COVERAGE INSIGHTS

Captives Are Growing Rapidly for the Middle Market… but Why?

The captive industry has been around for at least 60 years and in that time has shifted as a tool for only the Fortune 500 to utilize, to a tool that is now being used for companies with as little as $10 million in annual revenues. It all began with the structure of a "single parent" captive where one company would form their insurance company for the sole purpose of insuring their own risk. Typically, these firms will spend $3 million or more in annual insurance premium "spend" and the annual expenses of managing the captive insurance company would be $100,000 and up. We then witnessed the emergence of "cell" insurance companies, which go by various names (sponsored cell, protected cell, Series LLC, rent-a-cell, etc.), but target companies with premium spend around the $1 million level and expenses that begin at around $35,000 per year to manage. Below the $1 million premium level, potential insureds are guided toward "group captives" and have an entry point as low as $100,000 in casualty spend.

GROUP CAPTIVES

The concept is simple enough: the participant maintains responsibility for their own losses up to a certain level (commonly referred to as their A Fund or Frequency Fund), and then they participate in a shared, or pooled, layer (commonly referred to as their B Fund or Severity Fund) before the group purchases reinsurance protection for the captive.

An example of the basic A/B structure would be as follows:

- Premium of $500,000 – (WC, GL, Auto)
- A Fund – 48% of funding for losses up to a certain loss attachment (say $150,000)
- B Fund – 10% of funding for shared losses (say from the $150,000 to $300,000 layer)
- Program expenses – 42% for reinsurance, fronting, claims handling, and other administrative costs

There is also an additional A Fund (approximately $250,000 based on our example above) is required to be posted as collateral and is going to be the max exposure for the captive, in most cases. This would be drawn down if the initial A Fund is exhausted and the participant fails to pay their liability of the maximum.

This operates as protection for the other members of the group and insurance carriers that are participating. This collateral is also at risk if other members have losses in excess of their contributions and their maximum liability.

At it's most basic, if the insured had losses of $100,000, they could receive $150,000 ($250,000 minus the $100,000 of losses) plus what is left in their B Fund amount after shared losses are paid, plus investment income, after the underwriting year is sufficiently developed. The premium paid in should be tax deductible and the profit return would be taxable upon the receipt of the return.

For companies with an annual insurance spend of $300,000 to $800,000 in the casualty lines, this structure is the most attractive alternative risk product that makes financial sense and gives the opportunity to recoup some of their insurance expense for good loss experience. This product has been so successful, that one of the major promoters recently surpassed the $1.2bn in annual premium mark. These programs have stood the test of audit and the test of time. They are not going away any time soon.

831(b) ELECTION CAPTIVE

This election has been in existence since the mid-1980's, but has been rarely used due to a lack of risk quantification knowledge in the industry. We have seen the uptick in usage begin primarily in the last 15 years, or so, but this has hit a fever pitch in the last 7 years as the insurance industry has taken to promoting these structures away from the legal and tax industries. The increase in formations of insurance companies seeking to take this election has been nothing short of dramatic. At the time of this writing, there are now more than 38 US states that have passed legislation allowing for the formations of captives in their domicile, and a vast majority have been formed to capture the growth of insurance companies taking this election.

The 831(b) election was passed by congress to help the small farm mutual that served a need in their rural communities, but was not heavily capitalized or diverse. The election states that an insurance company whose premium is less than $1.2m annually can elect to pay tax only on its investment income. This means that underwriting profits are not subject to tax, until there is a dividend at a later date. The downside of this election is that underwriting losses cannot be recognized for tax purposes. In a year with an underwriting loss, the insurance company under this election would still be required to pay taxes on its investment income, but cannot use its operating loss as carry forward.

As the application for how this election has become better understood, more and more programs were established where loss ratios were expected to be very low and this election would appear to offer substantial benefits to the owner.

