



Captive Insurance Companies for the Middle Market

A captive insurance company is an enormously powerful financial planning tool for owners of middle market companies. It facilitates cost-effective and efficient risk financing and has the potential to provide benefits in the medium term amounting to literally millions of dollars.

What is a captive?

A captive is an insurance company owned by a business or a business owner, which insures the risks of that business.

Originally the preserve of only the very largest companies, captives are no longer the exclusive tool of those in the Fortune 500. In fact, there are now well over 5,000 captives writing over \$50 billion in annual premiums. Many of these captives insure middle market companies and successful professionals.

A captive provides a range of potential benefits to the business owner such as:

- ◆ **Lower Insurance Costs.** Use of a captive largely eliminates that part of commercial insurance premiums that covers the insurer's acquisition costs, overheads and profit. A captive may also help reduce insurance costs by charging a premium that more accurately reflects the insured's own loss experience.
- ◆ **Better Cash Flow.** By offering a more flexible premium payment plan and by enabling the business and its owners to retain premium and investment income, overall cash flows can be significantly improved.
- ◆ **Improved Risk Management.** A captive can act as a focus for the risk management and risk financing activities of the business. An effective risk management programme will result in recognisable profits for the captive and its owners. Access to the wholesale reinsurance market increases flexibility and lowers cost.
- ◆ **Better availability of Coverage.** A captive can provide coverage that is unavailable or uneconomical in the commercial market.
- ◆ **New Profit Centre.** A captive may operate as a separate profit centre by writing the risks of third parties, particularly customers of the core business. This often helps customer retention and provides valuable additional revenue.
- ◆ **Tax Benefits.** Insurance companies report profits differently from other companies and, accordingly, have significant tax advantages. Smaller insurance companies have additional tax breaks afforded to them by Section 831(b) of the Internal Revenue Code.

Cost-Effective and Efficient Risk Financing

A captive is a cost-effective way of financing risk because it helps a business structure its insurance programme to retain the risks that are not worth transferring and reducing the outflow of premium dollars to third parties.

It is an efficient risk financing vehicle because, as an insurance company, it can establish reserves and deduct these from taxable profits. Ordinary companies cannot do this. They can only deduct the cost of claims when those claims are actually paid. However, a business that pays premium to a captive can deduct the premium expense, while the captive itself can establish deductible reserves.

A captive is efficient because it provides the means to build up a contingency fund for the payment of future claims using pre-tax dollars.

IRC Section 831(b)

Small insurance companies enjoy additional advantages. A property and casualty insurer with annual premium income not exceeding \$1.2 million pays no tax on its underwriting profits but is taxed solely on its investment income. In this case, the business that pays premium to a captive deducts the premium expense while the captive pays no tax on the underwriting profits.

High Deductible Insurance Programmes

A business can reduce the premium that it pays to its insurers by accepting a higher deductible. This applies in most classes of business. The deductible can be set at a level where the insured business feels it has control of relatively predictable claims. After that its insurers step in to cover larger claims.

Insurers generally require the insured to collateralize high deductibles by providing a letter of credit. This is normally done by the insured business with the letter of credit backed by post-tax dollars.

Better by far for the business to pay premium to a captive for a deductible reimbursement policy and have the captive secure the letter of credit against pre-tax dollars.

Traditional Risks

Whether insuring General Liability, Professional Liability, Auto, Property or Workers Compensation risks, many businesses can reduce their overall cost of risk by retaining some portion of what they insure in a captive.

Liability coverages work well in captives because claims generally take a long time to work their way through the system and, while they are doing so, insurance companies earn investment income on the premium.

Property risks can most effectively be insured using a captive when the insured has many locations to insure or is faced with exclusions or high deductibles for catastrophic risks such as windstorm. A captive may also be useful when insurers do not give proper credit for safety features inherent in a building's design and construction.

