

Captive Insurance in Russia: Current State and Prospects for Further Development

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Abstract-This study focuses on the economic relations that occur in the process of designing strategies for captive insurance companies. In Russia, captive insurance forms appeared comparatively recently, mostly in financial and banking groups: it was in this period that the largest insurers were set up, such as *Renessans-strakhovanie*, *Sberbank-strakhovanie* and *VTB-strakhovanie*. Negative macroeconomic factors have rendered captive insurance ineffective, which means that in order to retain their position on the market and develop, captives need considerable structural transformations. The objective, subject matter and the focus of this study were determined by the high theoretical and practical relevance of captive insurance research. **Research objective:** to design an adaptive development strategy for a captive insurance company by taking into account the factors that shape the development of captive structures on the Russian market. **The methodological framework of this study** is based on the graphic, statistical, and economic-mathematical methods of data processing. **Main results:** 1. This study provides a systematized classification of captive insurance companies highlighting the key features captives should retain in order to preserve the corporate structure in the modernizing insurance market; 2. The model of combined risk insurance for an industry and financial group (IFG) is proposed; 3. A mechanism of shifting risk to an external reinsurer is described. **Main conclusions:** 1. A comprehensive description of the captive reinsurance mechanism based on risk shifting is described; 2. The authors hypothesize that the structure of captives should be optimized.

Keywords-*captive insurance companies, industry and financial groups, redistribution of risk*

I. INTRODUCTION – RESEARCH OBJECTIVE AND ITS SIGNIFICANCE

The main function of insurance is solidary distribution of losses among all the insureds. Risk redistribution includes forming a consolidated insurance fund from the premiums paid by policy-holders. This fund is used to pay compensations to insureds upon occurrence of the agreed insured event. In the majority of cases, this mechanism may be applied to an unlimited number of persons but there are insurance companies that serve a limited number of persons

affiliated with its owner. There is a view that captive insurance companies now include insurers owned by several parent companies, for example, partnerships, associations and unions. Eventually experts have come to the conclusion that captives not only serve parent companies' insurance-related interests but also their economic interests, for instance, financial interests and investment interests. The majority of large Russian insurers are of corporate origin because the principles of their operation correspond to those of captive insurance.

II. THEORETICAL FRAMEWORK AND METHODOLOGY

A 'classic' captive insurance company is created by the parent of an affiliated group of companies (an industry and financial group (IFG)) to insure risks of the parent company and its subsidiaries. This kind of insurance resembles self-insurance, which has one significant drawback – there is no risk redistribution as the losses will be covered by the IFG itself.

Some Russian and international experts classify captive insurance as one of the forms of insurance protection [2, 5, 7, 15]. Captive insurance is transformed into an investment mechanism, which is attractive as a direct investment, in the hedge fund format or in the form of reputation insurance, which is, however, rarely used in Russia [16].

From the perspective of a parent as an independent economic entity, the difference between these functions of a captive is marginal (see Fig.1).

Figure 1 illustrates how an insurance fund is established outside the parent company by creating a separate economic entity – an insurance company. Pursuant to the insurance contract, the policy-holder shifts risk to the insurance company in exchange for a fixed premium and if the insured event occurs, receives compensation. In the case of an IFG-owned insurance company, captive insurance is a form of self-insurance [9]. The IFG establishes insurance funds within the captive and these funds are later used to cover the losses if an insured event occurs (see Fig.2).

