MY BENEFIT ADVISOR

Captive Insurance: Advantages and Key Benefits

While many businesses can realize significant benefits through a captive benefit structure, due diligence is necessary to accurately determine the feasibility of the approach for each particular organization.

There are numerous factors to consider when making a decision on the appropriateness of forming a captive insurance company as an alternative to a traditional self-insurance model. But an analysis may be worth the time and effort as captive insurance could be a viable and effective solution that makes sense for your business. The experts at My Benefit Advisor (MBA) can help you analyze your company's utilization and financial data to determine the feasibility of such a program.

Evolution of the Captive Concept

The phrase "captive insurance" had its origin in the 1950s when an insurance broker used the term "captive" to describe an insurance company he helped form to provide coverage exclusively to his client and their "captive" subsidiaries. For most of the time since then, it has been primarily larger companies that have benefited from operating their own captive insurance companies. These captive programs were often domiciled offshore, in Bermuda or the Cayman Islands, and were established to provide coverage in instances where insurance was either unavailable or unreasonably priced.

In recent years, many smaller and mid-sized companies have discovered that they too can reap the benefits of the captive insurance arrangement as a variation of the typical self-insurance funding method.

What is a Captive Insurance Company?

Captive Insurance is generally defined as an insurance company that is set up and wholly owned by a non-insurance company to act as a direct insurer or reinsurer for the parent company and any subsidiaries. Its primary objective is reducing a company's total cost of risk.

In essence, captive insurance is a regulated form of self-insurance that is created, owned and controlled by its insureds. The owner can be a single company or a pool of employers joining together to reduce the cost of their medical benefit expenditures. By self-insuring within a captive, the typical insurance company profits are essentially eliminated. The primary objective of a captive arrangement is to insure the risks of its owners and allow the participants to benefit from any underwriting profits

Single Parent Captive Insurance

A single-parent captive, also referred to as a pure captive, is a licensed reinsurance company formed by a company to re-insure its own risk.

Group Captive Insurance

A group captive, also referred to as simply as a captive, is a licensed reinsurance company formed by a company to re-insure the risk of both the parent company and any subsidiaries

Captive insurance can create an opportunity for the right company to take control of their insurance program, reduce their cost of risk and help create and maintain a healthy, engaged workforce.

As a result, by incorporating a captive into a health plan strategy, members can invest their assets and benefit by being owners in an insurance company.

This is also one of the aspects of a captive insurance company that distinguishes it from a mutual company. Although the policy owners in a mutual company technically own and have control in the company, they do not put any of their assets at risk.

For many companies, obtaining group health coverage can be a difficult and complicated process. Conventional insurance options often present a lack of transparency and control over premiums, claims processes and other costs. Additionally, captive programs typically coordinate plan design, claim processing, risk protection and data reporting putting everything into one package.

Objectives of a Captive Insurance Program

For a business owner, the primary objective of participating in a group captive insurance program is the long-term reduction and stabilization of health insurance premiums.

Most employers with more than 1000 employees self-fund their group insurance program. The middle market, with employers ranging in size from 20 to 1000 employees would benefit from the cost savings of self-funding but struggle with the volatility of self-funding at meaningful retentions (greater than $100,000).

A group captive accomplishes this goal by placing members into a loss sensitive program where premium is developed based on the member's own experience. Rather than being subject to the annual fluctuations of the insurance market, members are priced based on performance.

Members of the captive also can recoup underwriting profit and earn investment income. The key difference is that the member is now an owner rather than a buyer of insurance. This alternative solution creates a new mindset for the member and provides incentives to better manage risk and prevent losses.

Additionally, by avoiding the restrictions of a fully insured model, they are able to customize their coverage to fit the specific needs of their company, avoid many of the ACA and premium taxes, and enjoy long-term premium stability.

Most employers with more than 1000 employees self-fund their group insurance program

Pros and Cons of a Captive Insurance Program

While a captive arrangement might work well for one company, it may not work as well for others. Although there are numerous benefits that a company may receive when developing or participating in a captive insurance program, it is important to note that there are also considerations that should be given to the extra burdens or potential risks of the arrangement. However, with a thorough and well-designed feasibility study, the right company can take advantage of a captive's many benefits and neutralize many of the potential drawbacks.

Potential Benefits of Forming a Captive:

Cost Control

With a captive arrangement, there is potential for reduced costs since in exchange for bearing the burden of risk, the company can reduce costs in three ways:

1

Reducing fixed costs

Unlike traditional insurance plans where costs are fixed and low claims produce little or no benefits, a captive program will allow a company's costs to drop if a strong claims history is maintained.

2

Underwriting gains

If a company can effectively control its losses, it will enjoy underwriting profits, allowing premiums to be retained or distributed.

