insurance dominates the activities of most of these operations and ascertaining the market rate is simplified with such business in view of the existence of the Fire Offices Committee tariff, but as the committee will provide special ratings for insured with large amounts of business who have had good past experience and such special ratings will follow individual experience, the rate obtained in the market will tend to be close to what the organisation could calculate for itself. The only variance in practice was with regard to whether a captive should allow for its lower operating costs in the rate charged to the parent, but virtually all the tax haven undertakings took the view that surpluses arising from lower operating costs should be allowed to accrue off-shore.

Risk examination and loss control

Conventional insurance companies have surveyors and techical experts on their staffs that contribute to what is usually called the "risk mangement" of their insured by:-

(a) Surveying risks newly proposed for insurance;
(b) From the surveyors reports, either requiring improvements in the risks to be made as a condition of insurance, or recommending changes for which reductions in premium could be allowed;
(c) Resurveying risks at intervals, particularly after a loss or at renewal to check that standards are being maintained and possibly to make new recommendations based on technological advances and growth of knowledge about the causes of losses.

There is little doubt that insured organisations consider the recommendations and advice of insurers to be a most valuable service, particularly in the area of property insurance. Insurers respresentatives will, for instance, be fully conversant with advances in knowledge made by such agencies as the Fire Insurers Research and Testing Organisation.

Given the high degree of expertise of insurers, a firm moving from conventional insurance to a captive might be expected to feel vulnerable in this area and indeed be prepared to concede that the new arrangements must bring a lowering in the standards of competence available. Most respondents indicated that they considered it essential to maintain the same standards of risk management as had been possible before their captives were formed and there was little evidence of complacency about the subject, however most organisations seemed convinced that the arrangements that had been made were adequate and generally the risk managers involved gave such matters a low priority of concern. A number of reasons were identified for this confident attitude:-

(a) Companies that are large enough to have captive insurance companies normally have quite sizeable insurance departments which include staff with previous experience in surveying and other aspects of physical risk management. In most cases the risk management function is heavily involved in the examination and improvement of risks as the organisations prefer to make their own improvements before being asked to do so by their insurers.

(b) In areas of high technology (and certain other specialist areas) the organisation may know far more about the processes and techniques involved than can possibly be known by insurance company personnel who must of necessity have a broad background, such knowledge may not actually be possessed by staff in the insurance department but it will be available to them.

(c) There are a number of firms that will provide risk management services for a fee and indeed a number of insurance brokers (and some other organisations) engaged in the management of captives have subsidiary companies or departments specialising in such matters.[6]

Thus, it was found that captive operators usually had available to them resources equivalent to a conventional insurance company.

In a number of cases such facilities were not in fact necessary. Where a captive is solely or predominantly writing lines on coinsurance schedules, the leading office will be responsible for such matters; in addition to the six undertakings already mentioned as being run on that

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[6] See "Risk Management", Commercial Union Risk Management Limited, London (1976) as an example of the services provided by a small number of insurance companies.

basis a further three in the sample (all of them long established domestic captives) are known to participate in coinsurance for major industrial risks. If one then adds the three undertakings only writing small risks, which cannot demand advanced risk management techniques, this gives a total of 12 of the 28 captives about which information was obtained in this respect that would not need to be over concerned about any inability to match the services of a conventional insurance company.

The companies that were involved in major industrial risks were found to be relying largely on their own resources for surveying and risk improvement. Typically, the risk manager in person was extensively involved in these areas but also had technical assistance from within the insurance department. Expert help from outside was frequently sought but in no case was that the main method of providing services to an organisation. Fronted captives are able, if it is desired, to rely on the fronting office for risk management; in the one case in the sample where a reinsurance captive was not simply writing lines on coinsurance schedules the fronting office's expertise was used

but not extensively; where employers' liability risks were fronted the insured organisations did rely on the fronting insurers to a considerable extent for accident prevention services and advice.

CHAPTER 10

REINSURANCE OF CAPTIVE INSURANCE COMPANIES

There are few features of the subject more likely to demonstrate its diverse nature than a study of the reinsurance arrangements of captive insurance companies. The research for the study revealed that, although it is possible to speak in terms of a typcial captive reinsurance programme, there are various adaptions of the normal approach and that in addition a number of operations have made entirely different arrangements.

Most captive operators interviewed took the view that the primary objective in this area was to arrange for as much business as possible to be placed through the captive; the subsidiary's managers then decide on the amount which it is able to retain (its net retention) and pass the remainder on to reinsurers under reinsurance treaties. Facultative reinsurance is very rare for captives and none of those in the sample used it to any great extent. The object of placing with the facility as much business as possible, even where substantial sums have to be reinsured, is to maximise

the use of the subsidiary and to obtain reinsurance commission. However, even this simple philosophy is not followed by all captive operators, actual procedures varying with the size of the risks involved and the objectives the owners have for the undertaking. It is to be noted that it was not found to be necessary to distinguish domestic from off-shore captives when analysing reinsurance facilities.

Typical programmes

Excess of loss treaties, where reinsurers pay the amount by which individual losses exceed a certain figure,[1] were found to be the mainstay of captive reinsurance. However, with such arrangements there is the danger that a captive faced with a large number of claims in one year will have insufficient funds to pay for those proportions of

[1]Detailed descriptions of reinsurance treaties will not be given as the information is to be found in a number of textbooks.

risks that were not passed on to reinsurers and consequently the typical captive will protect itself in addition with a stop loss treaty,[2] where reinsurers pay a proportion of the sum by which total losses in one year exceed a certain amount. For instance, the treaty might provide for the payment of 90% of the amount by which the underwriting loss ratio (i.e. the ratio of claims to premiums) exceeds a certain percentage, but it was found that most of the treaties of this type held by captives in the sample would simply pay the amount by which total claims exceed a fixed amount, with captive retentions ranging from £300,000 to £15,000,000. The latter type of treaty is in fact an aggregate excess of loss arrangement rather than a true stop loss, but for ease of reference both will be referred to as stop loss treaties.

It is normal when arranging excess of loss protection to have separate treaties for several levels (or layers) of protection, rather than one treaty with a very large upper limit. A senior executive with one of the reinsurance companies that handles a considerable amount of captive reinsurance, quoted the following as a typical

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[2] Duffy, K., in "Captives and Reinsurance", Reinsurance, June 1978, suggests that stop loss reinsurance is "particularly valuable in the early years when the captive's resources are least developed".

arrangement for a captive that wishes to retain £100,000 of every risk, where the largest exposures have estimated maximum possible losses of £10,000,000:-

1st Layer	£ 900,000	excess of £	100,000
2nd Layer	£4,000,000	" "	£1,000,000
3rd Layer	£5,000,000	" "	£5,000,000

In practice it will be wise to have considerably more than what the very largest risk would indicate is necessary, to allow for inflation and the possibility that the estimations of maximum possible losses are inadequate. The precise breakdown of the layers will depend on which combination is shown to be the most economic; most captives take the advice of specialist reinsurance brokers who will "test the market" where appropriate.

Treaties are layered in the manner described because such arrangements are cheaper than arranging a single treaty.[3] It would seem that underwriters are likely to be more generous with their rating when they are asked to quote with a substantial excess; underwriters will also write larger lines

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[3] See Barile, A.J., "Captives and Reinsurance", Reinsurance, June 1978

at higher levels thus making the cover easier to place. Such arrangements also save money by being administratively simpler; virtually all claims are eliminated by the excess retained by the captive itself, with most of what are left falling only on the first layer and it is simpler to have a few insurers involved thereon and responsible for the bulk of claims than to have a considerable number concerned with every incident.

Treatment of very large risks

The upper limits of excess of loss treaties will be determined by the largest sum which the organisation has at risk and where there are a number of exposures towards the upper limits with no very large (say upwards of £10m) single risks the captive will probably be able to arrange suitable protection simply by a series of excess of loss layers. However, where certain risks are very large, or most risks are small but there are just a few bigger exposures, more complex arrangements need to be considered.

One respondent, an insurance broker, handled the insurances of a retail organisation which had hundreds of shops with exposures in the order of £100,000 and just a few warehouses with several million pounds at risk. In considering the reinsurance of a captive for its clients the broker would not want to arrange a reinsurance programme based on the largest risks when the vast majority of exposures will come within the first layer and indeed many will not even exceed the captive's own retention.

In other cases, where single risks are very large (particularly with hazardous properties), the captive managers might encounter capacity problems in getting all the excess cover required placed.

In such situations it is quite common for the larger risks to be taken out of the excess of loss programme and to be placed in the direct market on a co-insurance basis, with the captive taking a line on the schedule. It would seem that few insurers have any objections to appearing on the same schedule as a captive insurance company and indeed one respondent claimed that it had helped to place the business as the organisation was seen by the

insurance market as showing confidence in its own risks by taking a large line. However, it is not normal for a captive to lead a schedule and the broker will need to find a good lead in the normal way.

A further alternative would be for the whole of the larger risks to be placed in the direct market, with no involvement from the captive, there would however seem to be little point in such an approach if the organisation is endeavouring to place as much business as possible with the subsidiary. It is not uncommon for companies with captives to attempt to place what they consider to be the poorest risks in their portfolios with the conventional market, leaving the captives with only the better insurances, such moves will almost certainly be resisted if discovered as insurers would naturally wish to obtain a fair share of the good risks if it is to be asked to insure the poor ones.

Less common arrangements

Detailed information about reinsurance programmes was obtained from 26 of the 33 captives in the sample and the data is summarised in Table 10.1. 11 of the undertakings had what has been described as a typical programme, excepting that four of these had excess of loss treaties without the additional stop loss protection and one had special arrangements for marine risks and excess of loss for the remainder.

Quota Share treaties

Four captives had quota share treaties (where a fixed proportion of every risk is reinsured), combined with excess of loss facilities. One of these undertakings only wished to retain £25,000 on certain risks and had arranged excess of loss reinsurance for losses above £100,000 and an underlying 75% quota share, thus raising the lower limits of the excess of loss cover, as excess of loss reinsurance is more economical and more easily obtained at higher levels. Another took part in a reinsurance pool of the type described at the end of the chapter. The other two (both domestic captives) had complex arrangements of various types of treaty.

Table 10.1

Summary of reinsurance arrangements of 26 captive insurance companies

TYPE	NO OF COMPANIES.
Excess of Loss and Stop Loss	6
Excess of Loss only	4
Quota Share and Excess of Loss	2
Stop Loss only	3
Other[1]	5
None	6

[1]The following summarises the remaining companies:-

(1) Two had a series of quota share, surplus and excess of loss treaties, with arrangements varying for each class of business.

(2) One wrote net lines on coinsurance schedules for marine risks and had an excess of loss treaty for the remainder

(3) One had a fronting arrangement for marine risks and the remainder was retained 100%

(4) One had a fronting arrangement for employers liability risks and the remainder was retained 100%

Stop loss only facilities

A further three captives relied solely on stop loss treaties. In once case a very large domestic captive (by far the largest of all the captives in the sample) had a treaty which operated from the level of £15,000,000; the other two (also domestic undertakings but much smaller) had stop loss figures of £750,000 and £300,000.

Where there is little risk of a captive being put into difficulties by a single large claim, either by virtue of the size of the undertaking or because it only accepts insurances within its general capabilities, the subsidiary only needs reinsurance to protect it from the possibility of total claims in any one year exceeding a certain level. This would seem to be the position with the three captives in question, although one of the two smaller undertakings appeared to be a particularly special case - reference had to be made to the file at Companies House for information and although not completely clear it suggested that reinsurance arrangements had been made with a "connected" company, that is one with similar ownership to the captive.

Captives without reinsurance

Reference was made in Chapter 10 to captives that were restricted to writing net lines on coinsurance schedules and to others that only undertook small risks; six of these captives operated without any reinsurance facilities and a further undertaking was in a similar position excepting that it had fronting arrangements for employers' liability risks.

The captive shown as having fronting facilities for marine risks with other insurances retained 100% was in a different position to the seven undertakings above as the fronting office ceded only 50% of risks to the captive (a very low percentage for fronting in the normal sense) and the arrangement can be more accurately seen as a quota share facility.

Calculation of net retentions of captives and parent company deductibles

An important part of a captive insurance company's reinsurance strategy concerns the amount of any risk which the subsidiary retains before reinsurance, the prime consideration being the retaining of as much premium as possible, conducive with the safety of the enterprise.

A conventional insurance company of the size of the average captive would only retain modest amounts, but the practice of most companies with captives is to incorporate its own deductible into the captives net retention, thereby enhancing the amount retained considerably. Thus, in terms of its actual insurances the insured company will not have a deductible (or at the most a small one) which would seem to conflict with the commonly held notion that large organisations do not need to be insured for other than major losses, however, a "deductible" in the form of a captive's retention is still in essence retained within the organisation and the savings in administration that are one of the main arguments for large deductibles will still accrue. Far more important however is the fact that

the larger premiums charged by a captive (where the insured company does not have a deductible) will be allowed as a business expense for tax purposes and will enhance the funds held off-shore, whereas any savings in premium arising from the insured organisation having a deductible, which are not expended on losses, will result in a liability for tax; this advantage does of course only arise with off-shore undertakings.

Despite a slight tax disadvantage it would still, however, be inappropriate for a captive to be involved in claims of a very modest amount and usually the insured company will carry a small deductible, perhaps hundreds or a few thousands of pounds depending on the organisation, in order to eliminate the trouble and expense of dealing with small losses.

A captive's retention can, therefore, be seen as being in two parts:-

(a) the deductible which the organisation would have carried had it been able to obtain reasonable terms from a conventional insurer;

(b) the amount which the undertaking is able to retain before reinsurance, calculated in the same way as it would be by a conventional insurance company.

As the retentions of small insurers are only modest the above will be virtually the same as saying that the captive's retention will be at the same level as the organisation's deductible. There is a danger, however, in merely looking at the insured company when determining retentions, for although the captive remains a part of the parent enterprise it will normally be expected to remain solvent within itself and therefore needs to consider retentions not in terms of its parent's resources but with regard to its own income, capital and (once established) accumulated reserves. The effect will be to seriously limit retentions unless the parent company puts in a substantial amount of capital, which it may not be able to afford, or is prepared to produce further capital in the event of insolvency caused by retentions being higher than might be prudent, which is usually out of the question and would tend to defeat the object of a captive which will presumeably be to pay for insured losses from it own resources when they occur.

If a captive is to be soundly run, therefore, it must be provided with a good level of capital on formation, but will probably initially have to retain less than the organisation could carry as a deductible and will only be able to increase retentions as reserves grow. Where that is not done (which seemed to be the case with some captives) it can be argued that the undertaking is not financially sound and that the owners might have to contribute should a serious loss occur - this is simply a value judgement that organisations have to make. Such matters will, however, only have a serious effect upon the feasibility of a captive where the portfolio of risks has a high proportion of large exposures; where there are a good number of risks with small sums insured the amount of premium which can be safely retained (which is the main factor for feasibility) will be higher.

One authority on captive insurance has produced criteria for measuring the amount which an undertaking can safely retain.[4] He suggests that retentions should

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[4] Kiln, R.J., "New Insurance Methods in the Field of Risk Management", Papers in Risk Management No. 1, Keith Shipton Developments Ltd., London (1974)

not exceed 15% of capital and not more than 50% of annual premiums; in the paper quoted the discussion is largely on new enterprises, hence the reference to capital, but for established enterprises free assets (i.e. captial and undistributed profits) would be the measure to use. The senior reinsurance manager mentioned earlier took the view that it would be safe for a captive to have a retention of 20% of free assets, particularly if that meant that the retention would only be a small proportion of premiums.

