

# Captive Insurance Company Glossary

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# Captive Insurance Company Glossary

## Introduction

This glossary seeks to clarify some of the terms and jargon used in the captive insurance marketplace and in presentations at conferences on captive insurance companies. The intent is to provide a basic understanding of terms for those unfamiliar with the terminology and a common reference point for others engaged in more advanced areas of captive application and theory. In general, this glossary has a U.S. perspective and presents explanations rather than definitions. Words appearing in **boldface** type are defined elsewhere in the glossary.

This glossary is not comprehensive, but is consciously selective in its choice of the terms included. Some explanations are simplified, for instance, when they pertain to technical tax matters. Explanations involving tax cases were written at the time this edition was produced. Some of the terms include references to publications of Towers Watson, which serve as sources.

We intend for this glossary to be a work in progress and welcome your comments and input. We are especially interested in terms the reader did not find in the glossary that should be included in future editions.

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## A

### ACCREDITATION

If a state passes all the NAIC's model acts and otherwise passes muster, **commercial insurers** domiciled there will be acceptable security in other states.

### ADMITTED INSURER

An insurer licensed to do business in the state or country in which the insured **exposure** is located.

### ADMITTED REINSURER

A reinsurer licensed to do business in the state or country in which the insurer is located (an important consideration as far as taking credit for **reinsurance** is concerned).

### AGENCY CAPTIVE

A captive formed by an insurance agency to reinsure the risks of third parties (i.e., their insured clients) from the agent's chosen fronting insurer. Referred to loosely in the industry as a captive, but more aptly named an "agency-owned reinsurance company."

### AGGREGATE DEDUCTIBLE

The maximum amount the insured can pay as **deductibles** over a specified period of time, typically one year. Offers protection to the insured from a high frequency of losses; sometimes called "annual aggregate deductible."

### AGGREGATE LIMIT

The insurer's maximum liability for a series of losses over a specified period of time, typically one year. Sometimes called "annual aggregate limit."

### AGGREGATE STOP LOSS REINSURANCE

A type of **reinsurance** in which the reinsurer pays losses in excess of the **aggregate deductible** or **attachment point**. This kind of protection caps the annual aggregate loss of the captive or insurer, subject to the limit of coverage.

### AICPA

Abbreviation for the American Institute of CPAs. Unofficial rival of **FASB** (the Financial Accounting Standards Board), the AICPA promulgates rules telling its members how to interpret captive financial information. Since all auditors must belong to the AICPA, these pronouncements are important. See also **EITF**.

### ALIEN INSURER

An insurer domiciled in and licensed under the laws of a country outside a given jurisdiction. For example, from the U.S. perspective, a Bermuda insurer would be an "alien insurer."

### ALLOCATED LOSS ADJUSTMENT EXPENSE (ALAE)

Insurer's items of expense such as attorneys' fees, investigative fees, etc., that can be associated with a particular claim. See also **loss adjustment expenses**.

### ALTERNATIVE MINIMUM TAX (AMT) (simplified explanation)

Additional U.S. federal income tax payable by an insurance company whose **generally accepted accounting principles (GAAP)**, or statutory total, income is significantly more than its taxable income.

### AMERCO

One of three cases decided in January 1991 (see also **Harper** and **Sears**) in which premiums paid to wholly owned insurance companies were deemed deductible expenses. Substantial unrelated business, among other tests, was critical.

### ASSOCIATION CAPTIVE

A captive insurer having two or more owners, typically members of an industry trade association. Sometimes the association itself is the owner of the captive. This is a generic term for all types of **group-owned captives**.

### ATTACHMENT POINT

The point at which the reinsurer or excess insurer starts paying losses on a specific or **aggregate stop loss** basis.

### AUTHORIZED NON-ADMITTED REINSURER

An unlicensed reinsurer authorized to transact reinsurance in the state or country (having established a **trust fund** for security).

## B

### BRANCH PROFITS TAX (simplified explanation)

An additional tax of about 30% payable on dividend remittance by offshore captives that are found to be **engaged in trade or business**.

### BROTHER-SISTER RELATIONSHIP

A term that first emerged during the *Humana* tax case, referring to separate subsidiaries owned by the same parent (such as a captive insurance company and an operating subsidiary).

### BURNING COST

The theoretical amount of premium it would take to cover losses only.

## C

### CAPACITY

From a “micro” perspective, the total amount of coverage available for a given **exposure** from an insurer or reinsurer; from a “macro” perspective, the total amount of insurance/**reinsurance** available in the marketplace.