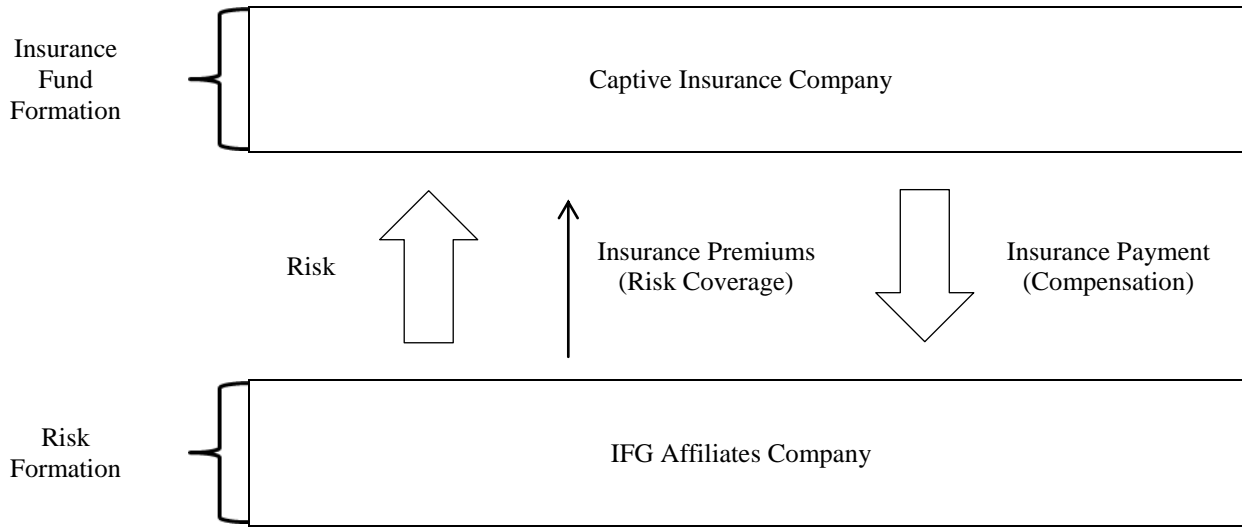


Figure 1. Risk insurance provided by an IFG-owned captive.

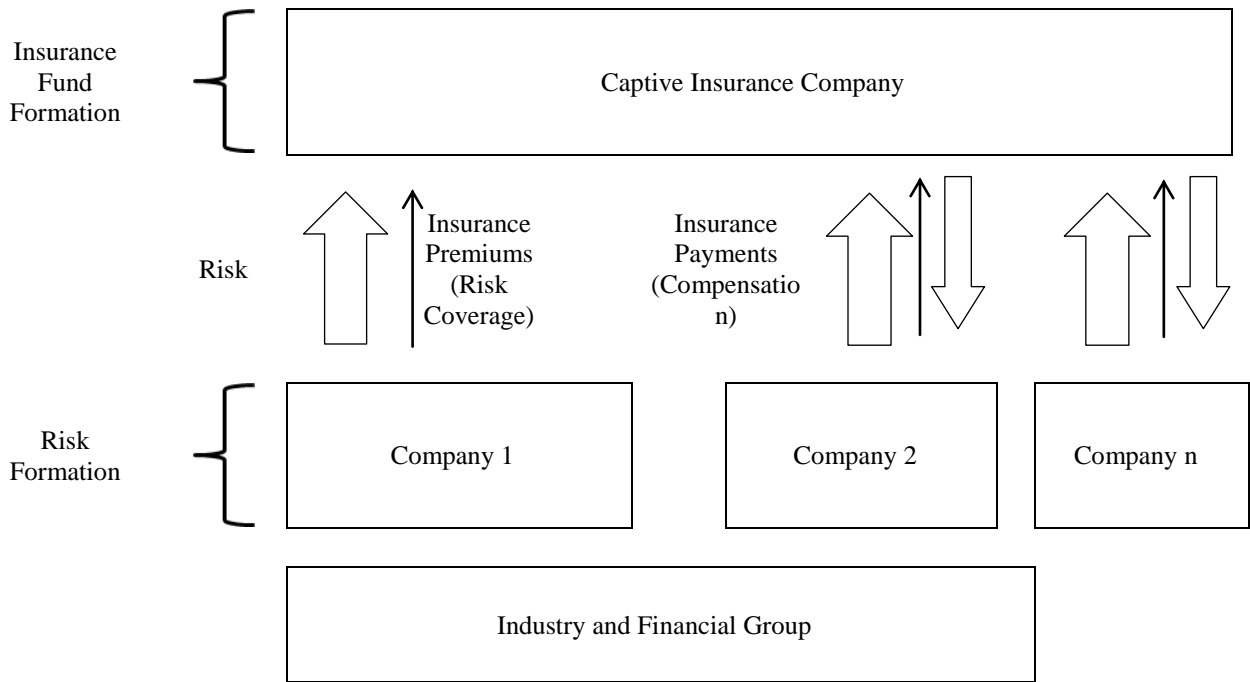


Figure 2. Captive insurance of risks in IFG.

