Using captive insurance companies for savings

Small companies have been copying a method to control insurance costs and reduce taxes that used to be the domain of large businesses: setting up their own insurance companies to provide coverage when they think that outside insurers are charging too much.

Often, they are starting what is called “a captive insurance company” an insurer founded to write coverage for the company, companies or people who founded it.

Here’s how a captive insurer works.

The parent business (your company) creates a captive so that it has a self-funded option for buying insurance, whereby the parent provides the reserves to back the policies. The captive then either retains that risk or pays reinsurers to take it. The price for coverage is set by the parent business; reinsurance costs, if any, are a factor.

In the event of a loss, the business pays claims from its captive, or the reinsurer pays the captive.

Captives are overseen by corporate boards and, to keep costs low, are often based in places where there is favorable tax treatment and less onerous regulation such as Bermuda and the Cayman Islands, or U.S. state like Vermont and South Carolina.

Captives have become a very popular risk-financing tool that provides maximum flexibility to any risk-financing program. And with the additional possibility of adding several types of employee benefits to captives, they can provide further strategic value to their owners.

While the employee benefit aspects have nor emerged as quickly as had been predicted, there is a little doubt that widespread use of captives for employee benefits is just a matter of time. While coverages like long-term disability and term life insurance typically require Department of Labor approval, other benefit-related coverages such as medical stop-loss can utilize a captive without the department's approval. Additionally, some midsized corporate owners also view a captive as an integral part of their asset-protection and wealth-accumulation plans. The opportunities offered by a captive play a critical role in the strategic planning of many corporations.

A captive insurance company would be an insurance subsidiary that is owned by its parent business(es). There are now nearly 5,000 captive insurers worldwide. Over 80 percent of Fortune 500 Companies take advantage of some sort of captive insurance company arrangement. Now small companies can also.

By sharing a large captive, participants are insured under group policies, which provide for insurance coverage that recognizes superior claims experience-rated refunds of premiums, and other profit-sharing options made available to the insures.

A true captive insurance arrangement is where a parent company, or some companies in the same economic family (related parties), pay a subsidiary or another member of the family, established as a licensed type or insurance company, premiums that cover the parent company.

In theory, underwriting profits from the subsidiary are retained by the parent. Single-parent captives allow an organization to cover any risk they wish to fund, and generally eliminate the commission-price component from the premiums. Jurisdictions in the U.S. and in certain parts of the world have adopted a series of laws and regulations that allow small non-life companies, taxed under IRC Section 831(b), or as 831(b) companies.

TRY SHARING

There are number of significant advantages that may be obtained through sharing a large captive with other companies. The most important is that you can significantly decrease the cost of the insurance through this arrangement.

The second advantage is that sharing a captive does not require any capital commitment and has very low policy fees. The policy application process is similar to that of any commercial insurance company, is relatively straightforward and, aside from an independent actuarial and underwriting review, bears no additional charges.

By sharing a captive, you only pay a pro rata fee to cover all general and administrative expenses. The cost for administration is very low per insured (historically under 60 basis points annually). By sharing a large captive, loans to its insureds (your company) can be legally made. So you can make a tax-deductible contribution, and then take back money tax-free. Sharing a large captive requires no significant financial commitment beyond the payment of premiums.

The operation of a stand-alone captive insurance company may not achieve the same cost savings that can be obtained through sharing. More important, group captives require little or no maintenance by the insureds, and can be implemented in a fraction of the time required for stand-alone captives.

If done correctly, sharing a large captive can yield a small company significant tax and cost savings.

If done incorrectly, the results can be disastrous.