The Rent-A-Captive Alternative

FM Global®

FM Global's Rent-A-Captives at a Glance

Considering the Captive Option

When purchasing insurance, every business seeks to optimize the point at which it transfers risk through its choice of self-insured retention. When the point is set too low, it can raise risk-transfer premium, and the business needlessly trades loss dollars with the insurance company. When set too high, it exposes the company to unnecessary volatility for relatively little savings.

Most companies still use a deductible as the sole means of controlling self-insured retention. Sophisticated companies are turning increasingly toward captives, which offer a more formal, flexible and controllable risk-retention framework. They are choosing captives for a variety of reasons—to share in the profits of favorable underwriting performance, generate investment income, fund consistent deductibles across all locations, maintain stability of pricing or obtain broader coverage. As a mutual insurer focused on the long-term interests of our clients, FM Global offers policyholders the opportunity to participate in, and receive the benefits of, a captive through our established "rent-a-captive" facilities. These options are available to our clients through the Watch Hill Insurance Company, based in Vermont, USA; and New Providence Mutual Ltd. (NPML), based in Bermuda (see sidebar at right).

How a Captive Operates

Although captive insurance companies have been effective risk management tools for many years, the word "captive" can be confusing, and the benefits of a captive often require some explanation to determine if a captive is the right choice.

A captive insurer—or simply, a captive, is a closely held insurance company whose insurance business is primarily supplied by and controlled by its owners, and in which the original insureds are the principal beneficiaries. Like a traditional insurance company, a captive collects premium, pays losses and derives investment income. The shareholder-insureds actively participate in decisions influencing underwriting, operations and investments.

Watch Hill Insurance Company – a sponsored, protected-cell (also known as a segregated cell), controlled corporation that serves as FM Global's onshore option in North America for alternative risk transfer. The company was established in the state of Vermont, the largest domicile for captive insurance companies in the United States, to meet the needs of clients in North America who want to keep their financial interests onshore.

New Providence Mutual Ltd. (NPML) – a segregated-cell, controlled corporation, based in Bermuda. Bermuda provides New Providence Mutual and its clients with a stable offshore political environment, along with an established insurance, reinsurance and banking infrastructure.

What Are the Advantages of a Captive?

An organization can realize many benefits from using a captive as part of its risk management program. Significant advantages include the ability to share in underwriting profit and investment income. By utilizing a captive, as opposed to relying on traditional insurance, the captive owner essentially retains the premium paid into the captive, earns income from the investment of the funds, and retains potential underwriting profit. In addition, a well-managed captive will carefully analyze its risk exposures, provide loss prevention assistance, monitor claims, and transfer unwanted risk to reinsurers, resulting in a lower net cost for insurance.

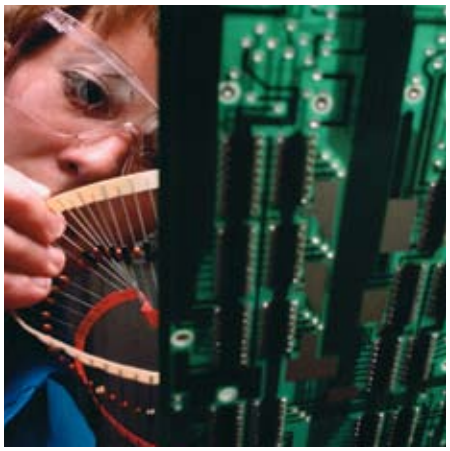
Is a Captive Right for You?

The captive option is ideal for many organizations, but not for all. The prime candidates generally take a long-term view toward risk management, have a strong belief in loss prevention, and are willing to share in the risk. Also, the captive option is most attractive to those clients who can contribute enough premium to justify the administrative costs involved. As a result, well-capitalized companies often look to captives as a strategic risk management solution.

Once a decision has been made to consider a captive, the next choice is simple: Do you establish your own captive company, or use an existing facility, such as one of FM Global's rent-a-captives?

The Rent-A-Captive Option

A rent-a-captive allows organizations to obtain the benefits of a captive insurance company, without the upfront costs, capital investment and significant maintenance cost associated with forming and managing an owned captive.
FM Global's rent-a-captives are structured as follows: the client effectively "rents" a protected/segregated cell, working capital, surplus and licenses from an FM Global-owned facility. FM Global also arranges the necessary administrative, claims, engineering, reinsurance placement and admitted fronting services. Under the segregated/protected cell structure, there is no pooling of risk between cells. While Watch Hill Insurance Company and NPML hold funds for their insureds, each cell, and its assets, is legally separated from the others. As a result, each participant is protected from another cell owner's adverse loss experience.



Choosing to Rent-A-Captive: A Case Study

Participation in a rent-a-captive is a practical and cost-effective alternative in any number of circumstances. The following example illustrates one of many scenarios that are possible through the negotiation process when designing a rent-a-captive program.

