

FINANCE AND MONEY TURNOVER

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CONCEPTUAL APPROACHES TO THE STUDY OF THE ESSENCE OF CAPTIVE INSURANCE COMPANIES

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The article discusses the modern problems of introduction of captive insurance organizations. It is noted that the issue of the activities of captive insurance organizations is not reflected in the legislation, that is, there is no legislative framework, although the activities of captive companies differ significantly from the activities of commercial insurers. Another problem that hinders the development of captive insurance is the lack of qualified personnel. There is also a problem with the information and technical support of captive insurance. It is shown that the parent company can consider a captive insurer as a tool for insuring only its own risks (the most common option now), or as a tool for obtaining a synergy effect. The main synergistic effects of captive insurance have been determined.

The main problems that arise during the organization of a captive insurance company are defined: limited insurance field; additional costs for the establishment and operation of a captive insurance company; the need to use the services of the insurance market; deterioration of the financial stability of a captive insurance company; time spent by management structures during the period of organization of a captive company for its creation and formation.

The advantages of creating a captive insurance company for the parent organization are determined: saving the company's funds and shorter terms of compensation for losses than with insurance; making a profit from the activities of a captive insurance organization; risk minimization; diversification of risks; supplement to insurance in professional insurance companies; entering the reinsurance market, etc. It is determined that the introduction of captive insurance can have a positive impact on the economic security of the parent organization and revive the development of the insurance market.

КОНЦЕПТУАЛЬНІ ПІДХОДИ ДО ДОСЛІДЖЕННЯ СУТНОСТІ КЕПТИВНИХ СТРАХОВИХ КОМПАНІЙ

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Ключові слова:

кептивна страхова компанія,
синергічний ефект, переваги
кептивного страхування.

В статті розглянуто сучасні проблеми впровадження кептивних страхових організацій. Зазначається, що питання діяльності кептивних страхових організацій в законодавстві не відображено, тобто відсутня законодавча база, хоча діяльність кептивних компаній суттєво відрізняється від діяльності комерційних страховиків. Іншою проблемою, яка перешкоджає розвитку кептивного страхування є відсутність кваліфікованого персонала. Також існує проблема із інформаційно-технічним забезпеченням кептивного страхування. Показано, що материнська компанія може розглядати кептивного страховика як інструмент для страхування виключно власних ризиків (найпоширеніший зараз варіант), або як інструмент отримання ефекту синергії. Визначено основні синергічні ефекти кептивного страхування.

Визначено основні проблеми, які виникають під час організації кептивної страхової компанії: обмеженість страхового поля; додаткові витрати на створення і функціонування кептивної страхової компанії; необхідність використання послуг страхового ринку; погіршення фінансової стійкості кептивної страхової компанії; витрати часу управлінських структур в період організації кептивної компанії для її створення і становлення.

Визначено переваги створення кептивної страхової компанії для материнської організації: економія грошових коштів підприємства і коротші, ніж при страхуванні, терміни відшкодування виниклих збитків; отримання прибутку від діяльності кептивної страхової організації; мінімізація ризиків; диверсифікація ризиків; доповнення до страхування у професійних страхових компаніях; вихід на ринок перестраховування тощо. Визначено, що впровадження кептивного страхування здатне позитивно вплинути на економічну безпеку материнської організації і поживати розвиток страхового ринку.

Problem statement

In modern conditions, it is time to clearly define the scope of activity and the rules of the game for captive companies, to bring the legislative requirements for such businesses in line with European practice, and thus to provide a resource for the growth of this segment of the insurance market, and the opportunity for Ukrainian business to effectively protect itself from various risks without incurring unnecessary costs, which will help many industries overcome the crisis and allow them to pursue a policy of sustainable development. Among the possible transformation options are the closure or sale of a business, the transformation of an insurance company into an intermediary, expansion, and transformation into a captive insurance company.

