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Finding Business Freedom Through Captive Insurance

I. What is a captive insurance company?

It is generally accepted that the term "captive insurance" was coined by Frederic Reiss in the 1950s. And while to some more than sixty (60) years may not seem like a lot, the underlying concept has been around for much, much longer. In fact the origins of our modern insurance in the 1500s and such insurance heavy weights as Lloyds, have their genesis in captive insurance.[1]

In simple terms, a captive insurance transaction is an insurance contract between an insured and an insurer that are related in some form or fashion, either through common ownership, control, management, or a combination of them or through familial relationships involving those parties.

A captive insurance company then is one that principally writes captive insurance transactions. It is important to note, however, that just because an insurer meets the definition of a captive insurance company as provided, doesn't mean that the insurer must be licensed as a captive insurance company, but may be a full commercial insurance company licensed under the same standards as any other.

Examples of current commercial insurance companies that started as a captive or have engaged in significant captive insurance transactions include ACE Limited ("ACE"),[2] which as of 2016 owns Chubb, and Allstate Insurance Co. ("Allstate").[3]

[1] Mutual insurance companies were the first to form in modern times as groups of similarly situated insureds would pool their resources to protect each other from such perils as fire or storm, or loss of cargo or ship at sea. Some were community based, while others were industry specific such as maritime merchants.
[2] ACE was formed in 1985, in the midst of the U.S. insurance crisis, by a consortium of 34 blue-chip companies in order to be able to obtain insurance through the captive insurance company.
[3] Allstate was formed in 1931 as a subsidiary of Sears, Roebuck & Company ("Sears"), and in 1945 Allstate begin to provide insurance to Sears. By the 1980s, between 0.25% of Allstate's premiums written came from Sears (which amount from Sears was about $14.4 million in 1982).

Perhaps the simplest example of a captive insurance company is a "pure" one. In the traditional sense, a pure captive insurance company is generally understood as one that insures only the risks of its parent.[4]

One of the more common examples of captive insurance companies in the commercial market is mutual insurance companies. While not thought of traditionally as captives, they are nonetheless captive insurance companies engaged in captive insurance transactions because the insurance company provides insurance to its owners.

A. How captives fit within the risk financing spectrum

From the very beginning, captive insurance companies have been highly flexible instruments used to create tailored programs for their insureds. A captive insurance company like all insurance companies are a form of social savings against the calamities of business and life. If insurance in the traditional market is unavailable or punitively priced, a captive insurer offers a custom route to achieve the same saving for risk in a more economical manner. Sometimes the term "self-insurance" is used, and while it is similar to a captive insurance, there are some significant differences.

In captive insurance for example, there is an insurance company, albeit related, that assumes the risk of the related insureds. The formality of the structure provides discipline and the regulatory oversight provides safeguards to make certain that the risks are being adequately funded. Self-insurance in contrast refers to the absence of insurance where a person retains risk and sets aside a reserve against calamity. Unfortunately, without the discipline that can be afforded by a properly constructed captive insurance company and program, self-insured programs tend to be woefully underfunded, making them problematic.

B. Types and uses of captives by construction companies

In modern practice, there are two principal types of captive insurance companies that are used, pure, which was described above, and group. Group captive insurance companies are typically either stock where a group of unrelated owners of the insurer each have a related business entity or entities insured by the captive insurer, or mutual where the group of insureds of the captive insurer are unrelated to each other and are the owners of the captive insurer.

1. Group Captive Insurer for Property & Casualty

A group of unrelated businesses come together to mutually cooperate in a risk management program. Groups can be organized on a homogenous basis or heterogeneous basis. A homogenous group is typically companies in the same industry or same geography. A heterogeneous group is composed of businesses with similar risk management ideals, regardless of industry or geography.

[4] However, in recent years, the meaning of a pure captive insurance company has expanded to include one that insures its affiliates or controlled unaffiliated business.

Typically group captives are fronted by an A-rated insured, satisfying all insurance requirements of the contractor. The fronting insurer will then insure risk to the group captive. The group captive will take a layer of risk, and then purchase stop loss or reinsure risk above a certain amount back to the fronting insurer or another reinsurer.