Thus, captive insurance is used to cover the losses if an event insured against occurs but not by distributing the losses among the subsidiaries but from the parent's funds (self-insurance). However, when the captive's scope of operation starts to go beyond serving the interests of the parent and its affiliates, we can speak of scaling of traditional commercial insurance. An IFG uses elements of self-insurance to form its insurance fund, which is a classic

example of self-insurance. By applying any of the above-described mechanisms, the parent intends to use its captive to cover the group's losses if an insured event occurs. Captive insurance is aimed at setting up a system based on the principles of self-insurance and commercial insurance to form an insurance fund and to cover the losses should the need arise.

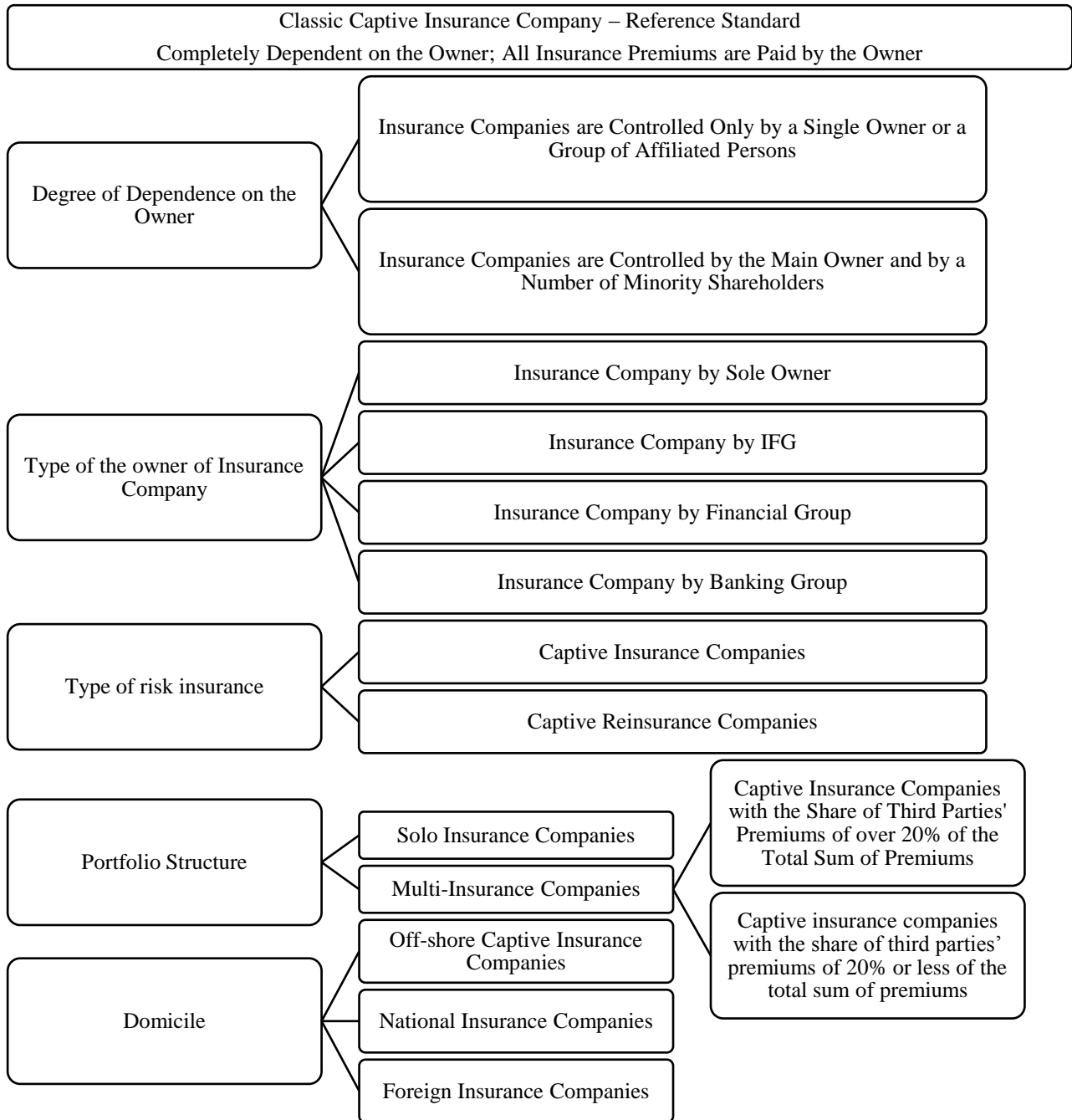


Figure 3. Classification of captive insurance companies

In the majority of cases, a captive insurer retains the key characteristics of captive insurance (depends on the owner; provides coverage for its parent company and its affiliates; its portfolio contains only the risks of the parent and its affiliates) but at the same time it can acquire some features of its own, for example, it may use capital contributions of minority shareholders to form a part of its registered capital

(these shareholders are not affiliated with the main owner) or its portfolio may contain third-party policies, and so on.

The question about the possible limits of captives' dependence on their owners and about the structure of their portfolio is still open for debate, and this discussion may go beyond the purely theoretical domain [1, 3, 4, 6, 11].

Some Russian researchers define the captive insurance company regarding market conditions [13] as a company that insures risks in the absence of competition. This definition raises a number of questions: on the one hand, a captive builds its portfolio under conditions of limited competition but, on the other hand, not all companies operating under conditions of limited competition can be called captive. We believe that this definition neglects one important characteristic – corporate dependence of the insurance company on the IFG.

