



# 180°

SRS Insight on issues affecting today's captives



Issue 10, 2006

## Captives—A Risk Management Solution for the Building Industry

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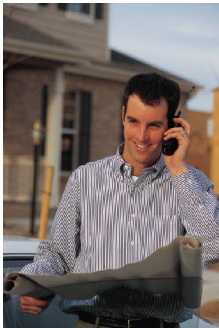
Captives—A Risk Management Solution for the Building Industry

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### The Problem

Homebuilders have been facing a difficult insurance marketplace – sometimes paying as much as their limit in insurance premium while having significant exclusions in the policies they buy.



Insurers are requiring higher deductibles or self-insured retentions and increasingly higher rates and premiums. They have removed coverage for additional insureds and completed operations and have stricter requirements for subcontractors that often invalidate coverage. They have added significant exclusions including:

- known loss exclusions
  - land movement/subsidence exclusions
  - mold, lead, silica and EIFS (synthetic stucco) exclusions
  - employment practices exclusions
  - exclusions for certain types of residential contractors (tract housing, attached housing, condominiums)
- and the list goes on.

At the same time, homebuilders typically need evidence of insurance coverage to satisfy their lender requirements whether that coverage affordably addresses their needs and provides coverage for their real risk or not.

To add insult to injury, the typical builder has had very little loss activity and often covers its own losses even where it has the right to claim against their insurer – especially in the event of property claims for completed operations. Builders often simply do the work to correct a situation without involving their insurance company – often while paying dearly for insurance protection for that risk.

**In short, builders are paying high premiums for a policy they are forced to buy, while they are effectively self-insuring a significant portion of their risk.**

### The Solution

Homebuilders have reacted by looking at the use of captives as an alternative to traditional coverage. They are

using captives to fill in gaps in coverage, to replace expensive coverage and to lower their cost of risk over the long term. At the same time, they are finding that the transaction may be a potential source of tax benefits, which may further enhance the use of the captive.

In most cases, the captives being established by homebuilders are very simple in concept. In many situations, at least in the initial year, little change is made to the existing program and a captive is set up simply to insure gaps in coverage. The captive writes the retained layer of risk and/or it writes risks that are not covered by the policy or risks that are specifically excluded, such as mold and construction defect. As the captive matures, and funds build up in the captive, the homebuilder is typically comfortable with assuming more risk, and will assume higher retentions and/or buy more restrictive coverage, thereby reducing the cost paid to the commercial marketplace over the long run. In addition, often there are significant tax efficiencies associated with the use of the captive making its use more attractive.

Some homebuilders have taken this approach a step further. They have opted to reduce the coverage being purchased commercially to a “bare bones” policy which excludes significant coverages. The commercial policy they buy still meets their evidence of insurance requirements while having a significantly lower cost. They then use the captive to provide the coverages not covered commercially.

A fronted arrangement may also accomplish the same end effect. A commercial policy is purchased, and the captive is set up to reinsure some, or all, of the coverage provided by the front allowing the homebuilder to recoup profits that would otherwise be lost to the commercial insurer. The fronted policy meets the homebuilder’s evidence of insurance requirements while the homebuilder enjoys the benefits of reducing its expenses and achieving potential tax efficiencies.

The problems in the commercial marketplace have also been addressed by builders and contractors as a group. In some instances, a group of builders with similar issues and

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concerns, have joined forces to combat their risk management issues. They form a group captive or risk retention group (RRG) to provide coverage with the goal of cost savings and more control over their risk management destiny over the long run.

### Warranty – An Added Bonus

In addition to helping homebuilders with their property and casualty risks, many homebuilders have discovered an additional benefit that comes from transferring their warranty coverage to their captive. For most homebuilders there are two elements to the claims that could be classified as warranty claims. The first is sometimes referred to as call-back risk – those problems discovered by a home buyer when they initially move into a property and discover that an item has been incorrectly installed or doesn't work. The other is the longer term exposure to homebuyer claims. Often homebuilders refer to this as 2-10 risk which refers to a commercially available product providing 2 years of coverage for systems and 10 years of coverage for structural defects. Homebuilders who currently use a commercial product to cover this risk typically find that premiums are high compared to the losses that are paid out. Some go in and rectify homebuyers' complaints to generate customer goodwill and never notify the carrier. The typical builder feels that premiums for warranty coverage are well in excess of any recoveries. Many eventually opt to self-insure this exposure.

Homebuilders that establish a captive often elect to include this warranty coverage in their captive. If they are currently using a commercial program, they instead use their captive to insure the warranty exposure and retain profits that are currently being transferred to an outside party. If self-insured, they transfer the risk to the captive and may achieve tax efficiencies by doing so. Further, though a complete tax discussion is beyond the scope of this article, suffice it to say that placement of the warranty coverage in the captive may constitute third party business which significantly strengthens the tax position of the captive as a bona fide insurance company\*.

### Potential Tax Benefits

We have mentioned the potential tax savings available under the various scenarios. For many homebuilders this comes from the significant tax efficiencies gained by owning a small insurance company or 831(b) insurance company. There is a provision in the tax code that allows small insurance companies, those writing under \$1.2 million in premium, to be exempt from taxes on their underwriting income. The small insurance company is taxed on its investment income only. (This provision is covered more fully in SRS Newsletter Q3 2004).

In essence, this provision allows homebuilders, who utilize a captive which qualifies as a bona fide insurance company\* to take a deduction for premiums paid to the captive at the homebuilder's effective tax rate. However, the full amount of the premium flows to the captive and, to the extent that there are no losses, the full amount of the premium less captive expenses remains in the captive and is not subject to federal tax. Therefore, a very tax efficient loss fund is developed. Further, if the captive has positive experience and is profitable, dividends may be returned to the owner- typically at preferential capital gain tax rates.