Typical lines of risk in a group captive are workers compensation, general liability, and auto liability.

Group captives offer risk management programs to their members, and allow members to share best practices with each other.

2. Group Captive Insurer for Employee Benefits

For employers that are self-insured for employee benefits, there are group captive programs available to purchase the medical stop loss policy from the captive. Typically these policies are fronted by an A-rated insurer, with the captive taking a finite layer of risk, with excess covered by the fronting carrier or other reinsurer.

3. Pure Captive Insurer for Standard Deductibles or Retentions

A pure captive typically is insuring risks of businesses related by common ownership, or businesses within common control. While fronting these captives is possible for larger single parent captives, most are not operating on a fronting basis. Thus, the risks insured by the captive are often the construction company's deductibles and retentions. Policies are written on a deductible reimbursement basis.

4. Pure Captive Insurer Uses for Non-traditional Risk

Pure captives are not limited to insuring only deductibles and retention on commercial policies. Other uses of pure captives include:

- Generating another profit source for the construction business, such as insuring construction defect insurance or extended warranties;
- Insuring gaps and exclusions in commercial policies;
- Being the sole insurer in commercially available policies (e.g., cyber liability, D&O); and
- Covering risks that are not easily available in the commercial market (e.g., Administrative Actions, Reputational Risk, and Litigation Expense).

All of these above uses are customized to the business and may be subject to regulatory restrictions.

As with the birth and early evolution of insurance in the modern era, the flexibility of captive insurance lends itself well to structuring and creating insurance programs that can cover risks that have not been traditionally or even previously available in the commercial market. This singular advantage positions captive insurers in a unique position to innovate in the insurance industry. For example, captives were offering cyber insurance coverage years before the commercial market offered this policy.

II. Deeper Dive: A Handful of Popular Uses of Captive Insurance Today by Construction Firms

The captive insurance industry is still going strong and here are a handful of popular uses of captive insurance by construction firms today:

A. Group Captive Insurance for Workers Compensation, General Liability, and Auto

See above description for background on group captives.

In a typical group captive arrangement, the premiums are applied to four areas:

a) Expenses for operating the group captive (premium tax, fronting cost, management services, brokerage services, audit, legal, etc.)
b) Loss fund tied to the individual performance of a particular participating business. This fund typically covers the first dollar of any loss.
c) Group loss fund, creating a sharing layer among the group for losses above a certain level. This fund's layer is capped by stop loss or reinsurance.
d) Risk transfer to a commercial carrier stop loss or catastrophic coverage.

Based on the performance of the individual loss fund and group loss fund, dividends can be paid from the group captive back to the participants.

B. Subcontractor Default Insurance with a Captive

One of the most significant uses today of captive insurance by construction companies is creating their own subcontractor default insurance program (e.g., Subguard[5]). With these types of programs, construction firms can often reduce costs, manage their risks associated with subcontractors, and even turn an additional profit.

C. Employee benefits

Like most other industries, construction firms seem particularly interested in using captive insurance to manage the costs and risks of employee benefits. Its use with employee health care casts is particularly pronounced. The increased requirements and taxes associated with the Affordable Care Act have caused many mid-sized employers to create self-funded health plans for their employees and then purchase medical stop-loss at a certain level from a captive insurer that then cedes the top layer to a commercial reinsurer.

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[5] Subguard is a subcontractor default insurance program developed by Zurich Insurance in 1996.

D. CCIP/OCIP with a Captive Insurer

A Contractor Controlled Insurance Program (or Owner Controlled Insurance Program) may also have a pure captive owned by the contractor (or owner) insuring a portion of the risk.

III. Risk Manager perspectives on financing construction risks in captives

While captive insurance may at times seem simple, it is important that the risk manager and all service providers, and officers of the captive have a sufficient depth of experience in their respective roles to anticipate problems as they arise, communicate options, and facilitate a speedy resolution, as well as to facilitate ongoing adaptation of the program to be in tune with the broader risk management and corporate finance strategy of the insureds. Among the many things risk managers should consider are the following.

The financial strength and capacity to assume risk within meaningful limits is central to all risk retention strategies that should seek to match risk appetite and tolerances with risk taking/retention decisions. Understanding how much risk you can afford to take must be aligned with final retention decisions and periodically revisited as circumstances change.

