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THE CAPTIVE INSURANCE TIPPING POINT

4 SIGNS A DIFFERENT APPROACH TO RISK MIGHT BENEFIT YOUR ORGANIZATION

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The traditional approach to property and casualty business risk is to transfer it to an insurance entity by purchasing a policy. Some organizations take the opposite approach and opt to assume all of that risk through self-insurance. But more and more businesses are pursuing a middle ground such as captive insurance. The number of captives has increased in the last two decades as companies of all sizes seek alternative solutions outside the traditional insurance market to insure against new and emerging exposures and maximize the benefits of an effective risk management program.

The easiest way to understand a captive is to think of it as an insurance company owned and operated by its insureds and/or members. These same individuals or groups that hold the insurance policies also own the captive insurance company. Captives are legal entities that are licensed and domiciled on-shore (Unites States and its territories) or off-shore (Caribbean, Europe, Asia). They're subject to similar regulations, albeit sometimes different statutes, as traditional insurance companies and must maintain financial solvency.

In a sense, captives are a more structured form of self-insurance that allow an organization to assume some risk while also accessing reinsurance for catastrophic and more extreme exposures best managed in the traditional insurance marketplace. The greatest benefits of captives are typically greater control over the insurance program, coverages and premium costs as well as the potential for additional equity through sound underwriting, pricing and loss control.

While there are numerous benefits to captives and their popularity is rising, they are not always the right fit for every organization and every risk. Yet as businesses evolve and their risk profile changes, it's worth periodically re-evaluating a role for captives in a broader risk management approach. That means getting a handle on the various types of captive insurance structures available and some critical tipping points that may indicate a captive approach is worth a closer look.

CATEGORIZING CAPTIVE OPTIONS

There are many different ways captives can be structured, but they tend to fall into one of three broad categories:

- **Single-parent captive** – also known as a pure captive, this structure is typically an insurance company owned by its parent company that insures the risks of that company and affiliates, which often fund large deductibles and may have complex risks. A single-parent captive is best suited for companies with premiums in excess of $2 million, but can be set-up for a company with premiums as low as $1 million. The captive's owners will have to put up initial capital based on premium writings, types of coverage and policy limits assumed by the captive.

- **Group captive** – this structure is based on a number of organizations joining together to form their own insurance company. Group captives are effective for mid-market organizations that do not want to incur all the costs of establishing their own insurance company. Performance is shared among the group members but it is quantified and follows a set methodology. Group captives can be homogeneous (similar industries) or heterogeneous (different industries), but typically companies are privately held and engage in sound risk management practices. A group captive is best suited for single organizations with annual premiums between $200,000 and $1.5 million for workers compensation, general liability and automobile liability.

- **Hybrid captive** – also known as a segregated cell or segregated portfolio captive, a hybrid captive allows organizations to use a captive structure without directly owning the insurance company. This structure allows an organization to "rent" the segregated cell's capital and insure specific coverages supported by another entity, usually another insurance company. A hybrid captive is best suited for single organizations with premiums in excess of $1 million or groups with premiums in excess of $3 million.

With this understanding of various captive models, here are four factors that suggest captive insurance might be a good fit for your business.

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TIPPING POINT #1
YOUR BUSINESS HAS A PROVEN TRACK RECORD

For organizations with a long-term risk financing strategy and proven results in loss control efforts, captives can be an effective way to drive down costs and retain greater control over coverage. Loss ratios below 50 percent and predictable costs year after year create an opportunity to tailor coverage limits and deductibles to maximize savings. This is especially beneficial in traditional property and casualty lines including workers compensation, general liability and auto liability, where there's an investment opportunity in insuring against long-tail losses. A business with a long-term strategy and good loss control may be better suited to handle the startup expenses associated with establishing a captive and realize the benefits of fewer costs and claims. This proven track record also suggests the organization will efficiently manage risk in the future.

TIPPING POINT #2
YOUR BUSINESS HAS A LACK OF TRADITIONAL INSURANCE OPTIONS

Other organizations may be driven toward captives by a lack of traditional insurance coverages. Businesses in niche industries can develop more tailored coverages and policies with fewer exclusions. This need for tailored coverage also applies to emerging risks, including cyber and terrorism coverage, which may have limited policy options or is prohibitively expensive in the traditional markets. Single parent captives are usually the structure

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used to address these coverage items. On the other hand, group captives may be able to obtain better rates and coverage enhancements compared to the traditional market, as group captives base their pricing on an individual members own loss experience. Group captives also benefit from mass purchasing power, including investments in safety and loss control programs to lower costs over time.

TIPPING POINT #3

YOUR BUSINESS IS ON THE CUTTING EDGE OF RISK

Company leaders with a deep understanding of risk or who like to manage all aspects of the business may not like the idea of ceding any control over risk to outside partners. In these cases, a captive approach may match leaders' entrepreneurial spirit. Companies and leaders may recognize the savings and control that come with a captive approach and want to take on the challenge of achieving a better risk management approach and view it as an investment in the future of their organization. Rather than allowing the traditional market insurance company to benefit from a company's good loss performance, a captive owner puts itself in the position of the insurance company and thus reaps the benefits of the superior performance.

TIPPING POINT #4

YOUR BUSINESS COULD BENEFIT FROM SHARED BEST PRACTICES

When organizations with solid loss control efforts combine forces in a captive, the potential for savings can be even greater. Group captives can benefit from an atmosphere of collaboration to better prevent claims and improve claims management. Homogenous captives have an opportunity to share industry best practices and set ambitious risk management goals.

WHAT COMES AFTER THE TIPPING POINT?

For businesses who may be primed for captive solutions, the next step is a relatively straightforward financial analysis. Organizations should compile five years of loss runs and corresponding premiums for the lines of coverage in consideration as well as exposure information. Crunching the numbers should quickly show if utilizing captives would make business sense. In most cases, an experienced partner can help figure out if a captive is a good fit and how to best structure this alternative insurance strategy.

To discuss captive insurance solutions:

Please contact a Conner Strong & Buckelew representative

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