



BY SANDRA R. DUNCAN

MEMBER-OWNED GROUP CAPTIVES: *Controlling Insurance Costs*



Casualty insurance can be one of a contractor's largest expense items – and, of course, a major concern for CFMs. While it is especially important for construction companies to control insurance costs because of their potential to negatively impact competitiveness when bidding on projects, it can be very difficult to do so.

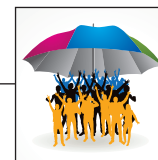
Despite sound risk management programs and reductions in losses and claims, premiums often rise, seemingly indiscriminately, ebbing and flowing with insurance market cycles. However, one option for small- to medium-sized contractors to help drive down and control their insurance premiums is to join a member-owned group captive insurance company.

A BRIEF CAPTIVE PRIMER

Captives are by no means a new risk financing mechanism. The origins of the modern captive industry date back to the early 1950s, when large corporations began to form single-parent captives, and 1970s, when Bermuda and the Cayman Islands developed captive-enabling legislation.

Single-parent captives were the most prevalent type for many years and still comprise the majority of captives. However, as the captive industry matured and alternative forms of risk transfer were embraced, various group structures emerged, making captives more accessible for smaller companies. Other types of captive insurance include group, agency, segregated cell, branch, special purpose vehicle, risk retention group, and reciprocal.

There is no single definition of a captive insurance company that fits every permutation. According to Towers Watson, a captive is “a closely held insurance company whose insurance business is primarily supplied by and controlled by



its owners, and which the original insureds are the principal beneficiaries. A captive insurance company's insureds have direct involvement and influence over the company's major operations, including underwriting, claims management policy, and investment.”

Captives fall into two categorizes:

- *Single-parent captives* – Have one shareholder and typically insure only the risks of the parent-company owner. They essentially become operating companies of the parent and can also insure the risks of affiliates or subsidiaries.
- *Group captives* – Can take a number of different forms, one of which is a member-owned group captive, or an insurance company that provides insurance solely to and is controlled by its multiple unrelated owners.

Member-owned group captives are often confused with association captives, which are insurance companies typically owned by two or more members of an industry, trade, or professional association that limit participation to association members. The association can also be the sole owner. Member-owned group captives, on the other hand, are composed of unrelated businesses that become joint insurance company owners.

Member-Owned Group Captive: Basic Tenets

In 1984, Raffles Insurance Ltd., a heterogeneous member-owned group captive, was formed by a group of nine companies with approximately \$1.5 million total premium. This original Raffles group agreed on the following basic tenets:

- The captive exists mainly to provide long-term cost stability – in any given year, costs may be lower or higher than the traditional market.
- The captive premium will be derived from members' own loss experience, which they have the ability to control.
- The operational costs of the captive will be lower than those of the traditional market.

The success of Raffles led to the formation of more member-owned group captives, both heterogeneous and homogeneous, to serve as a vehicle through which members could limit the adverse effects of traditional insurance market cycles on their businesses. Today, Raffles has approximately 330 members and \$208 million premium.

Control Air Conditioning Corporation, a commercial and industrial HVAC and plumbing contracting company based in Anaheim, CA, has been a member-owner of Raffles since

2005. “Retrospectively, when we saw how much we could have saved, we wished we had joined sooner,” said CFO Greg Rummmler, who estimated that the company's premiums are now on average 40-50% lower than what they were in the traditional market.

In recent decades, there has been a steadily increasing awareness of member-owned group captives among both small- to medium-sized enterprises and the insurance brokerage community that serves them. They are now more widely known and accepted as a financially viable and practical captive option for smaller businesses, including construction companies. So what do these captives look like today, and what is driving widespread interest in them?

THE MEMBER-OWNED GROUP CAPTIVE BUSINESS MODEL

The following eight major features render the Raffles business model unique among captive structures.

Ownership & Corporate Governance

The captive is owned solely by its members. No external ownership interest is allowed, thereby reducing potential conflicts of interest. Corporate governance is member-driven, and each member is an equal shareholder. Regardless of premium size, each member has one seat on the board of directors and one vote.

