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ADDITION OF THIRD-PARTY BUSINESS CONVERTS CAPTIVES INTO PROFIT-CENTERS

An increasing number of companies that own captive insurers are looking to third-party business as a way to turn their alternative risk-financing programs into profit centers.

While most captives are formed primarily to self-insure the risks of their parent companies, selling insurance to unrelated third parties can provide an additional source of revenue to help finance risk management initiatives or to enhance solvency should adverse loss experience occur.

Selling product warranty coverages, tenant contents insurance to consumers can have the added benefit of boosting customer relations, while offering voluntary benefits to employees that are reinsured by the company's captive can enhance morale.

Moreover, if more than 50% of the insurance underwritten by the captive is unrelated third-party business, the captive may qualify for insurance company tax treatment, enabling the parent to deduct on its federal income taxes premiums paid to the captive to insure its own risks, while the captive may deduct the loss reserves established to pay company claims.

Salt Lake City, Utah-based Extra Space Storage formed its Bermuda-based captive, ESM Re., in 2006 with the objective of using it to offer insurance to its self-storage tenants. The company requires its customers to insure the content of their storage units, but even though they can purchase this insurance from multiple sources, more than half of Extra Space Storage's customers now purchase coverage from ESM Re.

Customers pay premiums to Raleigh, North Carolina-based IAT Insurance Group, which serves as ESM Re's fronting company and is licensed to sell insurance in all 50 states plus Puerto Rico, and Extra Space Storage's captive reinsures the tenant insurance program.

"We believed we could provide better coverage and service to our customers if we worked with an insurance fronting company to create a program," said Mark Marshall, Extra Space Storage's Director of Risk Management.

"When we started, the coverage was basically the same as a homeowner's policy. It covered many of the same perils including fire, falling water, burglary, windstorm. As we went forward, we began to see other perils that other insurers weren't offering, so we added flood coverage for all locations and earthquake coverage for people in California. We also added pest coverage at policy limits, which nobody had offered before. Other insurers might have provided small limits, maybe $250. Our pest coverage covers anything from termites to ants and rodents. Also, there's no deductible on our product, which others require. This coverage can work hand-in-hand with homeowners and cover the homeowner's deductible," explained Marshall.

"A big reason we formed the company was that we wanted to provide a great customer experience. We have a TPA that manages claims—ACM—and we work closely with them, asking them to find coverage rather than looking for reasons to deny coverage," Marshall said.

In addition to offering more robust coverage than most other insurers catering to the self-storage industry IAT's premiums are competitive, according to Marshall.

With over half of the business reinsured by ESM Re., the captive also provides Extra Space's general liability and EPLi coverage, as well as covering the deductibles for its work comp program.

Extra Space also receives a dividend from the captive, so the captive contributes to the profitability of Extra Space Storage, helping to finance the growth of the company, which operates in 40 states and Puerto Rico, Marshall said.

Jason Flaxbeard, Executive Managing Director at Beecher Carlson in Denver, has been working with Marshall and several other U.S. businesses on turning their captive insurance programs into profit-centers.

"We try to help our clients drive profit by selling insurance related to their primary business. For example, a self-storage company may sell storage rental coverage, or a ski resort might sell ski pass insurance that reimburses purchasers if they cannot use their annual ski pass for any reason, such as an injury. It's a product that's ancillary and it drives customer satisfaction or

potential profit," said Flaxbeard. "They want to control their relationship with their customers and, if handled correctly, it can be profitable for the captive owner."

Other types of businesses that can profit and improve customer relations by using their captives to provide insurance to their customers include auto dealers and manufacturers and wireless carriers, Flaxbeard suggested.

"If you buy a particular brand of car, the car company will want you to buy the associated warranty because both you and the company will want to have access to genuine manufacturer parts," he said.

"Think about cell phone coverage. You buy a phone and what you're actually buying is the service. The captive comes in if there's a possibility of you losing that phone or dropping it and breaking it. On an individual contract, you pay a monthly fee and if something happens you get your data back and a new phone," Flaxbeard said.

In most cases, fronting insurers are involved with the captive reinsuring the risk, he said. Larger captive owners generally reinsure 100% of the risk, less fronting fees, while smaller captive owners might take a quota share plus a fee, he added.

