How Reinsurance Works in Captives

Captives and Reinsurers – Working Together

One of the key benefits from owning a captive is access to the reinsurance markets as viable alternative to the retail commercial insurance markets.

A captive can underwrite almost every line of business available from the retail commercial market and can also provide specialized coverage for unusual or hard-to-place insurance risks. These non-traditional risks may be mitigated by working with the more sophisticated reinsurance markets, which have a broader appetite for such risks when compared to the retail market.

As a result, there has developed a partnership between captives and reinsurers in which unusual risks are "incubated" in a captive, while being supported in large part by the reinsurance industry as the risk's experience develops. We can cite examples such as mold insurance or cyber risks when they were originally first introduced.

To Reinsure or Not to Reinsure – That is the Question!

When first contemplating the formation of a new captive -- as well as for its subsequent years of operation -- the decision on whether to buy reinsurance is a fundamental question for the Parent company to ask and answer.

The decisions surrounding the purchase of reinsurance behind a captive are quite involved and need a lot of thought to ensure that the optimum program is created to protect the captive.

The range of options may go from the blanket whole account or basket aggregated reinsurance -- which accesses reissuance for all lines combined – to a more complex web of inter-connected reinsurance contracts all working together to provide protection on a per risk, per catastrophe and per annual aggregate basis.

They key considerations will be:

- Why does the captive need reinsurance?
    - Inadequate initial capital;
    - Highly volatile risk;
    - Risk appetite of the Parent dictates more prudence, etc.
- How much risk should the captive retain and how much to cede
- The price of the reinsurance
- The quality of the reinsurer
- What is the best type of reinsurance to buy?
    - Facultative
    - Treaty
        - Proportional
        - Excess of Loss
- Whether to use the services of a professional reinsurance intermediary
- Will the reinsurer be able to assist the captive grow its business and be a true partner to deal with unforeseen obstacles and challenges.

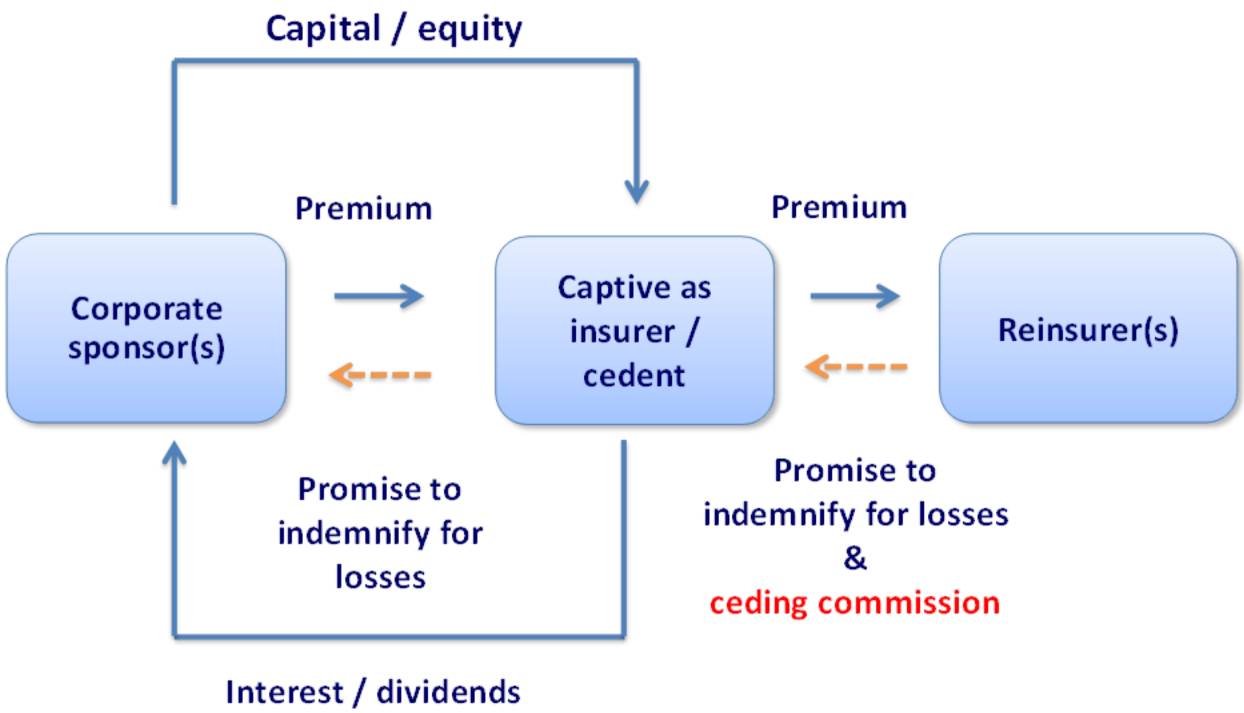
Captive Reinsurance – Similar but Different!

