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A hybrid risk financing option

Combining large deductible plan with captive insurer for comp cover

By Michael T. Rogers

LARGE-DEDUCTIBLE WORKERS COMPENSATION plans are increasingly popular because they offer most of the advantages of self-insurance without the drawbacks. But these plans, though a step forward, only partially resolve the problems of financing workers compensation risks. Combining a high-deductible plan with captive risk financing provides a fuller solution, offering more control, greater flexibility and potential tax savings.

High-deductible plans provide several key benefits. The company gets more control over the program through greater retention of risk. The large deductible reduces residual market loadings, premium taxes, surcharges and assessments. The employer has more incentive to control losses because it directly benefits from favorable loss experience. The company also controls more investment income.

In contrast, pure self-insurance poses problems. An employer must obtain regulatory approval for self-insured status in every state in which it operates. In many states, the application process is fraught with bureaucratic delays, political maneuvering and irregular rules and regulations. Self-insurers with exposures crossing state boundaries sometimes have problems managing their collateral requirements over such a widely dispersed arena of regulators.

Because large-deductible plans are insured by a licensed insurer, there is much less red tape. Typically, the deductible ranges from $100,000 to $1 million per any one loss. Insurance companies charge a deductible premium, which is often discounted as much as 80% from the manual premium and the actual cost of claims as paid. Most services are included in the deductible plan on a bundled basis. Because the insurer is statutorily responsible for paying claims, a letter of credit or other acceptable liquid collateral is usually required to secure the employer's payment of its share of expected ultimate losses.

Despite the many advantages of large-deductible plans, risk financing for the deductible remains a weak spot. The answer is to use a captive in a carefully crafted plan.

We call this approach a captive/deductible plan. With it, risk management costs can be allocated better and costs delineated better. The captive provides prudent, sound funding for the ultimate losses. A captive/deductible plan not only saves money, it is a powerful strategic risk management tool.

The advantages of a captive/deductible plan include:

- **More control.** With a captive, the risk manager can better control administration, claims management procedures and loss prevention programs. Even litigation and subrogation can be managed more effectively.
- **More flexibility.** The deductible can be raised or lowered in response to market conditions or corporate needs. The captive's ability to place reinsurance directly also adds flexibility to the retention levels and reduces costs. Once the captive is operating, it is not limited to workers comp. Conversely, if the company already has a captive that's active on other lines it can be coordinated with a large-deductible plan.
- **Improved allocation of risk management costs.** With a captive, costs can be compartmentalized, and the risk management department can become a separate cost center. Some companies actually transfer their risk management department and its payroll to the captive. Now the risk manager can more clearly document the department's bottom-line contribution. Furthermore, the captive makes it feasible to unbundled services. The risk manager can then select the most cost-effective providers of specialized services.
- **Potential tax deductions and savings.** A company and its affiliates may be able to take a deduction for premiums paid to the captive. Without a captive, only losses actually paid are tax-deductible. Furthermore, the captive can deduct its reserves and incurred-but-not-reported losses.
- **Precise delineation of costs.** Insurers are usually much more candid about what the deductible premium buys in a captive/deductible plan. The insurer should be able to tell you how much goes to administration, excess reinsurance, premium taxes, workers compensation boards and bureaus and residual market loads. If your insurer is reluctant to provide a breakdown, try the competition.
- **Sounder risk funding.** Deductible reimbursement or loss fund premiums are paid to the captive, which can build its reserves. This pool of money assures a solid source of funding from potential losses. Claims and loss adjustment expenses are paid from the captive's reimbursement policy premium funds. This is a better system than simply paying losses from the corporate treasury.
- **A tool for strategic risk management.** With a captive/deductible plan, reserves and liabilities are moved from the parent's to the captive's balance sheet. Once running, the captive is free to

write other lines of insurance. That flexibility may not be important today, but it could be crucial in the future. The captive also provides stability and leverage against premium increases. A captive/deductible plan can provide a long-term solution to both current and future insurance issues.

Here is a typical example. Best Widget Manufacturing and its affiliates or subsidiaries take out a large-deductible workers comp policy with ABC Insurance. The coverage is statutory for Part A, with $500,000 limits for Part B. The deductible is $500,000 per occurrence. The estimated standard premium would be $1 million. In contrast, the deductible policy's premium is just $230,000. It breaks down as: Administration and profit (6% of standard premium) would be $60,000; taxes, boards and bureaus (7.5% of standard premium) would be $75,000; residual market loads (5%) would be $50,000; excess reinsurance, for statutory excess of $500,000 for each occurrence (4.5%) would be $45,000.

The deductible policy premium is usually billed monthly. Most insurers collect a small escrow loss-development fund to cover expected paid losses during the first month of operations.

Best Widget and its subsidiaries form a Vermont-licensed captive called Widget America Insurance Co. to reinsure its workers compensation losses. Widget America Insurance issues a deductible reimbursement policy to insure losses up to $500,000 for each occurrence for Part A and Part B coverage. The reimbursement premium of $770,000 (also billed monthly) equals the difference between the standard premium and deductible premium. This goes into the captive's reserves and earns investment income.

Claims charged to the policyholders, Best Widget and its subsidiaries, are reimbursed by the captive, Widget America Insurance. Best Widget's liabilities are thus transferred to Widget America's reimbursement policy.

Additionally, Widget America Insurance purchase reinsurance directly for a layer of $250,000 excess of $250,000 for each occurrence. This further limits the captive's risk. By directly placing reinsurance, Widget America Insurance and its parent(s) have reduced their cost of excess reinsurance by the amount of ceding commissions normally added on by the deductible insurer. Successful negotiations with the deductible insurer can also limit the amount of security or collateral required.

Setting up and running a captive need not be expensive. An actuarial firm should charge about $10,000 to $15,000 for a feasibility study. A captive management firm may charge $25,000 to $50,000 a year. Professional fees for CPAs and attorneys run about $7,500 to $10,000 per year. The annual fee for actuarial certification is about $8,000 to $10,000. Finally, the state of domicile charges a premium tax on direct premiums. In Vermont, for example, the tax is now 0.6%; it will go down to 0.5% in 1994 and 0.4% in 1995. (Most other captive domiciles are comparable.) Depending on the size of the risk, the total cost of managing a workers comp captive will range from 2% to 4% of standard premiums.

However, the savings in direct placement of reinsurance, favorable tax treatment and greater control can far outweigh these nominal expenses. While a captive/deductible plan offers savings and advantages today, it also gives the risk manager a strategic risk management tool. The plan can be a platform for flexible, effective response to future challenges.