

A Comprehensive Evaluation of the Member-Owned Group Captive Option

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Introduction

A captive insurance company is a legitimate type of risk management arrangement that can take a variety of forms, but essentially works like self-insurance. While self-insurance is typically financially viable only for large, well-capitalized companies, mid-sized companies that seek to lower their insurance costs and control other aspects of their insurance program may consider the costs and benefits of group captive insurance arrangements.

In 2018 about 200,000 companies in the U.S. met the common definition of a mid-sized company, having revenues between \$10 million to \$1 billion. For these companies, the option to form a captive means establishing a new group captive or joining an existing group captive. This paper discusses the considerations for these companies from a financial cost and benefit perspective. Section 1 provides a general overview of the captive form of risk management. This overview includes information on the types of companies that use captives; the various types of captive arrangements; how they are currently used; and where they are located. Section 2 provides a more detailed discussion of how member-owned group captives operate and includes a comprehensive discussion of the benefits to forming or joining a member-owned group captive. Section 3 provides a discussion of the important legal and regulatory compliance concerns and Section 4 provides a brief discussion of several case studies.



1. Overview

What is a captive?

In its simplest form, a captive is an insurance subsidiary formed to provide risk-mitigation services to its parent company. Basically, a parent company retains the cost of insurance coverage through the captive instead of paying premiums to a third-party insurer for commercial insurance. Captives are usually formed to supplement other commercial insurance coverage and allow the parent company to retain some risks at a lower cost. The captive can provide coverage that is unattainable or inadequate in the private market and, in addition to the opportunity to obtain more comprehensive or specialized coverage for the company's risks, the parent company can achieve cost savings, tax savings and better control over claims decisions. The captive can be especially cost-efficient because the parent company retains what it would otherwise pay a third-party insurer whose costs would include profit, overhead, or state premium taxes.

The use of captives dates back to the late 1950s when poor market conditions led to increasing premiums, higher deductibles and tighter policy conditions. A few large companies formed "pure" or "single-parent" captive insurers to reduce their overall cost of risk. At that time,

this option was financially viable only for companies with significant capital. Today, most Fortune 500 companies have established captive insurance companies, but over the past 60 years, the variety of arrangements has expanded. Group captive insurance emerged in the 1980s as an alternative for mid-size companies, and today remains an affordable option for them.

The number of captives has grown significantly over the past few decades. Between 1960 and 1986, the number of captives grew from 100 to more than 2,000. The number has continued to grow, and there are more than 6,000 captives worldwide today.¹

Types of captives

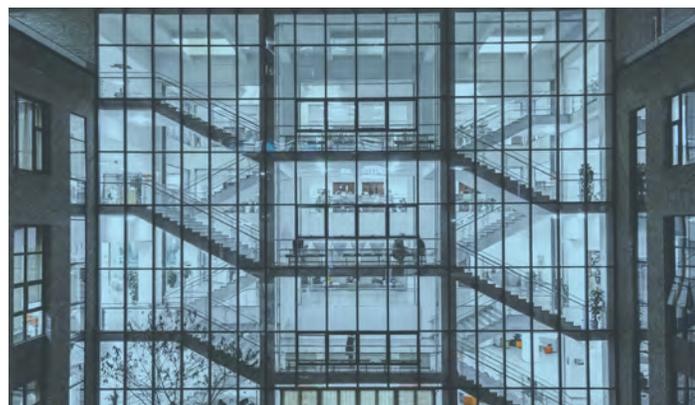
Captives can be categorized on two main dimensions. First, some are "owned," while others are "rented." In an owned captive, the policyholders are the owners. They hold the capital and manage the operations of the captive. A "rent-a-captive" is a licensed insurer owned by an outside organization that provides many of the functions of the captive for a fee. Their services include the underwriting, rating, claims management, accounting, reinsurance and other areas of financial expertise.

The second dimension relates to the organization of the captive as a subsidiary of a single company or a joint arrangement of multiple companies. While many captives are pure, single-parent subsidiaries, captives formed by

1. Business Insurance Survey, *Business Insurance*, March 2021.

groups of companies take a variety of forms. Types of group captives include: a member-owned captive; an association captive; rent-a-captive; diversified captive; risk retention group (RRG); special purpose financial insurance company (SPFI); sponsored captive; industrial insured captive; protected cell captive; branch captive; and an affiliated reinsurance company (ARC).² Member-owned group captives have become very popular in recent years. Unfortunately, there is no centralized source of data on the number of member-owned group captives, nor are there data on the average number of members in group captives.

