THE POTENTIAL POSITIVE EFFECTS OF CAPTIVE INSURANCE COMPANIES ON EFFICIENCY AND MORAL HAZARD WITHIN A GROUP OF COMPANIES

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Abstract

Captive insurance companies are 'in-house' (re)insurance companies formed with the specific objective of insuring the risks of their parent company and/or its affiliated companies. This alternative form of risk management is potentially or in fact an efficient means through which large listed or a group of companies other companies or a group of companies can protect themselves financially. In the process, the parent company has more control over how risks are insured and claims are managed. The parent company also has more insight into and is able to exercise more influence on the behaviour of the insured companies and their affiliates and therefore on the insured risks, as a result of which moral hazard is lower. There's also a positive influence on the problem of adverse selection. Insurance law and regulatory legislation, to which captives are also subject, also play an important role in the mitigation of moral hazard. An insurance captive can have important efficiency effects, but is not suitable for every company. The company to be insured must have sufficient financial buffers and a serious premium volume for a captive to be able to increase the prosperity of a company. The start-up costs are high, there are operational costs and the captive must comply with the same regulatory and financial requirements as regular insurance or reinsurance companies. European insurance regulatory legislation is very strict for direct writing captives, but this does benefit the quality of the captives and the risk management policy pursued and prevents captives from being misused.

Keywords: Insurance, Captives, Moral Hazard, Adverse Selection, Risk Management

1. INTRODUCTION AND BACKGROUND TO THE STUDY

An insurance captive is a company's own insurance company. The captive is established by the parent company and insures all or some risks of the parent company and/or other companies within a group of companies (Banks, 2004:226 & 88-101; Bawcutt, 1991). The goal of using a captive is, as with taking out insurance at a regular insurance company, to shift risks (potential financial losses) for the purpose of creating more certainty and predictability for the company. Insurance captives function largely in the same manner as commercial insurance companies: they also have to have a permit, are subject to regulatory legislation, issue insurance policies, collect premiums for the assumption of risks, make payments, etc. (Adkisson, 2006:1).

The insurance captive arose in the United States in the 1970s, when premium costs were high and some risks – such as product liability and product recall – were difficult to insure (IAIS , 2006:6). Almost all major corporations in the United States now have their own insurance company. Of all the companies listed on the S&P 500, 80% apparently have a captive. By now many listed companies in Europe also have an insurance captive (such as Adidas, BMW, BNP Paribas, Carrefour, Daimler, Heineken, Michelin, Nestle, Philips, Shell, Volkswagen) as well as a few other large corporations that are not listed but do have an extensive insurance portfolio. In addition, medium-sized companies have increasingly been establishing an insurance captive (such as housing associations). The reason for this is that insurance via a company's own captive can produce efficiency gains for a company in certain circumstances within the framework of risk management and risk financing compared to insurance at a regular insurance company.

Whereas there appears to be more than six thousand insurance captives worldwide, the insurance captive is surrounded by a certain mystique and it is regularly overlooked as a risk management and risk financing option or simply misunderstood. Specifically, there is a distinct lack of clarity regarding the precise significance of an insurance captive, the advantages and disadvantages thereof, and the effects for risk management and risk financing. This contribution is intended to provide more clarity and to demonstrate that under certain circumstances an insurance captive can have important efficiency effects and, among other things, a positive effect on moral hazard and adverse selection. For the purpose of acquiring more information on insurance captives and their operation, literature research was augmented by interviews conducted with the director of an insurance captive of a Dutch multinational, as well as with representatives from AON and Marsh, two major insurance brokers/consultancy firms in risk management that are often involved in the establishment and management of a captive.

First, a description will be set out below in respect of the types of insurance captives that exist (section 2). A discussion will then follow concerning the possible reasons for the establishment of a captive: the potential cost advantages that can be realised (section 3), the favourable influence on moral hazard and adverse selection (section 4), and a few other advantages, such as more flexibility in insurance conditions and the claim settlement (section 5). This will be followed by the disadvantages of a captive (section 6). The establishment and maintenance thereof entail costs and the requirements of the strict regulatory legislation must be complied with, as a result of which, when subjected to a cost-benefit analysis, it can be concluded that a captive is not suitable for every company. Subsequently, the applicability of the contractual insurance law to captives is discussed in section 7, which, in my opinion, supports efficient and effective risk management via a captive. Section 8 concludes with a short summary.

