Author of the International Best Seller ***The Laws of Insurance Attraction***, and ***Stop Being Frustrated & Overcharged (By Your Workers' Compensation Program)***

TURNING PREMIUMS INTO PROFIT$

How you can simultaneously build equity and reduce your total cost of risk by utilizing your business insurance program

DAVID R. LENG, CPCU, CIC, CBWA, CWCA, CRM

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To my good friend Bob Seltzer, you were one of a kind.

Even at 68, you proved you are never too old to learn and try new things, and use them to make a difference in someone's life.

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Foreword

As business owners, we face risks (threats) to our business every day. Plus, to run a successful business there are a lot of hats that must be worn. Whether we wear them all ourselves, or have others that help us; overseeing payroll, HR, production, distribution, safety, and the ever-changing OSHA and other governmental regulations that need complied with, are enough to make anyone's head spin.

In addition to all of those, having competition also squeeze our bottom-lines makes it imperative that we diligently maintain a certain level of frugalness when it comes to costs. And that is a hard-fought battle when it comes to the specter of rapidly increasing and often insurmountable insurance costs.

Increased costs have seemingly always been a trait of traditional insurance products. No matter how judicious we are in trying to control our company's risk factors, it always seems that at renewal time the needle invariably points north. You work hard to make your risks goes down, and yet, some insurance company underwriter seems to want to push your insurance costs up. On any business owner's frustration meter, I am sure this is definitely an 11.

So, one day, somebody who knows a whole lot more about managing risks and insurance than I do suggests that there is an alternative, one they call Captives. And what sounds like a P.O.W movie suddenly brightens up the insurance landscape. It's proverbially like somebody throwing a lifeline to keep us from fiscally drowning, one that we would be foolhardy not to latch on to.

We learned that by utilizing a **Captive Insurance Program** as an alternative to traditional insurance, we can use a type of self-insurance that allows us, in essence, to join with other like-minded, well run and safe companies, to form our own insurance company and, now get this, pretty much *insure ourselves*. Not only do we gain operational transparency, coverage flexibility, greater control, reduced costs and increased cash-flow, any profits from our insurance program is returned to us and not sent off to the insurance company's shareholders. Plus, our captive premiums are based on the quality of our business, and not on the general insurance marketplace rates. For us, it's the definition of a win-win.

For the same reason you probably wouldn't perform surgery on yourself, you need a talented insurance professional to really get into the nuts and bolts of how Captives works, and if it is right path for your company to take. I have known David Leng for years, and during that time have trusted him to steer our company in the right direction regarding our risks and insurance. And if David has the knowledge and the resources to put everything you need to know about Captives in the pages of this book, then I would suggest it's a book well worth reading. Don't wait to do so, as waiting for your insurance renewal date will probably cost you more in terms of money and headaches.

Bob Monpara,
President – MBPJ Corporation

Acknowledgements

I would like to thank Jon Kirssin for his education and insights on 831(b) Enterprise Risk Captives. John has worked closely with me and a number of my clients by helping them to implement appropriate alternative risk financing strategies for over 10 years. Jon D. Kirssin is the Principal of CFMC, Inc., a captive and general insurance consulting and management company formed in July 2001. Prior to founding CFMC, John was involved in managing captives for PMA Insurance Company.

I would also like to thank Dennis Silvia for his guidance and assistance in managing our group and agency captives for over 10 years. Dennis Silvia the captive manager for the Keystone Insurers Group, and has been the president of Cedar Consulting LLC, in Chagrin Falls, OH since 2005. Prior to that, he spent five years as Director of Group Captive Programs for CNA Insurance Co. in Chicago. In the decade preceding, Dennis served as Vice President, Captive Products for National Interstate Insurance Company in Richfield, OH. Dennis also serves on the faculty of the International Center for Captive Insurance Education (ICCIE)

Introduction

When it comes to controlling and managing your insurance program, and most likely with you focusing on reducing your premiums, the odds are you will probably agree with at least a few, if not all, of the following statements:

- *The insurance companies take more of your money than they pay out in claims on your behalf.*
- *It takes a lot of time to shop your insurance, and you still don't receive results you are satisfied with.*
- *Transitioning between insurance agents is painful, and between insurance companies even more so.*
- *There always seems to be something that gets missed when you make a change. And that "something" always comes back to haunt you.*
- *Insurance agents do not really understand what your business is and what your needs are.*
- *You do not fully understand the insurance system.*
- *Insurance companies don't seem to listen to you when it comes to paying your claims.*
- *You do not like to be blindsided by a large premium increase.*
- *The hard and soft insurance marketplace pricing makes it challenging to properly budget.*
- *The insurance industry is not very transparent.*
- *You feel the insurance company has too much control, especially when it comes to how they manage and settle your claims.*
- *There appears to be a lack of creativity when it comes to dealing with your business' risks.*
- *That feeling of being overcharged leaves you yearning for more cost-effective options.*

So how do you end this frustrating cycle of purchasing insurance that leaves you wanting more?

IT IS SIMPLE, JUST READ ON…

Over my 30-plus years as a speaker and an Outsourced Risk Manager, I have interviewed hundreds of business owners, business leaders and executives, and they have all expressed the frustrations I have just outlined. They have also lamented about the amount of time, energy and/or money they have spent dealing with their insurance program.

So why do you, as a successful business owner, keep doing the same things over and over when it comes to managing your insurance program? Only you can answer that question. But you can take some comfort in knowing that you are not alone.

When you look at the amount of money you have wasted on your insurance program, money you could have used to achieve a specific goal within your company, money that could have been used personally, money that could have built equity, how can you not feel frustrated? Think of the amount of time you have frittered away trying to obtain bids or quotes on your insurance program, only to fall short of the results you wanted. And by doing so, you now realize that this time could have been better spent focusing on growing and running your company.

Why do you feel this way?

The answer is really very simple; the insurance industry has taught employers how to purchase insurance but in a way that can best be described as clunky and confusing. You experience it every year, particularly 90-120 days prior to your insurance renewal. This is the time when it seems like insurance agents come out of the woodwork asking to quote your insurance, only to promise much and deliver little.

This is where you are dropping the ball:

- By thinking that being attractive to all the insurance agents calling you to quote your insurance (who simply want a commission from selling you policies) is the same as being *truly* attractive to all insurance companies, and therefore ***assuming insurance companies will provide you with a premium commensurate with your risk.***

- By wanting, ***instead of demanding,*** a better way!

