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Captive Insurance: An Alternative to the Additional Insurance Market

I. The Alternative Risk Transfer Market Generally.

Companies traditionally insure their risks, including the risk of workers' compensation liability, by purchasing insurance from insurance companies licensed from state-to-state, which provide policies covering the cost of wage loss indemnity benefits, medical care and treatment, and on occasion rehabilitation for workers injured on the job. Workers' compensation costs are one of the many factors that influence businesses to expand or relocate in a state. When premiums for insurance rise sharply, employers look for alternatives.

The alternative risk transfer (ART) market exists for that purpose. The ART market is broken into several different segments. The segment this session will discuss is the captive insurance market: what it is and its risks and benefits.

Captive insurance is a growing field of risk funding and finance. Once limited to large Fortune 500 companies, captive insurance today is a risk management tool available to many employers and industries on a pooled basis, where risk is shared among many members. So in general terms, the most common types of captive insurance companies are those created and owned by a single large corporation, and those which are created and owned by groups, or pools, of similar businesses which collectively create, own, and manage a captive insurance company. The requirements for captive insurance, and in particular, the requirements for captive insurance pools, are regulated by each state, just as is workers' compensation itself.

Insurance is a source of capital used to play claims. Because captive insurance is a growing field, every professional, including insurance adjusters, should be familiar with the benefits that a captive insurance company can provide.

II. Captive Insurance Companies

A captive insurance company is an insurance company created and wholly owned by one or more non-insurance companies to insure the risks of its owner or owners. Captives are, in essence, a form of self-insurance in which the insurer is owned wholly by the insured owner or members of the group or pool.

Captive insurers come in multiple forms. What they have in common and why they constitute a form of insurance with which insurance claims professionals, risk managers, and loss control managers should be familiar is because, since they are in essence a type of self-insurance, in a group or pool captive, the captive member companies generally demonstrate a significantly increased sensitivity to the way claims are managed and what is paid on a claim. They are, after all, spending their own money. Adjusters, therefore, must have an increased sensitivity to the costs of claims they are handling, and an awareness of the financial impact of claims, because there is a more direct correlation between the claim experience and result and the financial health of the member company than is typically found in a traditional insurance arrangement.

A pure captive insurance company is one with only one corporate owner, which insures only the risks of the parent organization or its subsidiaries. It is also called a single-parent captive. Thus, it has the closest correlation to self-insurance among the various types of captive insurance companies. Single-parent captives are still the single most prevalent structure in use today. Generally, a single-parent captive exists for the purpose of providing risk transfer financing on a specific line of coverage such as worker's compensation. The single-parent captive structure is a corporation. Thus, in the formation of a captive, consideration must be given to who will serve as the owners, directors, and officers of the captive insurance carrier.

In addition, all captives, whether single-parent or pooled/group captives, are regulated the states or, in some instances, foreign countries in which they are domiciled just as any commercial insurance company is regulated by domicile. There are many factors to analyze in determining where a captive should be formed, including operational and tax considerations, licensing requirements and capital considerations. A captive insurance company is formed, governed, and licensed under the laws of a particular state or domicile that issues insurance policies to related businesses in exchange for premiums. In recent years, offshore, foreign jurisdictions have become popular domiciles for captive insurers. Generally speaking, many Caribbean nations have relaxed standards for captives including lower capitalization requirements. These tax considerations are important in the original formation and domicile decisions when a captive is created. This session will introduce to claims professionals who attend some of these tax concepts to help them understand and learn why the captive insurers whose claims they manage are often domiciled in other jurisdictions or even offshore.

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A captive insurance carrier can provide workers' compensation coverage through a "fronting arrangement" as well as reimbursement of deductibles. In addition, the funding of a captive insurer brings potential tax benefits not available to any traditional insurance arrangements. Therefore, this session will provide adjusters with an increased knowledge and awareness of the financial and economic consequences of the claim process and the impact of claims on the bottom line profitability of the captive owner or group members. This awareness will help to increase the competence and knowledge base of adjusters handling workers' compensation claims.

In recent years, a growing number of states have allowed group or association captives, in other words, a pool, for multiple businesses to join together to use a captive to obtain coverage or limits on insurance that are otherwise unavailable. This form of captive insurance has increasingly become a source of revenue and industry association common among many trade groups. A group or association captive pool can be a management challenge as it brings together risk related issues common among the members but not always on a level where awareness and sensitivity are equal among the members. For example, group captives generally create management teams to police the loss control activities of members as well as the risk management functions of members of the pools. The growing popularity of group captives permits businesses too small to self-insure to retain the ability to mange their risks and their costs in ways otherwise not available. For example the profits of businesses are reduced by the cost of commercial insurance and further threatened with excessive or uninsured risks. Through the implementation of a captive, a business owner can reduce and contain commercial insurance and deductible costs, and even provide insurance for previously uninsured risks. The premiums received by a captive are invested and thus not "lost" if not used to pay claims in the same sense that commercial insurance premiums are paid to an unrelated insurance company. Insurance claims professionals who manage workers' compensation claims for group captives, in particular, confront and become familiar with financing and management issues that are not typical of most insurance companies. This session will introduce them to various methods of funding claims utilized by group captives in particular, and the unique challenges that group captive management structures often present. Group captives confront the special challenge of ensuring that each member of the group is exercising a high level of loss control and risk avoidance, and prudently managing and paying claims. The claims professional who manages these claims is an indispensable part of the success of this process.

Improved risk management and risk financing are the main reasons to form and operate a captive. In the commercial insurance market premiums must be adequate to meet the cost of claims, overhead, and profit by the insurance company. But by establishing a captive, the owner or the members can retain the profit within the business rather than see it go to an outside party. Captives may reduce insurance costs by charging premiums that more accurately reflect loss experience. In addition, captives can improve cash flow for the owner or members because they may offer more flexible premium payment plans.

Improved risk management is an important focus of captive insurers, whether a pure captive or group captives, and one of the significant impacts on the work performed by insurance claims professionals. Effective risk management programs can result in actual recognizable profits for the captive and its members. Therefore, risk management tends to be viewed by a captive owner or member not as a cost center but as a potential profitable part of the business. A successful group captive supervises and polices its members to ensure that highly effective risk management practices are employed. A group member which does not effectively manage its risks, and which encourages payment of dubious claims, can negatively impact the profitability of every other member. Therefore, claims professionals must have an awareness of these issues. This session will introduce these topics and impart to claims professionals and other attendees a new knowledge regarding the risks and benefits of captive insurance.

Finally, one of the great advantages of group captives to the members is the ability to unbundle services. This means that both single owner and group captives can contract with third party administrators of their choice to provide claims management services consistent with the goals and objectives of the captives and to ensure the captive members are receiving the best claim management services available. An insurance claims professional working on behalf of such captives becomes critically aware of the heightened sensitivity to the successful management of claims. This session on captive insurance carriers, therefore, will introduce a great many new concepts to insurance claims professionals and other attendees which will help them become more effective in the performance of their work everyday.