What's old is new again

With the middle market firmly in the sights of the insurance industry, **Sandra Duncan** of **Captive Resources** examines the allure of member-owned group captives in this light

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Whether it's the middle class or Mid-Century Modern, it seems nearly everything medial is in vogue. In the insurance industry, it's the middle market that's currently exciting interest, and in the captive sector, group captives are now *de rigueur* for mid-size companies. This relatively recent popularity may be new to some, but not to Captive Resources, LLC (CRI), which has specialised in the creation and oversight of member-owned group captives (Mogcs) for nearly 30 years.

Mogcs are far from new, yet their surging popularity warrants a closer look at how a well-crafted, successful one is structured and the benefits of membership. In addition, group captives have inherent challenges which must be recognised and appropriately addressed. Lastly, a brief look at some innovations may provide insight into the future.

The member-owned group captive model

The major features of CRI's group captive model distinguish it among captive structures. Captive ownership and aspects of corporate governance are particularly appealing to members. CRI's Mogcs are owned solely by their members with no external ownership, eliminating potential conflicts of interest. Corporate governance is member-driven – each member, regardless of size, has one seat on the board of directors and one vote.

The equity this creates across the membership is an important feature to members, particularly because there is a wide range of companies of varying size that comprise the 'middle market'. A strong committee structure requires the active participation of members and greatly facilitates captive operations, especially as a captive grows to have hundreds of members. Committees present recommendations to the board, which has sole decision-making authority.

One of the most important aspects of the model is the risk funding formula. In the 1980s, CRI worked with members of its first captive to develop an equitable, easily understood captive funding formula that incorporates risk sharing among the membership, now well known as the 'A fund/B fund' formula. The A fund provides for frequency losses, and the B fund for severity losses. A provision for assessment is incorporated should a member's experience exceed actuarially expected losses, which protects the captive by helping to ensure adequate funding, and also creates further incentive for members to focus efforts on loss prevention and claims management.

There are multiple layers of additional protection for the captive including reinsurance for catastrophic losses exceeding the captive retention, aggregate excess coverage, and 'basket' and 'clash' coverage. Interest income is accrued on unused loss funds, and returned to members in the form of dividends. The formula ensures that members' premiums are truly reflective of their unique risks, and its simplicity helps members to better understand how insurance works. It has become an industry standard for Mogcs.

Controlling losses is a responsibility of membership and it is through effective prevention and management that members can continually control their insurance costs. Exceptional loss prevention and claims management programmes and metrics are tailored to the unique needs of the membership. Examples include semi-annual risk control workshops, focused multi-disciplinary reviews of complex or difficult claims, and the development of an in-depth risk assessment methodology.

The captive has no employees; all support services are unbundled (including policy issuance, reinsurance, actuarial services, claims administration, loss prevention, financial auditing and so forth) and overseen by CRI, which reports directly to the captive board. Mid-size companies typically do not have the internal resources to dedicate to running a captive, so the inherent flexibility of unbundling is ideal for a Mogc.

Lines of coverage typically provided are workers' compensation, general liability, automobile liability and physical damage. Members have opted to focus on these core coverages and not stray into more difficult or specialised lines that could be less predictable, more difficult to manage, and produce negative results for the captive.

However, a Mogc is not for every mid-size company. For example, since the funding formula is frequency driven, industries prone to catastrophic losses are not a good fit. A typical member company is well capitalised/financially strong and stable; has management demonstrably committed to safety, loss prevention and claims management; has average to better-than-average loss history; and is committed to the responsibilities of captive ownership.

Benefits of membership

The following are some of the benefits of membership:

- **Control** Members can limit the adverse effects of the cyclicality of the insurance industry, which hinders efforts to maintain predictability and control. The captive provides members with long-term cost stability, premiums derived from their own experience, and lower operational costs through greater efficiencies gained through the unbundling of services and the buying power of the group.
- **Dividends** Members' unused loss funds (underwriting profit) and investment income is returned to them as dividends.
- **Premium deductibility** A properly structured group captive that addresses insurance risk of unrelated entities and incorporates appropriate risk distribution and risk sharing, should satisfy IRS deductibility requirements, resulting in fully deductible gross premiums.
- **Limited capital outlay** A modest capital investment is required for captive ownership as compared to a single parent captive, for example.
- **Loss prevention/claims management programmes** Extensive, customised, state-of-the-art safety, loss prevention and claims management services are available to members at no additional cost.

Meeting challenges

Mogcs present some inherent challenges. The model, however, has provisions in place to adequately address these issues.

- **Data sharing** Prospective members may be concerned about confidentiality of data across the membership. Strict confidentiality of data is maintained by presenting it to the captive in a blind/encoded fashion. Members are unable to attribute individual loss information, but have the aggregated data needed to monitor results and effectively manage the captive.
- **Quality growth** Highly effective loss prevention and claims management puts continual downward pressure on premium, and in the absence of new members, would of course, continually shrink the captive. Therefore, the captive must always be growing in order to maintain appropriate spread of risk and to fully leverage competitive operational cost. As a responsibility of membership, existing members (who understand the desired risk profile), refer other quality companies for consideration. In addition, an extensive and constantly growing network of brokers produces a continual flow of prospects.
- **Member retention** Long-term member retention has been an ongoing challenge for many group captives, particularly in recent years. CRI's captives, however, have maintained 97% of members year over year. Certainly, the more concrete benefits of membership contribute to member satisfaction. However, the importance of member education cannot be underestimated. When members fully understand how the captive works, and therefore its true value, they will be far less likely, for example, to be tempted by soft market pricing. Fully educating members both initially, and on an ongoing basis, is critical to the long-term success of the captive.

Innovation

The following are examples of how mid-size companies can manage a wider array of risks vis-à-vis innovative applications of CRI's group captive model.

- **Everest Property Insurance Company (EPIC)** EPIC is an Mogc providing property damage, business interruption and ancillary coverage for members of CRI's casualty captives. It is structured differently to a casualty captive, yet provides dividends when loss experience is favourable, but has no provision for assessment for adverse loss experience. A small capital contribution is required, but no additional collateral is required. With more than 400 members, it offers significant buying power and stability.
- **Well Health Insurance, Ltd.** CRI originally conceived and formed a group captive for medical stop loss coverage in 2000. Since that time, however, several developments in the healthcare industry, including highly refined managed care models and more sophisticated delivery mechanisms, now work together to provide the needed flexibility to better support the group captive model. Well Health Insurance, Ltd., introduced in early 2011, is proving to be quite popular with many brokers from across the US that have helped the captive to grow quickly to 22 members, with several more expected 1 January 2013.
- **Micro captives**. A group captive member can utilise an 831(b) captive to fund potential A fund (frequency) assessments, should expected losses be exceeded. CRI's approach to these small single parent captives is aligned with its group captive concept, in that its focus is primarily providing the captive owner with a true insurance mechanism. It assists companies, including current captive members, to develop and integrate 831(b) captives into their existing risk management programmes.

In the end…

Given their current popularity, it may seem that Mogcs are new, even trendy. However, they are well-entrenched in the captive industry and offer mid-size companies a viable and practical captive ownership option. As many more of these businesses discover the benefits of membership, they may come to believe that perhaps it's not such a bad thing that, inevitably, everything old is new again.

Mogcs: an extensive and constantly growing network of brokers produces a continual flow of prospects