Table 10.2 details the years of formation, capital, premium income, net retentions and (where available) free assets of the 26 captive insurance companies in the sample from which details of reinsurances were obtained. There are some exceptions, but generally the undertakings are being run well within the limits mentioned above; as far as could be ascertained all the captives where free assets are not shown had made profits since incorporation and it can be assumed that in most cases free assets considerably exceed share capitals, but it would seem that captive managers are tending to fix retentions according to income levels rather than capital or assets.

Table 10.2

Showing capital, premiums net of reinsurance, largest net retentions on any one risk and free assets, all relevant to the last available financial years, with years of formation of 26 captive insurance companies.

Capital £000s	Net Premiums £000s	Net[1] Retentions £000s	Free Assets £000s	Years of Formation
5,000	19,300	15,000[2]	24,200	1920
1,000	6,500	200	7,700	1926
500	1,500	500	500*	1975
500	200	70	600	1976
500	Not known	Not known	Not known*	1975
250	2,000	Not known	280	1973
250	1,100	250	Not known*	1975
250	1,000	1,000	Not known*	1976
250	500	300[2]	1,150	1965
250	250	100	580*	1973
250	100	50	Not known*	1975
250	Not known	50	Not known*	1975
210	700	120	4,650	1928
200	750	50	1,900*	1974
200	170	100	310*	1972
200	140	Not known	390	1971
150	760	750[2]	590	1972
100	5,250	1,000	5,050	1937
100	1,500	100	Not known*	1970
100	1,250	350	Not known*	1972
100	900	125	Not known	1945
60	2,000	2,000[3]	Not known	1973
50	450	50	460*	1972
50	350	50	Not known*	1971
50	300	75	Not known*	1971
(£100)	25	5	85	1946

Notes [1]In cases where the captives have no reinsurance the largest risks which the undertakings insure are shown

[2]These are stop loss retentions and cannot be considered in the same way as the others

[3]This retention is the maximum amount that the captive guarantees to pay the parent company in respect of any one loss, the subsidiary has no reinsurance

* Off-shore undertakings

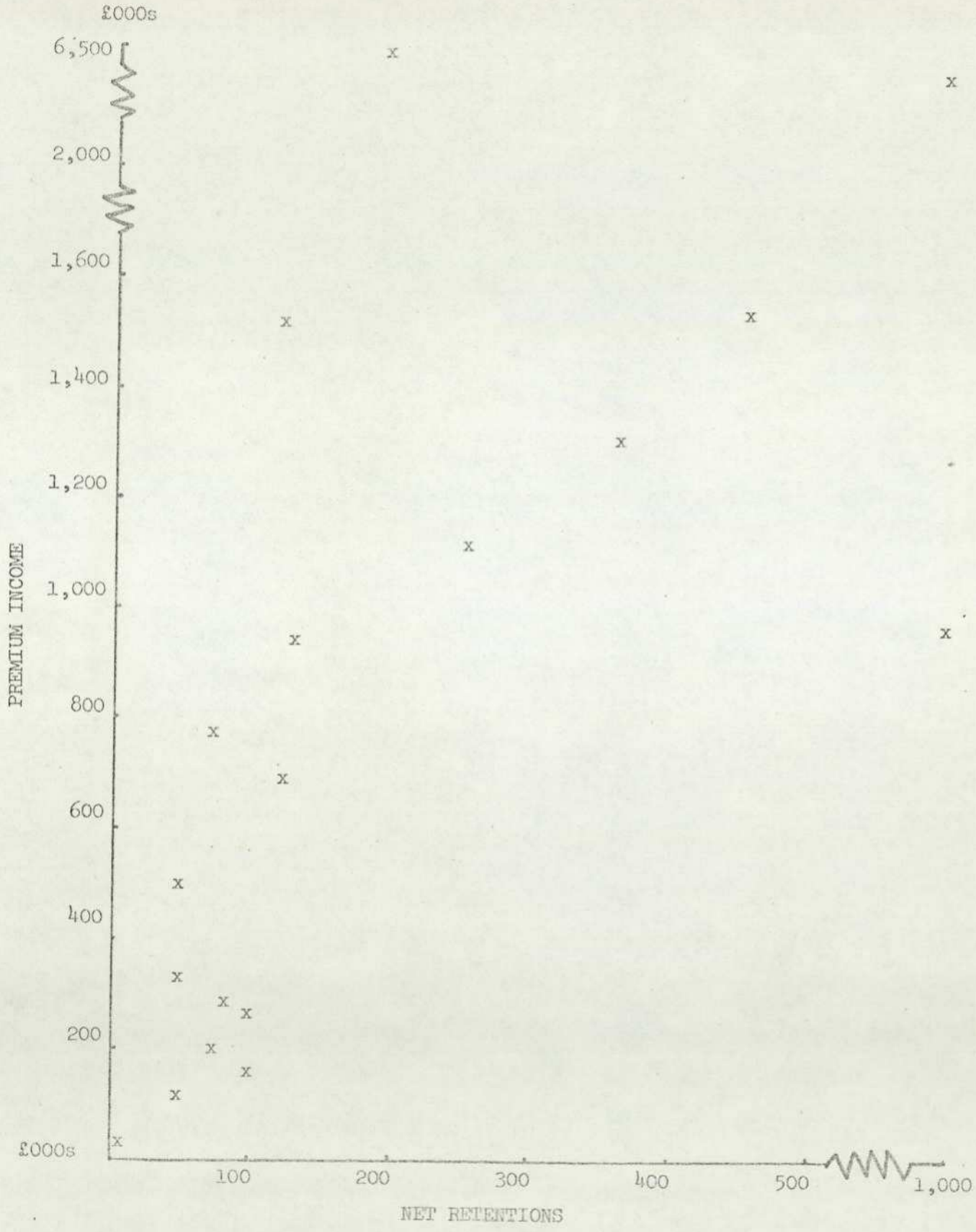
Analysis of relationships between net retentions and other variables

In order to ensure that the same method of calculation was applied in each case, it was necessary to calculate free assets from accounts supplied by respondents or in the case of domestic captives from files at Companies House. However, it proved to be difficult to obtain the accounts of off-shore undertakings and except in five cases all the data in that respect applies to domestic captives, detailed analysis of the relationship of assets to other variables would therefore have only been possible for the domestic group and was not attempted.

With regard to capital and premium income, one would expect to find positive relationships between those variables and net retentions, but the retentions of the three captives which only had stop loss reinsurance and the undertaking guaranteeing losses up to £2m bear no relation to the others and had to be eliminated from the analysis. For the remainder, a two-dimensional scatter diagram between variables for net retention and premium income in Table 10.3 confirms that a positive relationship

Table 10.3

Scatter diagram showing the relationship between premiums net of reinsurance and net retentions of 18 captive insurance companies



exists, although the degree of fit is not high. To ascertain whether the degree of relationship is significant a linear regression between the two variables was fitted, with retention levels as the dependent variable. The parameters of α and β were estimated to be:-

$$Y_i = 13.44 + .086\ x_i$$

The standard error of β was .044 and hence the parameter β was significant at the 90% level applying the t-test. The overall fit of the regression as measured by the coefficient of determination (R^2) was 0.21. This shows that the equation fit is not high, but one would not on theoretical grounds expect it to be so, as inter-company variations in the size and type of exposure are likely, among other variables, to significantly affect retention levels for a given net premium size.

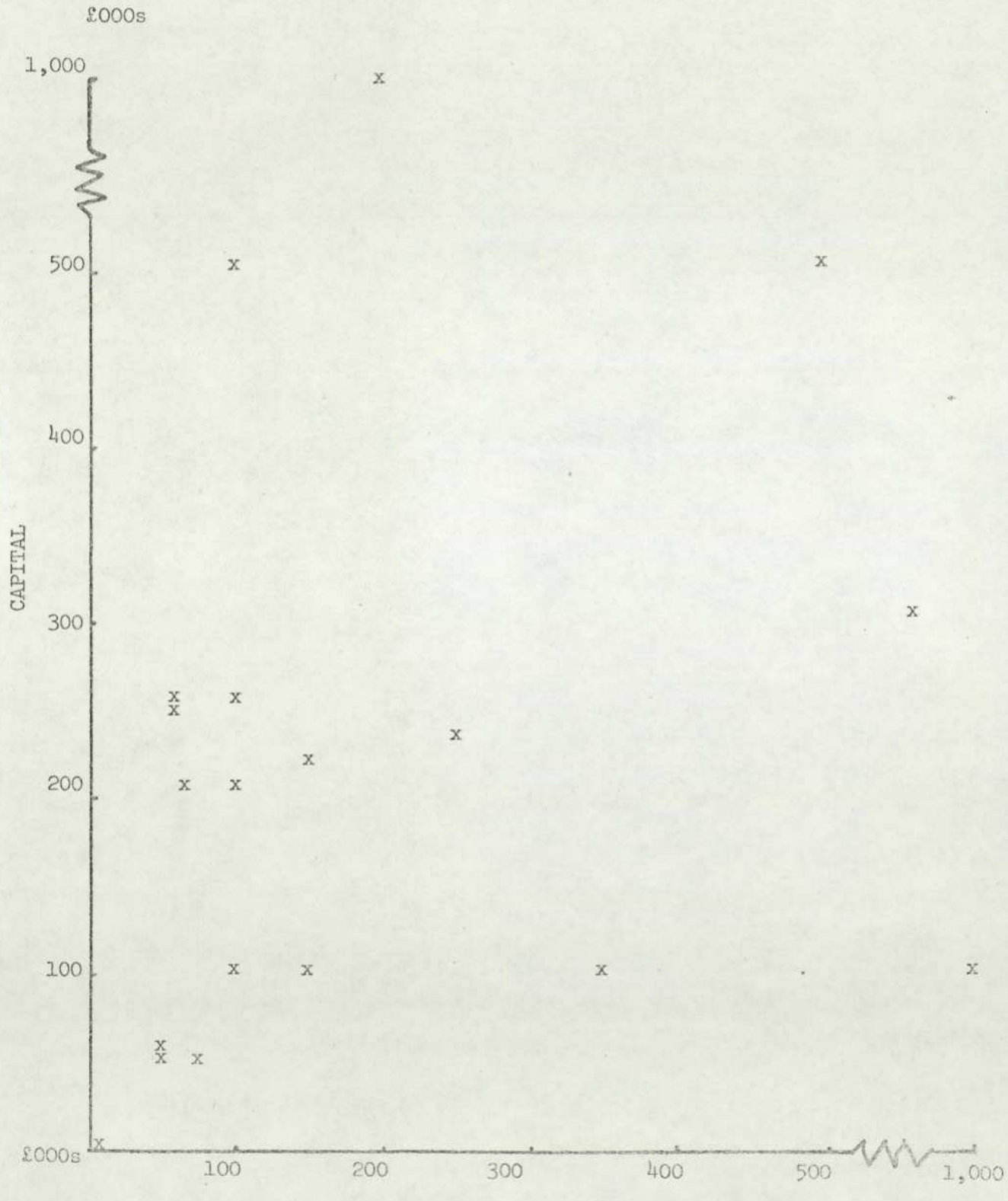
Unpublished work by F.E. Guaschi of the Mercantile & General Reinsurance Company, investigating the relationship between net retention levels and net premiums of insurance companies found the relationship to be positive but non-linear; the larger the

insurance company the higher was its retention level, but with the retention level increasing at a decreasing rate. To ascertain whether such a relationship existed for the captive insurance companies in the sample, the Durbin-Watson statistic was applied to the residuals of the regression. This gave a value of approximately 1.9, implying no significant non-linearity.

The two-dimensional scatter diagram between the variables for net retention and capital in Table 10.4 shows that there is no significant correlation between them. However, it was considered interesting to ascertain whether the capital of captive insurance companies together with net premiums provided a greater explanation of variations in retention levels. A multiple regression of the following form was applied:-

Table 10.4

Scatter diagram showing the relationship between premiums net of reinsurance and capital of 19 captive insurance companies



$$Y_i = \alpha + \beta_1 x_i + {}_2 z_i \beta + e_1$$

Where Y_i = net retention level for i^{th} company

x_i = net premiums " " "

z_i = capital " " "

Assuming: Var $(e_{i)} = C$

Correlation $(e_i\ e_j) = 0$

Parameters β_1 and β_2 were estimated simultaneously as .0617[5] and .0499. Application of t-tests indicated that both variables were significant at the 90% level and positive. The overall fit of regression (R^2) was increased from .21 to .28 by the addition of z. It would have been appropriate to estimate the significance of these explanatory variables by controlling for other variables which might affect retention levels, such as size and type of risk insured, the type of industry of the parent company and the size of the parent, but such analysis was not considered to be central to the main theme of the study.

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[5] The value of β_1 is slightly lower than in the simple regression because of the multicollinearity between variables x and z.

The placing of Captive Reinsurance

Such is the importance of reinsurance to captives that it is probably no coincidence that the growth in their popularity occurred side-by-side with a gradual acceptance of them as a proper subject for the main reinsurance markets of the world. As far as British captive operators are concerned, those that formed domestic captives in the 1920s and 1930s experienced few reinsurance problems because of their own high renown, but the pioneers of off-shore facilities had to go to considerable lengths to place reinsurance around the world and there is no doubt that for some time many of the most respectable reinsurance companies were opposed to the whole concept. The specialist reinsurers, which have throughout shown their traditional pioneering approach in comparison to the direct companies, were gradually persuaded into the arena until today there can be hardly a single reinsurance company of any note that is not involved. Certain Lloyd's underwriters were early in accepting captive reinsurance and that market also now plays a major role. More recently a number of direct insurance companies have begun to participate through their reinsurance departments and there is now the situation where insurers accept lines on reinsurance treaties on terms that direct underwriters

in the same company would not accept and where the public attitude of the organisation is total opposition to captives, it has even been suggested[6] that the willingness of some insurance companies to be involved in captive reinsurance approaches that of recklessness.

However, it must not be assumed that the reinsurance of a captive insurance company is easy to place, for although many are heavily involved, reinsurers have very good reasons for taking a rather reserved line on the subject. To the reinsurance market captive business is of only a minor nature and the treaties of a single captive of little significance; it relies on the conventional market for the bulk of its business and although the Lloyd's underwriters concerned are somewhat immune the reinsurance companies will obviously not want to appear over enthusiastic about captives, given the quite natural dislike of them by their major customers. Of more importance, possibly, is the nature of captive insurance and the particular problems it brings to the reinsurers; they will prefer to deal with established customers whose well trained and highly experienced staff they know and trust, whereas with a captive (even if it has been in business some years)

[6] Kiln, R.J., op cit.

the reinsurer often finds itself virtually in the position of a direct excess of loss insurer having to satisfy itself as to risk management procedures, underwriting bases and so on, which are matters which a reinsurer is not geared to dealing with. If the undertaking is only recently formed the business will need particularly close attention, as would any new insurance company, excepting that in the case of a conventional office the staff are likely to have had more immediate relevant experience (being hired from other offices) than the average risk manager who is placed in control of a captive insurance company.

