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More captives coming to Main Street

Smaller businesses warm to concept, large firms diversify risks

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Captive insurers, which large companies have long used to cover traditional risks such as commercial general liability and workers compensation, are being used more often by smaller companies as well as organizations looking to cover nontraditional risks.

One reason behind the increase in smaller businesses using captives is they have become more aware of the risk transfer option, said David Snowball, Utah's Salt Lake City-based captive insurance director.

"Smaller businesses are getting to the point where they know about the benefits of captives, and they are taking advantage of that. This education has taken a little longer to get to the West, but it appears to be catching up," he said.

Daniel Message, vice president and head of Latin America at R&Q Quest Management Services Ltd. (Bermuda), said there has been a proliferation in the use of cell captives and agrees increased "industry awareness" is helping drive growth of an area that is "constantly evolving as the market matures."

Microcaptives, or captives formed under Section 831(b) of the U.S. Tax Code also have been growing, boosted by the recent legislative increase to $2.2 million in annual premium income on which they can avoid federal taxes, effective in 2017. But stricter rules on what types of ownership structures are eligible for the tax deduction could result in some fallout for the frequently family-owned parent companies.

> "Insuring for cyber risk is a big issue right now. People are trying ... (to) incorporate it into their captive instead of buying it in the open market."

"There may be a little tapping of the brakes with small captives," said Art Koritzinsky, New York-based managing director of Marsh's Captive Solutions Group.

Michael Bemi, president and CEO in Lisle, Illinois, of the National Catholic Risk Retention Group Inc., a Vermont-domiciled RRG, said soft commercial insurance market cycles have little effect on captives, which differentiate themselves by writing broader coverage than typically available in the commercial market. He also said sophisticated buyers look into captives to gain control of their costs and risks.

Ellen Charnley, Marsh Captive Solutions' San Francisco-based managing director and global sales leader, also sees captive formations increasing despite soft traditional insurance prices.

"You can use them for risks that are not dictated by commercial lines or what the market is doing," Ms. Charnley said. "Today's captive is more strategic and is focused on risks it wasn't focused on 20 years ago — the enterprise risks such as supply chain, intellectual property and political risk."

As captives mature, captive owners are using the accumulated surplus to take on risks the commercial market is not so willing to accept.

Carolyn Snow, Louisville, Kentucky-based director of risk management at Humana Inc. and a former president of the Risk & Insurance Management Society Inc., said several risks are placed in Humana's captive, Managed Care Indemnity Inc.

General liability, errors and omissions, and professional liability are placed in the captive along with the deductible for workers compensation coverage. Ms. Snow said she recently added property deductible to the captive to cover Humana's wind and flood exposures in Florida.

"Insurance companies will only take some of that risk," Ms. Snow said.

Aircraft Gear Corp., a family-owned business that manufactures components for the aviation and auto industries, uses a group captive to insure its medical stop-loss coverage for 70 employees.

Jim Knutson, the manufacturer's Rockford, Illinois-based risk manager, said the company was struggling with the cost of stop-loss coverage that the commercial market was charging and turned to a group captive for a solution.

"It's really worked out well for us," Mr. Knutson said of the medical stop-loss that is the only risk for which Aircraft Gear uses the group captive, Everlong Group Medical Captive Services L.L.C.

While there has been industry talk about putting risks such as cyber liability in a captive, Jason Flaxbeard, senior managing director at Beecher Carlson Holdings Inc. in Denver, called it a "red herring" risk that is too new to put in a captive.

There "isn't enough data, and the modeling is not robust enough" for anybody to assign a risk financing charge against it, Mr. Flaxbeard said. "It may change over time, but the business interruption around it is hard to define. Nobody had a magic bullet for cyber in a captive."

However, many companies are examining captives as an option for cyber coverage because the commercial market may offer low limits or a limited breadth of coverage, said Donna Pankotai, Dallas-based president of DM Pankotai Consulting L.L.C. and senior adviser at Hanover Stone Partners L.L.C.

"Insuring for cyber risk is a big issue right now," said Bill Motherway, president of New York operations at insurance brokerage Conner Strong & Buckelew. "People are trying ... (to) incorporate it into their captive instead of buying it in the open market."

He recommends organizations have $5 million in cyber coverage as a minimum and upward of $25 million for hospitals and other large entities that have sensitive personal data.

"The cyber marketplace is going to get tough and problematic, and the primary layers for that kind of coverage are going to get expensive," said Michael Maglaras, a principal at consultant Michael Maglaras & Co., an Ashford, Connecticut-based unit of A.E.M. Holdings Ltd. "But mature captives are going to want to take in some of that risk."

Jim Swanke, Minneapolis-based director of risk consulting at Willis Towers Watson P.L.C., said he has seen more captive formation activity in the past year than the past decade because of risks such as cyber liability due to data breaches.

"The activity being seen is in the nonstandard types of risks that weren't put in captives in the "80s and "90s such as cyber, wage-and-hour coverage, crime insurance and benefits," Mr. Swanke said. "We are going to see a lot more people putting benefits in their captives."

Many multinational companies are looking to consolidate their global benefits and have one global insurer to provide benefits to their employees and then have the captive reinsure the coverage, Marsh's Ms. Charnley said.

To control expenses, there's a strong movement among for-profit and nonprofit organizations to bring benefits such as group life and group long-term disability coverage, into their captives, Mr. Maglaras said.

Beecher Carlson's Mr. Flaxbeard says controlling expenses is another reason for medical stop-loss becoming "more on the forefront" of captives since the Affordable Care Act.

"Chief financial officers want some form of certainty around budgets and don't want to be on the hook for an unlimited amount of insurance for employees," Mr. Flaxbeard said.

"As medical costs continue to go up and companies pay more attention to wellness programs, group captive activities will continue to be more prevalent," Marsh's Mr. Koritzinsky said.

As organizations examine putting new risks in their captives, Willis Towers Watson's Mr. Swanke recommends modeling the risk to gain a better understanding of what kind of losses could affect the organization.

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