And there is a better, more successful way to manage your insurance costs. Insurance is your way of transferring your *risk* of the unknown to an insurance company in exchange for a known amount of money, commonly known as a *premium*. Through your strong focus on safety and your corporate culture, you have come to a point where you have become very attractive to insurance companies and they are offering you *their* best premiums. But in the end, *their premium is still too much.*

Think of it another way, the efforts and focus on safety that has made you attractive to insurance companies is allowing those insurance companies to take your money (premium) so that they can take on the risks and pay the claims of other businesses that are not as focused on those traits as you are. And, your money also goes to benefit their shareholders. *So why allow your efforts to benefit others?*

This is why businesses are rapidly turning to Alternative Risk Financing Insurance Marketplace…

If you are paying over $100,000 annually in workers' compensation, general liability, and auto insurance premiums combined, or insuring more than 20 employees for health insurance, you can break this costly cycle and gain more control over your insurance costs. Alternative risk financing is when a business does not purchase traditional guaranteed cost insurance policies, but instead purchases insurance where they take on some risk to get potential rewards. For clarification, there is more insurance premiums invested by businesses in the alternative risk financing market than you realize, with the use of Group Captives being the most popular of the alternative risk financing programs being used.

Captives are not a new concept; they have been around for over 100 years. From around 1,000 captives in 1980, there are now over

7,000, according to a September 2014 report by Conning Research & Consulting. In fact, there has been more than a 35% increase in captives in the past 10 years as business owners become more sophisticated and demand better use of their capital. As a result, more and more businesses have turned to captives.

This book is divided into two sections:

In the first section, you will learn about the world of insurance captives, and how to take advantage of their significantly lower insurance costs structures. You will also discover the potential financial and estate benefits of captives, and obtain the ability to take control of your insurance program.

In the second section, the focus is on improving the profitability and results of your captive. We will explore the areas of Risk Management, Safety Culture, Claims Management, Human Capital and Benchmarking your results.

Yes, in the captive world you are able to take control of your insurance program, just as you control your business. In other words, instead of focusing on your insurance costs as an expense, you will now be able to view it as investing in a profit center that builds wealth for you.

1

The Insurance Marketplace

Business leaders who successfully manage their risks eventually ask the question: ***What should I do when the insurance companies continually takes more of our money than they pay out on our behalf?***

Face it, your efforts and focus on safety, the very attributes that have made you attractive to insurance companies, are allowing those same insurance companies to make an underwriting profit off your business. In essence, that underwriting profit is excess premiums, and it allows the insurance company to take on the risks and pay the claims of businesses that are not as focused as you are. Plus, your excess premiums go to benefit their shareholders in the form of insurance company profits.

Then you realize your situation has gotten worse when the insurance industry experiences a "hard market," a time period when the insurance industry seeks to increase overall rates due to inadequately charging companies with poor claims experience enough premium. When better performing companies like yours cannot offset the losses of poorer performing businesses, the insurance companies still need to be profitable for their shareholders, so they must increase *everyone's* rates - including yours. This is why businesses continue to turn to the alternative risk financing market.

Why is alternative risk financing so popular?

When you have a strong safety focus and a great corporate culture, whether buying insurance outright for your organization or buying excess coverage if you are self-insured, it typically comes down to financing your risk and purchasing some form of insurance. To answer the question as to why alternative risk financing programs, particularly group captives, have become so popular, it is necessary to review all of the programs available to you, so you can see what the options are.

There are multiple types of programs available to transfer risk to an insurance company for a premium. We will go through a number of the programs in some detail as well as summarize and provide highlights, with advantages and disadvantages of each. To include all the details associated with each form of insurance program outside of captives would be a lengthy book indeed.

The programs range from the highest cost for you to insure your risk down to the lowest cost. Ranking them in that order, starting with guaranteed cost as the costliest, we then move on to dividend, retrospectively-rated, high-deductible, captives. And, finally, the lowest-cost program, which is typically found with self-insurance programs.

	Plan
Lowest - - - - - - - Highest	Guaranteed Cost
	Dividend
	Retrospectively Rated
	High-Deductible
	Captive
	Self-Insurance

Each of these programs has pluses and minuses. Ultimately, you must make a decision based on the cost-benefit analysis for your company. You need to determine which program best suits you, your needs, your cash flow and your financial position, in order to pay the lowest net costs possible for your insurance program.

Guaranteed Cost

A Guaranteed Cost program is just what its name implies. You pay a certain premium based on the underwriter's perception of your risk. The only variation comes at the end of the year when the insurance company conducts its year-end premium audit. There is no real risk to you as an organization, outside of retentions or deductibles per claim, which are very small. The main advantage of this program is that you are able to budget exactly how much you will spend for your insurance for that year.

The reason Guaranteed Cost is the highest is because insurance companies are in business to make a profit for their shareholders. Therefore, they are going to determine the amount that they want to charge for the potential losses for your organization, based on what the underwriter perceives as your risks. The underwriter is then going to add their expense ratio (cost of marketing acquisition, policy underwriting and service, and agent commissions), the insurance company profit, and then add in for a margin of error. Typically, insurance company expense ratios are in the 25-35% range. After adding in profit and margin of error, you are looking at 35-50% of your premium being used for expenses not associated with paying any claims on your behalf.

To determine the premium of your insurance program, the insurance companies will ultimately want to calculate your policy premium in order for them to achieve an expected loss ratio of 30-50%. They will calculate the premium of an employer they perceive to be a better risk closer to an expected 50% loss ratio. Those they perceive to be more of a risk will be priced higher at an expected 30-35% loss ratio. To understand loss ratio, you must determine your yearly average claim total using the average of all your claim costs for the last five years. A 50% loss ratio premium could be calculated by doubling your yearly average. A 30% loss ratio premium could be roughly calculated by tripling your yearly average.

Also, "hard market" or "soft market" condition influences underwriters as well. In a "hard market," where buying insurance is a little more difficult and rates are going up, there is pressure on the underwriters for higher rates. The underwriters will err on the conservative side and judge a risk poorer and push more towards the

30% loss ratio, resulting in a higher premium. In a "soft market," an underwriter may be more aggressive and a little more forgiving, thus underwriting to a higher loss ratio, resulting in a lower premium. As you can see, they are taking all of your expected losses and significantly marking them up and adjusting them based on the perception of your risk.

For example, if the underwriter expected to pay out $120,000 a year in claims, depending upon their perception of your risk, and if it is a "hard" or "soft" market, they may charge you anywhere from $240,000-$400,000 for your policy.

Dividend Program

The Dividend Program is nothing more than a guaranteed cost insurance policy with a return of premium dividend potential. Based on the overall loss ratio (losses divided by your final premium), you may expect to receive a return of a portion of your of premium, typically one year to two years following the expiration of your policy. The dividend may be anywhere from zero dividend on poor performance, to perhaps 10%, 15%, or even potentially 20% for a good or outstanding performance.