The reinsurance transaction between captive and reinsurer is generally the same as it would be for any other insurance company seeking to reinsure its risk. There are, however, a few differences in reinsurance when a captive is involved.

1.) The Captive as the Insurer and Cedent

The diagram below shows the contractual relationships between the three parties of the Parent / Corporate Sponsor ("Parent") of the captive as the insured, the captive as the insurer and then the reinsurer.

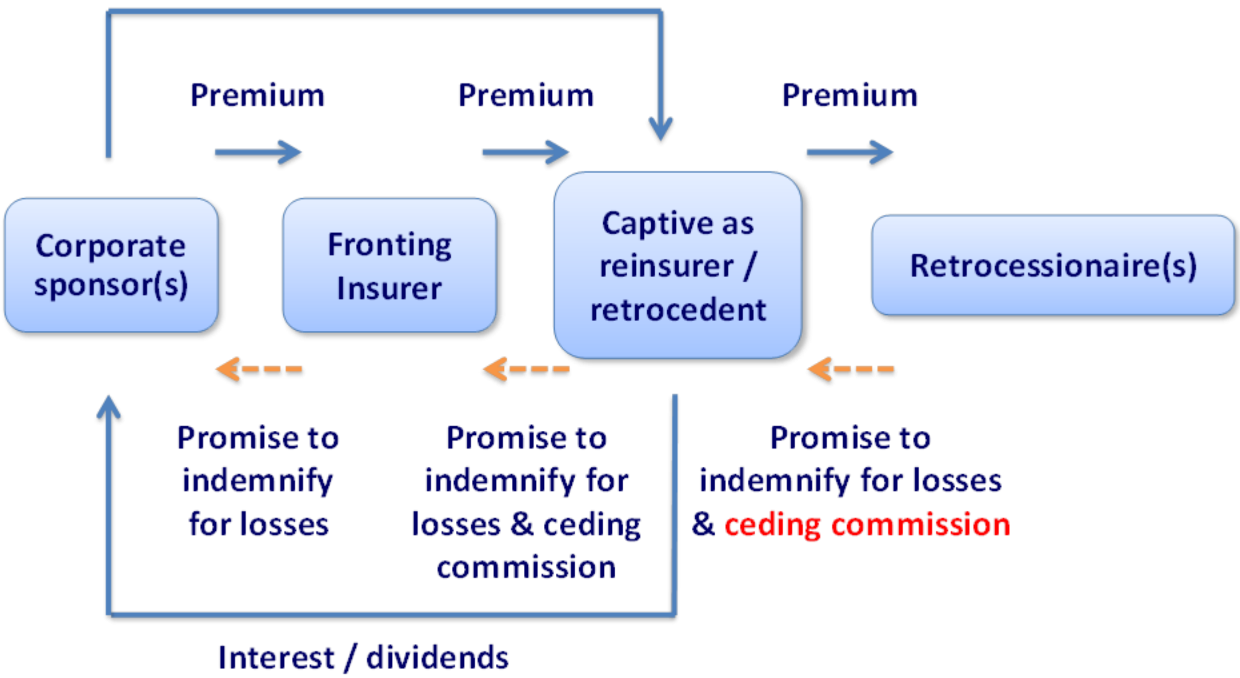
There is a policy of insurance between the Parent and the captive and a contract of reinsurance between the captive and the reinsurer.



