Management Methods Manual

What is a Captive Insurance Plan/Group and What Can It Do For Your Company?

WHAT IS CAPTIVE & WHY WOULD I JOIN?

The insurance market for contractors continues to face uncertainty as it deals with the lingering challenges of COVID-19, supply chain and material escalation impacts, labor shortages, loss run escalations, and overall adverse industry loss experience. In this article, the use of captives as a solution to provide greater cost control relative to a contractor's insurance premiums will be explored.

Historically, the construction industry has been the first to feel the effects of a "hardening" insurance market and the last to enjoy the benefits of a "soft" insurance market. What's worse? For most contractors, insurance is their second largest overhead expense behind payroll. While the insurance expense is growing, the control over it seems to be diminishing. The Property & Casualty insurance market is currently experiencing its record-setting 21st consecutive quarter of overall rate increases. Unfortunately for contractors, the construction industry continues to experience above the average rate increases.

A solution many contractors are turning too is captive insurance companies. A "Captive" is simply a privately held insurance company. When joining a captive, the contractor becomes a part owner of the private insurance company. By joining a captive, contractors have more control over their insurance rates and can take a fixed cost and turn it into an investment. The captive solution provides greater rate stability and cost control because the contractors who own the captive are not subsidizing the bottom half of performers in the insured market. Partnering with like-minded companies, contractors can build their own insurance company and take on logical tranches of risk. It is a risk-reward proposition whereby the contractors in the captive are taking on risk sharing. The risk sharing is typically minimal, but it does exist.

There are many different types of captives. Some captives are very large with hundreds of companies while others are smaller with perhaps 30-50 companies involved. The larger captives boast greater diversification while the smaller captives tend to have more control over who is in the group, get to know each other more personally and can act more like a peer group. Some captives are homogeneous, and others are heterogeneous. Homogeneous captives in this case are made up purely of contractors. Heterogeneous captives are not industry specific. Because of the unique nature of construction, many contractors prefer homogeneous captives.

Common complaints of contractors relative to their insurance premiums are frustration, lack of reward for a strong safety record, a sunk cost and essentially a total lack of control.

The goal of a group captive is to offer contractors the ability to get out of the whims of the standard insurance market, control and stabilize their costs, and turn what is currently a large expense into a profit center through the risk management and performance controls already inherent and mandatory in your business operations.

WHAT IS A GROUP CAPTIVE?

As previously mentioned, a captive is a private insurance company. A group captive is formed when a group of companies come together to form their own private insurance company. A captive provides control and stability of a significant business expense (i.e. - insurance premiums) while creating an opportunity to turn the expense into a new profit center. Furthermore, by partnering with other like-minded, best-in-class companies, a peer group and culture are created that helps each company explore ways to improve their business and further strengthen their bottom line. Homogeneous group captives are typically made up of multiple trades / disciplines such as mechanical, electrical, asphalt paving, general contractors, etc. That diversity provides a wealth of knowledge to draw upon in virtually every aspect of your business.

A captive takes the model of traditional insurance companies and delivers the financial benefit to its owners. A group captive retains the controllable (through safety and risk management) and predictable layer of claims and secures reinsurance for the more significant, unpredictable, and infrequent claims. Most of the premium paid to the captive goes to fund the retained layer (your opportunity), and what is not spent on your company's claims or the fixed expenses to run the captive, are received in distributions – thus, a new profit center. A well-run captive typically sees 40-60% of the premiums paid in premiums returned to the owners in the form of distributions. This strategy is not only a new profit center, but it also creates a competitive advantage in a contractor's cost structure versus those buying insurance in the open market.

THE CAPTIVE STRUCTURE

Captives often get falsely represented as a risk pool. A group captive is set up as an equity-based model, where your specific premiums are set aside for your company's claims. As with any traditional insurance company, captives must show the ability to share risk with unrelated entities ("risk sharing"). Well-structured group captives can minimize the amount of risk sharing with a commitment to underwriting integrity by funding expected claims correctly on the front end and ensuring that only the best companies are allowed in the group. A good rule of thumb is that less than 5% of your premium should be used to pay for someone else's claims. Or, said differently, 95% of your financial success in the captive is predicated by your individual claims experience. It is important to note that risk sharing also exists in the traditional insurance market amongst all the insured parties utilizing any specific carrier. For this reason, even contractors with favorable loss experience are getting penalized with increased renewal rates on certain lines of coverage for underperforming companies that are also insured by the same carrier. In a group captive, there is transparency and a partnership with the companies in the captive with your company. The result is a culture of accountability that does not exist in the traditional marketplace.

