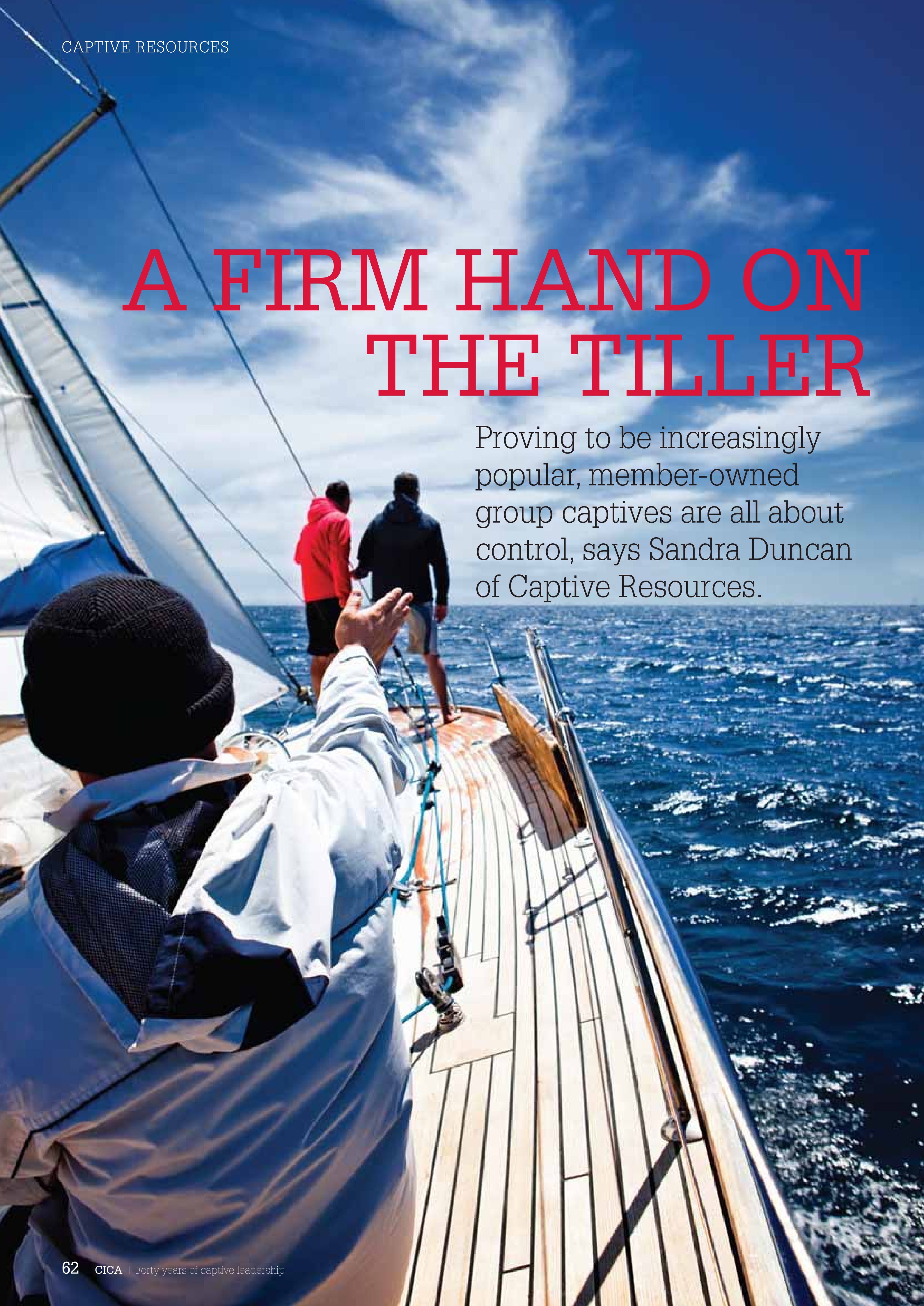

A FIRM HAND ON THE TILLER

Proving to be increasingly popular, member-owned group captives are all about control, says Sandra Duncan of Captive Resources.