A member-owned group captive insurance company is a special form of captive, formed by multiple companies to insure the risk of the member companies' businesses. Risks of the group may be homogeneous or heterogeneous. Advantages of pooling homogeneous risks include the benefits of sharing with members who are familiar with the exposures and understand the risk, and can share successful loss control mechanisms and best practices, education, etc. On the other hand, pooling of heterogeneous risks – e.g., pooling companies from different industries – allows for more diversification of the risks.



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To establish a captive, a single business owner forms a wholly-owned subsidiary, or a group of business owners form a jointly-owned company. The captive must be capitalized and domiciled in a jurisdiction that legally allows for captives to operate as a licensed insurer. The captive insurer is an unlicensed, nonadmitted insurer except in its own domicile. Because it is generally illegal for an unlicensed insurer to issue policies, captive insurers typically contract with a licensed insurer to issue policies, though the captive does not transfer the risk. These fronting arrangements allow captives to comply with various state financial responsibility laws that require evidence of coverage for certain lines, such as workers compensation, to be written by an admitted insurer. The captive determines the types of risks that will be covered and establishes premiums which are paid to the captive by the business owner(s). If claims exceed premiums in the captive, the company, or group of member companies, is liable for the excess cost. On the other hand, if losses for the coverage are less than expected, the excess premium can be distributed back to the business owner(s). An example of how the funding arrangement works for a member-owned group captive is provided in Section 3.

Types of coverages written in captives

Companies should not retain all risks, especially because a vibrant and competitive market exists for transferring most types of commercial risks to commercial insurers. While captives can allow companies a means for managing risks that cannot be placed with commercial insurers, the risks that are reasonably retained by companies in captives have some distinctive characteristics. For example, the frequency and severity of losses for risks transferred to the captive should be well understood by the company. Also, a company should have adequate experience with the risk to fully appreciate the actuarially-estimated expected losses associated with the exposure. The expected losses should also not be catastrophic in nature. Since these losses are infrequent, they can be more effectively pooled by an insurer who has more capacity and more opportunities to diversify its risks.

Thus, it is not surprising that captives are most often used for conventional property/casualty insurance coverage, such as general liability, product liability, professional liability, commercial auto, and workers compensation. Because a captive can provide specialized coverage for

2. For descriptions of the different captive arrangements, see [International Risk Management Institute, Inc.](#) and [National Association of Insurance Commissioners](#).

Table 1

Leading Captive Domiciles, 2020

Rank	Domicile	Number of captives
1	Bermuda	680
2	Cayman Islands	652
3	Vermont	589
4	Utah	396
5	Delaware	288
6	Barbados	276
7	North Carolina	250
8	Hawaii	242
9	Tennessee	212
10	Luxembourg	199

Rank	Domicile	Number of captives
11	Guernsey	191
12	South Carolina	175
13	Nevada	166
14	Arizona	131
15	Nevis	116
16	Montana	114
17	District of Columbia	106
18	Isle of Man	100
19	Anguilla	99
20	Singapore	80

Source: Business Insurance, March 2021.

hard-to-insure risks, some provide coverage for more nontraditional risks including pollution liability, asbestos liability, terrorism, cybersecurity, credit risk, and employee benefits.³ Workers compensation risk is often placed in a captive and represents the most common risk pooled in a group captive. State laws, described further in Section 3, may prohibit insurers from writing some types of coverage. Increasingly, employers are using captives to manage healthcare and medical liability risks.⁴

Captive domiciles

Captives may be domiciled in captive-enabling jurisdictions that are either onshore (in the U.S.) or offshore. Currently, more than 30 states have captive-enabling legislation. These domiciles are considered to be welcoming to captives due to minimal licensing and reporting requirements and favorable tax treatment.

Table 1 shows the most common places in which to domicile a captive and includes both U.S. states and foreign locations.

When considering where to locate a captive insurance company, companies should consider the following distinguishing characteristics of domiciles:

- Minimum capital requirements
- Application, incorporation and license fees
- Actuarial review fees
- Investment restrictions
- Taxes
- Reserve and underwriting requirements
- Regulatory and legal considerations
- Geographic convenience
- Political climate
- Local office requirements

Regulatory considerations for selecting a domicile are discussed further in Section 3.⁵

3. Lai and McNamara (2004) discuss Department of Labor decisions that expanded the ability for companies to use captive insurers for employee benefits, such as long-term disability income and life insurance coverage.

