WHITE PAPER

RISK FINANCING

Captive Insurance: An Affordable Solution for Associations and Affinity Groups

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INSTEAD OF TRANSFERRING YOUR MONEY TO A COMMERCIAL INSURANCE COMPANY THAT DOESN'T PROVIDE ANY SORT OF RETURN ON YOUR DOLLARS, YOU'RE NOT ONLY RECEIVING THE COVERAGE YOU WANT, BUT YOU'RE ALSO BENEFITTING FROM ANY UNDERWRITING PROFIT EARNED BY YOUR CAPTIVE INSURANCE COMPANY.

Rahul Kumar shook his head as he set the phone down. When the insurance renewal for his four sandwich-shop franchises arrived in today's mail, he was furious. Despite a great claims history, he was looking at a significant increase in premiums. Rahul immediately called his independent insurance agent and asked about other options. The agent apologetically explained that few carriers had an interest in his type of business, and the others were even more expensive.

Rahul knew he couldn't operate his stores without insurance, but felt like he was shoveling stacks of hard-earned dollars into the dumpster. In today's economy, he didn't think he could pass the increase along to customers through higher prices. His margins were tight as it was and the labor market was driving his wages up, too.

He called his friend, Parag, to see if there had been a similar increase. Parag owned six of the same franchises in a nearby city and the two men often compared notes. "It's funny you called now," Parag answered. "My cousin and I just discussed how expensive our coverage has become and he told me that he and a group of other business owners were starting their own captive insurance company."

What Is a Captive Insurer?

Parag's cousin had been discussing an alternative approach to business insurance that can lower costs while improving the coverage. The approach involves creating and operating what's known as a captive insurance company.

In simple terms, a captive is an insurance company created specifically to serve the needs of a like-minded group of insureds, such as an association or an affinity group. For example, a state association of manufacturers could establish a captive for its members. A group of inner-city small business owners, Latino primary care physicians, or boating enthusiasts could do the same. The members of the group own the insurance company, fund its loss reserves, and control its operations to benefit each other.

For example, Rahul and Parag know nearly 100 other owners of similar franchises. Each of those owners has been buying business insurance on the open market, working with local agents to find coverage. The policies vary widely in coverage options, but because each owner is a small business with limited buying power, the pricing tends to be quite high.

The owners decide to band together and create their own captive insurance company. They work with a consultant to develop a thorough understanding of the specific risks associated with the nature of their business. The consultant develops a customized policy that actuarially reflects those risks and is priced accordingly. Instead of paying premiums to a commercial insurance carrier, the owners all invest in their captive insurer, essentially putting part of their operating capital at risk. In many cases, their annual investment in the captive is much less than what they would pay in traditional premiums.

A True Insurance Company

You may be familiar with the concept of self-insurance, in which a business or other organization sets aside financial reserves as a hedge against potential risks, whether on its books or in a special bank account.

Starting a captive insurance company is a form of self-insurance, but it goes far beyond that concept. A captive insurance company is a licensed, regulated insurance company that must be legally established in a domicile—a state or nation—in compliance with the laws and rules of the domicile. Typically, it includes standards for capitalization and reserves, specific actuarial requirements, periodic audits, captive management and other reporting. The captive insurance company is a legal entity that is separate from the businesses who own it.

While a captive insurance company appears to be similar to a mutual insurance company, there are significant differences. It's true that a mutual insurance company is also owned by its policyholders. However, those policyholders lack control of the insurer. They may submit a proxy approving members of the board of directors, but any control is indirect at best. When the insured company stops making premium payments, they cease to be owners. And, even though mutual insurance companies usually have the power to issue dividends when they have a profitable year, most simply use those profits to bulk up their reserves.

Capital, or Expenses?

One of the most important distinctions between captive insurance companies and other approaches is the nature of the owner's payments to the insurance company. If your business is covered by a traditional insurance carrier, whether it's an investor-owned or mutual company, you pay regular premiums that are simply an expense to your business. The premiums provide coverage for a set period, and once that time expires, you have no equity remaining.