2. DIFFERENT TYPES OF CAPTIVES

If a parent company resolves to establish a 100%-owned insurance subsidiary and to transfer the most important risks (of the parent company and possibly those of the subsidiaries and sister companies) thereto, there are two options: having the captive act as a direct insurance company or as a reinsurance company (IAIS, 2006:8). The last option is the one that occurs most often.

In the case of a reinsurance captive, a regular insurer – the ‘fronting insurance company’ – insures in the first instance the risks of a company (IAIS, 2006:9). The company pays an insurance premium to this fronting insurance company (Adkisson, 2006:27-28). This insurance company issues the insurance policy and assumes the claim handling itself if a risk is realised. The difference with regular insurance policies is that the fronting insurance company partially transfers the insurance premium to the captive and partially or largely reinsures the risks with the captive (Bawcutt, 1991:33). Since the capacity of a captive is more limited than that of a regular insurance company, the captive will then generally transfer a part of the risk back to the traditional reinsurance market. In connection with its services, the fronting insurance company keeps a percentage of the collected insurance premium – the ‘fronting fee’ (Adkisson, 2006:28).

If the captive acts as a direct insurance company, it will not make use of the services of a fronting insurance company. The company immediately insures the risks with the captive (Bawcutt, 1991:33). The captive collects the premium, issues an insurance policy and also assumes the claim handling itself. In that case, too, the captive will partially or largely reinsure the risks.

In most cases, the parent company is the sole owner of the captive: the ‘single parent captive’ or ‘pure captive’ (Adkisson, 2006:29-30; Parkinson, 2002:241). It also occurs, however, that companies in the same sector jointly set up a captive for the purpose of insuring their equivalent risks: the ‘group captive’ (IAIS, 2006:8). In particular, this is an option if the premiums at regular insurance companies are high and the claims history is consistent (Adkisson, 2006:31; Bawcutt, 1991:31-32). For instance, a number of housing associations in Amsterdam have joined forces and set up a joint reinsurance captive. They have used it to transfer the fire and buildings insurance policies of some 200 residences to it. Their previous insurance company is currently acting as a fronting insurance company. The housing associations expect to save some EUR 2 million over a period of five years.

For the purpose of insuring its risks, a company will often make use of both its own captive and regular insurance companies. In that case, not all risks are transferred to the captive. Traditionally, a captive is used for fire and buildings insurance, business interruption insurance and corporate liability insurance (IAIS, 2006:8). For other risks, insurance was taken out with commercial insurance companies. Nowadays, policies such as contractors all risks insurance policies, D&O insurance policies, product liability policies and product recall policies, are also in force at the captive, but rarely are all risks insured with the captive.

3. POTENTIAL COST ADVANTAGES

It is said that 55% to 65% of the insurance premium at a regular insurance company is earmarked for paying claims and to build up reserves for future payments. This is the actuarial premium, the part of the premium that corresponds with the anticipated loss that the insurance company wishes to insure. The other 35% to 45% of the premium consists of the operating costs of the insurance company (such as advertising costs, office overhead costs, accommodation and inventory costs, costs relating to personnel, commissions to intermediaries, taxes, as well as reinsurance costs) and an allowance for profit for the insurance company (IAIS, 2006:13). A captive can save a large part of the costs of the insurance company that the actuarial premium is increased by and thus form a more efficient solution (Hale Stewart, 2011:8; Parkinson, 2002:10; Bawcutt, 1991:3). The smaller the difference is between the actual premium and the actuarial premium, the more efficient an insurance solution is; the prosperity of the insured company increases as a result. For instance, the overhead costs are lower since a captive does not issue insurance policies to the public and consequently needs fewer personnel. In addition, the captive will often be housed in a building that is already used by the company, so that barely any or no extra office space needs to be leased. If the services of a fronting insurance company are used in respect of the issue of a policy, claim handling and administration, the (re)insurance captive also does not need its own employees (aside from management).

The profit that a commercial insurance company makes on an insurance policy via the premium (profit mark-up) is used differently for a captive and also results in greater efficiency (Adkisson, 2006:3; Bawcutt, 1991:13-14). The amount of the premium that remains after deduction of the operational and claim costs of the captive is allocated to the reserves for future losses, is paid to the parent company as profit and/or results in a lower premium. Eventually, the profit that a commercial insurance company would normally make now benefits the company (Cross et al, 1986:471). In addition, the interest and the revenues that are derived from the reserves and investments now end up with the captive or its parent company, where such revenues, in the case of a regular insurance company, would otherwise go to its shareholders.