Many insurance companies like to tout their biggest potential dividend, which might be 30% or 35%. However, you would need zero losses ($0 paid *or reserved*) to attain the highest advertised dividend payout. If you have one dollar of loss (or reserve), you will have some percentage other than a 0.00% loss ratio and you will drop down to a much lower percentage.

Interestingly enough, insurance companies do tend to charge a little extra premium for policies with a dividend associated with them because they know that ultimately they will have to pay out, or could pay out, a significant portion of the premium in a dividend. This way they can maintain profitability.

The exception might be a group dividend program based on, for example, an association or a specific group of businesses. The insurance company is then able to spread the risk over more policies and therefore have a much more stable outcome from a profit standpoint. They would not necessarily need to inflate the premium of each policy to pay for the dividend.

It is important to note that the amount the underwriter may choose to inflate your premium by may be anywhere from a relatively small to an amount larger than you might think, so it is wise to ask what your premium would be with the dividend, and what your premium would be without the dividend. This way you can compare and decide if the difference in premium is worth waiting for the potential dividend.

When it comes to declaring a dividend, the insurance company will want to allow for “claim development,” which allows the adjuster more time so they have a better idea as to the severity of the injury and potential claim costs. Therefore, the dividend calculation date, or dividend valuation date, will typically be anywhere from 12-24 months after your policy expiration date. You may also want to know that the insurance company will not pay any dividend on “fees or assessments,” such as terrorism charges, state assessments or taxes, expense constant, etc.

An important item of note is that dividends are not guaranteed, and are subject to that insurance company’s board of directors’ approval. Although it is extremely rare not to be paid, there is the potential for an insurance company to choose not to pay out a dividend even if “earned,” especially if the insurance company is having financial difficulties.

Retrospectively-Rated Program

The Retrospectively-Rated Programs take this risk-reward proposition a step further. A Retrospectively-Rated Program is just what it says. After your program period is over, the insurance company will then retroactively determine your final premium. They will look backwards at what the total amount of your claims were and then calculate your final premium based on total amount of the losses, subject to both a minimum and maximum premium.

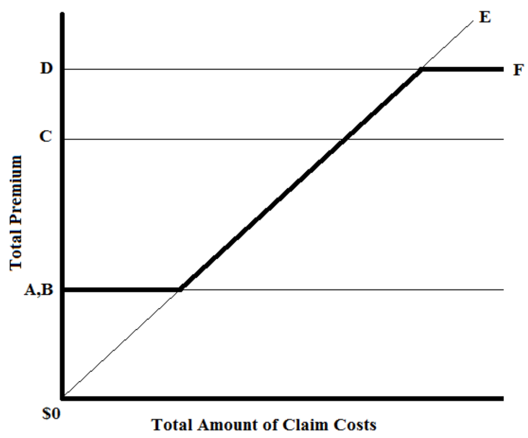
The insurance company will calculate the final premium charge each year until such time that the retrospective contract terminates. The retrospective contract could contain a three, four, five, six, or seven-year termination period. Most will be longer in length so that all claims close and the insurance company is confident that there is no possibility of a future claim reopening or being brought to light.

On the other hand, a shorter term may seem appealing, but then your final premium will be based on total claims, including reserves that have yet to be paid, or may never be paid.

Your standard premium, which is the basis for the Retrospectively-Rated Program calculation, is determined much like a guaranteed-cost premium, which is based on the perception of your risk. The difference is that a Retrospectively-Rated premium does not include a premium size discount and typically carries a slightly higher premium to start with as compared to a guaranteed cost policy.

The best way to understand a Retrospectively-Rated program is to go through an example. In this example, we will pretend your standard premium is $250,000 (line C in Diagram), and you will have had $60,000 in losses.

Retrospectively-Rated Program Diagram



First, the insurance company will have a Basic Premium Factor (line A in diagram), or base charge, which is their expense ratio, profit, and "reinsurance" if your losses exceed the formula's maximum rating ability. In this example, we will use 40% or $100,000 to cover their expenses and what they view as reinsurance or excess insurance should you have a horrendous loss year.

The insurance company will then add to the basic premium charge the $60,000 in losses that the insurance company paid out on your behalf, including reserves. In addition, there are usually two multipliers that are applied to those losses: Loss Conversion Factor, to pay for the costs of the claims department to adjust your claim and also to allow for development of the claim as claim costs typically go up over time; and a State Premium Tax Multiplier, to cover the associated state premium taxes. Line E in the diagram represents the final calculation of the loss portion of the premium determination.

Be aware that some insurance companies will also add in a third multiplier for IBNR (Incurred But Not Reported losses) for the potential that a claim may be reported years later. Now keep in mind that most states have statutes of limitations on how late a claim can be reported, but this charge would be in the Retrospectively-Rated Program contract and may be charged well after the statute of limitations is over.

Let us use a Loss Conversion Factor of 10% (1.10) and a Tax Multiplier of 5% (1.05). In this example, if you take your losses of $60,000 and multiply them by 1.10, and then by 1.05, you come up with a claims charge of $69,300. We will not use IBNR in this example, as it is not a normal charge.

As you can see, your final premium will be your claims plus surcharges, plus your base charge. However, that is a little too unstable, or too unpredictable, on both ends. So the insurance company typically will include a minimum percentage and a maximum percentage.

The insurance company will have a Minimum Premium Factor (line B in diagram), which is normally equal to that of the Basic Premium Factor. Occasionally, I have seen some policies that had higher minimum premium factors. Insurance companies use higher minimums when they want to use the Retrospectively-Rated Program more as a tool to collect additional premium from a business rather than to reward them for being a better risk.

On the other end of the spectrum would be a Maximum Premium Factor (line D in diagram). This would be used to determine the most you would have to pay for a program year. It might be 125% of your standard premium or even higher.

When structured properly, a Retrospectively-Rated Program will yield a lower net premium cost to you as a business. Keep in mind, whether you want a bigger reward or a lower Minimum Premium

Factor, the insurance company will typically push the Maximum Premium Factor higher to have the upper amount capped. When structuring your Retrospectively-Rated Program, you will want your Minimum Premium Factor to be as low as possible, making sure that the Maximum Premium Factor does not make the risk-reward decision too unpalatable.

For this example, we will use a Minimum Premium Factor equal to your Basic Premium Factor of 40% (0.40), and a Maximum Premium Factor of 125% (1.25). Your Basic Premium Factor is $100,000, and your losses result in a premium charge of $69,300, thus your final calculated premium would be $169,300. So in this example, as your total calculated premium is less than your Standard Premium, you would receive a refund of $71,700 in premium. If you had $0 in losses, you would receive a refund of $150,000. However, if your claim costs exceeded $129,870, you would owe additional premium over the initial $250,000 paid in. In this example, once your total claim costs exceeded $182,247, you would hit the Maximum Premium Factor and would owe an additional $62,500 in premium. The bold line F in the diagram represents the final premium you will pay based on the calculation of your losses.

