Captives

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The practice of risk management has identified four basic methods of dealing with the risks of accidental loss faced by a business firm:

1. Avoiding them
2. Reducing them through control measures such as safety training
3. Transferring them to others by contract or through the purchase of insurance
4. Retaining them up to some point

To employ the fourth option there must be adequate capital available if actual losses exceed the amount of expected losses. Rather than drawing this capital from operating income at the time of a loss it is advisable to create some sort of risk financing mechanism. The most popular financing mechanism is a captive insurance company which a business forms either individually or in association with other firms.

There are more than 5,000 captive insurance companies in operation around the globe; nearly 1,600 of them in the United Stated. This may seem surprising in view of the current "soft" market in commercial casualty/property insurance which traditionally does not favor the growth of alternative risk financing mechanisms. You might wonder why a business owner would choose to desert the conventional insurance market with its present low rates and relaxed underwriting standards for the unpredictability of a self-insurance program like a captive.

The answer, as many insurance buyers will admit, is that they have through soft markets before and they remember that they are always followed by a hard market. They recognize all too well the cyclical nature of the property/casualty insurance market with its swings of the pendulum every few years from high premiums and limited availability to low rates with plentiful underwriting capacity. It has made their business planning and expense budgeting challenging at best.

Some of those buyers have decided to take greater control of that aspect of their business by joining with other like-minded owners in forming their own insurance company. By establishing a group captive made up of a limited number of mid-size, usually privately-held companies in the same industry they can avoid the future volatility of those periodic cycles. Despite its reputation as a tax-reduction measure, captive membership has always been primarily driven by the desire to achieve greater control over the cost of risk. Other benefits that result from forming a group captive include:

>Development of more creative and flexible policy terms

>Opportunity to be proactively involved in claims management

>Reduction in net cost through sharing in the investment income on reserves

>Networking with peers on best practices in loss control and job safety

>Using the captive shares as wealth transfer vehicle

Captives have historically been set up offshore (Bermuda is still the world's major home for captive insurers) but recent years have been the rapid development of domestic captives in the U.S. Currently 26 of the 50 states, plus the District of Columbia and Puerto Rico provide domiciles for insurance captives; Vermont is the home of the largest number.

One prominent motivation for a business owner to consider a group captive even in a soft market is that participation requirements and underwriting guidelines are less restrictive in the current environment. In addition reinsurance for captives and the availability of standard companies to "front" for a captive are in ample supply now. Group captives remain an attractive option for a cohesion segment of companies in any industry which has been largely under-served by the conventional insurance market. Captives provide long-term advantages for their owners in all kinds of markets.

Make no mistake— joining a captive involves the assumption of some risk. But don't you assume risk with every decision you make in your business?