### CAPITAL

This all-purpose term means one of three different things:

- The amount initially needed to set up a captive or the initial amount paid in
- The total of this paid-in capital plus other forms of capital, such as **letters of credit**
- The sum of the two forms of capital (listed above) plus accumulated surplus

The difference between capital in a captive and other forms of insurance capital is that it is usually considered risk capital by the owners, ready to be used up by adverse results of the business.

### CAPTIVE INSURANCE COMPANY

A closely held insurance company whose insurance business is primarily supplied by and controlled by its owners, and in which the original insureds are the principal beneficiaries. A captive insurance company’s insureds have direct involvement and influence over the company’s major operations, including underwriting, claims management policy and investment.

### CAPTIVE INSURANCE COMPANY ASSOCIATION (CICA)

A trade association of captive insurers formed to provide networking opportunities that educate and support its members and interested parties about captives, regardless of domicile or business purpose.

### CAPTIVE INSURANCE COMPANY REPORTS (CICR)

International Risk Management Institute’s monthly newsletter, published in cooperation with Towers Watson, covering worldwide developments in the captive industry.

### CAPTIVE MANAGEMENT COMPANY

See **management company**.

### CEDANT (Ceding Insurer)

An insurer that cedes all or part of the insurance (i.e., risk and associated premium) it has written to a reinsurer.

### CEDING COMMISSION

Remuneration paid to the **ceding insurer**/reinsurer by the assuming reinsurer (either entity could be a captive), compensating the **cedant** for the various expenses (e.g., **underwriting**, business acquisition) that it incurs.

### CESSION

The transfer to a reinsurer of all or part of the insurance/**reinsurance** written by the **ceding** (or primary) insurer. Cession of reinsurance by reinsurers is called **retrocession**.

### CLAIMS-MADE POLICY

Provides coverage for claims filed during the policy period (or extended reporting period), provided the incident of loss occurred after the **retroactive date** specified in the policy. The **event** triggering coverage is usually not an accident or occurrence of an event, but rather the filing of a claim during the policy’s term or any applicable reporting period. In some cases, notification of an event is acceptable.

### CLAIMS-MADE REINSURANCE

Provides for **reinsurance** of **claims-made policy(ies)** or on a claims-made basis. Knowing which of these is applicable is important.

### CLAIMS-MADE TAIL

Liability for losses that have occurred but have not been reported to the insurer. See also **incurred but not reported (IBNR) losses**.

### COMMERCIAL INSURER (or Reinsurer)

Any insurer whose principal business is selling insurance to anyone who requests a quotation, not just shareholders of the insurer. The shareholders, not necessarily the insureds, benefit from the insurance profits. Compare this explanation to that given for **captive insurance company**.

### COMMISSION

Remuneration payable to insurance intermediaries or companies, based on a percentage of premium. There are other kinds of commissions, based on volume of business placed and/or a percentage of profits.

### COMMUTATION

Usually refers to the cancellation or dissolution of a **reinsurance** contract in which there are profits or losses to be allocated.

### CONFIDENCE INTERVALS (Levels)

Statistical concept expressing the degree of confidence that, for instance, total losses will be at or below a given amount in any specified time period, typically one year. The confidence level, or percentage, is interpreted as the long-run probability that the estimates will not be exceeded over many simulated estimate periods.

### CONTROLLED FOREIGN CORPORATION (CFC) (simplified explanation)

An offshore captive whose U.S. shareholders own more than 25% (50% for European companies) of voting control.

### CONVENTION BLANK

Report form developed by the **National Association of Insurance Commissioners (NAIC)** and required by some states for reporting annual captive financial results, most notably for **group-owned captives**.

### CONVERTED LOSSES

**Ratable losses** times a **loss conversion factor**.

### CREDIT LIFE CAPTIVE

A captive typically formed by a bank holding company, finance/mortgage company or auto dealership to underwrite **credit life insurance**.

### CREDIT LIFE INSURANCE

Insurance issued through a lender to cover payment of a loan, installment purchase or other obligation if the debtor dies prior to repayment. Coverage offered is term insurance for less than five years and generally decreases as the loan is repaid.

## D

### DEDUCTIBILITY

The issue of whether “premiums” paid to a captive may be deducted, for tax purposes, as an operating expense in the year payment is made. Premiums usually are not deductible for single-owner captives, but are for **group-owned captives**. Some tax cases won by individual taxpayers infuse hope and support into deductibility arguments. See **Amerco, Harper, Humana** and **Sears**.