3

Investment income

In addition to increasing cash flow, captives can earn investment income of loss and unearned premium reserves.

This all leads to better control of costs related to the employee benefit budget, including the stabilization of pricing and a reduction in costs associated with risk management.

Customization of Insurance

Traditional insurance is designed for the “average” person, failing to consider the unique set of needs found within the employee population of a specific company or group of companies. Traditional insurance companies also tend to be risk-averse and more generalized. Captives, on the other hand, enjoy the ability to customize the terms and conditions of coverage under their policy. In this way, unlike through most standard group policies, companies can avoid the reliance on commercial insurance companies and the restrictions that come with fully insured models. Instead, coverage can be tailored to fit the needs of each specific company.

Tax Advantages

Although it varies based on specific company circumstances, there are often certain tax advantages that may be obtained by a company involved in a captive insurance arrangement. A properly structured and managed captive could provide tax favored accumulation of underwriting and investment income, the deductibility of premiums paid, and distributions to captive owners at favorable income tax rates, in addition to other advantages based on domiciled and insured location.

Ability to Direct Investment Options

In a captive insurance arrangement, unlike that of a group obtaining commercial insurance, the captive controls the investment choices involving premium accounts.

Improved Cash Flow

The cash flow in a captive environment whereby premiums are paid in advance and claims are typically paid out over a lengthy period often results in the ability to generate significant investment income from unearned premiums.

Underwriting Advantages and Cost Transparency

Since captives are owned and operated by the insured, there is greater access to real-time data including:

Claims data	Medical diagnoses	Provider usage	Types of service

The ability to collect and analyze this data, seldom available with such depth and completeness through arrangements involving commercial carriers, provides a key benefit for captives. A wide range of analytical tools can be utilized with this data to improve outcomes in a variety processes and functions.

Improved Levels of Customer Service and Claims Processing

By establishing their own policies and procedures involving claims and customer services, the captive can reduce the time required to process and pay claims and elevate the level of customer service provided to employees.

Insight into Transparency

Captive insurance in the group medical insurance market is helping to level the playing field for small and mid-sized employers. Most employers who offer fully-insured health benefit plans have no idea what type or dollar amount of claims their covered population incur, or how their premium dollars are allocated. Most insurers simply do not disclose this data, especially not to anyone but their larger groups.

Unfortunately, without this information, business owners lack the data necessary to take control of their healthcare budgets.

With captive insurance arrangements, an employer will generally have full access to how their dollars were spent; detailed claim information, dollars allocated to retention costs and amounts paid for re-insurance. By sharing this information, companies participating in the captive are incentivized to help each other by sharing their best practices to lower loss experience, thereby improving the overall results of the captive.

Potential Concerns to be Aware of When Forming a Captive:

Administrative Burden

Unlike the involvement in a commercial insurance arrangement, a captive is responsible for underwriting, claim administration, loss control, and customer service processes. Additional funds, personnel, time, management and expertise are required to administer these services. Although these costs can be offset by contracting out the administrative functions to a third-party entity, doing so will reduce potential savings.

Capital Commitment

Especially during the initial stages of a captive formation, there will be the need for substantial financial resources to fund the set-up costs, such as plan formation, personnel requirements, legal fees and capitalization required by the domicile's regulatory body. Particular attention should be paid to hidden costs/fees in these types of arrangements.

Increased Risk

In a captive arrangement, without robust risk management policies, the owner-insured can put their own capital at risk. If a company experiences a high level of claim experience, the owner's capital could be lost.

