

Group Captives A Middle Market Alternative

By Joe Schaffner

Position in the Market

Have you checked out the stock market recently? This year has certainly seen its share of fluctuation. Of special interest is the insurance marketplace, which continues to soften. Throughout either hard or soft business insurance markets, however, group captives persist as viable alternatives for the middle market sector, and captive service providers and regulators expect 2007 to be a vibrant and busy year. Tim Wagner, Director of the Nebraska Insurance Department, recently said, "I think the formation of captives could continue. It's definitely a good risk management device."

While the traditional insurance market is cyclical and often unpredictable, group captives provide a more stable means not only to transfer but also to retain risk where it makes the most sense for businesses. Group captives are designed to provide middle market business insurance buyers with affordable coverage. At the same time, they offer the benefits of customized policy forms, greater control over losses and claims management and, ultimately, the economic advantage of earning income from investments and underwriting profits. Larger organizations have taken advantage of the captive strategy for decades, and the middle market sector is now being afforded those same benefits.

Group captives operate at their best with high-frequency, low-severity lines of coverage, including workers' compensation, commercial general liability and auto liability / physical damage. These specific

lines of coverage lend themselves well to actuarial analysis and ultimately offer the greatest potential for predictable underwriting profits and investment income. While these have traditionally been the most popular lines of coverage for group captives, there continues to be both growth and interest in other non-traditional lines, such as medical malpractice coverage and warranty and property coverages.

Group Captive 101

What is a group captive and how is it formed? A group captive is basically a collection of companies which partner to form their own insurance company. In most instances, the group captive is the re-insurance company, where the

shareholders are also the company's policyholders. The participating member companies can come from the same industry (homogenous) or from a variety of industries (heterogeneous). In each, the essential common denominator for success is a strong "top-down" dedication to safety and loss control. Having a proactive risk management philosophy is also a key element, and an entrepreneurial spirit is a common component amongst the members, especially the charter members.

One distinct advantage of a group captive is the ability to "unbundle" services typically provided by one carrier (see exhibit A for details). This advantage comes in the ability to specifically select the "best

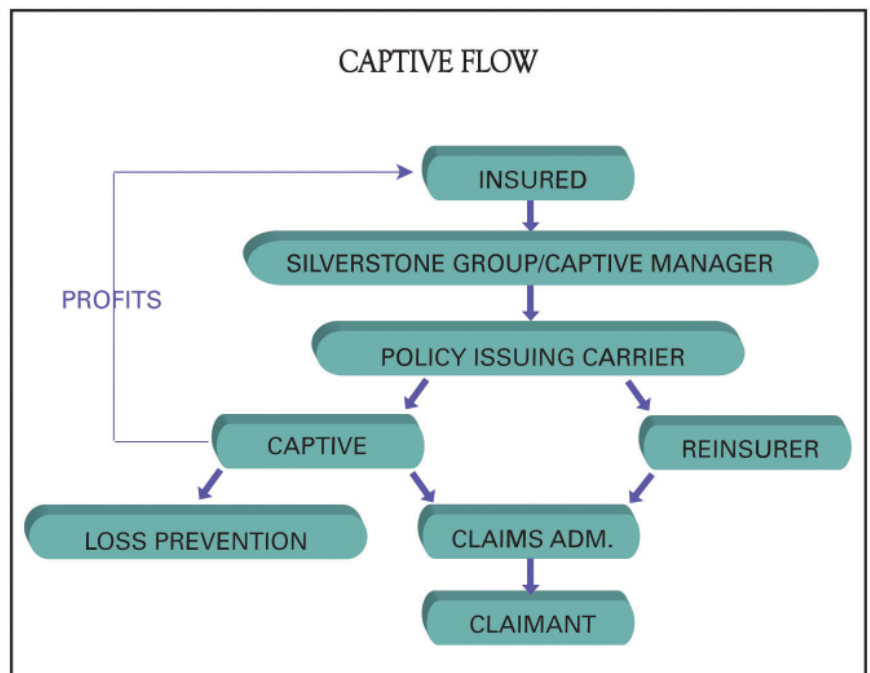


Exhibit A

in class” to handle functions such as safety and loss control, claims management, policy issuance, etc. The control that “ownership” provides is an attractive element to the members.

