CAPTIVE INSURANCE COMPANIES: A THEORETICAL AND EMPIRICAL STUDY

By

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DECLARATION

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

M E le Roux

Date

ABSTRACT

Much research has been done on risk coverage within the field of the traditional insurance market, but the concept of alternative risk transfer is fairly new to the world of risk management. The need for more innovative, multi-faceted approaches to meet possible losses, together with the growing resistance to the cross-subsidisation inherent in traditional insurance, has initiated the development of the captive insurance industry as an alternative risk transfer mechanism.

The objective of this research was to study the application of captive insurance as a risk management mechanism for managers. The objective comprised a modelling approach for managers to handle the strategic implications of establishing and operating a captive insurer. The tasks that were required for this assignment were as follows:

- The completion of a literature study of the basic theory available on captive insurance as an internal risk financing mechanism for management;
- The collection of relevant empirical information on the subject by means of questionnaires, which had to be based on the literature study;
- The critical analysis of the collected data; and
- The development of a decision-making model based on the outcome of the available information, that could provide a practical guideline for management to decide on the establishment and operation of a captive insurer.

Twenty-five questionnaires were sent out during February 2003 to cover all the registered onshore and cell captive insurance companies in South Africa. Offshore insurance companies could not be included in this study due to article 33 of the Reserve Bank's Act no. 90 of 1989 regarding confidential information. Of the 25 captive insurance companies, 21 companies completed the questionnaires, and three respondents declared that they did not perform captive insurance activities anymore. A response rate of over 95 per cent is therefore achieved.

The information obtained from the questionnaires was summarised on a SPSS spreadsheet and subjected to a statistical analysis to form the bases for the empirical investigation. The results of the empirical study for onshore and cell captive insurers leads to conclusions

regarding the importance of the objectives needed for establishing and operating the captive insurer.

The three most important *factors* which should determine the decision of a holding company to *establish* an *onshore* captive insurer were identified as the financial commitment of the holding company, the spreading of the risks of the holding company, and the retention capacity of the holding company. The three most important *factors* which should determine the decision of a holding company to *operate* an *onshore* captive insurer are the retention capacity of the holding company, the financial commitment of the holding company, and the management commitment of the holding company.

The three most important *factors* which should determine the decision of a holding company to *establish* a *cell* captive insurer were identified as the spreading of the risks of the holding company, the retention capacity of the holding company, and the financial commitment of the holding company. The three most important *factors* which should determine the decision of a holding company to *operate* a *cell* captive insurer are the financial commitment of the holding company, the spreading of the risks of the holding company, and the management commitment of the holding company.

A decision-making model for both onshore and cell captive insurers was developed as a tool for risk managers when deciding on the establishment and operation of a captive insurer as part of their risk management programme. The resulting conclusions and recommendations of this assignment are largely based on the personal viewpoints of the captive insurers active in the South African captive insurance industry. It is therefore recommended that future research also includes the role and views of the holding companies.

OPSOMMING

Heelwat navorsing is alreeds oor die tradisionele versekeringsmark ten opsigte van risikodekking gedoen, maar die konsep van alternatiewe risiko-oordrag is nog redelik nuut in die vakgebied van die risikobestuur. Die behoefte aan meer innoverende multivlak benaderinge om moontlike verliese te beperk, tesame met die toenemende weerstand teen kruissubsidiëring inherent aan tradisionele versekering, het tot die ontwikkeling van die gebonde (gevange) versekeringsbedryf as 'n wyse van alternatiewe risiko-oordrag gelei.

Die doelstelling van hierdie navorsing was om die toepaslikheid van gebonde versekeraars as 'n risikobestuursmeganisme vir bestuurders te bestudeer. Die doelstelling omsluit 'n modelboubenadering vir bestuurders om die strategiese implikasies van die stigting en bedryf van 'n gebonde versekeraar te beheer. Die voortvloeiende take van die werkstuk is soos volg:

- Die voltooiing van 'n literatuurstudie van die basiese teorie wat oor gebonde versekering, as 'n wyse van interne risikofinansiering vir bestuur beskikbaar is;
- Die versameling van relevante empiriese inligting oor die onderwerp deur middel van vraelyste wat op die literatuurstudie gebaseer is;
- 'n Kritiese ontleding van die versamelde inligting; en
- Die ontwikkeling van 'n besluitnemingsmodel op grond van die resultate van die beskikbare inligting wat as 'n praktiese gids vir bestuur kan dien met betrekking tot besluitingneming oor die stigting en bedryf van 'n gebonde versekeraar.

Vyf en twintig vraelyste is gedurende Februarie 2003 gepos om al die geregistreerde binnelandse gebonde versekeringsmaatskappye, asook gebonde versekeringsmaatskappye wat uit verskillende selle bestaan ("cell captive insurance companies"), in Suid-Afrika te bereik. Buitelandse gebonde versekeringsmaatskappye kon nie deel van hierdie studie vorm nie vanweë artikel 33 van die Reserwebank se Wet nr. 90 van 1989 insake vertroulike inligting. Van die 25 gebonde versekeringsmaatskappye het 21 maatskappye die vraelyste voltooi en drie respondente het aangedui dat hulle nie meer by die aktiwiteite van gebonde versekering betrokke was nie. 'n Reaksiekoers van meer as 95 persent is gevolglik behaal.

Die inligting vanuit die vraelyste is opgesom deur middel van 'n SPSS-sigblad en 'n aantal statistiese ontledings is gedoen, wat die basis van die empiriese studie gevorm het. Die resultate van die empiriese studie ten opsigte van binnelandse gebonde versekeraars, asook gebonde versekeraars wat uit verskillende selle bestaan, het tot gevolgtrekkings gelei met betrekking tot die belangrikheid van die verlangde doelstellings vir die stigting en bedryf van gebonde versekeraars.

Die drie belangrikste *faktore* wat die besluitneming van 'n houermaatskappy behoort te beïnvloed om 'n *binnelandse* gebonde versekeraar te *stig,* is geïdentifiseer as die finansiële verbintenis van die houermaatskappy, die spreiding van die risiko's van die houermaatskappy en die retensiekapasiteit van die houermaatskappy. Die drie belangrikste *faktore* wat die besluitneming van 'n houermaatskappy behoort te beïnvloed om 'n *binnelandse* gebonde versekeraar te *bedryf,* is geïdentifiseer as die retensiekapasiteit van die houermaatskappy, die finansiële verbintenis van die houermaatskappy en die bestuurs-verbintenis van die houermaatskappy.

Die drie belangrikste *faktore* wat die besluitneming van 'n houermaatskappy behoort te beïnvloed om 'n *gebonde versekeraar wat uit verskillende selle* bestaan, te *stig,* is geïdentifiseer as die spreiding van die risiko's van die houermaatskappy, die retensiekapasiteit van die houermaatskappy en die finansiële verbintenis van die houer-maatskappy. Die drie belangrikste *faktore* wat die besluitneming van 'n houermaatskappy behoort te beïnvloed om 'n *gebonde versekeraar wat uit verskillende selle* bestaan, te *bedryf,* is geïdentifiseer as die finansiële verbintenis van die houermaatskappy, die spreiding van die risiko's van die houermaatskappy en die bestuursverbintenis van die houermaatskappy.

'n Besluitnemingsmodel is as hulpmiddel vir risikobestuurders ontwikkel, vir beide binnelandse gebonde versekeraars asook gebonde versekeraars wat uit veskillende selle bestaan, om met besluitneming ten opsigte van die stigting en bedryf van 'n gebonde versekeraar as deel van hul risikobestuursprogram te help. Die voortvloeiende gevolgtrekkings en aanbevelings van die werkstuk was grootliks gebaseer op die persoonlike menings van die gebonde versekeraars wat aktief in die Suid-Afrikaanse gebonde versekeringsbedryf is. Dit word gevolglik aanbeveel dat toekomstige navorsing ook die rol en menings van die houermaatskappye insluit.

DEDICATION

This assignment is dedicated to
my parents Myburgh and Magdaleen le Roux

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION

Up to now, many risk managers have mainly focused on traditional risk management. As businesses struggle to be cost effective, protect profit margins and meet their stakeholders' objectives, this traditional approach might not be feasible in the future. Risk financing should become a more important part of risk management.

The concept of risk management has evolved to a significant degree over the past few decades. Risk management provides enterprises with the needed leverage to grasp the competitive advantage that some firms have lacked. The planning of a firm's risk management strategy can no longer be done in isolation. The business environment has changed and expanded so rapidly over the last years that risk managers are forced to adapt their management styles. They have to move beyond the boundaries of traditional risk management and start exploring cross border options and search for the optimal combination of total integrated risk programmes.

1.2 BACKGROUND AND DESCRIPTION OF THE STUDY SUBJECT

In this section the function of risk management and the role of the alternative risk transfer market is discussed.

1.2.1 Risk management

Increasing numbers of risk managers are attempting to create innovative strategies to address the uncertainties that threaten a company's competitive edge. Internal risk financing is increasingly employed as a tactical alternative to traditional risk transfer (Miccolis & Quinn, 1996:41).

The relationship between risk and insurance can be illustrated by in the fact that "insurance controls risk" or, as stated differently by Diacon and Carter (1992:7), buying insurance is one method of controlling the financial results of the unknown future. Insurance controls risk mainly by transferring the responsibility for paying of losses from one entity to another.

A risk management strategy embeds both the elements of physical and financial control of a company's risk programme. According to Briers (2000:1), 'business desires a holistic, consistent and integrated model of risk management that will satisfy the modern business enterprise's total need to respond to risk'. It therefore looks for consistent methodologies and measurement parameters for the identification, analysis and management of risk across the whole spectrum of the business.

The analysis of the various methods of risk handling is thus carried out by the *risk management function*. Risk management has been defined as the planning, structuring and controlling of activities and resources in order to minimize the impact of uncertain events for the benefit of the firm's stakeholders (Athearn, 1981:21; Binder, 1997:9; Diacon & Carter, 1992:73; Levin & Rubenstein, 1997:40; Marshall & Prusak, 1996:81). The process of risk management therefore has three main elements namely risk identification, risk measurement and risk control. The different methods of risk management are presented in Figure 1/1:

FIGURE 1/1: METHODS OF RISK MANAGEMENT

Source: Diacon & Carter, 1992:80, adjusted.

It is from the risk control perspective that the use of alternative risk transfer products become a meaningful tool for risk managers. Risk management is concerned with minimizing the detrimental effect of losses and can either be *financial* or *physical*. It therefore represents the operational efforts needed to prevent losses, or to put it plainly, ease the damaging effect on the enterprise (Levin & Rubenstein, 1997:37; Santomero & Babbel, 1997:234).

Physical risk control covers all techniques or physical operations designed to reduce the impact of the frequency and size of losses occurring during a period (Athearn, 1981:7; Diacon & Carter, 1992:73; Miccolis & Quinn, 1996:44; Santomero & Babbel, 1997:234). There are two alternatives, namely:

- The complete elimination of loss occurrence – this is *risk avoidance* or loss prevention, or
- Undertaking measures that affect the frequency and the size of loss – this is *risk reduction* through physical and procedural devices and education.

Even if a firm attempts physical risk controls, the risk manger is most unlikely to be able to remove every possibility of losses and therefore should make sure that means are available to meet losses if they occur (Diacon & Carter, 1992:73; Levin & Rubenstein, 1997:37). *Risk financing* can therefore be defined as "the process of making provision for sufficient resources either through self-financing or by access to third party funds" (Helbling et al., 1996:13). The enterprise that decides to meet those losses itself chooses what is known as *internal risk financing*. The enterprise that arranges for its losses to be paid by someone else, undertakes risk transfer or *external risk financing*. Risk financing can be implemented after the loss occurs (post-loss financing), or beforehand (pre-loss financing).

The means by which a company can finance a risk *after* an event has occurred, could comprise the following actions (Briers, 2000:2; Diacon & Carter, 1992:80 Levin & Rubenstein, 1997:38):

- Using cash available at the time;
- Selling assets not needed; and
- Borrowing from central funds of enterprises, obtaining external loans from financial institutions or raising additional capital from shareholders.

Arguably the more positive response to risk financing should be *pre-loss* financing. This pro-active strategy involves some financial arrangement to cope with a loss before it occurs. The methods of pre-loss financing inter alia includes (Diacon & Carter, 1992:80; Santomero & Babbel, 1997:235):

- Using capital markets to finance risk through securitisation, or exchange traded products;
- Buying insurance, the best-known traditional method of risk transfer;
- Establishing a pool through self-insurance or a contingency fund by making a provision on the balance sheet;
- Financial insurance which is an arrangement whereby the insured pays premiums and the reinsurer settles losses over time, but both parties share in the underwriting profit and investment income in the event of a good loss experience; and
- Forming a captive insurance company.

Risk managers will have very little choice but to look at other methods of financing risk besides the traditional insurance market. We shall see a move away from the traditional method of insurance and towards alternative risk transfer. An alternative risk transfer market can, in this context, be seen as a risk financing tool used as an alternative for traditional risk transfer products offered by insurers (Bowers, 1999:29). The question now is where do captive insurance companies fit into this changing environment of risk management. The following section deals with this aspect.

1.2.2 The Alternative Risk Transfer (ART) market

Competing in the current global marketplace is going to become tougher, with risk managers coming under more and more pressure to reduce the cost chain of their firms' risk financing programme (Gillett, 1996:3). Most key players in the insurance market have already established a separate entity that serves as captives insurance companies, risk retention groups and other risk financing arrangements that employ elements of self-insurance. This market now accounts for more than one-third of traditional insurance premiums (Ostermiller, 1998:34). An alternative risk transfer market is thus the competitive tool or intervention mechanism to substitute traditional risk transfer products offered by insurers (Bowers, 1999:29). Today companies can find greater long-term rewards in developing a strategic risk-financing programme than in continuing to buy traditional coverage at soft market prices (Zolkos, 1996:40).

Over the past decades, the alternative risk transfer market has developed in waves (Bowers, 1999:31). The first wave produced a mass migration of corporate accounts and the shifting of huge amounts of premiums from primary insurance companies to various types of alternative risk transfer market options. The second swell, formed in the late 1970s, focused on the trend to form group deals, self-insurance pools, trusts, group captive insurance companies and risk retention groups (Bowers, 1999:31). This sector has been the hottest area of growth in the alternative risk transfer market. By the time the market hardened in the mid-1980s the line between primary insurers and reinsurers had really become blurred. The third wave that the insurance industry faced manifested in the only pool left to traditional insurers, namely the small market commercial lines (Bowers, 1999:32). These are the only segments where primary insurance companies have made consisted underwriting profits. In the fourth wave insurance became embedded in the decision as how to finance the company as a global entity. Those who will dominate the market will have an array of financial skills, provide specialised services to clients, forge relationships with them and originate their own products (Bowers, 1999:35).

The need for more innovative, multi-faceted approaches to meet possible losses, together with the growing resistance to the cross-subsidisation inherent in traditional insurance, initiated the development of the *captive insurance industry*. (Bowler, 1998:54) The captive insurance company has been defined by a vast number of people. When all the relevant literature is consulted, the following definition of the captive insurance company stands out: A captive insurance company is, in its simplest and purest form, an insurance company that primarily insures all or part of the risks of its holding company or companies (Myers, 1996:2; Klumpp, 2002:1). This definition is, however, rather narrow and fails to reflect the way in which captive insurance companies have developed over the past years. A captive insurer may be more usefully described as a "closely held insurance company whose insurance business is primarily supplied by and controlled by its owners, and in which the original insureds are principal beneficiaries" (Shayne, 1999:28). The significant difference between captive insurance and traditional insurance companies is that captive insurance companies deal with a restricted risk that the company underwrites or reinsures themselves (Harris, 1998:1).

The captive insurance company concept has been in use for over 100 years, but in the 1960s the occurrence of captive insurance structures began to increase. In the early 1980s there was a significant surge in acceptance of captive insurance companies, with numbers climbing steadily ever since. In the mid- and late 1980s, headlines in the financial industry media talked endlessly about the hard insurance market and the widespread adoption by many large corporations of alternative risk transfer market techniques (Myers, 1996:1). The early 1990s brought news of market consolidations and softening insurance prices. In addition, today's insurance buyer has become more sophisticated and the traditional market has responded by expanding its offerings. The outcome is that the relationship between traditional and alternative risk transfer markets has become better balanced.

Some people predicted that interest in captive insurance companies would wane as the market softened; in the 1990s however, interest has remained high as seen by their continued growth (Myers, 1996:2). Enterprises have found that the flexibility of a captive insurance company is a strong benefit even during the soft insurance market phase. Developments such as the growing trend towards enterprise risk management and the integration of financial and business risks, have fuelled the growth of captive insurance formation (Koritzinsky, 1998:21).

The captive insurance market has therefore seen its strongest years of growth from the late 1990s to 2000, because of a global hardening of the insurance market, combined with tightened underwriting by primary insurers and reinsurers. This situation prompted many insureds to seek alternatives to the traditional insurers. Captives insurance companies have now moved away from being seen only as a tax-planning tool to an accepted tool for risk management in an increasingly sophisticated world (Grieves, 1998:22).

It is phenomena like these that form the subject and main objective of this assignment. The risk manager of today needs to know what alternative risk transfer options and mechanisms are available to build the best integrated risk programme for the enterprise.

1.3 OBJECTIVE AND SCOPE OF THE ASSIGNMENT

The subject of this assignment is a literature and empirical investigation of the importance of captive insurance companies as a risk management mechanism for managers. The findings should provide a practical tool for managers to measure the viability of forming a captive insurance company as an internal risk financing option. The subject thus includes certain objectives and tasks to be followed.

1.3.1. Objective

The objective comprises a modelling approach for managers to handle the strategic implications of forming a captive insurance company. Although a number of internal risk financing mechanisms exist, an extensive discussion of them does not fall within the scope of this study. The focus will mainly be on the feasibility of the three main types of captive insurance companies in South Africa, namely onshore, offshore and cell captive insurers.

1.3.2. Tasks

The tasks envisaged for this assignment are as follows:

- To complete a literature study of the basic theory available on internal risk financing, specifically of the use of captive insurance companies as an internal financing mechanism for business management;
- To collect relevant empirical information on the subject by means of questionnaires, which will be based on the literature study;
- To do a critical analysis on the collected data and information; and
- To build a model based on the outcome of the available information that should provide a practical guideline for management to decide on the feasibility of establishing and operating a captive insurance company.

1.4 STRUCTURE OF THE ASSIGNMENT

The assignment will be divided into five chapters. The theoretical and empirical results will be presented separately.

Chapter 2 contains an overview of the historic development of captive insurers and the related industry, with emphasis on the development of captive insurance companies, first as a global entity and, second, as a South African role player. When more players enter the insurance market, a risk manager has to differentiate the needs of his company more significantly to remain competitive. Today's insurance cannot be compared to the old traditional way of paying a premium and receiving some kind of cover that will hopefully meet the needs of the company. The result is a notable increase in self-insurance and therefore the environment for the evolving alternative risk transfer market is highly stimulated. Specific reference will be given to the South African captive insurance market.

In *Chapter 3,* the three prominent types of captive insurance companies will be discussed. The first part of this chapter involves a discussion of the reasons for forming a captive insurance company. This highlights the critical key advantages and disadvantages of investing in a captive insurance option. The latter part of Chapter 3 focuses on the difference between the various types of captive insurance companies, for example onshore, offshore and cell captive insurance companies. This is important because most risk managers need to establish whether their company will best benefit by facilitating their risk spreading through domestic or international intervention.

Chapter 4 forms the basis of the empirical study to this research. The formal data collection took place mainly by means of questionnaires. The population and therefore the total sample size is determined by the total number of registered captive insurance companies in the South African insurance market, both onshore and cell captive insurers. This data was obtained from the relevant governmental institutions e.g. the Financial Services Board and the Registrar of Insurance. After all the data had been collected, it was analysed both quantitatively and qualitatively. The analysis was expected to identify the critical key success objectives for establishing and operating a captive insurance company.

From the findings concluded in the previous chapter, *Chapter 5* summarises the main conclusions and recommendations from the existing literature as well as the empirical study. The chapter also presents a decision-making model that managers could use when deciding whether to form their own captive insurance company. This model should be of practical value as a tool for companies that are looking for an alternative to their current integrated risk programmes.

CHAPTER 2

DEVELOPMENT OF CAPTIVE INSURANCE COMPANIES

2.1 INTRODUCTION

Since managers help to direct their firms to approach risk management from a global perspective, the alternative risk market plays an increasing role in facilitating the efficient retention and allocation of risk throughout the enterprise (Sanderson & Koritzinsky, 1999:S6). One method of transferring risk through the alternative risk market is captive insurance.

Captive insurance has played a significant role in changing the outlook of the insurance industry since the 20th century. Not so long ago, a company may have stopped a certain activity if insurance coverage for that activity was non-existent, no longer available or had become too expensive to maintain (Goch, 2001:27). Captive insurance now provides a practical and financially feasible risk financing alternative to cover the risks of enterprises.

Since the 1960s, interest in and the use of captive insurance companies have grown more widespread. The captive industry has expanded worldwide at an accelerating rate, from 200 captive insurance companies in 1974 (Valsamakis, 1995:33) to 4 458 companies in 2000 (Anonymous, 2001b:30). Captive insurance companies are now providing a considerable amount of business insurance coverage once provided by traditional insurance companies. The traditional insurance market, as a result, has lost market share to captive insurance.

2.2 THE CONCEPT AND NATURE OF CAPTIVE INSURANCE COMPANIES

The simplest *concept* of captive insurance is what insurance experts define as an insurance company that only insures the risks of its holding company. This implies that a captive insurer has a restricted (or "captive") client base, which is limited to its owner or group of owners (Molewa, 1998:3). The term captive was actually coined by Fred Reiss (Schroeder, 1999:6). He began forming insurance companies for his clients under normal commercial insurance laws. In 1962 he went to Bermuda and persuaded the authorities to allow the formation, by private act, of insurance companies that would protect the risks of its holding company only.

A captive insurance company thus functions as an alternative to purchasing an insurance policy from an outside insurer (Yanchisin, 2001:738). Since the captive insurance company acts as insurer for the holding company or holding companies, it should be borne in mind that the amount of premiums paid to the captive insurance company should be adequate to keep the captive insurer economically viable. A number of rules and regulations exists to regulate the responsibilities of the captive insurer and the holding company. Transparency should therefore be one of the key factors to ensure the success of any captive insurance programme. A study by Adams and Hillier (2000:1804) showed that there is no firm evidence to suggest that captive insurance changes the risk structure of a holding company. The benefits rather manifest themselves in the fact that it provides an alternative to the traditional internal risk financing products offered by the financial markets.

According to Myers (1996:2), a captive insurance company offers the insured greater control of their risk management programme and the opportunity to expand their horizons. The formalised *nature* of a captive insurance company facilitates better understanding on the part of management of the global and integrated loss control within the firm. The cost of operating a captive insurance company is influenced by a number of fees that are payable. This method of risk financing also requires an initial capital investment by the holding company, which is generally lower than for normal commercial insurers (Nilsen, 2002:19). It should always be borne in mind that captive insurance is generally not a liquid type of investment and that it is speculative and long-term in nature (Gjertsen, 1999:15).

Captive insurance companies can be classified into group (or association) captive insurers or single-holding captive insurers. The group captive insurer is an insurance company formed to provide insurance to its group of owners (Petroni, 1998:289). The owners usually consist of enterprises from related business fields. The second type of captive insurance company, a single-holding captive insurer, is an insurance company formed to provide insurance coverage to its single holding company.

The concept of captive insurance companies as they are known today has evolved rapidly throughout the world. The "pure captive" insurer has rapidly evolved into more complex and innovative structures and various types of the original. Currently, the best known types of captive insurance companies worldwide are offshore, onshore and cell captive insurance companies. The types of captive insurance companies will be discussed in greater depth in Chapter 3.

2.3 HISTORY AND DEVELOPMENT OF CAPTIVE INSURANCE COMPANIES

The captive insurance industry has been operating since the early 1920s, even though many did not describe the type of structure used earlier as a captive insurance company. Mankind has sought to lessen individual loss exposure by forming groups to share risk since the very beginning of recorded time. The roots of insurance might be traced to Babylonia (1700 BC), where traders were encouraged to assume the risks of the caravan trade through loans that were repaid (with interest) only after the goods had arrived safely (Athearn, 1981:56). The earliest form of marine insurance can be traced back to the Egyptian civilisation. A number of farmers got together and divided their crops and livestock into equal portions to be transported along the Nile River. This action prevented the possible loss of all of a farmer's income if his boat should overturn in the river. Since then the insurance industry has come a long way and has continued to evolve. Captive insurance makes provision for a variety of purposes. The first type of captive insurance coverage includes marine protection and cargo and hull syndicates which historically is the oldest type of private insurance. Other coverage includes property, general liability and workers' compensation (Costle & Schauer, 2000:306). The true captive insurance company dates from the 1920s when one of the first, Imperial Chemicals Insurance Limited, was formed in the United Kingdom (Diacon & Carter, 1992:266). Imperial's formation, however, was not made under special captive insurance laws because those laws did not exist at the time (Schroeder, 1999:6).

