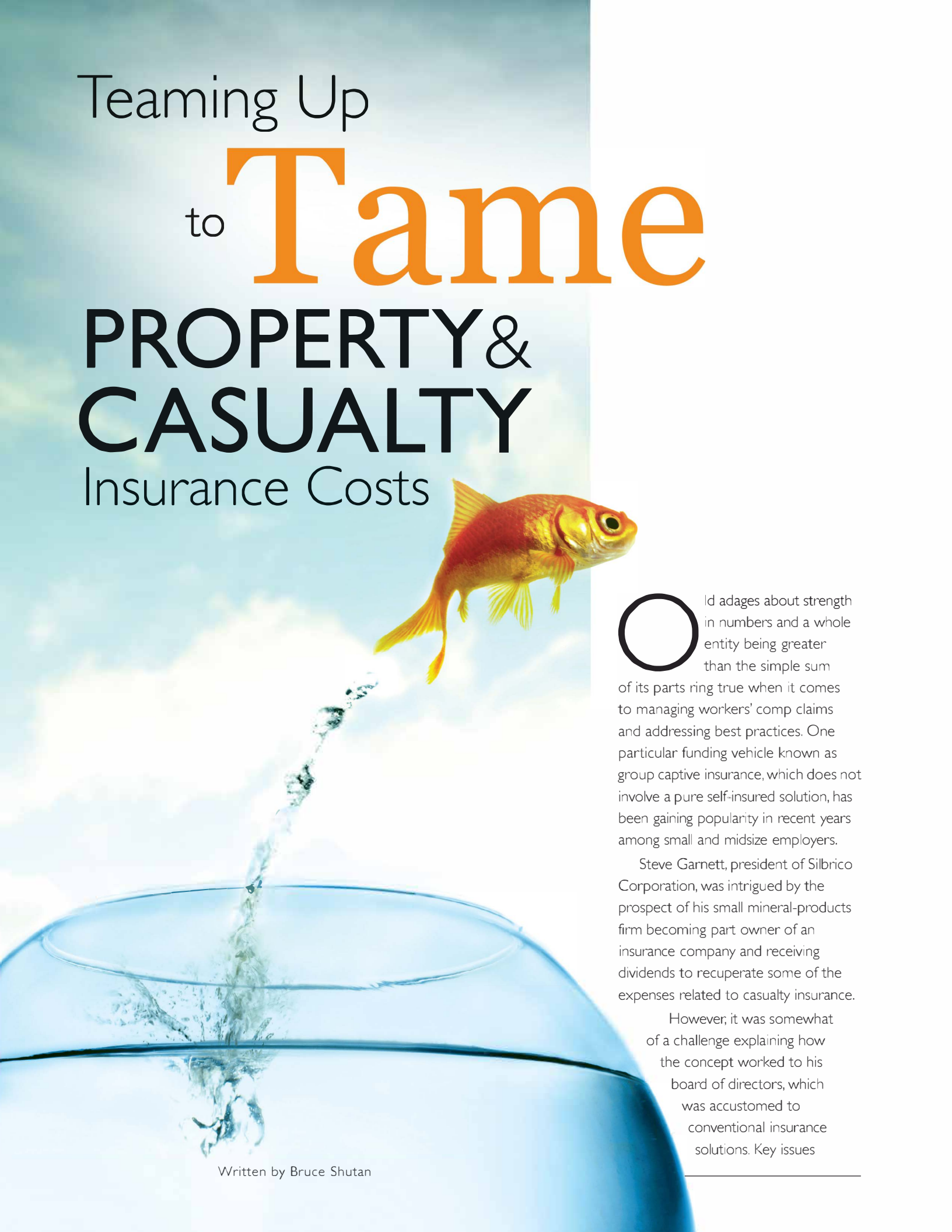


Teaming Up to **Tame** **PROPERTY & CASUALTY** Insurance Costs

A goldfish is captured mid-jump, leaping out of a clear glass filled with water. The fish is bright orange and yellow, with its fins spread. A trail of water droplets follows its path from the glass's rim. The background is a soft-focus blue sky with wispy white clouds. The overall composition is clean and modern, with a professional feel.

Old adages about strength in numbers and a whole entity being greater than the simple sum of its parts ring true when it comes to managing workers' comp claims and addressing best practices. One particular funding vehicle known as group captive insurance, which does not involve a pure self-insured solution, has been gaining popularity in recent years among small and midsize employers.

Steve Garnett, president of Silbrico Corporation, was intrigued by the prospect of his small mineral-products firm becoming part owner of an insurance company and receiving dividends to recuperate some of the expenses related to casualty insurance.

However, it was somewhat of a challenge explaining how the concept worked to his board of directors, which was accustomed to conventional insurance solutions. Key issues

Written by Bruce Shutan

included the necessity of an initial capital requirement for ownership and the need to establish collateral for the program, as well as the idea of a captive being domiciled offshore with semi-annual meetings, to take full advantage of membership benefits.

"It offers a great opportunity to reduce your accidents, which typically results in reduction of your claims cost, which ultimately lowers the premium the captive charges on an annual basis," observes Garnett, who employs 92 people. "The result is that we've seen lower claim dollars and lower premiums."



