Group Captive Insurance Programs
for Property and Casualty Coverages

Duke Niedringhaus, ARM
Vice President
J.W. Terrill, Inc.
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Group captive insurance programs can be an attractive alternative to traditional insurance. Regardless of the insurance market cycle, captives offer a new level of control and financial independence. 2012 had record growth for group captives and this segment has approximately $1.5 billion in market premium.

What is a group captive? It's an insurance company that provides insurance to and is controlled by its owners. In short, you (and several other businesses) own the company that provides your commercial insurance. Which means that you have greater control, and you – not an insurance company – benefit when the captive is profitable.

In addition, you have minimal administrative obligations. The program is administered by a captive management company that provides the necessary structure, claims management, legal, accounting and other functions necessary to operate.

Although captives can insure risks globally, most prefer to incorporate and conduct business in places such as the Cayman Islands or Bermuda. Offshore incorporation usually affords members lower operating costs, more friendly governmental regulations, greater tax advantages and access to captive specialists for banking and accounting. Domestic domiciles such as Montana, Nevada, Vermont and Missouri have also become very active in recruiting captives.

Benefits of a Captive

- Greater control over your insurance program
- As a shareholder, you accrue tax deferred underwriting profit
- As a shareholder, you benefit from investment income
- Premium calculation is based on your prior five-year loss history, not industry averages
- 60-68% of premiums will be available to fund losses and generate investment income
- Greater control over claims management
- Networking with other shareholders to enhance Risk Management
- Captive profits can be distributed directly to a family trust

Consider a Captive if Your Business Has:

- A favorable prior loss history
- Financial stability
- Casualty premiums that exceed $150,000 (Auto, Workers' Compensation and General Liability)
- An entrepreneurial attitude
Types of Captives
Captives provide coverage for a number of industries and are available in several configurations. Coverage generally includes Auto, Workers' Compensation and General Liability.

There are three types of captives to review: individual (called "single parent"), agency and groups.

Captives for single parents are generally for large companies (usually within the Fortune 1000) whose size and financial strengths allow them to handle the risk of insurance all by themselves.

Agency captives are controlled by insurance brokers who participate in insuring the risks of their own clients.

Group captives, the most common type, are mostly used by mid-sized companies (those that have between $20 million and $500 million in annual sales). Group captives enable similar or diverse businesses to band together to form a cooperative to share the risk, cost and benefits of providing commercial insurance to their members.

Captive Fixed Costs
Participants should be aware of the costs associated with joining a captive. The following information illustrates the costs usually associated with participation in a mature captive. Fixed costs will range from 28-40%.

Fixed Costs of a Typical Captive Program

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Captive Management Fee</td>
<td>4%</td>
</tr>
<tr>
<td>Fronting* Fee</td>
<td>9%</td>
</tr>
<tr>
<td>Reinsurance</td>
<td>10%</td>
</tr>
<tr>
<td>Broker Commission</td>
<td>4%</td>
</tr>
<tr>
<td>Claims Management</td>
<td>4%</td>
</tr>
<tr>
<td>Loss Control</td>
<td>1%</td>
</tr>
<tr>
<td>Offshore Actuary/Legal/Accounting</td>
<td>1%</td>
</tr>
<tr>
<td>Taxes</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36%</strong></td>
</tr>
</tbody>
</table>

(Higher Reinsurance costs would apply to high Hazard Groups)

*In the U.S., captives are not admitted insurance companies. In order to comply with state Department of Insurance regulations, captives work with carriers, who assume the responsibilities of licensing. In essence, these carriers are used to issue licensed policies on behalf of the captive. Captive members pay a fee to the carrier who manages the licensing aspects of the insurance.*
**Group Captive Model**

Although Group Captives can have a variety of structure and administration, we will focus on the most common model. Since the 1980's, the most successful Group Captive managers have essentially utilized one format.

These leading captive managers share similarities regarding premium funding, risk sharing and collateral requirements. Most importantly, these captive managers actively engage their captive shareholders in managing their risk.