You can reap the rewards of having your house in order and achieving better results by moving towards the alternative funding programs of retrospective, high deductible, captive, and self-insurance. And by doing so, you can reduce your cost of insurance far greater than with guaranteed cost or dividends.

You can see the advantage of significantly lower premiums and the flexibility of the program. The disadvantages of this program include uncertainty surrounding final premium, and the premium paid may be higher than guaranteed cost if you do not control your losses.

Unfortunately, Retrospectively-Rated Programs have earned a bad reputation because insurance companies typically present Retrospectively-Rated Programs to businesses that do not have their house in order and thus experience significant losses. The reason insurance companies do this is to collect the extra premium to offset the losses that have occurred. In essence, the insurance companies use the Retrospectively-Rated Program to provide them with additional premium. Because they simply cannot price the premium high enough to their liking, and cannot use a high enough rate or add enough surcharges to the guaranteed cost program as they would prefer, they use a Retrospectively-Rated Program to accomplish it.

At times I have seen Retrospectively-Rated Programs used with poorly managed risks with minimums of only 80% to 90% (0.80-0.90) and utilizing maximums as high as 150% to 220% (1.50-2.20). As you see, a Retrospectively-Rated Program can be used by insurance companies as a tool to collect more premiums by creating a skewed risk-reward with the advantage in favor of the insurance company.

On the other hand, these programs are not frequently proposed to businesses that do have their houses in order. Most insurance agents do not truly understand the Retrospectively-Rated Program and therefore cannot explain it to an executive well enough for that person to become comfortable with the program. Also, insurance companies do not readily offer them to well-run businesses as the insurance company would obtain more premiums from the business owner using the guaranteed cost policy.

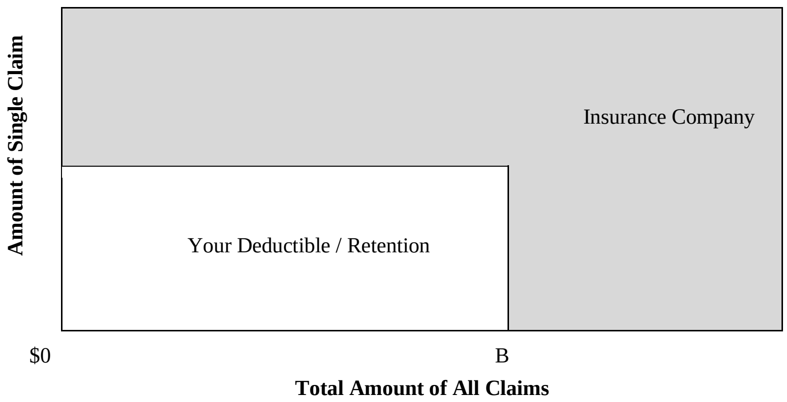
It is very important to understand how loss levels or claim total dollars spent equate to what premium you ultimately pay. That way you can make an intelligent financial decision regarding risk-reward.

High-Deductible

High-deductible is the next step just before you would go into a captive or self-insured program. In this program, you accept a high-deductible per claim, typically a minimum of $25,000 or $50,000 per claim or higher, with the possibility of $100,000, $250,000, $300,000 or even half a million dollars or more per claim (see A in diagram below). To prevent too much financial uncertainty caused by a high frequency of injuries with a high-deductible program, you may also have an aggregate-deductible amount (see B in diagram below). This aggregate-deductible enables you to have some maximum cost certainty. The aggregate might be two to five times the amount of the per-claim deductible, or even more, depending upon the premium size of your company.

It is up to the underwriter and the insurance company to determine exactly what this aggregate deductible amount might be. They then determine the amounts that exceed this per- claim deductible for an individual claim, or when the total of all your deductibles exceeds your aggregate maximum deductible, then the insurance company pays (see the diagram below).

High-Deductible Program Diagram



Through these high deductibles you will find yourself paying most, if not all of your claim costs. You are purchasing excess coverage from an insurance company for very large claims or very bad years. You receive a substantial premium reduction through a large credit that is applied to your policy in order to reduce the insurance premium portion you pay. In essence, a high deductible is not much different than self-insurance, except you do not have to deal with all of the state regulatory issues of self-insuring. All functions and services provided by the insurance company are marked up for their profit.

Much like you saw in the Retrospectively-Rated Program, the insurance company is going to mark up the claims to cover claims handling expenses, development factors, taxes and possibly fees. Read your contract carefully to understand exactly what they are adding to each claim dollar spent on your behalf, including reserves. The downside to the High-Deductible Program is the fact that you as an organization, from a tax standpoint, can only deduct as an insurance expense the amount of premium that you pay, and the amount you pay for actual claims paid. You will not be able to deduct the reserves you must set aside and pay to the insurance company for reserves (potential claims payout).

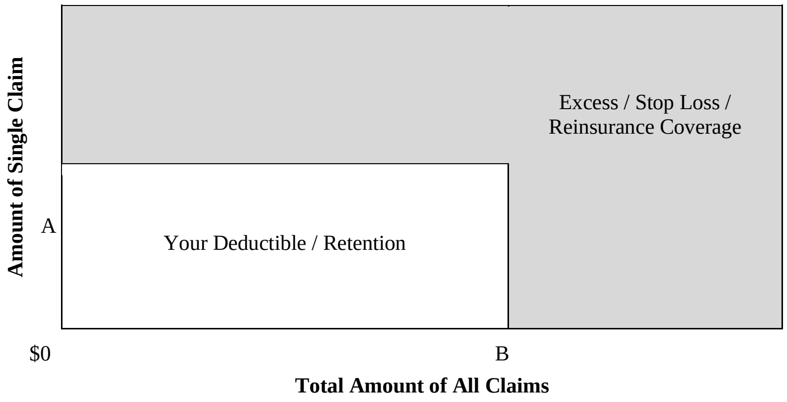
Each insurance company decides if they want to collect the deductible payment for both paid and reserves, or if it is based simply on paid claims. You may also have to set aside either a letter of credit or supply the insurance company with a cash deposit or letter of credit to collateralize and guarantee you will pay promptly any invoice for claim payments the insurance company makes on your behalf.

Self-Insurance

Although Self-Insurance will typically have a lower total cost of risk over a captive, we will jump ahead to Self-Insurance before we return to captives in the next chapter to close out this overview.