Although group captives are real insurance companies, they are typically smaller insurance companies relative to the size of well-known standard market carriers because captives can only take on so much risk responsibly. Understanding this, each group captive will only retain a specific layer of claims, the retention layer, and pass off the catastrophic risk to a re-insurance company. Leveraging the collective premium of the group, captives can secure re-insurance at favorable and stable rates relative to the open market for claims above the retained layer as shown in Figure 1. Outside of the captive, each company purchases their own umbrella/excess policies to fit their specific needs.

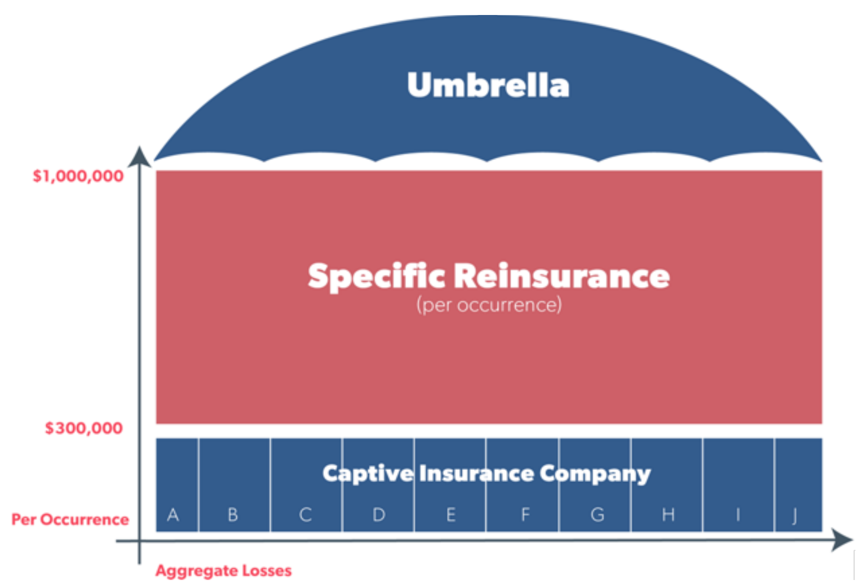
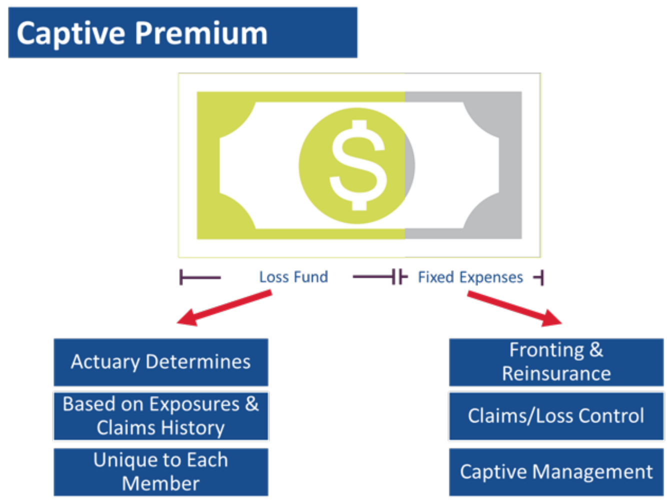


Figure 1 – An illustration of a captive taking the first $300K in risk, re-insuring $300K-$1M, and using Umbrella policies above the $1M loss rate:

HOW DOES IT WORK?

Contractor's benefit from the opportunity of owning a captive insurance company with other high-performing, safe contractors. To start the underwriting process, an independent actuary reviews your company's loss history, premiums, payrolls, and other insurance information. The actuary recommends a funding amount specific to your company (i.e. – your loss fund) that will be utilized to pay for your claims in the upcoming policy year. Overhead expenses (a set percentage for every member) are added to the loss fund. These two components—your loss fund plus expenses—become your annual premium as shown in Figure 2.

