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Self-insurance and captive insurance as a potential cost savings in risk management programs

SPECIAL TO THE RBJ

VIEWPOINT
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Most businesses purchase a variety of insurance products each year to protect against financial losses from a variety of risks. Typical insurance coverages may include workers' compensation, automobile, commercial property, directors and officers, and commercial general liability insurance to cover third-party claims. Your business may also purchase other specialized coverages and excess policies.

Traditionally, a business might purchase these coverages from one or more insurance carriers by paying an annual premium. In exchange for payment of the premium, the risk of loss for covered claims is transferred to the insurance carrier, subject to the terms, conditions and exclusions of the policy. But insurance companies calculate their premiums to cover their administrative overhead and earn a profit – in other words, the premiums charged to insureds will exceed expected losses. Thus, in some situations, a business might achieve greater cost savings (and increase its bottom line) by developing a self-insurance program.

Self-insurance is any means by which the insured retains the risk of loss and sets aside money to fund potential future losses. Commonly cited benefits of self-insurance programs are reduced costs; greater flexibility; increased insight and analysis of the company's loss experience; greater incentives to improve workplace safety and reduce risks; and faster, more responsive claims handling. Self-insurance can also provide more comprehensive protection as compared to typical insurance policies, as many insurance policies are written on industry-standard forms that exclude coverage for certain damages or causes of loss.

Self-insurance can take many forms. At its most basic level, self-insurance might simply be a separately maintained account where reserve funds are set aside to pay for potential future losses and the business administers claims internally. A more sophisticated self-insurance program might feature more robust procedures for setting and reviewing reserve amounts and the business contracts with a third-party administrator to manage and process claims. Self-insurance is typically only a piece of the insurance puzzle. A business might self-insure for certain types of predictable claims while purchasing commercial insurance for other coverages. Typically, a business will plan to cap their self-insured exposure through the use of excess policies or deductibles, such that the business effectively self-insures up to a defined limit, at which point the risk of loss shifts to an insurance carrier.

Another option for self-insurance is captive insurance, in which a company forms a separate entity that operates as a stand-alone insurance company. The captive insurer may be managed by its own in-house officers and employees, or the parent business may instead elect to hire a third-party captive manager.

Captive insurance offers many of the same benefits as other forms of self-insurance, including cost savings and customized coverages. Captive insurance can also have potential tax benefits, as premiums paid by the parent business to a captive insurer can be tax deductible, and smaller captive insurance companies may make an election under Internal Revenue Code § 831 such that the captive will not be taxed on its premium income, only on investment income derived from its reserves.

Again, a captive insurance company can form part of a broader insurance program and risk management strategy to reduce annual premium costs while capping potential out-of-pocket losses. For example, many businesses with a captive insurer will utilize the captive policy for its primary layer of insurance and purchase an excess insurance policy above the captive layer. Or the captive might also purchase reinsurance to reinsure the captive's losses beyond a specific point.

How does a business go about forming a captive insurer? In New York State, captive insurance companies are governed by Article 70 of the New York Insurance Law, and a business that wants to establish a new captive insurer must obtain approval from the New York Department of Financial Services (DFS).

The first step in the approval process is to meet with DFS' Captive Group. The DFS Captive Group conducts a preliminary meeting with all interested applicants to discuss the proposed captive and review the licensing and incorporation process in detail. A business then submits an application to DFS that includes financial statements, a plan of operation for the captive, an actuarial analysis prepared by a qualified independent actuary, and pro forma financials for the first five years of the captive's existence. A proposed captive must fulfill certain required capital and surplus requirements, which can be met through the use of letters of credit. Finally, prospective officers and directors of the captive must complete background investigation reports. Once the captive is approved and operating, captive insurers must submit annual statements to DFS.

It is also important to keep in mind that certain forms of self-insurance will require administrative approval—for example, an employer wishing to self-insure for workers' compensation coverage must obtain the approval of the New York State Workers' Compensation Board. Before undertaking any new self-insurance program, a business should consult with counsel and risk management professionals.

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