Even with Self-Insurance, you still have to typically purchase excess or stop loss (reinsurance coverage) to protect your organization when you have a significantly large claim or a series of larger claims. As an organization you should not assume unlimited risk. You normally purchase your reinsurance as your safety net so that you will know what your maximum annual liability will be (see B in diagram) and for any one claim (see A in diagram).

Self-Insurance Program Diagram



When you Self-Insure you must file with the state insurance department and receive approval. Most states will even tell you what reinsurance to purchase, stating the per claim and aggregate retention amounts that must be used. You must also hire a third-party administrator to legally adjudicate your claims unless you have a licensed adjuster on staff. You will need to set aside monies, also known as reserves, to pay your claims and future claims. You must also have your program audited by an independent auditor to evaluate and make sure you have properly funded your program.

As I mentioned with high deductibles, you will be able to deduct for tax purposes your excess premium and all the fees that you pay for claims administration and actuary services, as well as the actual amount you pay for claims. However, you will not be able to deduct the amounts that you set aside for reserves.

Because you self-administer more of the process, the cost structure of managing Self-Insured is lower than in a captive, and much lower than high-deductible programs. Therefore, your overall Self-Insurance will traditionally lower your net cost over time more than a captive, high deductible or guaranteed cost.

As you can see, the more risk you take on yourself, the lower your cost of risk, such as your insurance cost. However, never take that huge step into the alternative funding, or any change beyond guaranteed cost, unless you conduct an analysis and *fully* understand your risk-reward. You also need to understand the cash flow implications and collateral requirements of each model, so that ultimately you achieve your goal of dramatically reducing your costs.

2

What is a Captive?

Simply put, a captive is an insurance company. It receives premiums in exchange for providing coverage for the risks they are insuring or protecting and they pay claims. But the biggest difference between a captive and an insurance company is that although the insurance company can work with individuals and businesses directly, at large, a captive cannot sell insurance to the public. It can only manage and transact business with the members of those captive or other insurance companies. A captive identifies what the risks are, provides coverage and writes policies, sets premiums, and determines who they can and cannot insure. As you can see – it acts like any other insurance company.

Captives have been around for hundreds of years, dating back to ship owners that would share in the risks of voyages. In the late 1800's, protective indemnity clubs were created. Although captive growth was slow, they saw a significant growth, particularly in the 1980's when a significant hard market hit, making insurance hard to obtain and very expensive to purchase, which led to financial federal law reform. Today captives are exploding. Over the last 20 years the numbers have doubled. With over 7,000 worldwide, and more than a 35% growth since 2006, captives are the most popular of the alternative risk financing options.

Insurance companies must be initially formed, licensed, filed to do business and approved by a governmental body, and are often referred to their place of domicile. Or in the case of statutorily required coverage of Workers' Compensation and Auto Liability, by the state your employees or vehicles reside. Captives are being formed, or domiciled, both inside and outside of the United States. Outside, some of the biggest are Bermuda, Cayman Islands, and the

British Virgin Islands. Inside the United States, the leading domiciles are Vermont, Hawaii, South Carolina, and Arizona – and the numbers of states are growing.

Captives are growing in numbers because business owners are tired of the traditional insurance marketplace, where insurance companies determine what their risk profile is and what the insurance company expects to pay in claims, and *then* try to price their insurance to either a 30% hard market loss ratio, or a 50% soft market loss ratio. Loss ratio is your claims over a three-to-five-year period divided by the premiums you paid during that same period. Basically, business owners are tired of insurance companies charging them double or triple what is expected to be paid out on their behalf.

Either way, insurance companies expect to pay out far less than what they take in. And they make money in two ways: Underwriting Profit and Cash-Flow Investment Income.

Underwriting Profit

The insurance company charges premiums to their insured's (clients). From the premiums they receive they pay operational expenses, as well as pay for the claims of their clients. When an insurance company collects more in premiums than they pay out in expenses or claims, they make an underwriting profit. This underwriting profit is why most business owners that control their claims feel like the insurance industry takes advantage of them; the insurance companies collect more in premium than they pay out on their behalf.

Cash-flow Investment Income

The other way insurance companies make money is from cash-flow. This is why people like Warren Buffett are in the insurance business. For example, the insurance company charges and collects a business dollar premium on day one. We also know that the claims rarely happen on day one. They happen days and even months later. When claims do happen, they take a while to get reported. When they do get reported, they take a while longer to be settled. Insurance companies have the benefit of collecting that dollar premium, holding it, investing it, and earning compound investment income on it until that dollar is either paid out in the form of a claim or it is redistributed in the form of profits back to the insurance company's shareholders.

At a high level, the captive is all about transferring those two benefits away from insurance companies, to individual companies within the captive.

At the core, a captive insurance company is a risk financing tool. Ultimately, these underwriting profits, as well as the monies that are set aside and invested for reserves, as well as the growth in those funds, are hopefully returned to those captive owners. This feeling is especially true with business owners that manage their risks and their risk profile very well. Those that strive to be safe and have very few claims and injuries, that ultimately pay far, far more in premium than the insurance company pays out in losses. When you have the mindset that you do not want to have injuries or claims, and you get together with other like-minded businesses, you can see that as a group you can insure yourselves at a much more efficient means than the traditional insurance marketplace.

There are also situations where the traditional insurance marketplace will not provide coverage for you for the risks that you face as an organization. In these situations, you are retaining those losses as a company, to retain any losses you have to set aside money. That money you need to set aside ends up being considered profit and is taxable. Insuring risks in a captive can be a legitimate business expense. A captive gives you the ability to customize your coverage, and to provide coverage that you cannot buy in the insurance marketplace. Basically, it gives you flexible coverage and flexible terms.

So, why are the numbers of captives exploding? It is because smaller companies, particularly those that are be paying as low as $100,000 in premium are now eligible to join group captives, and as a result the group captive world has grown to a point that they have become more efficient in handling businesses of this size.

Being a member of a captive is quite interesting in that you get to act as your own insurance company, and also potentially receive the benefits of owning your own insurance company, including underwriting profit and investment income.

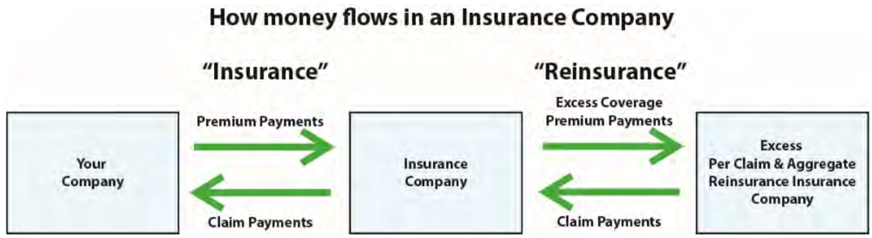
The key concept behind captive insurance is, in essence, self-insuring your risks. You do not completely leave the traditional insurance marketplace, because there are still risks that you may choose not to self-insure, and you may still need a licensed insurance company to assist you when a licensed insurance company is required, such as the case with workers' compensation or auto liability insurance. States typically require a licensed insurance company for these types of coverage.

