Group Captive Insurance Programs Offer Cost and Risk Management Alternatives

By: Travis Bogan, CPA

In an environment of rising insurance premiums, many companies are looking for alternatives to the traditional insurance market in order to control costs while managing risk. This may mean a company changes insurance providers or policies, retains more risk, or develops new risk management strategies. In some cases, a captive insurance company may provide an opportunity to achieve these objectives. Large corporations have benefited from operating their own captive insurance companies for many years. Recently, though, smaller, closely held businesses have also found benefits.

Captive Insurance Structure Options

A captive insurance company is formed to insure the risks of its owner (or owners). There are different structures of captive insurance companies. One of these is a "Pure Captive" which is structured to primarily insure the risks of the owner's operating business and related entities. The captive must be able to prove it is a valid insurance company. For tax purposes, generally insurance companies must include elements of risk shifting and risk distribution. To meet the risk shifting requirement, the operating company must show it has transferred specific risks to the captive insurance company in exchange for a reasonable premium. Risk distribution occurs when particular risks are combined in a pool with other, independently insured risks. Therefore, the captive must be accepting risks from multiple separate entities to satisfy this requirement. Most closely held businesses are not part of multiple entity structures insuring similar risks which leads some business owners to believe that captive insurance is not an option. While a "Pure Captive" may not be an option, another structure of captive insurance companies is "Group Captives" which have become an increasingly popular option.

A "Member-Owned Group Captive" provides insurance to, and is controlled by, its owners. In a group captive, the members are all owners of the insurance company. The membership retains the small predictable losses while purchasing re-insurance for potential large, unpredictable losses. There are two types of member owned group captives. Heterogeneous member owned group captives are made up of members from different industries. Homogeneous member owned group captives are made up of members from similar industries. Both types operate the same. A captive management company provides the necessary structure for these programs, as well as engages the essential services and third-party providers (claims adjusters, loss control specialists, fronting insurers, re-insurers, etc.)

Understanding the Benefits and Feasibility of Group Captive Insurance Programs

The main benefit from membership in a group captive is control. Each member will have more control over their future costs because their premiums are based on their specific loss experiences rather than a state filed rate used by traditional insurers. If a member can control losses and effectively manage claims, then their costs should decline even when their revenues and payrolls are growing. In the traditional market, the best performing insureds subsidize the insureds with poor experience.

Advantages of a Group Captive Covering Traditional Insurance Risks:

- Premiums are based on your loss experience
- Members are insulated from insurance market conditions
- Operating costs are lower
- Only good risks are accepted
- Underwriting profits and investment income are returned to members

Characteristics of Good Candidates for a Group Captive:

- Favorable prior loss history
- Financial stability
- Substantial, sustainable operating profits

Captive insurance companies are formed to mitigate the exposure of a variety of risks. Practically every risk that a commercial insurer may underwrite can be provided by a captive. Some captives provide mainstream property/casualty insurance coverage such as general liability, workers' compensation, auto liability, and professional liability. Other captives provide specialized coverage for unusual or hard to insure risks that may be infrequent, but have potentially high-cost events such as pollution liability, credit risk, terrorism, or cyber-theft policies.

While group captives offer a host of advantages, these programs require a financial commitment over a sustained period of time. As a result, a group captive is not a viable option for all businesses. Typically, companies considering a group captive should be currently paying traditional insurance premiums of at least $250,000. A new owner of a group captive will have an initial cash outlay to purchase common and preferred shares of stock of the captive insurance company. Common and preferred share prices vary, but will likely be at least a $30,000 to $40,000 investment. Collateral, in the form of cash or a letter of credit, will typically also be required based on actuarial assessments to cover potential losses in the early years of being a group captive member.

We Can Help

Elliott Davis Decosimo professionals can help you plan for your business needs. For guidance on your specific situation, check with your Elliott Davis Decosimo advisor or contact elliottdavis@elliottdavis.com to reach an experienced team member.