While the money you pay to a captive insurance company is normally also classified as a business expense for tax purposes, it actually represents an investment of capital into the captive. Your investment and that of the other group members becomes the reserves of your insurance company, available to pay out any claims. Any funds that aren't needed for claims can grow through investment. If the amount of any claims turns out to be less than expected and the reserves are prudently invested, it's possible that the owners' contributions could be scaled back in future years, enhancing your company's cash flow.

In other words, instead of transferring your money to a commercial insurance company that doesn't provide any sort of return on your dollars, you're not only receiving the coverage you want, but you're also benefitting from any underwriting profit earned by your captive insurance company.

Better Coverage, Too

When you purchase insurance on the open market, you settle for whatever coverage is available to you. Depending on how your policy is priced and how eager or reluctant the carrier is to cover a business like yours, the coverage you receive may be quite limited or carry a deductible that exceeds your comfort level. A policy that's written for one type of company may not be ideal for policyholders in other industries. For example, Rahul and Parag may be paying for fire and liability coverage designed for restaurants with deep fryers, while their sandwich shops only use less-hazardous microwave and toaster ovens.

With a captive insurance company, you can tailor the coverage specifically to the realities of your business. This means you aren't paying extra for coverages that are inappropriate for your industry, and that risks unique to businesses like yours will be covered. You may also be able to add coverages that aren't included in general policies, such as robust coverage for cybercrime.

ONE OF THE MOST IMPORTANT DISTINCTIONS BETWEEN CAPTIVE INSURANCE COMPANIES AND OTHER APPROACHES IS THE NATURE OF THE OWNER'S PAYMENTS TO THE INSURANCE COMPANY.

Many Other Advantages

Choosing the captive insurance company approach can also provide other significant advantages to members of the group, among them:

Greater control. Because you own and control your captive insurance company, you determine the rules (within legal limits). You and your fellow owners can set deductibles, maximum payouts and standards for claims. Your insurance company may be able to pay for services such as loss control for all the owners as an investment in reducing claims.

Safety culture. As part owner of an insurance company, you have a stake in the company's financial performance, so it's in your best interest to keep losses to a minimum. This can lead owners to place a stronger emphasis on employee safety, even to the point of making workplace safety consultants available through the company. Fewer injuries means fewer claims, leading to lower contributions and more money in your pocket.

Predictable pricing. Do you hold your breath when renewal time approaches? Businesses often face significant year-over-year premium increases from traditional insurance carriers, often with little or no warning, so it can be difficult to budget for coverage. When you're an owner of a captive insurance company, you're aware of its financial performance, so you have a better sense of any coming changes. Plus, if your actuarial guidance and underwriting are sound, you may see reductions rather than increases.

Stop loss options. To keep coverage affordable and protect against very large claims, some captive insurance companies include stop loss provisions. As an example, Rahul and Parag's group may determine the typical claims loss for a year won't exceed $250,000, but once in every decade, it's likely that there will be one much larger claim. So, their captive insurance company is set up to handle its own claims up to $250,000 annually, and they purchase an affordable stop loss policy for claims between $250,000 and $500,000.

ADDITIONAL ADVANTAGES OF A CAPTIVE

- Greater control
- Safety culture
- Predictable pricing
- Stop loss options

Getting Started

Creating and administering a captive insurance company requires specialized expertise. In addition to the many complexities of regulatory requirements, the basic design of the captive insurance company must be actuarially sound to ensure its viability and compliance with the expectations of the domicile in which it was created. Limits for the number and size of participants, as well as the aggregate limits for claims, are also critical.

A sound first step is the exploration of a feasibility analysis, in which a consultant examines the objectives, loss history and projects from an actuarial perspective before making recommendations for the most appropriate domiciles, ideal capitalization and lines of coverage.

Once the captive insurance program has been established, its day-to-day operations such as claims processing need to be managed, and reporting requirements must be met. As the program moves forward, an expert consultant can evaluate and adjust its operations and respond to owners' interest in changing the nature of or adding coverage.

Finally, thought needs to be given to exit strategies in the event the owners decide (or are required) to discontinue the program. Choosing a consultant who can provide cradle-to-grave services for a captive insurance company will simplify the process and is likely to enhance satisfaction for the owners.

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