You might think that self-insurance is too much for you. But every business is basically self-insuring; it is just a matter of to what degree. Every business that buys an insurance policy has a retention that they are self-insuring, also known as a deductible.

You may choose a low or a high deductible for retention. Think of it this way: if you were to add or raise your deductible on your general liability insurance from $1,000 to $10,000 and your premium was reduced by $5,000 a year, you may choose to increase your self-insurance amount because you feel that, over time, you are going to reap the rewards of that higher retention by saving premium over time. The concept of a captive just takes it to a higher level.

The concept of using a captive is like taking advantage of using larger deductibles, and captives allow you to control what you will have to ultimately pay for your insurance protection, all while reaping the benefits when you perform better than the worst-case scenario. The advantage of a group captive is that you get to take advantage of those large deductible premium savings without having to face the prospects of paying the entire large deductible yourself; the group in the captive will help you.

Just so you know the same concern over paying out huge claims applies to insurance companies as well. They do not want to take on millions of dollars in claims by themselves, so they go out and buy insurance themselves, which is called reinsurance. They keep only a portion of the potential claims, say the first $250,000 or $500,000 of a claim, and then let the reinsurance take care of the big claims. As the chance of something occurring that will bring about a claim of over $250,000 is very small, the cost of reinsurance is significantly lower as compared to the cost of insurance for the first $250,000.



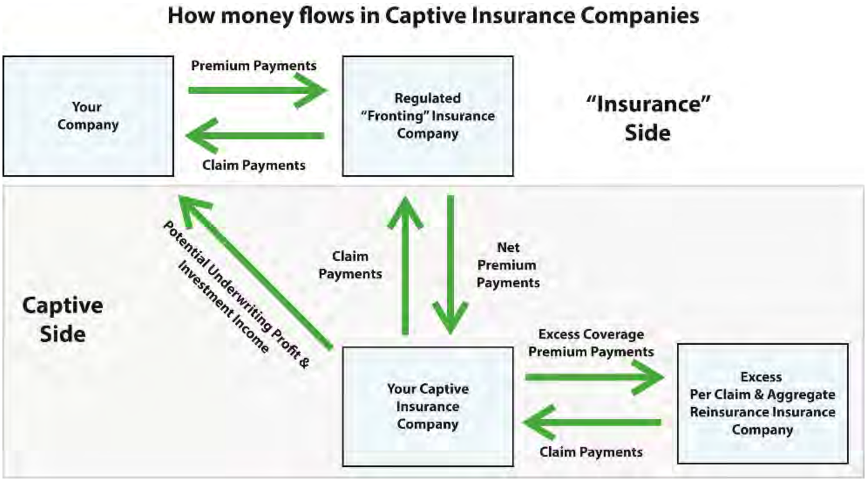
The insurance companies can charge the largest amount of their premiums, and make most of their profits, from insuring these small, predictable claims and letting others (reinsurance companies) take on the large, unpredictable million dollar claims.

From the "insurance side," a captive insurance program looks, acts and feels like a typical guaranteed cost insurance program. You purchase a standard, guaranteed cost insurance policy from and pay premiums to a regulated insurance company. The insurance company, or an approved Third Party Administrator, will pay your claims. You will be able to deduct your premium when it comes to taxes, and you will even have a year-end premium audit. No one outside of your company will know that you are an owner of a captive or that your policies are reinsured by your captive.

On the "captive side" is where things change.

Your captive enables you, individually or as part of a group, to fund and pay for those smaller, predictable claims. Therefore, the potential underwriting and investment income profits, which normally would go to the insurance company to insure poorer quality businesses and benefit their shareholders, would go to you or the group. In essence, you are able to bypass the insurance company in the traditional insurance model and access the reinsurance marketplace directly to take care of those large, unpredictable claims, thereby dramatically reducing your insurance costs.

As a captive cannot issue policies directly to the general public, and because coverages like workers' compensation and auto liability statutorily require a licensed insurance company, a captive uses a licensed "fronting" insurance company to issue the policies for the captive. The fronting company keeps a small percentage fee for the issuance of your insurance policies and dealing with any necessary regulations, state or federal filings, etc. The fronting company will then "buy" reinsurance from your captive and send it the net remaining premium. The fronting company is just what its name implies; it is the front or outward face of your insurance program.



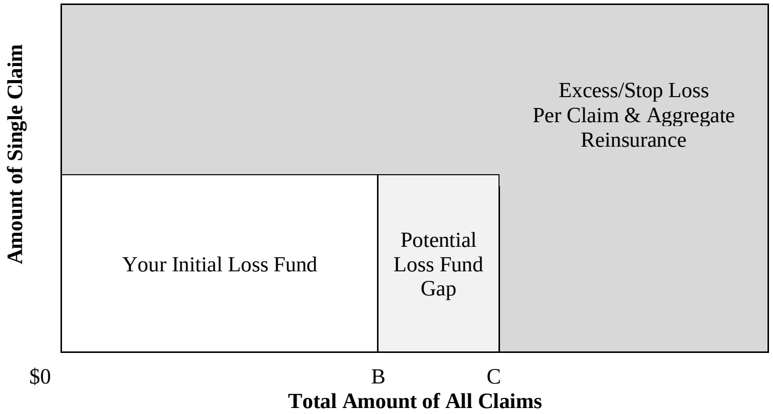
As you can now see, your captive insurance company will really be a reinsurance company for your policies. Instead of insuring the large, unpredictable claims, you or your group insure the smaller, predictable ones and then buy your own reinsurance for the large, unpredictable claims.

Your captive insurance company will manage and pay all of the claims for you or your group. After all expenses and amounts are paid out for claims, and if your captive takes in more money than it spends, it generates an underwriting profit that may be returned to you as the owner(s) of the captive.

However, much like a regular insurance company, you do not want to have your captive pay for all of your potential claims by itself. Therefore, you must purchase reinsurance for the captive in order to limit what you may have to potentially pay out. Through the reinsurance your captive purchases, your captive insurance company will function much like a high-deductible program. The captive will pay for claims up to an amount where any single claim (see A in Captive Program diagram below) or all claims in aggregate (see C in Captive Program diagram below) exceed a certain threshold where your reinsurance (your captive purchases from another insurance company) starts to provide excess coverage.

