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The Pros and Cons of Group Captives

Group captives can be very powerful risk financing mechanisms allowing insureds to come together to gain the benefits of risk retention and greater purchasing power. In the property & casualty market there are many very successful group captives offering competitive insurance to existing and prospective members.

But not all group captives are the same and while the upside of these captives can be attractive there are potential pitfalls as well. In this article we look at the pros and cons of joining a group captive.

Types of Captives

A group captive is organized as a captive insurance company under the applicable captive legislation of its domicile. They are formed to insure the risks of their owners or members and are closely held companies. Most will operate as a reinsurer behind a fronting company as they are not admitted to write insurance directly in the US. For liability risks though the group may organize as a risk retention group providing the ability to write direct.

Group captives vary from closed captives formed by a select group of similar organizations to open facilities often with heterogeneous members.

- **Closed homogeneous group:** a group of insureds from the same industry with similar if not identical risk profiles. Often the group exists outside of the captive and there is a high degree of trust between the members. The captive allows its members to benefit from economies for scale in group purchasing excess insurance and stability in retaining risk. Trust between the members allows for a greater pooling of risk within the captive and openness in the sharing of best practices for risk control. Closed homogeneous groups tend to have greater member involvement and control.
- **Open homogenous groups:** these groups have many of the benefits of the closed group, but are marketed to all possible candidates. With a greater target membership the captives are often larger, leading to greater economies of scale and more stability in loss experience. These programs are attractive to insurers as they can be written as books of business rather than individual risks. Homogenous groups can face challenges in sharing information and risk between competing members.
- **Heterogeneous groups:** these groups combine members from different industries which can help in overcoming competition and industry challenges. Successful heterogeneous structures have a turn-key nature that has been successful in attracting small to mid-size firms that want to participate in a captive without needing to control the structure.

Issues to Consider

In considering joining a group captive there are several key issues to consider. These will vary according to the type of captive and often unique to the captive itself..

Size

For group captives, size matters: too small and the expense structure is uneconomic, too large and you can lose the sense of ownership.

The expense structure of the captive is key to feasibility. Unlike commercial insurance, a captive's costs are unbundled. This provides greater transparency and competition for each of the expense components, but the sum of the parts needs to be competitive with the bundled commercial product. Many expenses related to the captive's operations are not linear. Increased size brings reduced overall expenses through non-linear expenses, increased retention and market leverage along with greater stability in loss experience. Exhibit A shows the type of reduction in expense ratio that can be expected with increases in premium size. The goal is to grow the captive to an optimal size, although what is the optimal size will vary with the situation. It is also important to understand what is included in the expense ratio, particularly whether excess and aggregate reinsurance costs are included.

Exhibit A: Illustrative Expense Structure		
Premium	Non-Loss Expense (inc R/I)	Members' Opportunity
\$2,000,000	45%	\$1,100,000
\$3,000,000	40%	\$1,800,000
\$4,000,000	39%	\$2,440,000
\$5,000,000	38%	\$3,100,000
\$7,500,000	35%	\$4,480,000
\$10,000,000	33%	\$6,700,000
\$12,500,000	31%	\$8,280,000

Risk Sharing

In a group captive members have to share risk with each other. The amount of risk sharing varies between structures, but all captives have to have an element of risk sharing to qualify as insurance. Prospective members should understand how much risk is shared versus retained on an individual basis and the structure of the risk sharing. There are two basic structures:

- **Socialized:** all risk in the group is pooled. Members' surplus and capital at risk is dependent on the loss experience of the group as a whole regardless of their own individual loss experi-

ence. In this structure surplus and capital is shared in proportion to the premium paid or an equal amount per member.

- **Individual:** each member is responsible for its own risk. Surplus is calculated on the member's own loss experience and capital is eroded by the members own loss experience, not the group. While there can be an element of individual risk taking, it can't account for 100% of the risk taking in the captive.

The trade-off between social and individual risk taking occurs in several areas of the captive's operations resulting in a myriad of different risk sharing structures. These areas include: pooling, premium calculations, capital contributions, and surplus distributions.

	Socialized	Individual
Pooling	Single pool	Layered funds <ul style="list-style-type: none"> • Primary layer (A Fund): individual • Excess layer (B Fund): social
Capital contributions and assessments	<ul style="list-style-type: none"> • Equally according to the pool's experience • In relation to premium 	Based on individual risk profiles
Premium contributions	Group rate for the pool	Based on individual loss experience
Surplus	<ul style="list-style-type: none"> • Equal share per member, or • In relation to premium contributed 	In relation to individual loss experience.

Commitment and Exit Strategy

Entering and exiting a group captive is more complicated than changing commercial insurers. Becoming an owner of your insurance company is fundamentally different than buying insurance. It requires a long-term commitment and should be viewed as a long-term decision to change an organization's insurance purchasing practices. Most group captives require a minimum time commitment or use various other legal means to lock-in their members. This protects the group from reduced size and problems from members leaving the captive. Groups establishing captives should clearly define the commitment required from members and how members can exit the captive. Prospective members should familiarize themselves with these provisions. While insurance exit may be accomplished fairly quickly, extracting equity from, cutting off the chance of future assessments and severing the ownership tie to the captive is likely to be more complicated and time consuming.