From the 1920s until the 1960s, private property became the most popular insurance line in the now known captives insurance industry (Costle & Schauer, 2000:306). Later, workers' compensation, professional and general liability became part of the captive insurance structure (Fletcher, 1997:94). Early property insurance captives included groups of textile manufacturers and other factory owners. Other successful early captive insurers were non-profit organisations like church insurance companies and other social services groups (Lenckus, 1998:102).

The roots of the *international captive insurance* movement can be traced back to the 1960s when a United States oil company, reacting by establishing captive insurance companies to obtain possible tax reductions by the Caribbean government, relocated to Bermuda (Wynn, 1998:49). Subsequently other large corporations began to realise that an offshore captive insurer could provide numerous benefits. The first formal pools of these captive insurance companies were organised in the 1960s and they transferred risk out through reinsurance, while accepting risk premium from the holding company (Costle & Schauer, 2000:306). However, the most prominent type of captive insurer in the 1960s and 1970s was the single-holding captive insurer who covers the risks of its holding company only. Hundreds of captive insurers were formed, mainly in offshore tax havens, but also in other domiciles during the 1970s. Both strong action taken by the United States' Internal Revenue Service on tax deductions towards captive insurance in the 1970s and a number of large captive insurer liquidations due to the writing of unrelated business in the 1980s, led to a slowing of interest in unrelated risk transfer (Koritzinsky, 1998:S21).

In the late 1970s, many companies experienced difficulties mainly in obtaining product, general and professional liability insurance (Ostermiller, 1998b:77). Special attention was given to this problem and recommendations were made to solve the problem through alternative risk transfer mechanisms. Risk sharing entities (risk retention groups) were formed to provide coverage for product liability. By the time a formal law on risk retention was enacted in the United States, the product liability insurance crisis had subsided (Costle & Schauer, 2000:306). It was not until the next insurance crisis in 1986 that risk retention groups were actively employed. This crisis was not restricted to product liability, but encompassed many different types of liability coverage for groups that ranged from healthcare and law enforcement professionals to schools and many others. This broader crisis prompted the passing of an amendment in the United States, and consequently a more comprehensive version of the original laws imposed on risk retention. It now encompassed all liability coverage and not just product liability coverage.

A hard insurance market accompanied by high premiums, in the mid 1980s prompted many firms to use captive insurance when there was no other alternative available in the market (Klumpp, 2002:1). As a result, insurance coverage which in the past was provided by traditional insurers, was now placed in captive insurance companies, with the result that many insureds are unlikely to ever return to the traditional market. The number of captive insurance formations continues to grow as companies become informed about ways to lower their insurance cost, as well as to deduct premiums for tax purposes.

The relationship between captive insurers and reinsurers has evolved quite differently (Greenwald, 1998:6). Before the 1970s, many reinsurers were cautious in their commitments to captive insurance companies. Today captive insurance is considered a significant, ongoing business opportunity for reinsurers to bypass the broker and give them direct access to clients.

Whit less expensive insurance pricing prevailing in the 1990s, some risk managers discontinued their self-insurance actions for the comfort of paying premiums and letting someone else worry about paying the losses (Bradford, 1997:124). As a result, self-insurance in the form of captive insurance or risk retentions groups, is showing slower growth in the soft insurance market. Although this scenario is true, the fact remains that the emergence of the alternative risk market has kept a lid on the traditional insurance price increases. It is therefore clear that the captive insurance industry is continuing to grow, but not necessarily for the same reasons as in the past.

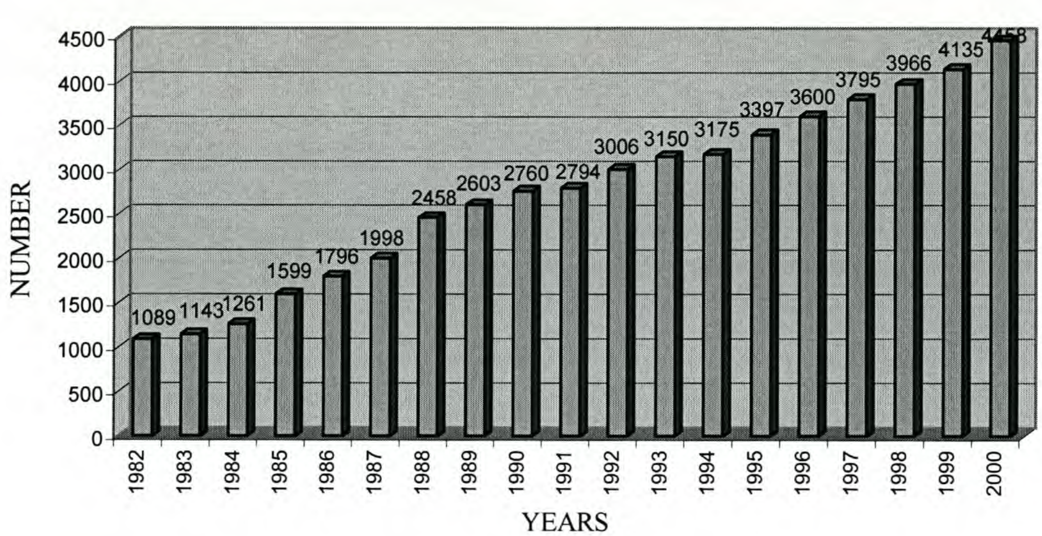
2.4 GROWTH OF CAPTIVE INSURANCE COMPANIES

When the growth of captive insurance companies expanded rapidly in the hard insurance market of the mid 1980s, captive insurance were thought by many to be a phenomenon that would lose its attractiveness when commercial insurance became more readily available and gained popularity with becoming inexpensive (Koritzinsky, 1998:S21).

When added to the unsettled stage of the financial markets along with the increasingly hard insurance and reinsurance markets, the forces unleashed by the events of 11 September 2001 in the United States, might have set the stage for tremendous growth in the alternative risk transfer market (Nilsen, 2002:18). From a captive insurance point of view, the drivers of captive insurance growth can mainly be seen as the hardening of the commercial insurance market, the ranges of explicit advantages captive insurance offers, and diversification opportunities into new business lines or products (Pilla, 2001a:85).

Best's Captive Directory lists all captive insurance companies throughout the world, with information taken from a variety of sources. As presented in Figure 2/1, there were 4 458 captive insurance companies listed in the directory with a net increase of 323 companies from the year 1999 to 2000 (Pilla, 2001a:85). The number of captive insurance companies by domicile in 2000 is presented in Table 2/1.

FIGURE 2/1: NUMBER OF CAPTIVE INSURANCE COMPANIES WORLDWIDE FROM 1982 TO 2000



Sources: Anonymous, 1999:4; Pilla 2001a:86.

TABLE 2/1: NUMBER OF CAPTIVE INSURANCE COMPANIES BY DOMICILE IN 2000

DOMICILE:	NUMBER	PERCENTAGE
Bermuda	1 405	31,5%
Cayman	535	12,0%
Vermont	381	8,6%
Guernsey	370	8,3%
Luxembourg	273	6,1%
Barbados	237	5,3%
British Virgin Islands	184	4,1%
Ireland	178	4,0%
Isle of Man	173	3,9%
Hawaii	73	1,6%
All Other	649	14,6%
TOTAL	4 458	100,0%

Source: Pilla, 2001a:85.

As seen from the data in Table 2/1, Bermuda is the world's captive insurance domicile leader by far, with 1 405 captive insurance companies or 31,5 per cent of the worldwide total of 4 458 captive insurance companies in 2000. The Cayman Islands provided the second largest international domicile, with 535 registered captive companies. Collectively, Europe and the British Isles had more than 22 per cent of the captive insurance companies, with Guernsey (370), Luxembourg (273), Ireland (178) and the Isle of Man (173) as the leading venues.

It is expected that the top captive insurance domiciles will attract the biggest share of new business. That is mainly because the parties forming a captive insurance company are seeking experience and stable infrastructure, so they migrate to regions that have proven records.

According to a recent analysis by A.M. Best Co., self-insurance, including captive insurance, will account for 49 per cent of the commercial property/casualty marketplace by the end of 2002, up from 33 per cent in 2001 (Anonymous, 2002:8). Not only does the growth of these domiciles and alternative risk financing tools provide the buyers of corporate insurance with more options, but they also serve to provide long-term commitments.

The worldwide captive insurance market shows the following trends (McDonald, 2001:4):

- Accelerated growth, especially in Europe and Asia;
- Greater transparency in offshore captive insurance companies;
- A move by healthcare captive insurance towards insuring medical malpractice for on-staff physicians; and
- More companies diverting their life and health benefits into alternative market vehicles such as captive insurance companies.

The number of new formations of captive insurers shows that, even with soft insurance market conditions, many entities are still choosing to take control of their own risk. The purposes of establishing and maintaining internationally domiciled captive insurance companies have shifted from market access and tax advantages to coverage for a variety of corporate risks (Wynn, 1998:50). Continued innovation means that the captive insurance community is likely to find ways to grow, regardless of market conditions.

2.5 THE SOUTH AFRICAN SHORT-TERM INSURANCE INDUSTRY

Short-term insurance in South Africa began in 1825 when the Alliance British and Foreign Life and Fire Assurance Company opened an office in Cape Town of (Santam, 1997:11). Not one of the original insurance companies remains, but they were the tiny origins of the insurance industry. Today the South African insurance industry is highly developed and ranks alongside the most sophisticated in the world. Both the short-term and the long-term insurance sectors boast strong links with the European and North American markets. Several major European and United States insurers and reinsurers are linked to domestic operations in South Africa. According to the general belief, South Africa's short-term insurance industry finds itself more at the mercy of global trends than ever before. One of its major challenges is to continue to grow in what some believe is a shrinking market.

The local market has changed dramatically during the latter part of the 1990s. Not only has it become characterised by increased competition due to the influence of some major international insurers, but there have also been a number of local mergers and acquisitions, and an increase in the number of specialist niche underwriting agencies. The socio-economic environment in South Africa has also contributed to the turbulence of the insurance market. The short-term insurance industry, mirroring international trends, has been declining in real terms over the past two years, and this is not expected to change in the near future (KPMG, 2001:3). Various aspects of the South African short-term insurance market receive due attention in the following sections.

2.5.1 Legislation

Insurance law in South Africa, like its counterparts worldwide, has developed from the mercantile law of Europe (Santam, 1997:11). South Africa now has separate acts governing long-term and short-term insurance. This legislation is concerned with regulatory matters such as the formation, registration, administration and solvency of insurance companies, as well as consumer protection. The acts contain important substantive provisions relating to policies and the client-broker-insurer relationship.

The terms and conditions of policies and the rates of premiums generally fall outside the scope of legislation (Santam, 1997:11). Transactions are influenced by strong competition created by a number of major insurers and reinsurers in the market and a strong insurance broker presence. The industry is regulated, largely through the Financial Services Board, with self-regulation structures supported by legislation and regulations (Financial Services Board, 2002:17). The South African legal and regulatory system also accommodates captive insurers, as well as cell captive insurance companies.

2.5.2 Market share

According to a survey of the South African insurance industry, that was undertaken by KPMG in 2001, the majority of the gross written premiums in the short-term insurance market continues to be underwritten by five companies, namely Santam, Mutual & Federal (excluding M&F Risk Financing), SA Eagle (excluding SA Eagle Risk Financing), Guardrisk and Hollard (KPMG, 2001:20). Collectively, they had 59 per cent of the market share in 2001 compared to 55 per cent in the previous year (KPMG, 2001:20). If the risk financing companies of Mutual & Federal and SA Eagle were included, with their holding companies, these five companies would have a more than 60 per cent share of the total short-term insurance market (KPMG, 2001:20). The top five companies by market share also changed from the previous year in 2001, with CGU being replaced by Hollard due to the acquisition of CGU by Mutual & Federal. A breakdown of the numbers of South African short-term insurers in the years from 1999 to 2002 are presented in Table 2/2. This was compiled from information provided by the Financial Services Board and a survey of the South African insurance industry executed by KPMG (2001:16). Typical insurers offer most types of policies mostly to the general public, while niche insurers mostly offer specialised cover only. The composition of the various types of insurers appears to have remained reasonably stable during the four years under investigation.

TABLE 2/2: NUMBER OF SOUTH AFRICAN SHORT-TERM INSURERS FROM DECEMBER 1999 TO DECEMBER 2002

Type of Short-term Insurer	Insurers in 1999		Insurers in 2000		Insurers in 2001		Insurers in 2002	
	Number	%	Number	%	Number	%	Number	%
Typical insurers	24	32,4%	25	31,6%	25	31,6%	22	28,6%
Niche insurers	29	39,2%	31	39,3%	31	39,3%	30	38,9%
Cell captive insurers	8	10,8%	8	10,2%	9	11,4%	10	13,0%
Onshore captive insurers	13	17,6%	15	18,9%	14	17,7%	15	19,5%
TOTAL	74	100,0%	79	100,0%	79	100,0%	77	100,0%

Sources: Financial Services Board, 2002:19; Financial Services Board, 2003:3 KPMG, 2001:16.

2.5.3 Financial overview

Compared to the previous year, the short-term insurance companies experienced a six per cent annual growth rate in *gross* written premiums in 2001 (KPMG, 2001:21). The annual growth rate in *gross written premiums* in the traditional segment was 16 per cent in 2001, while the annual growth rate of the niche, captive and cell captive segments was -13 per cent in 2001 (KPMG, 2001:21). Santam experienced the largest growth (65 per cent) of the top five companies by market share (KPMG, 2001:21). This growth includes the premiums of Guardian National, which Santam acquired during the year.

Price competition arising from over-capacity in the short-term insurance market has resulted in a moderate increase only in *net* premiums written. Unaudited figures for 2002 indicate an increase of nine per cent in net premiums written by short-term insurers. The table below shows the split between net premiums written by typical short-term insurers (who offer most types of policies mostly to the general public), net premiums written by specialist or niche short-term insurers (who mostly offer specialised cover only) and cell as well as onshore captive insurers. The data was compiled from a special report on the results of the short-term insurance industry by the Financial Services Board and a report published by the South African Special Risk Insurance Association (SASRIA). The total amount of net premiums written in 2001 and 2002 is presented in the following table.

TABLE 2/3: TOTAL NET PREMIUMS WRITTEN FOR THE YEARS 2001 AND 2002

Type of short-term insurer	**Total net premiums for 2001 (R'000)**	**Percentage**	**Total net premiums for 2002 (R'000)**	**Percentage**
Typical insurers	R14 497 000	78,30%	R 16 860 000	77,90%
Niche insurers	1 812 000	9,80%	1 868 000	10,20%
Cell captives insurers	1 608 000	8,70%	2 195 000	8,70%
Onshore captive insurers	596 000	3,20%	698 000	3,20%
TOTAL	R18 513 000	100,00%	R 21 621 000	100,00%

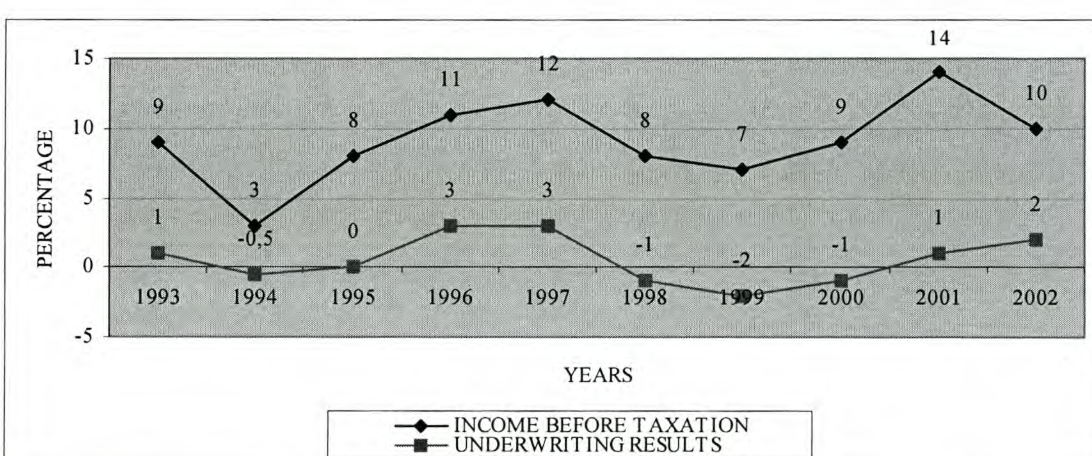
Sources: Financial Services Board, 2002:1-5; South African Special Risk Insurance Association, 2001:2.

The information summarised in Table 2/3 indicates that onshore captive insurers contributed 3,2 per cent of total net premiums written in 2001 as well as in 2002. Cell captive insurers contributed 8,7 per cent to the total net premiums in both years. Niche and typical insures accounted for 88,1 per cent in 2001 and 2002. A total of over R18,5 million net premiums written were reported in 2001, compared to the R17,3 million in 2000, and compared to R21,6 million in 2002. The growth of total net premiums between the four types of short-term insurer occurred in almost the exact same shares from 2001 to 2002.

2.5.4 Operating results

The South African short-term insurance industry is experiencing significant market turbulence, which is forcing many companies to reconsider their strategies. Cost cutting exercises and the launch of innovative new products and distribution channels are some of the survival strategies adopted by companies. Although the short-term insurance industry's underwriting results are under pressure, most insurers still disclosed significant income before taxation. Five of the 22 insurance companies classified as "typical insurers" reported underwriting losses for the year ended December 2002. The graph below indicates how underwriting results and income before taxation expressed as a percentage of net premiums have fluctuated since 1993.

FIGURE 2/2: UNDERWRITING RESULTS AND INCOME BEFORE TAXATION OF SHORT-TERM INSURERS AS A PERCENTAGE OF NET PREMIUMS



Source: Financial Services Board, 2002:2.

Figure 2/2 clearly shows that underwriting losses were reported by short-term insurers in the South African insurance industry for the year 1994 and for the period 1998 to 2000. The income before taxation indicates a more stable curve with best results in 1996, 1997 and 2001. According to a report published by KPMG (2001:3) the sound financial results in 2001 can be ascribed to the absence of significant weather-related losses in the first part of the year and they are also indicative of the hardening of the insurance market.

2.5.5 South African short-term insurance industry outlook

Consolidation in the short-term insurance industry is expected to continue to provide institutions with the means to meet the financial challenges that they have to face, with smaller insurers likely to focus more and more on niche markets. In order to continue to survive in the long term, the South African short-term insurance industry will have no option but to start developing new markets by also exploring the low-income groups or informal settlements. The ability of the short-term insurance industry to adapt to an ever-changing and demanding client base and to provide new and innovative products will be of prime importance.

2.6 DEVELOPMENT OF CAPTIVE INSURANCE IN SOUTH AFRICA

The South African short-term insurance industry is significantly affected by the socio-economic status of the country (Molewa, 1998:38). In particular, the high crime rate has led to high insurance premiums. On the other hand, the high unemployment rate, poverty and high interest rates have lessened the disposable income of many South Africans, making insurance coverage an even lower priority for a number of parties. The products, premium levels and services offered by the South African short-term insurance industry have influenced large enterprises to incorporate and license their own South African "single holding" captive insurer. Not only does captive insurance overcome the aspect of availability and market capacity, it also provides a tool for obtaining excess layer reinsurance from the international insurance market (Leighton, 2002:19). The insurance premiums charged by the captive insurer will not subsidise the poor loss experiences of other insureds, and make insurance more affordable.

The captive insurance market in South Africa evolved from a dual point of view. On one level it was practiced on an informal basis and on the other it evolved from a structured basis. From an informal point of view the concept of captive insurance has existed for a long time, having been practiced by lower income groups in the form of "stokvels", burial societies, friendly societies and investment syndicates or pyramid schemes (Molewa, 1998:49). Communities established these societies to protect themselves against risks and losses. From a risk management perspective it would be more feasible for these groups to seek alliance with a formal financial entity. Instead of just depositing the funds into low interest rate bank accounts, a structured financial entity can add value through specialised knowledge and investment expertise. The comparison between these informal groups and the cell captive insurance companies are significantly highlighted, because it provides the South African risk managers with new market opportunities.

The structured captive insurance base in South Africa evolved partly out of the motor industry (Anonymous, 1991b:17). The number of uninsured vehicles has been rising since the late 1980s because of sky-high premiums (Deans, 1995:31). The high premiums are linked to the various perceived risk profiles of vehicles. In this regard some vehicles owners are charged much more than others. Motor manufacturers such as BMW South Africa have been very critical of the insurance industry for charging these higher premiums relative to some of their competitors (Howard, 1996:13). Against this background, BMW decided to introduce their own vehicle insurance products. A growing number of enterprises soon came to see captive insurance as a workable practice for their current situation.

The rate at which South African captive insurance companies were being incorporated in tax haven domiciles in the late 1980s made the government wonder if these developments were not just a "money laundering scheme" established solely for purposes of circumventing the South African tax system (Anonymous, 1991b:17). In addition, the government suspected that malpractices and non-compliances with the law were taking place in the insurance industry (Molewa, 1998:6).

By the late 1980s, the South African government appointed a commission of inquiry under the leadership of Judge Melamet to investigate the captive insurance issues (Anonymous, 1991b:17). The findings of the Melamet commission confirmed the government's suspicion regarding the existence of malpractices and non-compliance with the Insurance Act (Molewa, 1998:7). At the time the inquiry identified 22 captive insurance companies (of which 21 were offshore) and the estimated premium outflow for 1988 was calculated at R200 to 300 million. The Melamet commission produced two reports in which they stipulate their findings and recommendations. The main recommendation was to modify the legal system to facilitate the establishment of onshore captive insurance companies to replace the practice of mismanaged offshore captive insurance companies.

Based on the findings of the Melamet commission, the Financial Services Board, the Registrar of Insurance and the South African Reserve Bank started to implement stricter rules and regulations for industries to abide by the law. According to the Financial Services Board 14 onshore and 11 cell captive insurance companies were incorporated into South African firms on 20 November 2002 (Van der Lith, e-mail: 20 November 2002). This excluded those that were located offshore in tax havens like the Isle of Man, Guernsey, Bermuda and the Cayman Islands. Contrary to the worldwide evolution, the number of captive insurance companies in South Africa has stabilised. This information is presented in Table 2/2.

It is clear from the preceding discussion that the South African short-term insurance industry provides a growing market environment for captive insurance development and stimulates the growth of the strategic relationship between the structured and the informal market of captive insurance.

2.7 SUMMARY

From a strategic perspective, it is evident that the risk management function has become more complex. It can be regarded as a strategic priority that the responsibility for this function can no longer be left to outside consultants (or, in some instances, traditional insurers) as they might not understand the strategic objectives of the enterprise. In this management measures are adopted and implemented in a manner that is consistent with the strategic objective of the enterprise as a whole.

To establish the above-mentioned approach, a risk manager can tap into the benefits that the alternative risk transfer market is offering. This market has been growing and developing over a long period of time, and the segment of captive insurance provides a fast and innovative number of services to comply with the customised needs of an enterprise.

The concept of captive insurance is not new in South Africa. It has been practised on an informal as well as a structured basis for many of years. A fair number of companies have taken advantage of captive insurance to overcome the main limitations of traditional insurance. Captive insurance has the ability to provide insurance at reasonable cost and with less restrictive stipulations.

CHAPTER 3

TYPES OF CAPTIVE INSURANCE COMPANIES

3.1 INTRODUCTION

The discussion of the development of captive insurance companies in Chapter 2 shows clearly that captive insurance forms an integrated part of enterprise risk management strategy. This chapter deals with the different types of captive insurance companies and the requirements for the implementation of each type. A detailed study of these aspects is imperative when a risk manager has to prove the economical merit of establishing a captive insurer. In recent times several changes have had an influence on the operation, regulation and location of captive insurance companies, which have become the core of the risk management programme for many large enterprises.

