FEATURE

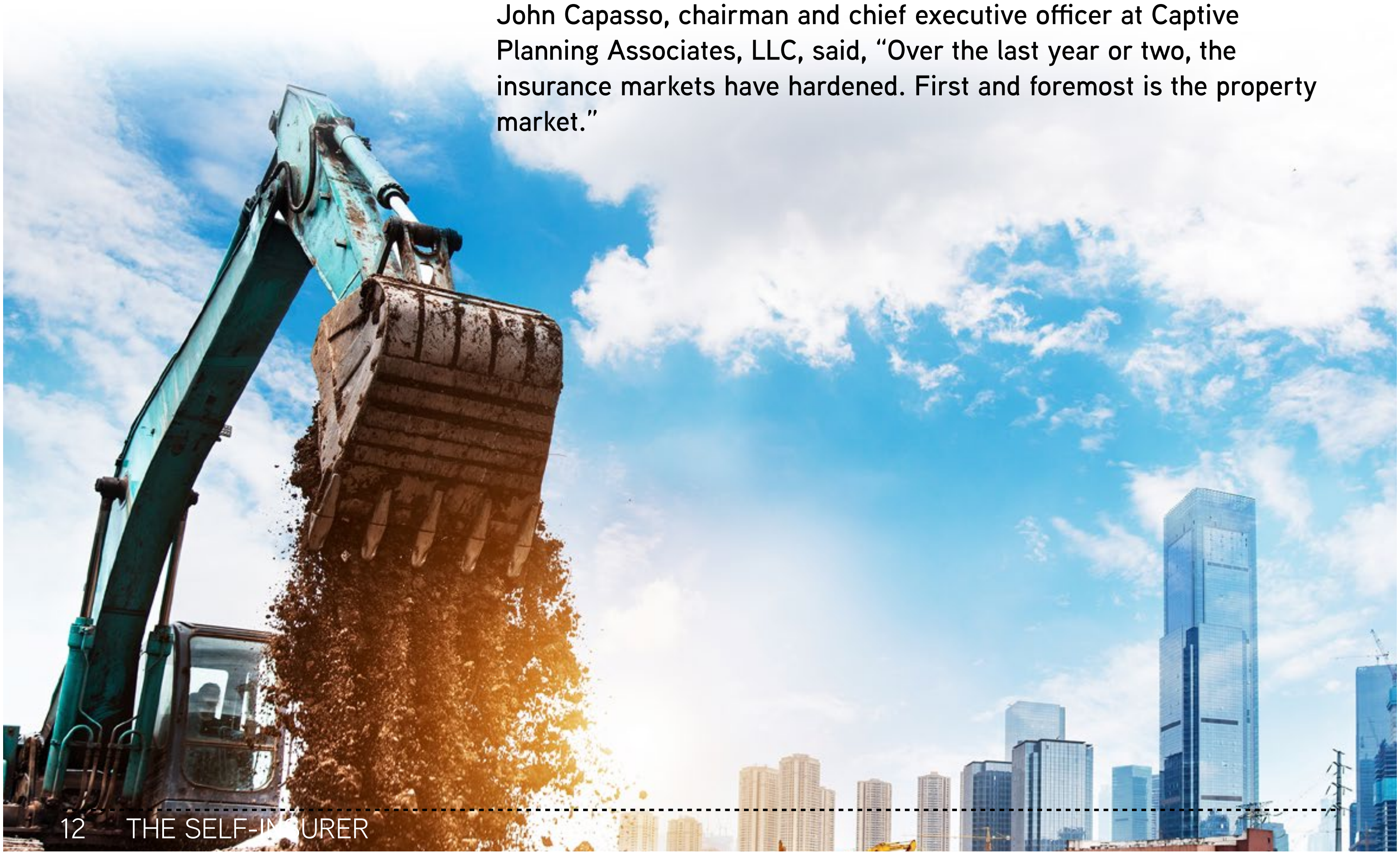
Contractors Turn to Captives to Gain Control

Written By Caroline McDonald

Faced with an unpredictable economy, rising insurance premiums and the increasing costs of property, supplies and transportation, the construction industry has been seeking ways to mitigate risk and exposure.

According to Swiss Re Institute's Sigma report, "non-life insurance premiums will grow by 1.6% globally in real terms in 2024, after 1.4% year-over-year real growth in 2023. In P&C we estimate 3.4% global real premium growth in 2023 given significant repricing of risk."

John Capasso, chairman and chief executive officer at Captive Planning Associates, LLC, said, "Over the last year or two, the insurance markets have hardened. First and foremost is the property market."



For example, he said, "In the agriculture industry, coverage for barns and other buildings went from $100,000 to $1 million."

Like other industries, the construction industry is increasingly turning to captive insurance to help curb losses. "Captives are being used for general liability, property when a company owns a building, and covering subcontractors," Capasso said.

In this industry, captives have been used for more than 15 years

"Because construction is capital intensive. However, the requirements of forming one can mean significant capital and/or collateral," he explained. "The captive can then become capital-intensive, and it becomes a tradeoff with the contractor as to how to allocate that capital wisely."