The key issue is how to address open claims or IBNR from the member's participation in the captive. As these claims will develop over many years, the exiting member is usually required to maintain collateral in the captive and any distributions from the captive will not be determined until the policy years are closed. How and when those policy years are closed should be established in the captive's

operating procedures or by-laws. An exiting member can also consider a buy-out at an earlier date, although that will probably require an actuarial opinion on the member's on-going claims and a negotiation with the captive, which will be required to take a conservative position to protect the interests of the remaining members.

Owner Involvement

Group captives vary considerably according to the amount of owner involvement. Closed homogeneous groups tend to more closely controlled by their members while open heterogeneous groups are more actively controlled by the service providers who serve as the "gate keeper" determining who can join, who stays in and the appointment of fronting carriers and other service providers. In many cases the program or captive manager fulfills many of the roles - underwriting, claims, investment management, loss control, etc. and is compensated for each.

Owner involvement has several benefits:

A stronger sense of ownership and protecting the captive's interests.

- Common interest among members.
- More sharing of best practices.
- Greater oversight and control of service providers.

Owner involvement takes time and requires owners to become involved in and understand the operations of an insurance company. It is not for everyone. Despite the time commitment, in our experience, the most successful group captives all have a high level of owner involvement.

Conclusion

For those groups looking to form a group captive, there needs to be a significant insurance problem to overcome or the challenges of bringing the group together will be too difficult to overcome. It is very difficult to establish a closed homogeneous group captive unless the group exists outside of the insurance problem. Once established group captives are one of the best examples of the benefits of alternative risk financing. They can and have delivered significant savings to their members, although there have also been failures. Prospective members should consider all the issues associated with entering a group captive and make the decision as a long term commitment not a reaction to commercial insurance market conditions.

Employee Benefits Update

In our Q4 newsletter in 2008 we reviewed developments in Employee Benefits in Captives. In this current article we provide an update on activity in the last year. This information is drawn from our November webinar on "What's Happening in Employee Benefits in Captives?"

As a refresher, most employee benefit plans in the US are covered by ERISA. This is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to

provide protection for participants. It prohibits transactions with “Parties in Interest”. Any company interested in funding employee benefits in captives must either:

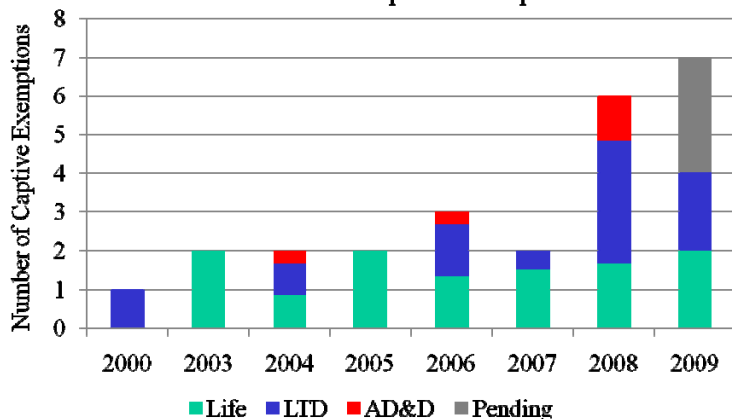
- Obtain an exemption to ERISA from the Department of Labor (DOL) or
- Use a structure which does not qualify as a related party transaction.

ERISA Exemptions

Most large corporations will seek an ERISA exemption so that they can use their own single parent captives to insure employee benefits. Since 2003 the DOL has had an expedited process (EXPRO) to approve exemptions for structures which follow the original two individual exemptions in this area (Columbia Energy and Archer Daniels Midland).

Only a handful of deals were seen in the initial years following the creation of EXPRO. However, there are signs that activity is increasing. Exhibit A shows that 2008 saw six EXPRO approvals and that 2009 may have seven with those pending. Life was the most common program included in these programs, although there is a growing amount of activity in long-term disability and even short-term disability.

Exhibit A: ERISA Captive Exemptions



With the increased level of interest and activity, there are signs that the DOL is becoming more conservative towards captive deals. This has been most evident in the DOL’s requirement that the captive must provide an objective and measurable enhancement to the benefits program for the plan participants. Examples of enhancements include early settlement on terminal illness for group life and the ability to increase LTD to 60% of pay. In our experience, this requirement is being more strictly applied.

Another EXPRO requirement is for the captive to reinsure an A rated carrier. In this area we have seen some flexibility from the DOL which has resulted in some opening up of the market for fronting companies.