In the first part of this chapter the different reasons for forming a captive insurance company are discussed. The reasons can be classified into four main categories, namely, financial leverage, control, flexibility, and commercial objectives. Once the different reasons for forming a captive insurance company have been investigated, the decisional factors for establishing and operating a captive insurance company will be analysed. The decisional factors should be a natural outflow of and complementary to the reasons identified for forming a captive insurance company. The second part of Chapter 3 gives due attention to the various types of captive insurance companies with special reference to the South African market. The focus is placed on the most widely used types of captive insurance companies in the South African insurance industry, namely the onshore, offshore and cells captive insurance companies. These forms of captive insurance will be discussed on the basis of the unique characteristics of each type, the advantages and disadvantages that they hold for a holding company; and their role in the South African insurance industry. After evaluating all the elements of captive insurance, the risk manager can base his decision on what best fits the enterprise as a whole. A strong determinant for captive insurance-related decisions is represented by the need for integrating and coordinating the risk management activities spread throughout the firm (Petroni, 1998:285). The chapter is concluded with a summary of important key points to consider for determining the relevance of forming a captive insurance company.

With more and more players joining the race for establishing their own captive insurance companies, most managers base their decision to form a captive on the reasons discussed in the sections to follow.

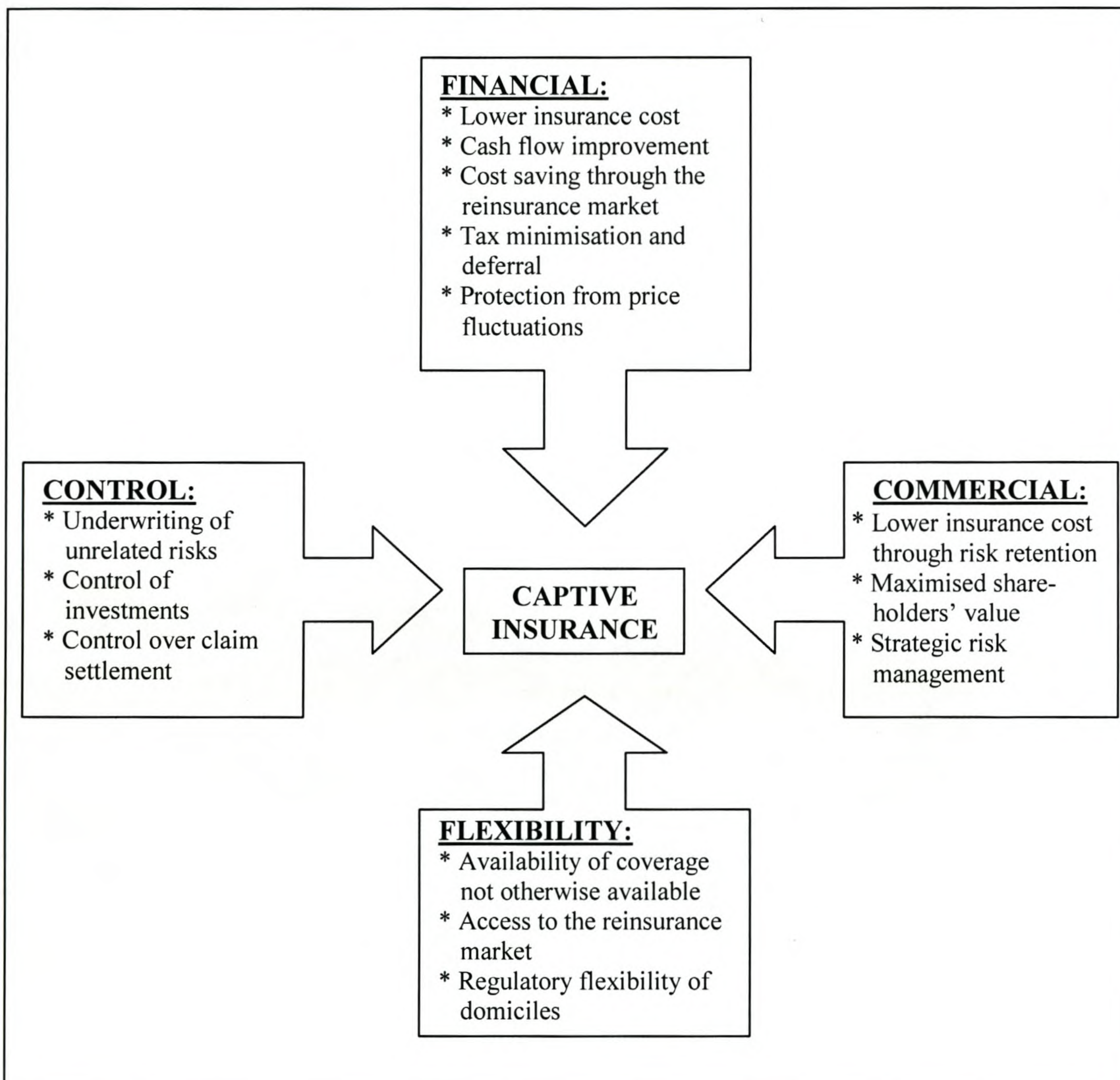
3.2 REASONS FOR FORMING A CAPTIVE INSURANCE COMPANY

In the past, captive insurance companies have sometimes suffered from being perceived as inferior to the traditional insurance companies. Captive insurance companies in many ways resemble mutual insurance companies and they operate in a similar way (Costle & Schauer, 2000:305). The perception of their image is partly due to the fact that many captive insurance companies have been formed in jurisdictions under laws, customs, and tax systems different to that of the domestic domicile. The integrity and business purposes of a holding company forming a captive insurer should not be influenced by whether it was formed offshore or onshore. The type of captive insurer and the domicile selection should cohere to the goals of the holding company.

It is universally believed that a captive insurer is mainly a tax minimisation mechanism (Eveleigh, 2000:1). In fact, captive insurance companies are usually formed for other economic reasons, with the main driver being minimisation of total cost of risk. The business reasons for forming a captive insurance company must be valid and sustainable (Hoban, 1995:10; McDonald, 2001:3). This requires a long-term view and total commitment from management.

For the purpose of this study, the reasons for forming a captive insurer can be divided into *four main categories*. These include *financial leverage, control, flexibility,* and *commercial objectives*. This does not mean that these categories exist in isolation, because they co-exist in practice and can have a significant influence on the risk management decision. In what follows, the above-mentioned aspects are discussed in greater detail. It helps by providing the risk manager with the necessary decision-making tools for determining the importance of captive insurance for the particular holding company. Figure 3/1 illustrates the four main categories.

FIGURE 3/1: SCHEMATIC ILLUSTRATION OF THE MAIN REASONS FOR FORMING A CAPTIVE INSURANCE COMPANY



By studying the reasons for forming a captive insurer, the risk manager can obtain a framework for compiling a feasibility study. A company should evaluate each reason for implementing a captive insurance company against the holding company's unique structure and needs. It is a general rule that more than one of the reasons that follows must be present in order to make the establishment of a captive insurance company worthwhile (Harris, 1998:1).

3.2.1 Financial leverage

The primary operating objective of most captive insurance companies is not to produce astounding returns, but to provide stability for their insureds at a competitive and reasonable premium (Sudowsky & Andre, 1997:1). The success of any insurance company originates from its underwriting profit and performance. Financial leverage can be achieved through lower insurance costs, cash flow improvement, cost saving through the reinsurance market, tax minimisation and deferral, and the protection from price fluctuations. The best risk management programme must achieve overall cost saving compared to its alternatives. The captive insurer can obtain this leverage by focusing on the financial aspects that follows.

3.2.1.1 Lower insurance costs

Commercial market insurance premiums must be sufficient to meet the cost of claims (Eveleigh, 2000:2). Like other commercial enterprises, insurers are also in business to make money and the premium will therefore include an element to provide for their procurement costs, overheads and profit (Eveleigh, 2000:2; Harris, 1998:2). This portion of the premium can represent as much as 20 per cent to 30 per cent of the insurance premium. A captive insurer will not eliminate all costs, but can assist in reducing them significantly. In establishing a captive insurance company, the holding company seeks to retain profit within the group of companies rather than see it go to an outside party (Klumpp, 1999:3). A captive insurer may also help to reduce insurance costs by charging a premium that more accurately reflects the holding company's loss experience (Klumpp, 1999:3; Shayne, 1999:28). Other costs which may contribute to a more competitive cost structure and which can be greatly reduced by using a captive insurance company includes administration and claim settlement, loss control expenses and brokerage commissions (Du Toit, 1999:25; Harris, 1998:2;

Sudowsky & Andre, 1997:3). Because captive insurers write business directly, they can generate a lower commission and administration fee. These cost savings may contribute to more favourable underwriting results. What has been a cost centre, can now become a profit centre (Anonymous, 1991b:14).

3.2.1.2 Cash flow improvement

If companies are trying to maximise their use of cash flow, captive insurance can provide an optimum cash management solution (Polo, 1993:14). Apart from pure underwriting profit, insurers depend a great deal on investment income. While claims are paid out over a longer period, premiums are normally paid in advance. Until claims become payable, the premium is available for investment purposes (Eveleigh, 2000:2; Harris, 1998:2). By utilising a captive insurer, premiums and investment income are retained within the group of companies. Additionally, the captive insurance company may be able to offer a more flexible premium payment plan, thereby giving a direct cash flow advantage to the holding company.

3.2.1.3 Cost saving through the reinsurance market

As a licensed insurance company, a captive insurer may purchase insurance from reinsurance companies at lower rates than would be available to commercial insurance brokers in the retail market (Petroni, 1998,287). Unlike the insurance market, the reinsurance market is largely unregulated with regard to forms, rules and rates (Shpritz & Calder, 1998:2). Unique exposures can therefore be handled by captive insurance companies through customised policy programmes. The cost saved by utilising the reinsurance market can also contribute to the holding company's cash flow.

3.2.1.4 Tax minimisation and deferral

The tax considerations with regard to forming a captive insurer will depend on the domicile of both the holding and the captive insurance company (Shayne, 1999:29). Tax reasons should not be the main consideration for forming a captive insurance company, and the integration of a captive insurer as part of an overall tax planning strategy is a complex subject. This implies that professional legal and tax advice is essential (Harris, 1998:2). Tax issues concerning captive insurance are complex and uncertain and there is no exact formula. The general rule states that premiums are deductible as expenses of the holding company. Deduction of the premiums paid is strictly monitored and open to challenge from the regulatory authorities. A holding company can only deduct the premiums paid when it actually pays the premiums over to the captive insurer (Roberts, 1997:36). The responsibility to prove that risk of loss has shifted and that the captive insurer is a separate entity rather that merely a division of the holding company lies with the owners of the holding company (Cuddy & Shuster, 1992:230; Shanye, 1999:30).

Offshore captive insurance can have additional tax implications for the holding company (Myers, 1996:4). The premiums and the investment income may be allowed to accrue tax-free in the offshore jurisdiction, or with very little tax payable. A number of rules and regulations are faced by holding companies to obtain deductions for premiums paid. According to Du Toit (1999:25) the following regulations should be considered: Firstly, the holding company needs to prove that there has been a clear shift of insurance risk to the captive insurer. Furthermore, the premiums have to be paid in order to gain the underwriting of insurance risk, and not become the creation of a reserve fund. Payments to establish a pure reserve fund are normally not deductible for tax purposes. Premiums paid must be comparable to those paid to independent insurers. Any excess in premiums will therefore not be allowed as a tax deduction. The further issue is connected to the domicile of the captive insurance company. Domestic laws of many countries will bring all entities controlled within their jurisdiction into their domestic tax structure. On the other hand, the profit of a captive insurer may sometimes be taxed in the country of the ultimate holding company. It remains upto the South African authorities if they will allow a particular holding company to deduct the premiums paid to an offshore captive insurance company for tax purposes.

3.2.1.5 Protection from price fluctuations

The cost of insurance is cyclical and volatile. By establishing a captive insurance company the holding company can better stabilise its risk management costs (Petroni, 1998:287). Insurance pricing is based on market forces and is relevant to the risks that a company needs to insure. The captive insurance premiums are determined by the company's own loss experience rather that by what is benchmarked form a collective group whose loss ratio can be much higher.

3.2.2 Control

In forming a captive insurance company, the holding company establishes control and ownership over the entire programme in having to manage underwriting requirements, claims practices and procedures. Control is considered by many as the most powerful benefit of establishing a captive insurance company (Gjertsen, 1997:3; St. Goar, 1995:19; Winston, 1999:28). Captive insurance improves risk control by centralising the risk management function (Shayne, 1999:29). The holding company will be involved in the total design and management of the risk programme. The element of control includes the underwriting of unrelated risks for profit, control of investments and greater control over claim settlement.

3.2.2.1 Underwriting of unrelated risks for profit

Aside from underwriting its holding company's risks, a captive insurer may operate as a separate profit centre by underwriting the risks of third parties that are unrelated to the risks of the holding company (Anonymous, 2000a:28; Eveleigh, 2000:2). Specifically, an enterprise may wish to sell insurance to existing customers of its core business. For example, retailers may sell extended warranty cover to customers with the risk being underwritten by the retailer's own captive insurer (Eveleigh, 2000:2). The predictability of the claims pattern of this type of business is usually very stable, with a large number of small exposures, and this can provide the retailer with a valuable additional source of revenue from lines of business that are unrelated to that of the holding company.

3.2.2.2 Control of investments

A captive insurance company provides the holding company with a facility to store funds for future losses and liabilities (Shpritz & Calder, 1998:1). Holding companies can maintain control of the premium payments that are made and can direct the management of those funds according their own investment strategy (Petroni, 1998:287). The holding company can therefore earn investment income via the captive insurer.

3.2.2.3 Control over claim settlement

A holding company can negotiate some predetermined agreement with the captive insurer, on the grounds of rules and specific criteria that will be in place if a claim should have to be settled. The fact that this agreement will be in the best interest of both parties makes claim settlement faster and more certain and removes the possibility of hidden clauses (Mead, 2002d:1). It is also imperative for a risk manager to understand the history, nature and scope of claims. The captive insurer can provide a detailed analysis of the claims that arise. A primary advantage for the holding company is therefore their ability to choose their own claims manager, risk manager and other service providers. An effective claim management system will provide control over claim settlement limits (Anonymous, 1993:12). When a loss occurs it has a certain value (Mead, 2002d:1). If the claim is not settled immediately, the time value of money becomes relevant. Projecting that value is one of the main functions of captive insurance actuaries.

3.2.3 Flexibility

One of the primary benefits of owning a captive insurance company is the flexibility in handling the changing risk financing environment. The captive insurer can provide coverage that is designed specifically to meet the needs of the holding company. The availability of coverage not otherwise available, access to the reinsurance market, and obtaining regulatory flexibility of domiciles can be seen as the main elements of flexibility.

3.2.3.1 Availability of coverage not otherwise available

Where the commercial insurance industry is unable or not willing to provide coverage for certain risks or where the premium is seen to be unreasonable high, a captive insurer may provide the cover required (Eveleigh, 2000:2). Captive insurance companies offer the flexibility to add coverage for liabilities such as wrongful termination and harassment of staff (Mandell & Clark, 2002:65). In general a captive insurer can cover worker compensation, general liability, motor vehicle liability, professional liability and credit risks. A recent line of risk coverage, fuelled by the events of 11 September 2001, is coverage of terrorism (Nilsen, 2002:18).

3.2.3.2 *Access to the reinsurance market*

Reinsurers are generally seen as the international wholesalers of the insurance world (Eveleigh, 2000:2; St. Goar, 1995:19). Operating on a lower cost structure than direct insurers, reinsurers are able to provide coverage at beneficial rates (Roberts, 1997:36). By using a captive insurance company to obtain access to the reinsurance market, the buyer can more easily determine his own retention levels and structure his risk programme with greater flexibility. Increasing numbers of reinsurers are dealing directly with companies and this can lead to a breakdown of entry barriers.

3.2.2.3 Regulatory flexibility of domiciles

Regulatory flexibility will be influenced by increased competition among captive insurance domiciles (Lonkevick, 1997:1). The growing number of captive insurance companies demands more flexible and economically viable regulations concerning the practice of captive insurance. A captive domicile should provide the necessary resources to effectively regulate the market. Major enterprises can also use their lobbying power with authorities to negotiate favourable tax deductibles or to permit tax-deferred catastrophe reserves (Kloman, 2002:3).

3.2.4 Commercial objectives

Some risk managers see captive insurance as part of their companies' long-term risk management strategy. The common goal should be to protect tangible and intangible assets with shareholders' value adding as the driving objective. The minimising of losses needs to be controlled at the lowest possible cost to the company (Shpritz & Calder, 1998:2). In this regard a captive insurance company can provide the setting of risk retention levels; maximising of shareholders' value of the holding company; and the planning of strategic risk management.

3.2.4.1 Risk retention levels

A firm's lack of willingness to retain more of its own risk, particularly by increasing deductible levels, may be influenced by the insufficient premium discount offered by insurers to take account of the increased deductible (Eveleigh, 2000:2). A company may also be incapable of establishing adequate reserves for potential losses. Establishment of a captive insurer can help to address both these problems. The captive insurer and its holding company can set the level of how much risk will be retained by the holding company and by the captive insurance company and how much risk will be placed onto the reinsurer. These retention levels can be customised to the specific needs of the parties involved.

3.2.4.2 Maximising shareholders' value of holding company

A holding company can make use of a captive insurance company to provide a broad range of existing and new services to its stakeholders (Roberts, 1997:36). The captive insurer can provide new products to their employees, vendors, dealers and customers. The relationship between the captive insurer and the owner will be closer (Shayne, 1999:28). This allows for an integrated risk strategy with synergistic advantages. A company may increase shareholders' value by reducing its cost base whilst maintaining or increasing its revenue. The key advantage is the ability of the captive insurer to earn underwriting profit and investment income, and therefore turn a cost centre into a profit centre for shareholders.

3.2.4.3 Strategic risk management

A captive insurance company can act as a measurement of the level of strategic risk management and risk financing activities of its holding company (Shpritz & Calder, 1998:2). An effective risk management programme can result in a sizable profit for the captive insurer and may also benefit the holding company. The risk management strategy may be viewed by a captive insurance owner; not purely as a cost centre, but rather as a potentially profitable part of the company's activities (Eveleigh, 2000:2). A captive insurance company can also be used by a multinational enterprise to set global deductible levels. This enables a local risk manager to insure with the captive insurance company at a level suited to the size of his own business unit, while the captive insurer only buys reinsurance in excess of the level appropriate to the group of companies as a whole. A captive insurer can also enhance awareness of the need for risk management control (Zolkos, 1999:3).

3.2.5 Concluding remarks

According to Petroni, (1998:288) the following aspects of captive insurance were isolated as *motivations* for forming a captive insurance company (in descending order of significance) were concluded from a study undertaken in Italy, which involved 183 Italian captive insurance owners:

1. Direct access to reinsurance market
2. Premium reduction
3. Negotiating power with insurer
4. Covering risk normally uninsurable with traditional insurance
5. Tax advantages
6. Enhanced cash flow
7. Business diversification
8. Image and reputation of the group of companies

Although the literature tends to emphasis the *control element* as an important reason to form a captive insurance company, this study by Petroni shows that the *financial objective* plays an important part in taking a decision on establishing a captive insurer.

Some authors have stated that captive insurance can be seen as the most overrated means of internal risk financing that has ever been invented (Howard, 1996:13). Although this statement is harsh and probably overrated in itself, it does have some merit. Captive insurance companies require a large capital commitment from the holding company and should therefore not be taken lightly. According to Paul Bawcutt, manager director of the Risk and Insurance Research Group, risk managers need to evaluate their risk strategy from a risk retaining perspective (Howard, 1996:13). He suggested that a few checkpoints should be constantly monitored to identify problems that indicate when a captive insurer cease to be viable:

- The captive insurer is not being used effectively.
- The holding company has too many captive insurance companies.
- The captive insurer has merely become a tax deduction instrument.
- The captive insurer has no strategy or long-term objective.
- The captive insurance companies become too expensive.
- The wrong location of the captive insurer.

The insurance chain can only be as strong as its weakest link, so holding companies must ensure that the management of their captive insurance company fully understands the risk entailed in the potential liabilities that it insures (Unsworth, 1996:30). The reasons for forming a captive insurance company remain as valid today as they were when the first captive insurance company was formed in the 1920s. Captive insurance companies, like every other alternative, offer advantages and disadvantages that risk managers must weigh and analyse carefully.

3.3 DECISIONAL FACTORS IN ESTABLISHING AND OPERATING A CAPTIVE INSURANCE COMPANY

Although the reasons to form a captive insurance company should fit the strategic outlook of an enterprise, certain *practical decisional factors* should also be considered. According to Petroni (1998:288) the following factors play a significant role in the decision to establish and operate a captive insurance company.

3.3.1 Loss/premium ratio of holding company

The norm in the traditional insurance industry is a loss/premium ratio that is below or equal to 0,7 (Financial Services Board, 2002:1). This means that insureds on average may recover up to 70 per cent of the premium, with the unavoidable consequence that premiums paid by an insured with a low risk profile may end up financing more risk-vulnerable insureds. According to Petroni (1998:288) captive insurance companies belong to an "under 30 club", which implies that they, unlike the traditional insurance market, only recover 30 per cent of their premiums paid to other insurers or reinsurers. The low risk profile of captive insurance should lead to lower premiums paid by captive insurers, and may eventually lead to lower premiums paid by holding companies to their captive insurers.

3.3.2 Financial commitment of holding company

Prospective owners of captive insurance companies should regard a captive insurance company as part of their long-term risk management strategy (Petroni, 1998:288). This vision should flow through to reflect the commitment to sufficient capitalisation in relation to the captive insurance company's planned insurance activities. Although initial investment is high, the long-term savings could benefit all parties.

3.3.3 Spread of risk of holding company

The risks underwriting by a captive insurer should not be concentrated on the high value exposures of the holding company only, but should rather be spread out (Petroni, 1998:288). The role of reinsurance should therefore not be neglected because this can provide the significant function of risk spreading.

3.3.4 Loss control of holding company

The success of a captive insurer will largely depend on its loss control programme (Anonymous, 1993:10). Loss exposures influence the profitability and the future development of a captive insurer. Management should implement a global risk reduction and prevention analysis to assist the captive insurer in controlling losses. Changes that could affect the loss situation should be closely monitored.

3.3.5 Management commitment of holding company

The process of integrated decision making by top management, risk managers and financial management will be decisive when the risk retention levels and reinsurance programmes for the holding company and the captive insurance company are planned from a holistic point of view (Petroni, 1998:288; Zolkos, 2001:17). If the management of the holding company is not totally committed, the optimum functioning of the captive insurer may be jeopardised.

3.3.6 Retention capacity of holding company

A set of financial indicators for determining the retention capacity which will refer to solvency, liquidity and performance measures can be deployed (Zolkos, 1996b:40). The risk manager, can for example, evaluate the working capital ratio, based on the company's combination of current assets and current liabilities, or he can look at the net cash inflow over the long term.

3.3.7 Regulation by government

Captive insurance companies are generally subjected to fewer regulations than traditional insurers, for the following reasons (Shayne, 1999:29):

- Captive insurers are self-insurers as they exist to cover only the risk of the holding company or companies.
- Captive insurers cannot sell direct coverage to parties other than their holding company or companies, or their stakeholders.
- The owner of a captive insurance company is also subject to a number of strict rules. The owner of a pure captive insurer should be a large sophisticated financial entity and should be measured on net worth and other applicable criteria.

3.3.8 Managerial competence of holding company

Among the most important factors in deciding to establish a captive insurance company are the skills and knowledge of the management of the holding company to constituting a captive insurer and in fully understanding its operating mechanisms (Petroni, 1998:289). This is usually done by means of an extensive feasibility study. Many companies outsource this factor to an external party. The decision to create and manage a captive insurance company must be governed by the upfront costs and administrative burdens associated with the operation of an insurance company (Shpritz & Calder, 1998:2).

After evaluating the advantages, disadvantages and decisional factors that relate to forming a captive insurance company based on the specific needs of the holding company, the risk manager has to decide on the type of captive insurance company that will best fit the particular enterprise. The different types of captive insurance companies will be discussed in section 3.4.

3.4 TYPES OF CAPTIVE INSURANCE COMPANIES

Captive insurance programmes can be structured in different ways. Since captive insurance was first practise in the early 1920s, the industry has continually looked at new ways of developing the captive insurance model to provide appropriate insurance vehicles for a wide range of owners and users. There are many types of captive insurers that are discussed below.

3.4.1 Single holding captive insurance company

The single holding captive insurer is still the most prevalent structure in use at present (Mead, 2002b:1). Often described as "pure" captive insurers, these are companies with a *single owner* to whom they provide insurance coverage (Harris, 1998:1; Kessinger, 2001:2). The purpose of this structure is to provide risk transfer or risk financing for an enterprise on a specific line of coverage. A risk manager or financial officer at the holding company usually monitors the captive insurer. A management company can also manage a single holding captive insurer where it is domiciled. This type of captive insurer was often used mainly for tax purposes, but this view has shifted to incorporate use for coverage or limits of indemnity otherwise unavailable (Mead, 2002b:2). The vital elements for being a single holding captive insurer are that it really insures a single insured, does not cover risks outside the line of business of its holding company, and the ownership is tightly related.

