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Insurance via 'Captives': Not as Sinister as It Sounds

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Smaller companies are increasingly copying a method to control insurance costs that used to be the domain mainly of large businesses: setting up insurance firms to provide coverage when they think outside insurers are charging too much.

After a string of catastrophes in recent years -- the terror attacks in the U.S. in 2001 and London in 2005, as well as Hurricane Katrina in 2005 -- a number of small and midsize public companies are putting more thought into how to get the most insurance protection at the best costs.

Often, they are starting what the insurance industry calls "a captive insurance company" -- an insurer founded to write coverage for the company, companies, or people who founded it.

The Procedure

Here's how a captive insurer typically works. The parent creates a captive so that it has a self-funded option for buying insurance, whereby the parent provides the reserves to back the policies. The company then either retains that risk or pays reinsurers -- companies that backstop insurers -- to take it. The price for coverage is set by the parent, though reinsurance costs, if any, play a factor.

In the event of a disaster, the company pays claims from its captive, or the reinsurer pays the captive.

Captives are overseen by corporate boards and, to keep costs low, are often based in places where there is favorable tax treatment and less onerous regulation -- like Bermuda and the Cayman Islands, as well as U.S. states like Vermont and South Carolina. British companies often favor Guernsey and the Isle of Man, according to insurance brokerage Marsh Inc., a unit of Marsh & McLennan Cos.

Companies with deep pockets like International Business Machines Corp., Diageo PLC and Exxon Mobil Corp. have used captive insurers for years. Captives are particularly useful for writing insurance to cover specialized risks where a company has as much experience as an insurance underwriter.

Nearly 5,000 Launched

Now there are nearly 5,000 captive insurers world-wide, according to Marsh. Captives collect about 8% -- or more than \$38 billion -- of the world's commercial insurance premiums, according to the Insurance Information Institute, an industry trade group in New York.

In the U.K., demand is growing fastest outside the country's 100 biggest firms, Marsh found. Marsh manages captive firms for clients. "More companies are seeing a captive insurer as a worthwhile tool to have over the long term for instances when insurance prices are too high," says Jonathan Groves, head of Marsh's captive insurance consulting group in London.

U.K. bus and train operator Arriva PLC, which has a £1.48 billion (\$2.91 billion) market value and 15,000 buses on the road in nine European countries each day, began self-insuring motor and liability coverage last year. It founded Arriva Insurance Co. in late 2005 in Gibraltar after quotes for motor and liability coverage from big insurance companies struck it as pricey and not reflective of its safety record, says David Evans, part of Arriva's risk-management team.

The company buys about 75% of its motor and liability coverage from its own insurer and says it saved 10% on premiums last year.

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