Coca-Cola Retiree Healthcare

One of the more prominent DOL applications reported this year has been Coca Cola’s application to fund its retiree health care program

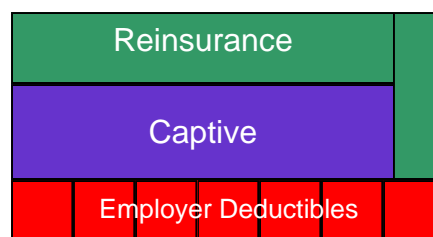
in its South Carolina captive, Red Re. This would be the first exemption allowed for retiree health care. Under the plan, the company would use assets in a VEBA to purchase medical stop-loss insurance from Prudential to pay claims over the expected lifetimes of retirees and dependents. Prudential would then reinsure the risk to the captive. The end result is greater financial flexibility by releasing assets restricted by the VEBA. The DOL granted initial approval of the exemption in December. The approval requires that any profit earned by Red Re due to favorable claims experience be returned to the retiree health plan.

Unrelated Party Transactions

These structures usually involve a group, Association or agency owned captive, which is not a Party in Interest under the ERISA definitions. Most of the recent activity in this area has been in the use of group captives to fund health insurance. This is one of the major benefit costs for employers in the US. Healthcare costs are increasing at double digit rates and for smaller middle market employers (50-1,000 lives) there are few options. This situation has fueled significant interest in the use of group captives.

There are various structures that can be used, but most provide for the captive to insure a pooled layer of risk above individual employers deductibles with specific and aggregate reinsurance purchased to protect the captive, as shown in Exhibit B.

Exhibit B: Group Health Captive



The market for these programs is immature, but growing with several new captive programs created in 2009. There are group captive programs for health insurance both onshore and offshore. Of those that have formed most are closed homogeneous groups often with an Association sponsor or endorsement. There are also open market facilities available.

Benefits and Challenges

- Premium stability and reduction: the captive can lead to premium reductions, but it also provides for more stability in health care costs.
- Transparency: in comparison to property & casualty, health insurance lacks transparency. This is both a challenge to creating captive programs and a benefit once the captive is established.
- Expertise: there are few people with expertise in both captives and health insurance. Programs usually require the involvement of both health insurance specialists and captive specialists.

Notwithstanding the passage of Healthcare Reform legislation, we believe that there will be continued growth in the use of group captives for health insurance in 2010.

Domicile News

Cayman Regulatory Appointments

In the fourth quarter the Cayman Islands Monetary Authority (CIMA) made two appointments in its Insurance Supervisory division. In October, it announced the appointment of Dwight Merren, Deputy Head of Insurance Supervision. Mr. Merren has 17 years experience in captive management and regulation. He joined CIMA in May 2009 as Chief Analyst.

In December, CIMA promoted Mr. William Hagan to the position of Deputy Head of Insurance Supervision. Mr. Hagan has over 20 years experience in the insurance industry in both property & casualty and Life.

Conference News

Utah and Arizona to Hold Western Captive Round-Up

The Boards of Directors of the Arizona Captive Insurance Association (AzCIA) and Utah Captive Insurance Association (UCIA) have announced that they will co-sponsor a combined conference called the Western Region Captive Insurance Conference (WRCIC).

The inaugural 2010 WRCIC will be held **April 5-8, 2010** at the Arizona Biltmore Resort in Phoenix, AZ. The combined conference will replace the domiciles' individual conferences and is intended to provide greater exposure for the captives in the western region while reducing costs to participants.

Ann Wick, President SRS (Arizona) is serving on the planning committee for the inaugural conference. Details on the conference including registration information are available at www.westerncaptiveconference.org.

Attendance Up at Cayman Captive Forum

The Insurance Managers Association of Cayman reported that the 2009 Cayman Captive Forum was another successful conference with 840 registered attendees. This is an increase in attendance over 2008 and demonstrates continued and growing interest in the domicile despite the current economic challenges.

The conference featured a key-note presentation from James Schmidt the former director of communications for Harley-Davidson, as well as many excellent presentations on captives and

Cayman as a domicile. Copies of presentations can be viewed at the IMAC website (www.imac.ky).

Congratulations to Ron Sulisz, Director of SRS Cayman on a successful conference. Ron chaired the conference committee and is the current chairman of IMAC.

Staff News

Karen Mahoney will be joining SRS (Vermont) as an account manager based in our Burlington, VT office. Karen was formerly an Account Manager for Aon Insurance Management in Burlington, VT.

Industry Events

SRS will be participating in the following upcoming industry events. Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

March 7-9, CICA 2010 International Conference: Brady Young will be attending this conference to be held at the Omni Orlando Resort, Orlando, FL.

April 5-8, 2010, Western Region Captive Insurance Conference. Brady Young and Derick White are speaking and Ann Wick is attending this conference to be held at the Arizona Biltmore Resort in Phoenix, AZ.

SRS Webinar Series

SRS hosts monthly webinars on topical issues affecting the captive insurance industry.

Our January 2010 webinar will feature a review of captive activity during 2009 and a look forward on likely activity in 2010.

- **January 20, 1pm:** Captive Insurance—the State of the Market

Recordings - Recordings of prior webinars may be viewed at any time. A full listing of webinars is on our web-site at www.strategicrisks.com/webinars. Recent recordings include:

- Captive Taxation - The Latest Developments
- What's Happening in Employee Benefits in Captives
- Why Captives Re-domicile
- Captive Taxation 101

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

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