3.4.2 Group captive insurance company

A group captive insurer is an established association in which *multiple businesses join together* to provide insurance coverage for its multiple holding companies to obtain coverage otherwise unavailable (Costle & Schauer, 2000:310; Harris, 1998:1; Mead, 2002b:2). The group can be either heterogeneous or homogeneous in nature (Pasher, 1998:40). Ownership rests with the association or individual members. They usually have a financial expert at the association level with prime responsibility, or outsource this function to a management company, broker or consultant. This type of group captive insurance is suitable for companies of similar size but from *varying industries*, and provides them an opportunity to pool their resources and form a joint venture captive insurer. Participants in a group captive insurance company share risks at a predetermined layer (Mead, 2002b: 3). Risk managers deciding to form a group captive insurance company should bear in mind that managing a diverse group of insurance is a challenge.

3.4.3 Industry captive insurance company

Industry captive insurance companies are owned by *companies within the same industry* that have come together to solve a specific insurance problem (Costle & Schauer, 2000:310). The group or entities forming an industry captive insurance company have common insurance needs and similar risk exposures. The stockholders generally appoint a board of directors to whom the management company reports.

3.4.4 Agency captive insurance company

An agency-owned captive insurer is a reinsurance company operated by an intermediary or group of intermediaries (Gjertsen, 1999:15; Harris, 1998:1). This type of captive insurance company is therefore *formed by intermediaries* to participate in the insurance programmes of their clients. This approach is considered to be a strong marketing tool, as it demonstrates that the intermediary is prepared to join them on risk participation. By taking a portion of their clients' risks, intermediaries have the opportunity to earn not just the traditional commission, but premium income as well. Some intermediaries have been excluded from the alternative risk transfer market purely because they lack the capital to finance their own captive insurer (Katz, 1998c:23; Ostermiller, 1998b:80). Now they can do so because third party investors may also provide capital to finance this type of captive insurer.

3.4.5 Cell captive insurance company

The four most important types of cell captive insurance companies receive due attention in the following sections. Sometimes, however there is little difference between the various types of companies.

3.4.5.1 Rent-a-captive insurance company

A rent-a-captive insurance company insures the risks of its members and returns underwriting profit and investment income to the insureds (Bradford, 2001: 16; Katz, 1998a:3; Penwell & Miller, 1999:10). This type of captive insurer lets part of their captive insurer to entities wishing *to establish a self-insurance programme, but not their own captive insurance company*. Normally companies utilise a rent-a-captive insurer because they are not large enough individually to form their own captive insurance company. It usually does not make financial sense for a company paying less than R10 million in premiums to form its own single holding captive insurer (Ostermiller, 1998a:34; St Goar, 1995:18). According to Ostermiller (1998a:34) companies paying R5 million to R10 million in premiums are the best candidates for rent-a-captive structures. This structure is attractive to groups because the insureds do not have to make an equity contribution up front (Ostermiller, 1998a:34). There is generally *no sharing of risk among the participants* but there is *no absolute protection from each and every creditor* of a rent-a-captive insurer or participant. An important part in considering a rent-a-captive insurer is the careful evaluation of the partners participating in the group. The insureds can be exposed to the solvency risk of a rent-a-captive insurer (Myers, 1996:4). The main expenses for this structure consists of a rental fee payable to the rent-a-captive owner. The level of control by a participant in a rent-a-captive insurer is also lower than in a single holding captive insurer (Zolkos, 1997:45).

3.4.5.2 Protected cell company

Protected cell companies are *essentially rent-a-captive insurers* with a special difference. Protected cell captive companies allow renters to *shield their capital and surplus from other renters* in the captive insurer *as long as the rent-a-captive's owner remains solvent* (Katz, 1998b:17). As a result, creditors have no claim to the assets of another cell (Howard, 2001:7). Legislation protects the individual cell from the liabilities of the other cell owners instead of having to rely on a formal contract for protection (Booth, 2001:8; Kessinger, 2001:2).

3.4.5.3 Segregated or sponsored cell captive company

This type of captive insurer has a structure in which an existing captive insurance company, owned by an insurance company, assists in the *creation of cells within itself. Assets and liabilities held within each cell are segregated from the assets and liabilities of the company itself* (Goch, 2001:27). All lines of coverage can be underwritten in a cell captive insurance structure. According to Mead (2002b:3), the owner of this type of captive insurance company must follow similar procedures as for single holding captive insurers, but the owner of a particular cell does not have to comply with ultimate regulatory approval, as the authorities look to the company owner for compliance with their regulations. *Individual cells in a segregated cell captive insurance company enjoy legal insulation of assets and liability.* Legislation has been approved in most major domiciles and cell segregation varies by demographics, risk profile and lines of coverage.

3.4.5.4 Contractual cell captive company

A contractual cell captive insurance company is established by means of an agreement between the client and the insurer, which enables the client to write both self-insurance and third party programmes (Booth, 2001:9). *The client is obligated to maintain the solvency of the cell* and the *insurer's management ensures that the insurance operations and the regulatory requirements are maintained on behalf of the client.* The client obtains the *full benefits of a wholly owned captive insurer but without the need to staff and administrated such an entity.*

3.4.6 Closing remarks

After assessing the reasons and decisional factors for establishing and operating a captive insurer, as well as the various types of companies, risk managers should proceed with the question of where the best location for a captive insurer will be. When choosing a location, the main consideration is whether it will be onshore or offshore. Each option holds particular benefits and limitations, which are mostly manifested in the legislation and regulations of each domicile.

In South Africa the onshore, offshore and cell captive insurance options are mostly widely used when if a firm has to decide on establishing a captive insurance company. Although there is little difference between the onshore and the offshore captive insurance company, both these types of captive insurance have their unique set of characteristics and will benefit a firm in different ways.

3.5 ONSHORE CAPTIVE INSURANCE COMPANY

The characteristics, advantages and disadvantages of onshore captive insurers, as well as the South Africa situation, receive the necessary attention in this section.

3.5.1 Characteristics of an onshore captive insurance company

A true onshore captive insurer has the captive insurer domiciled in the same country or state as the holding company (Dowing, 1994:40). The insurance premiums paid by the holding company to the captive insurer may be deducted by the holding company for tax purposes, as the captive insurance company will be taxed by the local authorities on the profit made during a financial year. As dividends paid by the captive insurer to the holding company are based on profit after taxation, the dividends will usually not be taxable in the hands of the holding company. The local authorities accept the onshore captive insurance structure as a fair and a legal entity.

There are a number of reasons for forming an onshore captive insurance company. Souter (1993a:64) states that large company size, internationalism and large risk exposures are three features common to most holding companies with onshore captive insurers. Most authors agree that the one further element that surfaces is patriotism. Many large enterprises have social and economic obligations in their local countries and they opt for the onshore captive insurance alternative to maintain their responsibilities.

3.5.2 Advantages and disadvantages of forming an onshore captive insurance company

Greater control is cited as one of the major factors in setting up an onshore captive insurance company. The risk managers of companies that have formed onshore captive insurers all find it easier to be involved with the management of the captive insurer (Souter, 1993a:64). Active involvement in claim settlement and reinsurance programmes contribute to better control. The second advantage is manifested in the fact that the funds flowing through the captive insurance company do not leave the local economy. Thirdly, domestic domiciled captive insurance companies may have less administrative obligations e.g. exchange control, but are subjected to the regulations of the country in which they are domiciled. Lastly, an onshore captive insurance company may also have greater credibility than a captive insurer formed in a rather unknown offshore domicile.

Onshore captive insurers are sometimes subjected to heavy and rigorous regulation by the local authorities (Souter, 1993a:64). Changes in regulatory aspects like tax laws can mitigate the original benefits of onshore captive insurance ownership. It may sometimes take longer to establish an onshore captive insurer than the offshore counterparts, as the offshore authorities may be more user friendly. In general, it seems that, until offshore captive domiciles lose all their tax, capitalisation and ease of establishment advantages, an onshore captive is unlikely ever to trouble the offshore captive insurance structure (Dowing, 1994:40).

3.5.3 The South African situation

Following the collapse of the AA Mutual Insurance Association Limited in 1986, the Melamet commission of inquiry put forward certain recommendations that were designed to minimise further failures (Allen, 1990:1; Anonymous, 1991b:17; Melamet, 1992:5; Molewa, 1998:6). As captive insurance companies are seen as independent insurers, they are subjected to the same rules and regulations as traditional insurers, but with certain exceptions and financial benefits. Most of the recommendations of the Melamet commission have since become part of the insurance acts (Friedland, 1990:39; Melamet, 1990a:5):

The Melamet commission's second report in the early 1990s recommended that the South African legal system should be modified to incorporate the formation of onshore captive insurance companies to counter the practice of dishonourable offshore captive insurance establishments (Friedland, 1990:39; Melamet, 1990b:5; Molewa, 1998:7).

According to Santam Limited, in the "South African Financial Sector Forum" (1997:1), the *solvency margin* was increased from 10 per cent to 15 per cent. The solvency margin is the company's share capital and free reserves expressed as a percentage of net premium income. However, the first warning level of 25 per cent also became applicable. Should a company's solvency margin become less than 25 per cent, six-monthly reporting to the Registrar of Insurance is required. A second warning level at a solvency margin of 20 per cent allows the Registrar of Insurance to move in and investigate the company immediately. A company must cease operating if its solvency margin falls below 15 per cent. A *contingency reserve* (originally called a catastrophe reserve) has to be established by every short-term insurer. The contingency reserve should be equal to 10 per cent of the net premium income. This reserve may be used only with the permission of the Registrar of Insurance.

3.6 OFFSHORE CAPTIVE INSURANCE COMPANY

This section focuses on the characteristics, advantages and disadvantages of offshore captive insurers, as well as the South African situation.

3.6.1 Characteristics of an offshore captive insurance company

Offshore captive insurers are subsidiaries formed outside the country of origin of their holding companies. It was not until the 1960s that the benefits to be gained from incorporating offshore captive insurers were widely recognised. The reasons for the growth of offshore captive insurance structures can be divided into three major areas, namely confidentiality, regulatory elements and political interference (Hampton & Levi, 1999:648). The confidentiality between the authorities of the country in which the holding company domiciles and the offshore captive insurer is one of the prime attractions for users of offshore captive insurers. Regulatory elements are determined by the authorities of the offshore domicile, according to the domicile's own laws and legislation, which are often less restrictive. The scope of political influence will depend on the ties between the mainland and the offshore domicile (Hampton & Levi, 1999:648). Many offshore captive insurance companies are located in traditional colonial countries that have become overseas tax havens. From a historical point of view, many countries still have ties with their former colonial territories. This creates a situation where these quasi-independent jurisdictions are "within yet without" the interventions of the holding company's domicile.

3.6.2 Advantages and disadvantages of forming an offshore captive insurance company

Most developed countries have enacted legislation to regulate insurance business but successive amendments often resulted in simple laws becoming complex statutes that were difficult to understand. With legislation being largely designed to protect the consumer, companies sought alternative methods of securing insurance for their own risks. It was soon recognised that by forming offshore subsidiaries, companies could arrange insurance cover appropriate to their needs and very often at a reduced cost. There was also the added benefit to the subsidiary of being able to maintain reserves and accumulate earnings in a low or no tax domicile which was also relatively free of over-restrictive regulation (Klummp, 2002: 2).

Many companies are incorporated in offshore financial centres, which offer several advantages (Harris, 1998:1). Some of the advantages in offshore financial centres include:

- Less restrictive insurance regulation;
- Freedom from exchange control; and
- Absent or low rates of taxation.

The offshore insurance market developed in a number of small territories which are perceived to be politically stable and whose laws are conducive to the conduct of insurance business. These territories also boast relatively good communications, financial and legal services, lower taxation and freedom from of monetary controls (Zolkos, 1996a:20).

Many tax havens came to the forefront as offshore insurance domiciles in the middle to late 1970s. At that time the purchasers of liability insurance in the United States of America, particularly hospitals and physicians, found it difficult to obtain professional liability cover at reasonable rates, if indeed it could be found at all (Costle & Schauer, 2002:306). The lack of coverage available in the traditional insurance market, coupled with spiralling premiums, caused many of them to form captive insurance or reinsurance companies. Several of these "medical malpractice" companies, as they are often referred to, were established in the offshore insurance domiciles during the 1976-78 period. They were followed by groups and associations from other professions and industries that recognised the benefits to be gained through having greater control over the cover and cost of their insurance. The rapid growth of offshore insurance in conjunction with the expansion of financial services in general, led to the enactment of new laws and regulations by the authorities (Hampton & Christensen, 1999:1621). Arising out of the legislation, special captive insurance "watchdogs" were appointed within various governments, to regulate the insurance market in the offshore insurance industries. This included the activities of insurance managers, agents and brokers. In South Africa this function is executed by the Financial Services Board.

Regulations in the United States make it possible for holding companies to domesticate their offshore captive insurer without too much disruption (McDonald, 2002:6). A holding company can domesticate its offshore captive insurer through portfolio transfer, a merger or the transfer of shares (Kertesz, 1992:65; McDonald, 2002:6; Myers, 1992:13). Domestication of a captive insurer therefore makes it possible to move the entire operation onshore without having to formally license a new insurance company. If the domestic domicile already has captive insurance legislation in place it will make it easier for the holding company to transfer the captive insurer's business.

3.6.3 The South African situation

In South Africa the main reason to form an offshore captive insurer is the lack of local insurance capacity (Friedland, 1990:39; Santam Limited, 1997:1). The consent of the Registrar of Insurance should be obtained under particular circumstances before an insurer may cede insurance premiums to an overseas entity. The major argument for forming an offshore captive insurer is because of the Registrar of Insurance's restrictive regulations to the registration of new onshore captive insurance companies. Strict exchange control and the tax deduction disallowance of insurance premiums paid to offshore captive insurers, prevent the company that needs an offshore insurance facility from building up the necessary reserves in the offshore domicile. In addition to this, the majority of South Africa companies complain that the recommendations of the Melamet commission are hampering offshore insurance (Friedland, 1990:39; Molewa, 1998:7). Moreover, the restrictive measures suggested by the commission could perhaps damage the international relationship between South African companies and the international insurance industry.

Offshore captive insurance companies are able to distribute their profits to their controlling shareholders by way of dividends (Anonymous, 1991a:9). This element is particularly attractive to companies in jurisdictions where there are no taxes on dividends from a foreign source. Under the South African legislation, dividends from a foreign source will be taxed (Huxham & Haupt, 2002:47).

3.7 CELL CAPTIVE INSURANCE COMPANY

The need for a risk transfer tool that would provide all the benefits of a wholly owned captive insurance company, but without the requirement to incorporate and license an individual insurance company, prompts the development of cell captive insurance.

3.7.1 Characteristics of a cell captive insurance company

Although cell captive insurance has only been operating as a formal entity for a few years now, the market has already been practising the concept for a while (Penwell & Miller, 1999:10). The reality proves that the cell captive concept is a powerful insurance vehicle that holds a number of additional benefits for the cell owner (Payne, 2000:104). Cell captive insurance can be seen as a value-adding tool for risk managers.

The cell captive insurance company can be compared to the sectional title principle obtained by an apartment owner in a block of flats (Molewa, 1998:9). Each owner has private and exclusive rights to the apartment, but share the rights of the common property with all the other apartment owners. This form of captive insurance has also been described as the honeycomb structure, which consists of different honey cells. In order to become the *owner* *of a cell captive insurance company* the company is required to apply to the Registrar of Insurance for a special license, but in a similar way as any other traditional insurer. This license imposes certain restrictions on the owner of the company. Applicants for cell captive insurance companies also need to subscribe to a special type of share structure (Booth, 2001:8). The profit-sharing mechanism is achieved by issuing preference shares to a prospective *cell owner* (Payne, 2000:100). The preference shares give the particular cell owner the right to share in the profits arising from the insurance business conducted by the *particular cell*. The owner of the cell captive insurance company earns its income mainly by charging a fee for the management function that it provides to the individual cell owners.

The cell captive insurance structure is specifically designed to enable those enterprises wishing to share in the insurance business to partake of the profit derived from such insurance. A cell captive insurance process is one that allows a client to buy an equity stake (or cell) in a cell captive insurance company which undertakes the professional management of the various cells (Anonymous, 2000b:94; Bowler, 1998:54). The functions include underwriting, reinsurance, claim management, actuarial and statistical analysis, investment and accounting services. The cell becomes the client's own self-insurance identity. Each cell is separately managed in its own right and the risks assessed accordingly (Payne, 2000:100). The cells are structured in such a manner that the profits and losses experienced by one cell owner will not affect the other cells. This is achieved by issuing a different class of preference shares to each cell owner (Payne, 2000:104). This function is probably the most significant reason for the rapid growth of cell captive insurance companies. Cell captive insurance products range from more comprehensive policies to tailor-made products for clients with specific needs. The cell captive structure is designed to meet real risk exposure and is based on individual actuarial assessments rather than general market perceptions. The result is a more efficient process of risk transfer, with the cell owner paying a more realistic risk-related insurance premium.

3.7.2 Advantages and disadvantages of forming a cell captive insurance company

For clients, one of the big differences between cell captive insurance and the traditional insurance market is that a cell owner retains all the benefits from a good underwriting year. It relates to the ownership of profits, investment income and underwriting flexibility.

The next advantage is the limited liability of each cell owner (Payne, 2000:100). Although the cell structure operates and functions as a unit, the risks are limited to each individual cell. If one cell should experience solvency problems it would not affect the other cells.

The main obstacle to forming a cell captive insurance company is the initial capital requirements. This obstacle is manifested in the provision of a shareholders' interest, which should not be less than 25 per cent of the net premium income. The fact that the cell owner is also less involved in the administration and management of the cell captive insurance company can result in to a feeling of losing control on the part of the cell owner (Myers:1996:4). The relationship between the cell operator and the cell owner should therefore be open and transparent at all times.

3.7.3 The South African situation

The cell captive insurance concept in South Africa was endorsed and ratified in February 1993 after lengthy investigations and audits by the Financial Services Board (Molewa, 1998:15). To prevent any malpractice that could occur, the South African Registrar of Insurance imposed a range of restrictions on the operating licenses of cell captive insurance. Cell captive insurance companies are required to adhere to legislation installed and applied to any other enterprise licensed to practice insurance underwriting in South Africa.

An example of a cell captive insurance structure operating in South Africa is to be found in the luxury car manufacturers providing insurance coverage as part of the car-purchasing package in the early 1990s (Howard, 1996:13; Payne, 2000:100). The objective is to offset the higher premiums that car buyers would have to pay on the traditional insurance market. In most cases, car sales were badly affected by high premiums until the manufacturer established a cell captive insurer (Payne, 2000:101). This concept has since been implemented successfully in various retail industries such as the cell phone, furniture, retailing and transport industries. The second line of cell captive insurance in South Africa, is the informal practice of collective funding through the formation of "stokvels", burial societies, friendly societies and investment syndicates or pyramid schemes (Bowler, 1998:55; Molewa, 1998:49). According to most insurance experts, the South African market has great development potential for cell captive insurance growth. The trend in the South

African insurance industry has been for insurance companies to develop more affordable and effective insurance for their clients. In the years ahead the rapid growth of the less formal market could well provide for a significant boost in cell captive insurance.

3.8 SETTING UP A CAPTIVE INSURANCE COMPANY

The first step in establishing a captive insurance company is to understand what is legally required by the relevant authorities and to determine whether it would be feasible for the company to implement such a structure. According to standard practices a captive insurer should maximise value for shareholders. In setting up a captive insurer, the risk manager should look at the captive insurance management arrangement, consider the location and then conduct a feasibility study.

3.8.1 Captive insurance management arrangements

A captive insurance *management* arrangement can be seen as the issuing of an insurance policy by one insurer to an insured on behalf of a second insurer, because the second insurer is not operating or permitted to operate on that line of business (Jacoby & Roth, 2000:1). The first insurer actually issues the policy to the insured, but is typically reinsured for its liability by the second insurer.

A captive insurance company can decide to opt for a captive insurance *management* arrangement for the main reason of providing reinsurance to the captive insurance *management* company (Jacoby & Roth, 2000:1; Prescott & Lambert, 2002:1). The captive insurance *management* company is a local-licensed insurer that performs the underwriting, calculates the premium and handles these aspects in compliance with state regulation. The risk is then fully transferred from the captive insurance *management* company to the captive insurer. The captive insurance *management* company receives a fee for its services, which may vary between five and 10 per cent of the gross premium. The captive insurer and the captive insurance *management* company will have an agreement, typically a reinsurance arrangement, that sets forth the terms of their understanding with respect to financial and risk management issues.

The second reason for forming a captive insurance *management* arrangement is the unwillingness or inability of captive insurance owners to self-administrate the captive insurer (Prescott & Lambert, 2002:1). This is mainly due to the fact that the holding company lacks the skills or knowledge required to fully operate the captive insurance company. For some captive insurers the outsourcing of particular functions will add more value than the fee of the captive insurance *management* company. The fee of the captive insurance *management* company and the cost of operating the captive insurance company oneself should therefore be evaluated carefully (Pilla, 2001b:1).

In the beginning of captive insurance development, many insurance regulators opposed captive insurance *management* arrangements, primarily for reasons related to solvency (Jacoby & Roth, 2000:2). Since captive insurance companies have become a significant and integrated part of risk management, some insurance regulators have changed their viewpoint with regard to this type of alternative risk transfer mechanism. This change has only occurred lately, since captive insurers have become both more of a creditable entity and a commercial competitor to be reckoned with in the insurance industry.

3.8.2 Location

The main factors to consider when establishing a captive insurance domicile is the time zone and accessibility, the regulatory environment, costs, political stability, infrastructure and support services (Anonymous, 2001a:30; Kurland, 1994:75; Mead, 2002c:1; Petroni, 1998:289).

3.8.2.1 Time zone and accessibility

As most captive insurance domiciles require an annual meeting in the domicile, access to that domicile is an important practical consideration (Mead, 2002c:2). Some people do not care for long airplane flights. Many captive insurance owners have tight schedules and do not wish to spend an excessive amount of time travelling for a captive insurance meeting. The time zone is also connected to the support service, because coordination can be aggravating if each service provider is in another physical place and time zone, (Anonymous, 2001a:30). The domicile of a captive insurance company should also fit with the image of the holding company. Many large enterprises are not comfortable with the choices of certain island offshore domiciles because they are linked to a holiday environment.

3.8.2.2 Regulatory environment

According to some captive insurance experts some authorities are still antagonistic towards alternative risk transfer mechanisms (Souter, 1993b:37). This is changing with captive insurance becoming more of an invaluable ongoing risk management option through all insurance market cycles. Although most authorities still operate according to strict rules and regulations, they are more inclined to become captive insurance friendly. From a holding company's perspective there has to be certainty that the laws that are applicable today will be the same in future before a captive insurer can be set up (Anonymous, 2001a:30). The regulatory environment is closely linked to political stability. If the government structure is stable, and secure the laws will be applied justly.

3.8.2.3 Costs

The most obvious cost is the minimum capitalization requirement of the domicile. The cost can range from as little as R1,2 million to R10 million (Mead, 2002c:3). Additional costs will include annual fees, payments of bureaus and boards of review, the annual meeting, if required in that state, and the taxes that are payable.

3.8.2.4 Political stability

Political stability in this sense means support for captive enabling legislation and progressive regulations that can be identified as being present in all major political parties rivalling for control of the government (Mead, 2002c:1). This applies not to offshore domiciles only, but also to onshore domiciles. It may happen that control of the government changes, and that the new authorities view captive insurance companies as exploitive, and wish to tax and over-regulate them. A holding company does not want to establish a captive insurer where there is a possibility that the assets might be seized (Schachneer, 1993:34).

3.8.2.5 Infrastructure and support services

Most states do not have a clear channel of communication to deal with incoming captive insurance business (Mead, 2002c:1). Support services are those secondary but necessary services that the captive insurers must purchase or outsource. These include a domicile manager, an actuary, an attorney, an accountant, a banker and reinsurers. All of these must be available, and there have to be aregular interface with all concerned.

3.8.3 Feasibility study

The feasibility study should focus on the background and scope of the proposed captive insurer, clearly identifying the holding company or companies, the outlay of the planned company structure, the source and the nature of the funding, and a clear distinction of responsibilities with separation between the holding company and the captive insurance company.

If the enterprise's risk management or insurance department is highly sophisticated and possesses the expertise necessary to conduct such a feasibility study, an in-house study can be prepared. Most companies do not undertake their own feasibility study, either because of a desire for the objectivity which an outside consultant can provide or because they simply do not know how to conduct it.