After one or both of these deductibles have been exceeded, the excess reinsurance that the captive purchased will pay any additional claim amounts. The excess reinsurance thereby limits how much you may have to pay out for claims in a particular year.

Captive Program Diagram



Whereas the captive is an insurance company that has to pay the operating expenses, in addition to paying a premium to fund your claims you will need to pay fees for the fronting insurance company, the captive's reinsurance company, the third-party claims administrator, and other normal operating costs of an insurance company.

However, just as with traditional insurance companies, the premiums that are received by your captive are not spent right away. They need to be set aside as reserves to pay claims. While the monies are held by the captive, the funds can be invested and any proceeds are available to pay claims or be returned as profits to the captive owners. Therefore, you may receive investment income to help pay for your claims and/or be returned to you as part of the captive's profits.

The standard insurance market is based on the law of large numbers. Better run businesses with fewer claims subsidize those with more claims. Those "better" businesses, that are well-run and safety-focused, can qualify to come out of the standard market and insure themselves in a captive program where the collective risk is significantly lower than in the general insurance pool. Since these businesses will have fewer claims, they will earn lower premiums than they would in the traditional market. Over time, most members earn very significant premium reductions.

Your premiums are determined by actuaries based solely on your individual claims history, not by general industry averages or insurance companies. Remember, captive members typically have better claims histories than the industry average and therefore having premiums based solely on their history will result in lower costs. Since members in a captive typically improve their claims performance year after year, this compounding of lower claims every year can produce rates for you that are dramatically lower than the industry average.

Approximately 40% of your premiums will be used to cover the expenses of your captive program. This will include the fronting company fee, the reinsurance for your captive, the claims management costs, agent commission, as well as other captive operating costs.

This lower cost structure of a captive allows approximately 60% of your premium to be seeded into your Initial Loss Fund (see B in Captive Program diagram below), as shown in the diagram above. If you do not completely use your Loss Fund, it will remain in your "account" for later distribution, potentially earning investment income. Also, since those claims that do occur are not paid immediately, the required claim reserves will also be set aside and invested with any investment proceeds also going to your account. As you can see, investment income is a significant way to help pay for potential claims as well as something to be returned to you later as a dividend.

However, as there is the possibility that your actual losses may exceed the amount estimated for your Loss Fund, you must also set aside additional funds or a letter of credit to guarantee payment for the Potential Loss Fund Gap (see B– C in Captive Program diagram above), also shown in the diagram above. The Potential Loss Fund Gap is the total amount you may have to pay if all of your losses exceed the Initial Loss Fund, and before remaining claims costs are picked up by the reinsurance company.

If all goes well and you have fewer if any claims, you will reap the rewards of both underwriting and investment profit via dividends. However, you do have the potential to pay additional funds when you have a bad year. In the group captive world, if the entire group has a bad year, which is extremely rare, you may need to pay into that Potential Loss Fund Gap as well.

It is important to remember that you have a per claim reinsurance program, and therefore a single catastrophic claim would not cause a member or all members to be affected as there is still a per claim threshold in which that catastrophic claim would then be transferred to the reinsurance company. It is a myth that a single claim can bring a captive down. The only reason the Potential Loss Fund Gap would need to be funded would be if there were an unexpected, very significant frequency of claims. With a member or group of members being so focused on safety and claims management, the likelihood of a frequency problem to arise would also be rare.

There are many advantages to a captive, two of which are the dividend of the underwriting profit and any investment income, and premium deductibility for tax purposes including the amount paid in for your loss funds. The dividend that you may earn will typically be significantly larger than what you could have received with a dividend plan as those typically stop if your loss ratio is over 25%, 30% or 35%. With 60% of your premium being used to cover claims, it provides you with a potential 35%, 30% or 25% return of underwriting profits respectfully, plus any investment income. Your potential “profits” will be returned as a dividend, and may be taxed as capital gains depending upon your captive ownership structure and nature, should your captive declare a dividend several years down the road. With an 831(b) captive, the dividends are typically received as a capital gain. However, captives insuring workers’ compensation and general and auto liability are typically treated as ordinary income. It is best to discuss with the captive manager and your accountant as to how dividends would be treated based on the type and ownership structure of the captive.

In comparison, with high-deductible and self-insurance, only paid claims can be deducted for tax purposes, and you will have to pay taxes on the claim reserves you set aside. Your captive's board will determine the amount of any dividends and when they will be paid. However, all accrued funds are eventually returned to you.

When it comes to distributing any underwriting profits and investment income, similar to a retrospectively-rated or high-deductible program, the period at which your captive adjusts the losses could take three to five years to play out and for the captive year to close. It takes a long-term investment for the dividend to be paid. But clearly it is not going to return the profits of the captive as quickly as a dividend program. We will go through how a captive closes claims and distributes potential profits in Chapter 7.

As you can see, the combination of shrinking premiums and the return of underwriting profits to you translate into an overall dramatically reduced cost to insure a business as compared to the traditional insurance marketplace.

Still, businesses in a captive typically also receive the additional benefit from **Greater Control over their Risk Management Program** due to an excessive pricing, limited capacity, coverage that are unavailable in the "traditional" insurance market, and/or the desire for a more cost-efficient risk financing mechanism. They are able to achieve that control through **improved cash-flow, transparency**, **the ability to customize coverage**, **improve claims handling and reporting**, and **stabilized budgets**.

Improved Claims Handling and Reporting

I have heard business leaders complain that there is an injured employee that they know should be working. They have either seen the employee doing something that they medically should not be doing, or maybe working for someone else under the table. In the traditional insurance world, the insurance company is in control of what happens. They may believe that ordering surveillance can be a costly long-shot, or that an IME (Independent Medical Evaluation) may be too costly versus what they believe the possibility of success to be. However, in the captive world, as you are paying those claim costs yourself, you can control having someone investigated.

The insurance industry is set up to handle the mass quantity of small claims like broken windshields, small fender benders, and medical only injuries. The problem is that those claims distract the adjusters from handling the larger, more complex claims that could cost you significant dollars. This could lead to smaller injuries becoming costly ones, which can cost you money. The captive programs address this issue head on.

As you can see, captive insurance provides member businesses much greater control over their claims management. If a captive member is concerned about the legitimacy of a claim, they can call for an investigation. Conversely, if they would like it closed and settled quickly, that is what occurs. With advice from the Captive Management Company, the third-party administrator, the member's attorney and insurance broker, the captive member makes the decisions that they believe are in their best interest.

