For many, self-insurance proves an uncaptivating choice

Programs are time-consuming and inflexible, they say

by Jim Mathhews

If your liability or workman's compensation insurance costs have gone through the roof, or if you've been dropped by your present insurer, you're probably wondering if a less conventional insurance scheme will give you the coverage you need.

Almost all who have looked into unconventional insurance options have found that there are really only two choices—doing without and doing it yourself.

Doing without insurance—going bare as the insurance pros say—is simply inviting disaster. Most responsible professional contractors do not consider this a safe or logical way to conduct business.

That leaves doing it yourself, which in practice means joining with other contractors to form an insurance company that will cover all of you. It's a much more attractive option than doing without insurance altogether, but there may be hidden disadvantages to self-insurance that are just as discouraging.

Insurance in captivity

An insurance company formed, capitalized and owned by the individuals or companies it serves is called a captive insurer. Robert Kuntz, senior vice president of insurer Fred S. James & Co.'s Chicago office, explains, "Their primary purpose is to provide a competitive insurance program for members at a reasonable cost." He adds that effective loss control and claims management should enable members to obtain long-term financial benefits from reduced insurance costs.

On the surface it appears to be a workable concept, and it's being used quite successfully by roofing contractors in several states to fund their workman's compensation coverage. But forming a captive to provide general liability coverage has proven to be a more difficult undertaking. As yet, no one has succeeded.

Many have tried and failed

Over the last 10 years, many groups have explored the feasibility of setting up their own general liability captives, but few have progressed beyond the talking stage. When they began to closely examine the operation of a general liability captive, they inevitably came to the conclusion that the disadvantages far outweighed the advantages. Contractors found that to gain any advantage from forming a captive they would have to give up too much time and freedom for the endeavor to be profitable.

According to Kuntz, "One advantage is having a reasonably sure and stable insurance market over the long haul, which shouldn't be subject to the wild price fluctuations we see in the conventional market." However, in exchange for price stability, contractors must give up the flexibility to respond to market conditions. When the conventional market is soft and insurers are willing to price their products below cost, as they did between 1979 and 1984, members of the captive may be tempted to drop out, getting their coverage at a lower cost from a conventional insurer. Kuntz says, "Many captives fell apart in the early 1980s for precisely that reason."

Contractors were also attracted to the control owning a captive gave them over the administration of their insurance program. But they discovered that successfully controlling an insurance program required considerable time and effort. According to Kuntz, committees had to be formed to determine who should be insured and at what cost, which claims should be paid, the amounts of the awards, and how premiums should be invested. Contractors who attempted to reduce their commitment by paying someone else to administer their programs found that they lost some of the control over the companies they had hoped to gain by forming the captives in the first place.

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In addition to these drawbacks, captive insurance companies have also faced some of the same problems that other primary insurers faced. As with other primaries, captives have to buy reinsurance or excess insurance, which is tremendously expensive. In the current market, captives have not had any better luck getting reinsurance than the big, conventional companies. In fact, some captives may not have done as well.

The biggest disadvantage most have found, however, is not the time, the commitment or the money it takes to operate a captive. It's dealing with the personalities involved. Getting members to put aside their competitive instincts long enough to pay each other's claims or share information on products, services and past loss histories has proved to be a stumbling block too large for many to avoid. According to Kuntz, "Nearly all the groups that seek James' help in forming a captive go nowhere because their members can't or won't put aside their individual differences to work together."

Workman's comp works well

That so many contractors are able to operate successful captives to cover their workman's compensation in spite of the problems involved may seem like a contradiction. However, according to Sam Piper of J.A. Piper Roofing in Greenville, S.C., workman's compensation lends itself well to coverage by a captive because an employer's liability limits are clearly defined. As he says, "It's not like an auto accident where you can be sued for almost any amount."

For the last 20 years, Piper has been an active participant in a captive insurance program for roofing contractors in North and South Carolina. Other contractors have set up successful workman's comp captives in California, Florida, Michigan and Minnesota.

Richard Lietz of Fred S. James supports Piper's conclusion, adding, "Over the years, the industry has collected a wealth of information enabling it to determine very precisely what workman's compensation rates are applicable to a group of any size. It's much more difficult to self-insure general liability because nobody can predict losses with much accuracy."

Premium rates for members of Piper's group are "fairly close" to rates available from conventional carriers, Piper says. If the group's loss experience is good, its rates can be below the cost of conventional coverage. However, Piper admits, "We've had periods in which we had to charge our members more than if they'd gone to an insurance company."

The Carolina captive is set up on a dividend basis. If premium payments in any year exceed losses, the difference is returned to participants as a dividend. "It's done on a pro rata basis," notes Piper.

A Board of Trustees, composed of program participants, acts as administrators and is responsible for operating the program. According to Piper, "That means we collect the money and invest it until it's needed for claims." In this respect, the responsibilities each member of Piper's group must shoulder are the same as those required of a general liability captive member.

Piper believes that limiting his captive's membership to roofing contractors is a definite advantage. "Our safety-and-loss-prevention engineer is *really* familiar with roofing. He's a specialist in our business," emphasizes Piper. That specialized knowledge is also valuable when assessing prospective members' commitment to safety and their safety programs and records.

Forming a captive company may not be the answer to your insurance dilemma. Although some contractors may find a captive workman's comp program to be a cost-saving alternative, it should be remembered that the biggest price increases and the coverage most difficult to find in the current market is for general liability. However, if the traditional insurance market continues to deteriorate, the hassles of administering a captive may seem trivial in comparison, especially for roofing contractors willing to work closely with their competitors.