Analysis of recent researches and publications

A captive company is an insurance company that is associated with a large structure, business group, or holding. Captive insurance companies provide risk mitigation services for the business of the dominant or parent structure and are united with them by common business processes. In the foreign scientific literature, a sufficient number of works are devoted to the issue of captive insurance, in particular [1,2]. It should be noted that captive companies are a common form of insurance business, but the issue of captive insurance is not sufficiently disclosed in the domestic scientific literature. Bidnyk N.B., Dzoba V.B. [3] analyze the peculiarities of the formation of captive insurance companies in Ukraine. Kravets A.V., Danylovykh T.B., Tymchyshyn I.E. [4] consider the issue of creating captive insurance companies as a method of self-insurance of industrial enterprises. However, recently there has been an increased attention to captive insurance from insurers. Thus, Chernyakhovsky V. [5], General Director of AIB, analyzes the advantages of creating captive insurance organizations.

However, the literature does not sufficiently systematize the advantages and disadvantages of captive insurance companies, as well as the problems of their implementation.

Formulating of objectives

The aim of the article is to analyze the possibilities and problems of the use of captive insurance organizations in

Ukraine, to consider the measures necessary for the active introduction of captive insurance.

Presentation of the main research material

A number of foreign and domestic researchers attribute captive insurance to one of the forms of insurance organization. Sometimes offshore and bancassurance are distinguished separately. Other experts consider captive insurance to be a special case of stock insurance or a special case of mutual insurance. There is a point of view that captive insurance, especially at the stages of forming an insurance fund, resembles self-insurance.

Opponents of classifying captive insurance as self-insurance put forward an argument based on the fact that in the captive insurance scheme the insurance company acts as a separate financial institution regulated by special legislative acts. From the point of view of each company, as a separate business entity, the use of a captive insurance company does not carry any fundamental differences.

Within the framework of risk insurance of a financial and industrial group (FIG), captive insurance is nothing more than self-insurance. The FIG independently creates funds that are used in the event of insured events and coverage of the loss, as shown in Figure 1.

If we take into account the financial and industrial group as a whole, then the elements of self-insurance are clearly traced: enterprises and organizations that are part of a financially industrial group jointly form an insurance fund, and this, in turn, is more reminiscent of the principles of formation of an insurance fund in self-insurance in its classical sense. One way or another, captive insurance is designed to provide compensation for damage that will be incurred by a financial and industrial group in the event of an insured event.

The dependence of a captive insurance company imposes a number of restrictions on the insurance company, which is a consequence of the lack of strategic independence of the company. The possibility of exercising corporate control by a person or a group of affiliates depends on the specifics of national legislation (the legislation of the country of registration of the captive insurance company) and on the constituent documents of the

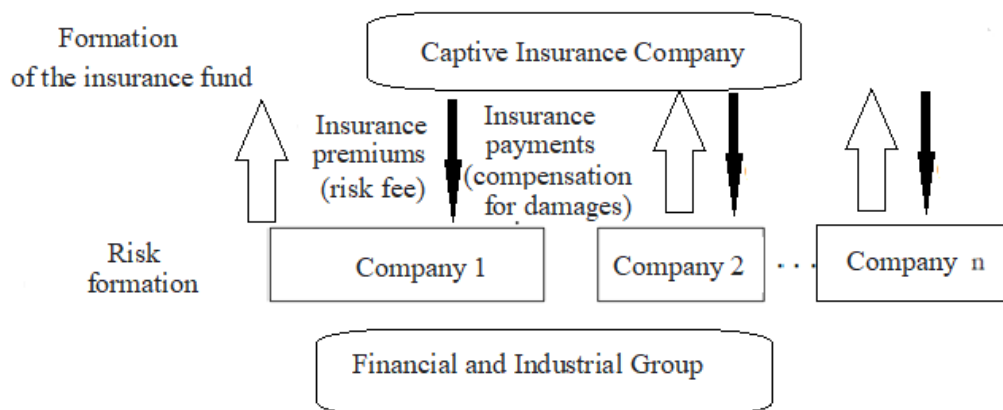


Figure 1 – Scheme of captive risk insurance in a financial and industrial group

insurance company itself. Undoubtedly, the first advantage of your own insurance company is the opportunity to save on insurance services.

