COMMERCIAL INSURANCE
EMPLOYEE BENEFITS
PERSONAL INSURANCE
RISK MANAGEMENT
SURETY

MAY 18, 2021

FIVE THINGS YOU NEED TO KNOW ABOUT CAPTIVE INSURANCE

Greg Lagreid | Account Executive

A captive is an alternative risk management strategy where an insurance company is owned by its insured(s). The captive then insures some or all of the risks of its parent company and any associated groups. Often, the risks insured in a captive are either very difficult to insure in the commercial insurance market or are very costly. In the simplest terms, a captive is a formalized mechanism of self-insurance. The captive does not need to retain all this risk; however, a captive can access reinsurance markets directly or be part of a group or pooling arrangement where some portion of risk is shared among all group members. The mere thought of captive insurance can be daunting, but it doesn't have to be. Here are five things to know about captives if you are considering forming one.

1 | YOU DON'T NEED TO BE A FORTUNE 500 COMPANY TO CONSIDER CAPTIVE INSURANCE

There are many different types of captive insurance companies. Although single-parent captives are typically associated with large companies, other captive vehicles can be very effective for small and middle-market companies. Group captives, cell captives, and rent-a-captives are all options for smaller companies that want to take more control of their insurance program. An entrepreneurial spirit is key in starting a captive, as it is an entirely new business the insured will need to operate effectively. A captive can provide a flexible and strategic platform for a company to manage risk. Regardless of size, any financially strong company willing to bet on itself should undoubtedly consider a captive insurance arrangement. According to the Insurance Information Institute, there are over 3,000 licensed captives in the United States – that goes a long way past the Fortune 500.

ABOUT PARKER, SMITH & FEEK

Parker, Smith & Feek is a private brokerage firm driven by client service. We offer a range of services, including commercial insurance, risk management, surety, employee benefits, and personal insurance. PS&F is ranked nationally as one of the 40 largest privately held risk management and insurance brokers. We are committed to serving the community and proud to be one of the top corporate philanthropists in the region.

LEARN MORE

About Parker, Smith & Feek

Industry Overview

Our Services

CONTACT US

Email

Tel: 800.457.0220

FOLLOW US

continued >

2 | SOLID LOSS CONTROL AND SAFETY PROGRAMS ARE A KEY TO A CAPTIVE'S SUCCESS

Just like all insurance companies, a captive takes in premiums and pays covered claims. In order for a captive to run effectively, robust risk management, claims management, and safety programs must be in place. Good captive candidates typically have low loss ratios and a favorable claims history. The captive provides an opportunity for the owner to share in the profitability garnered by the commercial insurance marketplace. On the flip side, a poorly performing operation can lead to financial losses and additional required capital within the captive. A captive also provides the insured control over the claims process, which often directly impacts the claim outcome – strong claims management processes will reduce the cost of claims. Over time, there are bound to be years where loss ratios are high in a captive, but this should be an exception rather than the norm.

3 | CAPTIVE INSURANCE ARRANGEMENTS CAN PROVIDE FLEXIBILITY IN HARD INSURANCE MARKETS

We are currently experiencing a hard commercial insurance market. In very brief terms, this means that insurance rates are increasing, and capacity is decreasing. This is part of the insurance market cycle – it has happened before, and it will happen again. Owning a captive during a hard market can provide tremendous flexibility and capacity to help navigate the difficult insurance marketplace and reduce premium volatility. The captive can provide an avenue to insure increased deductibles on a commercial program and provide some rate relief on the commercial side. When commercial insurers are reducing capacity, the captive can take on some of this risk, whether it be a middle or upper layer of a limit tower or the entire exposure for a more difficult risk. A captive can also insure new risks or risks typically excluded in the commercial market (e.g., pandemic risk, communicable disease exclusions, etc.). Once the commercial market normalizes or begins to soften, the insured can consider moving some of these risks/limits back into the commercial marketplace. Without a captive's added flexibility, an insured is bound to the terms of the commercial market, whether hard or soft.

4 | A CAPTIVE IS A LONG-TERM COMMITMENT

There are costs associated with forming a captive. Expenses such as a feasibility study, actuarial assessment, domicile fees, licensing, and more are part of starting a captive. Add in the capital requirements from the domicile, captive manager fees, annual financial audit, and the internal cost of operating a captive, and it is quickly apparent that captive insurance is not a short-term strategy. It takes a long-term commitment from the leadership of an organization to effectively operate a captive, but the long-term payback can be very compelling , as the captive owner is consistently rewarded for strong risk management and claims management practices. There are also some potential long-term tax benefits associated with operating an insurance company, such as accelerated deduction of claim expenses. Any tax benefits are entirely secondary to a captive's risk management strategy and tax counsel must be involved in any captive decision-making.

5 | THERE IS NEW LEGISLATION IN THE STATE OF WASHINGTON

There has been some uncertainty surrounding captives in Washington state over the past few years. As Washington does not have a statutory framework to allow for captives to be domiciled in the state, many Washington-based companies established captives in other domiciles, both in the U.S. and abroad. Additionally, there has not historically been any legislation to address premium taxes for captives not admitted in the state. With the

continued >

recent signing of Senate Bill 5315, there is now some clarity around eligible captives insuring risks in Washington. The state of Washington has defined an eligible captive by the following criteria:

- Partially or wholly owned by a corporation, company, nonprofit, or a public institution of higher education
- Insures risk of their captive owner, the owner's affiliates, or both
- Has one or more insureds whose principal place of business is in Washington state
- Has assets that exceed its liabilities by $1 million and can pay its debts when they come due, as verified by audited financial statements and prepared by an independent certified accountant
- Licensed as a captive insurer by the jurisdiction in which it is domiciled.

Eligible captives must pay an initial registration fee of $2,500 to Washington state and also "pay a 2 percent premium tax for insurance directly procured by and provided to its parent or affiliate for Washington risks" each year, according to the 2SSB 5315 Final Bill Report.

There are competing viewpoints regarding this bill, but at a minimum, it does provide some clarity and direction for Washington captive owners moving forward.

A captive insurance program can be a highly valuable asset for an organization, but it does come with some complexities. It's important to partner with a trusted insurance professional to learn more about your options and to take the first step in exploring the value a captive could deliver for your company. If you would like to learn more, reach out to Parker, Smith & Feek.