An innovative alternative

Many small to mid-sized captives struggle to find quality third party risks to insure. But Advantage Insurance has a solution, which involves an innovative alternative to traditional risk pooling, as the firm's Simon Kilpatrick explains to *Cayman Captive.*

While captives represent a tried and tested risk transfer mechanism for many US companies, there are also many firms that could benefit from their use but choose not to due to difficulties and concerns with assuming third party risk.

In order for a US business to treat the premiums paid to its captive as a tax-deductible expense the captive must meet the Internal Revenue Service (IRS) definition of a bona fide insurance company. There are essentially three tests that must be passed.

First, the captive must operate as a true insurer and insure commercially reasonable risks of the business. Second, risk transfer must be present in that the captive has to be a separate entity to its parent rather than a subsidiary that would disappear on consolidation. Third, the captive must achieve risk distribution by insuring sufficient unrelated, or third party, risk.

Simon Kilpatrick, senior vice president, Business Insurance of Advantage Insurance and president of Advantage Insurance Management (USA), says this third test is often the hardest of the guidelines for many captives to achieve.

"The IRS has issued revenue rulings that define two safe harbours for creating adequate risk distribution. One is if the captive insures at least 12 separate entities with each paying between 5 percent and 15 percent of the total premiums. This method has limited appeal because to achieve this, companies must have a sufficiently complex corporate structure or else their captives will need to directly insure unrelated businesses that they do not control.

"Most companies prefer to comply with the second safe harbour, which simply requires a captive to write over 50 percent unrelated risk. Most do this by transacting with a captive risk pool," Kilpatrick says.

Potential pitfalls

While it can work for some companies, this solution also has its drawbacks. Traditional risk pools co-mingle, or swap, risks with other captives. A captive sponsor gives up some of its good risks and takes on other, unknown, third party risks. Typically captives insuring a wide range of industries are sharing the same pool.

It is hard for pool participants to confirm that the risks the other members are putting into the pool are of a similar quality and priced consistently with those they are submitting. While participating in a pool can be beneficial in years where a captive experiences large claims

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from its parent, the flip side is that poor loss experience from the pool can lead to negative net returns for a captive sponsor.

To get around these problems some pools write coverages that generate low loss ratios by writing excess insurance outside the active layers, or by writing obscure coverages with little chance of a claim.

"While that might make people feel comfortable it also defeats the point of transferring risk in this way," Kilpatrick says.

"Consistently charging a high premium for a low risk will lead to a pool exhibiting a too-good-to-be-true loss ratio over the long term. This could eventually attract the attention of the tax authorities and lead to an IRS challenge to the tax deductibility of premiums.

"We are very cautious of the effectiveness of risk pools with aggressively low losses. Another concern we have is around the size and lack of transparency of the fees that are charged by pool operators. While there are indeed high quality pools out there with proven track records, it is also clear there are pools out there that do not present a good option for captives."

A cutting-edge solution

Advantage Insurance has developed an innovative alternative to traditional risk pooling that offers a solution to some of the problems faced by some existing pools. The company has found a way in which a company can insure 100 percent of its own risk in its captive and achieve risk distribution by matching it with risks from the open market.

Utilising its rent-a-captive facility based in Grand Cayman Advantage has gained direct access to the world's largest global insurance market. By hiring the market's leading underwriter, Advantage has been able to craft exposure to a globally diversified blend of traditional market risks including property, casualty, energy, marine, aviation, life and diversified reinsurance, Kilpatrick explains.

Advantage intends to reinsure its exposure to this portfolio of risks by entering into reinsurance contacts with its clients' segregated portfolios and standalone captives. The reinsurance agreements will be made on a quota share basis meaning that all participants will be treated equally and have the same risk exposure. Advantage will also retain a portion of the risk in-house to make sure its interests are fully aligned with those of its clients.

"The risks we will pass on to our captive clients are well defined market risks directly priced in the market. These are the very definition of commercial risks and they make an attractive alternative to the risk pools that write the more obscure coverages," says Kilpatrick.

"Our professional underwriters have a long track record in the industry and a disciplined methodology for choosing which risks to accept, so participants will have confidence in what they are getting."

Collateral needed

In order to reinsure Advantage and gain access to this third party risk a captive will have to post funds as collateral. Typically one dollar of collateral will support up to two dollars of assumed premium.

"This is a key difference between our idea and traditional risk pools. Typically with a pool a captive or business pays in premium and hopes not to lose too much. In this model we are trying to make money for participants by earning underwriting profits from their capital placed on risk," he says.

"A participant's exposure is also capped in that they could never lose more than their collateral funds.

"Another key difference is that captives can keep all of their good risks rather than having to share some of them with a pool. Using a typical pool, if a business had $1 million of premium, the captive would keep half and the other half would be sent to a pool.

"Under this new arrangement, the $1 million stays in the captive and the captive gains another $1 million of assumed premium," Kilpatrick says.

"We have also addressed the issues of high pool fees and lack of transparency. Our fees are fully disclosed in the reinsurance agreement. First, we charge an initial participation fee on the lower collateral figure rather than the amount of premiums assumed; second, we defer a portion of our fees and will charge them only if there is a certain level of underwriting profits earned by the participants.

"This is a brand new programme and Advantage has received a very warm reception when discussing it with clients," he says.

Kilpatrick expects a number of companies to use the structure in 2015 and is currently trying to firm up client commitments to gauge how much third party risk Advantage needs access to.

"It is like buying a pizza," he says. "You have to know how many slices you are going to need before you know what size to order."

He believes the concept could revolutionise the way small to mid-sized companies achieve risk distribution. "Companies too small to secure adequate diversification themselves and unsure of the shortcomings of traditional risk pools now have another option. We believe this structure will afford more companies the peace of mind to consider using a captive."

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