First of all, the savings come from the fact that the agency knows about the cost of insurance commission. Direct contact with the insurance company allows you to avoid the presence of intermediaries when buying an insurance service. According to various expert estimates, the commission of an agent or broker in insurance ranges from 10 to 30 percent of the cost of the service. Given the large amounts of money that the financial and industrial group allocates to insurance, the use of a captive insurance company can save significant amounts.

Secondly, the employees of a captive insurance company thoroughly know the specifics of the industry and widely use the experience of the employees of the owner company.

In the analysis of the risks to which the company is exposed, a significant role is played by maintaining the confidentiality of information received by the insurance company about the owner’s business. Any owner seeks to protect his business and provides information about it extremely sparingly, which does not allow for a full risk assessment. The perception of a captive insurance company as part of your own business allows you to avoid such a conflict of interest.

Managers of a captive insurance company, taking into account the identified and most significant risks, can offer a financial and industrial group a comprehensive insurance service that would optimally meet the needs of the owner’s company. In this case, savings arise in the absence of costs for insurance services, the risks of which are absent or not significant. Periods of payment of insurance premiums can be adjusted in such a way as to avoid cash gaps in companies that are part of a financial and industrial group. This may be necessary in cases where seasonality can be traced in the activities of the enterprise or the company carries out an investment project.

Its own insurance company can use retrospective insurance policies when insuring the group’s enterprises, which will allow, if necessary, to adjust the price of insurance services.

Another important aspect is service, i.e. the speed and quality of the service. Large financial and industrial groups

can have a developed network of enterprises located in different cities, regions and even countries. In this case, a captive insurance company, as a rule, has its representative offices in all cities where the main structure is present, it can be either large branches or representative offices, or simply managers of an insurance company located on the premises of an enterprise or a company that is part of a financial and industrial group.

The presence of a captive insurance company allows you to optimize the staffing of the enterprises included in the group. It is advisable to remove specialists who are engaged in insurance of property and other risks at enterprises, as well as those accompanying insurance contracts, and transfer their functions to employees of a captive insurance company, thereby reducing the cost of wages and deductions to social funds.

A captive insurance company can set tariffs for the owner at the level of necessary expenses, avoiding a commercial markup, which forms the profit of the insurance company, which will significantly reduce insurance costs. Undoubtedly, the advantages of a captive insurance company include the stability of the tariff policy. The rates of a captive insurance company can change only at the request of the owner company, in other words, the client of the insurance company, so the rates of a captive insurance company can remain at the same level for as long as you like.

On the other hand, the disadvantage of a captive insurance company is the high cost of the initial capital investment that the financially industrial group makes at the stage of acquiring an insurance company or creating it. Start-up costs can be leveled by locating an insurance company in a country with a more favorable tax climate.

Simply put, if the location of the insurance company is located in an offshore zone, then the costs of implementing a captive insurance scheme fall sharply. It is customary to distinguish such insurance companies into separate groups and call offshore captive insurance companies. Preferential conditions for registration of insurance companies and obtaining a license to carry out insurance activities may lead to the fact that the difference in costs for the registration of an offshore captive insurance company and an insurance company registered in the country of presence of the financial and industrial group becomes significant.

At the moment, a significant part of the largest captive insurance companies is registered in countries with a «favorable tax regime». The popularity of regions with a favorable tax regime among captive insurance companies is influenced by factors that ensure the efficiency of insurance and reinsurance operations:

- low administrative barriers to registration of an insurance company and obtaining an insurance license (a number of countries classified as offshore zones register and issue licenses within a few days after application);
- preferential tax regime;
- low level of supervision over the activities of insurance companies, often control consists only in the provision of annual audit reports, but without disclosure of confidential data to third parties;
- ensuring the protection of information about customers and owners;
- the presence of a stable political regime and well-established legislation contribute to the fact that financial and industrial groups registered in developing countries have the opportunity to reduce the risks of the country.