There are a few advantages to reinsuring captives over conventional insurance companies however. The captive will approach the reinsurers with a known portfolio of risks and will be able to produce loss experience to prove that its rates are adequate, consequently reinsurers will not be in the "blank cheque" situation which arises with most of their business. Also, a captive will usually have retentions in excess of the levels of many insurance companies, which the reinsurers will prefer and as only those companies with good loss records tend to form captives the business will usually be good

business. Furthermore, there is the advantage that the insured is in essence retaining for itself large amounts of the risk, which is one of the best guarantees that it will act reasonably and pay due attention to risk management.

Broking procedures

A small captive might be able to fulfill all its reinsurance needs by approaching just one reinsurance company, but it is normal for more than one office to be involved and although that does not preclude the captive management making its own arrangements it is usual to engage a specialist reinsurance broker for these purposes. A broker will, of course, always be needed for access to the Lloyd's market.

Those companies and underwriters that have some experience in captive reinsurance are usually open to approaches aimed at establishing the type of protection that will be most beneficial for a particular undertaking. In the case of a new operation it is normal to make contact with potential reinsurers at the feasibility study stage or at least soon after the decision to form a captive is made. The procedure for obtaining quotations will be simpler where a captive has been in business for

some years and the management has proved itself, but the following are the main areas on which the terms and rates will be assessed and which will need to be produced:-

(a) Loss experience over a reasonable period of time - at least five years;
(b) Details of the main risks and the estimations of maximum possible losses;
(c) Information on the perils to be insured, reinsurers will be reluctant to take that part of a portfolio which contains perils that are not generally insurable;
(d) Explanations of rating structures.

In some cases the captive or its broker will have definite ideas on the level of the subsidiary's retentions and the type of reinsurance programme required, but in others will approach reinsurers for advice on the technicalities and to obtain various quotations before making a decision. Most of those involved seem to prefer a flexible approach so that the programme can finally be formed in the light of views expressed by reinsurers.

Reinsurance Pools

Discussions with reinsurers revealed that a number of specialist agencies and insurance broking firms, engaged in the management of captives, have formed reinsurance pools for the undertakings they manage.[7] These can have considerable advantages in that the protection is readily available when a captive is formed (although there is usually a provision requiring new entrants to be approved by leading reinsurers) and the bulk procedure leads to better terms being obtained than could be arranged by a single captive. The pool also gives something of a guarantee of cover continuing to be available should a single captive suffer very poor underwriting experience, as reinsurers will tend to look at the pool as a whole.

Reinsurance pools are generally only open to captives actually being managed by the organisation that has formed the pool and one management company will not admit a captive to its pool (even if it is managing it) unless the risk management services of the insured organisation is also contracted to the managers. The pools are also mainly based in Bermuda. These factors explain why only a minority of the

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[7] One captive pool in Bermuda has been in operation since the late 1950s - see "Captives", Policy Holder Insurance Journal, op cit, p.509

captives in the sample were involved with such arrangements, as self-managed undertakings (including all the domestic captives) would not be eligible and Guernsey based captives might not have the facilities available to them.

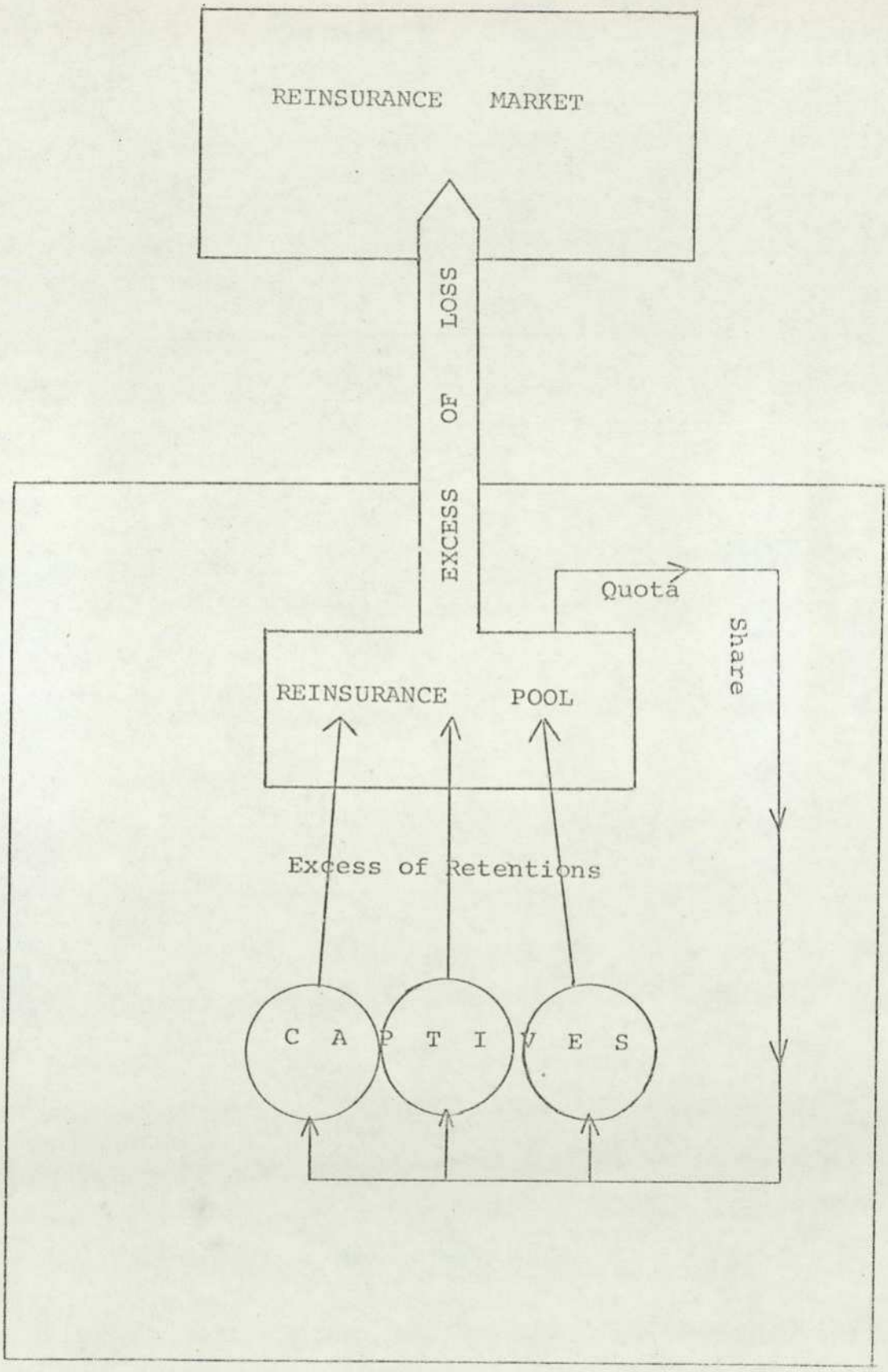
Reinsurance pools are basically of two types, there are those where each captive participates in the reinsuring of the other captives (participating pools) and those where the pool is in reality simply an agency arrangement, which places reinsurance for each captive it has under pre-arranged contracts (non-participating pools). One of the Bermuda based captives in the sample was a member of a participating pool; as far as could be ascertained the other managed Bermudian undertakings all had reinsurance arrangements through their managers, which in varying degrees amounted to non-participating pools.

Participating pools

Described here (and diagramatically in figure 10.5) is a typical participating reinsurance pool.

Figure 10.5

The operation of a typical captive reinsurance pool.



The large box represents the sphere of operation of the management company.

Each captive fixes its retention and places all the surplus with the pool. The first stage of the programme is a quota share treaty covering the whole of the pool, but in which only the captives participate. Thus the participants begin by sharing their risks with each other, which increases their income and reduces the pool's reliance on the reinsurance market.

Excess of loss reinsurance for the whole of the pool, is arranged in the market following the normal system of layers, the purpose of that cover being to:-

(a) protect the participants in the quota share arrangement from catastrophe loss;
(b) enable the captives to safely write larger shares of the quota share treaty.

New captives can be admitted into the arrangements at any time and the participants will rely on the managers to ensure that each new entrant is sound; there is also a requirement that new companies must be approved by the leading reinsurers on the excess of loss treaties.

It can be seen that the larger the pool the greater will be the benefit to the participants, in being able to achieve greater savings in administration and probably better and more secure reinsurance terms.

CONCLUSIONS

CHAPTER 11

CLASSIFICATION OF CAPTIVE INSURANCE COMPANIES AND CASE STUDIES

The purpose of this chapter is to present a classification system that will cater for most types of captive insurance company that are operated by British industrial organisations and then to provide a case study of a typical undertaking in each class. However, there are considerable difficulties involved in compiling such a system as there is quite a variety of captive companies in existence and given that only 33 were revealed by the study, too complex a classification system would result in there being a lot of groups each with very few memebers. The system proposed will not therefore deal with all the complexities of captive insurance company operations, but will serve as a method of conceptualising what are considered to be the main methods of operation; it concentrates on domicile rather than methods of obtaining business (i.e. pure captives, open market operations etc.) as the former provides more easily discernible criteria.

Basically, captive insurance companies owned by British companies can be divided into two groups - the first

contains those old established operations which are considered to be a part (if on the periphery) of the conventional insurance market; they are all domiciled in either England or Scotland and were formed between 1920 and 1945. The second group consists of the more recently formed captives, all have been established since 1965 and most have been formed in tax havens. However, a classification of this simplicity would be unsatisfactory as it would ignore the following points:-

(a) The captives formed more recently to be operated in this country have more in common with the old domestic captives than the off-shore type. In many cases the motives for recent domestic captives have been similar to those for the off-shore variety (market attitude to deductibles, savings on insurers costs, problems with capacity and uninsurable risks and the like), but the method chosen to deal with the problems is so significantly different that it warrants separate attention in a classification system.

(b) There are wide differences between captives in some off-shore territories compared with others. In particular, captives within the Scheduled

> Territories differ in many respects with those outside it and there is the problem of dealing with those undertakings that are domiciled within the Territories but are managed elsewhere.

Thus, a classification system should take into account the distinction between "traditional and old" and "modern" captives, but should concentrate on those aspects that distinguish the domiciliary features. The following system of two broad categories, with sub-divisions, meets both these needs.

Category One - Domestic Captive Insurance Companies

There are good grounds for considering all domestic captives to be part of a single main category, as although the recently formed are often quite different as regards original motivation and approach it appears that they are becoming more like conventional insurers and the traditional captives as time passes and that consequently what differences do now exist will be shown to be features of their present comparative "youth" rather than any fundamental difference in operation.

However, it is necessary at the present time to make

some distinction between the older and newer undertakings and therefore within the bounds of a single class two sub-divisions would seem appropriate:-

Category 1 (a) - Traditional Domestic Captives

Six captive insurance companies domiciled in this country were formed before 1946. Apart from the question of age, the distinguishing features are that captives of this type are more likely to be involved in open market operations and to write motor third party and other liability business than the more recently formed facilities.

Category 1 (b) - Modern Domestic Captives

Four captive insurance companies have been formed in this country since 1970; another was established in 1965 and although it could be more properly considered as falling somewhere between the two sub-divisions, it is placed here because it displays more modern than traditional features.

These captives are smaller, in terms of premium income, than the average traditional captive. This can be partly explained by the fact that the operators

of the older type are often much larger than the companies that have recently formed captives, but the latter also, on average, place a smaller proportion of their insurances with the subsidiaries.

Category Two - Off-Shore Captive Insurance Companies

There are also good grounds for grouping all off-shore captive insurance companies into one overall category, as there are considerable similarities as regards motivation, management and attitude regardless of the actual domicile. In essence, companies establishing off-shore captives have gone to the territory able to provide the maximum tax advantage at the time, provided a good level of management expertise existed; changes in attitudes to location have arisen not out of choice but as a result of legislation. However, it is necessary to distinguish between captives in the Scheduled Territories and those elsewhere and to take into account non-resident possibilities.

Category 2 (a) - Non-Scheduled Territories Captives

12 captives in the sample fall into this category, being formed either before the retraction of the

Sterling Area in 1972 or because the parent company was able to move funds to a tax haven from another country outside the Scheduled Territories; however only two of the 12 mentioned had been established since 1972. In addition to having their own captives in this category, two of the 12 companies were members of Oil Insurance Limited.

10 of the 12 undertakings were operated from Bermuda, one was in the Bahamas and the other resident in France.

Category 2 (b) - Resident Scheduled Territories Captives

Six of the companies covered by the study had set up captive insurance companies in Scheduled Territories tax havens and managed them as resident subsidiaries, thus making them liable for local income tax. Five of the undertakings were operated from Guernsey and the other from Gibraltar.

Category 2 (c) - Non-Resident Scheduled Territories Captives

Three companies were found to have established captives

in Guernsey as non-resident companies which were managed from Bermuda, thus escaping local taxation. It is not yet clear what the companies concerned plan to do following the decision of the Guernsey authorities to no longer allow insurance companies to operate as non-residents.[1]

Case Studies

In selecting case studies for each category, regard was given to the need to present undertakings that were typical of those in that category, however it was also thought to be appropriate for the whole selection to give an overall view and to include unusual features where this could be done without distorting the image of a class. Where, therefore, a captive does have characteristics that are not typical these are indicated in the main text. Information has been approximated where it would tend to identify the organisation concerned, in order to honour the pledge of confidentiality given to respondents.

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[1] Their future is also uncertain following the abandonment of exchange controls in 1979.

Case Study in Category 1 (a)

Parent Company: CSO Industrial Group: Chemicals

Turnover in last financial year: Over £1,000,000,000 (1976)

Captive

Founded: 1930s

Capital: £100,000

Premium Income in last financial year: £5,250,000 (1976)

Free assets at end of last financial year: £6,470,000

Risks Insured

This organisation originally formed its captive to write motor business, including third party, but it was gradually developed to write all classes of insurance. It is able to take 100% of the organisation's motor, liability and certain other risks (such as fidelity guarantee) and also handles certain marine risks; as regards fire material damage and consequential loss the captive usually takes a line on co-insurance schedules.

The captive's use is not, however, compulsory and the respondent indicated that the first choice is to insure conventionally, risks only being insured with the captive where it is able to accept them at lower rates than other insurers. Reasons given for the captive being able to undercut the market on occasions included the saving on operating costs,

particularly where there were large numbers of small losses, rates being increased because of poor experience in other companies of the same type and the retention of insurers profit and investment income. It was also stated that the subsidiary was sometimes used where the market would not provide the form of cover required for certain risks.

The company tends to insure (mostly with the captive) small risks that could be carried without insurance, merely for the purposes of administration and control. Deductibles of up to £50,000 are sometimes carried however, but that does not occur where a line is taken on a scheduled risk as the company's deductible would be seen as a part of the acceptance on the collective policy.

The captive does not insure risks outside the organisation, neither directly nor by way of re-insurance. This was not found to be typical of captives in this class, a number accept inwards re-insurance and a few direct business.

Administration

The subsidiary is run as an integral part of the

parent company's insurance department, with the firm's insurance manager holding a senior appointment in the management structure of the captive. It has its own underwriting and claims staff, but relies on the parent company for investment expertise.

The respondent stated that the organisation had experienced only a few difficulties with the Department of Trade, although the extent of supervision had increased very considerably since the captive's formation. Until quite recently the authorities had granted exemptions from some of the reporting requirements, but they now had to make the same full returns as any other insurance company; this had meant more work but the overall effect was slight.

Reinsurance and Retentions

The captive has a series of excess of loss treaties for various classes of business.