Another benefit is that the premium will or will need to fluctuate less. For a long period of time, a captive can charge the same premiums and in doing so build up adequate reserves in case loss or damage is claimed by the insured company or companies. A captive need not take into account the risks of other insured companies, as does a regular insurance company, and is influenced less by external factors such as economic fluctuations and market developments. The loss history at other companies can influence the premium of a specific insured party with an external insurance company, as well as the activities of such an insurance company on the investment market (Parkinson, 2002:56).

In the case of a captive, the cash flow is also positively affected (Hale Stewart, 2011: 8-9; Parkinson, 2002:12). Premiums are paid on a regular basis, while claims are paid over an extended period. Unused premiums flow into the reserves of the captive. The outstanding claims reserves can be saved at a bank, partially invested and/or lent (to the parent company or an operating company), as a result of which profit is generated that stays within the group of companies (IAIS, 2006:13).

In the event of a national or international group of companies, the parties concerned also obtain better insight into the risks at the group level. The risks are no longer spread over all operating companies, which may be insured at various insurance companies; all risks are run through the captive. This also entails that scale and negotiation power can be employed if the parties concerned decide to place specific insurance policies with the commercial (re)insurancemarket. After all, more insurance capacity is being purchased. Furthermore, an insurance company that knows that a company has a captive and can possibly insure risks itself will make more of an effort to keep or acquire that company as a client. That also creates more room to manoeuvre regarding premiums and conditions in negotiations with the insurance company in question (Hale Stewart, 2011:11-12; Adkisson, 2006:3-4).

Furthermore, the reinsurance market is only accessible to insurance companies and reinsurance companies. In light of the fact that a captive is an insurance company or reinsurance company, it can take out reinsurance directly. This has three distinct advantages: more risks can be insured considering the greater possibilities on the reinsurance market; it creates the option of spreading risks; and the costs of the insurance policy or policies is/are lower (IAIS, 2006:9). Reinsurance companies are the wholesalers in insurance products and the largest investors in the world. To a very large degree, they can realise risk diversification and will have fewer operational costs than direct insurance companies (Hale Stewart, 201111). As a result thereof, the capital costs of a reinsurance company are lower than the costs of the capital or extra capital that an insurance company or a captive would require to bear the risk itself. In short, it is cheaper for a company to insure its risks via the captive directly on the reinsurance market than insuring the same risks via a regular insurance company (IAIS, 2006:13).

Finally, a captive also offers tax benefits. The scope of tax benefits is dependent upon the country where the captive is based, but in general tax benefits can be generated via a captive. In tax terms, there are several attractive or very attractive places of business where many captives are established, such as Bermuda, the Cayman Islands, the Bahamas, Barbados, Guernsey, and a few states in the United States of America, like Vermont (Adkisson, 2006:79-85; IAIS, 2006:50; Van Fossen, 2002:503-521). The question is, however, whether such a location is positive for the reputation of the insured company. A tax benefit is an important effect when establishing a captive, but should not be one of the most important reasons (England et al, 2007:702).

4. MORAL HAZARD AND ADVERSE SELECTION CAUSE FEWER MAJOR PROBLEMS FOR A CAPTIVE

A captive is less affected by moral hazard and adverse selection than a regular insurance company (Diallo and Kim, 1989:233-252). The problem of moral hazard means that an insured party will possibly act more negligently due to the presence of an insurance policy and that consequently the occurrence of the risk will be affected (Shavell, 1979). There are fewer incentives to prevent loss, which results in an increase in the risk. It is, however, inefficient and undesirable if within the insured company the precautionary measures are possibly no longer taken that cost less than they yield in reducing the anticipated loss.