The attractiveness of doing insurance business in these countries is also ensured by the availability of the necessary infrastructure: comfortable office space, high-quality housing, security, as well as transport and telecommunications components of the infrastructure.

A captive insurance company allows you to create a risk insurance system for companies that are part of the owner's financial and industrial group. On the part of a particular company, part of the insured risks is transferred to the insurance company, but from the point of view of the financial and industrial group, the risks remain within the group. Thus, if the owner company has an insured event, then the losses have to be compensated from its own funds.

One of the ways to reduce your own risks when using a captive insurance company is to use reinsurance services in insurance companies that are external (not related) to the owner company. The risk can be reinsured, both for the entire insurance portfolio and for some part of it (grouped by types, industries, etc.), up to individual insurance contracts. A prerequisite for this is that the reinsurer company must not be associated with the parent financial and industrial group of the captive insurance company, otherwise the redistribution of risk will be conditional.

All companies that are part of a financial and industrial group insure their risks in a captive insurance company, which in turn reinsures them in a reinsurance company. The use of this system makes it possible to partially remove risks from the financial and industrial group, which allows you to count on at least some compensation for damage. At the same time, the use of an external reinsurance company entails an increase in insurance costs.

A captive insurance company in the presented scheme acts as an intermediary, nevertheless, this is a rather attractive scheme for building an insurance system for a financial and industrial group. Its advantage is that the captive insurance company retains control over the insurance of the group's risks, and reinsurance of risks, as a rule, is cheaper than primary insurance, not all risks are reinsured,

but only those that contain an increased threat to the financial condition of the financial and industrial group.

The need for reinsurance of the risks of a captive insurance company becomes higher if the individual risk of the financial and industrial group cannot be covered at the expense of the financial and industrial group at the expense of its own funds or in the case of accumulation of risks by the financial and industrial group. The presented scheme can be expanded to attract several reinsurance companies. Focusing on specific risks allows you to study their features and offer customers the most favorable tariff. In addition, the transferred risk may be too great for one reinsurance company, in such cases the risk may be divided between several companies, and it is also possible to apply a joint reinsurance contract.

The disadvantage of using the reinsurance system is that as a result of reinsurance, the assets of the insurance company, including its reserves, are reduced, which significantly reduces the possibility of placing the assets of the insurance company within the financial and industrial group. Insurance of the system of a financial and industrial group can be carried out in a combined way (Figure 2), i.e. insurance of the risks of companies to the financial and industrial group at the stage of primary distribution of risks is carried out both in a captive insurance company and in external insurance companies.

The situation when the primary distribution of risk occurs between several insurance companies, including a captive insurance company, indicates that risk management in a financial and industrial group is not centralized and each enterprise of the group independently decides which risks to insure. Undoubtedly, some risks are insured in a captive insurance company, this may be an order of the holding's management, or insuring a group of risks in a captive insurance company is economically viable for the enterprises of the group.

The combined system of risk insurance for a financial and industrial group is also used during the creation of a captive insurance company or during its liquidation.

The transition period when creating a captive insurance company is characterized by a gradual increase in the insurance portfolio. An instantaneous transition from one insurance system to another is impossible, this is hindered by: firstly, the organizational aspect – a captive insurance company must be created, appropriate licenses must be obtained, qualified personnel must be recruited, the captive insurance company must be given the appropriate authority to insure risks to a financial-industrial group. In addition, the study of the risks of the financial and industrial group and the determination of the optimal insurance policy takes a long period.

In case of liquidation of a captive insurance company, as a rule, insurance contracts are not terminated and the insurance portfolio is not sold, this period is characterized by the fact that new insurance contracts are not concluded, the insurance company continues to service the concluded contracts until their expiration date.