Fire business is generally written net, with the maximum retained on any one risk being limited to £1,000,000.

Case Study in Category 1 (b)

Parent Company: CSO Industrial Group: Manufacturing
Turnover in last financial year:
£300,000,000 (1976)

Captive: Founded: 1970s
Capital: £150,000
Premium Income in last financial year: £760,000 (1976)
Free assets at end of last financial year: £200,000.

Motivation

The original move to consider some form of captive insurance was caused by what were considered to be high fire insurance premiums, for the claims experience of the organisation. It was decided that the firm could carry a proportion of its fire material damage and consequential loss risks with considerable advantage and that the best way to arrange it was to float an insurance company as a subsidiary.

Risks Insured

Having decided to establish a captive basically to deal with fire risks it was found to be possible for the facility to handle, in addition, a large proportion of the parent organisation's marine cargo insurance (which because of the nature of the cargo had been difficult to insure adequately) and (subject to reinsurance) all of the liability risks of the enterprise.

Administration

The parent group had a dormant company which was re-constituted as an insurance company, being structured as a mutual association of the parent company and its subsidiaries. This arrangement is not typical being the only example of a mutual captive in this country. Because it is a mutual insurer the captive can only insure the risks of its members, but pays no tax on retained profits although it is liable for corporation tax on investment income.

At the formation stage the company seems to have had only few problems with the Department of Trade. Negotiations lasted for seven months and following

the necessary amendments to the memorandum and articles of the dormant subsidiary, authorisation was eventually gained within nine months of the initial approach to the authorities.

The organisation had seriously considered incorporating its captive in a tax haven, but was not convinced that substantial benefit would accrue from so doing; in fact apart from paying tax on investment income the captive as it is now operated is not at a disadvantage compared with an off-shore captive and has none of the costs of operating in expensive tax havens.

The captive has expanded quite rapidly since its formation, with premiums more than doubled in the last three years, although this seems to be largely due to growth in the business and inflation generally rather than greater use of the subsidiary, the only major piece of new business being a share of the insurance on one of the company's plants in Europe. The company suffered a serious fire nearly two years ago, the captive's share amounting to £120,000 and although this substantially reduced the reserves of the undertaking it remained solvent.

Half of the assets of the captive are kept within the

operations of the parent company, the subsidiary being credited with interest at bank deposit rates; the remainder is invested externally, mainly in short term corporation bonds.

Reinsurance and Retentions

The captive takes 15% of the fire material damage and consequential loss schedules and 40% of the marine cargo risks (in the latter case only, limited to £30,000 any one risk) with liability risks limited to £30,000 any one claim.

For fire business there is a stop loss treaty which limits total losses to £750,000 per annum. There are no treaties for marine cargo as the 40% retention is considered to be a net line. With regard to liability business, another insurer issues the policies (and the certificate under the Employers' Liability (Compulsory Insurance) Act), with the captive agreeing to pay the first £30,000 of every claim - this arrangement was necessary to satisfy the Department of Trade. There is an agreement that the captive will handle all claims below the excess level and what few claims there have been above that figure have been handled by the captive's lawyers with the insurers consent.

Case Study in Category 2 (a)

Parent Company: CSO Industrial Group: Engineering
Turnover in last financial year:
£675,000,000 (1976)

Captive
Founded: 1972 (Pre-June)
Domicile: Bermuda
Capital: £50,000
Premium Income in last financial year: £450,000 (1975)
Free assests at end of last financial year: £456,000

The capital base of £50,000 cannot be considered as typical for this category, although it was a quite common figure in 1972. Undertakings formed more recently have usually had capital in the range of £250,000 to £500,000.

Motivation

The company was drawn to considerting the possibilities of a captive insurance company by the prospect of

saving money on its insurance expenditure. The respondent stated that the company had not been influenced by the possibility of building up reserves in a tax haven and gave attitudes of the insurance market to deductibles and policy wordings, the general inflexibility of conventional insurers and the saving on costs, insurers profit and investment income as the main factors influencing their decision.

Risks Insured

The organisation sees the captive facility as an alternative to conventional insurance, the latter being used where it is considered to be beneficial - this explains why the captive handles less than half of the organisation's £1,750,000 expenditure on insurance. The captive writes fire material damage and consequential loss, but where risks are very large they are insured in the conventional market; it also writes special perils, theft, plate glass, motor accidental damage and goods in transit insurances. Liability business is not placed with the facility.

Administration

The original decision to look at captive insurance

companies was made by the company itself, their brokers were approached and they suggested the appointment of one of the smaller firms of consultants in Bermuda to conduct a feasibility study. The captive was eventually formed by and is now run by that consultant, the actual formation procedures having been completed shortly before the retraction of the Sterling Area. The consultant handles all aspects of the management of the subsidiary in Bermuda, except for investment which is controlled by separate advisors; most of the captive's assets are kept on short term deposit.

The respondent stressed that one effect of the use of captive insurance techniques was to increase the amount of risk assessment carried out by the company, there being more questioning than before as to whether insurance was necessary in particular cases.

Reinsurance and Retentions

The captive has quota share and excess of loss treaties, with losses limited to £25,000, except for fire risks where the limit is £50,000. The treaties are placed in the London market with a major reinsurance company leading.

Case Study in Category 2 (b)

Parent Company: CSO Industrial Group: Food, Drink and Tobacco
Turnover in last financial year: £800,000,000 (1976)

Captive: Founded: 1970
Domicile: Gibraltar
Capital: £100,000
Premium Income in last financial year: £1,500,000 (1976)
Free assets at end of last financial year: Not known

The domicile of this captive is not typical, being the only Scheduled Territories captive in the sample that is not established in Guernsey.

Motivation

The company has a few very large operating sites and a great number of small units all over the country and conventional insurers were consistently making profits on the insurances of the small premises, experience being highly predictable from year to

year because of the large numbers and the wide spread of risk. The organisation saw that by self-insuring it would retain the profits and also be able to achieve savings on the insurers operating costs, but for tax reasons a corporate form was to be preferred. A further factor concerned loss control; a large number of the risks were in the London area and insurers were becoming increasingly strict about theft precautions and even in the 1960s were moving towards insisting on burglar alarms on most of the company's London premises; such precautions were not thought to be necessary but the company was going to have to operate without insurance, or make its own arrangements, in order to prove its point.

Risks Insured

The captive insures the fire, special perils and theft risks of the small premises, with all other insurances being placed conventionally - the captive does not insure liability risks. Despite these restrictions the income of the subsidiary represents half of the total insurance expenditure of the parent organisation.

Administration

The captive charges a flat premium for each premises; this compares with the complicated rating structures that insurers would normally apply. The respondent indicated that the rates charged are much lower than those prevailing in the insurance market, but the loss ratio is currently below 15% of premiums.

All survey, risk improvement and claims work is handled within the insurance department of the parent organisation. Management in Gibraltar is conducted by a firm of accountants who are responsible for the investment of funds in addition to general administration. Gibraltar was originally chosen because the company had existing connections there.

Reinsurance and Retentions

The captive has no reinsurance, the risks involved being small enough to be accepted 100%, given the spread of risk and the size of the operation. However, no risk usually exceeded £100,000.

Case Study in Category 2 (c)

Parent Company: CSO Industrial Group: Manufacturing
Turnover in last financial year:
£200,000,000

Captive: Founded: 1973
Domicile: Guernsey as non-resident, trading in Bermuda
Capital: £250,000
Premium Income in last financial year: £250,000 (1975)
Free assets at end of last financial year: £576,000.

Motivation

This organisation was drawn towards captive insurance partly as a result of dissatisfaction with the service provided by their insurance brokers, which led them to consider what alternatives there were to conventional approaches to insurance. They were also influenced by what they saw as excessive commissions being earned by their brokers and their reluctance to remit some of it to them, with disenchantment over the type of cover offered by the insurance

market (deductibles were specifically mentioned) being a secondary factor. These primary motivations are not typical, no other respondent mentioned dissatisfaction with brokers.

Risks Insured

The subsidiary insures the company's material damage risks, principally fire, special perils and theft; it takes 100% of smaller exposures and a line on the major risks fire schedule. Motor accidental damage is also insured; the risk was carried without insurance before the captive was formed but was included to increase the feasibility of the undertaking. Consequential losses, liability and personal accident risks are all placed in the conventional market.

Until 1976 the company had been content to restrict operations to its own risks, but having become firmly established and having taken as much of the parent's business as was considered appropriate it was decided that the captive should look for outside business in the form of inwards treaty reinsurance. To date a small amount of business has been accepted, the company having decided to be cautious and selective.

Administration

A consultant from Bermuda was asked to carry out a feasibility study and the Board was impressed by his arguments in favour of that territory; however the particular consultant was virtually a one-man firm and the company was concerned at the risk of problems arising should he die. A larger organisation was therefore appointed to manage the subsidiary; while these deliberations were continuing the Sterling Area was retracted, but having been persuaded by the advantages of Bermuda the company decided on the corporation tax company arrangement. A domestic facility had been considered, but the organisation was attracted by the tax advantages of an off-shore captive rather than dissuaded by the disadvantages of a U.K. operation. It is clear that, even if the original motivations were genuinely insurance based, tax advantages have become a major factor in this enterprise.

The consultants in Bermuda handle most aspects of the management of the company, but investments are managed by a merchant bank in Jersey.

Reinsurance and Retentions

The captive has excess of loss and stop loss treaties placed in the Lloyd's market. Its maximum liability for any one loss is limited to £100,000.

CHAPTER 12

RECENT DEVELOPMENTS AND THE FUTURE FOR CAPTIVE INSURANCE

There have been a number of developments in captive insurance since the commencement of this study and in particular the number of captive insurance companies owned by British corporations has grown. Examination of these new undertakings not only makes possible comparison with earlier operations, it also indicates the extent and direction of likely developments in the future.

Various attempts to estimate the numbers of captives in existence were mentioned at the beginning of the study. More recently, the same writers and others have produced further estimates[1], but these suffer from the same shortcomings with regard to British-owned undertakings as earlier works in that they concentrate mainly on Bermudian captives and subsidiaries of North American operations.

It also has to be noted that the figures vary widely between different commentators. Kloman,F.,[2] has said

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1 For instance, lists of companies with captives have become an annual feature of Risk Management Reports, op cit.

2 Quoted by Becket,M., in "Safeguards with freedom in Bermuda"Policy Holder Insurance Journal,13.4.79 p.27.

that there were 850 "exempt" insurance companies in Bermuda at the end of 1978, most by inference being captives and that "the total must be at least 900 by now." He also says that there are 150 captives on-shore in the United States, 28 being based in Colorado which has introduced legislation to encourage formation there and the following numbers elsewhere in the world:-

Guernsey	100
Cayman Islands	80 to 100
New Hebrides	30
British Virgin Islands	20 to 30
Bahamas	15
Isle of Man	10
Gibraltar	10
Plus a few in Hong Kong and Panama	

Kloman's number for Bermuda conflicts with the 750 quoted in the Reinsurance journal[3] a few months after the Becket article, although there is agreement between the two writers with regard to their estimates of approximately 100 captives in Guernsey. It is also appropriate to note the annoyance of the Bermuda

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3 "The Captive Scene", June 1979, p. 64

Registrar of Companies at the suggestion that all the insurance companies registered on the island are captives[4]; the Registrar claims that there are many types of insurance company there including a large number of professional reinsurers, which could presumably be exempt companies as they do not insure property on the island.

It is therefore difficult to give even a rough estimate of the numbers of captives in existence throughout the world. Moving to within the boundaries of this study, it is equally difficult to calculate the number of industrial companies that own active undertakings, for as mentioned earlier large numbers of captives are dormant, many others are hospital schemes and mutual associations of doctors covering malpractice liabilities and some companies own more than one undertaking. After making allowance for these factors and taking the mid-point of the various estimates, it might be supposed that the number of industrial companies with active captives is in the region of 750, but the margin of error is extremely wide.

Turning to the estimates of the number of British companies with captives, it is virtually impossible

4 "Captives", Policy Holder Insurance Journal, 24.3.78, p.519

to come to a conclusion from the worldwide figures mentioned above and it is proposed to bring the estimates in Chapter 2 of this study up to date[5] by other methods. The discovery of thirty companies with captives in July 1977 led to the conclusion that the total number could be as high as forty-five; revisions in those numbers need to take into account changes in the original sample and the discovery of other captives formed either before or after the date mentioned.

Changes in the sample

There have been only two significant changes under this heading. One of the parent companies has been nationalised and the second has been taken over by an organisation that did not previously have a captive. In the first case the subsidiary has continued to operate, which means that two public corporations now have captives; in the second the undertaking is also still in operation although its future is at present uncertain.

All the other captives in the sample remain in operation.

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5 April, 1980

Other developments

The various contacts in the insurance industry that were maintained throughout the course of the study produced reports of companies forming captives and in two cases information about organisations that had formed them earlier and which had not been included in the sample. A number of press articles[6] have also mentioned the names of firms with such subsidiaries and although most of those quoted had either been included in the original sample or discovered by other means, these publications do indicate that the ownership of captive insurance companies is becoming increasingly well known and that very few captives are likely to remain undiscovered by an investigation of the type carried out for this study.

A total of fourteen further companies with captives were discovered and various amounts of information was obtained about each, usually by direct contact with the risk managers involved. Basic information about the subsidiaries and their parent companies is shown in Table 12.1. As the extensive enquiries

6 See, for instance Becket, M., op cit.

TABLE 12.1

Information on fourteen captive insurance companies not included in the original sample and their parent companies

PARENT COMPANY			CAPTIVE INSURANCE COMPANY			
INDUSTRY[1]	POSITION IN TIMES 1000[1]		DOMICILE	YEAR OF FORMATION	MANAGEMENT[1]	RISKS INSURED[1]
	1975-76	1979-80				
Retailing	51-100	51-100	Guernsey	1976	Own management	Fire (Material Damage) Employers & Public Liability
Clearing Bank	Not applicable		Guernsey	1976	Own management	Not known
Engineering	201-250	251-300	Bermuda	1977	Specialist	Fire & Special Perils (Material Damage & Consequential Loss)
Miscellaneous Manufacture	1-50	1-50	Guernsey	1977	Specialist	Fire (Material Damage & Consequential Loss)
Retailing	151-200	250-300	Guernsey	1978	Insurance Broker	Fire & Special Perils (Material Damage & Consequential Loss) Misc. Property
Chemicals	51-100	51-100	Guernsey	1978	Insurance Company	Fire & Special Perils (Material Damage & Consequential Loss)
Entertainments	51-100	100-150	Guernsey	1978	Insurance Broker	Not known
Miscellaneous Manufacture	1-50	1-50	Bermuda	1979	Insurance Company	Fire (Material Damage & Consequential Loss)
Entertainments	-	851-900	Guernsey	1979	Not known	Not known

TABLE 12.1 Continued

PARENT COMPANY			CAPTIVE INSURANCE COMPANY			
INDUSTRY[1]	POSITION IN TIMES 1000[1]		DOMICILE	YEAR OF FORMATION	MANAGEMENT[1]	RISKS INSURED[1]
	1975-76	1979-80				
Engineering	301-350	310-350	Guernsey	1979	Insurance Company	Fire & Special Perils (Material Damage & Consequential Loss) Public Liability Personal Accident
Engineering	1-50	1-50	Guernsey	1979	Insurance Broker	Fire (Material Damage & Consequential Loss) Misc. Property
Retailing	351-400	501-550	Guernsey	1979	Insurance Broker	Fire & Special Perils (Material Damage & Consequential Loss) Misc. Property Personal Accident
Retailing	51-100	51-100	Guernsey	1979	Specialist	Fire & Special Perils (Material Damage)
Retailing	0-50	0-50	Guernsey	1980	Insurance Broker	Not known

[1] As previously defined

have revealed only two further undertakings formed before July 1977, it is reasonable to conclude that very few British companies with captives formed before that date had been omitted from the original sample.