4. See Bianchi (2017), Talmadge (2017), and Giles (2018).

5. See also Cole and McCullough, 2008, for an overview of changes in captive domiciles, and factors driving these changes, over the period 2002-2007.

Leading Providers of Group Captive Services	
	Captive Resources LLC
	Artex Risk Solutions
	Cottingham & Butler
	Innovative Captive Strategies
	Alternative Risk Underwriting

2. Group captive operations

A group captive insurance company can provide many different types of benefits. To understand these benefits and any associated costs, it is important first to understand how a group captive arrangement operates. This section begins by describing how a group captive is formed and the common funding structure. This is followed by a discussion of the costs and benefits associated with using a captive, generally, with an emphasis on how these may be evaluated when considering a group captive arrangement. All costs and benefits described below assume that the group captive is formed for a legal purpose and meets the requirements for compliance with state and federal laws relating to captives. Relevant regulations are discussed further in Section 3 below.

Group captive formation

Establishing a member-owned group captive begins with completion of a feasibility study and the formation of a business plan. Most member-owned captives are formed by an administrator (e.g., a consultant or sponsor) which assumes responsibility for forming the captive to ensure that it meets the domicile's legal requirements. The administrator often also assumes the responsibility for advising member companies (hereafter, "members") on compliance issues going forward. Therefore, it is important that a company interested in joining a group captive evaluate the expertise of the administrator – i.e., its outside counsel and captive manager – to ensure they have domicile-specific captive expertise. Once the captive is formed, the administrator makes membership available

to companies. **Table 2** shows the leading providers of group captive services, who provide services to about 99 percent of the group captive market.⁶

One important decision at the formation stage is what the membership structure should be and whether the risks borne by the captive should be homogeneous or heterogeneous. A risk funding formula must be developed to help members understand how premiums are determined and provide transparency with respect to the insurance costs. The most common formula used is referred to as the A/B Fund model.

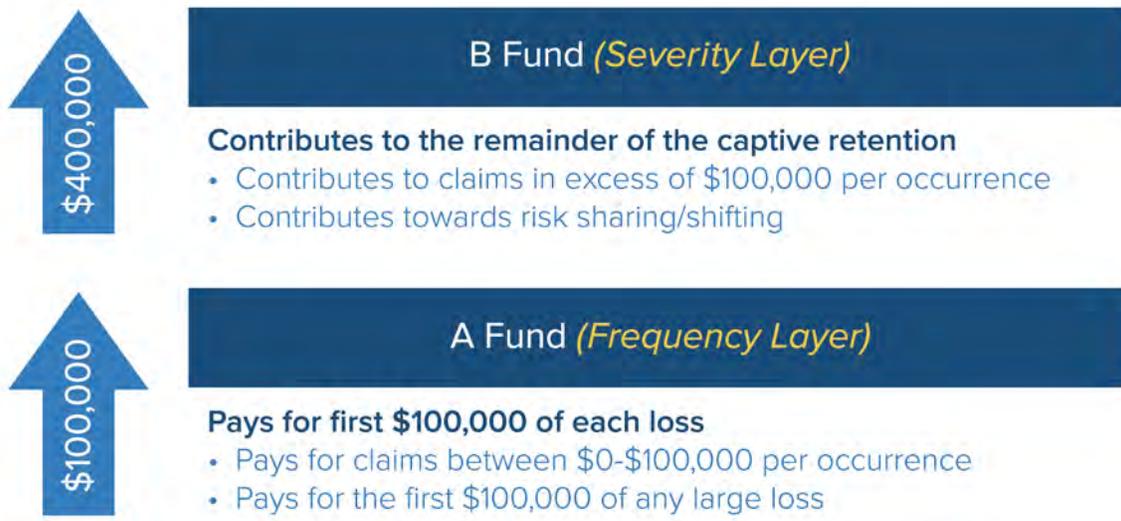


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6. This information was obtained from an actuary with 35 years of experience in consulting with group captives.

Figure 1

A/B Fund Layers



Overview of the A/B Fund model

The A/B Fund model is the typical funding structure for member-owned group captives. This model funds losses on a per-occurrence basis, and fundamentally benefits companies that are able to minimize the frequency of losses. These benefits are highlighted by the potential for a member to receive its unused A/B Funds back in the form of a dividend, with each member's individual financial outcome depending on the effectiveness of its loss prevention program. The A/B Fund model also ensures that the captive fulfills the need for an insurance company to have risk sharing amongst its members.