In the case of a captive, employees of the insured company will, however, be provided more incentives than with regular insurance policies to act with due care in their activities and, for instance, to take more safety and quality measures, since they know that the loss will be borne by their 'own company' (England et al, 2007;703). This is also the case for the insured company itself (IAIS, 2006:12). The company will increasingly strive to realise and monitor that optimum care is exercised within the company. The claims are eventually paid out of one's own pocket and optimum investments in safety and quality also translate directly into a lower premium and/or greater profit (Porat et al, 1991:664). If a regular insurance company requests that safety and/or quality measures are taken that favourably affect the loss history, the insured company will sometimes receive a discount on its insurance premium. The investments of a company will, however, often be higher than that premium discount. In the case of a captive, all revenues resulting from investments in safety, quality and loss prevention measures will end up with the company.

The converse incidentally also applies. In the event of a regular insurance company, if a company does not take loss prevention measures the premium will increase. Nonetheless, the insurance company generally spreads out that higher risk over the premiums of all insured parties (within a specific group). In the case of a captive, a company is confronted with the entire consequences of not taking preventive measures (Lee and Ligon, 2001:175 ff; Smith and Stutzer, 1995:545 ff). This provides more incentives to the company to take such preventive measures, which is important in the context of risk management.

From the captive's perspective, there is also a strong interest in keeping down the costs associated with loss. Where a regular insurance company can grow and be successful through PR and advertising plus attracting more policyholders in this way, there is growth for a captive if less need be paid out for loss and more reserves are built up (which can be invested). That will be the case in the event safety and quality measures are taken within the insured company or companies and risks are limited. Therefore, a captive will strive to achieve this and will want to clearly keep an eye on claims and loss figures (Adkisson, 2006:9). Consequently, an important side effect of having access to the reinsurance market is that the captive is able to dispose of the extensive sources of knowledge available at reinsurance companies. Since reinsurance companies insure major risks, they invest a lot in compiling and analysing information on these risks and the possibilities for managing them. A captive can immediately use the loss statistics and information of an insurance company on measures pertaining to safety and quality within a specific industry to increase the level of risk management within the insured company.

In other words, the problem of moral hazard occurs less often in the case of a captive. In addition, a captive still has the same instruments as a regular insurance company to keep moral hazard within certain limits. If insurance is taken out via a captive, exclusions of cover, deductibles and maximum insured sums are also used.

What is more, the problem of adverse selection (Rothschild and Stiglitz, 1976) is less of an issue for a captive. A commercial insurance company insures many companies with various risks. Since companies with poor (high) risks in particular have an incentive to insure themselves, the amount of the premium of insured parties with good (low) risks will possibly be negatively affected by the insured parties with poor risks. That is why insurance companies use different premiums in an attempt to differentiate between various risk groups and to keep the problem of adverse selection as small as possible. Adverse selection can, however, never be fully eradicated given the asymmetrical information between the insurance company and its insured parties in respect of the actual risks of a company. The costs of adverse selection are spread out over all insured parties (Porat et al., 1991:664). When premiums are set, the average risk within a group of insured parties is reviewed. Since a captive insures only one company or a limited number of companies and has more information on the activities within the company and therefore the actual risk present, adverse selection is barely up for discussion or not at all. Consequently, a company does not run the risk of paying too much premium as a result of loss or the risks thereof at competitors (Pressman et al, 2006:196; Adkisson, 2006:4-6; Bawcutt, 1991:15-24).

5. OTHER ADVANTAGES TO AN INSURANCE CAPTIVE

Furthermore, in the case of an insurance captive more flexibility and customised work are possible when the insurance conditions and exclusions of cover are determined. A captive can decide to indeed provide cover for several exclusions commonly applied by commercial insurance companies to provide cover to the extent such is permitted by insurance law (more on this below).

Incidentally, such customisation has its limits, as in some countries like the Netherlands the court has ruled – in connection with the application of tax legislation – that the policy conditions must be on market terms (Dutch Supreme Court, 21 August 1985, BNB 1985/301 and 302). In addition, reinsurance companies will be keeping a finger on the pulse and in the event that conditions derogate significantly, they will not or no longer be willing to reinsure the risk. A direct writing captive regularly uses brokers' policies (since brokers are often involved in the establishment and management of a captive) and the requirements of conformity with market standards are met. The captive also has an interest in preventing exceptionally broad policy conditions, since in that case (i) the insured party does not have an incentive to be risk-conscious and (ii) the captive cannot reject a policy claim. It is only if a policy is on market terms that the captive can pursue a solid financial policy and combat moral hazard. Ultimately, this is also in the interest of the company in whole or in part. If a fronting insurance company is used, it will possibly be prepared to apply several special clauses, but will otherwise want to use its own general insurance conditions (which are on market terms).

