

Captive Insurance: A Good Strategy for Your Business?

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The concept of insurance has been around for a long time. Over the years, businesses and individuals have used insurance as a form of risk management to hedge against the risk of a contingent loss with the primary intent being to transfer the risk of a loss from one entity to another. The cost of this risk transfer comes in the form of a premium.

Probably the most complicated aspect of insurance is the underwriting. Using a wide assortment of data and actuarial science, insurers predict the likelihood that a claim will be made against their policies and compute premiums accordingly. For a traditional insurance policy, a simplified calculation of profit is measured by taking the difference between the premiums collected plus investment gains minus amounts paid out in claims. Allocations of general overhead expenses will also need to be considered. Any profits and losses generated remain with the insurer.

What is an insurance captive?

Captive insurance companies have been around for many years. However, those who have been in risk management fewer than 10 years may not have heard of them. This is primarily because risk managers lived in a “soft” insurance market world for so long. In the pre-2002 market, insurance brokers were breaking down doors to give the best rates seen in more than 20 years. In the years following September 11, 2001, the insurance market changed. Companies are now faced with finding alternatives to the traditional insurance model.

A captive is a bona fide insurance or reinsurance company. It is primarily supplied and controlled by its owners. These owners participate in controlling the underwriting, claims and investment decisions of the insurance company. Typically, all insureds are owners of the captive where participation is required in order to help the captive grow. The owners of a captive usually have similar risk profiles and do not necessarily have to operate in the same industry lines. Any profits and losses generated remain with the captive. In essence, the captive serves as the owners’ insurance company.

How are captives structured?

Captives are comprised of three primary components: financial, operational and people.

The financial resources of captives include both premiums paid into the captive and investment income. These resources must be sufficient to fund the captive’s ongoing expenses and finance the captive’s legal responsibility to fulfill its insurance agreements.

The operational component of captives is similar to those of a traditional insurer. A captive issues direct policies to its insured, collects premiums and pays out claims. The captive also incurs operating expenses in addition to its claim payouts. As the captive collects premiums, it invests the funds in the market hoping to generate investment income that will be sufficient to cover operating expenses and supplement the captive’s claim payments.

Usually, three groups of people run a captive. These groups include the officers of the captive, the captive’s Board of Directors (the “Board”) and a variety of outside service providers. Most captives use captive management companies as opposed to having their own employees to run the captive. The management companies perform daily management duties, maintain the accounting records and serve as a liaison between the captive’s Board and outside regulators. Outside service providers of the captive include accountants, actuaries and legal counsel. These service providers report to the Board, which assists in setting captive policy for items such as claim management, underwriting and finance decisions.

What types of captives are there?

A number of different types of captives exist in the marketplace. Some of the more common types of captives are listed below.

- **Single-parent** - captives that underwrite only the risks of related group companies.
- **Diversified** - captives that underwrite unrelated risks in addition to related group companies.

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- **Association** - captives that underwrite the risks of industry or trade association members.
- **Agency** - captives formed by insurance brokers or agents to allow them to participate in the high-quality risks.
- **Rent-a-captives** - companies have the benefits of a captive insurance company without certain costs, capitalization requirements or legal ramifications.

What are the advantages and disadvantage of a captive?

Companies involved with captives have the ability to exercise more control over their insurance premium dollars. Captive premiums are spent to manage the risk of its owners as opposed to adding to the profit margin as with a commercial insurance company. There are many reasons for using a captive insurance company. The advantages of a captive include:

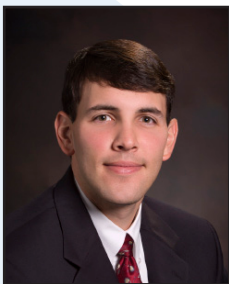
1. reduced cost coverage;
2. direct access to reinsurers;
3. provision of broad or otherwise unavailable coverage;
4. improved cash flow;
5. improved risk-retention capability;
6. mitigation of the market swings of commercial insurance;
7. spreading of risks; and
8. integration of insurance with an overall risk management plan.

Tax advantages, oddly enough, are not the principal reason for being involved in a captive. As each insured's business evolves, reasons for being involved with a captive may change.

Managing a captive can be a significant risk to a company. The decision to be part of a captive requires a long-term commitment. Captives call for a high amount of capital in order to be established and to fund claims. As with any insurance company, captives require a high level of professional expertise from both a management and from a fiduciary duty standpoint. Many regulations affect the insurance industry. Qualified professionals such as attorney, accountants and actuaries should be consulted in order to remain in compliance with laws and other local regulations.

Conclusion

Captive insurance arrangements continue to be popular with "hard" insurance markets. While captives can be a good strategy for many companies, they are not for everyone. Hence, companies should go through a detailed analysis to determine if a captive is the right solution for them. Furthermore, companies interested in pursuing a captive insurance arrangement should consult the assistance of professionals experienced in actuarial, accounting, tax and legal issues.



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