The basic similarities of Group Captives are in the following components that we will review:

A. Reinsurance  
B. Premium Development  
C. Risk Sharing  
D. Collateral  
E. Engaging the captive shareholder

Using an example of a window manufacturer, we will review these components. In our scenario, we will assume Window Company has the following guaranteed cost insurance premiums:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers’ Compensation</td>
<td>$350,000</td>
<td></td>
</tr>
<tr>
<td>General Liability</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Auto</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Window Company Premium</strong></td>
<td><strong>$450,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**A. Reinsurance**

The captive will purchase both Specific and Aggregate reinsurance. The fronting carrier issues admitted insurance policies on behalf of the captive. The fronter is reinsured by the captive for losses up to $300,000. The captive’s reinsurer would then indemnify the fronting carrier for losses in excess of $300,000.

**SPECIFIC REINSURANCE**

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$1,000,000

Umbrella

Reinsurance

General Liability  Auto  Workers’ Compensation

$300,000

Captive Retention

$300,000

Fronting Insurance Company

POLICIES
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**AGGREGATE REINSURANCE**

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Frequency Funds  Additional Frequency Fund for All members  Severity Funds  Excess Aggregate Reinsurance
```

B. Premium Development For Window Company.
The captive will develop a casualty premium based on 5 years of incurred losses and exposures. Large losses will be limited to $100,000.

<table>
<thead>
<tr>
<th>Year</th>
<th>General Liability</th>
<th>Auto</th>
<th>Workers’ Compensation</th>
<th>Total Casualty Losses</th>
<th>Actuarial Weight Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Losses</td>
<td>Sales</td>
<td>Losses</td>
<td># of Autos</td>
<td>Losses</td>
</tr>
<tr>
<td>1</td>
<td>0</td>
<td>$45MM</td>
<td>$10,000</td>
<td>40</td>
<td>$200,000</td>
</tr>
<tr>
<td>2</td>
<td>0</td>
<td>$40MM</td>
<td>$75,000</td>
<td>40</td>
<td>$200,000</td>
</tr>
<tr>
<td>3</td>
<td>$50,000</td>
<td>$35MM</td>
<td>$10,000</td>
<td>40</td>
<td>$200,000</td>
</tr>
<tr>
<td>4</td>
<td>0</td>
<td>$30MM</td>
<td>$10,000</td>
<td>30</td>
<td>$200,000</td>
</tr>
<tr>
<td>5</td>
<td>0</td>
<td>$25MM</td>
<td>$10,000</td>
<td>30</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Based on these historical losses and exposure growth, the actuary develops a loss fund of $300,000 allocated as follows:

- $ 250,000  (Frequency Fund 0 - $100,000 Layer)
- $ 50,000  (Severity Fund $100,000 - $300,000 Layer)

$ 300,000  total loss fund for Window Company

NOTE: In our scenario the insured does not expect a GL claim and their worst loss year for Workers’ Compensation will drop off next year. Year five had abnormal losses so we could apply a .50 weight factor.

Based on our $300,000 Loss Fund, we add $150,000 of fixed costs. This generates the following premium:

$ 250,000  Frequency Loss Fund
$ 50,000  Severity Loss Fund
$ 150,000  Fixed Costs
$ 450,000  Total Annual Captive Premium Paid by Window Company

Window Company’s final captive costs determined in 3-5 years:

<table>
<thead>
<tr>
<th>Fixed Costs</th>
<th>Incurred Captive Losses</th>
<th>Less: Investment Income</th>
<th>Total Captive Costs</th>
<th>% of Insured $450,000 Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>$150,000</td>
<td>0 Minimum</td>
<td>($20,000)</td>
<td>$130,000</td>
<td>27%</td>
</tr>
<tr>
<td>$150,000</td>
<td>$250,000 (Projected)</td>
<td>($20,000)</td>
<td>$380,000</td>
<td>84%</td>
</tr>
<tr>
<td>$150,000</td>
<td>$550,000 (Maximum)*</td>
<td>($20,000)</td>
<td>$680,000</td>
<td>151%</td>
</tr>
</tbody>
</table>

*Maximum Losses: Frequency Fund +Severity Fund+Additional Frequency Fund
C. Risk Sharing

- Each member can be assessed one additional frequency fund. Window Company could be assessed an additional $250,000 for losses within the first $100,000 frequency layer. Since this layer is driven more by loss frequency than severity, captives will require an additional assessment from that member.
- Any large losses over $100,000 that exceed Window Company’s severity fund of $50,000 will be shared with other members on a prorated basis. Any risk sharing to assist another member would be allocated from each member’s severity fund. In our scenario, the captive only has to fund any severe loss up to the $300,000 captive retention.

D. Collateral

Window Company will need two forms of security to join a Group Captive:

- Shareholder capitalization of $35,000
- Collateral which is usually 150% of the frequency fund ($250,000 x 1.50 = $375,000). This would be issued over a three year period

The frequency fund controls collateral and premium for Window Company. If losses are reduced, so will collateral and premium. If Window Company would leave the captive, capitalization and collateral would be released in 3-5 years, plus any investment income.