How does a group captive work? Captive premiums are traditionally made up of two components—loss funding and fixed costs. Loss funding is generally broken into two separate entities—the frequency fund and the severity fund. Reinsurance provides coverage over and above these two funds, and is part of the captive arrangement. The final piece of the coverage is the individual’s umbrella policy, which provides coverage over the captive, but is not actually part of the captive arrangement. Umbrella coverage is purchased separately by the individual member to the extent necessary for the business (see exhibit B for details). Each fund is derived from an outside actuary, typically utilizing a minimum of five years of detailed loss history as a basis. The fixed expenses are frequently a percentage of the loss funding and, more specifically, the frequency fund. These fixed costs include but are not limited to the following:

- fronting and re-insurance
- claims management
- loss control and management costs
- taxes
- brokerage fees

Each member company is responsible for the funding of its own projected losses for both the frequency and severity funds. That money, taken with fixed costs, makes up the “premium” amount for each member. These funds are also used to pay any losses below the re-insurance level. Only when a member’s entire loss funding is depleted is there traditionally any risk sharing on a claim. In an ideal year with no losses, all of the premium left in both funds would be

returned to the member company in the form of a dividend. However, it is more realistic to fund for your specific losses. While this is the goal of the actuaries, it is still quite difficult and sometimes almost impossible to predict the exact amount of funding necessary. Due to the length of development of some claims, dividends are generally distributed to members three to four years after the close of a given policy year.

A Beneficial Relationship

Membership in a group captive has many benefits. Essentially, it comes down to greater control of the way participating members manage risk retention and risk transfer. With greater control comes dramatic improvement in the way businesses purchase insurance. Group captives provide a much more stable and predictable mechanism than does the cyclical traditional insurance market. While group captives are still subject to the variances of the re-insurance market, such variances are mild compared with the volatility experienced

in the traditional marketplace. Ultimately, with greater control comes greater economic reward in overall cost savings, with members reaping the economic rewards of being called “best in class,” and retaining the profits for themselves, rather than sharing them with others throughout the marketplace.

Summary

It is apparent that group captives will continue to be a viable alternative for the middle market insurance buyer for years to come. The unpredictable and often frustrating insurance marketplace has motivated more and more businesses to recognize group captives as an attractive alternative. It is critical for the forward-thinking insurance buyer to see group captives as an opportunity to significantly improve their long-term approach to risk financing.

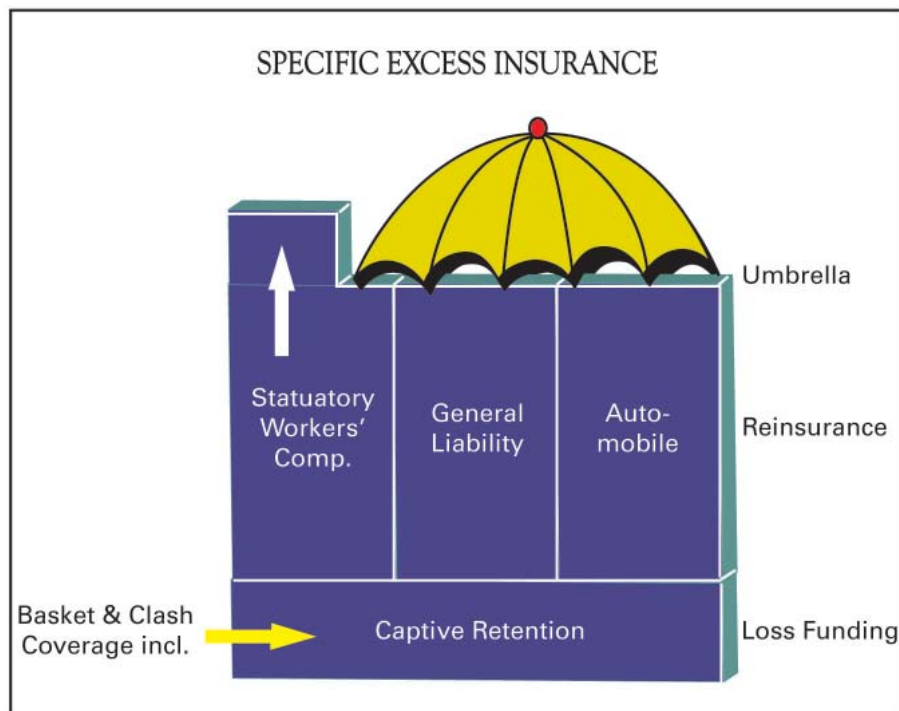


Exhibit B