Furthermore, a captive can insure risks that are difficult to insure with a regular insurance company, or only at high premiums and/or with many exclusions (Parkinson, 2002:14-16; Schmit and Roth, 1990:455 ff). Examples of this situation include product recall insurance policies, as well as liability of manufacturers of medical products, medical liability, environmental risks, credit risks, new health risks and certain types of trading loss (IAIS, 2006:13; Scott and Adams, 1994:29-30). For many companies those are important reasons for a captive, since another manner of risk financing is not possible.

There is also more freedom in handling claims, and there is more control over the manner in which a claim is handled as well as over the outcome thereof. If an insurance policy is placed with a regular insurance company, the insurer will largely determine the claim settlement and in doing so allow itself to be guided by a variety of factors, including its own interest. With a direct writing captive, that is less the case. If the claim is settled by a fronting insurance company, control by the company will be less far-reaching. Furthermore, in this case there is also a limit to the freedom: the reinsurance company will alert the party concerned if payment has been made erroneously.

6. THRESHOLDS FOR A CAPTIVE

An insurance captive is not suitable for every company. The start-up costs are high, there are operational costs and the captive must comply with the same regulatory and financial requirements as a regular insurance or reinsurance company. The establishment of a captive entails costs that vary between EUR 50,000 and EUR 150,000 (England et al, 2007:705). First and foremost, a feasibility study must be conducted. The costs of such a study average in the tens of thousands of euros. If the outcome thereof is positive, the process of applying for a licence begins. Specifically, all insurance and reinsurance companies and therefore insurance and reinsurance captives as well must be in possession of a licence from the national regulator. At the same time, among other things, the captive must be established, business/financial plans and articles of association drawn up, members of management selected and appointed, an accountant and a broker/risk management advisor involved, arrangements made with the bank (bank account, etc), and (in the case of a direct writing captive) draft insurance policies produced or (in the event of a reinsurance captive) contact with fronting insurance companies made. At least several months are required for the process of establishing a captive and in most cases the time frame lies between 12 and 18 months. Additionally, the parties concerned will strive in principle to set the inception date for the eventual insurance policies for 1 January and therefore to have completed the process (well) in advance.

After the captive has been established, there are, of course, the operational costs. A director of the captive must be appointed who represents it, arranges the day-to-day affairs, is charged with the policy thereof, and maintains contact with the insured companies, insurance companies, reinsurance companies, brokers, the accountant, regulators, etc. After all, within the company there will be no knowledge of and experience with insurance, the insurance industry, insurance legislation and having an insurance company. In addition, for a captive that functions as a direct insurance company, personnel will also have to be present that is involved in claim settlement and administration. The monthly operational costs will lie around several thousand euros for a reinsurance captive and double or triple that for an insurance captive.

Furthermore, a captive must dispose of its own shareholders' equity, which must be furnished by its parent company. Just like regular insurance companies and reinsurance companies, a captive must meet the capital and solvency requirements pursuant to the Solvency II guidelines, which are to be made more stringent in the near future. Whereas it is true that this equity does not leave the company / the group of companies, the parent company cannot dispose of it either (Hale Stewart, 2011:5). That means, for instance in the Netherlands, that a reinsurance captive must have a minimum shareholders' equity of EUR 1.2 million, according to Section 49(1)(b) of the Prudential Rules (Financial Supervision Act) Decree. These requirements are more stringent for a captive that acts as a direct insurance company. For a captive that directly concludes non-life insurance policies with the company, a minimum shareholders' equity of EUR 2.5 million must be present and in the event a captive like this has general liability insurance policies in its portfolio, the minimum shareholders' equity requirement is EUR 3.7 million (Section 3:53 of the Financial Supervision Act in conjunction with Section 49(1)(f) and (g) of the Prudential Rules (Financial Supervision Act) Decree). These requirements will stimulate companies to opt rather for a reinsurance captive than for a captive that acts as a direct insurance company. In addition, thanks to tax benefits companies will likely receive incentives to establish a captive in a country with a favourable tax climate.