### DEDUCTIBLE

The amount of first-dollar loss that the insured retains, on either a per occurrence (specific) or annual aggregate basis, before the primary layer of insurance coverage responds.

### DEDUCTIBLE BUYBACK

Using a captive to fund some or all of an entity's **deductible** — the most common use for single-owner captives.

### DISCOUNTED LOSS RESERVES

An estimate of the amount of **ultimate loss** reserves, discounted to present value to reflect anticipated future investment income. Since 1987, loss reserves must be discounted for calculating U.S. federal income tax for insurance companies. For GAAP purposes, use of discounting is mixed. See **Tax Reform Act**.

### DIVIDENDS

There are two kinds of dividends in the captive arena:

*Policyholder dividends:* These are paid back through the insurance premium process to the insureds. They are before-tax expenses for the captive.

*Shareholder dividends:* These are paid to the captive's shareholders after tax (and are then taxed again to the shareholder).

## DOMESTIC INSURER

An insurer that is formed under the laws of and admitted by the state or country in which the insured **exposure** is located.

## DOMICILE

The state or country under whose laws the insurer is licensed. Captive insurance companies usually operate in their state or country of domicile and are managed there.

# E

## EARNED PREMIUM

That portion of premium written by a captive that it has the right to take into income, or earn, over an accounting period, calculated on the basis of the expired portion of the time for which the coverage is in effect.

## EITF

The abbreviation of the Emerging Issues Task Force of the **AICPA**. The EITF puts out advance warning of new interpretations of accounting practices and calls for discussion and commentary.

## ELECTION (simplified explanation)

The opportunity for an offshore captive to pay U.S. income taxes directly rather than have the tax burden fall on its shareholders.

## ENGAGED IN TRADE OR BUSINESS (ETB) (simplified explanation)

A U.S. income tax term referring to an offshore captive whose business is really being run from onshore, in which case it is ETB and fully taxable in the U.S.

## EVENT

An occurrence that may or may not become a claim. Some **claims-made** coverages allow for reporting of events.

## EXCESS INSURANCE

Coverage provided above the primary policy's limit or the insured's **self-insured retention (SIR)**; typically provides coverage similar to the **primary insurance (layer)**.

## EXCESS OF LOSS REINSURANCE

Coverage provided to the **ceding insurer** (e.g., a captive) for losses that exceed a stated per-claim retained limit or **attachment point**.

## EXCESS/SURPLUS LINES INSURANCE

Business placed in non-admitted markets on an unregulated basis in accordance with the excess or surplus lines provisions of state insurance law, by licensed brokers. Captives sometimes qualify as E&S companies. Local premium taxes are payable by the broker.

## EXPENSE RATIO

Total expenses divided by **net written premiums**. Total expenses include the costs of acquiring, writing and servicing the insurance policy(ies), but not losses or **reinsurance**.

## EXPERIENCE RATING

A type of cost-plus method of rating insurance, in which the final cost is largely a function of the insured's losses, or "experience," with the balance of the cost attributable to insurer expenses.

## EXPOSURE (Exposure Base)

A measure of the propensity for risk to loss that can be expressed as units, such as units of assets, revenues, payroll, occupied hospital beds, etc. Sometimes referred to as an "exposure base," this base is used in conjunction with loss costs to develop a **pure premium**.

# F

## FACULTATIVE REINSURANCE

**Reinsurance** of individual risks on a case-by-case basis.

## FAS 5

Standards for recording for loss contingencies. Financial Accounting Statement (FAS) 5 prevents captives from setting up catastrophe or equalization reserves (i.e., accruals for unspecified business risks).

## FAS 113

Standards for accounting for reinsurance. FAS 113 requires reinsurance receivables and prepaid reinsurance premiums be reported as assets. Transfer of risk is required in reinsurance transactions to meet the conditions for reinsurance accounting.

## FAS 115

Standards for evaluating assets. FAS 115 requires (a captive's) investments in equity and/or debt securities to be classified and accounted for into three categories (held-to-maturity, trading securities or available-for-sale securities).

## FASB

The Financial Accounting Standards Board. Establishes standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

## FEASIBILITY STUDY (for captives)

A comprehensive analysis of the potential or continued viability of a captive insurance company. Involves the use of **financial modeling**, business plans and comparison to other alternatives.

## FEDERAL EXCISE TAX

A tax imposed on premium payments to offshore (re)insurers; 4% on direct premiums and 1% on **reinsurance** premiums. It can be eliminated if the captive:

1. Makes an **election** to be taxed as a U.S. corporation
2. If the transaction is not really insurance (i.e., not claiming premium deductibility) but argued to be a transfer of self-insurance reserves

## FEES

Fixed cost charges, as compared to percentage charges (called **commissions**). Captives seek to pay fee-based charges but then express the total as a percentage of premium.