Committee Structure

A strong committee structure requires the active participation of member-owners. Committees oversee finance and investments, underwriting, risk control, and other functions, and present recommendations to the board, which has sole decision-making authority. Members can participate in committees based on their interests and expertise, and similarly serve as officers of the captive.

Risk Funding Formula

The foundation of the captive business model is the risk funding formula. The founding members of Raffles worked to develop an equitable, easily understood captive funding formula that incorporates risk sharing among the membership for severity losses, and ensures that members' premiums are reflective of their risks and specific loss history.

The funding formula helps members understand how premiums are determined and provides transparency with respect to all components of their insurance costs. The formula is now known as the A/B Fund formula and has become an industry standard for member-owned group captives:

- *The A Fund* – Provides for frequency losses (e.g., \$0-100,000)
- *The B Fund* – Provides for severity losses (e.g., \$100,001-350,000)

Should a member's actual losses exceed actuarial projections, a provision for assessment is built in to help ensure adequate funding and creates incentive for members to focus on loss prevention and claims management.

Reinsurance protects the captive against catastrophic losses exceeding the captive retention (e.g., \$350,001-1 million), and aggregate excess coverage provides additional protection. Basket coverage (occurrences involving multiple lines of coverage) and clash coverage (where two or more insureds suffer a loss from the same occurrence) are also typically provided. Members earn investment income on their unused loss funds.

The A/B Fund formula fulfills the major captive objectives of providing sufficient funding and protection for the captive and cost control for the member.

Outsourced Support Services

The captive has no employees, but it has virtually the same functional areas of a traditional insurance company. All operational and support services – policy issuance, reinsurance, actuarial services, claims administration, loss prevention, captive management, financial auditing, and banking – are provided on an outsourced, unbundled basis. An unbundled structure is ideal for many small- to mid-sized contractors, which typically do not have the internal resources or expertise to operate a captive. The flexibility of unbundling allows the captive to more easily make changes to its services with lower cost or disruption.

Coverage

Workers' comp, GL, automobile liability/physical damage, property, and product liability are the most common types of insurance provided by group captives. Most member-owned group captives provide basic commercial coverage vs. some complex or specialized lines, which are typically less predictable and can potentially produce negative results for the captive. There are, however, some group captives that provide more complex lines of coverage, such as medical professional liability.

The policy-issuing or fronting company¹ is required to be reputable and have recently been issued an "A" rating by A.M. Best. The captive's underwriting committee periodically reviews coverage written as well as the types of businesses

to target, thus ensuring the overall desired risk profile for the captive.

Heterogeneous vs. Homogeneous

There are many heterogeneous and homogeneous member-owned group captives operating today.

- *Homogeneous group captives* – Often include GCs, commercial construction, roofing, distribution, trucking/transportation, temporary staffing, agribusiness, and oil and gas exploration and services
- *Heterogeneous group captives* – Include but are not limited to certain construction and manufacturing industries, and such service industries as retail, wholesale, and distribution

Both types of captives incorporate the same funding formula and unbundled structure. However, the owners of a new captive member company should feel comfortable with its choice of captive, both as an owner of the captive and as an insured. Perhaps a prospective member believes that a homogeneous captive with loss prevention programs customized to its specific industry will be more beneficial, whereas another company may prefer a heterogeneous captive offering a greater spread of risk across various industries.

Loss Prevention & Risk Management

A percentage of each member's premium is allocated to loss prevention, risk, and claims management services. Unlike most traditional insurance, the member may apply its allocated funds according to its specific loss prevention and safety needs. It is through effective prevention and management of losses that members can control their insurance costs and create opportunity for the return of their unused loss funds in the form of dividends.

"From a risk management and safety perspective," said Jim Shields, risk manager at Control Air Conditioning, "we found that in the captive, safety and risk management are so much more in the forefront."