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The core philosophies of the A/B Fund model are based around a captive member's commitment to safety and loss prevention, and an overall desire to control its insurance costs. A member's commitment to these philosophies is

an important factor because the funding for the model is developed through loss forecasting, an analysis of loss history and exposures, which is seen as a member's expected losses for a policy year. Consequently, a company that has trouble focusing on safety and controlling losses would not be a good fit for a captive. The loss forecast is developed by an independent actuary, using a member's previous five years of loss history and current exposures, with the total forecasted amount varying for each member. That loss forecast is then split between the A and B Funds.

The A Fund is known as the frequency layer and holds the majority of the forecasted loss dollars. This fund is used to pay out losses, on a per-occurrence basis, from the first dollar of a loss up to the A Fund's limit, typically \$100,000. If a member is successful in controlling their losses, then the A Fund should be sufficient in its ability to cover losses for the policy year. The B Fund, known as the severity layer, holds the remainder of the forecasted loss dollars, and covers losses from the A Fund's limit to the captive's overall retention limit, typically \$400,000-\$500,000. It is important to understand that the A Fund limit and the captive's retention limit are the same for every member in a captive. A well-managed captive will also seek to place aggregate excess insurance above the A and B Funds to limit the exposure of the captive as a whole. **Figure 1** provides an illustration of these layers.

Figure 2

A/B Fund Example for a Low-Frequency Year

Low-Frequency Year				
Fund	Loss Fund	Frequency Losses	Catastrophic Loss	Potential Dividend (prior to risk sharing)
A Fund	\$325,000	-\$200,000	\$0	\$125,000
B Fund	100,000	0	0	100,000
Total	\$425,000	-\$200,000	\$0	\$225,000 in Funds remaining

A/B Fund Examples

The following examples follow a loss-producing sample member to illustrate how losses flow through the A/B Fund model. For all examples, assume the captive's retention is \$400,000 and the member's loss forecast \$425,000. The loss forecast is split, with \$325,000 allocated to the A Fund and \$100,000 to the B Fund.

Figure 2 provides an illustration of a low-frequency year. In a low-frequency year, the sample member had \$200,000 in losses, each of which is less than the A Fund's per occurrence limit of \$100,000. These are known as frequency losses. The losses are paid out of the member's A Fund of \$325,000, leaving \$125,000 still available in that Fund. Assuming no other losses, this member would then receive the remainder of its A and B Funds back (plus investment income earned on those unused loss funds), in the form of a dividend, less any costs associated to risk sharing, once the policy year has been closed out.

Figure 3 provides an example with a catastrophic loss. Let's assume now that the sample member experienced a \$1 million loss, as well as \$100,000 in frequency

losses. First, the frequency losses are paid out of the A Fund, bringing its A Fund balance to \$225,000. For the \$1 million loss, the captive is only responsible for paying each claim up to the captive's retention limit; therefore, the captive's total liability for this loss is \$400,000. The first \$100,000 of the loss comes out of the loss-producing member's A Fund first, so the remaining balance in its A Fund is reduced to \$125,000, and the captive's remaining liability for the catastrophic loss becomes \$300,000. The member's \$100,000 B Fund is used next, bringing the remaining liability for the captive to \$200,000. At this point the loss-producing member still has \$125,000 in its A Fund to pay claims. So, before the other members in the captive are asked to share the risk, the remaining A Fund will be used as well. Finally, with the captive still having a \$75,000 liability on the \$1 million loss, and with the loss-producing member's loss funds used up, risk sharing will then occur amongst the other captive members. Risk sharing is done on a pro-rata basis, based on an individual member's remaining B fund amount, relative to the available B fund dollars in the whole captive. A final example is provided in **Figure 4**. In this example, the sample member has a high frequency of losses, resulting in an assessment. Let's assume the member has \$400,000 of

Figure 3

A/B Fund Example for a Catastrophic Loss Year

Catastrophic Loss Year					
Fund	Loss Fund	Frequency Losses	Catastrophic Loss	Risk Sharing	Potential Dividend (prior to risk sharing)
A Fund	\$325,000	-\$100,000	-\$225,000	\$0	\$0
B Fund	100,000	0	-100,000	0	0
Risk Sharing	N/A	0	-75,000	75,000	N/A
Total	\$425,000	-\$100,000	-\$400,000	\$75,000	\$0 in Funds remaining