## FINANCIAL MODELING

This involves the generation of pro forma financial statements over a multiyear period created under various loss and financial scenarios.

## FINANCIAL REINSURANCE

A **reinsurance** contract where investment income is usually reflected in the pricing and where there is an **aggregate limit** on the risk transferred. Often the contract is for multiple years, and the price is based on the present value of expected future losses at an aggregate limit. However, in recent years, these contracts have been written with additional risk elements.

## FOREIGN INSURER (from the U.S. perspective)

A U.S. domiciled insurer, domiciled in a state different from the one in which the insured **exposure** is located.

## FRONTING (Front)

An insurer serving as the front, for a predetermined price, will issue a policy written on its paper to cover a risk, sometimes only insuring a (small) percentage of it and reinsuring the majority or all of the risk to a captive. For example, fronting is used when captive insureds need evidence of insurance from a recognized insurer. Usually, the front also provides insurance services on behalf of the captive.

## FUNDED SELF-INSURANCE

A more formalized approach to self-insurance involving the creation of an earmarked asset account to match loss reserves. Distinguished from “unfunded” or “pay as you go” self-insurance.

## G

### GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Uniform method of procedures and concepts that have been developed, by general consensus of the accounting profession, to assist in the preparation of various financial statements. This method of accounting is intended to recognize income as it is earned. Compare to **statutory accounting principles (SAP)**.

### GROSS WRITTEN PREMIUM

The premium(s) paid by the original insured(s). Also referred to as **original gross premium**.

### GROUP-OWNED CAPTIVE

A captive insurance company with more than one owner. See also **association captive**.

### GUARANTEED COST PREMIUM

A self-descriptive term. Premium is determined prospectively, locking in the cost for the policy period. The only way the premium can generally change is upon audit of the underlying **exposure**.

## H

### HARPER

One of three cases decided in January 1991 (see also **Amerco** and **Sears**) in which premiums paid to wholly owned insurance companies were deemed deductible expenses. Substantial unrelated business, among other tests, was critical.

## HUMANA

A 1989 tax case won by taxpayers establishing **deductibility** of premiums paid by or for brother-sister subsidiaries to a captive insurance subsidiary. Parent premiums, however, were still not deemed deductible.

## I

### INCURRED BUT NOT REPORTED (IBNR) LOSSES

Losses that have occurred but have not been reported to the insurer as of a particular date, sometimes referred to as “pure IBNR.” Pure IBNR is analogous to **claims-made tail**. The definition of IBNR is often expanded to include future development on case reserves and loss on reopened claims, sometimes referred to as RBNE (reserved but not enough). The amount of IBNR is typically estimated by a casualty actuary.

### INCURRED LOSSES

Losses that occur during a given time period, whether or not adjusted or paid during that period. Reported incurred losses exclude **IBNR**, while ultimate incurred losses include IBNR.

### INDUSTRIAL INSURED

An insurance buyer whose premiums are large and who employs a risk or insurance manager. The industrial insured is to insurance commissioners what the “sophisticated investor” is to the Securities and Exchange Commission.

## L

### LETTER OF CREDIT (LOC)

A financial guarantee issued by a bank that ensures that funds will be available if requested. For captives, LOCs serve two possible purposes: (1) they may be used in lieu of or in addition to cash or other securities as **capital**, and/or (2) to securitize the **fronting** insurer’s reinsurance receivable created by a **non-admitted reinsurer** (i.e., the captive).

### LIABILITY RISK RETENTION ACT

Federal legislation in the U.S. authorizing the formation of **risk retention groups** and **purchasing groups**. These groups can be used to write all liability coverages except workers compensation and personal risk liability, but must be located onshore and cannot include any ownership interest other than that of their insureds.

## LIMITED LOSSES

An amount of losses whereby the size of a claim of a specific occurrence is limited to a particular value, for example, \$500,000. See also **retention**.

### LOSS ADJUSTMENT EXPENSES (LAE)

Additional costs incurred to settle claims, such as legal fees, experts and research. LAE includes both **allocated loss adjustment** expense and **unallocated loss adjustment expense**.

### LOSS CONVERSION FACTOR

In **retrospective rating**, the percentage applied to **ratable losses** to provide for **unallocated loss adjustment expenses**.

