

## Captive Insurance

### A viable alternative?

Many firms today are frustrated by the traditional approach of financing risk. They feel in many cases that their risk management practices are best in class and they end up subsidizing other businesses that do not pay as close attention to risk management and therefore incur higher frequency and severity of claims. These suspicions in many cases are correct, however the approach is not for every company so proper due diligence must be used when considering a captive.

In a traditional approach, insurance companies arrive at rates by taking the loss experience from every member of a particular class of business and develop a rate based upon that experience. This methodology is great for a firm that has poor loss experience but then best in class organizations end up subsidizing the weaker players.

Captive insurance came into vogue in the 1970s. A Fortune 500 company became disenchanted with the traditional insurance market. They looked at their insurance program and felt that there must be a more efficient way to manage risk. Their cost of risk, they felt, was not being effectively managed. Their approach follows:

An insurance company provides the following services within the traditional insurance contract:

1. Loss control engineering
2. Claims management
3. Actuarial services
4. Financing of losses

Why not take those services, unbundle them, and then price them out and contract with the best service provider at the most economical cost. Furthermore pay the smaller, controllable losses directly.

The result was lower fixed costs and a much lower overall cost of financing risk. In summary, these firms were able to take control of their insurance destiny and not be subject to the will of insurance carriers. When markets harden as we are seeing now, prices are based upon your organization's experience, not the insurance industry's experience.

Since the 70's more of the fortune 1,000 companies are insured by captives. In fact, today more than 50% of the US insurance market is insured in an alternate risk transfer vehicle which includes captives.

The majority of CEOs, CFOs and Risk Managers are familiar with the term Captive Insurance, but are not entirely sure of how they work or how they might benefit their organization.

In the following pages we provide some basic information on captives:

#### CAPTIVE DEFINITION:

An insurance company that provides insurance to and is owned and controlled by its owners

#### Types of Captives

Single parent- A single parent captive is owned and controlled by one organization. They are formed for the sole purpose of insuring the risk of the parent company.

Rent a Captive: This is a captive that is formed to be available for various organizations to participate for a fee. In most cases they are an insurance carrier or other financial institution that provides the framework and financing of the captive for a fee.

Agency Captives: An insurance broker or agency may form a captive for the specific purpose of insuring appropriate customers of the agency.

#### Group Captive:

Group Captives operate in the same way as single parent captives but are chosen because the members are not large enough to form their own single parent captive. Homogeneous Group captives are a group of similar businesses that make up the captive and Heterogeneous Group Captives are a group of dissimilar businesses that come together to form a captive.

## Why a Captive?

Reduced Costs: For a business where the captive approach is appropriate, unbundled fixed costs and reduced loss costs can substantially reduce premiums.

Improved risk management: Companies who join a captive typically see reduced loss ratios in the area of 25% in the first few years. This is driven by two factors. Loss control is enhanced and companies with “skin in the game” take a much more active role in risk management.

Return of underwriting profit and investment income: With traditional insurance, underwriting profit and investment income is kept by the insurance carrier. In a captive the underwriting profit and investment income is returned to the owners of the captive.

Multi-State Capabilities: Captives have the capability of providing coverage in every state.

It is important to recognize that captive insurance is not appropriate in every case, however, in many cases it can be a viable alternative. Every CEO, CFO and Risk manager should at least consider this alternative.

Like brokers and insurance carriers, not all captives are created equal. There are some very good captives and some very poor captives. Due diligence requires a 5 year pro forma and thorough investigation before moving forward.

We at the Chittenden Group would be happy to assist you in the due diligence process. With a minimal amount of information, we can assess whether or not a Captive would be appropriate for your organization.

Please [click here](#) for more information and to tell us about any specific products or services that you would like to learn more about.