What drives their formations in this industry, he said, "is control – control of the claim and control of the premium dollars."

There is also a profit motive, "to share in the underwriting profit rather than giving it to commercial carriers," Capasso said. "And if they are large enough, they can usually qualify as an insurance company for tax purposes, because they have sufficient risk distribution."

He added that each building "is its own business enterprise and some of the captives are formed as LLCs with multiple properties, which gives them risk distribution."

Randy Sadler, principal at CIC Services notes that "About a fifth of our clients are in the construction space and that's been consistent. That includes remodelers, homebuilders, and builders of commercial structures. It also includes road builders and graders, tunnelers and bridge builders."

He, too, is seeing a hard market as the main driver for formations. "During the past two years we've seen a steady build-up. The insurance markets are definitely hard right now," Sadler said.

GETTING STARTED

Why do construction companies turn to captives?

"What happens is that invariably they will get a premium increase, but what really pours salt in the wound is a reduction in coverage," Capasso said. "Usually, it's their insurance broker that they talk to first about the high cost of coverage."

A good agent, he added, will propose alternatives, such as a captive.

Another scenario is that someone they know will suggest a captive. "Captives are becoming more prevalent in mainstream vocabulary in various circles. Also, a lot of industry periodicals now have articles about captives," Capasso said. "We picked up a client recently after a conversation about captives was broached at a cocktail party."

Currently, construction captives are being used mainly for general liability, property and covering subcontractors, he said.

WHO IS FORMING THEM?

The types of companies he is seeing forming captives most are construction companies/property managers. "They are usually family owned and have multiple divisions, from construction to building management, and some have a real estate license, and buy and sell properties. They're diversified," Capasso said, noting

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that pure captives are used in such cases.

"We just got one approved a week ago. They build and property-manage in the captive," he said. "We're also working on forming another one, as their premiums are going up significantly."

Having a captive, he said, is a way to help them assume risk "if they have the proper risk appetite and are able to show five to 10 years of loss runs."

With one contractor, "We took their general liability from a little over $3 million and put $2 million of that into the captive because their loss history averages $400,000 to $700,000 a year. Overnight they saved more than $1 million by transferring the first layer to the captive."

Sadler noted, "We work predominantly in the middle markets and what we're seeing typically is a need to control construction costs. Many of our clients turn to group captives for their workers' compensation and their liability as well," he said. "They also turn to us for builder risk, construction defects and warranty."

The logic with construction defects and warranty, he said is that "most realize that if something is wrong, they will go back and fix it anyway. So, more are self-insuring construction defect because they would rather fix it themselves."

Using this same reasoning, they seldom file warranty claims, "It makes a lot of sense to insure builder risk or construction defect through a captive and reserve for it," Sadler said.

More and more clients are also creating a profit center for their subcontractors' bonds. Subcontractors, he said, are typically required to buy bonds or insurance, which is purchased from a third party. "We've had quite a few that realize that they manage their subs well," Sadler added, "so they formed captives so subcontractors could buy the products from them. That has been a serious growth area."

Many contractors, he said, are operating in an environment "where they're building so fast that there is a lot of profit. But we're also dealing with an environment where construction clients are focusing on getting more out of what they have."

A CONTRACTOR'S PERSPECTIVE

Joe Leonello Jr., president of Franjo Construction, a general commercial contractor in Homestead, Pennsylvania with 300 employees, says, "As contractors, we make mistakes." As a result, he said, construction firms deal with the big issue of workmanship claims.

Because risk mitigation around workmanship issues is not covered by traditional insurance, Leonello said they must take financial responsibility for these issues when they arise as uninsured claims, which can happen years in the future and can cause project profits to fade.

He cites as an example a hotel that his firm had built, that had an issue with panels blowing off the building several years after completion. Franjo remedied the situation with its captive covering the repair cost of $70,000. Without the captive, Leonello adds, "We would have taken it on the chin."

Franjo started a single-parent captive six years ago to manage these risks. Leonello adds that the captive program enables his firm to benefit from a better understanding of risks in general and the workmanship issue in particular. "We gain risk management awareness," he said. "We identify issues to reduce their likelihood of reoccurring. We can also price them more clearly in future proposals, reducing the chances of a profit fade."

LOOKING AHEAD

"I expect that captives will continue to grow, not just in construction," Sadler said. "It's going to become guaranteed cost insurance because it's so expensive. What a captive does is force you to have skin in the game."

By having captives, he added, "businesses have a big incentive to stay on top of what they are doing and try to minimize loss. And familiarity with captives is growing."

Sadler added that he believes reinsurance carriers will "figure out a way to have captives come down-market. In a lot of cases reinsurance carriers can only write large risks, but with A.I. and other automated ways to do underwriting I would expect that we will see reinsurers writing smaller and smaller risks," he said.

This will allow captives to insure smaller companies and also give those companies more access to reinsurance "because now you must be in a group to get reinsurance access. I think that will evolve," Sadler concluded.■