In order to systematize the possible models of captives' transformation, which can be used to design strategies for their further development, we propose the following classification of captives (see Fig.3).

Since a captive insurer is strategically dependent on the parent company, there are a number of limitations [8]. The possibility of corporate control exercised by the owner or a group of affiliated persons depends on national legislation (legislation of the country where the captive is registered) and on the constituent documents of the captive itself.

Some experts divide captive multi-insurance companies into several groups depending on the share of third parties' insurance premiums in their overall profit. In some countries, for example, Bermuda, one of the long-standing domiciles, this distinction is incorporated into legislation. For instance, its legislation distinguishes between:

- captives with the share of third parties' premiums of 20% or less of the total sum of premiums

- and captives with the share of third parties' premiums of more than 20% of the total sum of premiums [12].

Such division allows to make the taxation system more flexible and enables insurance companies to choose what suits them best.

Like any other commercial organization, an IFG is aimed at making profit, which means that captives are created with a certain purpose, more specifically, with the view to enhance the revenues of the whole group.

III. DATA ANALYSES

A captive insurance company allows the parent to create a system of risk insurance for the affiliated companies. Seen from the perspective of an individual affiliated company, a part of risk is transferred to the insurance company, but from the perspective of the whole IFG, the risks remain within the group. In the event of a loss, it will have to be compensated from the group's own funds. One of the ways to reduce the group's risks is to transfer the risk to an outside firm, that is, to an unaffiliated insurer [9].

A captive insurance company can use a system of reinsurance to transfer a part of the risk outside the financial and industrial group to an external company (see Fig.4). The prerequisite is that such reinsurer should not be connected to the parent IFG, Otherwise there would not be any actual risk redistribution.