Member-owned group captives are now enjoying the same widespread appeal, garnering similar press interest and eliciting the same intense interest as other captive structures have done over the years. Dispelling early, dubious perceptions, they are now more widely known and accepted as a viable and practical captive option for mid-sized companies, and comprise a fast-growing segment of today's captive industry.

Steady growth

Until recently, an idiom for the evolution and growth of the member-owned group captive sector could have been 'slow and steady wins the race'. Not to imply there's a prize to be had (or a race, for that matter)—except perhaps for the thousands of middle-market companies that have reaped the benefits of membership. Rather, it is perhaps a fitting description of the steadily increasing awareness of, and participation in, these structures over the past two to three decades.

The origins of the modern day captive industry can be traced back to the early 1950s, when large parent companies began to establish their captives offshore, through to the late 1970s when Bermuda and the Cayman Islands developed their captive laws. It was only natural that single parent captives were at the forefront of developments, but as the industry matured and the alternative risk transfer market flourished, so too did various group structures such as association and affinity programmes, risk retention groups, rent-a-captives and special purpose captives among others, many with the goal of making captives more accessible to mid-sized companies.

So while group structures have been around for decades, they have not historically elicited the intense interest that we see now. In more recent years, mid-sized companies have joined member-owned group captives at an exceptionally rapid rate, and further dynamic growth is looming on the horizon. An impending hard market is likely only to heighten interest.

Member-owned group captives have always been the sole focus of Captive Resources, LLC (CRI), since 1984 when it formed Raffles Insurance Ltd, the world's largest heterogeneous, member-owned group captive, and recipient of the 2009 Captive Insurance Companies Association (CICA) Outstanding Captive Award. The pioneering success of Raffles spawned other member-owned group captives, both heterogeneous and homogeneous, groups that utilised the same frequency-driven model. CRI has borne witness to this vigorous growth and its business has grown from that first group of nine Raffles founding members with about $1.5 million in premium, to more than 25 captives, 2500-plus members and nearly $1 billion in premiums.

So what do these member-owned group captives look like today, and what is generating the unprecedented interest in them?

Distinguishing characteristics

The defining characteristics of the majority of today's most successful member-owned group captives make them unique among captive structures.

- The member policyholders are the only owners, with no outside ownership interests. This eliminates any potential conflicts of interest and provides the owners with full control.
- Corporate governance is member-driven, which further supports the central captive purpose of providing the members with control. 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 attractive feature to members since each one, regardless of premium size, has the same voice. This is an important feature, since there is a wide range of companies of varying size that comprise the middle market.
- A strong committee structure allows for even greater individual participation by members according to their specific interest or expertise. Committees bring their recommendations to the board (for review and discussion by the entire membership), which has sole decision-making authority. This further facilitates the management process for members, especially as a captive grows to have hundreds of members.
- An equitable, easy to understand risk funding formula incorporates risk sharing among the members, and ensures that members' premiums are truly reflective of their risks. Widely known as the 'A fund/B fund' formula, CRI worked with Raffles members on the development of this captive funding formula in the 1980s. The A fund provides for frequency losses, the B fund for severity losses, and there is a provision for assessment should a member's experience exceed actuarial projections. Reinsurance protects the captive against catastrophic losses exceeding the captive retention, and aggregate excess coverage further protects the captive. (While it has always been an important aspect of a properly structured group captive, in recent years catastrophe protection has taken on greater significance in light of increasingly volatile cat trends.) Basket and clash coverage is typically provided. The formula has become an industry standard for member-owned group captives.
- Support services including policy issuance, reinsurance, actuarial services, claims administration, loss prevention, financial auditing and banking are all provided on an unbundled basis. This is an ideal structure for a mid-sized company which, typically, does not have the resources to dedicate to running a captive. The inherent flexibility allows the captive to change any of its services at any time with minimal, or no, disruption or additional cost.

