The Benefits of Forming a Captive Insurance Company

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The idea behind traditional business insurance is relatively simple: Your company pays premiums to an insurance company that promises to pay out claims if your business suffers a covered loss. But some companies are looking at insurance in a whole new way that enables them to essentially form their own insurance company that they fully control themselves.

These are called captive insurance companies. Captive insurance is an alternative to self-insurance in which a parent group or groups create a licensed insurance company to provide coverage for itself.[1] A captive insurance company can be formed as a full standalone company providing many different types of insurance, including general liability, umbrella, directors and officers (D&O), health and commercial auto insurance.

A captive insurance company can also be formed to augment your existing commercial insurance policies where there may be gaps in coverage, or where certain risks aren't adequately covered. Captive insurance may be useful if you can't find a traditional insurer willing to insure against a business risk. Often, insurance obtained through a captive is more affordable and/or offers better coverage for the same amount of money.

An Increasingly Popular Option
Captive insurance is becoming an increasingly popular option today as many companies face the prospect of soaring premiums for traditional insurance along with inadequate coverage to meet their unique risk profile. Companies may face a wide range of negative impacts due to these and other factors, including the following:

- Exposure to gaps in coverage.
- Becoming unaware of certain policy exclusions too late.
- Excessive payments for out-of-pocket losses.
- High volatility in premium pricing.

One solution is to create a captive with flexibility to take advantage of positive loss history, thus increasing deductibles to lower premiums of commercial policies. A captive can customize coverage that will provide for shortfalls in traditional commercial insurance coverages.

Virtually any type of business can form a captive insurance company. Manufacturers, dealerships and construction companies, for example, are common types of businesses that have successfully formed captives. Captives can be started with a budget of less than $50,000 and operated on fixed expenses of $3,000 a month. Smaller captives — dubbed "micro-captives" — may even be able to take advantage of Section 831B of the Internal Revenue Code that may exempt their operating income from federal income tax. The premium limit for micro-captives was recently raised to $2.2 million.

Customizing Your Coverage

One of the biggest benefits of forming a captive insurance company is that you can customize your coverage package and pay premiums that more accurately reflect your true loss exposure. You may also be able to participate in the captive's underwriting profits. In effect, your business will retain the profit that you would normally pay to an insurance company.

There are some criteria that a captive insurance company must meet to qualify. Specifically, premiums must be priced based on underwriting and actuarial considerations and there must be a sufficient level of risk distribution as defined by the IRS. Essentially, this means that risk must be spread out among a sufficient number of employees.

Forming a captive insurance company could result in many positive outcomes for your business, including the following:

- Lower insurance premiums.
- Improved control over risk management.
- Significant tax advantages.
- Direct access to the reinsurance market.
- Coverage to fill gaps where traditional insurance is unavailable or unaffordable.

Concluding Thoughts

Some businesses today are looking at insurance in a whole new way that enables them to essentially form their own insurance company, or a captive insurance company. Captive insurance is becoming an increasingly popular option as many companies face the prospect of soaring premiums for traditional insurance along with inadequate coverage to meet their unique risk profile. An outsourced CFO services provider can help you weigh the pros and cons of forming a captive insurance company.

1 Captive Insurance; Wikipedia
en.wikipedia.org/wiki/Captive_insurance

About CFO Edge

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