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Do-It-Yourself Insurance

MANY HIGH-NET-WORTH BUSIness owners can significantly benefit by creating and managing a captive insurer. But while captive insurance is a potent and valuable advanced planning strategy in the right circumstances, its complexity can sometimes be off-putting.

Nevertheless, high-net-worth business owners are increasingly recognizing the value a captive insurance company can provide toward the creation of both business and personal wealth.

WHAT IS A CAPTIVE?

A captive insurer (or "captive") is a special-purpose insurance company formed primarily to underwrite the risks of its parent company or affiliated groups. It has characteristics similar to a traditional, commercial insurance company:

- It is a licensed insurance company.
- It sets premiums and writes policies for the risks it chooses to underwrite.
- It collects premiums.
- It pays out claims.

The biggest difference between a captive insurer and a commercial insurance company is that a captive cannot sell insurance to the general public. Instead, it can only underwrite the risks of its parent organization or related entities—companies owned by the high-net-worth business owner. Another key difference is that the regulations governing captive insurance companies are typically less onerous than those governing traditional commercial carriers.

At its most basic level, a captive works like this:

1. A corporation with one or more subsidiaries sets up a captive insurance company as a wholly owned subsidiary.
2. The captive is capitalized and domiciled in a jurisdiction with captive-enabling legislation, which allows the captive to operate as a licensed insurer.
3. The parent company identifies the risks of its subsidiaries that it wants the captive to underwrite.
4. The captive evaluates the risks, writes policies, sets premium levels and accepts premium payments.
5. The subsidiaries pay the captive tax-deductible premium payments and the captive, like any insurer, invests the premium payments for future claim payouts.

In 1995, there were just over 3,000 captives; today, there are more than 8,000. Not surprisingly, the largest and most sophisticated corporations were the first to explore, develop and refine the modern captive market. In fact, virtually

[Fortune 500 companies] discovered that a captive insurance company gives them greater flexibility and control over their risk-financing needs without relying exclusively on the traditional insurance market.

FIGURE 1
Benefit Comparison

PLAN COMPARISON	RETAIL INSURANCE	SELF INSURANCE	CAPTIVE INSURANCE
Lower Insurance Costs	No	Yes	Yes
Provides Protection From Risk	Yes	No	Yes
Tax Deductible Premiums	Yes	No	Yes
Policy Design Flexibility	No	Yes	Yes
Control Claims	No	No	Yes

FIGURE 2
Profits Compared

TRADITIONAL CARRIER MODEL			
YEAR	PREMIUM PAID	LOSSES	BUSINESS RETAINED PROFIT
1	$1,000,000	$300,000	$0
2	$1,000,000	$300,000	$0
3	$1,000,000	$300,000	$0
4	$1,000,000	$300,000	$0
5	$1,000,000	$300,000	$0
Total	$5,000,000	$1,500,000	$0

CAPTIVE MODEL			
YEAR	PREMIUM PAID	LOSSES	BUSINESS RETAINED PROFIT
1	$1,000,000	$300,000	$700,000
2	$1,000,000	$300,000	$1,400,000
3	$1,000,000	$300,000	$2,100,000
4	$1,000,000	$300,000	$2,800,000
5	$1,000,000	$300,000	$3,500,000
Total	$5,000,000	$1,500,000	$3,500,000

all of the Fortune 500 companies operate at least one captive. These organizations discovered that a captive gives them greater flexibility and control over their risk-financing needs without relying exclusively on the traditional insurance market.

WHY FORM A CAPTIVE?

There are a number of very significant reasons a high-net-worth business owner would establish a captive:

• *Greater control.* The greatest benefit a captive offers a company is significantly greater control over risk management.

• *Improved cash flow.* In addition to lowering premiums, captives improve cash flow through custom insurance coverage, improved claims handling and stable insurance budgets.

• *Improved claims handling and reporting.* The premiums charged to companies by a commercial insurer are largely based on the average industry cost to process claims. A captive handles processing either with its own administrators or contracted third parties.

• *Stabilized budgets.* A captive can help companies develop a strategy that allows them to take a measured approach to understanding and insuring their risks.

• *Incentive to control losses.* A captive insurer does not have the same operating expense structure, overhead or profit requirements of a commercial carrier. Moreover, a captive does not have to maintain higher average rates to ensure it can cover the losses associated with the high-risk members of its pool of insured policyholders. A captive's concern is sharply focused on one company as opposed to the entire industry, thereby allowing it to directly reflect that company's efforts to lower insurance costs through better risk management.

• *Direct access to wholesale reinsurance.* Reinsurance is coverage purchased by commercial insurance companies. With a captive, the high-net-worth business owner can often obtain better pricing when reinsuring risks.

• *Positive tax benefits.* The deductibility of premiums is a very important benefit of establishing and running a captive (see Figure 1). The tax impact of operating a captive is very complex and should be considered only with the advice of a competent tax professional with a background in captive insurance.

Figure 2 compares a traditional model to a captive insurance company for a business that pays $1 million annually in liability insurance premiums and has a 30% loss ratio.

For a captive to make sense, it must provide a valid business purpose. That said, for the high-net-worth business owner, a captive could have meaningful wealth-creating benefits. For example, captive insurance can be used to lower estate taxes.

CONCLUSION

A captive insurance company structure has become mainstream for many high-net-worth clients. In the right situation, the captive provides significant benefits to its parent company. These companies are complex structures that are strictly regulated by state and federal authorities, so they need to be created and managed by experts. When set up correctly, they are a perfect way to transform millions in premiums to millions in additional profits for the parent company and the high-net-worth business owner. *PW*

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