It must be stressed that no additional random sample was taken to produce the new total of forty-four British companies with captives and that one is not, therefore, entitled to draw definite conclusions, but as it seems that organisations are far less secretive about such operations than they were, it is unlikely that more than a few other firms were involved. It might be assumed that up to sixty British companies could have had captives in April 1980, but the number was more likely to have been around fifty.

Trends in Captive Insurance

Analysis of the data on recently formed captive insurance companies and information received from other sources suggest that a number of aspects are likely to affect companies involved or likely to become involved with captives over the next few years. Forecasts beyond the medium term will not be attempted, as it is considered that the many factors to be taken into consideration cannot be determined with any accuracy, making attempts at long-term forecasting mere guess work.

The factors that seem to be of relevance at present can be grouped under the following headings:-

(a) The types of company engaged in captive insurance particularly with regard to their size and type of business and the motivations involved;

(b) The risks insured with captives;

(c) Domiciliary considerations, including the various economic and political factors;

(d) Measures that might be taken to curtail off-shore activities and the ways in which organ-isations can avoid them.

Sizes and types of company with captive insurance subsidiaries

These aspects are connected to some extent, for as mentioned earlier there are more oil, chemical and certain other types of company in the list of largest organisations than, say, retailing and engineering companies. However, the trends suggest that in some cases the factors are distinct and they will be separated here for purposes of analysis.

Size of parent company

Of the twelve companies that were found to have formed captives since July 1977, five were outside the list of the 250 largest companies published in 1979, whereas the survey conducted at the beginning of the study discovered only one captive operator outside the top 250 and indeed only two outside the top 200. It is to be noted that two of the five were within the top 250 list published in 1975, which was used in the survey, but they are without doubt small companies compared with nearly all of those found to have formed captives earlier.

Although one must beware of coming to definite conclusions from quite small numbers, it does seem that

captive insurance companies can no longer be considered the sphere of only the very largest organisation. One reason for the change may be that inflation has made captives more viable for smaller companies and the provision of more facilities for the managing of the undertakings in Guernsey at modest cost compared with Bermuda may also have affected feasibility. However, it seems that in a number of cases captives have been found to be viable for certain smaller companies with a wider spread of risk, such as retailing organisations with many hundreds of shops throughout the country and the widely dispersed type of engineering company.

Comparison of size and type of business

Details of the parent companies of the recently formed captives can be summarised as follows:-

Largest Companies		Smaller Companies	
Position in Times 1000, 1979-80	Industry	Position in Times 1000, 1979-80	Industry
0-50	Engineering	251-300	Engineering
0-50	Miscellaneous Manufacturing	251-300	Retailing
0-50	Miscellaneous Manufacturing	301-350	Engineering
0-50	Retailing		
51-100	Retailing	501-550	Retailing

51-100	Chemicals	851-900	Entertain-ments
101-150	Entertainments		

It can be seen that the types of organisation found to be forming captives in the early 1970s continue to do so, the very large international companies probably finding that their sheer size makes the subsidiaries feasible. Such companies usually have very considerable sums at risk at individual premises and are often engaged in what would generally be regarded as high risk industries from an insurance point of view.

In theory, the organisation with a wide spread of risk is particularly suitable for captive insurance because the subsidiary is able to retain large proportions of each risk, a factor that seems crucial to feasibility. However, it had been assumed that such companies had not formed captives in the past (only one retailing company being revealed by the original survey) because they were better than average risks, obtained low rates of premium from their conventional insurers and thus saw no advantage in forming captives. This situation seems to have changed in the last few years, with four of the recently formed captives being owned by retailing organisations; in addition the two smaller engin-

companies
eering/are diverse in nature and one of the firms in entertainments is in a similar position with a large number of cinemas and bingo halls. The trend is emphasised further if the two recently discovered captives formed in 1976 are included, for one of those is owned by a large retailing firm and the other by a bank with many hundreds of small premises.

None of these developments can be explained by increases in insurance rates, indeed the market for these mainly good types of risk seems to have become even more competitive in recent years.

Companies likely to form captives in the future

These trends can be expected to continue, with more smaller companies becoming interested, but only the wider spread of such firms finding captives feasible for them. One might expect many of the major retailing chains to form captives in the next few years, with breweries (for their public houses), gaming companies (for their betting shops) large hotel groups and various service organisations also becoming involved.

The formation of a captive by a bank is an interesting development. Most of the large banking organisations,

with their numerous small branches, would probably find captives beneficial and with their existing establishments in tax havens they would have little difficulty in setting them up. To date no other bank seems to be thinking along these lines, but it would be surprising if one or two others did not become involved soon.

Motivations of companies with recently formed captives

In order to compare the motivations of companies that had recently formed captives with those of firms in the original sample, attempts were made to obtain information from the risk managers and financial controllers of the twelve companies found to have formed captives after 1976. The same system and follow-up procedures were used as with the earlier sample and eight risk managers eventually agreed to state what they considered were the two most important reasons for their companies establishing captives; the replies received are summarised in Table 12.2. The financial controllers (as defined earlier) in the same companies were asked the same questions and as with the original sample it was only possible to obtain brief comments in most cases and summaries of these are shown alongside the replies from the

risk managers in Table 12.2.

It can be seen that there is little difference in attitude between the companies with recently formed captives and those investigated earlier, the following being an analysis of the replies received from the former:-

(a) In five of the eight cases risk managers gave what could be termed insurance cost saving reasons as the main motivation. In one of the other cases "insurance reasons" were quoted and although very little information could be obtained it appeared that the company had experienced problems in obtaining what it considered to be reasonable terms for its insurances. In another instance, the risk manager had experienced a wide range of difficulties with insurers, including disputes on policy wordings and the rating of deductibles. In the remaining company, it seemed that the risk manager had not been involved in the formation of the captive and all the decisions had been taken by the Finance Department.

(b) In two cases the second most important reasons given by the risk managers were stated to concern

Table 12.2

Showing the main reasons given for the formation of their undertakings by the Risk Managers and Financial Controllers of eight organisations with captive insurance companies formed after 1976.

	RISK MANAGERS	FINANCIAL CONTROLLERS
1.	Reductions in the insurance budget. Certain risk management advantages.	Cheaper provision of insurance. Better control of risk.
2.	Insurance reasons Tax reasons	Financial advantage, particularly from off-shore operations.
3.	Problems with insurers Tax advantages	Part of development of risk management strategy.
4.	To reduce cost of insurance Improvement of risk management.	To save money on insurance
5.	Our insurance broker approached the Finance Director and persuaded him to form a captive. (No other reason given)	It was shown that a captive could reduce our insurance costs and make a profit for us.
6.	To improve on what the insurance market was offering in terms of rates and cover.	No reply.
7.	Reduction in insurance premiums Difficulty in getting reasonable terms from insurers.	Ultimately a tax avoidance device, but there were also insurance reasons.
8.	Improvements in rates charged to the company. Better insurance cover.	To produce a profit centre. General improvements in insurance provision.

risk management improvements, two respondents quoted tax advantages and in the only other instances where specific second reasons were mentioned, one risk manager gave the difficulty in obtaining terms from insurers and a second said that a captive was able to provide better insurance cover.

(c) The financial controllers largely followed the view of the risk managers in the same companies, although they tended to speak in terms of financial as opposed to insurance advantage. In one case, however, the Financial Director spoke only in terms of risk management strategy when the Risk Manager had mentioned problems with insurers and tax advantages.

It is difficult to make comparisions and to draw conclusions with such small numbers, but it is possible to conclude that the views of the two sets of respondents agree with regard to:-

(a) The emphasis on captives being formed to save money on insurance premiums;

(b) In some cases captives being established because of difficulties with the conventional insurance market.

(c) Importance being given by some firms to captives generally improving risk management procedures;

(d) Stress on tax advantages in only a few cases.

Risks insured with captive insurance companies

There seems to have been little development in the last few years with regard to the types of insurance that British companies place with their captives. Few of the original sample of companies have changed their policies and the information in Table 12.1 shows that the recently formed undertakings are following the same pattern as the established captives. Most organisations continue to concentrate on property risks and to avoid liability insurances, but one commentator[7] has taken the view that "the singular reluctance on the part of captive insurance companies to consider risks in the accident and liability area", despite the fact that many American owned undertakings consist "very largely of the casualty risks insured by their parents", is largely due to unfounded fears of administrative difficulties. Sofon is of the opinion that the problems can be overcome by fronting arrangements, a good reinsurance programme and the establishment of a countrywide claims handling facility, but few captive operators seem likely to take his approach in the near future.

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7 Sofon, T., "Liability - The Captive Choice", Insurance Age, March 1980, p. 23.

There has also been little enthusiasm for using captives to insure risks that are either uninsurable or difficult to place in the conventional insurance market. Some writers have mentioned products liability and directors liability as being suitable for captives[8], but as with such risks as products recall and obsolescence, one generally has to go to the United States for examples.

It is perhaps surprising to note this conservative attitude amongst the owners of captives. The formation of such an undertaking requires a significant change in thinking in the parent company and the taking of some risks, thus one might have expected firms entering into those arrangements to be more enterprising in their use. There are a number of possible explanations:-

(a) Most captives are still fairly recent in origin and would need to become firmly established before expanding their spheres of operation;

(b) Many of the British companies with captives are small in comparison with the very large

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8 Vaughan, D.B., "Beginning to assemble the part", Policy Holder Insurance Journal, 24.3.78, p. 511

American corporations that have used their undertakings more widely;

(c) Companies may consider that simplicity is the key to a successful operation and that extension beyond the property field would reduce cost effectiveness.

There is evidence that all these factors have been considered as relevant, but it also seems that many captive owners see development of their undertakings not in terms of increasing the involvement of the risks of the parent companies, but in the taking of outside risks.

Open market operations

This must be seen as one of the major developments in captive insurance in the next few years. It is already apparent that, following the lead set by American owned undertakings, British owned captives are becoming increasingly involved in what have become known as "open market operations" or the insurance of "unrelated business", that is the acceptance of risks from outside the parent company's organisation as a part of the worldwide insurance market. Such business can be conducted in a number

of ways:-

(a) the acceptance of reinsurance from other captives, either directly or by participation in a reinsurance pool;

(b) the acceptance of reinsurance from conventional insurance and reinsurance companies;

(c) participation, by way of coinsurance, in the risks of industrial firms;

(d) direct involvement in the insurance market, with a captive's policies being issued to industrial firms and the public.

One reinsurance pool has been in existence in Bermuda for nearly twenty years and with the formation of others in various parts of the world, captive involvement in the reinsurance of other captives is now common, with the majority of the undertakings that formed the original sample for this study taking part in such arrangements. Most of the future developments must therefore lie in the other areas, but it seems likely that most undertakings will restrict themselves to reinsurance because of the problems of acceptability to those insured, particularly with direct insurance.

The direct issue of a policy by a captive is virtually unknown, except for the old established domestic captives and the quasi-captives mentioned earlier and most firms and members of the public are unlikely to be prepared to insure with off-shore captives in the foreseeable future.

Open market operations are difficult areas for captives and there is no shortage of advice on the dangers involved[9]. As well as the obvious warning of avoiding undesirable risks, New stresses that a captive should only enter the market after proper preparation and with the use of professional advice. He also suggests that the total premiums of a captive (that is both parent company and outside business) should not exceed three times the undertaking's capital and reserves and that not more than half the premiums should be from unrelated business.

However, there is a danger that most commentators seem to overlook and that involves the type of business that a captive is likely to receive when

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9 See, for instance, New, H., "Unrelated business - Image or Profitability", Reinsurance, June 1979 p. 86.

it expands beyond the reinsurance of other captives. The type of insurance placed by a parent company with its own insurance subsidiary is, almost by definition, usually profitable business, but that cannot be said for the normal reinsurance placed on the world markets. It has always been difficult for even the largest and most professional reinsurance companies to make an underwriting profit and one must ask whether small captives can survive in a market which has narrow margins, is notorious for slow settlements and frequent insolvencies and which generally expects new entrants to take more than their fair share of poor risks. It is possible that some captives will not survive their open market ventures.

Factors affecting the domicile of captive insurance companies

No consideration of the future of captive insurance companies can ignore the constantly changing political and economic situations in which they operate. The fact that most captives operate in tax havens makes them particularly susceptible to changes on three fronts:-

(a) political and social developments in the tax haven used;

(b) changes in the tax laws and insurance regulations of off-shore territories;

(c) amendments to United Kingdom exchange control regulations.

Domestic changes off-shore

Most of the territories used as sites for captives, although fairly stable, are not without their problems.

There were race riots in Bermuda following the execution of convicted murderers in 1977 and reports on the circumstances leading to the disturbances revealed that all may not be well in terms of race relations there. Bermuda is still a British colony and there seems no likelihood of the people asking for independence in the near future, but a change in the Island's status could lead to moves against the tax haven community, despite the fact that both political parties are at present committed to maintaining the current situation.

The Isle of Man (sometimes suggested as an alternative site to Guernsey) is the subject of an action before the European Court of Human Rights and some of the population have suggested breaking the links with Britain if the decision goes against the Manx government; complete independence does seem unlikely but any increase in anti-British feeling could make the situation extremely difficult for firms with operations on the Island. The issue of Spanish claims to Gibraltar has receded in the last few years, but it would be a bold person who claimed that the present situation is a permanent one; it is to be noted that Spain has its own tax havens in North Africa and that a take-over of Gibraltar would not necessarily affect the territory's status in that regard; nonetheless, such an occurence would be likely to cause considerable difficulties for British-owned captives.

However, these matters are either at present minor issues unlikely to dramatically change the situation in a particular territory, or mere conjectures of what might happen. Furthermore, the most popular territory of late for British-owned captives (Guernsey) has remained completely stable. The

possibility of domestic circumstances forcing captives to leave any of the territories commonly used are rarely even discussed, reflecting the fact that the risks of substantial change are small.

Changes in legislation off-shore

The pattern in a number of territories has been for the governments to initially welcome the formation of captives, imposing virtually no controls on the undertakings and then to realise later that, in order to prevent abuse, certain regulations are necessary. Such changes, although necessary from the point of view of the territories concerned, will obviously cause annoyance amongst companies originally attracted to the countries because of the absence of controls; in some cases this has led to an exodus of existing operations and in others firms considering the use of a particular territory have gone elsewhere.

These factors explain a number of past developments with regard to the domicile of captive insurance companies, although with regard to British-owned undertakings changes in U.K. exchange controls have played a part. It is therefore significant that

the main centres for captives (Bermuda and Guernsey) have proposed new regulations for undertakings in their territories and one might speculate as to what the effects will be.

The Bermuda parliament has passed the appropriate legislation, in The Insurance Act 1979, but the regulations to bring the law into effect have yet to be published. The new Act gives the Minister of Finance power to make regulations covering such subjects as minimum capital and solvency margins, the filing of financial statements and the maintaining of assets in Bermuda; however pronouncements by government officials stress that a large degree of self-regulation will remain[10]. Guernsey now forbids the formation of new corporation tax companies, but existing undertakings have been allowed to continue to operate; that Island is expected to produce new draft insurance legislation shortly of a similar form to that to be introduced in Bermuda.