Figure 2 – Loss Fund plus Captive Company Expenses Equate to Annual Premium



The portion of your loss fund that does not get allocated to the claims that you incur flows back to you as an owner of the captive. In the traditional marketplace your insurance expense is a sunk cost with any underwriting profit going toward your carrier's bottom line or to fund for the adverse loss performance of another insured party. In a captive, this sunk cost is turned into a profit center for your business. Premiums paid in but not used are invested in the market to earn a return prior to allocation back to the captive owners. Excess premiums are typically held for 3-4 years to ensure any unexpected claims do not appear and funding is in place in the event they do.

This underwriting process is repeated each year that you are involved in the captive as the actuary reviews the most recent five years of data. As expected, the opportunity to return profit promotes a heightened risk management and safety focus which leads to better performance over time. As your company's underwriting data improves, the actuary determines that less funding is needed per unit of exposure—putting you in charge of your cost going forward, not the market. The financial benefits of a captive are realized through both front-end rate reductions and back-end profit distributions.

One of the biggest hurdles to joining a captive can be the upfront cost. Typical captives can cost upwards of $700K to join. This is either cash paid in or a letter of credit. Some captives allow the buy in to be spread across several years to reduce the impact on cash flow.

THE CAPTIVE MARKETPLACE

There is much misinformation regarding captives in the marketplace, largely driven by the myriad different types of captives. In fact, there are over 7,000 captives worldwide. The term “captive” can mean something entirely different to insurance professionals and consumers alike.

One of the most misconstrued elements of group captives is taxation. While there are certain captive structures that have been created with tax implications in mind, no one will join a group captive for a tax benefit. Most group captives are domiciled in Grand Cayman and contrary to popular belief, this is not for tax purposes. An owner of a group captive will pay U.S. tax on any profits returned or recognized from their performance in the group. The reason that group captives are domiciled in Grand Cayman is mainly due to the established infrastructure and regulatory environment the island provides.

As a domicile, Grand Cayman provides a track record of nearly 50 years of stability and, most importantly, a commitment to the captive industry. As an owner of a group captive, Grand Cayman allows you the ability to manage with a long-term outlook and avoid surprises in regulatory changes. Second, offshore domiciles are popular in the group captive space due to the minimized cash outlay to start or join a group captive.

Finding the right captive can also be a challenge. It is unlikely that your current broker will push you into a captive as they lose commissions. Therefore, it is recommended that contractors reach out to industry professionals who are knowledgeable about the captive market who can help guide you. Industry specific consulting firms are a good place to start the conversation.

BECOMING A BETTER BUSINESS

While the financial upside is significant, most members realize that the benefits of a group captive extend far beyond premium reductions and profit distributions. Every business is at a different stage of their risk management journey when they first join a captive—some are robust, well-oiled machines that are fighting and avoiding complacency while others have had their “luck” run out and are seeking to formalize their practices and create repeatable processes that drive predictable results. No matter where a business falls on the risk management spectrum—from compliance-based safety to true learning organizations—group captives can serve as a peer group that promotes improvement.

Learning from other like-minded companies, captive members are afforded an immediate support network to share experiences, losses, frustrations, and solutions so that each member can learn from the events of another. The group sharing and accountability coupled with the ability to recapture premium dollars puts a heightened emphasis on performance and safety. For those that get excited about the opportunity, the success stories are abundant. The exchange of information and ideas is not limited to loss control. Strategic, financial and operational best practices along with comparative benchmarking exercises can make a captive truly invaluable to the growth of a contractor’s business.