Combined insurance can be chosen consciously by the management of a financial and industrial group. It is advisable to use such a system in the following cases:

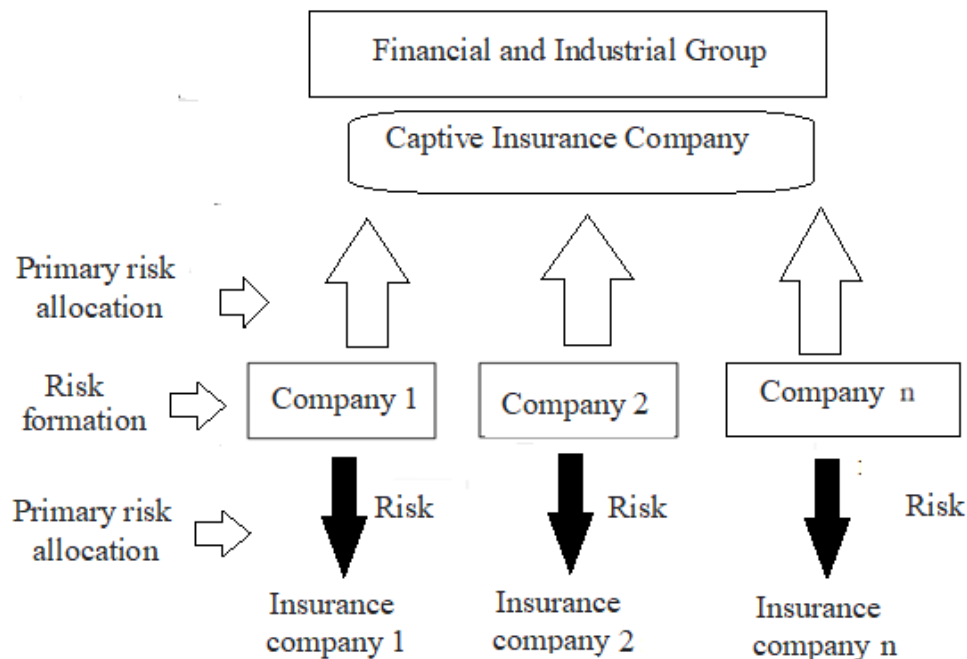


Figure 2 – Scheme of combined insurance of risks of a financial and industrial group

– the captive insurance company does not have a license to insure certain types of risk, the financial and industrial group in this case is forced to conclude insurance contracts with external insurance companies that have such a license;

– if there is a situation on the market in which a certain type of insurance becomes unprofitable;

– if the insurance risk is too high for the captive insurance company, and the conclusion of an insurance contract for this risk may lead to a violation of the financial condition of the insurance company.

The disadvantages of the combined insurance system are:

– decentralization of management of the insurance system to the financial and industrial group;

– leveling the effect of reducing the cost of risk insurance, since the costs of creating a captive insurance company are high, and the savings on insuring a small part of the risks of the financial and industrial group are minimal;

– low investment income of a captive insurance company, as a result of a small insurance portfolio;

– low rate of return on insurance costs for the business of the financial and industrial group.

The use of the third captive insurance scheme is largely aimed at solving two problems. The first task is to reduce the costs of the financial and industrial group for risk insurance; The second task is to return part of the funds, accumulate them and reinvest them in investment projects to the financial and industrial group. The main idea of the third captive insurance scheme is to use a captive reinsurance company. A captive reinsurance company is a reinsurance company owned or dependent on one owner or a group of affiliates acting in its interests, which reinsures mainly the owner’s risks. Such schemes are most often used by

industry unions and associations that reinsure mainly specific risks.

During the initial transfer of risk to an insurance company that is not part of the parent financial and industrial group, the terms of the contract may prescribe a condition on mandatory reinsurance of the assumed risk. As a rule, one of the prerequisites for participation in such organizations is the mandatory reinsurance of certain risks or risks of companies to this financial and industrial group. Visually, the captive reinsurance scheme is as follows (Figure 3).

