Group captives: strength in numbers

Group captives have the potential to service a burgeoning middle market interest in captive insurance. *US Captive* talks with leading figures from the market about the considerations behind going down the group captive route.

While those that opt to enter a group captive arrangement will inevitably face challenges around balancing the management of such entities—particularly as regards governance, claims, the division of profit and loss, and entry and exit from the group—they nevertheless represent a potentially strong fit to a host of sectors. As Nick Hentges, executive vice president and principal at Captive Resources, an independent captive consultant outlined, the group captive concept works well for manufacturers, wholesalers, retailers, distributors and contractors, with the potential for many other industries to pursue the concept.

As Hentges explained, Captive Resources has developed an energy captive for oil drilling and support service operations, and is in the process of forming a heavy construction captive. Often, group captives can be a great solution to such companies, those that are writing classes of business that may struggle to find a home in the commercial market. “Risk management programmes can be tailored to address the challenging exposures they face,” he said, with a group solution representing an attractive alternative to the commercial market.

Andy Sargeant, chief operating officer at USA Risk concurred, also stating that group captives are a potentially strong fit for a range of industries. He said that USA Risk works with groups operating in the healthcare, transportation, construction, public entity, manufacturing and professional services industries. It would seem that there are few sectors that are not a potentially good match for the group captive concept.

Diverse drivers

Group captives offer the potential to self-insure to those firms that have not traditionally been active in the captive space—small and medium-sized enterprises (SMEs) in particular. Many in the industry recognise this as a potential goldmine of new formations and for many SMEs the ability to pool resources in a group captive will be the most appropriate means of accessing the market. As Peter Mullen, CEO of Aon Risk Solutions, Bermuda made clear, “There has been a huge push among medium-sized companies into the group captive space. It has helped create a vibrant and growing market for group captives. If you want to improve your losses and better manage your risk, but are too small to own a single parent captive, a group captive offers an excellent alternative.”

Sargeant said that there is increasing awareness among small and mid-sized companies regarding the potential of captives, with many forming 831(b) captives or participating in pools. Addressing the growth of more traditional group captives, he said that this would likely be driven by a tightening of the commercial market. When such market hardening does occur, Sargeant said that SMEs will inevitably become “more familiar with the group captive concept”.

Hentges said that there were a number of factors driving the growth of group captives and SME interest in the area, including “the tightening traditional market, the strengthening economy, a better understanding and acceptance of the group captive concept by the broker community, and a greater awareness on the part of the buyers”. Captive Resources had seen the market grow steadily over time, but over the last few years the “combination of an improving economy and a hardening market (following a soft market of nearly 10 years), had intensified interest and accelerated growth”. Hentges added that despite additional impetus during hard markets, the group captive concept is as applicable during soft markets, emphasising that the decision to join a group captive should not be based solely on market conditions.

Looking back over the development of group captives over the past two decades Hentges commented: “15 years ago, a middle market account was say $100,000 to $2,000,000 in casualty premium (workers’ compensation, general liability and automobile) but now, we consider a middle-market account to range from as low as $100,000 up to as much as $10,000,000.

“A large group captive ($50-200+ million in premium) can easily accommodate a $10 million account, whereas this will be a challenge

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for a startup or smaller captive. So it may not be so much ‘a push’ to get small and medium-sized firms into these captives, but that the evolution and growth of these captives means that they are now a viable option for the broader spectrum of middle market accounts.”

Changes under the Patient Protection and Affordable Care Act (PPACA) are also likely to drive interest in group captives, said Sargeant, with a number of SMEs considering “self-insuring their employee healthcare plans and joining a group captive to share the stop loss risk”. He added that it would be interesting to see how many group captives are formed in response to developments under PPACA.

An informed decision

When considering their options in terms of domicile, captives—be they group or otherwise—really are spoiled for choice. But it is apparent that the quality of captive delivery, rather than any geographical choice, will be the key consideration when opting for a home domicile. As Hentges explained, those considering the group captive route need to consider several issues. “Offshore management experience and reputation; the cooperation, flexibility and experience of regulatory bodies; initial capitalisation; ongoing fees and taxes; tax considerations; ease of doing business (travel and meeting requirements); and availability of qualified and experienced service providers are among the many considerations when selecting a domicile.” A number of US and offshore domiciles satisfy these criteria. Group captives will need to consider their choices closely.