BECOMING A BETTER BUSINESS

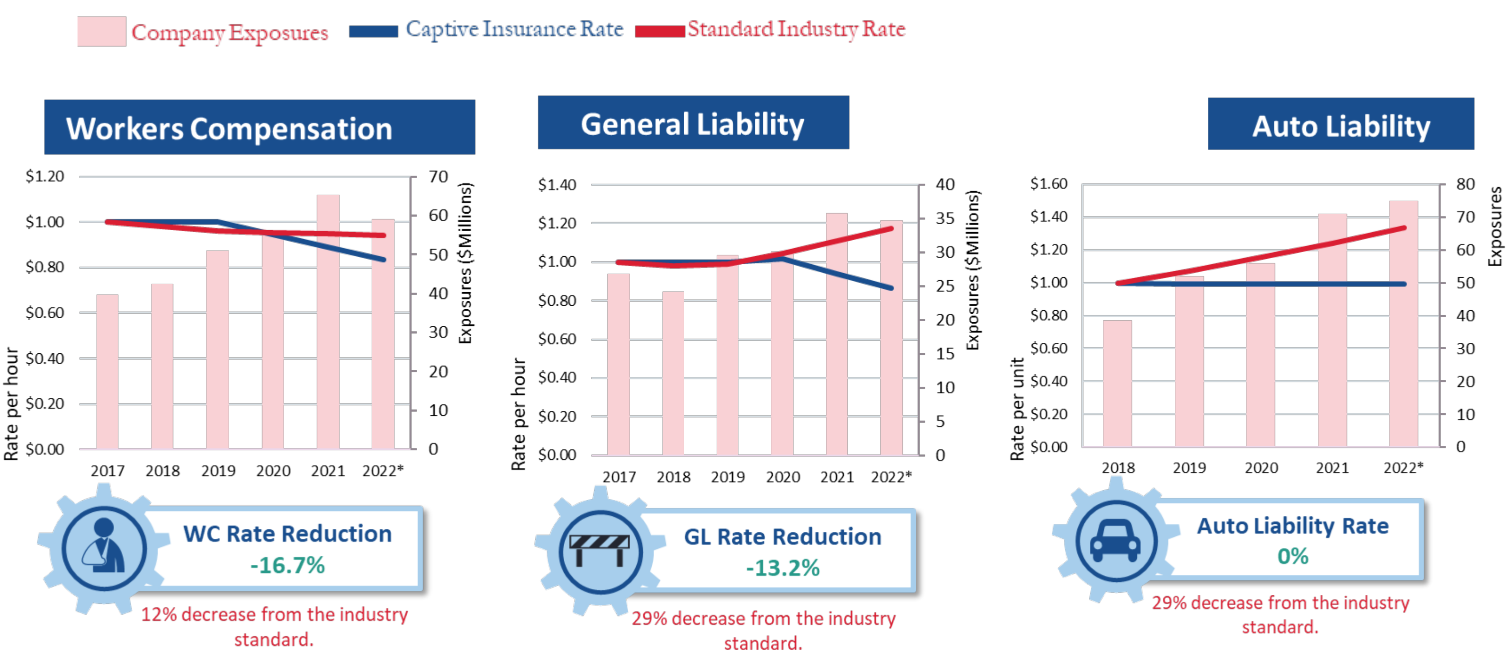
To illustrate the impact and results from captives, below are two case studies of actual clients who have joined a captive and benefited from the choice.

Case Study 1: A California based HVAC Commercial Contractor

Case study one is captive client is a California-based mechanical and HVAC commercial contractor. The frustration with volatility in traditional insurance rates led this business to join an Innovative Captive Strategies (ICS) group captive in 2019. They have since seen significant improvement in premium return and reduction in insurance rates.

By switching to an ICS captive, this company has earned nearly $900,000 in underwriting profit opportunity to be returned to their pockets. In addition, the workers compensation, general liability and automotive liability insurance rates have trended well below the industry standard for the past 5 years as shown in Figures 3-5 below:

Figures 3-5 – Rate Changes in Key Controllable Lines of Coverage (Case Study 1)