Sandra Duncan, VP of operations at Captive Resources, LLC, an industry pioneer that assists Silbrico, has seen group captive programs really

take off with smaller and midsize employers that lack the critical mass, internal resources and expertise to maintain their own captive. She says they feature state-of-the-art safety, risk management and claims services and support for members, adding that several have an ongoing membership to the National Safety Council.

Since July 2012, total premium among Captive Resources' client captives grew \$700 million and now totals approximately \$1.7 billion. She says the reasons include an improving economy, loosening of credit, an increasing number of brokers wanting to educate their clients about the group captive concept and a snowball effect from group captive member-owners recommending other companies they do business with explore this option.

While single-parent captives date back to the 1950s and even

earlier, Duncan says they gained popularity in the late '70s, with group captives surfacing in the '80s mainly as association-sponsored programs. Member-owned group captives also date back more than 30 years, which is when Captive Resources formed its first client captive, now the world's largest heterogeneous group captive.

At that time, she explains it could be a challenge to secure the required fronting and reinsurance for group captives given that they were a relatively new captive form. Today, with several large casualty insurers interested in group captives, she says that's no longer the case.

While most of the 30 captives with nearly 3,300 member companies that Captive Resources works with are workers' comp driven, they also include general liability, auto liability and auto physical damage.

Group Captives vs. Self-funding

Mindful that workers' comp is very state specific in comparison to a captive, which can combine general liability coverage across several lines of business, Freda Bacon of the Alabama Self-Insured Worker's Compensation Fund prefers a funding mechanism that focuses solely on workers' comp. A captive wouldn't make sense for her fund because the group self-funding mechanism accomplishes the same objective, which is using a group fund and coverage liability.

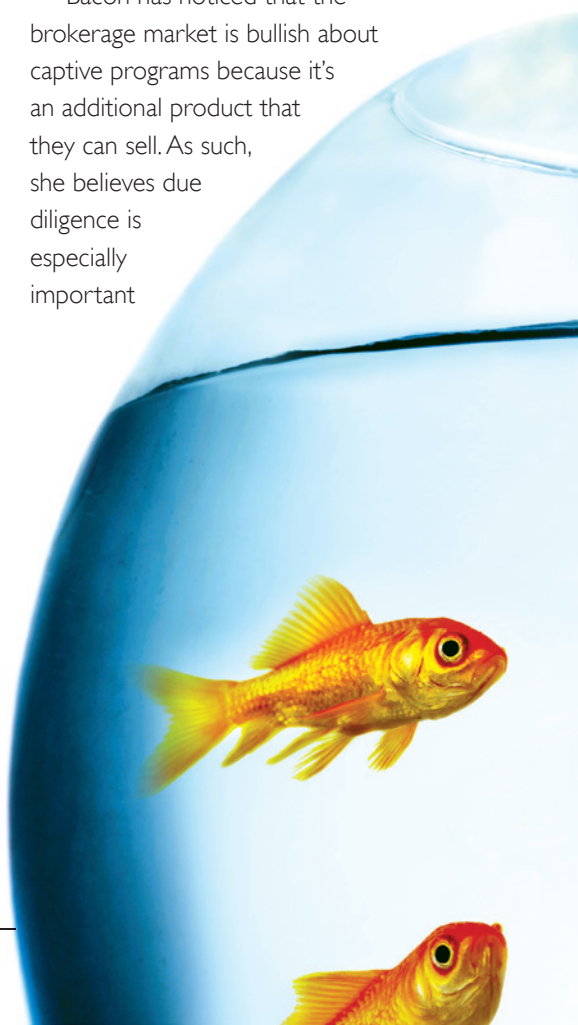
Bacon points to a long and reliable track record for group self-insured funding in the comp area with joint and several liability – from underwriting and claims management. "There is one particular group fund in the state that is celebrating their 50th anniversary," she says, adding that the fund she administers has been around for 38 years.

"It is a very good avenue to pool your liability if managed and operated properly," she continues. That means having a strong board of trustees

to oversee the program, responsible administrator and aggressive focus on claims management.

One potential downside to this arrangement is that group self-insured funds are subject to competition in terms of pricing the coverage, according to Bacon. "I think captives probably run into that same situation," she surmises. "If you look at the definition of captive, you're captive. You're there forever. You have that exposure or liability for the period of time that you're in that captive."

Bacon has noticed that the brokerage market is bullish about captive programs because it's an additional product that they can sell. As such, she believes due diligence is especially important



for captives because they involve a long-term commitment unlike, say, shopping for homeowners' or automobile insurance coverage every two or three years. Her larger point is that employers need to be vigilant about whatever arrangement they pursue, which would include vetting the strength of the fronting company for captives or excess carrier for group self-funding.

Lasting Control of Claims Costs

The true value of group captives is that they're part of a mechanism that allows employers to control their workers' comp costs long-term, explains Joe Herbers, managing principle with Pinnacle Actuarial Resources, Inc., which has served this



market for more than 25 years and is currently working with between four and five dozen group captives.