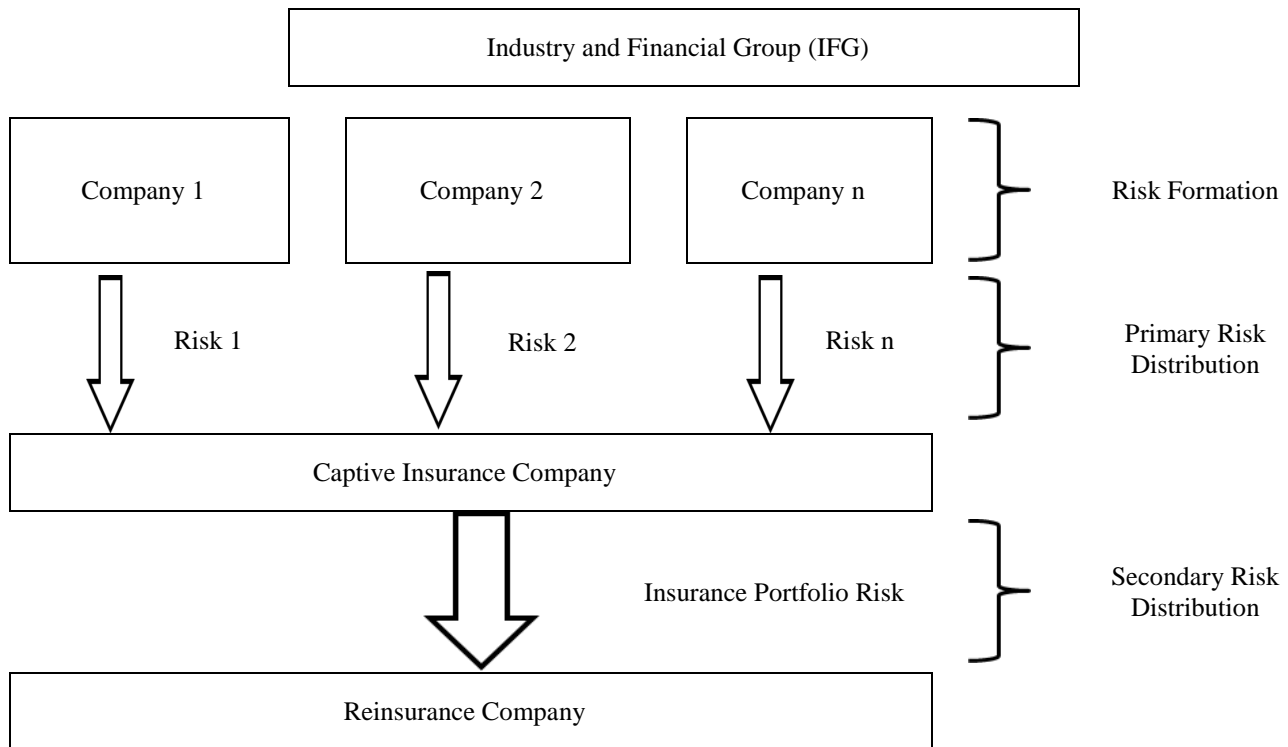


Figure 4. Mechanism of risk transfer to a reinsurer.

All IFG affiliates insure their risks in the captive, which, in its turn, shifts these risks to an external reinsurer. This system allows to partially transfer the risk outside the IFG, which means that it will receive some sort of compensation should there be a claim. Using external reinsurance, however, increases insurance costs.

In this scheme, the captive acts as an intermediary. Nevertheless, this scheme offers the IFG a number of advantages: first, the captive retains its control over insurance of the group's risks; second, reinsurance of risks is usually cheaper than primary insurance; third, not all risks are reinsured but only the ones that threaten the group's financial stability.

Reinsurance is particularly recommended if the IFG's individual risk cannot be covered by the group's own funds or in cases of risk accumulation.

This scheme can be expanded by involving several reinsurers. There are specialized reinsurers that deal with

industry risks: aviation risks, railway industry risks, and public liability risks. Focusing on specific risks allows the company to study them better and to offer its customers a more attractive insurance rate. If there is too much risk for one reinsurance company, it may be shared by several reinsurers or a joint reinsurance contract may be signed.

A downside of the reinsurance system is that it leads to a decrease in the insurer's assets, including its reserves, which diminishes the possibility of placing the insurer's assets within the IFG.

IV. RESULTS

An IFG can apply the combined risk insurance method (see Fig.5), which means that the risks of the parent and its affiliates at the stage of primary risk distribution are insured by the captive as well as by external insurers.

