Strategies for Making the Most Effective Use of Surplus Funds in a Captive Insurance Company

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If you were to ask most corporate risk officers about the primary benefits of creating a captive insurance company to cover their risks, most would point to the opportunities to reduce the cost of coverage and the flexibility to structure coverage to better align with the realities of their companies and their strategic objectives. Those are indeed two of the biggest benefits of the captive strategy.

There is another benefit that is less well known but can be just as important in helping a company remain competitive and profitable in an often-brutal business climate. It involves making use of the surplus balances in a well-managed captive that accrue over time. And while fewer risk officers would be likely to cite the opportunities presented by the surplus as their experiences with their captive structures progress, they'll begin to recognize that those surpluses emphasize even more flexibility and creative uses under their control. Like most forms of retained capital, those advantages are less about the surplus amount and more about how the company leverages its value.

As captive professionals support risk officers through establishing and maintaining their captive insurance structures, determining the best use of surplus dollars should always be one of the primary objectives. This article will examine how surpluses generally reflect highly effective management of a company's captive insurance company, specific ways in which surpluses may be leveraged to pursue business objectives, and considerations that inform decision-making about surpluses.

Nature of Captives

Conversations about captives should begin with a general discussion about their nature, purpose, and structure. While a growing share of those with responsibilities for managing risks are aware of captives, some individuals are new to the concept, so it becomes important to avoid the flawed assumption that everyone shares the same awareness or comfort level.

Simply put, a captive is a licensed insurance company owned and operated by those it insures. The captive is licensed in a domicile with friendly legislation. Organizations can enhance protection, increase their self-insurance opportunities, and customize their insurance coverage by establishing captives. In addition, they can benefit from any underwriting profits that would normally go to the commercial marketplace, further reducing their overall spending. That last benefit is where surpluses enter the discussion.

No matter the purpose for which captive insurance companies are established, they require two elements: meeting the regulatory requirements of the domicile in which they're licensed and being structured in an actuarially sound manner. In other words, the captive must fund to adequately meet the anticipated financial obligations associated with the expected claims. Because it is generally considered prudent to take the most conservative approach, most organizations may select a higher confidence level of funding for their captives. This provides an additional cushion to help the captive absorb a large adverse claim or still be solvent in an unusually bad year for claims.

Source of Surpluses

Ideally, that conservative approach will mean the level of funding exceeds the amount paid out in claims year after year. In addition, a key element of effective captive operations involves pursuing strategies to reduce the number and financial impacts of those claims. When loss control measures such as safety programs or wellness cost-containment measures reduce claim volume, the excess funding becomes a surplus. As the organization's management of both the captive and the risk it addresses improves, that surplus typically will begin to grow.

Generally speaking, a healthy surplus is a sign of an extraordinarily well-managed captive, unless it resulted from dramatically overestimating and overfunding potential claims. That is because a surplus could normally mean the company has achieved a significant decline in losses from claims. Perhaps leadership implemented an intensified safety effort, such as telematics, or bought production equipment that automated once-dangerous processes. Either way, those investments were rewarded through the surplus—and they'll continue to pay rewards year after year as they continue to reduce claims.

How Surpluses Are Managed

Managing captive surpluses begins with the investment policy you adopt when implementing a captive insurance company. The documentation should detail exactly what you can do when your highly skilled operations result in a surplus. Your investment policy should specify the types of investments appropriate for the captive based on your business objectives, risk tolerance, and any regulations related to your choice of domicile. As you develop that policy, consider whether you may want to accommodate specific options, including those described later in this article.

Also, please remember that a company's ability to manage and leverage a captive's surpluses depends upon the laws and conventions of individual domiciles. What's discussed in this article reflects the most common (and generally accepted as best) practices among domiciles. If you have any interest in handling surpluses as described here, be sure to talk with your captive consultant, certified public accountant, attorney, and others who you count on to look out for your best interests.

Where Are Surpluses Kept?

Captive surpluses are not going to be a closely guarded secret. In addition to reporting requirements for the domicile, surpluses will be reflected in the company's regular financial statements. Most companies manage those surpluses conservatively, often to their detriment. Typically, they'll park them in low-risk investment vehicles such as cash equivalents.

If company leaders are willing to assume additional risk with the unencumbered cash in the captive, they may invest it however the investment policy dictates. That may involve something like lower-risk equities and commercial debt, or it could encompass some of the strategies this article will introduce. The goal of the investment is not only to help the company further its mission and achieve its objectives but to grow the surplus itself by earning a higher rate of return. In turn, that will create even more unencumbered funds that could potentially be leveraged.

Captives can replace a portion of premiums paid to outside insurers with a significant capital commitment. You may think about the retention you maintain with a captive as a cost of doing business, but the most effective captive owners see it differently. They view the retention as an opportunity to grow their business by creating an easy-to-access source of investment capital, turning an expense into an asset.