Figure 4

A/B Fund Example for a High-Frequency Year

High-Frequency Year					
Fund	Loss Fund	Frequency Losses	Catastrophic Loss	Assessments	Potential Dividend* (prior to risk sharing)
A Fund	\$325,000	-\$400,000	\$0	\$75,000	\$0
B Fund	100,000	0	\$0	N/A	\$100,000
Total	\$425,000	-\$400,000	\$0	\$75,000	\$100,000 in Funds remaining

*Factoring in assessments, the net potential dividend for the year would be \$25,000.

losses, each of which is under the A Fund’s per occurrence retention limit of \$100,000. The member’s A Fund has \$325,000 allocated to it and therefore will not be able to cover the full amount of the frequency losses. When this occurs, the captive member is assessed in order to cover the additional losses. The maximum assessment amount for any member is one additional A Fund, which for the sample member is \$325,000. In this specific example, the member would only be assessed \$75,000, the exact amount of the shortage.

Other group captive characteristics

Member-owned group captives use a captive management company that takes responsibility for the day-to-day operations of the captive, including overseeing governance; regulatory reporting; cash management and accounting; audit and tax coordination; providing the registered office; and all corporate secretarial functions including compliance. Most often, the various functions of the captive such as claims management, loss control, policy issuance, arranging for reinsurance and actuarial services are “unbundled” to industry service professionals. While a management firm manages the day-to-day operations of the captive, each company has a say in the decisions facing the captive. Typically, the captive’s board of directors is made up of all members who each receive one vote on all operational decisions, regardless of their company’s size. Company bylaws address various organizational concerns, such as the process and standards for allowing additional companies to buy in and become an equal shareholder of the captive.⁷

7. Gordon (2019) suggests that “The captive should take on financially strong members that are committed to loss prevention,” and may want to set increasingly higher standards over time.

Benefits of group captive membership

While the package of benefits achieved by a member-owned group captive will be unique to the particular members served, there are some benefits that are universal. These include:

Greater control. One of the greatest benefits of a group captive is that it provides member companies significantly greater control over their unique risk management concerns. Captives can customize insurance programs to suit their specific needs because the captive provides more risk financing options.

Lower costs of protection. Member companies experience lower costs of insurance for two main reasons. First, premiums to the captive are based on the individual member company’s loss experience, which the member company can control and reduce. Secondly, the cost of protection is reduced significantly when a traditional insurer’s loading costs are excluded from the premium calculation. Captive member premiums do not have to cover an insurer’s acquisition costs, marketing expenses, administrative expenses, overhead and commission expenses.

Improved claims handling and reporting. In the member-owned group captive, member companies have greater involvement in claims management, influencing claims-management strategy, and ultimately having a direct impact on claims-management costs. In a traditional insurance arrangement, companies must rely on the insurer’s claims team and its claims management processes. Group captives unbundle claims management to third-party claims administrators (TPAs), that work closely with individual member companies. Group captive

members can also be actively involved in selecting counsel and managing the process of investigation and claims resolution. However, it is important to note that claims must still be handled according to the provisions in the policy issued by the policy issuing/fronting carrier.

Improved cash flow. The benefits described above provide captive member companies greater opportunities to improve cash flow. This can be achieved through developing precisely tailored coverages, improving claims handling and stabilizing insurance budgets. Many group captives provide premium payment options that maximize individual members' cash flow.

Enhanced incentives for risk management.

Premiums to the member-owned group captive are established based exclusively on the member company's loss experience.

In a traditional commercial insurance arrangement, companies with excellent safety records and loss ratios far below the average in their industry may pay the same premium as companies with much higher loss histories. In the captive, if a company's experience is better than the average experience in the market, the company will realize lower-than-average premium costs. This incentivizes member companies to undertake more loss control efforts.

Improved risk management. Group captives also provide members risk control and safety support services/programs, and formal education opportunities. Members of a group captive also benefit from the exchange of ideas and best practices with other members in the captive.

Direct access to reinsurance. A captive can go directly to the global reinsurance market and purchase coverage at wholesale rates because it is essentially an insurance company. Further, the price for reinsurance coverage is driven by the captive's own exposures and loss record, not the experience of the industry. The captive does not have to work through a commercial insurer for this access, and thus saves on the expenses associated with dealing with commercial insurers – e.g., commission costs, administrative costs, and profit markup. Member companies retain much more control over the selection of, and arrangements with reinsurance partners.