This meant that the company that had previously been targeted for the group captive could now consider setting up its own standalone captive. They could write the same risk levels as we mentioned earlier in the article and augment their insurance company with some non-traditional enterprise risk management coverages. By doing so, the company can establish a captive with say $810,000 in premiums and $120,000 in losses, creating a profit of $645,000 ($810,000 - $120,000 (losses) - $45,000 (expenses)) which would be taxed at the capital gains rate upon the payment of a dividend to the owners of the captive.

Captives for the Middle Market

In our example, the $810,000 in premium may consist of the following coverage areas:

WC, GL, Auto ($150,000 deductible reimbursement)	$250,000
Cyber Risk (data protection) $500,000 policy limit	$60,000
Reputational Risk $500,000 policy limit	$100,000
Employment Practices Liability $500,000 policy limit	$75,000
Regulatory Compliance Defense Costs $300,000 policy limit	$60,000
Loss of Key Customer $500,000 policy limit	$125,000
Property Deductible – Windstorm or Quake	$60,000
Short Term Disability $50,000 policy limit	$10,000
Supply Chain Disruption $500,000 policy limit	$70,000
TOTAL	$810,000

The biggest issue facing the 831(b) election captive structure is if it can meet the risk transfer, risk distribution, and (new to 2017) the "diversification" requirement tests to qualify as an insurer for tax purposes. The "insurance" test can be met by having premiums paid by twelve or more separate legal entities (not single member LLC's per IRS rulings on the matter) or by having 51% of its total premium come from third-party business. There are lower court rulings that suggest that a captive can have less entities paying premiums and/or 30% of total premium coming from third-party risk, but the above lays out the conservative approach and are considered "safe harbor." The risk "diversification" requirement that is new for 2017, requires that (1) there is a 20% cap on any single policy holder or (2) there is no wealth transfer function to the insurance company. In other words, the ownership of the insurance company must mirror the ownership of the operating company.

If there are sufficient legal entities, then the captive can be structured to have sufficient diverse risks to pass the insurance test. If not, then we turn to third-party risk and the concept of risk pooling. Although some third party risk may exist inside of our organization (portions of the employee benefit plans, warranty programs, joint ventures, construction wrap-ups, etc.) most companies choose to enter into a risk pooling arrangement with like-minded companies.

Captives for the Middle Market

For a pool to be utilized, it should pass the following tests (at a minimum):

- Premiums for coverage should be actuarially determined
- There should be sufficient members in the pool to achieve risk distribution (at least 12 or more)
- The pool should pay losses (like to see at least a 5% loss ratio)
- There should be a good combination of risks inside the pool
- Premium has to make good business sense

Most pools charge between 3-5% of premium written and, when combined with an operating cost of $45,000 (in our example), the company will already see a large portion of any potential tax arbitrage eaten up. If the tax arbitrage is the driver behind these captives, it will not stand the test of time as tax laws can change as quickly as congress changes. These captives are most successful when they are formed for the risk management benefit of the firm and just so happen to have a tax benefit. Let me be as clear as the written word allows: **these structures should not be established for tax reasons**.

What you will find is that the staunch advocates of each of the captive structures we have laid out above, sell their product hard and work to convince you that this is the best structure for your firm. The reality is that each of the programs should be examined carefully and a clear risk management objective identified to align perfectly with a company's strategic direction.

The growth in the middle market captive sector has been primarily driven by promoters trying to push companies' one direction because the promoter has an ownership stake in the product they are selling. There has been too much of the "if all I have is a hammer, everything looks like a nail" approach. As a company begins down the path of discovering whether this model will work for their firm, it is best suited to partner with a group that has no stake in the outcome and is independent in their recommendation.

For more information about beginning a Captive program for your company, please contact Bo Midgett,
Senior Vice President at Lipscomb & Pitts Insurance, LLC
at (901) 321-1178 or at bom@lpinsurance.com

Lipscomb Pitts
INSURANCE