If the feasibility study is going to be outsourced to third parties they will need the following minimum information (Barile, 2002:1):

- The enterprise's current insurance programme and underwriting details;
- A five-year loss history of the enterprise;
- A detailed explanation of the company's operations;
- Information about management philosophy and loss control awareness; and
- Future plans, including any contemplated overseas expansion.

According to Harris (1998:3), a complete feasibility study should comply with the following criteria: First, there should be a set minimum level of capitalisation and premium volume that will make the captive financially viable. The second criterion encompasses that the holding company has efficient risk management and loss control in place. The third criterion is that reliable captive insurance management arrangements and good quality reinsurance are available. A further criterion is a commitment from the holding company's management to support the captive insurer with adequate financing and expertise. This inter alia entails the availability of competent management services to operate the captive insurance company. An entity should only commit to a captive insurance company after all of these criteria have been researched and evaluated.

A well-prepared feasibility study should lead to a report that covers the following aspects:

1. Domicile of the captive insurer
2. Financial and legal requirements for establishing and operating the captive insurer
3. Organisational structure
4. Internal operations of the captive insurer
5. Captive insurance management arrangements of the captive insurer
6. Policy issuing requirements and costs
7. Reinsurance programme for the captive insurer
8. Conclusions
9. Recommendations

3.9 SUMMARY

The variety of alternative risk transfer options available to enterprises is increasing and a broad knowledge and understanding of the options are required to make it possible to implement the most appropriate structure. Both internal and external factors, which include the exposures facing the enterprise, any expected environmental changes, new product developments and the integrated goals of the company should be considered. The establishment of an alternative risk transfer structure is a dynamic process and requires continuous adjustments. The right balance between the factors can provide a firm with the competitive advantage needed to survive in an ever changing global economy. Intense competition among offshore jurisdictions and onshore players have caused a visible trend of increasing innovation in the creation and evolution of the legal structure, all with the aim of providing improved and cost effective financial services to the international markets.

The continuing increase in the number of captive insurance companies being formed is a reflection of general acceptance globally and an appreciation of their being a long-term financial tool with significant advantages for many enterprises. Today captive insurers are being formed in the light of an overall strategic business plan. Captive insurance should not be used as a short-term solution. Although this form of alternative risk transfer is very flexible, forming a captive insurance company to fill a need for a few years does not hold merit economically or adds value. When the benefits become less significant in a soft insurance environment, many captive insurance owners prefer to leave their captive insurer dormant until the market conditions call for innovative action. Most enterprises who have formed captive insurance companies generally state that they have based their decisions on the fact that the traditional insurance industry did not meet their financial needs with regard to price, cover and service.

The key factors identified for establishing a captive insurer as a means of alternative risk transfer structure can be summarised as follows: The main reasons for forming a captive insurance company should be manifested in an integrated balance between financial leverage, control management, operational flexibility and commercial objectives. Financial leverage includes lower insurance costs, cash flow improvement, cost saving through the reinsurance market, tax minimisation and deferral and protection from price fluctuations. The element of control includes the underwriting of unrelated risks for profit, control of investments and control over claim settlement. Unavailability of cover, access to the reinsurance market, and obtaining regulatory flexibility can be seen as the main elements of flexibility. A captive insurance company can made provision for the commercial objectives by setting risk retention levels, maximising shareholders' value of the holding company and strategic risk management. A clear destinction should be drawn between whether the holding company wants to merely establish, or also operate the activities of the captive insurance company. It is therefore important that all of the above factors be studied and evaluated extensively by a risk manager before the decision on establishing or operating a captive insurance company is taken.

The type of captive insurance company will depend on the holding company's internal risk transfer needs, as well as the structure and long-term strategy of the holding company. Many types of captive insurers are available in the insurance market, and in South Africa the general line of captive insurance business focuses on onshore, offshore and cell captive insurance. According to most of the parties involved, captive insurance is one of the clear and definite structures in the insurance industry that promises to continue to grow and evolve innovative cost saving mechanisms for risk managers.

CHAPTER 4

EMPIRICAL STUDY

4.1 INTRODUCTION

One of the tasks of this assignment, as mentioned in Chapter 1, is to gather information on the impact of captive insurance as an alternative risk transfer option for risk managers, by means of questionnaires.

The empirical study covers a number of aspects dealing with the decision-making process of a risk manager to establish and operate a captive insurance company. In addition to general information about this field of study, attention is given to the specific objectives that could be considered by the risk manager. On the basis of the theoretical information gained in the previous chapters it is clear that, a risk manager needs to consider a number of critical success factors before implementing a risk programme, in which captive insurance becomes the essential core of the holding company's alternative risk strategy. For the purpose of this study, the objectives or reasons to form and operate a captive insurance company have been divided into four main categories. These include financial leverage, control, flexibility, and commercial objectives. The significance of these four categories can be interpreted in different ways with regard to the decision to establish or to operate a captive insurance company. A number of aspects regarding the decision to establish and to operate a captive insurance company is therefore also covered by the empirical study. The risk manager needs to determine which objectives are important for the enterprise to decide to either just establish or to also operate a captive insurance company as part of its alternative risk management programme. Lastly, the factors that determine the decision to establish and to operate a captive insurance company is investigated. The three most important decisional factors are determined for both the establishment and the operation of a captive insurer. The strategic difference between establishing and operating a captive insurance company will be clearly highlighted in the study.

The research methodology, findings and conclusions resulting from the empirical study are reported in the sections that follow.

4.2 RESEARCH METHODOLOGY

The survey was conducted by means of questionnaires that were sent to relevant officials at all the captive insurance companies registered in South Africa. Two separate questionnaires were developed for both the onshore captive insurance companies and the cell captive insurance companies. Although these questionnaires do not differ in essence or structure, it was decided to made a distinction between the questionnaires for the onshore and the cell captive insurance companies. In the following statistical analysis, these differences between the onshore and cell captive insurers are presented separated. This should be meaningful for the risk manager's decision-making process regarding establishing the best alternative risk management programme for the holding company.

A covering letter explaining the nature and scope of the study accompanied the questionnaires. Copies of the covering letters are attached in Annexure A. The covering letter was directed to the managing director of the captive insurance company under the letterhead of the Department of Business Management at the University of Stellenbosch.

The study aimed to cover the total population of all the registered onshore and cell captive insurance companies in South Africa. After the completed questionnaires were received from the research population, they were statistically analysed to obtain the basis for the main findings and conclusions of the study.

4.3 THE RESEARCH POPULATION

In this section, the identification of the population size will be explained and discussed. The Financial Services Board was contacted as the first step in the process to identify the total population (Van der Lith, e-mail, 20 November 2002). A population in this context can be defined as "the set of all members about whom the study intends to make inferences"

(Albright et al., 2000:378) or, stated differently, a population includes all the objects of interest.

The population for this research consists of the total number of companies registered as captive insurance companies in South Africa for the year 2002. This came to a total of 25 companies. The information on the 25 companies that was provided by the Financial Services Board, was split between the categories of onshore captive insurance and cell captive insurance companies (Van der Lith, e-mail, 20 November 2002). All 14 onshore captive insurers and 11 cell captive insurers were contacted.

The information as disclosed by the Financial Services Board included the postal address of each insurer, the telephone and facsimile numbers and the names of their public officers. It was decided to address the covering letter directly to the managing directors of all captive insurers. The full name of the managing director was obtained by contacting the public officers of the captive insurers. The decision to send the letter directly to the managing director was based on the perception that their seniority and position within the company would influence and improve the response rate. It was also believed that the managing director would ensure that the request for co-operation received attention at the highest level possible.

4.4 DATA COLLECTION BY MEANS OF THE QUESTION-NAIRES

In this section, the structuring and testing of the questionnaires, together with the response rate and reliability of the respondents are explained. The problems incurred during the study are also highlighted.

4.4.1 Drafting the questionnaires

The questionnaires (copies attached in Annexures B and C, respectively for onshore captive insurance companies and cell captive insurance companies) were drafted with reference to the literature study in Chapters 2 and 3. The questionnaires consisted of *three main sections*, namely general information, objectives to establish and operate a captive insurance company and factors that determine the decision of a holding company to establish and operate a captive insurance company.

Firstly provision was made to obtain general information that could be used to classify the participating captive insurers into subgroups. The general information included biographical information about the individual who completed the questionnaire and information on the company itself.

In the second section, an effort was made to include as many as possible of the objectives relevant to forming a captive insurance company as identified during the literature study. Because of the fact that every captive insurance company has its own characteristics and field of experience, provision was also made for the respondents to fill in "other objectives" best suited to their company's situation. It is important to note that the questionnaire is making a clear distinction between the objective for establishing and operating a captive insurance company. This is significant because it became clear in the literature that there is a difference between the reasons to establish a captive insurer and the objectives in operating a captive insurance company. In the first part of this section of the questionnaire, the variable was expressed numerically on a 1-to-5 Likert scale, from "not important" equals 1 to "extremely important" equals 5. The 1 to 5 scale also formed a continuum, so that weights could be given to the measures.

The last section focused on determining the decision-making factors that are most widely used by captive insurance managers to establish and operate a captive insurer. In this section the respondents had to indicate the four most important factors out of eight possible factor choices identified through the literature study, to determine their reasons for the decision to establish and operate a captive insurer. Open-ended alternatives were also available to the respondents.

The questionnaires were then made available to the Centre of Statistical Consultation at the University of Stellenbosch to be tested for statistical analysability. This first test was done in conjunction with Dr Martin Kidd, and he helped to structure and code the questionnaires according to statistical operations. Because of the categorical nature of the questionnaires, the variables could be coded numerically. It is important to note that coding a truly categorical variable does not make it numerical and open to arithmetical operations (Albright et al., 2000:30). Only non-parametrical statistics can be applied to categorical data sets. Dr Kidd also helped to rephrase some of the questions so that the respondents would understand the manner and way to complete the questions more clearly. This held specific importance and meaning for the reliability and usability of the information obtained from the population. This questionnaire should be seen as part of research into the profile of captive insurance companies. It will serve as a basic tool for determining the reasons for forming a captive insurance company. Because it is a first step in the decision-making process for the risk manager, further study should follow and is recommended in Chapter 5, under opportunities for future research.

4.4.2 Testing the questionnaires

The questionnaires were tested at one well-established South African short-term insurance company and one major South African risk management institution. The testing of the questionnaires was regarded as very important, seen in the light that adjustment, unlike in a discussion guideline, could not be made after they were sent out. The results of the questionnaires tested at these companies were only used to test the questionnaires and are not included as part of the results of this study.

As a result of this testing, some minor adjustments were made to the original questionnaires, to prevent problems of interpretation when the respondents were completing the questionnaires.

4.4.3 Responses obtained from the population

The questionnaires were sent to all of the 14 onshore captive and all of the 11 cell captive insurance companies, as identified by the Financial Services Board during February 2003. The respondents were given three weeks to respond to the requested information on their specific captive insurance company. After the three weeks, eight of the 14 onshore captive insurance companies had sent their questionnaires back and only four of the 11 cell captive insurance companies had completed their questionnaires. Therefore there was a response rate of 57 per cent for onshore captive insurers and 36 per cent for the respondents of cell captive insurers. Because of the fact that the total population size consisted of only 25 companies, it was very important that the study include as many participants as possible. Since the danger of having an unrepresentative data set of such a small population is very high, it was necessary to do follow-up. The follow-up was done by resending the questionnaires and covering letters to those companies that did not reply during the first round of data collection. Added to this was an additional letter requesting the company to kindly complete the questionnaire and send it back within the next two weeks. The follow-up was also done in conjunction with personalised telephone calls to the non-responding companies. This was to confirm that they had received the relevant questionnaire, and to ensure that all the information given in the covering letter and questionnaire was clearly understood.

After this follow-up, 13 of the 14 onshore captive insurers and eight of the 11 cell captive insurance companies replied. This follow-up thus had a significant response rate. The one non-responsive onshore captive only confirmed by means of a telephone conversation that they no longer perform captive insurance activities, and therefore was no longer a member of the population of onshore captive insurance companies. Hence the actual response rate for onshore captives was 100 per cent.

Two of the non-responding cell captive insurers confirmed by means of letters that they were no longer active in the cell captive insurance business, and one confirmed that their company's managing director does not allow the information requested on the questionnaire to be given to third parties. Hence the actual response rate for cell captive insurers was eight out of nine, or more than 88 per cent.

4.4.4 Reliability of the information obtained

The reliability of the information obtained from the respondents fully depended on the honesty and the integrity of the respondents. It should also be noted that the answers of the respondents purely represented their personal views, based on their own company situation and years of experience in the captive insurance field. The empirical findings of this study are therefore completely based on the opinions, knowledge and experience of the 21 respondents who completed the questionnaires. Seen in this light, the findings and conclusions drawn from this study should be viewed in the context of not the South African short-term insurance market only, but also the specific business environment of each of the respondents. Due care was taken to ensure that the information obtained through this study could be regarded as reliable and no information that reflected negatively on the reliability of the information obtained therefore came to the knowledge of the researcher.

The strategy to follow a top-down approach when the respondents were requested to take part in this study did achieve the required response rate. The levels of seniority of the respondents are illustrated in the following table.

TABLE 4/1: SUMMARY OF THE POSITIONS OF OFFICIALS WHO COMPLETED THE QUESTIONNAIRES

	Onshore captive insurance respondents		**Cell captive insurance respondents**	
Position	Frequency	Percentage	Frequency	Percentage
Managing Director	3	23,0%	0	0,0%
Divisional Director	1	7,7%	0	0,0%
Senior Manager	1	7,7%	1	12,5%
Risk Manager	0	0,0%	3	37,5%
Financial Manager	3	23,0%	1	12,5%
Captive Manager	2	15,5%	1	12,5%
Assistant Financial Manager	1	7,7%	1	12,5%
Business Developer	0	0,0%	1	12,5%
Financial Analyst	1	7,7%	0	0,0%
Group Finance Official	1	7,7%	0	0,0%
Total	**13**	**100,0%**	**8**	**100,0%**

Source: Responses to question A3 of the questionnaires.

As can be seen from Table 4/1, 18 of the 21 respondents had already achieved management status, while six of them were senior members of the top structure of their respective enterprises. The seniority of the respondents not only made a vast field of experience available to the study, but it also meant that they could respond confidently about risk management practices at their companies. The seniority of the respondents therefore contributed to the reliability of the information obtained from the questionnaires.

The number of years of experience of the respondents, as seen in the following table, provided further support to the reliability of the obtained information.

TABLE 4/2: SUMMARY OF THE NUMBER OF YEARS OF EXPERIENCE OF RESPONDENTS IN CAPTIVE INSURANCE

	Onshore captive insurance respondents		**Cell captive insurance respondents**	
Number of years of experience	Frequency	Percentage	Frequency	Percentage
1	0	0,0%	1	12,5%
2	2	15,4%	0	0,0%
3	0	0,0%	2	25,0%
4	4	30,8%	0	0,0%
5	2	15,4%	0	0,0%
6	3	23,0%	2	25,0%
7	0	0,0%	0	0,0%
8	0	0,0%	1	12,5%
9	0	0,0%	0	0,0%
10	1	7,7%	0	0,0%
11	0	0,0%	0	0,0%
12	0	0,0%	1	12,5%
13	0	0,0%	0	0,0%
14	1	7,7%	0	0,0%
15	0	0,0%	1	12,5%
Total	**13**	**100,0%**	**8**	**100,0%**

Source: Responses to question A4 of the questionnaires.

From the above table, it can be seen that seven of the 13 onshore captive respondents had five or more years of experience in captive insurance. This represents 53,8 per cent of the onshore captive insurance population. The highest indicated number of years in onshore captive insurance experience was 14 years, the lowest only two years. According to the same table, five of the eight respondents from the cell captive insurance companies had five or more years of experience and three had less than five years of experience. The highest number of years of experience among the cell captive insurance respondents is 15 years, with the lowest only one year.

4.4.5 Problems experienced

The first problem experienced with the empirical study was the gathering of data of offshore captive insurance companies. The Financial Services Board could be of assistance in obtaining the relevant contact details for all the onshore and cell captive insurers registered in South Africa, but they did not have any information on the details of the South African offshore captive insurance companies. They proposed to contact the South African Reserve Bank, but according to the South African Reserve Bank, this information could not be released, because of article 33 of the Reserve Bank's Act no. 90 of 1989 (Crove, e-mail, 13 November 2001). It was therefore decided that the offshore captive insurance companies, although equally important as onshore and cell captive insurance companies would not fall in the scope of the empirical study. But offshore captive insurance still forms a significant part of the theoretical chapters because of its considerable relevance to captive insurance.

The second problem evolved out of the response rate of the respondents. The first *total* response rate of 48 per cent (12 of 25 companies) was not significant enough to draw clear and meaningful conclusions from a statistical analysis. Although a response rate on posted questionnaires of nearly 50 per cent is in general meaningful, the fact that this study consisted out of a small population of only 25 companies makes it difficult to work with only a 48 per cent response rate. A follow-up was done, and although this resulted in a *total* response rate of 95,5 per cent (21 of 22 companies) (see section 4.4.3), it resulted in a significant *loss of time* to the study.

4.5 DATA ANALYSIS

The information obtained form the questionnaires was captured on a SPSS spreadsheet and analysed in conjunction with Prof. Piet Bracke, statistical analyst of the Department of Sociology at Ghent University. He helped to give structure to the analysis of the data and to decide on the extent of refinement that would be meaningful from a statistical point of view. Prof. Bracke therefore helped guide the aspects of the statistical analysis that followed.

To standardise the data analysis through SPSS, the data was presented in rows and columns (Albright et al., 2000:28). Each column represents a variable, and each row corresponds to an observation, in this case a member of the population. It is important to remember that the majority of the data obtained from the questionnaires can be classified as categorical. The categories of the variables can be arranged in any particular order that suits the needs of the investigator, without losing information (Reynolds, 1984:10).

Firstly the data was inspected for any inconsistencies and missing values. Through the SPSS spreadsheet, a specific value is given (usually the number 9) to any missing values in the data set. In this study, the amount of missing values due to non-responses was limited to two answering categories. This means that the integrity of the response-quality was extremely high, and further analysis of the data is not hampered by the missing values.

Secondly, the study presents the data in the form of simple frequency tables. This gives a clear view of the spread of answers within each answering category, and provides a first basis on which some patterns and decision-making processes can be concluded. By using the frequency tables, a clear picture from the answer categories indicated by the respondents can be established, as to what the most important objectives and factors in the formation of a captive insurance company are.

4.6 RESULTS AND KEY FACTORS IDENTIFIED FROM *ONSHORE* CAPTIVE INSURANCE COMPANIES

In this section the findings of the statistical results from the SPSS spreadsheet containing the data of the onshore captive insurance companies, are discussed and outlined by presenting the findings in table format. The statistical analysis on the onshore captive insurance companies is mainly based on descriptive statistics. This mainly consists of frequency tables, which will indicate how many observations fall in various categories. By using the frequency tables, one can establish a clear picture from the answer categories indicated by the respondents, as to what are the most important objectives and factors to form a captive insurance company. For this study it is also important to analyse the important difference between establishing and operating a captive insurance company. The frequency tables therefore also serve as a good indicator for comparing and differentiating between the motivations to establish and to operate a captive insurance company.

4.6.1. Age of the onshore captive insurance companies and the number of holding companies involved in the ownership

Based on the results obtained from the questionnaires completed by the 13 onshore captive insurance companies the following statistical analyses and conclusions could be drawn. The statistics from section A of the questionnaire for onshore captive insurers (see copy of questionnaire attached in Annexure B) are presented first.

TABLE 4/3: AGE OF THE ONSHORE CAPTIVE INSURANCE COMPANIES

	Frequency	Percentage
Age of the onshore captive insurer in years		
3	4	30,8%
4	2	15,4%
5	1	7,7%
6	1	7,7%
7	1	7,7%
8	1	7,7%
9	1	7,7%
10	1	7,7%
11	1	7,7%
Total	**13**	**100,0%**

Source: Responses to question A5 of the questionnaire.

On the basis of Table 4/3, it was concluded that all the onshore captive insurance companies investigated in South Africa existed for at least three years. The oldest onshore captive insurance company was 11 years old and the youngest only three. Seven of the 13 companies were younger than six years and six were older than five years.

TABLE 4/4: THE NUMBER OF HOLDING COMPANIES INVOLVED IN THE OWNERSHIP OF THE ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Number of holding companies		
1	12	92,3%
2	1	7,7%
Total	**13**	**100,0%**

Source: Responses to question A6 of the questionnaire.

Twelve of the 13 onshore captive insurance companies, stated that they have only one holding company and one stated that their captive insurer was owned by two holding companies. This data cohere with the theory where it is generally seen that in the establishment of an onshore captive insurer, it is only one holding company that identified the need to have its own captive insurer.

4.6.2 Objectives to establish and to operate an onshore captive insurance company

The objectives to establish and to operate an onshore captive insurance company forms part of section B of the questionnaire. This section places emphasis on the four specific main categories, namely the financial, control, flexibility, and commercial objectives in forming a captive insurer, as identified in Chapter 3. In this section of the questionnaire, the aim of the study was to determine the order of significance placed by the respondents on each of the four main categories. Following this, the significance between the *objective to establish* and the *objective to operate* an onshore captive insurer is researched for each of the categories, divided into their representative subsections.

The following frequency tables present the onshore captive insurer respondents according to their answer categories.

TABLE 4/5: THE MAIN OBJECTIVES TO ESTABLISH AND TO OPERATE AN ONSHORE CAPTIVE INSURANCE COMPANY

	Not important	Little important	Moderately important	Highly important	Extremely important
Obtaining financial benefits	0	0	4	5	4
Obtaining control	0	0	1	9	3
Obtaining flexibility	1	2	2	5	3
Obtaining commercial objectives	1	3	1	3	5
Focus on risk control	0	0	0	1	0

Source: Responses to question B1 of the questionnaire.

According to Table 4/5, all 13 respondents completed the question by indicating which objective was the most or the least important for establishing their onshore captive insurer. This only gives an overview of the variables which the respondents indicated as being important or not important. Through statistical manipulation one can perform a sum of weighted scores, by which the ranking of the answer according to their importance can became clear.

At sight, one can rank the answers from seen as the most important to seen as the least important according to the number of respondents that marked specific categories of answers as “extremely important”, “highly important”, et cetera. In order to bring out the ranking mathematically, the highest weight is given to “extremely important” and the lowest weight to “not important”. Weighting is an accepted statistical manipulation of data when using a continuum in order to take into account the relative importance of answer categories (Albright et al., 2000:224). By multiplying the “not important” frequencies by 1, the “little important” frequencies by 2, “moderately important” by 3, “highly important” by 4 and “extremely important” by 5, we can calculate weighted scores for each answering category, and more objectively infer the order of importance of the categories of answers. The calculation of these weighted scores are presented in Table 4/6.

TABLE 4/6: SUM OF WEIGHTED SCORES OF OBJECTIVES TO ESTABLISH AND TO OPERATE AN ONSHORE CAPTIVE INSURANCE COMPANY

	Score "not important" x 1	Score "little important" x 2	Score "moderately important" x 3	Score "highly important" x 4	Score "extremely important" x 5	**Sum of weighted scores**
Obtaining financial benefits	0	0	12	20	20	**52**
Obtaining control	0	0	3	36	15	**54**
Obtaining flexibility	1	4	6	20	15	**46**
Obtaining commercial objectives	1	6	3	12	25	**47**
Focus on risk control	0	0	0	4	0	**4**

Source: Table 4/5.

The weighting of the data brings out more clearly the ranking in importance of the different categories of answers. As can be seen from the sum of weighted scores of Table 4/6, obtaining control is viewed as the most important objective to establish and to operate a captive insurance company. The second most important objective is obtaining financial benefits, the third most important objective encompasses commercial benefits and the fourth most important objective focuses on flexibility. One of the respondents from the onshore captive insurance companies mentioned "focus on risk control" as a highly important additional objective to the four objectives provided on the questionnaire. The significance of the subsections of each category follows below.

TABLE 4/7: MOST IMPORTANT *FINANCIAL* OBJECTIVE TO *ESTABLISH* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Providing lower insurance costs	7	53,8%
Cash flow improvement	2	15,4%
Cost saving through the reinsurance market	0	0,0%
Tax minimisation and deferral	2	15,4%
Protection from price fluctuations	2	15,4%
Total	**13**	**100,0%**

Source: Responses to question B2 of the questionnaire.

It can be seen from Table 4/7 that the most important financial objective to *establish* an onshore captive insurance company is to provide lower insurance costs to the holding company, as indicated by 53,8 per cent of the respondents. Three of the financial objectives were seen as the most important objective by two respondents each, while cost saving through the reinsurance market was not regarded as important by any respondent.