Greater potential for profits. Member companies are rewarded for effective risk management because unused

loss funds are paid back to the company in the form of a dividend (less provision for risk sharing). Also, investment income earned on loss funds as well as capital and cash collateral, accumulate for the members' benefits. In traditional insurance arrangements, investment income is retained by the insurer and in fact, is a major source of income.

Limited capital outlay. The member-owned group captive arrangement allows businesses who could not afford to set up a single-parent captive, the same types of benefits at a reasonable cost. Member companies are required to make a one-time capital investment for group captive ownership. The amount typically ranges from \$25,000 - \$36,000 per member, which is significantly lower than the capital required to start a single-parent captive.

Tax benefits. The deductibility of premiums is a significant benefit

of establishing and running a captive. As long as a captive meets the IRS guidance defining its purpose as an insurance function, member companies receive a current deduction for premiums paid to the captive to fund reserves for future liabilities. In addition, the captive can deduct the cost of covering claims if it has reinsured them. The eligibility for tax benefits is discussed further in section 3.⁸

Costs of group captive membership

Administration costs. Compared to a traditional insurance program, the management of a captive arrangement requires significant resources. Since these costs, which include payments to captive managers, are shared across member companies, they may be outweighed by the savings achieved through lower premiums in a member-owned group captive.

Capitalization and collateral. Companies must commit significant capital in order to comply with minimum capitalization requirements. Also, collateral in the form of a letter of credit or cash must be posted by member companies to secure member-to-member obligations. While considerably less capital is required when joining a member-owned group captive versus a single parent captive, member companies are generally expected to



Captive member companies have greater opportunities to improve cash flow.

8. One of the main concerns with tax-deductibility is gauging the degree of risk shifting between companies and the captive insurer. Several studies have investigated the relationship between risk shifting and tax-deductibility and consider whether premiums paid to captive insurers should be tax-deductible for federal income tax purposes. These studies include Smith (1986), Cross et al. (1988), Han and Lai (1991) and Lai and Witt (1995).



make a long-term commitment when joining the captive and it likely would not make sense unless they planned to remain in for at least 3 to 5 years. If a member company chooses to leave, its collateral will be returned when the last policy year in which it participated, is closed.

Dependence on service providers. While captives can select from a large number of organizations to provide services, the captive’s owners must carefully monitor and ultimately approve the actions and decisions of captive managers, consultants, auditors, lawyers, actuaries, and investment managers. Captive owners must ensure that all service providers are adequately meeting their needs. Agreement among board members in a member-owned group captive may be harder to reach when evaluating the quality of services provided to the captive.

3. Compliance with regulatory and legal requirements

Captives are regulated like traditional insurance companies, but companies joining a member-owned group captive may be unfamiliar with the ways in which insurers

are regulated. This section first provides a discussion of state laws governing establishment and operation of a member-owned group captive. This is followed by a discussion of regulation in the world’s two largest offshore domiciles – Bermuda and the Cayman Islands. A short discussion of state and federal laws that member-owned group captives must follow to maintain legal compliance concludes the section.

State regulation of captives

Most captive insurance companies, whether pure (single-parent) or group in form, are regulated by the state in which they are domiciled, and all domiciles are generally “regulation friendly,” meaning the state’s laws encourage the formation of captives. State regulation of these entities includes a minimum capital requirement; registration and incorporation expenses; premium taxes; investment restrictions; reserve and underwriting requirements; reporting requirements; and local office requirements. The specific forms of regulation on these dimensions vary across both onshore and offshore domiciles. Historically, onshore domiciles were stricter regulators than offshore domiciles, but many states have enacted legislation to relax the regulation to encourage more captives in the state. For example, North Carolina enacted captive-enabling legislation in 2013 that propelled it to become one of the leading captive insurance domiciles. A primary feature of this legislation are low regulatory costs for forming and operating a captive. Vermont, which

has been licensing captives since 1981, currently has the highest number of domiciled licensed captives. It is also the third-largest captive domicile on a worldwide basis, following the Cayman Islands and Bermuda.

Initial licensure in Vermont involves a \$500 fee and a \$6,000 actuarial application review. Thereafter, the captive must pay a \$500 annual license renewal fee. The direct premium tax rate depends on the size of the captive and ranges from 0.072 percent to 0.38 percent. A tax on assumed reinsurance premiums is also levied based on the size of the captive and ranges from 0.024 percent to 0.214 percent.⁹

Regulation of group captives in offshore domiciles

Historically, offshore domiciles were popular due to unfavorable regulations in the U.S. that made it costly to operate a captive in the U.S. While the regulatory differences have become less over time, offshore domiciles have matured; captives in these locations typically benefit from lower capital requirements, no premium taxes, well-reputed and proportional regulatory environments and the ease of conducting business.

