Captive insurance and trusts

With the risk management industry constantly looking to new avenues of innovation, **Conor Jennings** of **Captiva Managers Limited** takes a look at how the blending of captives and trusts can benefit the industry

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Working in the financial services industry, I meet people all the time who are experts in their own particular field but know relatively little about the work other service providers do. This prompted me to consider ways in which insurance and trusts can be used together in a blended product.

For starters, captive insurance and trusts are both financial instruments popular among corporations and individuals who wish to manage their risk and financial affairs better. Both are common in offshore jurisdictions where modern legislation has been specifically introduced to better facilitate these and other financial services. Before we delve into how the two products can be combined, it would be useful to take a quick look at the components of captives and trusts and what is involved in each instrument. We understand some of you may be frequent flyers, but please take time to read the following definitions.

What is a captive insurance company?

In essence, it's an insurance company owned by a company that self-insures its own risks. The company pays premiums every year to its own captive insurance company, and if there are no claims, the captive makes a profit.

That's probably one of the shortest definitions you'll see anywhere, but as you may suspect, there are many variations of that theme. For example, there are single parent captives as already described and association, industry, agency, and segregated cell or protected cell companies (PCCs) as well.

Captives are popular due to the following, well known, advantages. While reading this list, think of what each point means to the organisation that is lucky and smart enough to own its own captive insurance company.

1. Reduced reliance on commercial insurance
2. Reduction in the costs of risk management
3. Stabilisation of pricing
4. Provision of cover where otherwise unavailable
5. Access to reinsurance markets
6. Improved cash flow benefits
7. Reduction in government regulations and interference
8. Ability to customise insurance programmes
9. Formalisation of the allocation of deductibles for corporate self-insurance retention
10. Underwriting advantages inherent in captives
11. Opportunities for improved claims handling and control
12. Creation of a profit centre
13. Ability to direct investment options
14. Tax deferral advantages

Each of these is important to any organisation, and collectively they help explain why the captive industry has been so useful in supporting industry and commerce in countries around the world for many years.

Although the modern risk manager will appreciate the important role a captive can play in the risk management process, he will also appreciate that it is just part of the whole risk management solution. An holistic approach to risk management highlights that organisations have many risks which are just not insurable but still need to be managed and controlled. The astute risk manager will have realised that there are other ways of managing and controlling risks like these. The use of trusts can be another management tool for an organisation, especially if the company is privately owned.

What is a trust?

The result of the establishment of a trust is quite simply that assets which had previously belonged to one party legally belong to another, the trustee.

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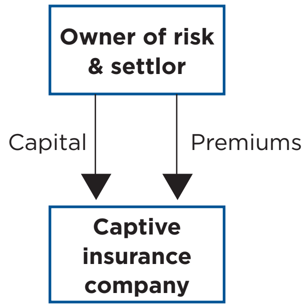
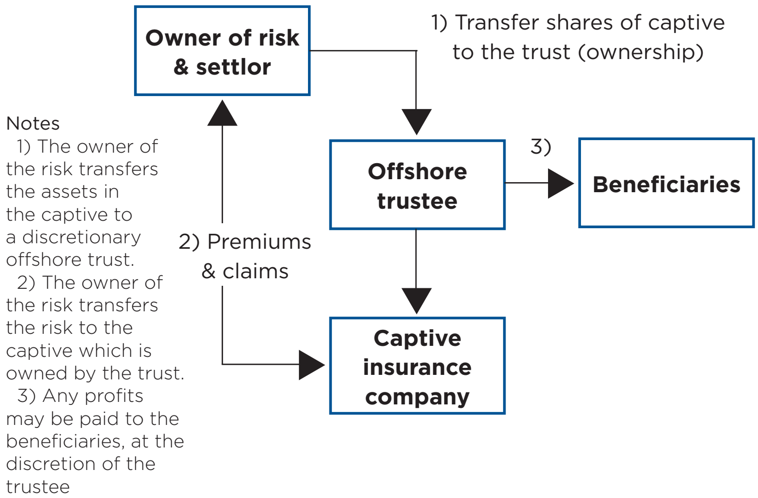
TRADITIONAL STRUCTURE



BLENDED STRUCTURE



The trustee, as the legal owner of the property, will generally hold it on trust for the beneficiaries. Should a discretionary trust be established, the trustee has the discretionary power to distribute the assets as he deems fit in accordance with the terms of the trust instrument. This means that the beneficiaries have the hope of receiving the assets at some stage, but not the right. This is important, for as long as the trustee has the discretion to distribute, he is the rightful owner.

Asset protection and estate planning

The significance of this for a risk manager or the owner of an organisation is that they can structure their various companies so that they are no longer the legal owners. This may sound strange, but it has a number of significant benefits. Some of these relate to the asset protection advantages of a trust. For example, if the individual owner of an organisation is sued, the claimant would have access to all that person's assets, including his company, his home and his other personal investments. However, it goes without saying that if he has already transferred those assets to a trust, he is no longer the legal owner, and the claimant cannot seize those assets.

Trusts work particularly well for privately-owned businesses and family wealth, especially when you consider some of their other benefits. These benefits include protection against a disgruntled spouse and/or disinherited family members of the original owner wanting a share of the business, and for people living in politically unstable countries, protection against confiscation and seizure of assets by government without due process.

In jurisdictions where there is no testamentary freedom (so-called 'forced heirship jurisdictions') where an individual is forced to distribute a certain percentage of his wealth on death in a fixed manner to certain close family members, a discretionary trust can help by carving out a separate settlement which is not part of the final estate and therefore is not considered by the executors of the will. It provides testamentary freedom to those subject to forced heirship provisions. It also provides confidentiality which may be of help in certain sensitive family situations where perhaps illegitimate children exist which the wider family are not aware of, and which the testator does not wish mentioned in the will. Further restructuring of the trusts could result in significant estate planning benefits, which could enable the inter-generational transfer of wealth in a tax-efficient manner. Other more sophisticated options could involve life assurance and lending arrangements.

While there may be some tax benefits for certain nationals looking to establish offshore trusts, for US and UK nationals, the establishment of a trust is considered a tax-neutral event. The oft repeated comment about 'hiding' assets offshore is not at all accurate. Assets placed offshore have some of the most robust asset protection features available, but they are still reportable, even if they are out of the reach of the settlor, the creditors and the US or UK courts.

Blended products

The captive insurance world is already quite familiar with Regulation 114 trusts (referring to Regulation 114 of the Insurance Department of the State of New York) being used for collateral purposes as an alternative to more traditional letters of credit. The posting of collateral, be it by trust or letter of credit, is seen as a necessary cost of doing business rather than a benefit.

However, when we think of and use trusts in this limited way, we are perhaps overlooking the real benefits of trusts mentioned above. The usual list of captive advantages can be extended to include asset protection and estate planning, while the many advantages of trusts can be enhanced by the trust owning a captive insurance company.

This whole area of blending insurance with asset protection and estate planning is fascinating and exciting, and those financial consultants, insurance managers and regulators that have both these sets of skills are the ones that will be able to offer the best advice and levels of services.