In this case, the captive occupies the same level as other insurance companies.

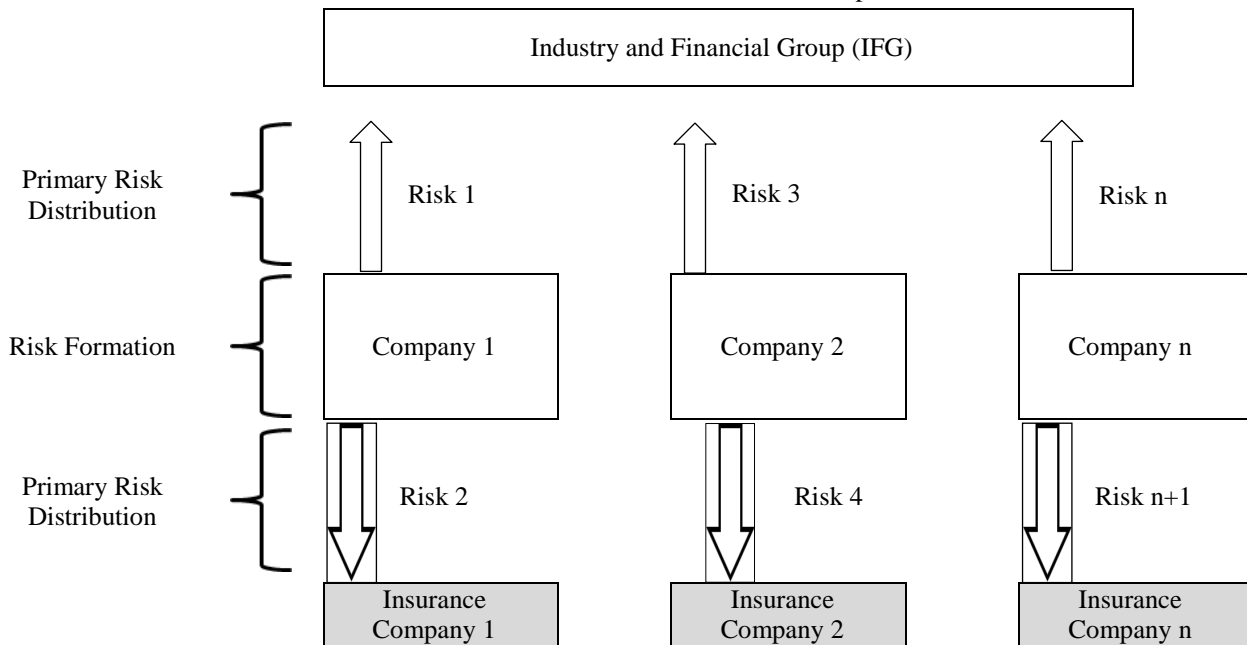


Figure 5. Combined risk insurance of an IFG

The combined risk insurance model is also applied in the process of establishing or liquidating a captive. The transition period is usually accompanied by the gradual accumulation of the captive's portfolio. Immediate transition from one insurance system to another is impossible due to the following reasons: setting up a captive takes time as one must obtain the necessary licenses and recruit qualified staff. Then, the captive must be authorized to insure the risks of the IFG. One must also assess the IFG's risks and determine the optimal insurance policy, which is a time-consuming process.

The combined insurance model can be chosen by the group's executives deliberately in the following cases:

- if the captive is not licensed to insure against certain types of risk, the IFG will have to purchase insurance from external companies which have such a license;
- if the situation in the market renders certain types of insurance cost-ineffective;
- if the costs of covering a particular risk are too high for the captive and such insurance contract may destabilize its financial condition.

The drawbacks of the combined insurance system are as follows:

- decentralized management of the IFG insurance system;
- the cost-saving benefit of the captive can be negligible if the costs of setting up a captive are high and insurance of an insignificant part of the IFG's risks is not cost-effective;
- the captive provides low investment returns due to its small portfolio;
- the low rate of return of insurance expenses to the IFG's business.