### LOSS DEVELOPMENT

The increase in losses reflecting discrepancies and/or trends between loss amounts initially reported at subsequent evaluation dates and at ultimate disposition.

### LOSS RATIO (Ultimate)

**Ultimate losses** as a percentage of **earned premiums**.

### LOSS RESERVE

An insurer’s estimate of its liability (including **LAE**) for all unpaid claims that have occurred as of a given date. This estimate includes not only losses due but not yet paid, but also **incurred but not reported (IBNR) losses**.

## M

### MALONE & HYDE

A tax case lost by taxpayers after several appeals, rejecting **deductibility** of premiums paid to a single-owner captive due to parental guarantees, among other items.

### MANAGEMENT COMPANY

A firm in the captive **domicile** specializing in accounting and other related services for captive insurance companies, usually serving as the captive’s principal representative in the domicile. The management company usually handles all necessary filings and recordkeeping, and also deals with other captive service providers, such as auditors, actuaries, investment advisors and visiting insureds.

### MAXIMUM FORESEEABLE LOSS (MFL)

The worst loss that is likely to occur because of a single **event**. Also referred to as “probable maximum loss” (PML).

### MAXIMUM POSSIBLE LOSS (MPL)

The worst loss that could possibly happen because of a single **event**.

### MEMBERSHIP ACCOUNTING

**Financial modeling** for each captive participant, showing past history, status of the individual account, and liquidation value (i.e., what each would get if the captive were to be liquidated). Also used to show effect of future losses, future profits and future **dividend** strategies.

### MUTUAL INSURANCE COMPANY (Mutual)

An insurer whose policyholders are its owners. A mutual does not have **capital**, but it does have “initial contributed surplus,” which amounts to the same thing.

## N

### NAIC

The National Association of Insurance Commissioners. Traditionally anti-captive and anti-fronting, the NAIC’s Model Acts, which suggest or require states become **accredited**, can be a cause of concern to captive owners.

### NET WRITTEN PREMIUM

**Written premium** less deductions for **commissions** and ceded **reinsurance**. The premium that is received by a captive.

### NON-ADMITTED INSURER

An insurer not licensed to do business in the state in which the insured **exposure** is located.

## O

### OCCURRENCE POLICY

A policy covering claims that arise out of an **event** that took place during the policy period, regardless of when a claim is made.

### ODECO

A tax case won by the taxpayers on the basis of unrelated business, which ultimately sank the captive.

### OFFSHORE CAPTIVE

From the U.S. perspective, a captive domiciled outside the U.S.

### ONSHORE CAPTIVE

From the U.S. perspective, a captive domiciled in a U.S. state or territory.

### ORIGINAL GROSS PREMIUM

The total premium paid prior to any deduction for **commissions**, taxes or other expenses.

## P

### PAID LOSSES

Portion of **incurred losses** actually paid out by the insurer.

### PASSIVE FOREIGN INVESTMENT COMPANY (PFIC) (simplified explanation)

An offshore company whose income is more than 50% passive investment income or 75% of whose assets produce such passive investment income. If an offshore captive is deemed to be a PFIC, the tax burden on its owners will increase substantially.

### PAYOUT PATTERN

The assumed timing of the payments of losses. Varies by line of insurance.

### PER-LOSS DEDUCTIBLE

Specifies the amount of first-dollar loss paid by the insured for each loss.

### POOL

A collection of insurance underwriters with prespecified guidelines by which premiums, losses and expenses are shared equally among insurers and/or reinsurers.

### PORTFOLIO TRANSFER

Sending some or all of the captive’s liabilities and enough assets to cover them to a willing reinsurer, sometimes to a related captive. A form of **financial reinsurance**.

### PRIMARY INSURANCE (Layer)

The first layer of coverage. Coverage is provided for the first dollar of loss (exclusive of any **deductibles**) up to the primary policy’s limit.

## PROPORTIONAL/PRO RATA REINSURANCE

A catch-all term for all types of **quota share** and **surplus reinsurance**, in which the reinsurer shares proportionally the losses and premiums with the **ceding insurer**.

## PROSPECTIVE AGGREGATE COVERS

**Reinsurance** cover for a specified maximum amount of loss coverage (capping the reinsurer's risk) for a future period. The premium charged by the reinsurer reflects the present value of the **aggregate limit** of losses and an assumed loss **payout pattern**. See **financial reinsurance**.