Two popular offshore domiciles for group captives are the Cayman Islands and Bermuda. Both have very similar regulatory environments that reflect the global harmonization of regulatory principles. Captives domiciled in the Cayman Islands are now subject to the Cayman Islands Insurance Law of 2010, which became effective in 2012. The law reflects a comprehensive modernization to align with international standards. While the new law strengthened the regulatory powers of the Cayman Islands Monetary Authority (CIMA), it did not materially affect the captive industry because the law reflected existing regulatory practices.

Establishing a member-owned group captive in the Cayman Islands requires a formal application for a Class “B” insurance license, which includes an application fee of about \$10,000 to \$12,000. An annual fee of the same amount is required to maintain the license, but there are no premium taxes.¹⁰ The CIMA requires captives to maintain a minimum capital and surplus. There is no income or capital gains tax in the Cayman Islands.

In recent years, the Cayman Islands has become a more attractive domicile for group captives due to the responsiveness of CIMA to unique requests for licenses and an open door regulatory approach.¹¹ As of June 2018, 120 group captives were reported to be domiciled in the Cayman Islands. Medical malpractice liability is the largest primary line of business covered in Cayman captives, followed by workers compensation.¹²



Captives in offshore domiciles typically benefit from lower capital requirements, no premium taxes and favorable regulatory environments.

Captives in Bermuda, the most popular domicile location for captives globally, are licensed by the Bermuda Monetary Authority which was established in 1969. Group captives are licensed as Class 2 or Class 3 entities and must have a required minimum fully paid-up amount of capital. They must maintain a minimum level of capital and surplus (\$250,000 for Class 2, \$1,000,000 for Class 3) at all times. Initial registration fees begin at \$3,750 and depend on expected gross premiums written. Likewise, annual fees start at \$3,750 and depend on gross premiums written. No local premium tax is imposed. Bermuda has no income, profit, or capital gains tax.

While fees to maintain a license are higher in places like Bermuda and the Cayman Islands, offshore domiciles offer a significant tax advantage.

9. Vermont Statutes Title 8, Chapter 141 § 6014.

10. The tax benefits associated with [operating a captive in the Cayman Islands](#) are discussed at Captive International.

11. The benefits of Cayman as a domicile are discussed in a 2013 [interview with James Rawcliffe](#) of Sagacor Insurance Managers.

12. Captive counts in the Cayman Islands are [reported by Captive.com/IRMI](#).

Captives and the IRS

Regardless of the reasons for formation and the specific organizational form chosen, a captive must abide by state and federal regulations that address the entity’s risk shifting purpose, its risk distribution, pricing decisions and claims settlement processes. These regulations have been shaped by years of court decisions.¹³

Gross premiums paid by group members are fully deductible under IRC sec 162(a) as long as the group captive addresses insurance risk — not investment risk or business risk – in its “commonly accepted sense.” The group captive must incorporate sufficient risk shifting and risk distribution among the group’s unrelated, insured entities. Over time, additional guidance and clarification has been provided by the IRS through Revenue Rulings. Companies that self insure in the traditional sense cannot deduct any premiums for tax purposes. Thus, one of the benefits of captive membership is that premiums are paid to the captive and these payments are tax deductible. If properly formed and operated, member-owned group captives can provide tax benefits to such companies and their owners. To ensure compliance, group captive

managers typically provide in-house tax management and accounting services for members.