Workers Compensation is something of a captive favourite, accounting for about 43% of the alternative risk market. Use of a captive allows better control of costs for those claims falling within the range of ordinary predictability (often through use of a high deductible programme) and provides an excellent focus for improved risk management procedures. For many, the

introduction of a captive element into their Workers Compensation programme will have significant tax advantages.

Uninsured Risks

Every business is exposed to risks that are not insured. These fall into two categories:

- ◆ Unavailable/unaffordable insurance;
- ◆ Unconsidered risks

Insurance policies contain many exclusions, which can leave a business uninsured against very real perils. For some businesses and professionals, certain types of coverage are either completely unavailable or so expensive as to be uneconomical. The policies issued by a captive can be specially designed to meet the precise needs of the insured.

Unconsidered risks are those risks that a business has simply not thought about insuring, probably because it did not know that they could be insured. All businesses have them and those that do not identify them and insure them are making no provision for future claims. Such risks may include various loss of income risks, loss of key customer, computer data risks, loss of goodwill, product recall, equipment failure etc. The list is literally endless.

Many of these risks, once identified, can be assessed and insured. It makes sense to do so.

Suitable Candidates

Captive solutions will best suit forward-looking, energetic and profitable active businesses in the middle market. Pre-tax profits will probably exceed \$1.5 million. Passive investment vehicles, however profitable, are rarely good candidates for a captive solution. Manufacturers, retailers, developers, contractors, physicians and other healthcare service providers, professionals and services businesses can all enjoy the benefits of a captive.

Estate Planning

Estate planning is an important business continuity consideration for closely held companies as well as for their owners. A captive insurance company can be a key component in estate planning with the captive being owned by or for the benefit of the next generation and so enabling an in lifetime transfer of pre-tax underwriting profits. A captive may also buy a reasonable sum of life insurance, planning for key man exposures and the execution of buy sell agreements.

The Captive Marketplace

The captive market just keeps on growing. In 1990 there were about 2,500 captive insurance companies worldwide. Today, in 2008, that figure is closer to 5,500 with premiums paid to captives exceeding \$50 billion. While the use of captives is a worldwide phenomenon, American businesses use captive solutions much more frequently than those of any other country. Captive insurance companies have historically been formed in offshore jurisdictions such as Bermuda, Cayman Islands, British Virgin Islands and Barbados. Recently, however, US jurisdictions led by Vermont have become major players in the captive marketplace and are now experiencing significant growth.

Jurisdiction

The first decision in choosing a jurisdiction for a middle market captive is whether to form the company onshore or offshore. Some lines of coverage, such as employee benefits, will dictate the use of an onshore domicile for the captive. Usually though the choice is determined by the difference in capital requirements, ongoing operating costs, including captive management and

premium taxes and the overall flexibility of the regulatory framework within which the captive will operate. Other factors in this decision will include tax and asset protection objectives.

Offshore jurisdictions generally have lower capital requirements, lower government fees and somewhat less onerous annual filings. Nonetheless, the minimum surplus requirements of jurisdictions such as District of Columbia and Kentucky (\$250,000) do not present a significant obstacle for most middle market businesses and for many there is a preference to do business within the US.

Jurisdictions now busy with middle market business include Cayman Islands, Anguilla, British Virgin Islands, Nevis, DC and Kentucky.

Formation and Management

In any of the most popular captive jurisdictions, a new captive can be formed within 8 weeks and often more quickly. The pre-application development phase must be added to that and may take anything from 4 weeks to 3 months.

The first step is to identify the risks to be insured by the captive and to assess how they will be financed. The results of this analysis form part of a feasibility study and business plan. Any planning for tax purposes or asset protection should also take place at this time.

After submission and approval of a business plan and insurance licence application to the regulator, the captive can be formed and capitalized and, after receipt of its licence or certificate of authority, it can start business.

Atlas Insurance Management provides a complete captive formation service, working with a select group of professionals such as actuaries, attorneys and CPAs. Once a captive is formed, Atlas will manage all aspects of its operations reporting to the owners and directors and working to achieve their objectives.