As you can see, by applying the captive reinsurance system, the parent financial and industrial group returns part of the funds spent on insurance. Having considered the schemes of redistribution of risks of the parent financial and industrial group, it is possible to make the following classification according to the form of insurance of the owner’s risks as captive insurance companies and captive reinsurance companies.

One of the main reasons for the use of captive reinsurance is an attempt to return cash flow to a financial and industrial group.

The money saved for insurance can justify the investment costs associated with the creation of a captive insurance company and its maintenance. Therefore, the owners of a captive insurance company seek to turn the cash flow in the direction in which the holding structure operates; These can be investment projects of a financial and industrial group or current operating activities of the group’s enterprises. Many countries are trying to prevent this or limit this practice as much as possible. The fact is that when investing the funds of a captive insurance company in the activities of the parent financial and industrial group, as such, an insurance reserve is not created. Funds

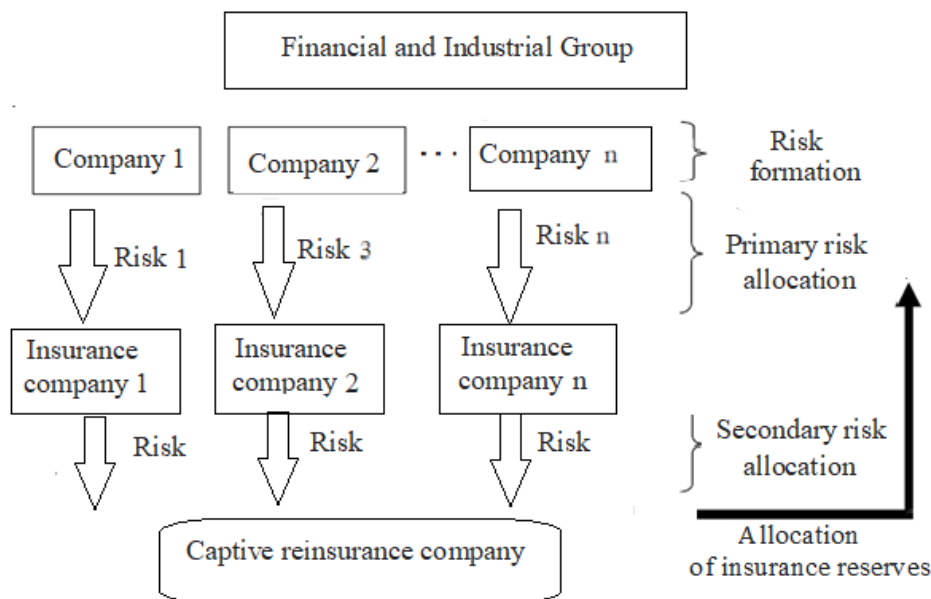


Figure 3 – Captive reinsurance scheme

withdrawn from the turnover of companies of a financial and industrial group for insurance are sent to a captive insurance company, in which part of them is directed to the formation of an insurance fund, which is then again poured into the working capital of companies of a financial and industrial group.

Thus, the insurance fund remains formed only «on paper» and in the event of adverse consequences of the financial and industrial group, it cannot count on it, since it is already involved in the financial and economic activities of the enterprises of the financial and industrial group.

In such a situation, insurance completely loses its functions: the risk is not transferred; Insurance funds are not formed. However, the owners, using captive insurance companies, try to direct the funds accumulated by the insurance company to cover their own financial needs. Since the insurance company is obliged to maintain a fairly high liquidity of the placement of insurance reserves, not all the funds collected by the insurance company can be transferred to the owner. Part of the insurance reserve is placed in highly liquid assets, such as deposits, so that it is possible to quickly withdraw them and make insurance payments, and part in highly liquid securities (government bonds, highly liquid shares of large companies).

In order to increase the company’s insurance reserves, the holding’s management insures third parties. This allows you to increase the amount of monetary resources that a captive insurance company can use in the interests of the owner. Another reason for using a captive insurance company, especially during the transition period, is the possibility of reducing the tax base. The tax legislation of a number of developing countries classifies insurance costs as an element that lowers the tax base. The presence of a captive insurance company can significantly reduce the amount of taxes paid by increasing the insurance portfolio. At the same time, by influencing

the investment policy of a captive insurance company, a financial and industrial group can ensure the reinvestment of funds spent on insurance.