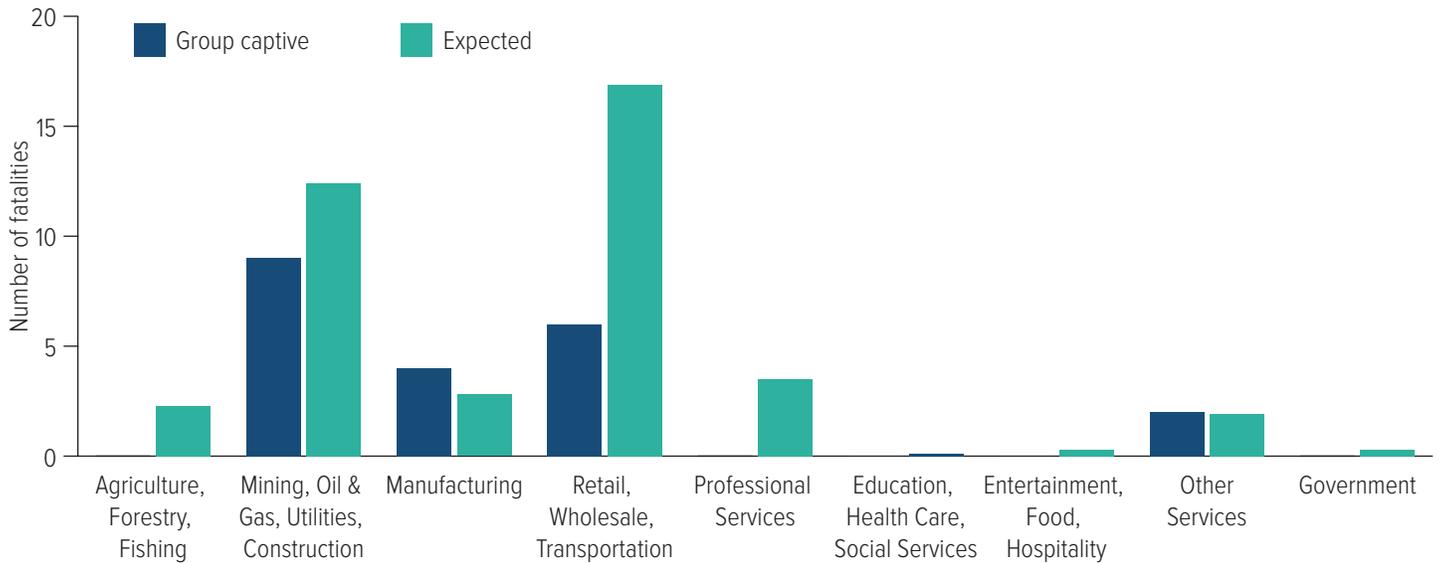
4. Group captive case studies

Reports from captive management companies provide some specific examples of how group captive arrangements have achieved success. A 2015 actuarial study by Pinnacle Actuarial Resources, assessing actual 2013 workers compensation exposure and claims data, found that members of Captive Resources’ client captives experienced a significant decrease in accidents and 50 percent fewer fatalities when compared to companies in similar industries. **Figure 5** compares the actual experience of group captive member companies versus the expected number of fatalities using data from the U.S. Bureau of Labor Statistics (BLS).

Overwhelmingly, case studies point to the ways the group captive helps and incentivizes its members in controlling

Figure 5

Group Captive vs. Expected Fatalities by Industry*



*Using data from the Bureau of Labor Statistics.

13. Discussions of court decisions affecting captive insurance arrangements include Barker (1986), Winslow (1989), Lai and Witt (1995), Kehler (2002), Tucciarone and Biscotti (2018).



Overwhelmingly, case studies point to the ways the group captive helps and incentivizes its members in controlling the frequency of loss events and reducing the severity of events that do occur.

the frequency of loss events and reducing the severity of events that do occur. A sampling of some specific benefits realized by group captive member companies are summarized below.

- A commercial trucking company improved its loss ratio by more than 75 percent in three years by using the loss control services supplied by the group captive program.
 - A commercial contractor working in road construction maintained a loss ratio of under 10 percent over a four-year period, motivated by the services available to control claims.
 - An electrical contractor achieved a 38 percent reduction in its experience modification index and a 52 percent reduction in its workers compensation premium rate over 10 years.
 - A mechanical company saved nearly \$400,000 over three years on the cost of employee benefits provided to 175 employees.
 - A fresh produce company improved its safety record across the organization; safety seminars provided by the captive helped cultivate a stronger culture of safety awareness.
- A camper manufacturer reduced its premiums and accumulated more than \$1 million in its asset account over four years.
 - A food service/restaurant company notes that captive membership provided more predictable and stable rates, facilitating budgeting and growth.
 - Thirty-one members of a state concrete products association in a newly-formed group captive experienced a rate increase that was half of the increase seen by similar companies for the same types of coverage in the traditional market.

5. Conclusion

Group captives have become an attractive risk management option for a growing number and type of companies. The current hardening in the traditional insurance market makes captives even more enticing and suggests the captive industry will see more growth in the form of new captive formations and increasing group captive membership.

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