To Be or Not To Be: That is the Question

Forming Captive Insurance Companies

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So you think that a captive for your organization may be your ticket to more-efficient risk financing? It may indeed be nobler in the mind to suffer the slings and arrows of outrageous fortune, but it makes more sense to take arms against that sea of troubles. But William Shakespeare also knew that by taking arms against them, one could have a very bad day if one did not think through the process. The process of studying the feasibility of a course of action is as old as man's thought processes, but never more important than in the present economic times.

Determining the feasibility of the participation in a captive within the structure and culture of your organization is no exception. In many domiciles the regulators require that a feasibility study be completed and filed with the insurance departments. In those that don't, management should still perform a feasibility study for its own due diligence, education and understanding.

There are many reasons to participate in or form a captive. Those reasons are usually assumed to be true from the start. What may not be so clear is why not to use the captive mechanism to address those reasons. Reasons for captive formation can be based upon false assumptions without proper investigation into alternative methods of risk financing.

Forming a Captive Without a Feasibility Study Is Like Going into Battle Without a Gun

Participating in a captive without a feasibility study would be akin to opening a completely new and different product line without understanding the impact of that new and different venture. Managements of organizations that form captives usually do not understand the financial, tax or regulatory requirements of insurance. They understand the dynamics of their own business because those were the reasons for their organization's creation. Insurance is one of the most unique lines of business because it carries with it not only unique benefits but also unique risks.

Without a feasibility study, there would be no in-depth analysis of the needs of the customer (the organization itself), no strategy to satisfy those needs or alternative considerations, no tactics of implementation, no analysis of capital requirements over the long term under differing economic scenarios, and no exit strategy. Probably most important, not all of those within the organization who participate in the captive decision will be as familiar with the captive mechanism as are the proponents of the captive mechanism. In those instances where no feasibility study is performed, management would be forced to defer its confidence to the proponents of the captive. This could lead to career-threatening events for the proponents should those not understanding the implications of their decision be caught off guard.

The feasibility study should be considered the foundational document for the proposed captive mechanism. It has great utility as a document, both to prove up the captive decision and to defend actions needed years down the road. If the organization finds itself under completely different economic or market conditions, the feasibility study can provide bases to alter methods of operation based upon those conditions. Organizations change over time, and the reasons for a captive mechanism can change along with the organization.

So what are the reasons *not* to do a feasibility study? I would maintain that there are none for such a labor-, time- and capital-intensive decision. The bases for the captive decision can be compared to other alternatives, the return on investment compared to other risk financing techniques can be measured, capital requirements can be forecast, management can be better educated, buy-in from within the organization and with the insurance regulators can be facilitated, and the match between captive participation and the organization's goals can be more in line with reality.

Captive Feasibility Examines a Very Different Venture Within All Organizations

Reality … now there's a word that has been missing from the global economic landscape for some time. Many illusions of the last twenty years or so have been created by "Special Purpose Companies" or "SPCs." Many companies before and since their demise have taken the art of deception through SPCs to new levels.

Captives are in essence SPCs. Captives in all forms were targets for the IRS long before Enron and SPCs became headlines. But thanks to the many coordinated talents and efforts of those within the captive industry, captives in the last year have withstood yet another major IRS challenge to their tax treatment. The speed and resolve of the recent decision by the IRS are a testament to the maturity and professionalism of the captive industry. In order to assure that the organization's reasons for participation in a captive are well documented, a comprehensive feasibility study can be a major defense against an organization's challenge by the IRS that could potentially blow up the best of intentions.

The reasons supporting a feasibility study should clearly make this the first essential step in the process of deciding upon captive participation or formation. With that said, what questions should one expect of the feasibility study? These are among the many questions to consider:

- Which risks should and which risks should not be included within the captive?
- Should the captive write direct insurance, reinsurance or both?
- Which domicile is best for the captive and for the organization?
- What competitive advantages are present in a captive strategy?
- Is there adequate manpower for the captive process support?

- Does the captive rationale persevere through both hard and soft markets?

A comprehensive list of questions to be answered is quite extensive in all organizational and captive structures. Those questions touch on the needed areas of expertise both inside and outside the organization: underwriting, legal, claims, actuarial, banking, accounting, audit, tax, regulatory, reinsurance, fronting, broker markets, administrative and others. These are all a challenge even to someone with experience in those processes. For a risk-management department familiar with some but not all of these processes, they are even more of a challenge. For the organization's management, these processes can be a blur of detail involving terms and concepts not familiar to either the CFO or CEO of the organization. It is not surprising that no one individual has expertise in all areas, and all of that expertise is what is needed when committing capital from the organization for the long term.

The Team Approach Is the Most Efficient and Reliable

One answer to the complexity of this problem is to put together a team of individuals, each within their own area of expertise, with oversight of all areas provided by a team coordinator. It is not at all uncommon to have many people in many locations, all working toward answers to questions in their own area of expertise. If someone within the organization has experience in coordinating those functions, then all the better. However, the process of coordinating those efforts at some point becomes a full-time job if goals are to be met with any degree of timeliness. Add to that the likely limited experience of the inside coordinator, and the case for an outside coordinator with expandable capabilities makes sense.

The outside coordinator should have experience in touching each area of expertise in the feasibility study. Those having experience as captive managers will have encountered most, if not all, of the questions involved with feasibility studies and the development of the end product to present to the organization's management. They are familiar with the requirements and the providers' capabilities.

The Feasibility Using Differing Life-Cycle Scenarios

Whatever the motivation for creating a captive insurance company within your organization, it is useful to stress the various options using differing economic conditions and to have an exit strategy in case those motivations unwind. Having a strategy to unwind the captive makes the process of forming one less risky because there is a contingency plan in effect for those times when the need for a captive disappears for whatever reason. Mergers and acquisitions also many times involve the combination of captives, captive run-off in the event of duplication, or redeployment of assets into a new and more robust captive structure. Contingency planning makes the formation or participation in a captive much less daunting to upper management.

Whoever the proponent of the captive may be, any new concept within an organization must have its champion. That champion must have an arsenal of information in order to be able to lead the captive concept through the creation or participation processes. The captive industry is now very mature and has at its disposal many avenues of education and information to assist in guiding one through the slings and arrows of captive formation.

Just in the last few years, the International Center for Captive Insurance Education (www.ICCIE.org) has made available many areas of study specifically for the captive industry. Over the last three decades, the International Risk Management Institute (www.IRMI.com) has become a most prolific publisher of information on captives and captive formation. The various domiciliary state organizations have material and reference to resources that can assist anyone who delves into the captive realm. These organizations would almost certainly concur that the feasibility study is the foundational document for captive formation and participation.

So whether it is to be or not to be, may your journey through the captive formation or participation process be educational and smooth. Enjoy the journey and consider the wisdom of another series of favorite soliloquies while you are answering Shakespeare's question:

"To be is to do." - Plato

"To do is to be." - Sartre

"Do, Be, Do, Be, Do."- Sinatra