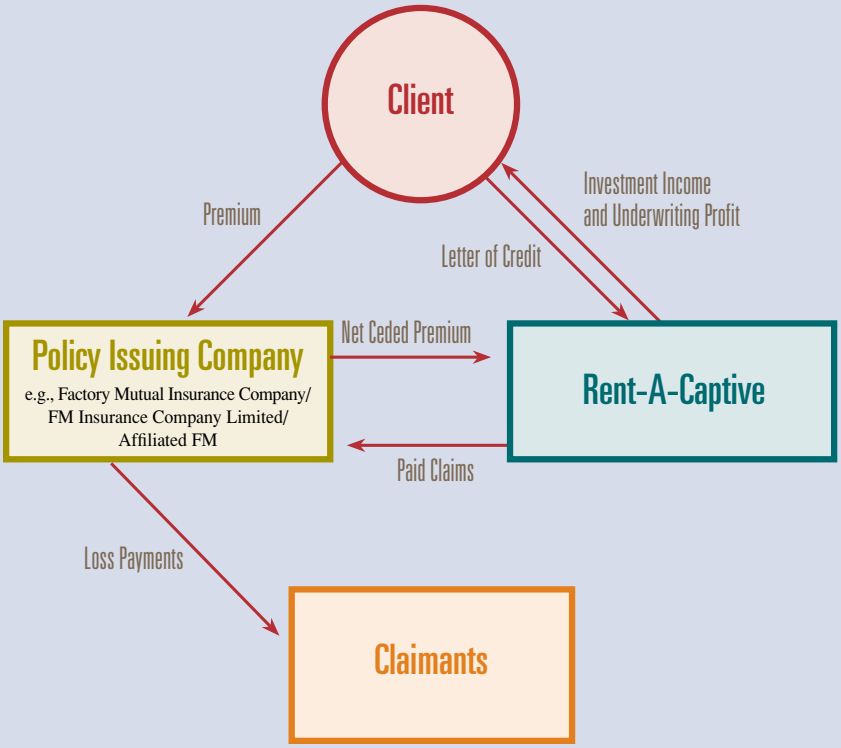
During renewal discussions, a manufacturing company was seeking a means to continue with the same program and services already being delivered at the local level, and for the corporation to benefit from its excellent loss experience. The company also wanted to pre-fund for future losses. Logically, the discussion turned to captives, and which type of captive would suit the company's objectives. For this mid-sized organization, the process of forming an owned captive would be complex and costly. If participating in a group or association captive, the company's funds might be exposed to the losses of others. Therefore, the firm decided on a protected cell rent-a-captive. The next step was to choose one.

It was important that the company retain its current engineering, fronting and claims services, and that the rent-a-captive be a fully fronted program with a financially stable insurance carrier. Following analysis of its finances and risk profile, the company chose to become a cell owner with New Providence Mutual Limited (NPML) by retaining the first US$5 million of annual aggregate losses and expenses above the policy deductible. To reach the decision on the terms of its program, several factors were considered. First, the risk management team was confident in improvements already made to prevent loss at the company's facilities. They also had determined their company could comfortably retain the first US$5 million (post-deductible) annual aggregate of losses. Moreover, the program would be easy to administer and be independently audited every year, and the company would receive quarterly financial statements detailing the performance of its cell.

Under the agreement, FM Global would credit the premium for the manufacturer's US$5 million of additional risk retention, and cede that exposure to the segregated/protected cell established within the rent-a-captive. The fund benefits by positive underwriting results plus investment income. Money in the fund can then be reinvested, used to reduce the letter of credit, put toward assuming a larger share of risk in future years, applied toward the reduction of future premium, or taken back and used elsewhere by the insured.

Rent-A-Captive: How Does It Work?

Launching your rent-a-captive program is as simple as signing a participation agreement—as contrasted with the many details involved in establishing a new captive company. The diagram below shows the flow of funds in a typical rent-a-captive program.



The insurance transaction with our rent-a-captive works much the same as that of a traditional insurance program: The client pays premium to the insurance company. A portion of the premium (an amount determined as part of the program design) is then ceded as reinsurance to the client's cell in our rent-a-captive.

When there is a claim, the policy-issuing company makes the payment, and then seeks reinsurance reimbursement from the client's cell in the rent-a-captive.

FM Global's Rent-A-Captive Advantages

Stabilization: Virtually all CEOs, CFOs and risk managers have seen the volatility of commercial property premium over the past several years. The use of a rent-a-captive is an effective means to properly structure a program to smooth the impact of market fluctuations.

Improved Cash Flow: Because you are the captive cell owner, both you and the insurance company benefit from profitable underwriting.

Risk Improvement: The captive cell owner benefits directly from property loss prevention measures to improve risk quality at the owner's locations.

Ease of Implementation: Fully established and professionally managed, our rent-a-captive program offers you instant access to an operating company, which means reduced capital requirements and minimal administrative burden. Also, our rent-a-captive option provides one-stop access to all property insurance services, including fronting, with easy entry and exit provisions, from a stable, financially secure provider.

Flexibility: While the rent-a-captive approach does not fit every situation, the professionals at FM Global have the ability to help assess whether a program can be designed to best meet your organization's insurance needs and serve its long-term interests.

Your FM Global client servicing team representative can help you determine whether a rent-a-captive might be the right option for your risk management program.

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