Incidentally, one could wonder whether it is reasonable to impose the same requirements on commercial insurance companies and insurance captives. Financial problems at a captive will only affect its own company and, in contrast with regular insurance companies, no consumers. An adjustment of the minimum level of shareholders' equity for captives and simplified supervision of captives in Europe, at least in the various European countries, is, in my opinion, desirable. This will also provide European companies with incentives to establish a captive in their own country and not in an exotic one and not to relocate existing European captives to other countries.

Given the costs of establishing and maintaining a captive and the financial requirements, the parent company or the group of companies that jointly establish a captive must have sufficient financial capacity and a serious insurance budget for a captive to be worth the effort. Whether a captive is an attractive option for a company will depend on various factors and the nature, activities and size of the company. The general rule of thumb, however, is that a captive is viable for simple risks – such as fire and transport risks – and low risks (in light of the average loss statistic in the sector), if the company or group of companies pays at least EUR 500,000 in premiums for its non-life insurance policies on an annual basis (Hale Stewart, 2011:5; Adkisson, 2006:25 & 46). If there are also tremendous and complicated risks – for instance, a product recall – requiring more administration, the total annual premium volume must be at least EUR 750,000 to EUR 1 million to justify the costs of a captive.

That means that a captive, in particular for a larger company, could be attractive as an instrument for risk financing given that such companies pay huge amounts in insurance premiums. For smaller companies in the same industry with similar risks (both in terms of type and size), a captive, jointly set up by a group of companies or not, can also be interesting and provide the opportunity of pooling risks at lower premiums. Nonetheless, a captive must be considered as a long-term method for risk management and risk financing. It has to be set up for a period of at least five to ten years (Hale Stewart, 2011:4). Only after several years can the benefits thereof be reaped. Reserves must first be built up and the start-up and overhead costs are partially or wholly recouped only after several years.

Finally, it should be pointed out that the risks are not transferred to a third party but are kept within the company. If many and/or major incidents occur or the captive experiences financial problems for other reasons, that may result in significant problems for the entire company. That is certainly the case if the company does not have any large financial buffers. Relevant to this situation is that a captive has less opportunity to spread risks than regular insurance companies. For that reason, if the company scores poorly relative to the average loss statistic, the external insurance market would be a better option, unless the above-average risk of the company is difficult to insure, in which case a captive would be an adequate solution for those risks.

7. CAPTIVE SUBJECT TO INSURANCE LAW

A captive that acts as a direct writer is not only an insurance company within the meaning of regulatory legislation, but also within the meaning of both applicable national contractual insurance law and the Principles of European Insurance Contract Law (PEICL). For instance, all elements of an insurance contract referred to in Article 1:201 of the PEICL are present: '*a contract under which one party, the insurance company, promises another party, the policyholder, cover against a specified risk in exchange for a premium*'. As a result thereof, the insurance contracts concluded by a captive are subject to the national rules of insurance law and possibly the PEICL. That is, in my opinion, also relevant for being able to realise both the efficiency gains of a captive and the possibility of a more effective risk management within the company.

In many legal systems and in the PEICL (Article 1:101) as well, the rules of the law pertaining to insurance contracts, however, do not apply to reinsurance companies; reinsurance captives are therefore also exempt. Nonetheless, reinsurance contracts can be partially interpreted in light of this legislation. In that case, the rules are, of course, directly applicable to the fronting insurance company and stipulate the legal relationship between the policyholder (the company) and this fronting insurance company.

The applicability of the contractual insurance law entails, for instance, that in taking out insurance, the policyholder has a duty to inform the insurance company of relevant circumstances of which he is or ought to be aware (Article 2:101, PEICL). The rules relating to the duty of disclosure are comparable in many European legal systems. See for instance, Article L.112-3 paragraph 2 of the French Insurance Code; Article 10 of the Spanish Insurance Contract Act; Section 19 of the German Insurance Contract Act; Article 1892/1893 of the Italian Civil Code; Article 7:928 et seq. of the Dutch Civil Code; and Article 5 of the Belgian Non Marine Insurance Act. Breach of the pre-contractual duty of disclosure will occur (much) less quickly with a captive than with a regular insurance company in view of the stronger bond and the shorter line between a captive and the policyholder. Additionally, it will occur much earlier that there is information of which the insurer was or should have been aware and which for that reason does not have any consequences for the cover or payment (see Article 2:103, PEICL). Within a large group of companies, however, a significant distance can exist between the insured company and the captive. This is certainly the case if it concerns decentralised companies, which may be the case for multinationals. An example of this is an operating company located in Hungary or Korea that takes out machinery breakdown insurance or directors' and officers' liability insurance with a French captive. A larger distance can also be present with a captive jointly set up by a group of companies. In that case, the captive must – just like a regular insurance company – be able to rely on the accuracy of the communicated facts for setting the premium(s). A contributing factor is that the reinsurance company stays in the background and alerts the captive in the event risks have been incorrectly estimated. In such an event, it is worthwhile that the captive is able to invoke the sanctions that are usually in effect for violations of the duty to disclose information, specifically termination or partial/full refusal of payment (Article 2:102, PEICL). The policyholder will then receive incentives to act carefully and to disclose relevant facts concerning the risk. In other words, moral hazard will also be combated in this way.

