Captives & SPV Use (E) Subgroup

Definition of Insurance Risk (Including First & Third Party)

As are result of the survey, NAIC Staff have received several requests regarding the definition of "third party risk." Thus, NAIC Staff has prepared the following recommended definition and suggests the Subgroup ask the Financial Condition (E) Committee for a charge clarification:

In risk management terms, risks can be addressed in a number of ways. These include loss avoidance, loss control, combination, non-insurance risk transfers, insurance or retention. If a business or person decides to retain its risks rather than avoid or transfer them, then the business or person is engaging in self-insurance.

The traditional captive insurer is simply a formal self-insurance plan. The business entity forms the captive insurer as its wholly-owned subsidiary to accept risk transfers from the business entity, its subsidiaries and affiliates for a fee. The risk is transferred to the entity; however, it is the business entity and its subsidiaries and affiliates whose risk of loss is transferred and who is responsible for the premium.

The traditional insurer is an entity whose business is accepting risk transfers from other nonaffiliated businesses and people for a fee. The contract affecting the risk transfer and identifying the consideration is known as an insurance policy. The businesses and people transferring risks to the insurer are known as policyholders. The risk accepted by the insurers is known as either first-party risk or third-party risk. First-party risk occurs when only the insurer and the unaffiliated business or person is involved in the risk transfer. Examples of first party risk are a property insurance policy for a business or a homeowners policy for an individual. Third-party risk differs from first party risk in that there is another party to the transaction. Examples include: an auto liability policy where the third party is the person hit who otherwise might not have any relationship with the insurer or policyholder; a workers' compensation policy where the employer is the first party and the injured employee is the third party; or a group life policy where the employees and their relatives are third parties and the employer is the first party.

The term "third-party risk" has mistakenly been used to describe both first-party and third-party risks transferred by unaffiliated businesses and individuals to insurers. A more fitting term would be "insurance risk" where insurance risk is defined as a formal risk transfer, by contract known as an insurance policy, of an unaffiliated business or person to an insurer for consideration known as premium.