Compliance Concerns

Concern: Potential MEWA

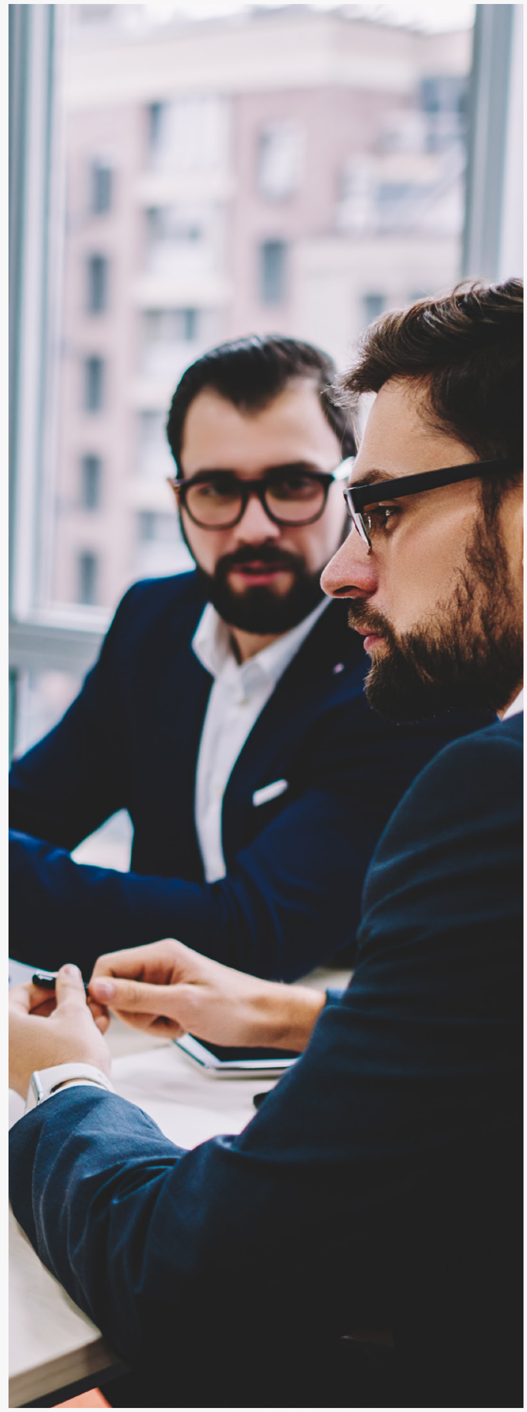
This type of group arrangement might be viewed as a Multiple Employer Welfare Arrangement (MEWA) by the Department of Labor and state regulations. This is particularly true if the stop loss policy is part of the welfare benefit program. It is important to note that, if regulated as a MEWA from the state level, this arrangement will likely be viewed as self-insured and thus may not be viable in certain states. There are likely other laws and regulations outside the scope of benefits governing the establishment and maintenance of a captive or group captive by an employer, which should be reviewed with counsel prior to implementing such a program.

Concern: Foreign Situs

For welfare arrangements (e.g., life, disability and medical plans) that are subject to the Department of Labor's jurisdiction, the captive must be sitused in the United States.

Concern: Prohibited Transaction

Reinsuring the risk associated with a welfare benefit plan through an employer's captive may be a prohibited transaction under ERISA, as the employer is a party in interest. The Department of Labor allows employers to apply for an exception through a lengthy and onerous process.



Determining the Feasibility of a Captive Arrangement for Your Business

As corporate healthcare spending continues to escalate, more businesses are considering a move from the traditional insurance marketplace to captive insurance as a method of cost control and risk management. A captive program enables a business to self-insure programs that would otherwise be insured by a third party.

Although there are many benefits of a captive insurance arrangement however, it will not be the right approach for all organizations. As such, a detailed, methodical, and professional analysis should be performed prior to any decisions being made. Along with the resources offered by a well-qualified benefit consultant, a business owner should consider an evaluation from professionals regarding tax, accounting, and legal issues.

Criteria to be considered for organizations considering creating or joining a captive include:

Claim Utilization History

A loss ratio of less than 50% is ideal, as is low claim frequency and a history of few major claims. If claims are costing more than the premium paid by the company, it would be better to have a third party bear the risk.

Profitable Business Entity

A sufficient cash flow is required to cover any risk or fluctuations in claim funding.

The Ability to Post Collateral

One of the requirements of a captive arrangement is for the company to set aside funding for the payment of claims arising from the risk taken.

A Minimum Level of Health Insurance Premiums

Required levels could vary, but generally, an insurance premium of at least $100K is needed to achieve the benefits of a captive program.

A Sufficient Tolerance for Risk

Although there are many benefits of a captive arrangement, it is a form of self-insurance that involves risk. Companies that go the captive route should be able to accommodate the risk that is involved.

A Long-Term Strategy

A successful captive arrangement requires that a business owner consider it to be a long-term strategy. The benefits cannot be achieved in a short period of time.

A Low-Risk Nature to the Company's Business Purpose

A company involved in hazardous operations is generally not a good candidate for a captive program.

A Review of Compliance Concerns

Employers should be familiar with Department of Labor and state laws and regulations to ensure compliance.

The Process of Forming/Joining a Captive Insurance Program

For the most part, captive insurance works the same way that conventional insurance programs work with just a few significant differences. The following represents a simplistic overview of the process involved with joining a captive:

Feasibility

The performance of a feasibility study will determine if a captive arrangement is a viable alternative.

Coverage Levels

Once feasibility is determined. The company can establish a desired level of coverage.
Both aggregate and specific attachment points are established to protect against catastrophic losses.

Pricing

Pricing for the benefit program is calculated by the captive manager's experienced underwriting team to ensure appropriate funding levels and profitability.

Funding

To fund the captive's assumed risk above the collected premium, collateral is provided by each participating business. If the actual claim expenses are less than what was projected for any specific year, the excess funds can be returned to the business.

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