The authorities in Bermuda and Guernsey seem to take the view that their countries will not be

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10 Burgess, S., Registrar of Companies in Bermuda, quoted in "The Captive Scene", Reinsurance, op cit, p.64.

adversley affected by these changes, because of their prominant positions in the captive field and the fact that most existing undertakings will easily meet the financial requirements to be placed upon them. However, some commentators have stressed that the filing of information will be a stumbling block for some and there can be little doubt that interest in other territories as sites for captives stems partly from developments in Bermuda and Guernsey, although it must be recognised that other factors are involved, not the least being that it is becoming increasingly difficult to keep captives in the main centres a secret.

The formation of new American captives shows trends towards such territories as the Cayman Islands and the Netherlands Antilles, with the New Hebrides and Hong Kong also being mentioned by some commentators. Nearer to Britain, the new controls in Guernsey and the relaxation of regulations in Gibraltar seem likely to cause some change in preference from the former territory to the latter. One contact in captive management reported a considerable growth in interest in the establishment of captives in Gibraltar and it is understood that a small number

of British companies have recently formed undertakings there.

It is impossible to indicate precisely what developments will occur, but it does appear probable that captives will become somewhat more dispersed than in the past. A factor making such movements possible for British companies is the recent abandonment of exchange controls.

United Kingdom exchange controls

There were always good grounds for believing that changes in domestic regulations were more likely to affect British-owned captives than developments offshore, for the tax havens could only benefit from the existence of captives in their territories, provided there were some controls, whereas the British Government could see only the loss of tax revenue and foreign exchange. It therefore came as a surprise to some that the first action taken by a British government in recent years that had a bearing on captives should actually improve their position, for the abolition of virtually all exchange controls announced in October 1979 means that British companies are now free to establish captives anywhere in the

world. This actually represents a marginal improvement on the situation that prevailed before the contraction of the Sterling Area in 1972, because before that date there were a number of tax havens (such as the Netherlands Antilles) that were outside the Area and which are not now closed to the movement of funds from the United Kingdom.

Commentators have not been slow to point out[11] that British companies are once again free to establish captives in Bermuda by direct transfer of capital from Britain. It remains to be seen, however, if companies forming new captives will prefer Bermuda (or other countries outside the Scheduled Territories) to Guernsey (or other places within the Territories) and whether some organisations with captives already operating in the latter will move them elsewhere.

In financial terms, the choice between Guernsey and Bermuda appears to largely depend on whether, for a particular undertaking, the tax on investment income that has to be paid in the former exceeds the extra cost of operating in the latter. However, the facilities available for captive management in each

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11 See, for instance, Finney, M., "Captives - The Future Approach", Post Magazine & Insurance Monitor, 6.3.80, p. 638.

territory have to be considered and although the services on Guernsey have grown considerably in recent years, most commentators would take the view that the vast range of facilities on Bermuda, which have arisen from the many hundreds of captives and other insurance undertakings operating there, far exceed what is available in Guernsey. Firms offering facilities in Guernsey would probably argue that their rivals in Bermuda are merely relying on status and one can perhaps only safely conclude that each organisation with, or contemplating the formation of, a captive must decide the questions of domicile according to its particular circumstances.

The close proximity of Guernsey to the United Kingdom might be one of the deciding points with many British companies and in the final analysis it seems unlikely that very many captives already in the Balliwick will move. However, there can be no doubt that Guernsey will no longer be virtually the only site considered by potential captive owners in the United Kingdom.

The possible use of other countries outside the Scheduled Territories is less certain. Most still lack even the basic facilities for the administration

of captive insurance companies and it is to be expected that most organisations would need special reasons for choosing them. This is not to say that all British companies will prefer the usual territories; those with existing operations in other tax havens might have good reasons for placing their captives with their present undertakings and firms with substantial interests in the Far East could find it beneficial to use a country in the Eastern hemisphere.

Action by British tax authorities against captives.

Changes to the detriment of British companies with captives are more likely to arise under this heading than with regard to exchange control.

Information was received during the closing stages of the study about a research team that had been formed within the Department of Inland Revenue, to investigate captive insurance companies. The researchers are still looking at the subject, but their general policy was made clear during an interview with one of the senior officials involved, when the view was given that the payment of premiums to a wholly owned subsidiary of an insured organisation

must be treated in the same way as payments to an internal self-insurance fund and therefore such premiums cannot be allowed as a pre-tax business expense. The Inland Revenue is not merely aiming to attack off-shore captives, for it is clear that they also see the domestic undertakings as operations which take advantage of a tax loophole that must be closed.

The views of the Inland Revenue outlined above follow closely the American Internal Revenue Service who as mentioned earlier have already taken action to disallow premiums to captives and have to date had their action confirmed by lower courts, with an appeal pending. Discussions with Inland Revenue officials indicated that their thinking was similar to the Internal Revenue Service in other respects and in particular they consider that:-

(a) Fronting arrangements and reinsurance captives must be treated in the same way as pure captives.

(b) Open market captives (in respect of their owners' insurances) are also the same as pure captives, unless a substantial amount of unrelated business is written; some American commentators have suggested that if 25% of the total business

is unrelated the authorities there will be satisfied[12], but that seems a low figure and there is currently no indication of what the Inland Revenue's view would be.

As in the United states, opinions differ in the United Kingdom as to whether the authorities have sufficient powers within the present laws to disallow premiums to captives, however the Inland Revenue seemed to be prepared to bring a test case against one of the companies known to have a captive.

The likelihood is that such action would cause the company under attack and many others to think seriously about discontinuing their operations and the result could be that activities are substantially reduced without any change in the law being necessary; however if the Department were to rely on "scare" tactics a captive would be viable (and legal) so long as it remained undiscovered.

Developments to avoid action by the Inland Revenue

The tax authorities have the right to ask for a list of a firm's subsidiary companies worldwide and would do so where they were trying to establish whether a

12 New,H.,"Unrelated business - Image or Profitability" op cit

captive was owned, or might even do so as a matter of course for major companies should a full offensive be decided upon. Thus, in order to reduce the risk of discovery and generally to make legal action more difficult captive operators can be expected to increasingly take precautions such as:-

(a) The formation of an undertaking as a reinsurance captive; this would not prevent discovery in the event of a full investigation into a company's affairs, but the chances of a totally fronted captive being chosen for a test case are at present slight, first because discovery would be more difficult and secondly because the Inland Revenue's case would be more easily put against a direct undertaking. Further, if a ruling were obtained against an unfronted captive a reinsurance operation could still legally continue until such time as a successful case was concluded against such a facility. Some commentators took the view that most captives would be formed as reinsurance captives in the future and that some existing facilities might be converted to that method of operation.

(b) Insurance not being used in the subsidiary's name, so that a list of companies in a group would not indicate the ownership of an insurance company, although any operation in a tax haven would immediately raise suspicion unless the organisation had other interests in the territory.

(c) The maintenance of absolute secrecy regarding the operations. Some organisations have made their undertakings widely known, but it is likely that companies will increasingly come to regard the ownership of a captive as a confidential matter.

However, such precautions, which merely aim to prevent the detection of a captive, can only be seen as short-term measures. One longer term solution, which is favoured by a number of American practitioners, is the conversion of a captive into a conventional insurance company, either by the taking of large amounts of unrelated business (as mentioned earlier), or by combination with other organisations to form a group or industry captive. The argument is that premiums to such an undertaking would have to be allowed before tax, because it would be an ordinary insurance company.

The open-market option will probably be the more feasible in most cases, for it will be difficult for firms to agree on joint undertakings and there are numerous legal and administrative difficulties. There can be little doubt that the growth of interest shown by American captive operators in unrelated business arises in part from the risk of action by the tax authorities. If developments in Britain follow the American pattern, most captive operators will wait until the Inland Revenue brings a test case before becoming interested in outside insurance for tax reasons, but there is obviously a limit to the amount of business available and it seems that the more forward looking captive owners are becoming substantially involved in unrelated business, not simply for expansionist reasons but also as a precaution for the future.

THE ENCOURAGEMENT OF DOMESTIC CAPTIVES AS AN ALTERNATIVE TO OFF-SHORE UNDERTAKINGS

It is difficult to defend the continuation of off-shore captive insurance companies. At the least the organisations involved are avoiding payment of U.K. corporation tax on their profits and are losing the country foreign exchange, but in addition this study has shown that some companies manipulate their captives to enhance the tax benefits either by insuring risks they would otherwise have been content to carry uninsured and/or by paying premiums at an inflated rate. This is a situation that no government can be expected to tolerate and it can only be a matter of time before the British authorities take action; it is perhaps surprising that nothing has been done before.

What then is the likely future position of the British-owned off-shore captive? It may be possible for parent companies to organise their undertakings in a manner that will prolong their existence, by avoiding Inland Revenue action in the short-term, but it is probably inevitable that either the courts will concur with the tax authorities or parliament will eventually approve

legislation that will drastically reduce the number of captive insurance companies in existence. Undertakings operating on a substantial open-market basis will probably be able to survive by persuading the authorities that they are bona fide insurance companies, although it can be argued that such subsidiaries are not captives and most of the advantage of captive insurance is lost where large amounts of outside business is accepted. Payments to undertakings of the mutual type, that is group or industry captives, are also likely to continue to be allowed before tax. However, it is unrealistic to assume that more than a minority of the companies that now have captives could continue to operate by switching to one of these arrangements; group or industry captives are very difficult to organise unless there is a special problem shared by many companies and there would not seem to be enough outside insurance available to captives to enable more than a few to develop major open-market operations. The hope of some captive operators may be that action by the British government will be delayed long enough for them to become well established in unrelated business and it does seem likely that the longer captives are allowed

to operate without interference the greater will be the number able to escape.

Although action against off-shore undertakings would seem fair and reasonable, it would be unfortunate if such moves led to difficulties being caused to companies with domestic captives. If tax allowances on premiums to captives were simply disallowed that would apply equally to off-shore and domestic undertakings and in addition to making captives operating in Britain unworkable, there would also be no opportunity for a firm winding up an off-shore captive to set up a similar subsidiary in the United Kingdom. This study has shown that tax considerations are not the only factors usually influencing the formation of a captive insurance company and indeed it is reasonable to assume that tax avoidance as such is not a primary aim in most cases.

It has been shown that captives are usually a genuine attempt to improve risk management in the parent organisations and in particular that they are often formed because of a failure on the part of the conventional insurance market to provide the type of protection required by large companies. Consequently, it would seem to be wrong for the

government to take action against captives, which would support the very insurance companies that are accused of failing to provide for insurance buyers, without first making provision for tax relief to domestic captives. Provided there are regulations to prevent abuse, it should not matter to the government where premiums go, as a properly run domestic captive would make the same profits as a conventional insurer and therefore pay the same tax.

Despite the lack of distinction in tax law between domestic and off-shore undertakings it seems probable that the first captive owners to come under attack will be those with subsidiaries in tax havens. Consequently, there is likely to be time for firms with domestic captives to lobby the government for special provisions to be made for them, although it is possible that such organisations might make approaches to the authorities before any action is taken by the Inland Revenue.

Regulations for domestic captives

The simplest solution to the problem of disallowing tax relief on premiums to off-shore captives, without affecting the viability of domestic under-

takings, would be a provision in a Finance Act allowing premiums before tax to a subsidiary company domiciled in the United Kingdom and approved under the Insurance Companies Act and disallowing any other premiums to a subsidiary that could not be shown to be a bona fide insurance company. In theory, the government would need to go no further but they might be concerned about possible abuse and therefore wish to impose regulations beyond those contained in the Insurance Companies Act where an insurance company primarily insures its parent company. It might also be argued that the government should take a positive view of captive insurance and actively encourage British firms to operate their insurance subsidiaries in the United Kingdom rather than try to continue in tax havens. In preventing abuse and encouraging domestic captives the authorities would need to consider two main issues:-

(a) Manipulation of a captive insurance company established in the United Kingdom could lead to as much loss of tax revenue as that saved by stopping its operation off-shore. The problem is not, however, that companies could charge improperly high premiums for that would

simply increase the profit of the subsidiary and its tax liability. Neither would there be a problem with firms insuring risks they would otherwise carry uninsured, because all uninsured losses are permitted as a pre-tax expense and it therefore makes no difference whether a loss is carried by a parent company or an insurance subsidiary, provided both are paying U.K. tax. The actual danger is that tax could be avoided by a captive carrying unnecessarily high unexpired risk and outstanding claims reserves; although a conventional insurer could equally seek to reduce its tax liability in this way, the vested interest of the insured in the insurer's results, that exists in the parent/captive relationship, does not arise elsewhere.

(b) A major problem for the small domestic captive would be the British insurance regulations. The provisions for minimum share capital are not onerous, but the solvency margins could be and the close control exercised by the Department of Trade over insurance companies (particularly with small and newly formed firms) could be if applied to captives. There is also the question of the detailed returns

required under the insurance regulations. Such provisions are, however, mainly intended to protect the public from the insolvency of insurers, which would not seem to be a problem where a captive only insures its parent, but there is the well-being of employees, customers and suppliers to consider, for a serious fire or other loss could render the parent insolvent if a captive were unable to meet the loss. Where an undertaking insures liability risks the government would also probably feel it had a duty to ensure that claimants were not prevented from recovering their damages because of the failure of an insurance company owned by the organisation incurring the liability.

The provisions of a possible Captive Insurance Company Act

Thus, if British organisations are to be given the freedom to have the risk management procedures of their choice, special legislation for captive insurance companies would seem to be needed and perhaps interested parties should petition for an appropriate Act of Parliament. There is a pre-

cedent for such a law in the Captive Insurance Company Act, 1972 of the State of Colorado; similar legislation was recently introduced in Tennessee and some other American states are expected to do the same.[13]

In addition to providing for tax relief on premiums paid to captive insurance companies of any type, where authorised in the normal way under the Insurance Companies Act, the legislation might make the following provisions where an undertaking only insures the risks of its parent company:-

(a) In order to prevent abuse with regard to reserves, the Department of Trade could be given special powers to investigate a company seen to be carrying reserves above the level that would be expected for the types of business involved. The Department's experience in this area would enable it to estimate the level of reserves that would seem appropriate in each case.

(b) The normal solvency margins could be waived where an undertaking was not insuring liability risks and in such cases shortened forms of return could

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13 "The Captive Scene", Reinsurance, op cit.

be allowed. The extent to which the British authorities could take such action would depend on Common Market regulations and the extent to which the Community as a whole could be persuaded to agree to special provisions for captives. At present, the Department of Trade can waive the solvency margin, but not the minimum guarantee fund, for small insurers and has wide authority to grant concessions with regard to the accounting returns.

(c) In order to protect the interests of employees and others with dealings with the parent company, the Department of Trade could be given special powers to examine the reinsurance arrangements of a captive and to demand changes where appropriate in the type of reinsurance effected and the reinsurers used. The Department already has some authority in this area, but even stronger provisions might be considered necessary with captives because of their dependance on reinsurance.

(d) Captives could be permitted to undertake the liability risks of their parents, but if they did they would have to comply in full with the regulations that apply to conventional insurance

companies. Separate funds and accounts could be required for such business, against which claimants would have direct access in the event of the insolvency of an insurer or its parent company.