Sargeant spoke in a similar vein, arguing that the selection of domicile “primarily comes down to the supporting infrastructure of knowledgeable regulators and service providers. Although cost is always a factor, selecting the domicile with the lowest capitalisation requirements is not really the way to go”.

“As part of the regulatory framework the owners should recognise that every onshore captive will be examined every three to five years.

A number of domiciles engage contract examiners which can be an expensive proposition due of the lack of familiarity these 'traditional' examiners have with captives." Sargeant added that groups should also consider accessibility to achieve full attendance at board and committee meetings. He warned that for risk retention groups the options are more limited, however. As he explained, they necessarily have to be onshore and not all states cater for the formation of such vehicles. For these, the choice will be narrower.

Devil in the details

Once established and the domicile settled on, there are still plenty of issues that group captives will have to iron out around their structure and function. As Sargeant explained, parents need to recognise that they are running an entity that requires "proper governance, efficient operations and proper financing". They need to be clear that there are key aspects that need to be in place for a group captive to function effectively, including "a critical mass of business, sufficient capitalisation, realistic underwriting and rating, group wide risk management procedures, effective claims management and experienced service providers to perform these functions".

"The board also needs to recognise that their fiduciary responsibility is to the captive, not to themselves as policyholders—that's a tough conflict to overcome," said Sargeant. "Most successful group captives display willingness to problem solve and share ideas particularly on risk management initiatives." This approach is easier in homogenous captives, he said, although such problem-solving is equally possible in heterogeneous captives.

Mullen spoke of the need for a shared philosophy, one that considers the captive value over the long term. "Participants in the group captive need to commit to risk management and loss control practices linked to the group," said Mullen, with the drawing together of resources and experience central to the success of the captive and the group concept.

Hentges said that no single factor is the key to success, but that a "sound business model and risk funding formula" represents a solid foundation on which to build. Members should feel empowered to make decisions, including those that encourage best practice around risk control and loss mitigation that will help deliver the best results for the wider group. Education will form a significant part of this process, he said, particularly since many of the members will not be from an insurance background.

Sargeant said that group captives should energetically support the involvement of members in the running of such entities, encouraging them to play an active role on its board and committees. He said that it is beneficial "to have a mixture of board members, some of whom have had tenure on the board (for experience) and newer members to bring new ideas".

A measure of control

Hentges and Mullen both said that there needs to be an equality of control within the group. Mullen said that such conditions need to be set out at the formation stage, with the "division of votes within the group captive based on membership, not premium volume or size". Mullen said that new entrants "must be able to come in on an equal footing. The rules of participation need to be clear".

A key consideration for groups will relate to transparency around claims and their division across the group. Mullen said that transparency should be instilled where possible, although many group captives provide their members with a level of opacity around bad actors, with the intention being to instil best practice without finger-pointing. Again, such considerations will be decided upon in the group captive's foundation document, but it will need to be closely considered.

Sargeant said that the division of claims can be one of the leading areas of conflict, with recognition needed at the outset regarding the pooling of risk and the establishing of methodology around the allocation of capital and net income. "One of the key determinants of capital is the amount of premium written by the member, so participants need to be aware how their premium is derived. There is also the problem of members with poor loss experience and whether they should be allowed to share in net income," said Sargeant. "Some groups restrict the amount of allocable net income to a member's equity account if they have a high loss ratio. The key is full disclosure, up front and on an annual basis."

Hentges added that a formula that ensures equitable and adequate funding for individual members and the captive as a whole, and which also incorporates appropriate levels of risk distribution and risk sharing, is vital to the success of a group captive. The by-product of such an approach will be a "mature, growing, successful captive that ultimately benefits its members by being financially sound, incentivising members to focus on safety and risk management, and rewarding them for success by returning the captive's profit to them in the form of dividends".

He added that it is key to apply group formulas regardless of market conditions or external factors. Member premiums should be derived from individual loss experience, as it is the ability to control premium costs and generate profits that are the most significant incentives to members within the group. Through active involvement in the group, members can ensure the captive serves their "individual and collective interests", with such an approach going "a long way towards maintaining transparency and promoting fairness". ■