## PROTECTED CELL COMPANY (PCC)

A PCC is a single legal entity that operates segregated accounts, or cells, each of which is legally protected from the liabilities of the company's other accounts. An individual client's account is insulated from the gains and losses of other accounts, such that the PCC sponsor and each client are protected against liquidation activities by creditors in the event of insolvency of another client. Many **domiciles** have enacted legislation enabling the formation of PCCs (e.g., Guernsey) or other similar structures (e.g., segregated account companies in Bermuda and segregated portfolio companies in the Cayman Islands).

## PURCHASING GROUP

A collection of two or more individuals/groups banding together with the purpose of purchasing liability insurance and gaining benefits available to groups (discounts). Each individual/group has its own policy and does not share the risk with other group members. Purchasing groups were made possible by the **Liability Risk Retention Act** and may only be insured by onshore licensed insurers.

## PURE CAPTIVE

A **captive insurance company** with one corporate owner, insuring principally only the risks of the parent organization or its subsidiaries. Also called a **single-parent captive**.

## PURE PREMIUM

The portion of the total premium that is needed to pay expected losses and **allocated loss adjustment expense (ALAE)**.

# Q

## QUOTA SHARE REINSURANCE

**Reinsurance** involving pro rata sharing of premium (less an expense allowance) and losses between the reinsurer and **ceding insurer**, based on the percentage agreed upon in the arrangement.

# R

## RATABLE LOSSES

The insured's **incurred loss** dollars, including all losses paid and outstanding, subject to a maximum per-loss amount or loss limitation.

## RECIPROCAL INSURANCE

A system of protection against loss whereby individuals or entities undertake to indemnify each other against specified kinds of losses via a mutual exchange of insurance contracts.

## RECIPROCAL INSURER

An unincorporated association (or "exchange") facilitating an exchange of insurance contracts, managed by an attorney-in-fact. Analogous to the insurance company in a stock or mutual format.

## REINSURANCE

Insurance in which one insurer, the reinsurer, assumes all or part of the **exposures** covered by another insurer. A captive buys reinsurance from (or cedes it to) the reinsurer, who assumes it. A captive may reinsure, or assume reinsurance from, a fronting company. The captive may also be assuming reinsurance from other captives or **pools**. The use of the same term, reinsurance, for "inward" and "outward" transactions is a common cause of confusion.

## RELATED PERSON INSURANCE INCOME (RPII) (simplified explanation)

Premium income to an offshore insurance company from policies issued to shareholders of the company. RPII (pronounced "rippy") is a complicated subject. One of its aspects worth looking into is that if less than 20% of a captive's income is RPII, U.S. federal income tax treatment is more favorable.

### RENT-A-CAPTIVE

An insurer or **reinsurer** that rents its **capital, surplus** and legal capacity to client users. The sponsor, not the policyholder, controls the rent-a-captive and usually provides administrative services, reinsurance, and/or an **admitted fronting insurer**. The insured's **underwriting** account is typically segregated from the other insureds of this entity. This segregation can be achieved by words, through accounting procedures or statutorily. See also **protected cell company**.

### REPORTED LOSSES

Paid losses plus case reserves. Excludes **incurred but not reported losses (IBNR)**.

### RETENTION

1. A method of financing an organization's losses through the use of **self-insurance**, deductibles or non-insurance agreements. This can be active/intentional or passive/unintentional
2. The amount of each loss retained by an insurer or reinsurer
3. In some life and benefits business, an amount (usually expressed as a percentage) "retained" by the servicing insurer

### RETROACTIVE DATE

When pertaining to claims-made coverage, that date prior to which incidents that occur cannot be brought as claims against a **claims-made policy**.

### RETROCEDANT

A reinsurer placing further **reinsurance (retrocession)** of an **exposure** to loss.

### RETROCESSION

The **reinsurance** of reinsurance.

### RETROCESSIONAIRE

A reinsurer of a reinsurer.

### RETROSPECTIVE RATING

A loss-sensitive plan using a rating mechanism based on losses incurred or paid. The ultimate amount of the premium is determined after all losses have been evaluated; these evaluations are made annually after the close of the policy period. Ultimate costs are based on actual losses, perhaps limited to some level, plus program expenses.

### RISK-BASED CAPITAL

Capital requirements, based on a complex formula promulgated by the NAIC, that are necessary to meet regulatory thresholds. Calculation reflects underwriting risk, investment risk and credit risk. Does not apply to offshore captives, though can be used as a benchmark.

### RISK DISTRIBUTION

A term used in tax-**deductibility** discussions. If there are enough individual **exposures** insured by the captive, one can argue that there is risk distribution. Taxpayers and the IRS may have very different interpretations of risk distribution.