Application of the third scheme of captive insurance is primarily aimed at the following goals: first, to enable the IFG to cut its insurance costs; and, second, to enable the parent to return some of the funds, accumulate them and reinvest in the group's projects.

V. DISCUSSION AND CONCLUSION

The third scheme of captive insurance is based on using a captive reinsurer. A captive reinsurer is a subsidiary

which is owned and controlled by a parent company or a group of affiliated subsidiaries acting in the parent's interests and which primarily serves to meet the risk-management needs of its owners.

Such schemes are usually popular with industry associations, which choose to reinsure the specific types of risk.

Primary risk transfer to an external insurer may be done by signing a contract that stipulates mandatory risk reinsurance. In some cases, risks can be insured against only in those insurance companies that are affiliated with the corresponding groups and associations, for instance, a railroad insurance association. As a rule, one of the obligatory conditions to be met when joining such organizations is to reinsure against certain types of risks and risks of the IFG's subsidiaries.

Figure 6 illustrates how an IFG can return some of the funds spent on insurance with the help of the captive reinsurance scheme.

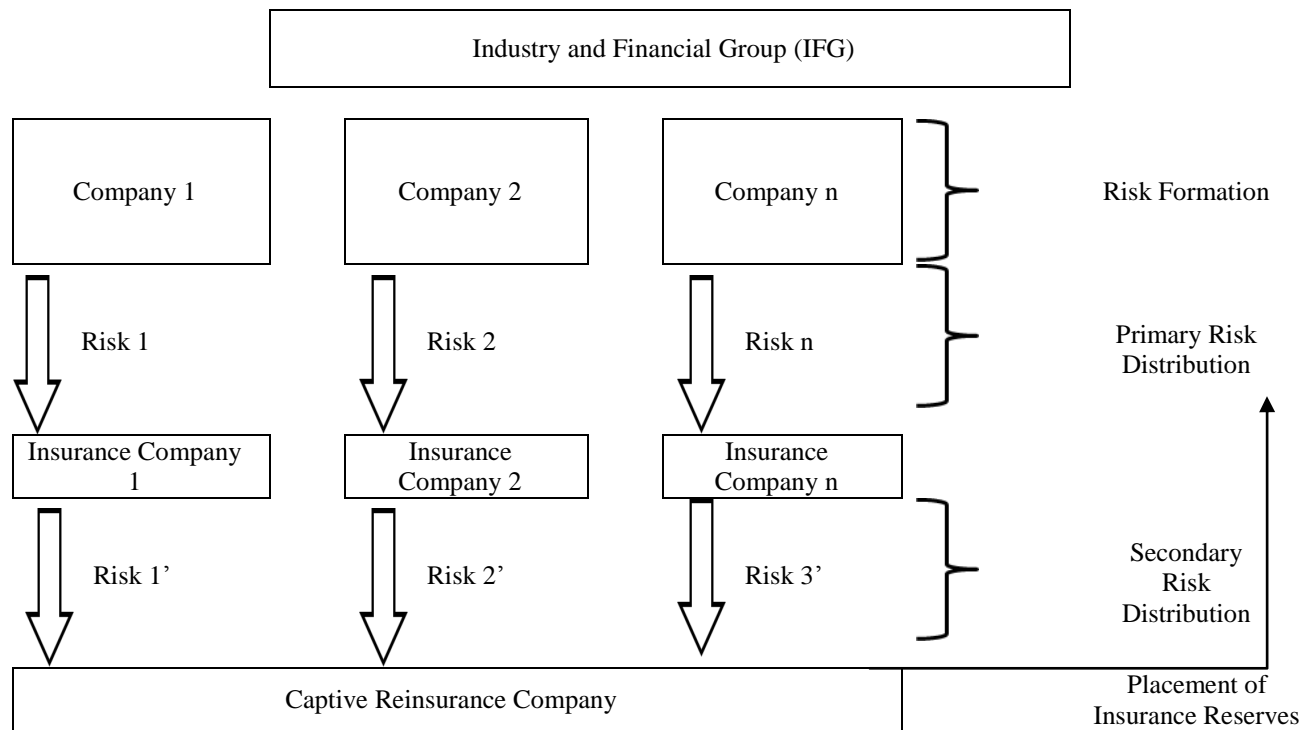


Figure 6. Optimization of the captive reinsurance mechanism.