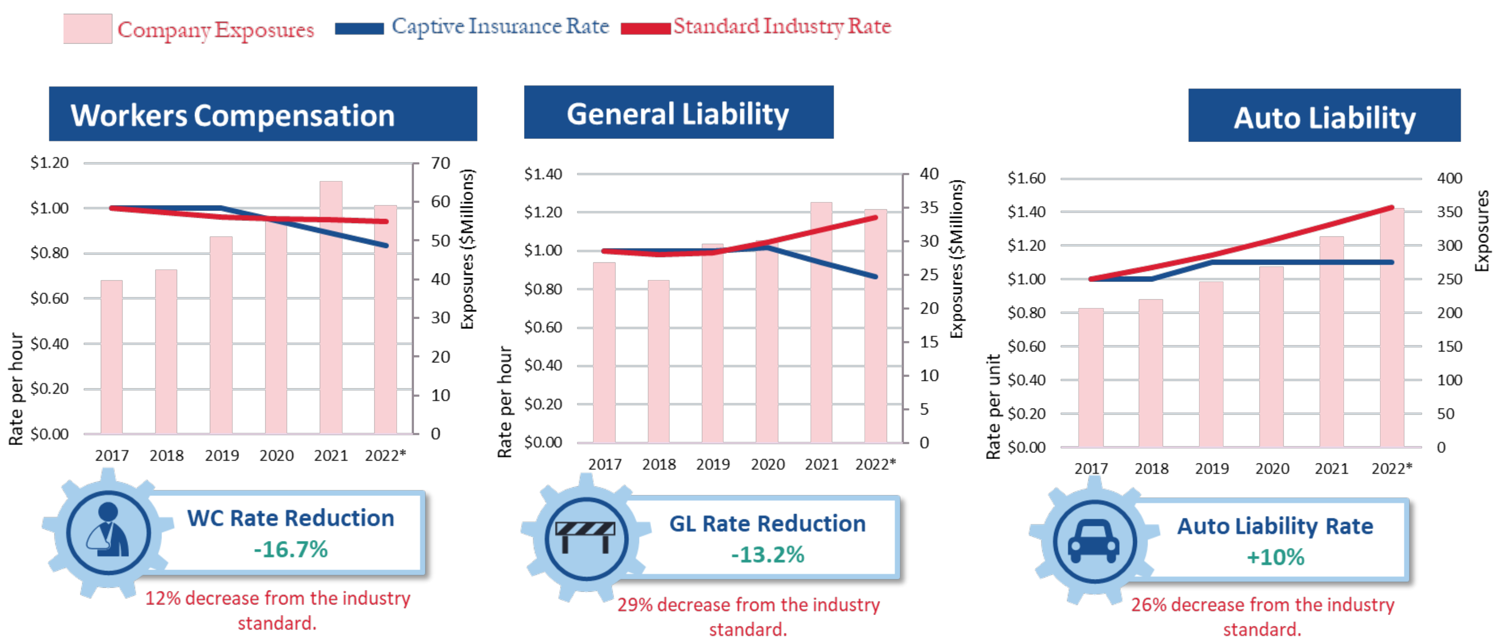
Market data sourced from the Council of Insurance Agents & Brokers, Commercial Property/Casualty Market Index Q1/2023 Report

Case Study 2: An Iowa Based HVAC and Electrical Contractor

This captive client is an Iowa-based specialty contractor. The frustration with volatility in traditional insurance rates led this business to join an Innovative Captive Strategies (ICS) group captive in 2017. They have since seen significant improvement in premium return and reduction in insurance rates.

By switching to an ICS captive, this company has earned nearly $1.8 Million in underwriting profit opportunity to be returned to their pockets. In addition, the workers compensation, general liability and automotive liability insurance rates have trended well below the industry standard for the past 5 years as shown in Figures 6-8 below:

Figures 6-8 – Rate Changes in Key Controllable Lines of Coverage (Case Study 2)



Market data sourced from the Council of Insurance Agents & Brokers, Commercial Property/Casualty Market Index Q1/2023 Report

WHO QUALIFIES TO JOIN?

Captives are not a solution for every contractor. Typically, there are three main criteria for a company to qualify for a group captive:

- Premium Volume: Given the risk for reward structure of a captive, a contractor must have enough premium for it to make sense. Although not a black and white rule, a good starting point is $200,000 in total premium across Workers Compensation, General Liability, and Auto lines of coverage. When properly structured, a captive can scale to fit the needs of contractors anywhere from $200,000 to more than $3 million in premium.
- Safety Culture: With safety being the foundation of financial success in the captive, companies with strong track records of safety and risk management are better suited to evaluate a captive. That said, regardless of past success, there needs to be a strong commitment to and emphasis of continuous improvement.
- Entrepreneurial Spirit and Desire to Take Control: This is a fancy way of saying that businesses with the ability to look long-term typically fare best in the captive. Captives are not a one-year solution, they should be evaluated with a long-term outlook in mind.

MOVING FORWARD

Although gaining in popularity in a tough insurance market, captives are not a new concept, and they are not going away. In fact, the captive marketplace exceeds the property & casualty premium that remains in the traditional market. Companies that remain in the traditional marketplace are being forced to swim in a dirtier pool as best-in-class operations seek stability and control through a captive.

Captives have provided stability and control throughout multiple hard and soft market cycles over the last 50 plus years and they continue to display their market-neutrality. As with any business decision, education is key. Captives are a great option and should be explored as a potential solution for your business.

ABOUT THE AUTHOR

Michael McLin is the Managing Director of Maxim Consulting Group responsible for leading the business and guiding the strategic direction. Michael works with construction related firms of all sizes to evaluate business practices and assist with management challenges. Michael is a nationally recognized, dynamic public speaker and published author.