### RISK FACTOR

As used in **Towers Watson Recognized and Accepted Captive Standards**, the ratio of the maximum per loss risk retained by a captive to **capital** and **surplus**. It provides a gauge of the potential effect of a maximum loss from a single event.

### RISK RETENTION GROUP (RRG)

An insurer formed under the laws of any U.S. state, whose primary activity is assuming and spreading all liability coverages except workers compensation and personal risk liability (for example, private passenger auto). An RRG must be owned by its policyholders, and its policyholders must be insured by the group. An RRG must be licensed as an insurer under the laws of a state, and is subject to regulation under that state's laws.

### RISK SHIFTING

A term used in tax-**deductibility** discussions. If the insured transfers the risk of loss to an unrelated entity or, potentially, off its balance sheet to a related sister organization, this is said to be risk shifting.

## S

### SEARS

One of three cases decided in January 1991 (see also **Amerco** and **Harper**) in which premiums paid to wholly owned insurance companies were deemed deductible expenses. Substantial unrelated business, among other tests, was critical.

### SELF-INSURANCE

A system in which a company sets up a **loss reserve** account and, depending on whether the account is **funded** or **unfunded**, may segregate an asset account to match the reserve. Self-insurance is often confused with non-insurance, which is simply waiting for a loss to occur without any funding or accounting measures.

### SELF-INSURED RETENTION (SIR)

The amount of each loss the insured pays out of pocket before the insurer participates in a loss. Similar to a **deductible**, SIR is a term usually used in liability or casualty insurance, where the insured may wish to exert greater influence on the handling of a claim. See also **retention**.

### SELF-PROCUREMENT TAXES

State-imposed premium taxes of up to 4% on premiums paid to most captives. Owners and advisors find many ways to avoid paying them.

### SINGLE-PARENT CAPTIVE

A captive with one shareholder, also referred to as “pure captive.” There are far more of these than **group-owned captives**.

### SOLVENCY RATIO

A statutory solvency measure. Commonly used ratios include premium to surplus and reserve to surplus.

### STATUTORY ACCOUNTING PRINCIPLES (SAP)

Accounting rules prescribed or permitted by state law or regulatory authorities for use by insurance companies, the general focus of which is on solvency and liquidity. SAP differs from **generally accepted accounting principles (GAAP)** in several key areas, including non-admitted assets, unauthorized reinsurance, excess loss reserves, prepaid expenses, deferred federal income taxes, business combinations and consolidated financial statements, and premium deficiency.

### STOCK INSURER

Widely held **commercial insurer** whose owners are not necessarily policyholders.

### STOP LOSS REINSURANCE

An agreement whereby a reinsurer assumes, on a per-loss basis, all loss amounts of the reinsured, subject to the policy limit, in excess of a stated amount. Not to be confused with **aggregate stop loss** reinsurance. See also **excess of loss reinsurance**.

### SUBPART F INCOME (simplified explanation)

A definition of income in the U.S. Tax Code as **underwriting** and investment income earned by an offshore insurer/reinsurer writing primarily U.S. risks. The definition has been extended to almost all the income earned by offshore insurers/reinsurers, even if not strictly on U.S. risks.

### SUBSCRIBER

A party entering into the **reciprocal** agreements of indemnity who becomes both an insured and insurer.

### SUBSCRIBERS' ADVISORY COMMITTEE

The governing body of a reciprocal insurer. Analogous to a board of directors.

### SURETY BOND

A third-party agreement involving a principal that undertakes to perform its contractual obligations, an obligor(s) and a surety that will compensate the other party(ies) in the event that the principal fails to perform. Surety bonds can sometimes be used as security in lieu of **letters of credit** or cash.

### SURPLUS

The amount by which assets exceed liabilities. This is an important denominator in several statutory ratios, with various figures being compared to surplus amounts. Can include or exclude **capital**.

### SURPLUS LINES

See **excess/surplus lines**.

### SURPLUS NOTES

Evidence of a loan to a captive for the purpose of getting additional **capital** into the captive. The loans have to be repaid, but without calling it debt.

### SURPLUS REINSURANCE

**Reinsurance** of amounts in excess of the **cedant's** retained limit, in which premiums and losses are shared proportionally between the insurer and the reinsurer.

## T

### TAIL

Actuarial estimation of unreported losses. See also **claims-made tail** and **incurred but not reported (IBNR) losses**.

### TAX REFORM ACT (simplified explanation)

Legislation (1986) that required all insurers, captives included, to change the way their taxable income was computed, such as computing reserves on a discounted basis.

### TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988 (TAMRA) (simplified explanation)

Of interest to captive owners for its sections on tax treaties with Barbados and Bermuda, and the **elections** for offshore captives to be taxed as U.S. domestic corporations.

### TOWERS WATSON RECOGNIZED AND ACCEPTED CAPTIVE STANDARDS (TRACS)

Financial guidelines for captives developed by Towers Watson in a monograph by the same name.

### TREATY REINSURANCE

A predetermined arrangement whereby the **ceding insurer** automatically cedes certain designated types of insured **exposure** to the assuming reinsurer abiding by the terms of the **reinsurance** contract (treaty), without the assuming reinsurer evaluating each exposure on a case-by-case basis.

### TRUST FUND

In captive parlance, an onshore guarantee fund using assets of the captive. It is used to gain admission onto the **NAIC** approved list or to replace a **letter of credit** in certain **fronting** reinsurance arrangements. For another use of this term, a trust fund is a formalized self-insurance vehicle that operates pursuant to its governing trust document. A trust fund is often used as an alternative to a captive for more narrowly defined business purposes and risk funding.

## U

### ULTIMATE LOSS

The total sum the insured, its insurer(s) and/or reinsurer(s) pay for a fully developed loss (i.e., paid losses plus outstanding **reported losses** and **incurred but not reported [IBNR] losses**). It may not be possible to know the exact value of **ultimate losses** for a long time after the end of a policy period. Actuaries are employed to assist with these projections for purposes of **financial modeling** and/or year-end reserve determinations.

### UMBRELLA POLICY

A liability coverage designed to provide an excess layer of limits (usually in amounts of at least \$5 million), typically over a firm's primary commercial general liability, auto liability and employer's liability policies. Coverage is provided for those same **exposures** covered in the underlying policies, subject to the same exclusions if it is "following form." In addition, the umbrella usually provides broader coverage than the underlying policies, with an SIR (often \$10,000 or more) that applies to losses that are covered under the umbrella, but not covered by the primary policies.

### UNALLOCATED LOSS ADJUSTMENT EXPENSE (ULAE)

Insurers' expense items, such as salaries and overhead costs, that are not assigned to the expense for a particular claim. See also **loss adjustment expense**.

### UNBUNDLED COSTS

The separation of the services (e.g., claims administration) and charges ancillary to the purchase of insurance that are typically lumped together with the purchase of insurance. Often, these services can be obtained from an organization separate from the insurer, sometimes at an overall savings to the program.

### UNDERWRITING

The process of determining whether to accept a risk and, if so, what amount of insurance the company will write on the acceptable risk and at what rate. Underwriters are companies, individuals or insurance companies that carry on this critical activity for their own account or for the account of others.

## UNEARNED PREMIUM

That portion of the premium equal to the unexpired portion of the period for which the total premium has been paid. It equals the **gross written premium** less the **earned premium**. Reserves for **unearned premiums** are considered liabilities for insurance accounting purposes and must be discounted for U.S. income tax purposes.

## UNFUNDED SELF-INSURANCE

A system in which a company creates a “paper” reserve figure. It does not specifically segregate funds to match the reserve it has set, but uses the money for other purposes.

## UNRELATED BUSINESS

The insuring of risks not related to those of the captive owner(s).

# W

## WAREHOUSING

A service provided by a **fronting** insurer typically at the start up of a captive. As part of this service, the front starts to receive premiums that should be reinsured to a captive. However, the captive isn't ready, as yet, to receive the premiums.

## WORKING LAYER

That layer of **excess insurance** in which loss frequency is expected. **Retrospective rating** is often used to price this layer.

## WRITTEN PREMIUM

Total amount of premium charges in a particular period for all policies the insurer “writes.” Differences between **earned premium** and written premium arise because written premium is booked immediately, whereas earned premium is booked proportionally over the policy's duration.

## About Towers Watson's Captive Consulting Practice

Towers Watson is a recognized leader in the captive consulting arena, as evidenced by:

- Our ongoing relationship with many of the 300-plus clients we assist on captive-related matters
- Our dedication to and education initiatives within the captive marketplace through sponsorship of major conferences and workshops on captives worldwide, as well as our contributions to captive-focused publications (e.g., Captive Insurance Company Reports, Towers Watson Recognized and Accepted Captive Standards, and this glossary)

Typical captive consulting services include, among others:

- Feasibility determination
- Rate and reserve analysis
- Strategic planning
- Financial modeling
- Client satisfaction measurement
- Retention and surplus analysis
- Reinsurance review/design/placement
- New product development

## About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.