Where a captive was operated on an open-market basis, which could include the acceptance of reinsurance, special provisions would only seem to be necessary with regard to the question of reserves. In all other respects the undertaking would be treated as a conventional insurance company, complying with the solvency requirements and making the full returns.

Domestic captives and risk management in the future

This study has shown that the use of the captive insurance company in risk management is often clouded by questions of taxation and operations in tax havens. There are, however, good grounds for believing that such an undertaking can produce significant improvements in the risk management processes of a major industrial or commercial company. The introduction of provisions to disallow tax relief on premiums to subsidiary insurance companies outside the United Kingdom, coupled with legislation to

encourage such activities within the country, would prevent unjust abuse of the tax system without affecting an organisation's freedom to arrange the protection of its choice. Risk management might then enter a new era, with the captive insurance company fully recognised as a genuine device for financial provision against risk.

APPENDIX I

Analysis of the results of the AIRMIC Survey

Table 13.1

Analysis of the replies to the question on respondent's position in employing company.

Insurance Managers	42
Company Secretaries	4
Risk Managers	2
Directors	2
Accountant	1
No reply	14

Table 13.2

Analysis of replies

1. Examination of subject	No. replying Yes
(a) in depth	15
(b) to a more limited degree	12
(c) superficially	33
(d) not at all	4

(No Reply: 1)

2A Perceived advantages	YES	NO	DON'T KNOW	NO REPLY
(a) the possibiltiy of insuring unusual risks	34	24	7	
(b) the more effective use of deductibles	49	11	5	
(c) tax advantages	45	16	4	
(d) lower premiums	24	32	9	
(e) lower administrative costs	26	34	5	
(f) saving of insurers profits	42	19	4	
(g) more effective control of risk	39	20	6	
(h) cutting out brokers	11	50	4	

2B Perceived disadvantages

(a) fear of U.K. government action	34	22	8	1

		YES	NO	DON'T KNOW	NO REPLY
(b)	cost	16	42	6	1
(c)	political risks overseas	32	20	11	1
(d)	lack of acceptance by conventional market	22	37	5	1
(e)	lack of expertise	27	33	4	1

3. Which of the following most closely fits your attitudes towards captives:		Chosen by:
(a)	they are parasites living off the conventional market and should not be tolerated	0
(b)	the basic principle is reasonable but the government should not allow them to escape U.K. taxation by being formed in tax havens	2
(c)	they have been forced on the large insurance buyers by the intransigence of the conventional market	10
(d)	they are a sensible approach to risk management which enables the captive owner, in co-operation with the conventional market, to provide the sort of protection it requires	53

APPENDIX II

Information on Tax Havens used as domiciles for

Captive Insurance Companies

Bahamas

The Bahamas are a group of about 700 islands in the Caribbean, South-East of Florida. They were a British colony for over 250 years until independence in 1973.

A large number of captives were formed there in the 1960s, the country often being preferred to Bermuda. The government considered it necessary to act against certain disreputable elements and in 1969 passed an Insurance Act requiring insurers to maintain minimum reserves of B$140,000 or 20% of annual non-life premium income whichever was the greater. The Act provided such unfavourable conditions for even the reputable operators and most of the captives domiciled in the islands moved elsewhere[1].

More recently, a few new captives have been established in the Bahamas, but many commentators consider that the territory cannot compete with Bermuda[2].

The country has virtually no taxes. Companies pay an initial registration fee of B$600 and a further sum of B$250 annually.

Bermuda

The British colony of Bermuda, situated 600 miles East of Florida, is by far the most popular domicile in the world for captive insurance companies.

Details of the territory's insurance regulations and tax provisions will be found on pages 237 and 238 ante.

British Virgin Islands

The Virgin Islands are situated to the East of Puerto Rico in

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[1] Barile, A.J., "Locating, Managing The Captive", The National Underwriter, 16.3.73

[2] ibid

the Caribbean. Only the northern islands of the group are administered by the United Kingdom, the southern islands being possessions of the United States of America.

The islands have only recently been used as a tax haven; a small number of captives have been formed and it is apparent that the authorities actively encourage interested parties[3]. To date virtually all the undertakings formed have been American owned, but some British companies might be attracted following the removal of exchange controls.

Insurance regulations are minimal, but a disadvantage compared with some sites is that profits are taxed at a rate of 12%.

Cayman Islands

This British colony consists of three islands to the South of Cuba. They were a dependancy of Jamaica for a number of years, but reverted to being a directly administered colony in 1962.

The territory has been used as a site for captives for many years. It has never enjoyed the level of popularity of Bermuda, but it is now substantially used by American corporations and probably has nearly as many undertakings as Guernsey[4].

There are no insurance regulations and no taxes. New companies pay a fee of CI$1,200 and an annual fee thereafter of CI$600.

Cyprus

The island of Cyprus, in the Eastern Mediterranean, became a possible site for captives in 1979 when the Greek-speaking administration in the South of the country enacted legislation which gives dispensations to insurers that do not insure domestic risks.

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[3] Kloman, F., quoted by Becket, M., in "Safeguards with freedom in Bermuda, Policy Holder Insurance Journal, 13.4.79, p.29

[4] ibid

Such undertakings need have a paid-up capital of only C£10,000, instead of the normal C£100,000; they are also exempt from the local insurance regulations but do have to file their accounts[5]. Tax on profits is levied at a rate of 4.25%.

A small number of captives have been formed to date[6], but it is too early to say whether Cyprus will develop into an important captive centre.

Gibraltar

The British colony of Gibraltar, on the Southern tip of Spain, has been a tax haven for many years. The authorities exempt from tax all companies that receive their income from outside the territory; such "exempt companies" may be resident in and carry on business in Gibraltar with the approval of the Financial and Development Secretary, but until 1977 the Secretary would not give exemption to insurance companies. However, since that date the authorities have agreed to authorise insurance companies on an exempt and resident basis and a small number of captives have been formed there.

Exempt companies pay no tax, but are liable for a fee of £225 if resident and £200 if non-resident. Non-resident companies would be in a similar position to the Guernsey Corporation Tax Company, but the removal of exchange controls makes the formation of a captive in Gibraltar but managed from (say) Bermuda unnecessary.

Guernsey

The Channel Islands, of which Guernsey is the second largest, are independent States linked to the United Kingdom with regard to foreign affairs and defence. They have only associate membership of the Common Market.

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[5] Bawcutt, P., "Offshore locations for captive insurance companies", Risk Management, October 1978

[6] McNally, P., "Self-Funding Techniques and Captives", Reinsurance, June 1979, p.78

The retraction of the Sterling Area in 1972 led to Guernsey becoming the most popular site for British-owned captives, but it has also been chosen by companies in other countries, particularly the United States. The territory is now second only to Bermuda as a captive insurance centre.

Details of insurance regulations and tax provisions will be found on pages 242 to 245 ante.

Hong Kong

The British colony of Hong Kong is an enclave on the coast of South-East China, 90 miles from Canton. The island of Hong Kong was ceded to Britain by China in 1842, following the Opium War; Kowloom peninsula on the mainland was added in 1860, but the largest part of the colony (known as the New Territories and consisting of 365 square miles of the country's total area of 398 square miles) is held on a 99 year lease that expires in 1997.

The moderate tax rate of 15% has attracted some captive insurance companies, particularly those formed by firms with interests in the Far East. However, there are some onerous regulations. An insurance company must have a minimum paid-up capital of HK$50,000 and must make deposits of between HK$100,000 and HK$200,000, depending on the types of business transacted. Despite the fact that there are no other controls on insurance companies, these requirements appear to have led some Far Eastern organisations to prefer the New Hebrides to Hong Kong[7].

Isle of Man

The Isle of Man is in the same position as Guernsey in its connections with the United Kingdom. It is internally self-governing, but Britain is responsible for defence and international relations.

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[7] Bawcutt, P., op cit

The territory has been a tax haven for many years, being used extensively by people retiring from the mainland. The retraction of the Sterling Area in 1972 led to it being considered as a site for captives, but a £5,000 registration fee and a tax rate of 21.25% (compared with Guernsey's 20%) were partly responsible for the Isle of Man being passed over in most cases in favour of Guernsey. However, it must also be said that the Manx authorities do not appear to have been as active as those in Guernsey in attracting captives to their island.

An Income Tax Act of 1979 has reduced the registration fee to £250 and this may lead to more interest being shown in the Isle of Man, possibly by companies based in the North of England, who might find it more accessible than Guernsey.

Netherlands Antilles

The islands of the Netherlands Antilles are a Dutch colony, consisting of two groups, the first off the coast of Venezuala and the other to the East of Puerto Rico. It is in the first group that most tax haven activity is centred, particularly on the island of Curacao.

The islands are attractive to captive operators because the Inspector of Taxes grants special assessments where a company conducts business outside the territory. Usually, 80% of net taxable income will be allowed tax free, the remainder being taxed at between 24% and 30% with the provision that the maximum payable will not exceed 6% of net taxable income[8]. There are particular advantages to Dutch companies, because payments to parent companies in the Netherlands are deducted from net taxable income. As a consequence, a few Dutch firms have formed captives there.

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[8] Bawcutt, P., op cit

New Hebrides

The territory of the New Hebrides is a group of islands in the South-West Pacific, about 500 miles North-East of Australia. It has been administered as an Anglo-French condominium since 1906, but is due to receive independence on 30th July 1980.

The territory is often mentioned as a possible location for captives owned by Far Eastern and Australasian companies. A disadvantage at present is that there are only limited banking facilities and communications are not of the highest order[9]. However, legislation has been enacted to encourage the formation of captives and undertakings that do not insure risks on the islands may be registered as "exempt insurers" and thus gain exemption from all the local insurance regulations.

There are no taxes. Companies pay an annual fee of £1,000.

The recent separatist revolt by French-speaking people on the largest island of Espiritu Santo underlines the uncertainties that exist with all tax haven operations. However, there would appear to be no risk at present to such operations in the New Hebrides, because they are based in the capital Vila on the island of Efate.

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[9] Grundy, M., "Grundy's Tax Havens", Bodley Head Limited, London (1974)

APPENDIX III

Summaries of the Captive Insurance Companies covered by the study

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Chemicals	275,000	2,200[5]	Guernsey	1975	1,100[5]	F&SP (MD&CL) Motor Accidental Damage Employer's Liability	None	Excess of loss and Stop loss	250	Reinsurance captive, managed by insurance brokers
Metals	225,000		Bermuda	1975	1,500	F&SP (MD&CL) Misc Propty Motor Accidental Damage Public Liability Fidelity Guarantee Performance Bonds	None	Excess of loss	500	Pure captive, own management
Foods	Over 1,000,000		France							Managed by lawyer agent
Enter-tain-ments	75,000	1,000	Bermuda	1971	300	F&SP (MD&CL) Misc Propty	None	Excess of loss and Stop loss	75	Pure captive, managed by specialist agent
Foods	800,000	3,000	Gibraltar	1970	1,500	F&SP (MD) Misc Propty	None	None	100	Pure captive managed by accountants. Only insures particular types of property of limited size

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Engineering	300,000	2,000	England	1971	140	F&SP (MD&CL) Misc Propty Personal Accident Motor	None	None		Pure captive, own management. Only writes lines on coinsurance schedules
Foods	Over 1,000,000		England	1928	700	F&SP (MD&CL) Misc Propty Marine	None	Quota share, surplus and excess of loss	120	Open market captive, own management
Manufacturing	600,000	4,000	Bermuda	1972	170	F&SP (MD&CL) Misc Propty Motor Accidental Damage	None	None	100	Reinsurance captive, but writes some business direct
Oil	Over 1,000,000		England	1920	19,300	F & Explosion (MD) Marine	None	Stop loss	15,000	Pure captive, own management
Oil	Over 1,000,000		Bahamas							
Textiles	625,000	2,500	Scotland	1976	200	F, Aircraft & Explosion (MD)	None	Excess of loss and stop loss	70	Pure captive, own management

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Textiles	Over 1,000,000	9,000	Guernsey	1973	2,000	SP (MD), F&SP (CL) Machinery breakdown Employer's Liability C.L. Strikes	C.L. Strikes	None (Employer's Liability fronted)	2,000[4]	Corporation tax company, managed from Bermuda by insurance brokers Pure captive; apart from employer's liability only insures minor types of peril
Engin-eering	675,000	1,750[5]	Bermuda	1972	450[5]	F&SP (MD), F (CL) Misc Property Motor Accidental Damage	None	Quota share and excess of loss	50	Pure captive, managed by insurance company
Chemicals	250,000		Guernsey							Pure captive, managed by an insurance company
Foods	125,00		Off-shore							
Chemicals	400,000		Guernsey	1975		F&SP (MD&CL) Marine Public Liability	None	Excess of loss		Pure captive, own manage-ment

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Retailing	850,000		England	1965	500	F&SP (MD&CL) Misc Propty Marine		Stop loss	300	Pure captive own management
Chemicals	Over 1,000,000		England	1926	6,500	F&SP (MD&CL) Motor Employers & Public Liability Personal Accident Marine	None	Quota share, excess of loss and surplus	200	Basically a pure captive but occasionally accepts inwards reinsurance. Own management
			Bermuda	1969		F&SP (CL)	None	Quota share and excess of loss, Member of reinsurance pool		Pure captive own management
Metals	225,000[5]	2,500	Bermuda	1972	1,250	F&SP (MD) Marine	Issues some special wordings on valuation and inflation	Excess of loss	350	Pure captive managed by specialist agent
Electronics	725,000		Guernsey	1975		Misc "All Risks" Personal Accident Credit Marine Products Recall	Products recall	None, but marine risks fronted and fronting office retains 50%	50	Pure captive managed by specialist agent

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Manu-facturing	200,000	750[5]	Guernsey	1973	250[5]	F&SP (MD&CL)	None	Excess of loss and stop loss	100	Corporation tax company, managed from Bermuda by insurance brokers. Basically a pure captive, but has some inwards reinsurance business
Chemicals	175,000	3,500	Bermuda	1976	1,000	F (MD&CL)	None	None	1,000	Reinsurance captive, managed by insurance brokers
Manu-facturing	300,000	2,100	England	1972	760	F&SP (MD&CL) Marine Employer's Liability Public Liability	None	Stop loss	750	Pure captive, own management. Operates largely on coinsurance basis
Traders	900,000	600	Bermuda	1971	350	F&SP (MD&CL) Personal Accident Plate Glass	None	Excess of loss and stop loss	50	Pure captive, managed by specialist agent
Manu-facturing	Over 1,000,000		Bermuda							Pure captive, managed by specialist

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Transport		1,100[5]	Scotland	1945	900[5]	Motor Personal Accident	None	Excess of loss	125	Pure captive, own management
Electronics	175,000	1,100	Guernsey	1975	100	SP (MD) Misc Property Motor Accidental Damage	None	None	50	Pure captive, managed by insurance brokers. Only insures minor types of peril.
Foods	Over 1,000,000	5,000	England	1925	25	Marine	None	None	5	Pure captive, own management. Only writes lines on co-insurance schedule
			Guernsey	1974	750	F&SP (MD) Misc Propty Personal Accident Marine Commodity losses	Commodity losses	Excess of loss and stop loss	50	Corporation tax company. Pure captive, managed by insurance brokers from Bermuda, but about to change to own management

PARENT COMPANY			CAPTIVE INSURANCE COMPANY							
INDUSTRY[1]	TURNOVER (approx) £000s	INSURANCE EXPENDITURE £000s	DOMICILE	FOUNDED	PREMIUM INCOME (Net) £000s	RISKS INSURED	UNCONVENTIONAL[2] RISKS INSURED	REINSURANCE ARRANGEMENTS	NET[3] RETENTION £000s	METHODS OF OPERATION
Oil	Over 1,000,000		Bermuda	1970		F&SP (MD&CL) Misc Propty Marine				Pure captive, own management
			England	1973	2,000	F&SP (MD&CL) Misc Propty Personal Accident Marine				Pure captive, own management
Chemicals	Over 1,000,000		England	1937	5,250	F&SP (MD&CL) Misc Propty Motor. Personal Accident Employer's & Public Liability Marine	None	Excess of loss	1,000	Pure captive, own management

Abbreviations F = Fire; SP = Special Perils; MD = Material Damage; CL = Consequential Loss

Notes

[1]The industry of the parent company is sometimes given in general terms to avoid revealing the identity of the respondant.