TABLE 4/8: MOST IMPORTANT *FINANCIAL* OBJECTIVE TO *OPERATE* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Providing lower insurance costs	2	15,4%
Cash flow improvement	2	15,4%
Cost savings through the reinsurance market	6	46,2%
Tax minimisation and deferral	1	7,6%
Protection from price fluctuations	2	15,4%
Total	**13**	**100,0%**

Source: Responses to question B2 of the questionnaire.

As seen from Table 4/8 the most important financial objective to *operate* an onshore captive insurance company, according to 46,2 per cent of the respondents, is the provision of cost savings through the reinsurance market to the holding company. Providing lower insurance costs, cash flow improvement and protection from price fluctuations were seen as the most important objectives by each of two respondents. The tax minimisation and deferral was seen as the most important objective to operate a captive insurer by only one respondent.

Comparing Table 4/7 and Table 4/8, makes it clear that there is a significant difference between the decision to establish and the decision to operate an onshore captive insurance company on the basis of financial objectives. According to Table 4/7, most respondents indicated that the most important objective to *establish* an onshore captive insurer lies in the fact that it results in lower insurance cost. According to Table 4/8, most respondents indicated that, in the case of *operating* the onshore captive insurers, cost savings through the reinsurance market was the most important objective.

TABLE 4/9: MOST IMPORTANT *CONTROL* OBJECTIVE TO *ESTABLISH* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Control of unrelated business lines	10	76,9%
Control of investments	3	23,1%
Control over claim settlement	0	0,0%
Total	**13**	**100,0%**

Source: Responses to question B3 of the questionnaire.

The control of underwriting of lines of business that are unrelated to the risks of the holding company was seen as the most important objective to *establish* an onshore captive insurance company by 76,9 per cent of the respondents. Control of investments received 23,1 per cent of the answers and none of the respondents found that control over claim settlement was an important consideration in establishing an onshore captive insurer.

TABLE 4/10: MOST IMPORTANT *CONTROL* OBJECTIVE TO *OPERATE* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Control of unrelated business lines	6	46,2%
Control of investments	6	46,2%
Control over claim settlement	1	7,6%
Total	**13**	**100,0%**

Source: Responses to question B3 of the questionnaire.

The most important control objective concerning *operating* an onshore captive insurance company was equally divided between the control of underwriting of lines of business that are unrelated to the risks of the holding company and the control of investments, with each representing 46,2 per cent of the respondents. Only one of the respondents felt that control over claim settlement was an important consideration with regard to operating an onshore captive insurer.

Comparison of Table 4/9 and Table 4/10 shows that most respondents felt that the control of underwriting of lines of business that are unrelated to the risks of the holding company are very important with regard to *establishing* as well as *operating* an onshore captive insurer. Comparing *operating* an onshore captive insurance company, the control of investments is supported by an equal number of respondents.

TABLE 4/11: MOST IMPORTANT *FLEXIBILITY* OBJECTIVE TO *ESTABLISH* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Availability of coverage not otherwise available	8	61,5%
Access to the reinsurance market	4	30,8%
Regulatory flexibility of domiciles	1	7,7%
Total	**13**	**100,0%**

Source: Responses to question B4 of the questionnaire.

From Table 4/11 it is clear that the availability of coverage not otherwise available is seen as the most important flexibility objective to *establish* an onshore captive insurance company by 61,5 per cent respondents. The next most important objective, which had the support of 30,8 per cent of the respondents, is access to the reinsurance market that captive insurance can provide for the holding company. Only one of the respondents felt that regulatory flexibility of domiciles was important to establish an onshore insurer.

TABLE 4/12: MOST IMPORTANT *FLEXIBILITY* OBJECTIVE TO *OPERATE* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Availability of coverage not otherwise available	7	53,8%
Access to the reinsurance market	6	46,2%
Regulatory flexibility of domiciles	0	0,0%
Total	**13**	**100,0%**

Source: Responses to question B4 of the questionnaire.

Availability of coverage not otherwise available was also seen by 53,8 per cent of the respondents, as the most important flexibility objective concerned with *operating* an onshore captive insurer. Access to the reinsurance market is supported by 46,2 per cent of the respondents as the most important objective concerned with operating an onshore captive insurance company. None of the respondents found that regulatory flexibility of domiciles plays an important role in operating of an onshore captive insurer.

By comparing Table 4/11 and 4/12, it becomes clear that the availability of coverage not otherwise available is regarded by most respondents as a very important flexibility objective to *establish* as well as to *operate* an onshore captive insurance company. The flexibility objective of access to the reinsurance market was also highly supported by a reasonable number of respondents as important in *establishing* and *operating* an onshore captive insurer.

TABLE 4/13: MOST IMPORTANT *COMMERCIAL* OBJECTIVE TO *ESTABLISH* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Risk retention levels set according to needs of holding company	10	76,9%
Maximise shareholders' value of the holding company	2	15,4%
Strategic risk management	1	7,7%
Total	**13**	**100,0%**

Source: Responses to question B5 of the questionnaire.

According to Table 4/13, the most important commercial objective to *establish* an onshore captive insurance company, as seen by 76,9 per cent of the respondents, was that the risk retention levels were set according to the needs of the holding company. Two respondents support maximising shareholders' value of the holding company as the most important objective, and one of the respondents indicated that strategic risk management was an important commercial objective to establish an onshore captive insurer.

TABLE 4/14: MOST IMPORTANT *COMMERCIAL* OBJECTIVE TO *OPERATE* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Risk retention levels set according to needs of holding company	6	46,2%
Maximise shareholders' value of the holding company	3	23,0%
Strategic risk management	4	30,8%
Total	**13**	**100,0%**

Source: Responses to question B5 of the questionnaire.

Risk retention levels set according to the needs of the holding company was according to Table 4/14 seen by 46,2 per cent of the respondents as the most important commercial objective to *operate* an onshore captive insurance company. Strategic risk management was selected as the most important objective to operate an onshore captive insurance company by four of the respondents. Maximisation of shareholders' value of the holding company was indicated as the most important commercial objective to operate an onshore captive insurance company by three respondents.

Comparing Table 4/13 and Table 4/14 shows clearly that most respondents felt that having risk retention levels set according to the needs of the holding company is the most important commercial objective, both in *establishing* and in *operating* an onshore captive insurance company.

4.6.3 Factors which determine the decision of a holding company to establish and operate an onshore captive insurance company

The factors that determine the establishment and the operation of an onshore captive insurance company forms part of section C of the questionnaire. This section places emphasis on the theoretical decisional factors identified in Chapter 3. The respondents had to select in order of their importance, four of the given factors that determinate the decision of a holding company to establish and to operate an onshore captive insurance company. The results are presented in Table 4/15 and Table 4/16.

TABLE 4/15: FACTORS WHICH DETERMINE THE DECISION OF A HOLDING COMPANY TO *ESTABLISH* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Most important factor	Second most important factor	Third most important factor	Fourth most important factor	**Total of the four most important factors**
Importance of loss/premium ratio of holding company	2	1	0	1	**4**
Importance of financial commitment of holding company	2	2	3	4	**11**
Importance of spreading risks of holding company	3	2	3	1	**9**
Importance of loss control of holding company	0	1	2	2	**5**
Importance of management commitment of holding company	0	3	2	1	**6**
Importance of retention capacity of holding company	1	3	1	3	**8**
Importance of regulation by government	3	1	2	1	**7**
Importance of managerial competence of holding company	0	0	1	0	**1**
Importance of tailor-made service to the holding company	1	0	0	0	**1**

Source: Responses to question C1 of the questionnaire.

By calculating the totals of the four most important factors indicated by the answers of the respondents, it can be concluded from Table 4/15 that the three most importance factors determining the decision of the holding company to *establish* an onshore captive insurance company are (in decreasing order of importance) as follows:

- financial commitment of the holding company;
- the spreading of the risks of the holding company; and
- the retention capacity of the holding company.

TABLE 4/16: FACTORS WHICH DETERMINE THE DECISION OF A HOLDING COMPANY TO *OPERATE* AN ONSHORE CAPTIVE INSURANCE COMPANY

	Most important factor	Second most important factor	Third most important factor	Fourth most important factor	**Total of the four most important factors**
Importance of loss/premium ratio of holding company	1	2	2	0	**5**
Importance of financial commitment of holding company	4	1	1	1	**7**
Importance of spreading risks of holding company	1	2	3	0	**6**
Importance of loss control of holding company	0	3	0	1	**4**
Importance of management commitment of holding company	1	4	2	0	**7**
Importance of retention capacity of holding company	2	0	3	4	**9**
Importance of regulation by government	1	1	0	3	**5**
Importance of managerial competence of holding company	0	0	1	3	**4**
Importance of managerial competence of the captive insurer	3	0	0	0	**3**
Importance of the risk profile of the holding company	0	0	1	0	**1**
Importance of flexibility	0	0	0	1	**1**

Source: Responses to question C2 of the questionnaire.

By calculating the totals of the four most important factors indicated by the answers of the respondents, it can be concluded from Table 4/15 that the three most importance factors determining the decision of the holding company to *operate* an onshore captive insurance company are (in decreasing order of importance) as follows:

- the retention capacity of the holding company;
- the financial commitment of the holding company; and
- the management commitment of the holding company.

The comparison between the three factors indicated by the respondents as the most important to *establish* and the three factors indicated as most important to *operate* an onshore captive is presented in Table 4/17:

TABLE 4/17: COMPARISON BETWEEN THE THREE MOST IMPORTANT FACTORS TO *ESTABLISH* AND TO *OPERATE* AN ONSHORE CAPTIVE INSURANCE COMPANY

The three most important factors determining the decision of a holding company to *establish* an onshore captive insurer	**The three most important factors determining the decision of a holding company to *operate* an onshore captive insurer**
* Financial commitment of the holding company	* Retention capacity of the holding company
* Spreading risks of the holding company	* Financial commitment of the holding company
* Retention capacity of the holding company	* Management commitment of the holding company

Source: Tables 4/15 and 4/16.

From Table 4/17, it can be concluded that most of the onshore captive insurance respondents see the following two factors for determining the decision of a holding company to both establish and to operate an onshore captive insurance company as very important: the financial commitment of the holding company and the retention capacity of the holding company. These two decisional factors of the holding company therefore are significant elements that the risk manager should include in the company's decision-making model. Spreading the risk of the holding company was indicated as important to establish an onshore captive insurer, while management commitment of the holding company was indicated as important when operating an onshore captive insurer.

4.6.4 Future and usefulness of captive insurance

In the last part of section C of the questionnaire the respondents were asked to give their opinion about the future and usefulness of captive insurance as an alternative risk transfer mechanism in the South African market. The following tables present the views and opinions of the 13 onshore captive insurance respondents.

TABLE 4/18: WHETHER THE RESPONDENTS REGARD THE CAPTIVE INSURANCE COMPANY AS A LONG-TERM OR SHORT-TERM ALTERNATIVE RISK TRANSFER MECHANISM FOR A HOLDING COMPANY

	Frequency	Percentage
Short-term	2	15,4
Long-term	11	84,6
Total	**13**	**100,0**

Source: Responses to question C3.1 of the questionnaire.

From Table 4/18 it is concluded that 84,6 per cent of the respondents are of the opinion that their captive insurance company should be regarded as a long-term alternative risk transfer mechanism for the holding company. Of the respondents 15,4 per cent indicated that their onshore captive insurance company is only a short-term alternative solution for the holding company.

TABLE 4/19: OPINIONS OF RESPONDENTS ON WHETHER CAPTIVE INSURANCE COMPANIES ARE SUCCESSFUL IN REDUCING THE RISK EXPOSURE OF THE HOLDING COMPANY

	Frequency	Percentage
Yes	12	92,3
No	1	7,7
Total	**13**	**100,0**

Source: Responses to question C3.2 of the questionnaire.

According to the preceding table 92,3 per cent of the respondents felt that their onshore captive insurers were successful in reducing the risk of the holding company. Only one respondent indicated that the captive insurer did not reduce the risk of the holding company successfully.

TABLE 4/20: OPINIONS OF RESPONDENTS ON WHETHER CAPTIVE INSURANCE WOULD BECOME MORE IMPORTANT DURING THE NEXT FIVE YEARS

	Frequency	Percentage
Yes	12	92,3
No	1	7,7
Total	**13**	**100,0**

Source: Responses to question C3.3 of the questionnaire.

More than 92 per cent of the respondents were of the opinion that captive insurance will become more important during the next five years. One respondent indicated the opposite. The respondents were also asked, in an open-ended question, to motivate the answers recorded in Table 4/20. Their motivations are summarised in Table 4/21.

TABLE 4/21: MOTIVATION FOR OPINIONS OF RESPONDENTS ON WHETHER CAPTIVE INSURANCE WOULD BECOME MORE IMPORTANT DURING THE NEXT FIVE YEARS

Motivations from respondents who believe that captive insurance *will become more important* during the next five years	**Motivations from respondents who believe that captive insurance *will not become more important* during the next five years**
Global changing market conditions force companies to adapt and by having an own financial vehicle to retain high levels of self-insurance, the cost of risk transfer can be decreased.	The current insurance environment and market are too unstable for any form of self-insurance to be truly effective.
High cost alternatives form the traditional insurance market.	
Limitation of available coverage from traditional insurance.	
Self-insurance can become a valuable tool to access the reinsurance market.	
Earning of investment income on funds.	
Providing an additional service to clients.	

Source: Responses to question C3.4 of the questionnaire.

Most of the respondents indicated that their opinion about the future of captive insurance in South Africa is positive. The main conclusion from their views is that captive insurance provides an alternative to the traditional insurance market and can therefore offer a cost saving to the holding company.

4.7 RESULTS AND KEY FACTORS IDENTIFIED FROM *CELL* CAPTIVE INSURANCE COMPANIES

The following statistical analysis and conclusions could be drawn from the results obtained from the questionnaires completed by the eight cell captive insurance companies. As with the analysis of the onshore captive insurance companies, the statistical analysis will present mainly descriptive statistics. This firstly consists of frequency tables, which indicate how many observations fall in various categories, according to answers derived from the respondents from the cell captive insurance companies.

The statistics from the general section A of the questionnaire, (see copy of questionnaire attached in Annexure C) are presented first.

4.7.1 Age of the cell captive insurance companies and the number of holding companies involved in the ownership

TABLE 4/22: AGE OF THE CELL CAPTIVE INSURANCE COMPANIES

Age of the captive insurance company	Frequency	Percentage
3	1	12,5%
4	3	37,5%
5	1	12,5%
6	1	12,5%
10	2	25,0%
Total	**8**	**100,0%**

Source: Responses to question A5 of the questionnaire.

According to Table 4/22, five of the eight cell captive insurance companies are younger than six years, and three cell captive insurers are older than five years, with the oldest cell captive insurer having operated for 10 years.

TABLE 4/23: THE NUMBER OF HOLDING COMPANIES INVOLVED IN THE OWNERSHIP OF THE CELL CAPTIVE INSURANCE COMPANY

Number of holding companies	Frequency	Percentage
1	6	100,0%
Total	**6**	**100,0%**

Source: Responses to question A6 of the questionnaire.

Note: Only six of the eight respondents answered this specific question.

Only six respondents answered this question and they indicated that only one holding company is involved in the ownership of the cell captive insurer. But the information shown in Table 4/23 contradicts the generally believed theory that a cell captive insurance company forms part of a larger group of owners (see Chapter 3).

4.7.2 Objectives to establish and to operate a cell captive insurance company

The objectives relating to establishing and to operating a cell captive insurance company form part of section B of the questionnaire. This section places emphasis on the specific four main categories, namely the financial, control, flexibility, and commercial objectives relevant to forming a captive insurer, as identified in Chapter 3. Through this section of the questionnaire, the aim of the study is to determine the order of significance placed by the respondents on each of the four main categories. Following this the significance between the *objective to establish* and the *objective to operate* a cell captive insurer is researched for each of the four categories and then divided into their representative subsections.

The following frequency tables present the responses of the cell captive insurance respondents according to their answer categories. The same statistical principle that was used and described in section 4.6.2 is applied in the following two tables. Weighted scores for each category of answers were again calculated in the same way as explained in section 4.6.2 to make it possible to infer the order of importance of the categories of answers more objectively. The calculation of these weighted scores is also presented in Table 4/25.

TABLE 4/24: THE MAIN OBJECTIVES TO ESTABLISH AND TO OPERATE A CELL CAPTIVE INSURANCE COMPANY

	Not important	Little important	Moderately important	Highly important	Extremely important
Obtaining financial benefits	1	0	0	3	4
Obtaining control	1	0	0	4	3
Obtaining flexibility	1	0	2	5	0
Obtaining commercial objectives	1	1	4	1	1
Obtaining an alternative to competing insurers	0	0	0	1	0
Obtaining improved risk management	0	0	0	0	1
Obtaining an alternative revenue stream	0	0	0	0	1

Source: Responses to question B1 of the questionnaire.

TABLE 4/25: SUM OF WEIGHTED SCORES OF OBJECTIVES TO ESTABLISH AND TO OPERATE A CELL CAPTIVE INSURANCE COMPANY

	Score "not important" x 1	Score "little important" x 2	Score "moderately important" x 3	Score "highly important" x 4	Score "extremely important" x 5	**Sum of weighted scores**
Obtaining financial benefits	1	0	0	12	20	**33**
Obtaining control	1	0	0	16	15	**32**
Obtaining flexibility	1	0	6	20	0	**27**
Obtaining commercial objectives	1	2	12	4	5	**24**
Obtaining an alternative to competing insurers	0	0	0	4	0	**4**
Obtaining improved risk management	0	0	0	0	5	**5**
Obtaining an alternative revenue stream	0	0	0	0	5	**5**

Source: Table 4/24.

According to the preceding table, it is clear from the sum of weighted scores, that obtaining financial benefits is viewed as the most important objective to establish and operate a cell captive insurance company. The second most important objective, with a weighted score very close to that of the first objective, is obtaining control; the third most important objective focuses on flexibility benefits and the fourth most important objective encompasses commercial benefits. Two of the respondents from the cell captive insurance companies mentioned "offer alternative to competing insurers", "improve risk management", as well as "obtaining an alternative revenue stream" as additional objectives to the four provided on the questionnaire. The significance of the subsections of each category follows hereafter.

TABLE 4/26: MOST IMPORTANT *FINANCIAL* OBJECTIVE TO *ESTABLISH* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Providing lower insurance costs	4	50,0%
Cash flow improvement	2	25,0%
Cost savings through the reinsurance market	0	0,0%
Tax minimisation and deferral	0	0,0%
Protection from price fluctuations	1	12,5%
Funding of self-insured layers	1	12,5%
Total	**8**	**100,0%**

Source: Responses to question B2 of the questionnaire.

As presented in the preceding table, the most important financial objective to *establish* a cell captive insurance company according to 50 per cent of the respondents is the provision of lower insurance costs. Cash flow improvement was regarded as the most important objective by 25 per cent of the respondents, while protection from price fluctuations had one supporter. One of the respondents identified "funding of self-insured layers" as an additional financial objective to consider.

TABLE 4/27: MOST IMPORTANT *FINANCIAL* OBJECTIVE TO *OPERATE* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Providing lower insurance costs	2	25,0%
Cash flow improvement	4	50,0%
Cost savings through the reinsurance market	0	0,0%
Tax minimisation and deferral	1	12,5%
Protection from price fluctuations	1	12,5%
Total	**8**	**100,0%**

Source: Responses to question B2 of the questionnaire.

According to Table 4/27 the most important financial objective to *operate* a cell captive insurance company is the benefit of cash flow improvement, according to 50 per cent of the respondents. Providing lower insurance costs was seen by two respondents as the most important objective to operate a cell captive insurer. Protection from price fluctuations and tax minimisation and deferral were each regarded by one respondent as the most important financial objective. Providing cost savings through the reinsurance market was not seen by any respondent as important at all.

Comparing the preceding two tables reveals that most respondents indicated that when *establishing* a cell captive insurer, they see the provision of lower insurance costs as the most important financial benefit to take into account. When, on the other hand, *operating* the cell captive was considered, most respondents indicated that cash flow improvement is the most important financial objective to focus on.

TABLE 4/28: MOST IMPORTANT *CONTROL* OBJECTIVE TO *ESTABLISH* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Control of unrelated business lines	3	37,5%
Control of investments	4	50,0%
Control over claim settlement	0	0,0%
Specify structure specifications yourself	1	12,5%
Total	**8**	**100,0%**

Source: Responses to question B3 of the questionnaire.

From the preceding table it is clear that 50 per cent of the respondents stated that the most important control objective to *establish* a cell captive insurance company is control over investments. The control of underwriting of lines of business that is unrelated to the risks of the holding company was seen as the most important objective to establish a cell captive insurance company by three respondents. The other additional objective specified by one respondent was "specify structure specifications yourself". Control over claim settlement was not seen as important by any respondent.

TABLE 4/29: MOST IMPORTANT *CONTROL* OBJECTIVE TO *OPERATE* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Control of unrelated business lines	3	37,5%
Control of investments	1	12,5%
Control over claim settlement	2	25,0%
Flexibility	1	12,5%
Specify structure specifications yourself	1	12,5%
Total	**8**	**100,0%**

Source: Responses to question B3 of the questionnaire.

The control of underwriting of lines of business that are unrelated to the risks of the holding company was seen as the most important objective to *operate* a cell captive insurance company by 37,5 per cent of the respondents. Control over claim settlement was stated by two respondents as important. Control over investments was indicated as the most important objective by only one respondent. Additional objectives given by one respondent each were "flexibility" and "specify structure specifications yourself".

By comparing the preceding two tables, it emerges that most respondents indicated that having control over their investments was the most important objective for *establishment* of a cell captive insurance company. When it came to the *operating* of a cell captive insurer, most respondents were of the opinion that the control of underwriting of lines of business that are unrelated to the risks of the holding company was the most important objective.

TABLE 4/30: MOST IMPORTANT *FLEXIBILITY* OBJECTIVE TO *ESTABLISH* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Availability of coverage not otherwise available	8	100,0%
Access to the reinsurance market	0	0,0%
Regulatory flexibility of domiciles	0	0,0%
Total	**8**	**100,0%**

Source: Responses to question B4 of the questionnaire.

Table 4/30 markedly shows that all eight respondents felt that the availability of coverage not otherwise available is the single important objective to *establish* a cell captive insurance company in terms of flexibility. Access to the reinsurance market and regulatory flexibility of domiciles were not indicated as important at all.

TABLE 4/31: MOST IMPORTANT *FLEXIBILITY* OBJECTIVE TO *OPERATE* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Availability of coverage not otherwise available	5	62,5%
Access to the reinsurance market	2	25,0%
Tailor-made risk programme	1	12,5%
Total	**8**	**100,0%**

Source: Responses to question B4 of the questionnaire.

In term of *operating* a cell captive insurance company 62,5 per cent of the respondents indicated that the availability of coverage not otherwise available is the most important flexibility objective. Access to the reinsurance market was seen as the most important objective by two respondents and the additional objective mentioned by a respondent was indicated as "tailor-made risk programme".

In comparing the two preceding tables, it becomes clear that in *both establishing and operating* a cell captive insurer, the availability of coverage not otherwise available is seen by most respondents as the dominant flexibility objective. This corresponds significantly with the theory on the development of South African captive insurance concerning enterprises experiencing the lack of options and choices from the traditional insurance market (see Chapter 3).

TABLE 4/32: MOST IMPORTANT *COMMERCIAL* OBJECTIVE TO *ESTABLISH* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Risk retention levels set according to needs of holding company	6	75,0%
Maximise shareholders' value of the holding company	1	12,5%
Strategic risk management	1	12,5%
Total	**8**	**100,0%**

Source: Responses to question B5 of the questionnaire.

Risk retention levels set according to needs of the holding company is indicated in Table 4/32 as the most important commercial objective to *establish* a cell captive insurer, by 75 per cent of the respondents. Maximisation of shareholders' value of the holding company and strategic risk management were each indicated by one respondent as the most important commercial objective.

TABLE 4/33: MOST IMPORTANT *COMMERCIAL* OBJECTIVE TO *OPERATE* A CELL CAPTIVE INSURANCE COMPANY

	Frequency	Percentage
Risk retention levels set according to needs of holding company	1	12,5%
Maximise shareholders' value of the holding company	3	37,5%
Strategic risk management	4	50,0%
Total	**8**	**100,0%**

Source: Responses to question B5 of the questionnaire.

As shown in the preceding table, the most important commercial objective to *operate* a cell captive insurance company was identified, as strategic risk management by 50 per cent of the respondents. Maximisation of shareholders' value of the holding company was seen as the most important objective by three respondents, and risk retention levels set according to the needs of the holding company was seen by only one respondent as the most important commercial objective.

When comparing Table 4/32 and Table 4/33 it becomes clear that there is a significant change with regard to the importance of *establishing* and *operating* a cell captive insurer in terms of commercial objectives. When *establishing* a cell captive insurance company emphasis is mainly on the risk retention levels set according to the needs of the holding company, but when the focus was on *operating* the cell captive insurer, the emphasis shifted mainly to strategic risk management.

4.7.3 Factors which determine the decision of a holding company to establish and operate a cell captive insurance company

The factors that determine the establishment and the operation of a cell captive insurance company forms part of section C of the questionnaire. This section places emphasis on the theoretical decisional factors identified in Chapter 3. The respondents had to select, in order of their importance, four of the given factors that determine the decision of a holding company to establish and to operate a cell captive insurance company. The results are presented in the following tables.

TABLE 4/34: FACTORS WHICH DETERMINE THE DECISION OF A HOLDING COMPANY TO *ESTABLISH* A CELL CAPTIVE INSURANCE COMPANY

	Most important factor	Second most important factor	Third most important factor	Fourth most important factor	**Total of the four most important factors**
Importance of loss/premium ratio of holding company	0	0	0	0	**0**
Importance of financial commitment of holding company	1	1	1	2	**5**
Importance of spreading risks of holding company	5	3	0	0	**8**
Importance of loss control of holding company	1	0	0	1	**2**
Importance of management commitment of holding company	1	0	1	2	**4**
Importance of retention capacity of holding company	0	4	3	0	**7**
Importance of regulation by government	0	0	2	0	**2**
Importance of managerial competence of holding company	0	0	1	2	**3**
Importance of tax planning	0	0	0	1	**1**

Source: Responses to question C1 of the questionnaire.

By calculating the totals of the four most important factors indicated by the responses of the respondents as recorded in Table 4/34, it can be concluded that the three most important factors that determine the decision of the holding company to *establish* a cell captive insurance company are (in decreasing order of importance) as follows:

- the spreading of risks of the holding company;
- the retention capacity of the holding company; and
- the financial commitment of the holding company.

TABLE 4/35: FACTORS WHICH DETERMINE THE DECISION OF A HOLDING COMPANY TO *OPERATE A* CELL CAPTIVE INSURANCE COMPANY

	Most important factor	Second most important factor	Third most important factor	Fourth most important factor	**Total of the four most important factors**
Importance of loss/premium ratio of holding company	0	0	0	0	**0**
Importance of financial commitment of holding company	3	2	3	0	**8**
Importance of spreading risks of holding company	0	3	1	2	**6**
Importance of loss control of holding company	0	0	1	1	**2**
Importance of management commitment of holding company	2	3	1	0	**6**
Importance of retention capacity of holding company	1	0	2	2	**5**
Importance of regulation by government	0	0	0	1	**1**
Importance of managerial competence of holding company	2	0	0	2	**4**

Source: Responses to question C2 of the questionnaire.

By calculating the totals of the four most important factors as revealed in the answers of the respondents, it can be concluded from, Table 4/35, that the three most important factors determining the decision of the holding company to *operate* a cell captive insurance company are (in decreasing order of importance) as follows:

- the financial commitment of the holding company;
- the spreading of risks of the holding company; and
- the management commitment of the holding company.

TABLE 4/36: COMPARISON BETWEEN THE THREE MOST IMPORTANT FACTORS TO *ESTABLISH* AND TO *OPERATE* A CELL CAPTIVE INSURANCE COMPANY

The three most important factors determining the decision of a holding company to *establish* a cell captive insurer	**The three most important factors determining the decision of a holding company to *operate* a cell captive insurer**
* Spreading risks of the holding company	* Financial commitment of the holding company
* Retention capacity of the holding company	* Spreading risks of the holding company
* Financial commitment of the holding company	* The management commitment of the holding company

Source: Tables 4/34 and 4/35.

From Table 4/36, it can be concluded that most of the respondents see the following two factors as very important in determining the decision of a holding company to both establish and to operate a cell captive insurance company: the financial commitment of the holding company and spreading risks of the holding company. These two decisional factors of the holding company therefore are significant elements that the risk manager should include in the company's decision-making model. Retention capacity of the holding company was indicated as important to establish a cell captive insurer, while the management commitment of the holding company was indicated as important in operating a cell captive insurance company.

4.7.4 Future and usefulness of captive insurance

In the last section of the questionnaire, the respondents were asked to give their opinion on the future and usefulness of captive insurance as an alternative risk transfer mechanism in the South African market. The following tables present the views and opinions of the eight cell captive respondents.

TABLE 4/37: WHETHER THE RESPONDENTS REGARD THE CELL CAPTIVE INSURANCE COMPANY AS A LONG-TERM OR SHORT-TERM ALTERNATIVE RISK TRANSFER MECHANISM FOR A HOLDING COMPANY

	Frequency	Percentage
Short-term	0	0,0%
Long-term	8	100,0%

Source: Responses to question C3.1 of the questionnaire.

All respondents indicated that their cell captive insurance company was regarded as a long-term alternative risk transfer mechanism for the holding company.

TABLE 4/38: OPINIONS OF RESPONDENTS ON WHETHER CELL CAPTIVE INSURANCE COMPANIES ARE SUCCESSFUL IN REDUCING THE RISK EXPOSURE OF THE HOLDING COMPANY

	Frequency	Percentage
Yes	8	100,0%
No	0	0,0%

Source: Responses to question C3.2 of the questionnaire.

All respondents felt that their cell captive insurance company was successful in reducing the risk exposure of the holding company.

TABLE 4/39: OPINIONS OF RESPONDENTS ON WHETHER CELL CAPTIVE INSURANCE WOULD BECOME MORE IMPORTANT DURING THE NEXT FIVE YEARS

	Frequency	Percentage
Yes	6	75,0%
No	2	25,0%
Total	**8**	**100,0%**

Source: Responses to question C3.3 of the questionnaire.

When asked about the future of the captive insurance market, 75 per cent of the respondents answered that they believed that cell captive insurance would become more important during the next five years. Two respondents noted that they did not believe that cell captive insurance would become more important during the next five years. The respondents were also asked in an open-ended question to motivate their answers. Their motivations are summarised in the following table.

TABLE 4/40: MOTIVATION FOR OPINIONS OF RESPONDENTS ON WHETHER CELL CAPTIVE INSURANCE WOULD BECOME MORE IMPORTANT DURING THE NEXT FIVE YEARS

Motivations from respondents who believe that cell captive insurance *will become more important* during the next five years	**Motivations from respondents who believe that cell captive insurance *will not become more important* during the next five years**
The cost of risk transfer can be decreased.	Cell captive insurers still experience difficulties in obtaining reinsurance.
The current growth of captive insurance in the South African market.	
Availability of coverage from traditional insurance is not adequate.	
Globalisation of financial markets.	
Diversification of risks is obtained.	
Providing customised service to clients.	

Source: Responses to question C3.4 of the questionnaire.

Most of the respondents indicated that their opinion on the future of cell captive insurance in South Africa. The main conclusion from their views is that captive insurance provides an alternative solution to the traditional insurance market and can offer cost saving to the holding company and tailor-made services to customers.

4.9 SUMMARY

After completing the empirical study, the following main results are summarised. Separate sections are used for onshore and cell captive insurance companies.

4.9.1 Onshore captive insurance companies

This study concluded the following main findings with regard to the establishment and operation of an onshore captive insurance company in South Africa:

It is concluded that all the onshore captive insurance companies in South Africa that have been investigated have existed for at least three years. The oldest onshore captive insurance company is 11 years old and the youngest only three years old. Seven of the 13 companies are younger than six years and six companies are older than five years. More than 92 per cent of the respondents have indicated that only one holding company was involved in the ownership of the captive insurance company.

The following main *objectives*, in order of importance, were identified:

First, obtaining control objectives:

- The most important control objective to *establish* an onshore captive insurance company was identified as the control of underwriting of lines of business that are unrelated to the risks of the holding company.
- The most important control objective to *operate* an onshore captive insurance company was identified as the control of underwriting of lines of business that are unrelated to the risks of the holding company together with control of investments.

Second, obtaining financial benefits:

- The most important financial objective to *establish* an onshore captive insurance company was identified as the provision of lower insurance costs.
- The most important financial objective to *operate* an onshore captive insurance company was identified as the provision of cost saving through the reinsurance market.

Third, obtaining commercial objectives:

- The most important commercial objective to *establish* an onshore captive insurance company was identified as the ability to set the risk retention levels according to the needs of the holding company.
- The most important commercial objective to *operate* an onshore captive insurance company was also identified as the ability to set the risk retention levels according to the needs of the holding company.

Fourth, obtaining flexibility:

- The most important flexibility objective to *establish* an onshore captive insurance company was identified as the availability of coverage not otherwise available.
- The most important flexibility objective to *operate* an onshore captive insurance company was also identified as the availability of coverage not otherwise available.

Lastly, the other objective identified by one respondent:

- The additional most important objective to establish and to operate an onshore captive insurance company was identified as "the focus on risk control".

The three most important *factors* which should be considered to determine the decision of a holding company to *establish* an onshore captive insurance company are as follows:

- the financial commitment of the holding company;
- spreading risks of the holding company; and
- the retention capacity of the holding company.

The three most important *factors* which should be considered to determine the decision of a holding company to *operate* an onshore captive insurance company are as follows:

- the retention capacity of the holding company;
- the financial commitment of the holding company; and
- the management commitment of the holding company.

Most of the respondents indicated that they see captive insurance as a long-term alternative risk transfer mechanism for a holding company, and that captive insurance companies are successful in reducing the risk exposure of the holding company. Most of the respondents have also indicated that captive insurance will become more important during the next five years, and that they have a positive opinion about the future of captive insurance. The main conclusion from their views is that captive insurance provides an alternative to the traditional insurance market and can therefore offer financial benefits to the holding company.

4.9.2 Cell captive insurance companies

This study has resulted in the following main findings with regard to the value of establishing and operating a cell captive insurance company in South Africa:

The empirical study has led to the conclusion that five of the eight cell captive insurance companies are younger than six years, and three cell captive insurers are older than five years, with the oldest cell captive insurer having operated for 10 years. All the respondents (who answered the particular question) indicated that only one holding company is involved in the ownership of their cell captive insurer.

The following main *objectives,* in order of importance, were identified:

First, obtaining financial benefits:

- The most important financial objective to *establish* a cell captive insurance company was identified as the provision of lower insurance costs.
- The most important financial objective to *operate* a cell captive insurance company was identified as the improvement of cash flow.

Second, obtaining control objectives:

- The most important control objective to *establish* a cell captive insurance company was identified as the control of investments.
- The most important control objective to *operate* a cell captive insurance company was also identified as the control of underwriting of lines of business that are unrelated to the risks of the holding company.

Third, obtaining flexibility:

- The most important flexibility objective to *establish* a cell captive insurance company was identified as the availability of coverage not otherwise available.
- The most important flexibility objective to *operate* a cell captive insurance company was also identified as the availability of coverage not otherwise available.

Fourth, obtaining commercial objectives:

- The most important commercial objective to *establish* a cell captive insurance company was identified as the ability to set the risk retention levels according to the needs of the holding company.
- The most important commercial objective to *operate* a cell captive insurance company was identified as the application of strategic risk management.

Lastly, the other objectives identified by respondents:

The additional most important objectives to establish and to operate a cell insurance company was identified as "obtaining an alternative to competing insurers", "obtaining improved risk management" and "obtaining an alternative revenue stream".

The three most important *factors* which should be considered to determine the decision of a holding company to *establish* a cell captive insurance company are as follows:

- spreading risks of the holding company;
- the retention capacity of the holding company; and
- the financial commitment of the holding company.

The three most important *factors* which should be considered to determine the decision of a holding company to *operate* a cell captive insurance company are as follows:

- the financial commitment of the holding company;
- spreading risks of the holding company; and
- the management commitment of the holding company.

All the respondents indicated that they see cell captive insurance as a long-term alternative risk transfer mechanism for a holding company, and that cell captive insurance companies are successful in reducing the risk exposure of the holding company. Most respondents have also indicated that cell captive insurance will become more important during the next five years. The main conclusion from their views emphasises the fact that captive insurance provides an alternative solution to the traditional insurance market and can offer cost saving to the holding company and a customised service to clients.

The information and conclusions drawn from the empirical study will form the basis for developing a decision-making model to assist risk managers in structuring their study of captive insurance as an alternative risk transfer mechanism for their holding company. Different decision-making models will be developed for onshore and cell captive insurance companies. These models will be presented in Chapter 5, together with the final recommendations.

CHAPTER 5

CONCLUSIONS, DECISION-MAKING MODELS AND RECOMMENDATIONS

5.1 INTRODUCTION

The basic concept of captive insurance companies has clearly been in use for almost a hundred years and their role significantly accelerated after the economic reforms of the 1980s. At that time a growing number of enterprises came to see captive insurance as a workable alternative risk transfer mechanism to the pricing and coverage volatility of the traditional insurance markets.

As a result of this, there has been a trend by enterprises to move away from the traditional insurance market towards more self-insurance and strategic risk management programmes. This has resulted in the growth of captive insurance companies into the now well establish large and sophisticated captive insurance industry. Where on a worldwide basis there were 200 captive insurance companies operating in the early seventies, now there are over 4 500 captive insurers. With this in mind, the objective of this study, as outlined in Chapter 1, included the evaluation of the decision-making process of risk managers to establish and to operate a captive insurance company as an alternative risk transfer mechanism, given the basic theory available in this regard. The conclusions drawn from the study can lead to a better decision-making process by risk managers in general. To achieve this objective, a literature and empirical study were undertaken. Information about the relevant aspects was obtained by means of questionnaires send to captive insurance management.

The next two sections summarised the findings and conclusions reported from the literature study and the empirical survey. Thereafter decision-making models will be presented, for respectively onshore and cell captive insurance companies. In the last section, recommendations and future research opportunities will be discussed.

5.2 FINDINGS AND CONCLUSIONS RESULTING FROM THE LITERATURE STUDY (CHAPTERS 2 AND 3)

To place Chapters 2 and 3 in context, *Chapter 1* provides a broad overview of the concept of risk management. By studying this concept, a number of specific methods of risk management were identified. The risk manager firstly needs to determine whether the company wants to focus on physical risk control or on external or internal risk financing. If a company should choose internal risk financing, captive insurance would form one of the available alternatives (refer to Figure 1/1). The strategic implication of establishing a captive insurer should be carefully considered, because each company operates in their own specific circumstances and environment.

The first task of this study has been to complete a literature study on the basic theory available on internal risk financing with specific focus on the use of captive insurance as an internal risk financing mechanism for business management. After completion of the literature study, the following important aspects are summarised.

5.2.1 Development of captive insurance companies (Chapter 2)

From a strategic perspective, it is evident from *Chapter 2* that the risk management function has become more complex. It can be regarded as a strategic priority that the responsibility for this function can no longer be left to outside consultants (or, in some instances, traditional insurers) as they might not understand the strategic objectives of the enterprise. In this regard it is imperative for management to ensure that appropriate and integrated risk management measures are adopted and implemented in a manner that is consistent with the strategic objective of the enterprise as a whole. To establish the above-mentioned approach, a risk manager can tap into the benefits that the alternative risk transfer market is offering. This market has been growing and developing over a long period of time, and the segment of captive insurance provides a fast and innovative number of services to comply with the customised needs of an enterprise.

The concept of captive insurance is not new in South Africa. It has been practised on an informal as well as a structured basis for many of years. A fair number of companies have taken advantage of captive insurance to overcome the main limitations of traditional insurance. Captive insurance has the ability to provide insurance at reasonable cost and with less restrictive stipulations.

5.2.2 Types of captive insurance companies (Chapter 3)

The variety of alternative risk transfer options available to enterprises is increasing and a broad knowledge and understanding of the options are required to make it possible to implement the most appropriate structure. Both internal and external factors, which include the exposures facing the enterprise, any expected environmental changes, new product developments and the integrated goals of the company should be considered. The establishment of an alternative risk transfer structure is a dynamic process and requires continuous adjustments. The right balance between the factors can provide a firm with the competitive advantage needed to survive in an ever changing global economy. Intense competition among offshore jurisdictions and onshore players have caused a visible trend of increasing innovation in the creation and evolution of the legal structure, all with the aim of providing improved and cost effective financial services to the international markets.

The continuing increase in the number of captive insurance companies being formed is a reflection of general acceptance globally and an appreciation of their being a long-term financial tool with significant advantages for many enterprises. Today captive insurers are being formed in the light of an overall strategic business plan. Captive insurance should not be used as a short-term solution. Although this form of alternative risk transfer is very flexible, forming a captive insurance company to fill a need for a few years does not hold merit economically or adds value. When the benefits become less significant in a soft insurance environment, many captive insurance owners prefer to leave their captive insurer dormant until the market conditions call for innovative action. Most enterprises who have formed captive insurance companies generally state that they have based their decisions on the fact that the traditional insurance industry did not meet their financial needs with regard to price, cover and service.

The key factors identified for establishing a captive insurer as a means of alternative risk transfer structure can be summarised as follows: The main reasons for forming a captive insurance company should be manifested in an integrated balance between financial leverage, control management, operational flexibility and commercial objectives. Financial leverage includes lower insurance costs, cash flow improvement, cost saving through the reinsurance market, tax minimisation and deferral and protection from price fluctuations. The element of control includes the underwriting of unrelated risks for profit, control of investments and control over claim settlement. Unavailability of cover, access to the reinsurance market, and obtaining regulatory flexibility can be seen as the main elements of flexibility. A captive insurance company can made provision for the commercial objectives by setting risk retention levels, maximising shareholders' value of the holding company and strategic risk management. A clear destinction should be drawn between whether the holding company wants to merely establish, or also operate the activities of the captive insurance company. It is therefore important that all of the above factors be studied and evaluated extensively by a risk manager before the decision on establishing or operating a captive insurance company is taken.

The type of captive insurance company will depend on the holding company's internal risk transfer needs, as well as the structure and long-term strategy of the holding company. Many types of captive insurers are available in the insurance market, and in South Africa the general line of captive insurance business focuses on onshore, offshore and cell captive insurance. According to most of the parties involved, captive insurance is one of the clear and definite structures in the insurance industry that promises to continue to grow and evolve innovative cost saving mechanisms for risk managers.

5.3 FINDINGS AND CONCLUSIONS FROM THE EMPIRICAL STUDY (CHAPTER 4)

After completing the empirical study, the following main results to determine the decision-making process of a risk manager for establishing and operating a captive insurance company are summarised. Separate sections are used for onshore and cell captive insurance companies.

5.3.1 Onshore captive insurance companies

This study concluded the following main findings with regard to the establishment and operation of an onshore captive insurance company in South Africa:

It is concluded that all the onshore captive insurance companies in South Africa that have been investigated have existed for at least three years. The oldest onshore captive insurance company is 11 years old and the youngest only three years old. Seven of the 13 companies are younger than six years and six companies are older than five years. More than 92 per cent of the respondents have indicated that only one holding company was involved in the ownership of the captive insurance company.

The following main *objectives*, in order of importance, were identified:

First, obtaining control objectives:

- The most important control objective to *establish* an onshore captive insurance company was identified as the control of underwriting of lines of business that are unrelated to the risks of the holding company.
- The most important control objective to *operate* an onshore captive insurance company was identified as the control of underwriting of lines of business that are unrelated to the risks of the holding company together with control of investments.

Second, obtaining financial benefits:

- The most important financial objective to *establish* an onshore captive insurance company was identified as the provision of lower insurance costs.
- The most important financial objective to *operate* an onshore captive insurance company was identified as the provision of cost saving through the reinsurance market.

Third, obtaining commercial objectives:

- The most important commercial objective to *establish* an onshore captive insurance company was identified as the ability to set the risk retention levels according to the needs of the holding company.
- The most important commercial objective to *operate* an onshore captive insurance company was also identified as the ability to set the risk retention levels according to the needs of the holding company.

Fourth, obtaining flexibility:

- The most important flexibility objective to *establish* an onshore captive insurance company was identified as the availability of coverage not otherwise available.
- The most important flexibility objective to *operate* an onshore captive insurance company was also identified as the availability of coverage not otherwise available.

Lastly, the other objective identified by one respondent:

- The additional most important objective to establish and to operate an onshore captive insurance company was identified as "the focus on risk control".

The three most important *factors* which should be considered to determine the decision of a holding company to *establish* an onshore captive insurance company are as follows:

- the financial commitment of the holding company;
- spreading risks of the holding company; and
- the retention capacity of the holding company.

The three most important *factors* which should be considered to determine the decision of a holding company to *operate* an onshore captive insurance company are as follows:

- the retention capacity of the holding company;
- the financial commitment of the holding company; and
- the management commitment of the holding company.

Most of the respondents indicated that they see captive insurance as a long-term alternative risk transfer mechanism for a holding company, and that captive insurance companies are successful in reducing the risk exposure of the holding company. Most of the respondents have also indicated that captive insurance will become more important during the next five years, and that they have a positive opinion about the future of captive insurance. The main conclusion from their views is that captive insurance provides an alternative to the traditional insurance market and can therefore offer financial benefits to the holding company.

5.3.2 Cell captive insurance companies

This study has resulted in the following main findings with regard to the value of establishing and operating a cell captive insurance company in South Africa:

The empirical study has led to the conclusion that five of the eight cell captive insurance companies are younger than six years, and three cell captive insurers are older than five years, with the oldest cell captive insurer having operated for 10 years. All the respondents (who answered the particular question) indicated that only one holding company is involved in the ownership of their cell captive insurer.

The following main *objectives,* in order of importance, were identified:

First, obtaining financial benefits:

- The most important financial objective to *establish* a cell captive insurance company was identified as the provision of lower insurance costs.
- The most important financial objective to *operate* a cell captive insurance company was identified as the improvement of cash flow.

Second, obtaining control objectives:

- The most important control objective to *establish* a cell captive insurance company was identified as the control of investments.
- The most important control objective to *operate* a cell captive insurance company was also identified as the control of underwriting of lines of business that are unrelated to the risks of the holding company.

Third, obtaining flexibility:

- The most important flexibility objective to *establish* a cell captive insurance company was identified as the availability of coverage not otherwise available.
- The most important flexibility objective to *operate* a cell captive insurance company was also identified as the availability of coverage not otherwise available.

Fourth, obtaining commercial objectives:

- The most important commercial objective to *establish* a cell captive insurance company was identified as the ability to set the risk retention levels according to the needs of the holding company.
- The most important commercial objective to *operate* a cell captive insurance company was identified as the application of strategic risk management.

Lastly, the other objectives identified by respondents:

The additional most important objectives to establish and to operate a cell insurance company was identified as "obtaining an alternative to competing insurers", "obtaining improved risk management" and "obtaining an alternative revenue stream".

The three most important *factors* which should be considered to determine the decision of a holding company to *establish* a cell captive insurance company are as follows:

- spreading risks of the holding company;
- the retention capacity of the holding company; and
- the financial commitment of the holding company.

The three most important *factors* which should be considered to determine the decision of a holding company to *operate* a cell captive insurance company are as follows:

- the financial commitment of the holding company;
- spreading risks of the holding company; and
- the management commitment of the holding company.

All the respondents indicated that they see cell captive insurance as a long-term alternative risk transfer mechanism for a holding company, and that cell captive insurance companies are successful in reducing the risk exposure of the holding company. Most respondents have also indicated that cell captive insurance will become more important during the next five years. The main conclusion from their views emphasises the fact that captive insurance provides an alternative solution to the traditional insurance market and can offer cost saving to the holding company and a customised service to clients.