An insurance captive can also raise contributory negligence as an objection (intentional and reckless behaviour) vis-à-vis an insured party (Article 9:101, PEICL). Neither the policyholder nor the insured is entitled to indemnity to the extent that the loss was intentionally caused, or by a reckless act or omission and with knowledge that the loss would probably result. This is also favourable with a view to the prevention of moral hazard and the issue of behaviour incentives to insured parties for the prevention of loss.

The same reasoning applies to the insured's duty to avoid/mitigate insured loss (Article 9:102, PEICL). The insurer shall reimburse the costs incurred by the insured in taking measures to prevent/mitigate insured loss, to the extent the policyholder or the insured was justified in regarding the measures as reasonable under the circumstances. If an insured fails, however, to take reasonable steps to prevent/mitigate insured loss, the captive can generally deduct the loss that it suffers as a result from that payment. In some cases, it even means – depending on the national insurance law and the regulations in the insurance policy – that the insured loses the right to recover damages (that would have been avoided if reasonable steps had been taken). This provides the insured party with incentives to take those measures, which reduces moral hazard once more.

Furthermore, premium must be paid for the captive to continue to exist. If the policyholders/companies (in other countries or captives jointly set up by a group of companies) are in default, it will be relevant for a captive to be able to invoke termination or suspension (Article 5:103, PEICL) in the event the duty to pay premium is not complied with. This way, it has an incentive in hand that will stimulate the policyholder to pay in a timely manner. A captive, in particular, would otherwise run the risk that a policyholder would not take its duty so seriously to promptly pay the premium.

The concurrence of insurance policies can also occur (multiple insurance). For instance, an employee is involved in an accident involving work equipment. The determined liability of the employer can be covered by corporate liability insurance that has been taken out with the captive, as well as by machinery and equipment insurance taken out with a regular insurance company. The insured party can then choose which insurance company to call upon to pay for the loss (Article 8:104, PEICL), but after payment mutual recovery is possible. The insurance company called upon to pay for the loss will, for instance, make the payment on behalf of the insured employer and have recourse against the machinery and equipment insurance company. This convergence rule is relevant after the fact for the position of the captive (possible division of the loss), but it pre-emptively contradicts moral hazard. It prevents loss from being paid out several times and the insured party from having an interest in the occurrence of the insured risk.

8. CONCLUSION

In spite of the fact that much is not known concerning (re)insurance captives and that a wrong impression of – and a certain aversion towards – them appears to exist amongst many shareholders and risk managers of companies, in the past few years (re)insurance captives have experienced enormous growth around the world. That can be explained by the need of major and smaller companies for efficient and effective risk management and risk financing methods to augment the insurance products available on the commercial insurance market. Possibilities actually exist to realise efficiency gains via an (re)insurance captive and to arrive at more effective risk management. In that regard, it is important to know that the problems of moral hazard and adverse selection occur less quickly with a captive. This has a positive effect on the costs and the anticipated loss of the company, resulting in an increase in prosperity therefor. The law pertaining to insurance contracts also applies to both the captive and the fronting insurance company, which supports these possibilities. There are thresholds, however, for realising efficiency gains via a captive. The company to be insured must have sufficient financial buffers, a serious premium volume and a long-term vision for a captive to be able to increase the prosperity of a company. Nonetheless, even though European insurance regulatory legislation is, to my way of thinking, currently very strict or too strict for direct writing captives, this does benefit the quality of the captives and the risk management policy pursued and prevents captives from being misused. In addition, there must be a commitment at and within the company to prevent loss, to monitor risks and to take loss prevention measures.

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