The size and number of participants of group captives is also important to understand to ensure you're risk profile is in sync with those of others with whom you are sharing risk. Ideally, exposures should be similar in order to experience similar loss trends and financial results with the others in the group. Risk managers must also understand the risk profile of the existing group members and any legacy risks that may exist from former insureds as this will impact your experience and may expose you to liabilities you may or may not have anticipated.

As with most captive structures, the quality and stability of the fronting and reinsurance relationships will also ensure that regulatory expectations are met and that risk transfer through reinsurance will be an aspect of your strategy you can count on when and if needed after certain loss scenarios are incurred. This relates back to risk appetite as some reinsurers and front arrangements will be represent more risk than others.

Since captive performance is so dependent on the quality of the service providers and the availability of risk management, loss control and claim support for each member, these provider relationships should also be carefully vetted to ensure they meet stakeholder expectations and that the appropriate due diligence has been completed to achieve the desired service results.

As with all insurance entities, cash flows associated with premiums, loss payments and participant equity accounts and their interdependencies are critical to stable financial results and in funding both short and long term operational requirements of the captive. Well-constructed pro-formas and ultimately disciplined financial performance management and tracking are needed to achieve successful performance.

The quality and skills of the facility's management and corporate governance will ultimately determine how well the captive will perform as all operational and strategic decisions are vested in the people occupying these roles. Careful consideration should be given to their identification and selection.

Finally, since no captives last forever and there are often reasons that emerge that will require shut down of the facility, it is important to have an exit strategy and to be sure you understand the regulatory requirements for doing so, including loss security, access to equity account funds and future assessment obligations. This should be part of the feasibility study that precedes launch.

IV. Things a Risk Manager Should Be Aware of When Considering a Captive

A risk manager should be aware of a number of things when considering a captive; specifically: (A) certain key suitability questions, (B) misconceptions, (C) the many kinds of captive insurance structures, and (D) the concerns by the IRS regarding captives.

A. Many Kinds of Captive Insurance Solutions Available

Captives are like trusts, they are very flexible and there many types, configurations, coverages, and programs that can be tailored to fit particular needs.

Common types of captives include: pure, industrial, group, agency, sponsored, and rent-a-captive. Programs may include pools, commercial reinsurers, coverage layers, retentions, deductibles, commercially available coverages, specialty coverages, and more.

B. Concerns by the IRS Regarding Closely Held "Pure" Captives, Particularly Small Ones

The IRS has been regulating captive insurance companies virtually since their arrival in the 1970s. The tax rules are an area that has changed and evolved over the past 40 years, and this trend is expected to continue in the future.

Most recently the IRS has attacked small captive insurers making a special tax election available to small insurance companies under 26 U.S.C. §831(b). Even though there are a number of cases involving these small captive insurance companies before the U.S. Tax Court, it is anticipated that the court will continue to take a balanced approach and by and large ignore these ongoing IRS complaints.

C. Suitability Questions to Consider

A Risk Manager should carefully consider the following questions:

- Do I understand and can I articulate the risk management and risk financing role of the captive?
- Am I willing to spend the time to gain the benefit of a group captive or pure captive arrangement?
- Am I looking to share risks with others in my industry, or other different industries?
- Do I have the financial capacity to post capital?
- Will I respect and be able to cause others in my organization to respect the captive as a regulated insurance company?
- Have I or can I set up sufficient controls to make sure that all transactions with the captive insurance company are principally arms-length?
- Have I or can I set
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- controls to identify and timely file with the captive insurance company, all claims coverable or likely coverable under the insurance policies issued by the captive?

D. Misconceptions

The following are misconceptions about captives, one or more of which are sometimes held by those who are first learning about captives:

- It is a piggybank/operating slush fund/ “my money”
- I don’t care if the regulators said no, I’m doing it anyway
- Captives will also be cheaper than the market each and every year
- I want to control my risk through a captive, but am too busy to spend time understanding how the captive operates
- I think the capital & surplus should be as low as possible

Prompt correction and education should be given at the first indication of any of the above misconceptions.