Member Responsibilities

In addition to paying premiums and posting collateral, captive members have responsibilities to the captive and their fellow member-owners, including:

- Controlling losses as per the captive's established risk management standards
- Attending and participating in board and committee meetings
- Referring other quality companies for membership



Controlling Insurance Costs

CATALYSTS OF GROWTH

Despite an extended soft insurance market from 2002-2011 (during which commercial rates were extraordinarily low at times), interest and participation in group captives have continued to grow. Captive Resources, LLC estimates that the group captives it consults to grew in premium volume by 300% and in number of member companies by 233% during this period.

There are several underlying reasons for this popularity:

- The cyclicity of the traditional insurance market pricing model can hinder efforts by CFMs to maintain predictability and control. Member-owned group captives appeal to companies seeking long-term control and cost stability.
- Challenging economic conditions have prompted companies to more aggressively control expenses and look for different and innovative ways to reduce costs.
- A greater awareness and understanding of group captives has led smaller companies to recognize that captive ownership is no longer only for large corporations.
- Saturation in the single-parent captive sector has led captive service providers to pursue opportunities in the middle market, thereby raising awareness of group captives.
- Improving availability and lower cost of credit has facilitated membership. Letters of credit are the most widely accepted form of collateral for member-owned group captives. However, restricted credit had been an impediment to some companies subsequent to the financial crisis of 2008. The recession that followed prompted some companies considering membership to assume a wait-and-see posture.

MEMBER BENEFITS

The collective benefits of member-owned group captives include the following.

Greater Control over Insurance Costs

Members are able to control their own insurance costs in part because they are insulated from the adverse effects of insurance market cycles on their businesses. Insurance costs are lower because premiums are based on individual loss experience, which members can control and reduce; the captive's operating costs are lower than the traditional market due to efficiencies gained through the unbundling of services and group purchasing; and, only good risks are accepted, contributing to the financial health of the captive.

"We never had any idea what our insurance costs would be and were getting quotes at, literally, the very last minute," said Byron Talbot, owner of Byron E. Talbot Contractor, Inc., a civil and industrial construction company headquartered in Schriever, LA. The company's insurance is "significantly less expensive" as a Raffles member, he noted.

Dividends

Members' unused loss funds (underwriting profit) and accrued investment income is returned in the form of dividends, further reducing overall costs. Danny Graham, CEO of Lincoln Builders, Inc., a commercial and industrial GC headquartered in Ruston, LA, said the dividends were more than he anticipated. "This really makes you focus on safety and gives you greater incentive to control your losses," Graham said.

Premium Deductibility

From a tax standpoint, if the group captive addresses insurance risk (vs. investment or business risk) in its "commonly accepted sense," incorporating sufficient risk shifting and risk distribution among the group's numerous unrelated, insured entities, then members' gross premiums should be fully deductible under IRC §162. The IRS has issued several Revenue Rulings over the years that provide guidance and clarification.²

Limited Capital Outlay

A one-time capital investment is required for group captive ownership. Capital investment for a member-owned group captive averages \$25,000-36,000 per member. In comparison, start-up costs for a single-parent captive typically range from \$50,000-100,000 for a feasibility study, actuarial analysis, attorneys, captive management, domicile fees, letters of credit, and consulting and brokerage fees. Should a Private Letter Ruling³ from the IRS be desired, costs could be substantially higher. Initial capitalization varies widely based on types of risk financed and domicile, but generally ranges from \$250,000-\$1 million in cash or letter of credit.⁴

Customized Safety & Loss Prevention

Captives develop programs and metrics tailored to their members' needs and solicit feedback to ensure that programs are meeting member needs and expectations.

Examples of captive safety and loss prevention resources include:

- Risk control workshops
- Monthly webinars

- Focused, multi-disciplinary reviews of complex and high-value claims
- The development and application of an in-depth risk assessment methodology that incorporates key performance indicators
- Safety video library
- Risk control group purchasing program (discounted safety products/services)
- National Safety Council membership

Loss prevention services are continually refined and customized to meet the needs of the captive's diverse membership. For example, General Contractors Insurance Ltd., a group captive for commercial GCs, is currently considering the use of predictive analytics in workplace safety. This involves utilizing computer modeling to help companies pinpoint where an accident is most likely to occur. Models are based on algorithms that incorporate companies' actual safety observation data and historical work site incidents, including injuries and fatalities.

