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Risk Management | April 25, 2013 | CFO.com | US

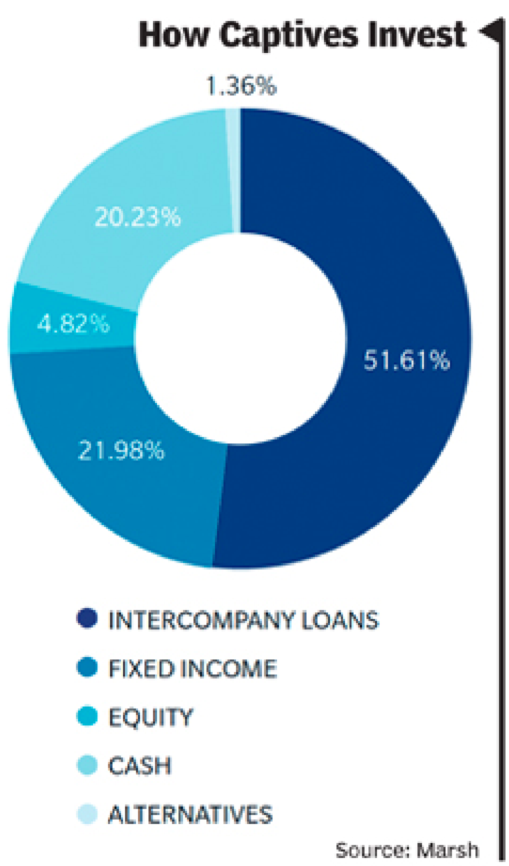
Companies Grabbing Cash from Captives

More than half of the investments made by captive insurance corporations consist of loans to their parent companies, according to a new report.
David M. Katz

Driven by a hunger for liquidity that's persisted since the financial crisis, companies are borrowing more than half of the investment funds of their captive insurance companies, according to a captive benchmarking report released by Marsh, the insurance broker, earlier this week.

The "intercompany" borrowing marks a big shift "since the economic downturn of 2008, when captives were heavily invested in equities," according to the report, which was released at the Risk and Insurance Management Society Conference. (The widely used term "intercompany" is in this case a misnomer, since it refers to transactions between a parent company and its self-owned captive insurance company, which may be better referred to as "intra-company" dealings.)

The report, which was based on the activities of 886 captive insurance companies managed by Marsh, found that about 52 percent of their aggregate investment consisted of intercompany loans, followed by 22 percent in equities and 20 percent in cash.

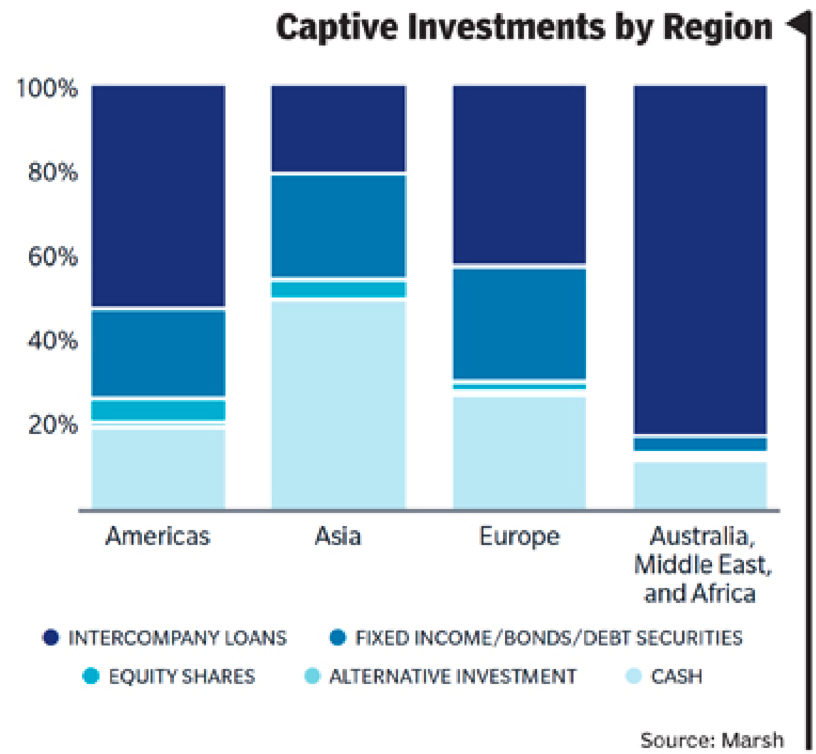


Like traditional insurers, captives amass large amounts of investible cash in reserve for potential losses by the insured. Among captives owned by North and South American corporations — by far the largest contingent of the Marsh-managed captives — total investments amount to about $90 billion, with a 4 percent yield.

The predominance of captive intercompany investments in the parent entity or in corporate affiliates stems mainly from companies' desire for a lower cost of capital and wish to boost liquidity, according to the report. These investments are classified as "demand loans, securitized loans, factored accounts receivables, notes and other financing secured by assets such as fleets, inventory and other assets," according to the authors of the report.

Could such investments attract the attention of regulators, to whom such transactions might seem to be a form of self-dealing? "Most captive regulators are comfortable" with them, said Arthur Koritzinsky, Marsh's North American captive advisory leader, answering a question by *CFO* at the press briefing. That's especially true since a state or offshore captive regulator will have had to approve an intercompany loan in the first place, he noted.

The only time a loan by a captive to a parent company might become an issue is during an Internal Revenue Service audit, according to Koritzinsky. Ideally, "if you were going to set up a captive, you wouldn't set up one [to offer] intercompany loans" if favorable tax treatment was your only objective in forming the captive, he said.



But structuring a captive involves a "balancing of factors" that include more than just taxation, according to the broker. Besides gaining favorable tax treatment for financing corporate risks, corporations have traditionally formed captives to supply coverage that conventional insurers won't provide. Captives also offer cheaper prices and give the parent company better control of its insurance costs.

In that context, company executives should weigh the advantages of borrowing from a captive against those of providing "the best set of facts from a tax perspective," Koritzinsky said.