This reinsurance structure is used where the captive is able to directly issue insurance policies to its Parent without the need for an unaffiliated insurance company, known as a fronting company, to first issue a policy to comply with regulatory or other stakeholder requirements. Examples of this direct relationship would be for deductible reimbursement policies and property insurance where there is no requirement for the insurance to be provided by a well know insurer or an insurer that carries a certain minimum A.M. Best's rating.

2.) The Captive as the Reinsurer and Retrocedent

For those risks requiring licensed paper fronting -- the route to access the ultimate reinsurance market -- becomes longer. As shown in the diagram below, the fronting carrier is the primary insurer of the Parent. The fronting carrier then reinsures the risk into the captive, which in turn retrocedes the risk to the retrocession (reinsurance or reinsurance!) markets.



Examples of a fronting carrier used as part of the chain to access reinsurance would include any compulsory lines of cover (Auto or Workers Compensation), property insurance for which a mortgage holder or bank requires insurance from a licensed insurer with a minimum A.M. Best's rating, General Liability, and for group captive programs.

Specific Mechanics of a Captive Reinsurance Transaction

Ceding Commission

As displayed in the two preceding diagrams, the reinsurer or retrocessionaire often agrees to pay to the captive a Ceding Commission as part of the transaction. A Ceding Commission is a commission payable usually as a percentage of the premium received by the reinsurer / retrocessionaire. It is designed to cover the administrative costs and acquisition expenses incurred by the cedent and is more common in proportional reinsurances than in excess of loss contracts. The size of the commission can vary according to overall desirability of the risk being assumed by the reinsurer/ retrocessionaire. The range can be wide -- from 5% up to 30% in some instances.

Facultative or Treaty Basis

The process of Reinsuring a captive borrows heavily from the placement of reinsurance on a facultative basis. The contract is between the captive insurer and the reinsurer and tends to be for a particular risk, such as the Workers Compensation, General Liability or the Property exposures of the Parent company. The exception to this would be where the reinsurance contract is for the entire portfolio of risk as may be found under a whole account reinsurance covering a basket aggregate for a wide range of insurance lines. These forms of reinsurance are more akin to treaty reinsurance placements.

Direct Placement or Placement Through a Reinsurance Intermediary

The International Association of Insurance Supervisors ("IAIS") defines a captive as "an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities, and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties."

From this definition we can say that captives are formed by Parent companies who are experienced managers of risk and are deemed to be more sophisticated than retail insurance customers. The reinsurance contract is between and insurance company and a reinsurer. It is true that both parties still deal with each other as equals in the negotiation of the contract, but it is fair to say that the reinsurers will have more of an advantage over the captive when it comes to the day-to-day operations of insurance enterprises.

While the use of a reinsurance intermediary is not essential, it is good practice for the captive as cedent to use the services of a qualified reinsurance intermediary. This will provide the captive as cedent with the best advice available to negotiate a fair and reasonable reinsurance contract that is up to date with current market developments.

Conclusion

The development and purchase of a captive reinsurance program requires a good deal of expertise and input from the captive's parent and external advisors. The programs are definitely not "set and forget" and once the program has been put in place, it should also be monitored to ensure it is providing the cover required.

Few decisions regarding the use of a captive are more important than the structure, quality and collectability of a captive's reinsurance program. Unless the Parent is well versed in the vagaries of the reinsurance market, it is advisable to obtain expert advice from reinsurance intermediaries on the best approach to follow.