A Group Captive Member's Profile

Member-owned group captive members are typically Best in Class companies in their respective industries and have been carefully vetted in the recruitment and underwriting process. However, a member-owned group captive is not suitable for every construction company. For example, since the funding formula is frequency driven, companies subject to catastrophic losses are not a good fit.

A typical member possesses the following attributes:

- Entrepreneurial with a desire for control
- Financially strong and stable
- Management committed to safety, loss prevention, and proactive claims management
- Better than average loss experience for industry group
- \$100,000-3 million total combined workers' comp, GL, and automobile premium (premium can total more than \$10 million)

Professional Networking

Captive members can build new business relationships and share best practices with fellow captive members. Networking opportunities include:

- Board, committee, and orientation meetings
- Risk control and safety workshops
- Online webinars
- Communications (facilitated through the captive's website)

CHALLENGES OF GROUP CAPTIVES

Member-owned group captives present some inherent challenges. The business model incorporates provisions to address these issues.

Quality Growth

Effective loss prevention and claims management continually reduces premiums; therefore, the captive must grow in order to maintain appropriate spread of risk and fully leverage competitive operational costs. In addition to member referrals, an extensive and growing network of brokers also produces a continual flow of prospective members.

Member Retention

Long-term member retention is critical to the ongoing success of a group captive. There is a direct correlation between adequate member education and member satisfaction and retention. Prospective members should investigate the captive's member-retention rate, as it is often an indication of overall member satisfaction.

Data Sharing

Members have the aggregated data needed to monitor results and while they are able to view data of individual members, the identity of each is protected. Data is presented to the captive in a blind/encoded fashion, thereby maintaining data confidentiality in the captive.

CONCLUSION

Member-owned group captives are now widely used and offer small- and mid-sized contractors and other businesses a viable and practical captive ownership option. These captives enable businesses to become insurance company owners rather than insurance buyers, strategically positioning their companies with a competitive advantage and shielding them from traditional market volatility. Company owners considering membership, however, should be committed to safety and take an active role in the captive. ■

Endnotes

1. Captives employ “fronting” arrangements whereby a licensed, admitted insurer issues the policies on behalf of the captive, most often to comply with financial responsibility laws imposed by many states (such as for automobile liability and workers’ comp). The captive retains all or a specified amount of the risk through a reinsurance agreement with the fronting company. Since the fronting company assumes all obligations imposed by the policy, it is especially important that it be financially strong and stable.
2. The tax deductibility issue must be considered in light of the IRS’ position expressed in Rev. Rul. 2001-31 (modifying Rev. Rul. 78-338, 1978-2 C.B. 107); Rev. Rul. 2002-89; Rev. Rul. 2002-90; Rev. Rul. 2002-91, 2002-2 C.B. 991; Rev. Rul. 2005-40; Rev. Rul. 2008-8; and others, as well as various case law.
3. A Private Letter Ruling from the IRS pursuant to Rev. Proc. 2002-75 can affirm in writing that the IRS will treat the captive as an insurance company pursuant to IRC §831 and that all premium payments will be deductible as business expenses per IRC §162.
4. *Business Insurance*, “Captive Insurance Becoming Attractive to More Midsize Companies.” September 4, 2011.

SANDRA R. DUNCAN, ARM, is Vice President-Operations of Captive Resources, LLC, an independent consulting company specializing in the creation and oversight of member-owned group captive insurance companies in Schaumburg, IL.

Sandra has 27 years’ experience in insurance, reinsurance, and risk management, specializing in alternative risk structures including captives. She has been published in *Captive Review*; IRMI’s *Captive Insurance Company Reports*, *Risk Management*, and *Emphasis*. She has also presented for the Risk & Insurance Management Society.

Sandra earned a BBA from American International College in Springfield, MA.

Phone: 847-879-2845

E-Mail: sduncan@captiveresources.com

Website: www.captiveresources.com