Ability to Custom Tailor Coverage

The standard general liability policy has exclusion for "your product." Therefore, insurance companies do not pay for damages to your product, only for the resulting bodily injury or property damage. Therefore, a manufacturer of food products runs the risk that their food could become contaminated, but the contamination is not revealed before it is shipped to consumers. A standard general liability policy does not cover the cost of recalling their product, the cost to advertise to the public, or to send communication directly to consumers to alert them of the issue. Nor does it cover the cost of replacing the food item, the cost of disposing of the bad food, and the cost of hiring a public relations firm to help maintain or restore the image of the manufacturer in the public's eye. In a captive, you can either add coverage for such an issue, or simply remove the exclusion, because you can control the coverage.

Many captives are established because insurance in the commercial insurance market is prohibitively expensive, poorly matched to the business' needs, or not available at all. A captive insurance company can successfully provide coverage for difficult risks that are tailored to fit the exact needs of the business – as long as the captive operates within sound underwriting, actuarial, and regulatory guidelines.

Stability in Pricing and Availability

Pricing stability is achieved over time as a captive matures and expands its own risk retention capability. The more capital that is accumulated, the greater the captive insurance company's ability to retain risk and insulate itself from changes in the commercial insurance market. A captive can also provide stability in the availability of coverage.

Transparency

Since you are an owner of the captive insurance company, there is complete transparency. You will know how every dollar of your premium is being used, and in a group captive, how every other member's premiums are used as well. You will have access to all captive's financial information. You can see how much is spent to pay claims, to issue policies, provide claims management and loss control services, to secure reinsurance and cover general overhead.

Improved Cash Flow (Return of Unused Premiums)

Cash flow improvements are achieved in a number of ways. The premiums you pay to cover losses and potential losses are normal business expenses ("tax deductible"), as are monies set aside for claim reserves and things such as Incurred But Not Reported claims. If these losses are retained yourself ("self-insured"), a business would have to pay taxes on those funds they have to set aside.

When an insurance company uses less money to pay claims than it takes in, the unused monies generate an underwriting profit for the insurance company. In the captive world, the underwriting profits, and gains from the invested premiums, that would otherwise be held by a conventional insurance company are retained by the captive. Even with conservative investment portfolios, the dollar amounts are substantial due to the high levels of capital and surplus typically held.

The proceeds are eventually returned to the captive owners rather than to the shareholders of a traditional insurance company.

This ability to return underwriting profits to you will also provide the incentive and the financial reward to increase your focus even more on preventing and reducing injuries and claims.

Finally, cash flow is improved by reducing the expense factors associated with commercial insurance. Generally, insurance companies allocate 50-55% of premiums they receive to loss payments, while the other 45-50% covers expenses and profits. Captives have far fewer expense components than do commercial insurance companies. Estimates for the expense components of captives typically fall in the 30-40% range. This means that for every $10 million in net written premium, a successful operating captive can save business owners $1 million to $2.5 million in expenses alone. Successful group captives allow their members to also share proportionally in these savings.

Increased Control over the Program

Ownership and control by its owners distinguish a captive insurer from a commercial insurance company. This is not the type of ownership or control evidenced by a nominal percentage share in the company's surplus. It means ownership in the company's strategic business purpose.

Captive insurers offer increased control in a number of other ways as well. For one, captive owners have more control over insurance-related services such as safety and loss control, as well as claims administration. Safety and loss control services established by a captive can be tailored to each participant's individual needs, resulting in safer workplaces and more favorable loss experience. Claims handling services are unbundled and arranged separately. Strict guidelines can be drafted and enforced by the captive. This is preferable to allowing a commercial insurance company, whose interests might be more self-serving, to dictate how claims are handled.

Is Your Business Insurance Driving You Crazy?

As a business owner, or business leader, when you look at the amount of money you have just handed over to the insurance companies and received very little, or nothing in return, and the exhausting amount of time you have spent trying to obtain bids or quotes to reduce the cost of your insurance program, only to fall short of the real results you wanted to occur, how can you not feel frustrated… or like you are going insane? And why do they keep doing the same things year after year when it comes to your insurance programs? After all, isn't that the very definition of insanity; doing the same thing over and over and expecting a different outcome?

But that high-priced insanity stops here.

In his latest book, David Leng shows you how to break this costly insurance cycle and gain more control over your insurance program while simultaneously building equity that will help you and your business, rather than it being pocketed by the insurance company and its shareholders. You will see how businesses that are paying over $100,000 annually in insurance premium can benefit from ***Alternative Risk Financing***, where a business does not purchase traditional guaranteed cost insurance policies, but instead purchases insurance where they take on *some* risk to get potential rewards. With a 30-year track record in advising employers on how to save substantial money in their premiums, David spells out clearly and precisely why the use of Captives has become the most popular of the alternative risk financing programs being used today. And why it just might be the solution your company needs to increase both its *profitability* and its *equity*.

ABOUT THE AUTHOR

"David Leng understands insurance, and he knows how to make sure I understand it as well. David isn't just ahead of the curves; he makes the curves. He has saved our company tens of thousands of dollars in premiums. I've read David's books, and I have no doubt you will find this book helpful and informative." – *Bob Holbein, President, Holbein, Inc.*

"I would expect that most employers, like me, find insurance issues difficult to stay on top of and thus resist spending time that feels unproductive when so much time is required just to get up to speed. This is particularly true in the areas of workers' compensation insurance, where most of us face issues with rising costs, OSHA concerns, job safety, getting employees back to work, etc. But somehow David has meshed all this together, making it easier to understand while helping us to better manage our risks, our employees, and our insurance program. He's honest, accessible and, above all, really knows his stuff. I consider David to be a valuable asset and an effective part of the Elk team." – *Ralph Kemp, President, Elk Air Conditioning*

"We live in an age of information overload, where all types of news seems to continually bombard us. And the insurance industry is no different. David's knowledge enables him to be our 'insurance filter'. This means all the information goes through him and what emerges is just the information we need to be successful and profitable. David always knows what we need, *often before we know what we need."* – *Tiffanie Blair, HR Director, McGann & Chester*

David R. Leng, CPCU, CIC, CBWA, CRM, CWCA

David Leng, author of *Stop Being Frustrated & Overcharged* and *The 10 Laws of Insurance Attraction*, is the Executive Vice President of the Duncan Financial Group in Irwin, PA. A 30-year veteran specializing in Risk Management, he is regarded as one of the brightest minds in the insurance industry. Since 2004, David has saved his clients well over $60,000,000 in premiums and overcharges, and was named Advisor of the Year by the Institute of WorkComp Professionals. A frequent contributor to such magazines as *Workers' Compensation*, *Dynamic Business*, and *Environmental Health & Safety*, as well as numerous other publications and association news letters, David has been a guest speaker in front of multiple association conferences and workshops across the country.