Considering the schemes for an IFG's risk redistribution, we can classify captives depending on how the group's risk is insured: we can distinguish between captive insurance companies and captive reinsurance companies. Captives' efficiency is negatively affected by the lack of a regulatory framework that would 'legalize' the corporate structure. This creates problems for captive insurers and offsets their

competitive advantages, which are enjoyed by their counterparts in developed economies.

In addition, when the Russian market was about to open up for foreign insurers, Russian insurance companies started to consolidate, which means that a number of captives were no longer capable of meeting the requirements of the Central Bank. As a rule, captives are

not large organizations since they serve the interests of their owners and, therefore, do not need much capital. Moreover, this capital is formed by the owner itself and the IFG management often refuse to increase investment into non-core businesses. It is worth noting that this investment is necessary during the recession or in case of a structural crisis in the insurance market.

Thus, our hypothesis that digitalization of financial processes in Russia's economy requires structural transformations of captives is confirmed. The possible scenarios of captives' transformations are as follows:

Scenario 1: consolidating captives by increasing investment from the parent and expanding their portfolio to include companies from the same industry as the owner;

Scenario 2: merging several captives affiliated with companies operating within the same industry or related industries;

Scenario 3: transformation of the captive into a universal commercial company;

Scenario 4: liquidation of the captive.

Unfortunately, at the moment, many owners struggle with the shortage of cash which they could otherwise invest into their own insurance subsidiaries. Therefore, liquidation of captives is a common practice.

Some captives [10, 14] affiliated with large industrial companies, which could afford to develop a range of non-core businesses as far back as in the early 2000s, have started their transition from the captive to a more universal structure. When the economic growth was stable, they managed to increase their volume of insurance and create robust financial structures. These include SOGAZ, Renessans-strakhovanie, VSK and some others. As far as their portfolio structure is concerned, such captives have started to resemble universal companies. There is no doubt that this trend will continue in the Russian insurance market and that captives with such features will do well on the market competing with large universal insurers such as Rosgosstrakh and insurers affiliated with financial and banking groups.

VI. CONCLUSION

Mechanisms and principles of captive insurance have been known and widely used in developed countries since the mid-twentieth century. In Russia, however, this form of insurance protection is comparatively recent: it evolved to meet the demands of the evolving market, when captive insurance companies compensated for the narrowness and insufficient capitalization of the Russian insurance market. Processes within captive structures, including their integration into insurance relations, can be managed only if relevant international experience is adopted by Russian economy since captive insurance often lacks actual risk redistribution. Therefore, captive insurance can be regarded as independent insurance protection only to a certain extent

since risks are funded by the IFG itself. The legal framework for redistribution of risks relies on the regulation of insurance reserves. At the same time IFGs are losing the opportunity to return the funds to the projects of their affiliated companies since they are now required to invest in highly liquid assets in insurance funds, which contributes to the financial stability of captive insurers and the insurance market in general.

Our analysis of the strengths and weaknesses of captives has revealed cases when a captive has a positive economic effect on its owner's performance but at the same time damages the state financial system, for instance, through the reduction of the tax base. When a considerable number of insurers are captives, the amount of taxes 'lost' by the state budget can become quite significant. The second case is when companies return their insurance costs in the form of captives' profits and, as a result, deploy less of their capital on stock markets, which is detrimental to the capital redistribution mechanism underlying the financial market concept. Thirdly, the development of captives reduces the volume of the free insurance market and limits competition on this market.

In this paper, we sought to consider various alternatives of captives' development and to identify the most viable captive forms in the existing economic conditions. Unfortunately, Russian legislation does not distinguish captives as a separate type of insurance companies, which is why captive companies should struggle to meet the requirements set for commercial insurance companies and thus loses their competitive advantages and acquire the characteristics of universal insurance companies.

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