Simplest Form of ART: Direct Writing Captive

By Dick Goff

This month we'll jump back into our descriptions of captive insurance structures, just in case readers are warming up to the idea that alternative risk transfer (ART) is worth considering as a method to self-insure health benefits in addition to its longtime role in the P&C world.

Alert readers will recall that last month we discussed fronted captives – that is, a captive in partnership with a traditional insurance company that "fronts" the coverage and administrative services while ceding to the captive that part of the premium that corresponds to the captive's retained risk.

This month we promised a discussion of direct writing captives, then in future issues we'll cover the other two main captive structures, service provider sponsored captives and service provider controlled risk retention groups (RRG).

Essentially, direct writing captives are the simplest. It is what it says: a captive insurance company that directly writes its own coverage. The captive self-insures the risk(s) and, if stop-loss insurance is needed, it's called reinsurance and is readily available.

For several reasons that we'll discuss, direct writing captives are most appropriate for non-state regulated insured risks. ERISA-approved employee benefits plans are a notable example of non-state regulated insurance. So when a captive provides employee benefit related coverages, it may be appropriate to do so as a direct writing captive or, to use industry slang, direct writer.

However, there is a giant caveat: while ERISA plans are not regulated by states, they must meet U.S. Department of Labor standards which have in the past expressly prohibited employee benefits being provided by captives.

But that is changing. Several captives have received exemptions from the DOL prohibition, and others are in the pipeline. The DOL has established an Expedited Procedure (ExPro) to reduce the time it normally takes to approve captive exemptions. From time measured in years, the procedure has been tightened down to about 80 days in the most recent case.

The major DOL standard that has continued to be upheld is that captives providing employee benefits must reside in a U.S. domicile. That's really no challenge because of the recent development of business-friendly U.S. domiciles such as South Carolina and the District of Columbia. Those domiciles will license branches of captives based offshore. This allows the offshore captive's branch the ability to write employee benefit risks under the DOL guidelines, even though the risk may ultimately end up offshore.

Most states will not accept direct writing captives to provide regulated insurance coverage such as workers' compensation or automobile liability. Examples of non-regulated coverages for which direct writing captives would be appropriate include medical malpractice, helicopter hull coverage, or even group medical stop-loss insurance.

Coverage being written for a government entity, whether local, state or federal, would not usually be appropriate for a direct writing captive. Government jurisdictions usually require evidence of insurance by regulated carriers. Also, a further negative with direct writing captives is that financial institutions have not always accepted their certificates of insurance, as one example. You may have gold-plated capital and surplus ratios to direct written premium and still not have your captive's paper accepted, and that's just a fact of life.

The benefits of insuring through a direct writing captive make it a worthwhile consideration. A captive will operate at far lower costs (excluding losses) than a traditional insurance company with its office towers, management layers and fleet of jets. Overhead and administration usually soak up 30 to 35 percent or greater of premium written, and captives can operate on a sliver of that amount.

Taxes, too, represent considerable possible savings, and/or at least enhanced cash management. Usually an employer can tax deduct the entire premium paid to a captive rather than waiting for payment of claims within a qualified self-insured benefit(s) program. This should be particularly attractive to organizations insuring health benefits for current or retired employees.

The organizational benefits of captives include greater strategic focus for the CFO and great potential efficiencies for managing the entire corporate spectrum of risks.

Almost any individual, group or corporate structure can own a direct writing captive. Captives are owned by TPAs, MGUs, franchiser organizations, professional groups such as physicians – the possibilities, indeed, are endless.

Next month we'll get more specific on the topic of service provider-sponsored captives.

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