CAPTIVE INSURANCE:
THE ANSWER TO MANAGING COSTS?

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Are Captives the Answer to Managing Insurance Costs?

Billions of losses are being reserved on the balance sheets of property and casualty insurance companies as 2020 continues to be one big cataclysmic event for the insurance industry. The industry was coming off historical losses just two years ago from Hurricanes Irma, Harvey and Maria. The following year came the wildfires and now, we have the pandemic. According to Fitch, COVID-19 related claims are estimated at $23 billion and will continue to grow until the virus gets under control. All these losses are reducing insurance capacity while driving up premium rates. Renewals are up across all lines of coverages, and all industries are impacted. Renewal increases are averaging 10 percent to 25 percent but can be over 100 percent for more difficult risks.

Companies are taking action, as they seek to find cost-effective solutions for their insurance spend. The most popular option within the alternative category is a captive. Captives have been around since the 1950s and currently account for half of all property and casualty premiums, according to a 2011 survey by Insurance Journal. While popular among the Fortune 1000s, with 90% reporting captive participation, middle market companies represent the fastest growing segment of the market.

WHAT IS A CAPTIVE?

A captive is an insurance company set up by its owners to self-insure against the company's specific risks. These structures can be designed for a single corporation or a group of companies. They can be utilized to cover a wide range of risks, including most casualty exposure, property, terrorism, cybersecurity, and even employee benefits. The captive operates like a commercial insurance company and is subject to state regulatory requirements, including financial reporting, capital/ solvency support and reserve adequacy, including an annual actuarial opinion.

WHY WOULD A COMPANY WANT TO OWN THEIR OWN INSURANCE COMPANY?

Here are some of reasons:

- Increase cash flow
- Coverage tailored to meet your needs
- Reduced operating costs
- Greater control of claims
- Funding and underwriting flexibility
- Incentive for loss control
- Capture underwriting profit
- Potential tax benefits
- Price stability
- Investment income
- Flexibility in managing risk

All of these are important, but there are a few that stand out when a company looks to form a captive.

ONE - the ability to capture the potential underwriting profit. When a company is in the commercial market, the company pays its annual premium and will receive no compensation back. With a captive, the company will pay the annual premium, but at the end of the policy period, the earned underwriting profit will be returned to the company. Underwriting profit is determined by premium minus expenses and any claims payments.

TWO - there is coverage tailored to meet your needs. As we are experiencing in the current market upon renewal, companies are not only facing increased premiums, but also, as important, are encountering underwriting restrictions. With a captive, the company can determine types of coverage and coverage limits that best fit its needs. Captive premium pricing and coverage limits are determined through an independent actuary.

The other key advantage is the potential tax benefits. The annual premium can be eligible for a tax deduction. The captive must be structured properly to qualify for a premium tax deduction this can be achieved through proper tax advice during the formation.

There are a number of different types of captives that can be utilized to achieve the company's goals: group, industrial, segregated cell, pure and risk retention group, to name a few. The company will have the ability to select which captive structure best fits within its company goals.

Creating a Captive

Forming a captive is not typically a difficult process. Hiring a captive manager or captive consultant will provide you the advice and assistance with getting through the formation and capturing the license to operate. One of the first items is selecting a domicile in which to license the captive. There are a number of domiciles from which to choose. You can choose to domicile in the U.S. or offshore.

The three domiciles with the largest number of captives are the Cayman Islands, Bermuda and Vermont. Vermont is the largest U.S. captive domicile, although there are others to choose from, such Arizona, South Carolina, Delaware, Utah, Tennessee and Washington, D.C., just to name a few. There are a several things to take into consideration when selecting a domicile, such as the capital requirement. Most domiciles require a 3-to-1 investment. For example, on a $1 million premium, the captive would be required to carry $300,000 in capital. In most cases, the capital can be provided with a "letter of credit" in lieu of cash. The domicile will make the final determination of capital requirement.

When forming a pure or stand-alone captive, there are certain requirements. First is selecting your captive manager. The captive manager is critical in the structuring the captive. The captive manager will assist with completing the actuarial and the feasibility study, which are necessary to submit to the selected domicile for licensing.

Next is the selection of all the vendors required to operate the captive. Some of the additional vendors after the captive manager and actuary that need to be selected are: tax and audit, reinsurance (if needed) and a claims third-party administrator (TPA) (if needed). Again, your captive manager can assist with these vendors.

If the company decides to join a group captive, the vendors within the group captive will be used. This can make the formation of the captive less complex. But, joining a group captive can have its limitations. For example, if the company forms its own captive, it owns the captive outright, which is not the case with a group captive. Also, in a group captive, the company would share risk within the group. If the company has very good loss experience, they may not want to share risk within the group. If the company does not have enough premium to form their own captive, the group captive option could be a good option.

Captives allow for a company to get out of the traditional commercial market space, which is prone to potential premium increases and underwriting uncertainties year to year. Captives allow companies to insulate themselves from the traditional market conditions.

While captives may not be the answer for all companies to the pending commercial market conditions, they do allow for an alternative for companies to finance their risk.

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