E. Engaging the Captive Shareholder

The leading captive managers require active participation by each shareholder in the following areas. This is the primary reason for the consistent success of group captives:

- Shareholder meetings (semi-annual two day events)
- Regional risk control seminars
- Active participation to refer prospective shareholders
- Committee participation for underwriting, risk control or investments
- Monthly loss reports and quarterly claim reviews

Group Captives vs. Self-Insured Workers' Compensation Groups (SIG’S)

Almost all states have several approved Self Insured Workers' Compensation Groups, which have many similar benefits of group captive programs. There are, however, several differences in their structure.

**Coverage Provided:** Most captives offer the shareholder control over Workers’ Compensation, General Liability, Auto and Property compared with the SIG only offering Workers' Compensation coverage.

**States Available:** By using a fronting carrier, captives are portable in all states. SIGs are only approved to insure Workers’ Compensation payroll in one state.
**Financial Protection and Assessability:** The captive's fronting carrier assumes ultimate financial responsibility for the group. SIGs which don't utilize a fronting carrier rely on "joint and several" membership liability, an important consideration regarding the reinsurance structure of the group. However, SIG's do avoid potential problems of having a fronting carrier become insolvent such as Reliance National, Legion or Kemper.

**Fixed Costs:** Many large SIGs can have very low fixed costs compared to captives. Each program should be evaluated to determine fixed costs. In general, the larger the size the lower the fixed costs. The most significant advantage to a SIG is the elimination of the fronting fee since a policy issuing carrier is not utilized.

**Taxes:** Depending on the structure, captives may offer advantages for tax deductibility and deferment. However, SIG’s avoid assessments from states for Assigned Risk Pool deficits (RML Taxes). This was a significant advantage for SIG’s in the 1990’s but less of an issue recently.

**Property Captives**
Group Captive Managers can also offer shareholders a Property captive. The structure is more basic than the casualty captives.

- Group purchasing offers very competitive premiums
- Non assessable
- Dividends up to 25% available within 6-12 months
- No collateral
- Designed for low to moderate hazard property and generally will exclude significant coastal wind and other hazardous categories.

**Entrepreneurial Vision**
Business owner entrepreneurs will enjoy the asset accumulation aspect of Group Captives. By turning the insurance expense into an asset, owners create an additional source of income. If your objective is to accumulate a variety of business assets to generate family wealth, then a Group Captive is an alternative that should be evaluated.

Some captive owners in low margin industries like trucking could generate more profit from their insurance captive than their trucking operation. Other captive owners can become fanatical in every aspect of risk management once they are engaged from captive participation.

JW Terrill, Inc. recommends taking a long term outlook on insurance risk financing. Using our Window Company example, the company is paying $450,000 in annual casualty premiums. Over the next ten years that would be about $5,000,000 of pure expense when you include investment income. Even moderate success in a captive program could generate $500,000 of asset for the owner (or family trust) over that period.
In Summary
As the commercial market undergoes many changes, group captives are a growing alternative to traditional insurance. When it comes to the control of the insurance, with traditional insurance, the insurance carrier has the control. With a group captive, the shareholder retains the control. Once owners use a captive, they rarely return to the traditional market.

In addition to reducing insurance costs, captive members find there are many intangible benefits to captives:

- Understanding how premiums are developed
- No annual insurance bidding
- Renewal premiums are calculated 30 days prior to renewal, eliminating last minute insurance quotes
- Networking opportunities with other successful business owners
- Owning a part of the insurance company
- Generate a return on what is normally a pure expense

Many group captive shareholders are now looking to expand their captive use to other aspects of their business. These include benefit captives to control healthcare and 831B microcaptives to fund uninsured business risks.

To Learn More About Group Captives
For more information, please contact:

Duke Niedringhaus, ARM
Vice President
JW Terrill, Inc. – St. Louis
SIIA Workers’ Compensation Committee Chairman
314-594-2622
dniedringhaus@jwterrill.com
www.jwterrill.com