[2]Risks which respondants considered they would be unable to insure in the conventional insurance market.

[3]The figures shown are the largest amounts the captives retained on any one risk, excepting that where the only reinsurance shown is a stop loss treaty it is the upper limit of the captive's liability before the treaty operates.

[4]In this case the figure is the limit of the captive's liability as agreed with the parent company.

All figures are for the financial years ending in 1976, unless otherwise shown

[5]Financial year ending in 1975

APPENDIX IV

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Chapter 1

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APPENDIX VI

Questionnaires

QUESTIONNAIRE ON CAPTIVE INSURANCE COMPANIES AND SELF-INSURANCE

1. Company

2. Turnover of group in last financial year: £

3. Expenditure on insurance (including self-insurance arrangements) in last financial year: £

4. Do you have a captive insurance company?

   If YES, please state:-

   (a) Name of subsidiary

   (b) Year established

   (c) Country of domicile

   (d) Premium income in last financial year: £

   (e) Whether the subsidiary accepts risks from other than your group

   If NO:-

   (a) Are you in the process of forming one?

   (b) If not, have you ever considered the possibility?

5. Do you have a self-insurance programme? i.e. any process whereby risks are deliberately left uninsured, but losses are met from an internal fund established for the purpose.

   If YES, please state:-

   (a) Risks covered

   (b) Whether the fund is held by a subsidiary company established for the purpose

   (c) Whether the fund is protected by reinsurance or a funding policy (please state which)

6. Would you be prepared to provide further information (in confidence) on your insurance arrangements and on your company's attitude towards captive insurance companies and self-insurance?

THANK YOU FOR YOUR ASSISTANCE

Please return the form to:-

K.J. Allen,
Department of Accountancy & Company Administration,
Sheffield City Polytechnic,
Pond Street,
Sheffield,
S1. 1WB.

QUESTIONNAIRE ON CAPTIVE INSURANCE COMPANIES (A.I.R.M.I.C.)

The questionnaire is in two sections, the second of which requests confidential information relating to your company. If you feel unable to answer Section Two, please do not let this preclude you from completing Section One.

SECTION ONE

Please answer the questions in your capacity as an individual insurance or risk manager, rather than on behalf of your company.

1. Have you examined the advantages and disadvantages of captive insurance companies:

   (a) in depth — YES/NO
   (b) to a more limited degree — YES/NO
   (c) superficially — YES/NO
   (d) not at all — YES/NO

2. If you were in the position of advising a company on the formation of a captive insurance company:

   A. Do you think you would give the following as good reasons for such a move:

   (a) the possibility of insuring unusual risks — YES/NO/DON'T KNOW
   (b) the more effective use of deductibles — YES/NO/DON'T KNOW
   (c) tax advantages — YES/NO/DON'T KNOW
   (d) lower premiums — YES/NO/DON'T KNOW
   (e) lower administrative costs — YES/NO/DON'T KNOW
   (f) saving of insurers profits — YES/NO/DON'T KNOW
   (g) more effective control of risk — YES/NO/DON'T KNOW
   (h) cutting out brokers — YES/NO/DON'T KNOW

   B. Do you think you would cite the following as disadvantages:

   (a) fear of U.K. government action — YES/NO/DON'T KNOW
   (b) cost — YES/NO/DON'T KNOW
   (c) political risks overseas — YES/NO/DON'T KNOW
   (d) lack of acceptance by conventional market — YES/NO/DON'T KNOW
   (e) lack of expertise — YES/NO/DON'T KNOW

3. Which of the following statements most closely fits your attitude towards captives (please tick one):

   (a) they are parasites living off the conventional market and should not be tolerated;

   (b) the basic principle is reasonable but the government should not allow them to escape U.K. taxation by being formed in tax havens;

   (c) they have been forced upon the large insurance buyers by the intransigence of the conventional market;

(d) they are a sensible approach to risk management which enables the captive owner, in cooperation with the conventional market, to provide the sort of protection it requires.

SECTION TWO

Information obtained under this Section will be treated in the strictest confidence and the name of your company will not be revealed under any circumstances.

NAME:

EMPLOYER'S NAME AND ADDRESS:

POSITION:

1. Does your company have a captive insurance company? YES/NO

   if not:

   (a) is it in the process of forming one? YES/NO

   (b) has it ever considered the possibility? YES/NO

2. Would you and/or your company be prepared to supply further information (in confidence) on your experiences in this area and on your attitudes towards captives?

   YES/NO

QUESTIONNAIRE ON THE FORMATION AND MANAGEMENT OF CAPTIVE INSURANCE COMPANIES

PART ONE - Insurance arrangements before the captive was formed

1. (a) Did you have an in-house brokerage?

   (b) If YES, was it established as an intermediate stage in the formation of a captive?

2. Please describe any self-insurance fund you had and the risks it covered:

3. What risks were deliberately left uninsured, without the protection of a self-insurance fund?

4. What deductibles did you carry on the main classes of risk?

5. Please give details of any unconventional policy wordings that you were able to negotiate with insurers, e.g. All Risks on buildings and plant; first loss fire insurance; amendments to the standard fire policy.

6. Did your department arrange insurances for each division separately, or was insurance placed for the group as a whole?

7. Please mention any other points that are relevant to an understanding of your insurance arrangements before the captive was formed:

PART TWO - The decision to form a captive

1. Were the initial moves at the instigation of the company or an outside agency, e.g. a consultant or insurance broker?

2. Please indicate how you obtained information about captives, by ticking any of the following as appropriate:-

Own instigation	Outside agency
An approach was made to the company's broker	The company's broker suggested a captive
Another broker was contacted	Another broker contacted the company
A specialist consultant was approached	A specialist consultant approached the company
Other (please specify):	Other (please specify):

3. The following is an hypothesis on the reasons why captive insurance companies are formed:-

"Captive insurance companies are formed with the objective of saving the parent company money in a direct way, 'risk management factors' (greater risk consciousness, better control of risk, more flexible risk management policies etc.) are seen as being important, but are not in themselves critical enough to persuade a company to form a captive where direct monetary advantage cannot be shown. Consultants and insurance brokers play an important role in persuading companies to form captives, but in essence they do little more than draw the attention of potential captive owners to the possibilities. Direct monetary advantage is seen to stem from fewer insurance regulations and lower taxation in tax havens, inflexibility in the conventional insurance market (attitude to deductibles, policy wordings etc.), the captive being operated at lower cost than a conventional insurer and the retention of profit and investment income that would otherwise go to the insurer. The main objections to captives come from fear of the possible political consequences of operating in tax havens, but these are largely ignored in the final calculation."

(a) Please indicate the extent to which your experience corresponds with the hypothesis, with regard to:-

	Same	Similar	Dissimilar	Very Different
The importance of direct monetary advantage				
The view that 'risk management factors' are considered important				
The view that a captive would not be formed on the strength of 'risk management factors' alone				
The role of consultants and brokers				
The view that the only disadvantage taken seriously is the political risk in tax havens				
The view that no attempt is made to place a value on the political risk				
The implication that no attempt is made to place a value on other disadvantages				

(b) Please weight the importance of the factors that influenced your decision:-

	Very Important		Important		Unimportant
Fewer insurance regulations in a tax haven	5	4	3	2	1
Lower taxation off-shore	5	4	3	2	1

General inflexibility in the market	5	4	3	2	1
Attitude of market to deductibles	5	4	3	2	1
Attitude of market to policy wordings	5	4	3	2	1
Lower operating costs than a conventional insurer	5	4	3	2	1
Saving of insurers profit	5	4	3	2	1
Retention of investment income	5	4	3	2	1
"Risk management advantages"	5	4	3	2	1

Other (please specify)

.....

.....

(c) Please give any comments you have to make on the hypothesis which have not been covered:

4. Was your company influenced in its decision by the possibility of building up reserves in a tax haven for other than insurance purposes?

5. Please give the following information on your captive:-

(a) Capital originally transferred to it

(b) Year of formation

(c) Country of domicile

PART THREE - Role of the Insurance/Risk Manager

1. Were you appointed before the captive was formed?

If YES:

(a) Has you job title changed? (please give details)

(b) Please describe how you:-

(i) saw your role before the subsidiary was formed

(ii) see your role now

2. What position do you have within the management structure of the captive?

3. Please describe the main responsibilities of your department and how they have been affected by the captive:

PART FOUR - Current insurance arrangements

1. What was your group's total expenditure on insurance in the last financial year (please give year end)?

2. What part of that expenditure represents premium income to the captive?

3. What risks does the captive insure?

4. What risks are insured elsewhere?

5. Please describe any self-insurance fund that you now have and the risks it covers:

6. What risks are deliberately left uninsured, which you feel would be accepted by the insurance market if offered to it?

7. What deductibles (excluding the captive's retention) do you now carry on the main classes of risk?

8. Please describe any special policy wordings issued by the captive that you consider you would not have been able to negotiate with conventional insurers:

9. Please describe any risks insured by the captive that you feel would not be accepted by conventional insurers:

PART FIVE - The management of the captive

1. (a) What reinsurance arrangements does the captive have?

(b) Where is it placed?

(c) Who places it?

(d) What amounts does the captive retain of the main classes of business, where this is not already revealed above?

(e) Please describe any special arrangements that are made for large accumulations of risk at single situations:

2. (a) What arrangements are made for the investment of funds?

(b) Who is responsible for investment decisions?

3. (a) How are costs incurred by the parent company in connection with the captive, which would normally be incurred by a conventional insurer (e.g. loss investigation, risk improvement), allocated to the subsidiary?

(b) If such costs are not allocated, how does the parent company attempt to assess the advantages of the captive compared with conventional insurance?

4. Do you engage an agent to manage the captive?

If YES, is the agent involved only with the management of captives, or is he part of an insurance broking organisation?

If NO, please describe the arrangements for managing the captive:

APPENDIX - Summary of results of captive in last three financial years

It would be extremely helpful if you could attach copies of accounts for the last three years, failing this please give as much information, on the lines indicated below, as you are able to reveal.

YEAR ENDED	19..	19..	19..
	£	£	£
1. Premium Income (gross of reinsurance)			
2. Reinsurance premiums ceded			
3. Claims paid and outstanding, relating to the financial year, before reinsurance recoveries			
4. Reinsurance recoveries made and outstanding, relating to the financial year			
5. Management expenses incurred direct by the captive			
6. Expenses incurred by the parent company and allocated to the captive			
7. Investment Income			
8. Outstanding claims reserves at year end			
9. Unexpired risk reserve at year end			
10. Capital and free reserves at year end			

QUESTIONNAIRE 4

QUESTIONNAIRE ON THE CONSIDERATION OF CAPTIVE INSURANCE COMPANIES

This questionnaire requests information regarding your consideration of the possibility of setting up a captive insurance company and your decision not to form one. The answers should, as far as possible, reflect your company's attitudes rather than your personal views.

PART ONE - The decision to examine the subject

1. Please indicate whether you consider that your company looked at the possibility of forming a captive insurance company:-

   (a) In depth

   (b) To a more limited degree

   (c) Superficially

2. Were the initial moves to look at the possibility of forming a captive made at the instigation of the company or an outside agency e.g. a consultant or insurance broker?

3. Please indicate how you obtained information about captives, by ticking any of the following, as appropriate:-

Own instigation	Outside agency
An approach was made to the company's broker	The company's broker suggested a captive
Another broker was contacted	Another broker contacted the company
A specialist consultant was approached	A specialist consultant approached the company
Other (please specify):	Other (please specify):

4. Was a full feasibility study carried out and a report prepared?

PART TWO - Examination of the subject

The following is an hypothesis on the reasons why companies consider the formation of captive insurance companies:-

"Captive insurance companies are considered with the objective of saving the parent company money in a direct way, 'risk management factors' (greater risk consciousness, better control of risk, more flexible risk management policies etc.) are seen as being important possible advantages, but would not be the reason for considering a captive unless direct monetary advantage was thought to be possible in addition. Consultants and insurance brokers play an important part in the process, but in essence do little more than draw the attention of potential captive owners to the possibilities. The factors seen to contribute to direct monetary advantage are fewer insurance regulations and lower taxation in tax havens, inflexibility in the conventional insurance market (attitude to deductibles, policy

wordings etc.), the captive being operated at lower cost than a conventional insurer and the retention of profit and investment income that would otherwise go to the insurer. The only real disadvantage of a captive is seen to be the possible political consequences of operating in a tax haven, but rarely is any attempt made to place a value on such a risk when the final decision is made".

1. Please indicate the extent to which your attitudes, when considering a captive, corresponded with the hypothesis:-

	Same	Similar	Dissimilar	Very Different
The importance of direct monetary advantage				
The view that 'risk management factors' are considered important				
The view that a captive would not be considered for 'risk management factors' alone				
The role of consultants and brokers				
The view that the only disadvantage taken seriously is the political risk in tax havens				
The view that no attempt is made to place a value on the political risk				
The implication that no attempt is made to place a value on other disadvantages				

2. Please indicate the extent to which you considered the factors mentioned in the hypothesis to be applicable both in general and to your organisation:-

	Relevant to the Company	Relevant generally but not to the Company	Not Relevant	Not Considered
Fewer insurance regulations in a tax haven				
Lower taxation off-shore				
General inflexibility in the market				
Attitude of market to deductibles				
Attitude of market to policy wordings				
Saving of insurers profit				
'Risk management advantages'				

Sav

Please detail other factors considered and your decision on them

3. The hypothesis places considerable stress on the importance of tax havens:-

   (a) Was your company ever influenced by the possibility of building up reserves in a tax haven for other than insurance purposes?

   (b) In your opinion, are other companies influenced in that way?

4. Please give any comments you have to make on the hypothesis which have not alraedy been covered:

PART THREE - The decision not to form a captive

1. If your company has made a definite decision not to form a captive in the immediate future, please indicate whether one or more of the following apply to that decision:-

   (a) Generally, the disadvantages were seen to outweigh the advantages

   (b) The claimed advantages were seen to exist, but were not considered to be applicable to the company

   (c) Advantages to the company were seen to exist, but were not thought to be significant enough to warrant a change in the company's approach to risk management

   (d) The company was largely dissuaded by the prospect of having to operate in a tax haven

   Please mention any other points that are relevant to an understanding of your decision not to form a captive:

2. If you have not made a definite decision, please outline the present position of your company in this area and indicate your view on the likely outcome of your deliberations and the reasons for it: