Captive Insurance Companies: How to Reduce Your Costs

Checklist Description

This checklist assesses the impact of captive insurance companies and how they can help businesses to reduce costs and improve profit margins.

Definition

Captive insurance companies are insurance companies that have the specific objective of financing risks from a parent group or its customers. The process is a risk management technique—a company forms its own insurance company subsidiary to finance its retained losses. Captives are of interest to companies when they find that their insurance premiums have risen significantly as they can reduce costs. In addition, companies can gain greater control by owning an insurance company.

Creating a captive offers a self-financing option for buying insurance. The captive either holds onto the risk of providing insurance or can pay reinsurers to take the risk. Captives are usually based in a country that has a favorable tax regime with more relaxed controls. When a company uses captive insurance, the money buys a service and is invested with a good possibility of a return. Cost savings can be realized through reduced overheads, allowing a larger percentage of the premium to be used for claims payments.

Captives also give access to the reinsurance market, which operates on a lower cost structure than other direct insurers, and there is the potential to earn investment income on unpaid loss reserves.

There are several types of insurance captive:

- Single-parent captive: An insurance or reinsurance company formed primarily to insure the risks of its parent or affiliate.
- Association captive: Owned by a trade, industry, or service group for the benefit of its members.
- Group captive: Jointly owned by a number of companies to provide a vehicle to meet a common insurance need.
- Agency captive: Owned by an insurance agency or brokerage firm for the purpose of reinsuring a portion of their clients’ risks.
- Rent-a-captive: Providing captive facilities, for a fee, to others—often companies that are too small to establish their own captive.
- Special purpose vehicle/company: Mostly used for catastrophe bonds and reinsurance “sidecars.” They may be formed as a rent-a-captive facility to enable companies that do not have a sufficient volume of insurance premiums to access many of the benefits associated with an offshore captive.

Offshore captive insurers are often more attractive because they enjoy lower tax rates on investment and underwriting income, resulting in reduced expected tax payments. Captives give noninsurers access to reinsurance markets that were previously only accessible to commercial insurance companies. The reasons for creating a captive insurance company are varied, but it may be that the external insurers are charging too much, or that the required coverage is unavailable.

Advantages

- Premiums paid to a captive insurance company are tax-deductible.
- Insurance can be obtained through the international reinsurance market at a more favorable premium.
- Investment returns can be obtained directly on the invested capital.
- The types of risk that a captive can underwrite include damage to property, public and product liability, professional indemnity, employee benefits, employer’s liability, and motor and medical aid expenses. Risks that may be uninsurable or cost-prohibitive can be included.
- Additionally, the parent company’s entire family can benefit from group funding of a captive through consolidation of coverage, centralized administrative support, and a significant reduction in insurance expenses.
Disadvantages

- A substantial amount of capital is initially required to ensure that the captive remains financially healthy.
- Third-party dependency on service providers.
- Inadequate loss reserves where actual losses exceed initially expected levels and additional funds need to be allocated. Such a situation could disguise risks to the parent company.
- Reduced availability of other insurance facilities.

Action Checklist

- Create an insurance program based on the needs of your company.
- Exercise greater control over your cover because you do not have to choose a standard offer from the commercial market.
- Keep a clean loss record so that premiums do not increase.

Dos and Don’ts

Do

- Stabilize the cost of insurance and determine your premiums by your company’s own loss experience, not by an industry-wide standard.
- Obtain more competitive wholesale quotes from primary insurers.
- Maximize the yield on the portfolio.
- Structure the maturities to meet your cash flow requirements.

Don’t

- Don’t cut corners to save costs.
- Don’t assume that your company is too small for captive insurance.
- Don’t forget to look at renting rather than buying a captive insurance facility.

More Info

Books:


See Also

Checklists

- Corporate Insurance Cover: A Primer
- Understanding the Components of an Insurance Contract

Industry Profile

- Insurance

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