Captive Insurers – Part 1

About 20 years ago, the 1986 Federal Risk Retention Act (FRRA) was created. This act allowed similar or related businesses or groups to form for the purpose of buying liability insurance. The Act was in response to a severe shortage of liability insurance for certain types of business. Businesses who wanted to continue to operate had to devise a strategy to do so in a way that also protected them against their vulnerability to accidental losses. The answers were captive insurers and risk retention groups (RRGs)

Captive insurance companies were first created in the 1950s. This method of handling losses lowered insurance costs for corporations and, originally, also allowed huge tax advantages that were subsequently outlawed. In spite of that, and because of the volatility of traditional commercial insurance companies in the United States, the number of captives continued to grow.

Many large corporations wanted the investment income generated from the premiums paid to their captive insurance companies. Additional income was also created by the loss reserves (sums set aside for handling anticipated, accidental losses) generated by those premiums. This provided even more motivation to form captive insurers. Sophisticated corporate risk managers realized they could benefit from any of a number of insurance premium-related investment income opportunities. This was seen as yet another advantage over purchasing commercial insurance coverage from an insurance company that controlled premiums, loss reserves and the interest income that those funds generated.

Initially, most offshore captives were "pure" captives (see Captive Insurers – Part 2 for more information). As time passed, many pure captives found even greater tax advantages if they insured other, unrelated organizations. Unfortunately, because of writing too much business and lacking expertise, many of these captives became insolvent.

The insurance market problems of the mid-1980s also spurred the creation of Risk Retention Groups (RRGs) and the concept (also known as group or association captives) became popular. RRGs are insurance companies established and capitalized by a group of businesses to underwrite and insure their own collective insurance risks. In addition, many trade associations formed and funded association captives to underwrite and insure risks of the members of a particular trade association.