Leveraging Surpluses

Leveraging the surpluses generated by a well-managed captive allows companies to use the retention they've taken as working capital for any number of purposes. When your company has free surplus that's unencumbered, you have a substantial amount of flexibility in how you put it to work for your company's needs. What are the best ways to increase the amount of free surplus? The strategies all come down to running your captive efficiently and effectively and reducing your risk and claims as much as possible.

The flexibility afforded by the captive structure is extraordinary. Every day, companies find innovative ways to address their unique needs and objectives better. What follows are some of the more common and potentially beneficial ways to leverage surpluses; they offer insight into how well captives and creativity work together.

Increase Retentions

If you maintain existing retentions as part of your current captive structure, you could leverage the surplus to allow you to increase the retention levels. For example, a company that has essentially self-insured for the first $500,000 of a claim through a retention may consider increasing that amount to $750,000, significantly reducing reinsurance costs. Instead of paying a reinsurer for coverage on the extra $250,000, you're paying the captive you own and control. The better that you control a captive's losses, then the less of your hard-earned money you'll have to transfer to the commercial marketplace.

Reducing Risks

Investing in loss control measures and other ways to reduce risks in your operations can be the gift that keeps giving. For example, investing in a top-flight safety program can significantly reduce the number of incidents and injuries, along with the average cost of claims. That can provide an ongoing return on a one-time investment.

How you can use the surplus to address risks is limited only by your captive's limits and creativity. For example, during the COVID-19 pandemic, some captives leveraged their surpluses to cover the cost of personal protective equipment and other tools to limit the spread of the virus. Trucking companies may be able to invest in telematics equipment to help them better monitor operations and identify potential safety issues. A manufacturer may use the surplus to purchase safer and more modern production equipment. By focusing on the causes of claims, strategies like these help companies drive down their losses, making the captive that much more financially healthy going forward.

Expand Lines of Coverage

Perhaps your captive was established to help your company manage the cost of benefits in a competitive job market. Could it also accommodate another area of risk, say auto liability or a property issue you can't get underwriters to understand? Adding lines of coverage keeps more of your risk management costs within your organization; you'll pay yourself instead of an outside insurer and leverage your dollars for investment.

Become a Lender

Suppose your company is about to undertake a significant expansion but the commercial loan rates and terms have you thinking about a long-term delay. Your captive's surplus is large enough to cover double the cost, so the captive lends the money to the company with what is essentially a callable note. What happens if the captive subsequently needs the money to pay claims? The company pays it back and secures other funding, and the captive's funds are never put at risk. (It's easy to get tripped up by some tricky language in the Internal Revenue Code, so make sure your tax adviser is involved in the process).

Share the Wealth

Depending upon the size of the surplus, one option is paying a dividend to the owners of the successful captive: your company. A sizable infusion of cash can accomplish many things for companies, including financial rewards for the company's owners, fixing cash flow issues, or purchasing needed equipment or other assets. The list of possibilities is endless.

Purchase Real Estate

Have an opportunity to purchase the right site for a new facility or a promising piece of ground? Just as you can invest the surplus in securities, you can also buy real estate, as long as your investment policy and domicile permit and you communicate effectively and seek appropriate approvals. That could provide an opportunity to capture a key property at the right price without draining your working capital or going to the marketplace for a loan.

Plan from Day One

To get the greatest value from leveraging a captive's surplus, plan for how you'll use it when you and your advisers are drafting the initial documentation. While it may be possible to go back and amend your captive as needed, it's easier and far less disruptive to take the extra time to think through the level of surplus your company may reasonably expect to amass and how you could best leverage its value to pursue business strategies. Exploring strategies other businesses have employed can be an excellent starting point for this process.

Don't Go It Alone

Captives are a fundamentally simple concept that involves a remarkably complex web of legal and tax considerations. While it can be tempting for a company's leadership (especially those with strong financial management tenure) to tackle establishing a captive on their own, the likely result would be far less satisfying and effective than if they tapped into expertise.

Companies need to work with experienced captive consultants who are conversant with laws, regulations, domicile considerations, and taxation as they relate to the structure and management of a captive insurance company. Captive professionals have helped many organizations through the process and can identify the ideal sources for the many services a captive will require. Their involvement will dramatically increase the likelihood that your organization's captive will meet your objectives and generate a surplus to support your goals.

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A veteran of the captive insurance industry, Ms. Towle leads the Global Risk and Captive Solutions team at Hylant. She has 30 years of experience with diverse projects and has worked with captives and other alternative risk transfer vehicles in many key onshore and offshore domiciles.

Ms. Towle manages captive projects through feasibility and implementation, developing unique customized structures tailored to each client's needs. She has been instrumental in arranging fronting and reinsurance programs for her captive clients.

Prior to joining Hylant, Ms. Towle was an executive vice president with JLT and formerly a senior consultant with Willis Towers Watson for over 7 years. Ms. Towle also spent time as a senior manager in public accounting and 10 years in taxation, where she provided consultancy services to captive owners. She managed client projects through feasibility and implementation processes in structuring captives and managed their accounting and tax compliance functions. Before that, for over 6 years, Ms. Towle worked in private industry in the insurance tax departments of several Fortune 500 insurance and financial institution companies.

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