An indisputable advantage of a captive insurance company is the ability to insure against accidents of its own personnel of the financial and industrial group, as well as to carry out additional voluntary medical insurance. This practice is characteristic, as a rule, of large financial and industrial groups that carry out responsible social and personnel policies. The management of large holding companies disposes of this opportunity in different ways, sometimes they provide such insurance as an incentive for any merit to the company, sometimes it is extended only to management positions, or all employees can be involved, but with different limits of insurance payments.

So, let’s briefly define the main pros and cons of a captive insurance company. For the owner of a captive insurance company, the advantages are as follows:

1. Ease of managing an insurance company and the absence of corporate disputes.
2. The presence of a captive insurance company allows the owner company to reduce the cost of insurance due to: no agency fees; delegation of authority to manage insurance contracts to an insurance company; the possibility of setting special, lower tariffs; optimization of insurance rules; termination of ineffective insurance.
3. Optimization of insurance coverage. Thorough study of the group’s risks and making objective decisions on insurance and measures to reduce the likelihood of an insured event.
4. There is a possibility of a significant reduction in the tax base and it is possible to return part of the funds spent on insurance to the FIG as an investment;
5. Rapid self-sufficiency of the insurance company due to the rapid replenishment of the insurance portfolio in conditions of reduced competition;

6. When insuring third parties, the ownership of a large financial and industrial group is a significant competitive advantage.

Cons for the owner:

1. High initial costs for the creation or acquisition of an insurance company, as well as the presence of costs for its maintenance;

2. Captive insurance companies have a low return on equity;

3. A captive insurance company is provided with relatively low insurance protection in comparison with ordinary, commercial insurance companies, since the risks remain within the financial and industrial group.

For the financial system of the state, the positive aspects are: the ability to quickly increase the number of insurance business entities; captive insurance company improves the financial condition of the parent financial and industrial group; The financial strength of a captive insurance company depends on the financial strength of the group – which significantly increases its reliability.

Negative aspects for the financial system of the state are: captive insurance companies aimed at insuring affiliates reduce the volume of the free insurance market, which affects the business of universal, commercial insurers; a captive insurance company often participates in tax evasion schemes, which helps to reduce tax collection; the desire of the owner of a captive insurance company to return to direct the insurance company's funds to his own business hinders the development of the capital market.

As we can see, what is a plus for the owner of a captive insurance company is not always a plus for the financial system of the state, therefore, when developing a strategy for the development of the insurance market, a balanced approach is needed that would take into account the interests of owners, insurers, as well as national (state) interests.

Conclusions

The concept of captive insurance companies should be introduced in the Ukrainian legislative field, a simplified procedure for controlling such companies and regulatory indicators for them should be developed compared to the requirements for ordinary insurers. After all, the captive business does not work with individual consumers of insurance services, as a result, the issue of consumer protection or the creation of any, including systemic risks for the insurance industry, is removed. How exactly this can be implemented:

1. Definition of the concept of a captive insurance company in the new version of the Law «On Insurance».

2. Determination of the range of counterparties (insureds) with whom the captive insurer has the right to work.

3. Reduction/limitation of prudential supervision requirements, similar to what is currently happening in Europe. In particular, during the current revision of the requirements of the European Directive Solvency II, the European Insurance and Pensions Authority (EIOPA) notes that scenario analysis and stress testing are unnecessarily complex and burdensome for small and captive companies.

4. Regulation of the activities of captive companies should be carried out in accordance with the requirements of the so-called. Solvency I, implemented in the current version of the Law «On Insurance», and not according to the extremely complex mechanism of Solvency II.

5. Simplification of the requirements for corporate governance of a captive insurance company, since all complex mechanisms are required for structures without a controlling owner and in the presence of a large number of third-party individual clients.

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