The number of captive insurance companies taking on third-party business is growing a double-digit rate, according to a June 2019 Captive Landscape Report published by global insurance broker Marsh. In 2018, 22% of Marsh-managed captives globally with a value of $18.7 billion in premium were writing some form of third-party coverage. Common third-party coverages being sold by captives included extended warranties, auto liability, theft, travel accident and independent contractor/customer risk vendor policies, Marsh found. Coverage or non-employed contractors, vendors, independent contractors and customer risk showed the greatest growth, surging 138% over the last five years and generating more than $162 million in net premiums in 2018, according to the report.

"This is all about enhancing the customer experience," said Michael Serricchio, Managing Director at Marsh Captive Solutions in Norwalk, Connecticut. "It could be a big retailer offering life insurance to its customers, a utility offering home warranty or device protection insurance, or an employer offering professional liability coverage to gig workers. We're also seeing payroll and financial services firms offering low-limit cyber insurance to small businesses."

New technologies, including mobile applications and blockchain, also are making it easier for captive owners to offer insurance to third parties including customers and suppliers, according to Jose Heftye, a Managing Director in

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Marsh's Global Risk & Digital division responsible for sales of Bluestream™, Marsh's cloud-based digital broker platform for the affinity market.

"Bluestream is the front end of the product the captive is offering. It is set up so the end user can get a quote and enroll in the program with the tap of a button. It's platform agnostic, so it could be on a mobile phone or on a computer," Heftye explained. The application, which is being offered as an enhancement to the services Marsh provides to its captive management clients, also can be used to report losses, he said. "We have some clients using it to sell personal lines coverages to their customers from their captives."

Property managers have begun using their captives to provide renter's insurance to tenants, both to protect their personal property as well as to protect landlords in case of a tenant's negligence, according to Jeff Kurz, Managing Director, Captive Insurance Sales and Consulting, North America, at Artex Risk Solutions in Rolling Meadows, Illinois.

"The industry started requiring renters to buy renter's policies about 10 or 12 years ago as an industry standard. But what if a tenant doesn't have coverage and there's a loss? We created a program in which the tenant signs a waiver of their insurance requirement in exchange for a nominal monthly fee. This money goes into the captive to fund any losses caused by the tenant," Kurz explained.

Some companies are using their captives to offer voluntary benefits to their employees as another way to introduce third-party business and diversify the captive's risk portfolio. In such cases, employees typically pay 100% of the premiums through payroll deduction to a fronting carrier which, in turn, cedes a portion of the coverage to the captive. Some common coverages offered include critical illness, hospital indemnity, accident, legal insurance and pet insurance.

However, companies that offer voluntary benefits via their captives should be aware that some of these coverages, such as those related to medical, life and disability benefits, could be subject to the Employee Retirement Income Security Act, thereby requiring U.S. Labor Department approval for them to be insured by a captive, according to Karin Landry, Managing Director at Boston-based Spring Consulting.

In most cases, companies that offer voluntary benefits via their captives do so to provide them at a lower cost than employees might pay from another vendor, Landry said.

"Let's say the target loss ratio for critical illness is 40% or 50%. By using a captive, employers can offer the voluntary coverage a more competitive price and save employees money. But, depending on how they set it up, it may or may not be subject to ERISA," she said, advising employers to seek expert advice

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On the other hand, an employer may profit by selling non-ERISA benefits such as auto or homeowner's insurance, cell phone coverage or identity theft protection since such lines of coverage have low risk and loss ratios, according to other voluntary benefits experts. Premiums average between $10 and $30 per month, while claims do not exceed a few thousand dollars.

The addition of third-party business to a captive may, in some cases, enable its insured to deduct from its federal taxable income the premiums paid to the captive. The captive may also be able to deduct the loss reserves that are established to pay claims. But that depends on how much unrelated third-party business the captive writes, according to Charles "Chaz" Lavelle, a partner at Bingham, Greenebaum, Doll LLP in Louisville, Kentucky.

"There is no statute or regulation, but there is a revenue ruling that puts the bright line tests at 10% or under and over 50%. So if you have 10% or less unrelated business, you never qualify, but if you have more than 50%, then you do qualify, assuming everything else is 'plain vanilla,'" Lavelle said.

Under Revenue Rulings 2002-89 and 2002-90, the IRS established safe harbors for when premiums paid to captives are deductible: If the captive gets at least 50% of its premiums from unrelated third-party insureds and/or if the captive has at least 12 "brother-sister" insured entities, each having between 5% and 15% of the total risk. ■

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