How does a Captive Work?

A captive insurance company operates in a comparable way to a traditional property and casualty insurance company. A captive issues policies, processes claims, follows all appropriate regulations, files a property and casualty insurance company income tax return, and retains profits, if profitable, which are available to the insurance company owners. The difference is that with an insured owned captive insurance company, the captive owner(s) decide whether or not to retain or distribute the company's profits. With a traditional insurance company, the insurer, and its shareholders, instead of the insureds, retain the profits.

We will be discussing how a captive is structured and set up, as well as how policy premiums flow from the captive owner's company to the captive insurance company. We will also consider how the captive owner can invest and retain profits in the captive as well as receive dividends from the captive.

While the particulars of the planning may vary, a captive insurance structure often encompasses the captive owner's operating company paying premiums to a ceding or fronting company, which is a term that defines the insurance company that guarantees the captive insurance policy, or "writes the paper."

The company that writes the paper issues the actual insurance policy to the business that is acquiring coverage, the insured. The captive then normally reinsures the fronting or ceding company through a common type of agreement called a "quota share agreement." A quota share agreement is a pro rata reinsurance contract where the insurer and reinsurer share premiums and losses corresponding to a fixed preset percentage.

For example, if the fronting or ceding company each shares 50 percent of the risks, the fronting or ceding company then retains 50 percent of the premiums. A conventional quota share agreement that falls within the Internal Revenue Service safe harbor rules for risk shifting and risk distribution is one where at least 50 percent of the risk must be shared.

For instance, if an insured pays $1 million in premium to a fronting or ceding company, $500,000 would at the start be retained or held back by the fronting or ceding company for claims. The remaining $500,000 would be transferred to the captive insurance company that is reinsuring 50 percent of the risk from the fronting or ceding company. After the opening holdback or retention by the fronting or ceding company and after claims history and an actuarial analysis are factored in, at a specific point, the fronting or ceding company could distribute half of the remaining premium that was originally held back.

In this example, the opening amount held back is $500,000, and distributing half of this results in an additional $250,000 distribution. The holdback, prior to distribution, is generally invested as an insurance company reserve and usually includes interest earned or investment income on the retained funds reduced by the cost of any claims. The final $250,000 (out of the initial $500,000 holdback) is typically released by the fronting or ceding company after all policies issued by the fronting and ceding company have expired and have been afforded an additional time period to file claims.

The additional claims period is generally 45 to 60 days from the policy expiration date. Typically, after this 45-to-60-day period, the fronting or ceding company will shift such remaining funds to the captive in addition to any investment income earned while the funds were retained, reduced by the paid and outstanding claims amount and a ceding fee. A fronting or ceding fee is the fee charged by a fronting or ceding company to the captive for issuing policies and pooling the insurance risk.

A question often posed by captive owners is, *what happens after the captive receives its premiums from the fronting or ceding company?*

Where does this money go?
The captive's profits become part of its surplus. Surplus funds (assets minus liabilities) may be invested pursuant to the approved investment policy of the jurisdiction where the captive is licensed and governed. Notably, surplus is also used to determine an insurance company's economic potency or viability and is used in many financial ratios to examine an insurance company's viability.

Do the surplus funds have to be retained indefinitely?
No.

Or more relevant to a captive owner, how are profits taken out of the captive?
Remember, like any company, a captive has the ability to distribute dividends to its owner shareholders. As captive dividends are generally qualified dividends, the distribution of profits may be income tax advantageous to a captive owner. Keep in mind that the process for receiving a dividend from a captive is more complex than it is for owners of a nonregulated company. As a regulated and licensed insurance company, approval is generally required from the department of insurance within the jurisdiction where the captive is licensed.

To commence the dividend process, the captive owner (or captive owners) asks the captive insurance manager to seek approval from the department of insurance. The department then

assesses the insurance company financials to ascertain what effect taking a dividend has on the insurance company's ratios and its ability to pay claims.

The department also performs supplementary financial testing as it deems reasonable and pragmatic within the jurisdiction's regulatory program. If the department of insurance authorizes the captive manager's request, then the captive insurance company may issue a dividend payment from the captive.

A captive is a licensed, regulated entity that must qualify within a jurisdiction as an insurance company and must comply with applicable rules and regulations. Like any business, a captive investor and shareholder enter into a transaction to earn a profit and retain the valuable capability to manage the operate a company's risks.

Once profitable, dividends are generally available within the horizon of the department of insurance and its regulatory program for shareholders. As a licensed and regulated company, a captive insurance company will require additional care and attention over many businesses, but a captive's unique ability to manage risks and create profits for its owners can transform a business's insurance from merely a cost to a method of making risk management profitable.