

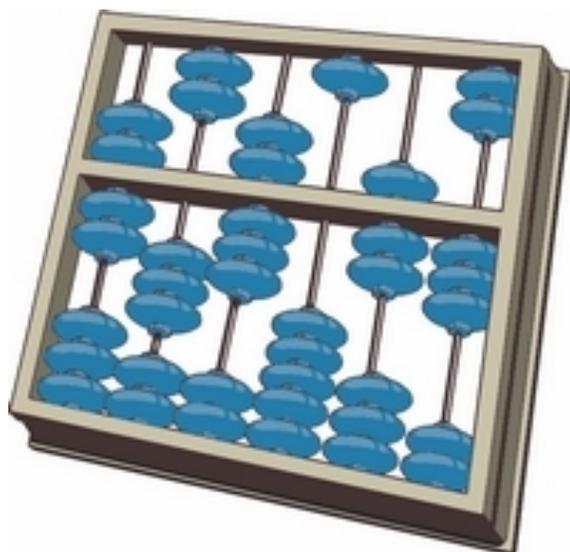
BUSINESS INSURANCE.

Captive feasibility studies analyze plans for expected benefits, tax issues

Posted On: Mar. 02, 2014 6:00 AM CST



Joanne Wojcik (mailto:jwojcik@BusinessInsurance.com)



Although the content of captive insurer feasibility studies can vary almost as much as the types of risks these special-purpose vehicles are established to insure, all must contain a basic actuarial analysis of the types of losses an owner anticipates in operating the captive, experts say.

“Each captive is unique. It sounds like a cliché, but it's true. The feasibility study will be different depending on the types of risks it will insure,” said Kevin Doherty, president of the Tennessee Captive Insurance Association Inc. and a partner at law firm Nelson Mullins Riley & Scarborough L.L.P. in Nashville, Tenn.

“A captive feasibility study is a mixture of words and numbers, a quantitative and qualitative analysis that outlines what the program might look like, coverages written, risk retained, how to fund and capitalize it (and) domiciles,” said John Lochner, a director at consultant Towers Watson & Co. in Hartford, Conn. “It will also include pro forma financial statements to highlight the financial commitment that's required, project likely financial results given certain loss and investment returns, describe potential adverse scenarios and compare the captive program to the current program.”

“The role of the feasibility study is to establish the business purpose of the transaction,” said Phillip England, chairman of the captive insurance practice group at Anderson Kill P.C. in New York. “As a general rule, you cannot create a captive unless there is a legitimate business purpose other than tax savings.”

The cost of captive feasibility studies also varies depending on what a captive encompasses.

“At a minimum, a study should develop a business plan that shows potential premiums and losses and addresses some of the tax issues,” said Art Koritzinsky, managing director of Marsh L.L.C.'s captive solutions group in Norwalk, Conn. “That might cost \$15,000. But a full-blown study that the client could use to educate its leadership and put in a file in case the Internal Revenue Service ever asks for the business case will also talk about domiciles, operation issues, perhaps include a multiyear plan for expansion. That might cost another \$15,000.”

Although actuarial firms often are hired to conduct captive feasibility studies, insurance brokers, consultants or captive managers also may perform the reviews. But experts warn other parties may have a bias that could affect their recommendation.

“Everybody's got an angle,” said Brady Young, Atlanta-based president and CEO of captive manager Strategic Risk Solutions Inc. “Consulting firms want to sell studies, brokers could potentially lose commissions. We have a separate division that does feasibility studies.”

“I try to discourage (potential captive owners) from doing the feasibility study if I can tell they are not a good candidate,” Mr. Young said. “Even with this upfront vetting, probably only half end up moving forward after the study is performed.”

Companies considering captives should do financial and risk tolerance soul-searching before paying \$15,000 or more to conduct a feasibility study, experts advise.

“Everyone says they want to take risk. But when you get down to it, a lot of business owners don't,” said R. Wesley Sierk III, president of consultant Risk Management Advisors Inc. in Long Beach, Calif. “It also depends on the structure of the business. If they have a culture that doesn't support or reward risk management, then they probably aren't going to be successful.”

Companies also must realize that captives require a considerable upfront investment — with sufficient capital, premiums and reinsurance in place to pay for at least one policy-limit claim — as well as ongoing operating expenses ranging from \$25,000 annually for a protected cell company with minimal loss activity to \$100,000 a year for a very active captive, experts say.

When performing a captive feasibility study, “we usually like to start with looking at the insured program and the business operations,” said Fay Okamoto, Honolulu-based division senior vice president at Artex Risk Solutions Inc., a subsidiary of Arthur J. Gallagher & Co. “We look for areas where they are already retaining risk in the form of deductibles, exclusions under their insured programs, and risks that are uninsured either because it's too expensive or they feel they don't have a big exposure so they don't buy insurance. We also conduct an actuarial analysis on the loss data available. The further back it can go, the better, to understand how risk may have changed over time, such as if there were acquisitions or divestitures, or if they entered a new segment of business.”

A captive feasibility study also will examine risk transfer, “because the first thing the IRS asks for when doing an audit is the feasibility study,” said Karin Landry, managing partner of Boston-based Spring Consulting Group L.L.C. “There has to be legitimate risk transfer for premiums to be tax-deductible. Otherwise, only the incurred losses are tax-deductible for the captive owner.”