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- Workers' compensation, general liability, automobile liability and physical damage, property and products liability are the most common coverages.
- Heterogeneous and homogeneous options are readily available. There are no major differences in the way these operate, but a prospective member may feel that a homogeneous captive with loss-prevention programmes tailored specifically to its industry will be more beneficial than, say, a heterogeneous captive offering a greater spread of risk across various industries.
- Successful group captives target best-in-class risks: companies that are among the best in their respective industries. Members are financially strong and stable, have management with a shared commitment to safety/loss prevention and proactive claims management, and an average, or better than average, loss history.

Catalysts of growth

Today, mid-sized business owners are proactively choosing to be captive owners, versus being driven to explore a captive due to the exorbitant cost or lack of availability of coverage in the commercial market, as was often the case in the early 1980s. Joining a member-owned group captive should be largely a market neutral proposition, and this is increasingly the case, as significant growth has punctuated both hard and soft insurance cycles. Despite an extended soft market, during which commercial insurance rates have been—at times—extraordinarily low, mid-sized business owners' interest in these captives has continued to grow. There are several reasons for the intense interest of recent years.

- **Desire for control:** The desire for greater control has led to a generally more vigilant and aggressive posture toward managing risk in the middle market. There is frustration with the traditional market pricing model and the cyclic nature of the industry, which exacerbates efforts to maintain predictability and control. Member-owned group captives appeal to mid-sized business owners seeking long-term control and cost stability.
- **Economic conditions:** A persistently difficult economy is motivating companies to squeeze every dollar of expense and to look continually for ways to control costs.
- **Greater knowledge and acceptance:** In recent years, awareness and the market presence of member-owned group captives has increased markedly in the middle-market sector. Mid-sized companies recognise that captives are no longer the sole purview of large corporations, and are more receptive to exploring the possibilities of captive ownership. Businesses now readily consider member-owned group captives as a viable and practical risk management solution.
- **Improving availability of credit:** Recently, an increased availability of letters of credit (LOCs) at improved prices has facilitated membership. LOCs remain the most widely accepted form of collateral for member-owned group captives, and following recent turmoil in the financial markets, restricted credit had been an impediment to captive membership for some companies. Respondents to CICA's annual Fronting Survey in 2009 and 2010 indicated 'collateral concerns' as their biggest challenge to ownership (22 percent and 27 percent, respectively), but in 2011, this was not nearly as worrisome (12 percent).

Benefits of membership

Certainly, as member-owned group captives have moved into the mainstream of the insurance and risk management arena and the benefits of membership have become more widely known, this has generated interest and contributed to growth. The major benefits of membership include:

- **Control:** Members are able to control their own insurance destiny by limiting the adverse effects of the cyclicality of the insurance industry on their businesses. They recognise that the captive provides long-term cost stability, their premium is derived from their own experience (and, as such, is within their influence and control), and that the captive's operational costs will be lower than that of the traditional insurance market due to 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 in the form of dividends.
- **Premium deductibility:** From a tax standpoint, if the group captive addresses insurance risk, incorporating sufficient risk shifting and risk distribution among the group's numerous

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unrelated, insured entities, then members' gross premiums should be fully deductible.

- **Limited capital outlay:** Membership in a group captive requires a modest capital investment as compared to setting up a single parent captive for example, which typically involves a significant capital outlay.
- **Loss prevention/claims management programmes:** The best member-owned group captives provide extensive loss prevention programmes to support members' efforts, and claims management oversight, since it is through effective prevention and management of losses that captive members can continually control their insurance costs.
- **Professional networking:** Members have the opportunity to network and build new business relationships with fellow captive members - other professional and entrepreneurial business people from across the US. These relationships have benefited members in many ways such as the safety and risk management best practices, but also in other ways completely unrelated to insurance.

The challenge of managing risk in an ever-changing, uncertain world demands proven, cost-effective and flexible risk management strategies that not only protect operations, but also contribute to competitive advantage. Thousands of business owners have found that member-owned group captives fulfil this need by providing a long-term, stable mechanism to control their insurance costs and cope with changing market dynamics. No longer 'alternative', these captives are now a strategic risk management choice that places member-owners in a commanding position of control.

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