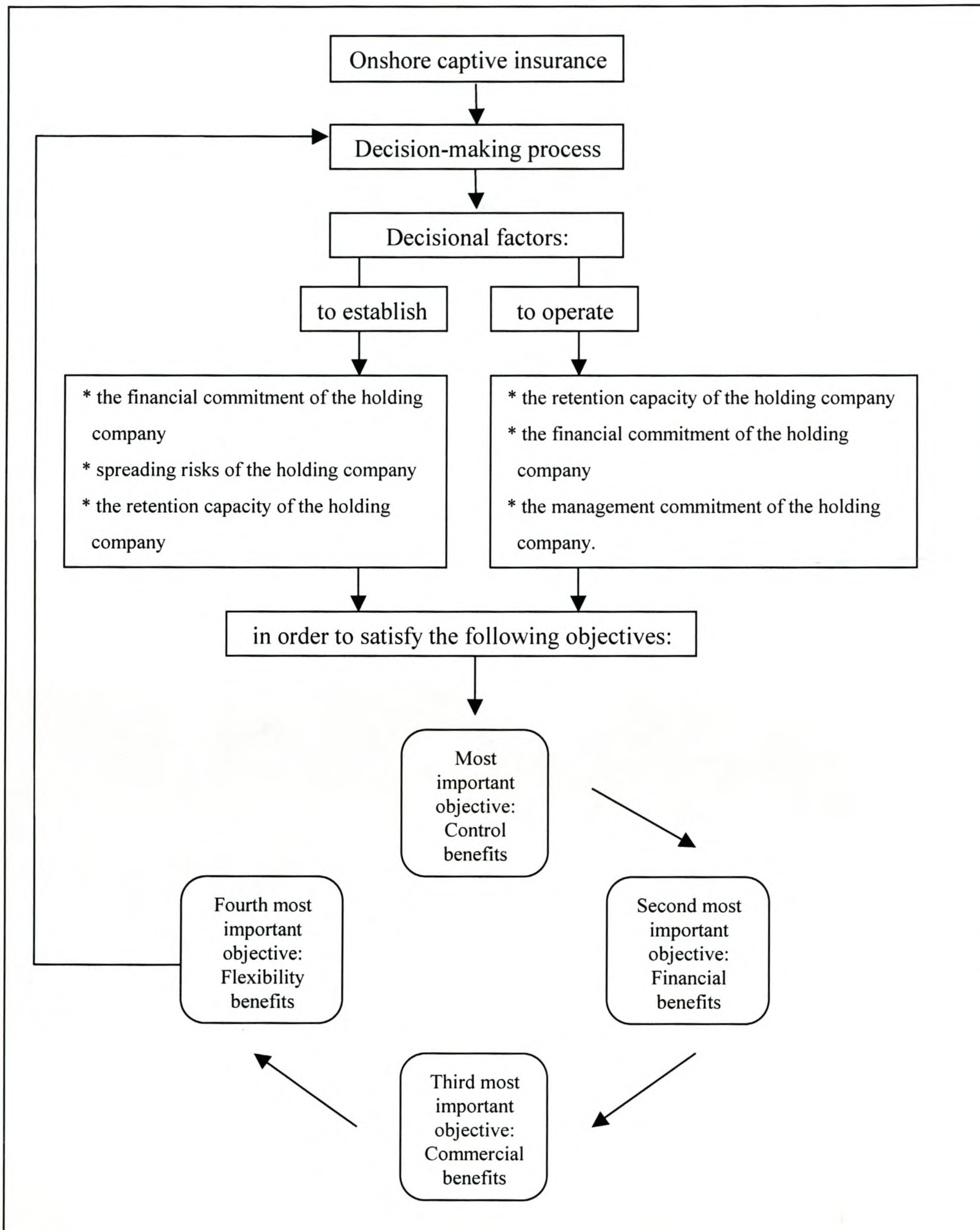
5.4 DECISION-MAKING MODELS

One of the tasks mentioned in Chapter 1 was to comprises the development of a model based on the outcome of the available empirical information, that should be a practical guideline for management to assess the feasibility of establishing and operating a captive insurance company. In order to address the different needs of onshore and cell captive insurers, two models are developed.

5.4.1 Decision-making model for *onshore* captive insurers

The decisional factors to establish and to operate an onshore captive insurer in order to accomplish particular objectives are illustrated through the following model:

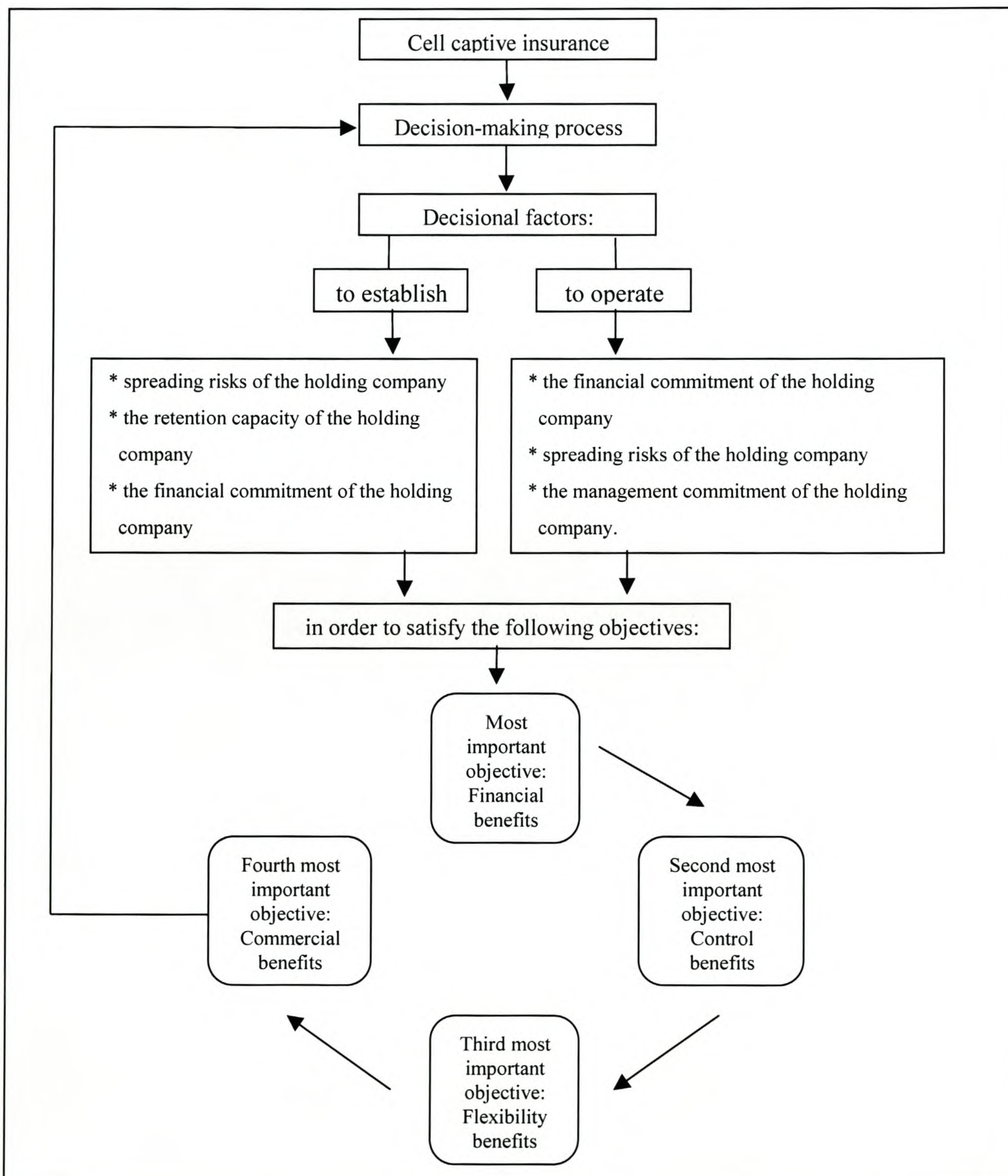
FIGURE 5/1: DECISION-MAKING MODEL FOR ONSHORE CAPTIVE INSURANCE



5.4.2 Decision-making model for *cell* captive insurers

The decisional factors to establish and to operate a cell captive insurer in order to accomplish particular objectives are illustrated through the following model:

FIGURE 5/2: DECISION-MAKING MODEL FOR CELL CAPTIVE INSURANCE



5.5 RECOMMENDATIONS FOR RISK MANAGERS CONCERNING CAPTIVE INSURANCE

5.5.1 Recommendations for *onshore* captive insurers

The recommendations are presented in two subsections, focussing respectively on the establishment and on the operation of an onshore captive insurer.

5.5.1.1 Recommendations for risk managers who want to *establish* an *onshore* captive insurance company

The risk manager of a company who decides to establish an onshore captive insurance company should focus on asking the following questions based on the outcome of the empirical results (Chapter 4) and the decision-making model in Figure 5/1:

- Firstly, to what extent will the holding company obtain control, with emphasis on control over lines of business unrelated to the risks of the holding company;
- Secondly, what will the possible financial benefits for the holding company be, with emphasis on providing lower insurance costs to the holding company;
- Thirdly, what will the commercial benefits for the holding company encompass, with emphasis on setting the risk retention levels according to the needs of the holding company; and
- Fourthly, to identify the possible flexibility opportunities derive for the holding company, with emphasis on the availability of coverage not otherwise available.

When risk management is conducting their feasibility study, the three most important decisional factors recommended for establishing an onshore captive insurer to take into account are:

- the financial commitment of the holding company;
- the spreading of the risks of the holding company; and
- the retention capacity of the holding company.

5.5.1.2 Recommendations for risk managers to *operate* an *onshore* captive insurance company

The risk manager of a company who decides to operate an onshore captive insurance company should focus on asking the following questions based on the outcome of the empirical results (Chapter 4) and the decision-making model in Figure 5/1:

- Firstly, to what extent will the holding company obtain control, with emphasis on control over lines of business unrelated to the risks of the holding company as well as control over investments;
- Secondly, what will the possible financial benefits for the holding company be, with emphasis on cost savings through the reinsurance market;
- Thirdly, what will the commercial benefits for the holding company encompass, with emphasis on setting the risk retention levels according to the needs of the holding company; and
- Fourthly, to identify the possible flexibility opportunities derive for the holding company, with emphasis on the availability of coverage not otherwise available.

When risk management is conducting their feasibility study, the three most important decisional factors recommended for operating an onshore captive insurer to take into account are:

- the retention capacity of the holding company;
- the financial commitment of the holding company; and
- the management commitment from the holding company.

5.5.2 Recommendations for *cell* captive insurers

The recommendations are presented in two subsections, focussing respectively on the establishment and on the operation of a cell captive insurer.

5.5.2.1 Recommendations for risk managers who want to *establish* a *cell* captive insurance company

Companies who decide to establish a cell captive insurance company should focus on asking the following questions based on the outcome of the empirical evidence (Chapter 4) and the decision-making model in Figure 5/2:

- Firstly, what will the possible financial benefits for the holding company be, with the emphasis on providing lower insurance costs to the holding company;
- Secondly, to what extent will the holding company obtain control, with the emphasis on control of investments;
- Thirdly, to identify the possible flexibility opportunities derive for the holding company, with emphasis on the availability of coverage not otherwise available;
- Fourthly, what will the commercial benefits for the holding company encompass, with emphasis on the ability to set risk retention levels according to the needs of the holding company.

When risk management is conducting their feasibility study, the three most important decisional factors recommended for establishing a cell captive insurer to take into account are:

- spreading risks of the holding company;
- the retention capacity of the holding company; and
- the financial commitment of the holding company.

5.5.2.2 Recommendations for risk managers to *operate* a *cell* captive insurance company

Companies who decide to operate a cell captive insurance company should focus on asking the following questions based on the outcome of the empirical evidence (Chapter 4) and the decision-making model in Figure 5/2:

- Firstly, what will the possible financial benefits for the holding company be, with the emphasis on cash flow improvement;

- Secondly, to what extent will the holding company obtain control, with the emphasis on control over lines of business unrelated to the risks of the holding company;
- Thirdly, to identify the possible flexibility opportunities derive for the holding company, with emphasis on the availability of coverage not otherwise available;
- Fourthly, what will the commercial benefits for the holding company encompass, with emphasis on strategic risk management.

When risk management is conducting their feasibility study, the three most important decisional factors recommended for operating a cell captive insurer to take into account are:

- the financial commitment of the holding company;
- the spreading of the risks of the holding company; and
- the management commitment of the holding company.

5.6 OPPORTUNITIES FOR FUTURE RESEARCH

The following opportunities for future research are highlighted:

1) *The nature and scope of the holding companies concerning captive insurance.*
   In this study the population consisted only out of the captive insurers themselves. To obtain a complete picture of the objectives to establish and operate a captive insurance company, the views of the holding companies should also form part of the empirical investigation.

2) *The inclusion of offshore captive insurance companies.*
   The fact that the detailed information on offshore captive insurance companies could not be obtained from the South African Reserve Bank, leaves scope to try to include this type of captive insurance company by some alternative means in future.

Profound trends at work in both insurance and the larger business world, as well as consolidation within and across business segments and across national borders, will drive further creativity in risk management. Although the basic core of captive insurance has been practice for many decades now, the concept of the captive insurance company as known today, only exists internationally for a few decades, while in South Africa the captive insurance phenomena exists for almost 15 years. Even though it is still a fairly young industry, it may provide a significant alternative risk transfer solution to the traditional insurance market for many companies.

ANNEXURE A

A.1

UNIVERSITEIT VAN STELLENBOSCH
UNIVERSITY OF STELLENBOSCH

27 January 2003

The Managing Director
COMPANY XYZ
PO Box ....
PRETORIA
0001

Dear Sir/Madam

CAPTIVE INSURANCE COMPANIES: A LITERATURE AND EMPIRICAL STUDY

Captive insurance is of particular importance to the South African economy due to the fact that this type of insurance structure forms part of the alternative risk transfer market. Captive insurance presents a number of benefits to the holding company, but can become very costly without the necessary feasibility study. It is therefore of the utmost importance that the objective to establish and operate a captive insurance company should be thoroughly analysed.

Against this background, the Department of Business Management at the University of Stellenbosch is conducting research focusing on the relevance of captive insurance for South African companies. Information obtained through this survey will be treated as highly confidential and it will be used in a manner that makes it impossible to identify any respondent.

The results of the study should benefit risk managers in their assessment of captive insurance as part of their strategic risk management programmes. In this regard, the research also has as a stated objective to provide risk managers with a tool which may help them in the decision-making process. The results gained from this study will also be of significant value to university students who are following courses in business management. An abstract of the main findings will be forwarded to all participants.

You are therefore kindly requested to participate in the survey which will be conducted by means of questionnaires, during February 2003. The questionnaires will be sent out by Miss M E le Roux, who is conducting the study in association with myself. We should appreciate it if you would complete the questionnaire and return it in the enclosed self-addressed and stamped envelope before 17 February 2003. Alternatively, you may fax the required information for the attention of Miss M E le Roux, at facsimile number 028 3840 564. For any inquiries, you may e-mail her at maresaleroux@hotmail.com.

Fakulteit Ekonomiese en Bestuurswetenskappe
Departement Ondernemingsbestuur
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Please accept our apologies for any inconvenience caused by this request. We, however are, convinced that the results of the survey will be of benefit in the decision-making process for the risk manager, as well as for the students at our university who specialize in business management.

Yours sincerely

FJMostert

PROF F J MOSTERT
Professor of Business Management

UNIVERSITEIT VAN STELLENBOSCH
UNIVERSITY OF STELLENBOSCH

27 January 2003

The Managing Director
COMPANY XYZ
P O Box
PRETORIA
0001

Dear Sir/Madam

CELL CAPTIVE INSURANCE COMPANIES: A LITERATURE AND EMPIRICAL STUDY

Cell captive insurance is of particular importance to the South African economy due to the fact that this type of insurance structure forms part of the alternative risk transfer market. Cell captive insurance presents a number of benefits to the holding company, but can become very costly without the necessary feasibility study. It is therefore of the utmost importance that the objective to establish and operate a cell captive insurance company should be thoroughly analysed.

Against this background, the Department of Business Management at the University of Stellenbosch is conducting research focusing on the relevance of cell captive insurance for South African companies. Information obtained through this survey will be treated as highly confidential and will be used in a manner that makes it impossible to identify any respondent.

The results of the study should benefit risk managers in their assessment of cell captive insurance as part of their strategic risk management programmes. In this regard, the research also has as a stated objective to provide risk managers with a tool which may help them in the decision-making process. The results gained from the study will also be of significant value to university students who are following courses in business management. An abstract of the main findings will be forwarded to all participants.

You are therefore kindly requested to participate in the survey which will be conducted by means of questionnaires, during February 2003. The questionnaires will be sent out by Miss M E le Roux who is conducting the study in association with myself. We should appreciate it if you would complete the questionnaire and return it in the enclosed self-addressed and stamped envelope before 17 February 2003. Alternatively, you may fax the required information for the attention of Miss M E le Roux, at facsimile number 028 3840 564. For any inquiries, you may

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e-mail her at maresaleroux@hotmail.com.

Please accept our apologies for any inconvenience caused by this request. We, however are, convinced that the results of the survey will be of benefit in the decision-making process for the risk managers, as well as for the students at our universities who specialise in business management.

Yours sincerely

PROF F J MOSTERT
Professor of Business Management

ANNEXURE B

UNIVERSITY OF STELLENBOSCH

DEPARTMENT OF BUSINESS MANAGEMENT

QUESTIONNAIRE ON CAPTIVE INSURANCE COMPANIES

Please note:

1. The information will be treated in the strictest confidence and in such a way that no captive insurance company can be recognised.
2. Please make a cross in the relevant blocks, where applicable.

A. General

1. Name of your captive insurance company. ______________________
2. Contact phone number ______________________
3. Your position or job title ______________________
4. How many years of experience do you have in captive insurance? ______________________ Years
5. How long does your captive insurance company exist? ______________________ Years
6. How many holding companies are involved in the ownership of your captive insurance company? ______________________ Number

B. Objectives to establish and to operate a captive insurance company

1. How important are the following objectives to form a captive insurance company?

(Not important =1; Little important = 2; Moderately important = 3; Highly important = 4; Extremely important = 5 where 1 - 5 form a continuum)

1. Obtaining financial benefits (e.g. cash flow improvement for holding company)	
2. Obtaining control	
3. Obtaining flexibility	
4. Obtaining commercial objectives (e.g. maximising of shareholders` value of the holding company)	
5. Other (please specify) ______________________	

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2. Please indicate (by way of a cross) the single most important financial objective firstly to establish and secondly to operate a captive insurance company:

Objective:	To establish	To operate
Providing lower insurance costs		
Cash flow improvement		
Cost savings through the reinsurance market		
Tax minimization and deferral		
Protection from price fluctuations		
Other objective (please specify)		

3. Please indicate (by way of a cross) the single most important objective in terms of control firstly to establish and secondly to operate a captive insurance company:

Objective:	To establish	To operate
Control of underwriting of lines of business that are unrelated to the risks of the holding company		
Control of investments		
Control over claim settlement		
Other objective (please specify)		

4. Please indicate (by way of a cross) the single most important objective in terms of flexibility firstly to establish and secondly to operate a captive insurance company:

Objective	To establish	To operate
Availability of coverage not otherwise available		
Access to the reinsurance market		
Regulatory flexibility of domiciles		
Other objective (please specify)		

5. Please indicate (by way of a cross) the single most important commercial objective firstly to establish and secondly to operate a captive insurance company:

Objective:	To establish	To operate
Risk retention levels set according to the needs of the holding company and the captive insurance company.		
Maximise shareholders' value of the holding company		
Strategic risk management		
Other objective (please specify)		

C. Factors which determine the decision of a holding company to establish and operate a captive insurance company.

1. Please indicate four of the following factors in order of their importance for the establishment of a captive insurance company. (only one cross per column)

Factors to **establish** a captive insurance company:	Most important factor	Second most important factor	Third most important factor	Fourth most important factor
1. Loss/premium ratio of holding company				
2. Financial commitment of holding company				
3. Spread of risk of holding company				
4. Loss control of holding company				
5. Management commitment of holding company				
6. Retention capacity of holding company				
7. Regulation by government				
8. Managerial competence of holding company				
9. Other factor (please specify)				

2. Please indicate four of the following factors in order of their importance for the operation of a captive insurance company. (only one cross per column)

Factors to **operate** a captive insurance company:	Most important factor	Second most important factor	Third most important factor	Fourth most important factor
1. Loss/premium ratio of holding company				
2. Financial commitment of holding company				
3. Spread of risk of holding company				
4. Loss control of holding company				
5. Management commitment of holding company				
6. Retention capacity of holding company				
7. Regulation by government				
8. Managerial competence of holding company				
9. Other factor (please specify)				

3.1 Do you see your captive insurance company as a long-term or a short-term alternative risk transfer mechanism for a holding company?

Short-term	
Long-term	

3.2 In your opinion, are captive insurance companies successful in reducing the risk exposure of the holding company/companies?

Yes	
No	

3.3 Do you think that captive insurance will become more important during the next five years?

Yes	
No	

3.4 Please motivate your answer to question 3.3 ____________________

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4. Please provide your name, postal address and e-mail address if you want a summary of the main findings of this survey.

Name: ____________________

Postal address: ____________________

____

____

____

E-mail address: ____________________

Thank you for your co-operation.

ANNEXURE C

UNIVERSITY OF STELLENBOSCH

DEPARTMENT OF BUSINESS MANAGEMENT

QUESTIONNAIRE ON CELL CAPTIVE INSURANCE COMPANIES

Please note:

1. The information will be treated in the strictest confidence and in such a way that no cell captive insurance company can be recognised.
2. Please make a cross in the relevant blocks, where applicable.

A. General

1. Name of your cell captive insurance company. __________
2. Contact phone number. __________
3. Your position or job title. __________
4. How many years of experience do you have in captive insurance? __________ Years
5. How long does your cell captive insurance company exist? __________ Years
6. How many holding companies are involved in the ownership of your cell captive insurance company? __________ Number

B. Objectives to establish and to operate a cell captive insurance company

1. How important are the following objectives to form a cell captive insurance company?

(Not important =1; Little important = 2; Moderately important = 3; Highly important = 4; Extremely important = 5 where 1 - 5 form a continuum)

1. Obtaining financial benefits (e.g. cash flow improvement for holding company)	
2. Obtaining control	
3. Obtaining flexibility	
4. Obtaining commercial objectives (e.g. maximising of shareholders` value of the holding company)	
5. Other (please specify) __________	

____

____

2. Please indicate (by way of a cross) the single most important financial objective firstly to establish and secondly to operate a cell captive insurance company:

Objective:	**To establish**	**To operate**
Providing lower insurance costs		
Cash flow improvement		
Cost savings through the reinsurance market		
Tax minimization and deferral		
Protection from price fluctuations		
Other objective (please specify)		

3. Please indicate (by way of a cross) the single most important objective in terms of control firstly to establish and secondly to operate a cell captive insurance company:

Objective:	**To establish**	**To operate**
Control of underwriting of lines of business that are unrelated to the risks of the holding company		
Control of investments		
Control over claim settlement		
Other objective (please specify)		

4. Please indicate (by wat of a cross) the single most important objective in terms of flexibility firstly to establish and secondly to operate a cell captive insurance company:

Objective	**To establish**	**To operate**
Availability of coverage not otherwise available		
Access to the reinsurance market		
Regulatory flexibility of domiciles		
Other objective (please specify)		

5. Please indicate (by way of a cross) the single most important commercial objective firstly to establish and secondly to operate a cell captive insurance company:

Objective:	**To establish**	**To operate**
Risk retention levels set according to the needs of the holding company and the cell captive insurance company.		
Maximise shareholders` value of the holding company		
Strategic risk management		
Other objective (please specify)		

C. Factors which determine the decision of a holding company to establish and operate a cell captive insurance company.

1. Please indicate four of the following factors in order of their importance for the establishment of a cell captive insurance company. (only one cross per column)

Factors to **establish** a cell captive insurance company:	Most important factor	Second most important factor	Third most important factor	Fourth most important factor
1. Loss/premium ratio of holding company				
2. Financial commitment of holding company				
3. Spread of risk of holding company				
4. Loss control of holding company				
5. Management commitment of holding company				
6. Retention capacity of holding company				
7. Regulation by government				
8. Managerial competence of holding company				
9. Other factor (please specify)				

2. Please indicate four of the following factors in order of their importance for the operation of a cell captive insurance company. (only one cross per column)

Factors to **operate** a cell captive insurance company:	Most important factor	Second most important factor	Third most important factor	Fourth most important factor
1. Loss/premium ratio of holding company				
2. Financial commitment of holding company				
3. Spread of risk of holding company				
4. Loss control of holding company				
5. Management commitment of holding company				
6. Retention capacity of holding company				
7. Regulation by government				
8. Managerial competence of holding company				
9. Other factor (please specify)				

3.1 Do you see your cell captive insurance company as a long-term or a short-term alternative risk transfer mechanism for a holding company?

Short-term	
Long-term	

3.2 In your opinion, are cell captive insurance companies successful in reducing the risk exposure of the holding company/companies?

Yes	
No	

3.3 Do you think that cell captive insurance will become more important during the next five years?

Yes	
No	

3.4 Please motivate your answer to question 3.3 ______________________________

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____

____

4. Please provide your name, postal address and e-mail address if you want a summary of the main findings of this survey.

Name: ____

Postal address: ____

____

____

____

E-mail address: ____

Thank you for your co-operation.

ANNEXURE D

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