For homebuilders transferring more than \$1.2 million of premium into their captive, there may also be benefits if the company qualifies as a bona fide insurance company\*. In this case, the tax benefit would be derived from the ability to deduct loss reserves – not just losses as and when they are paid – and, therefore, the tax consequence is a timing/acceleration benefit.

### An Example

The average \$125 million builder pays in excess of \$600K a year in premium for the first \$1 million in coverage and has filed less than \$100K total in claims over the last 5 years. This builder decides to buy a policy with reduced coverage but which still meets its evidence of insurance requirements for \$300K. At the same time, the builder decides to establish a captive and use it to cover its retained risk – both its high deductible and the coverages excluded from its new "bare bones" commercial policy. It also insures risks for which it formerly had no coverage such as construction defect and mold, and it covers its warranty exposure. A combination of a market and actuarial assessment indicate that the premiums associated with the risks transferred into the captive should be \$1 million. The builder has an effective tax rate of 40%.

Assuming that the captive qualifies as a bona fide insurance company\*, the builder receives a tax deduction of 40% of the premium paid which amounts to \$400K on a \$1 million premium. Therefore, on a net basis, he pays \$600K for the coverage in the captive. On the other hand, the captive receives \$1 million, and if there are no losses, this - less the administrative costs of the captive - flows through to the bottom line. Administrative expenses of operating the captive are likely to be in the range of \$70K-\$80K – so this means that a loss fund of over \$900K is set aside. The \$1.2 million cap on premium applies annually so that over a number of years, in the absence of significant losses, a sizeable loss fund can be set aside.

For more information please contact Kathryn Marsh at 678-429-1708 or by email at [kathryn.marsh@srsmail.com](mailto:kathryn.marsh@srsmail.com)

\* A discussion of how a captive qualifies as a bona fide insurance company is beyond the scope of this paper, but is essential to achieve the tax efficiencies discussed.

## SRS Staff News—

We are pleased that Patrick Pollard and Alihan Alihan have joined our Burlington, Vermont office.

### Patrick Pollard-Director/Domestic Operations

Pat has more than 18 years of experience in the insurance industry and will be responsible for managing operations, ensuring continued outstanding service to SRS clients as well as providing timely and accurate financial reporting to regulatory authorities.

Prior to joining SRS, Pat held various financial and operational positions at Arkwright Mutual Insurance Company and was instrumental in managing and implementing several key operational initiatives. As a member of both the Operating and Management Committees of Arkwright, Pat was a part of leading the organization through a significant growth period as well as merging Arkwright into FM Global, currently a \$4.0 billion property insurance company.

He also held planning and financial analysis positions at both a risk management consulting firm as well as a \$16 billion asset management firm. Most recently Pat provided consulting services to companies in the insurance and asset management industries.

Pat graduated from Babson College with honors in the top two percent of his graduating class with an accounting and finance degree and has been a member of various professional planning organizations as well as community boards.

Pat is married and has 2 sons (one in college) that keep him and his wife quite busy.

### Alihan Alihan—Account Manager

Prior to joining SRS, Alihan spent some time as a captive manager and was previously a staff accountant at Gallagher Flynn, a local Vermont accounting firm. He will perform account manager functions at SRS in Burlington, doing a lot of the day to day accounting and regulatory work for a portfolio of clients. Alihan holds a Masters in Accounting (Taxation) from the State University of New York (Albany), and Bachelors in Accounting from the State College of Accountancy, in Jakarta, Indonesia.

## Client News—SRS new clients include:

- Border Shield Insurance Company Ltd is a privately owned captive formed in the Cayman Islands to provide reinsurance for Canadian physicians and surgeons.
- CC Assurance Company, Ltd is a single parent captive previously managed by another company in the Cayman Islands, which SRS was appointed as the insurance manager effective August 31, 2006.
- Orange Indemnity Ltd is a single owner captive formed in the Cayman Islands to provide wind storm deductible coverage for coastal properties in Florida.
- CAYMAANZ Insurance Company is a Cayman Islands group captive formed to provide deductible reimbursement workers compensation insurance.
- Wasalan Indemnity Company Ltd is a single owner captive formed in the Cayman Islands to provide wind storm deductible coverage for various coastal properties.
- MedCap Insurance Company is a single owner captive established in the Commonwealth of Kentucky on August 20, 2003 and recently appointed SRS their insurance manager. The Company provides general and professional liability coverage to its parent and affiliated companies who own and manage skilled nursing facilities in Kentucky.

## Domicile News

Vermont Governor Jim Douglas has appointed Paulette Thabault as the new Insurance Commissioner effective January 22, 2007 to replace the retiring John Crowley. Among other positions, she was previously deputy commissioner of the Vermont Department of Banking, Insurance, Securities and Health Care Administration, Health Care division.

We do not anticipate any significant changes to Vermont's captive regulatory environment or business support as a result of this appointment. Thabault has been active within the current administration and should continue to be a strong advocate of promoting captive insurance within the state of Vermont.

## SRS Events

- SRS will be hosting a 2006 Recap and 2007 Outlook web seminar. More details will be emailed soon.
- SRS is a sponsor of the Vermont Captive Insurance Association Road Show in Texas on February 8, 2007. Visit [www.VCIA.org](http://www.VCIA.org) for more information.

For more information on SRS, visit us at [www.strategicrisks.com](http://www.strategicrisks.com)

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