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COMMENTARY: Captives still solving problems

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Three hundred years ago, if someone had said they had a captive in the Caribbean, they most certainly would have been a pirate. But today, captives are held by the vast majority of Fortune 500 companies and an increasing number of middle-market firms as an alternative risk financing vehicle.

While islands such as Bermuda and Guernsey historically have been the most popular domiciles for captive formations, many of the captives being created today are in such land-locked locations as Vermont, home to more captive insurers than any other U.S. state with 572 licensed captive insurers at the end of 2010.

The idea of self-insuring risks in a captive rather than buying commercial insurance is attributed to Frederic M. Reiss, known as the father of captive insurance, who used the term “captive” to describe an insurance company subsidiary he helped form for the Youngstown Sheet & Tube Co. in the 1950s. The company had called the mines whose output was used exclusively by the parent corporation “captive mines.”

Because this first wholly owned insurance company subsidiary was created to provide insurance coverage solely to its parent, Mr. Reiss aptly dubbed it a “captive,” and the name stuck, although it is something of a misnomer for many of today's captives that provide insurance to third parties as a way to preserve the tax deduction for premiums paid into them.

The captive movement gained momentum during the hard commercial insurance market of the mid- to late 1980s when liability coverage was either unavailable or unaffordable for many buyers. As buyers were forced to raise their deductibles to lower the cost of insurance coverage, they discovered they could squirrel away some of the money they were setting aside to pay claims within those deductibles into captives, where it would earn investment income at a time when interest rates were exceptionally high. Today, more than 5,000 captives exist worldwide.

Something similar is happening today as captives provide a way to address the high cost of employer-sponsored health benefits programs. Some midsize employers that self-fund health benefits are joining group captives to pool a portion of those medical risks, reducing the cost of health benefits by allowing employers to purchase medical stop-loss coverage at higher attachment points.

In another creative use of captives, some mid-market companies are tapping some of the reserves that have built up in their captive subsidiaries to form “microcaptives,” permitted under section 831(b) of the federal tax code, to provide reinsurance to their captives rather than purchasing such coverage from traditional reinsurers. Other companies are using captives to provide added financial protection in the event of supply chain disruptions like those that occurred after the recent earthquake and tsunami in Japan.

Like most innovations, captives were created to solve a problem. And they will continue to evolve and proliferate to address the growing need for alternative risk transfer.