"The control element is so important to middle-market type companies because they don't want to be susceptible to the ups and downs of the commercial casualty market, where they can have their premiums whipsawed at whim," he says.

But that's exactly what has happened repeatedly across the U.S., including California where he says rates can change dramatically from one year to the next without any regard for an individual risk's claim experience. His point is that premiums should reflect actual claims experience. From an actuarial standpoint, Herbers opines that it's easier to project forward with group captives because the data becomes much more consistent from year to year.

Paying Dividends

To the extent that employers are able to control their frequency layer type claims, Herbers says they're able to obtain a return from the loss fund that they paid into "by virtue of the dividend policy of those group captives." "That's money that you get returned back into your pocket that you would otherwise have paid to a third-party insurance company," he explains.

Silbrico is able to track its loss ratio relative to loss funding and return of dividends on an annual basis, as well as delve into specific incident categories causing losses in the company.

Results for Silbrico have been impressive during the 10 years it has participated in the group captive. There have been policy years with zero claims that saw Silbrico receiving dividends and a year with catastrophic loss which required Silbrico to pay additional loss funding to the captive.

Captive Resources' client captives have the option to invest in The Captive Investors Fund (CIF), a Cayman Islands Mutual Fund. The CIF was established by Captive Resources in 1994 to address the specific investment needs of group captives. "The investment structure is spread among many different levels of risk and it helps alleviate some of the peaks and valleys of investment," Garnett says. "It's been very worthwhile to have that investors fund [CIF] available for us to put our funds into and earn the return." The average blended return of the CIF has been solid at between 6% and 6.5%.

Joining the captive also enabled Silbrico to identify a variety of areas where it was deficient in safety. "We have not only tightened up many of our policies and procedures," he explains, "but also hired a safety manager and structured our company to take advantage of knowledge and expertise that's available for us to tap into."



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All captive members have equal voting rights and no other parties, including brokers/agents and service providers, have any ownership interest in the captive, according to Duncan, whose firm also falls into that category. She says all members also contribute an equal, but modest initial capital investment.

Captive Resources developed a funding formula that has become an industry standard for member-owned group captives. It features two layers: one that provides for losses up to a specified amount such as \$100,000 – the “A” fund layer; and another for larger losses, which covers the next \$100,001 to \$350,000 for example – the “B” fund layer.

“Over and above that,” Duncan explains, “the captive purchases reinsurance, typically up to \$1 million for GL and Auto and up to statutory limits for WVC and then aggregate excess coverage, basket coverage, clash coverage and so forth. The captive’s well protected. That’s essentially how it works.”

Group captives that use the A/B Fund formula developed by Captive Resources aren’t for everyone. For example, they won’t work for employers that are prone to large catastrophic losses because the model is frequency driven, according to Duncan. The best candidates are those committed to controlling their losses through solid risk management and safety strategies.

Group captives provide members with tools they may not have as a self-insured entity, Herbers notes. They include risk scoring, an objective view of risk levels relative to some industry norms and access to best-practices that can be used for each company, as well as the industry in which they operate.

He says group captives usually offer risk-control workshops two or

three times a year featuring detailed discussions about claims-handling strategies, dealing with attorneys and other service providers and cost control on the medical side. “As a self-insurer, you don’t necessarily have access to the body of knowledge that these group captives can bring to bear just by virtue of their size and their access to resources,” he adds.

The actuarial process of group captives focuses heavily on an experience-rating approach. “We forecast future loss funds based upon their prior experience,” Herbers explains. “And while they’ve been members of these group captives, the claims data that emerges has generally been much more consistent from one year to the next.”

One noteworthy dynamic is that the aggregate claims experience for the group as a whole improves considerably when its members have been together for a half-dozen or so years, Herbers observes. “It’s largely because many of these members of the group captives are middle-market businesses,” he says. “They don’t know much about the business of insurance at all. By joining a group captive and becoming an owner of a group captive insurance company, they embark on that journey that sometimes takes several years of learning the fundamentals of the insurance process.”

Once members of the group captive improve their learning curve, Herbers says they have a better understanding about the nature of the business, claim lags, steps that exacerbate or influence claims and strategies to control their claims long-term.

Addressing Total Health Expenses

Captive Resources also introduced a group captive five years ago that provides employers a unique option

for their self-insured medical stop-loss coverage, which has been very popular. In the late ‘80s and early ‘90s, Duncan recalls how many workers’ comp practitioners borrowed managed care techniques from the non-occupational health care arena and successfully applied them to occupational injuries and disease management.

“Now we see more and more employers working to manage health care costs through the introduction of wellness programs,” she says, “which is something that this captive focuses on in an effort to help employers manage their total health care expenditures, including costs below their specific retentions, where the bulk of their health care dollar is spent. It will be interesting to see if wellness initiatives are in some way now specifically tailored to occupational risks, as in the past.”

With workers’ comp medical costs continuing to increase substantially, Bacon says there’s a very long “tail” associated with benefits paid. “Employers in any program where there is long-term liability should be mindful of the potential increase in their exposure,” she says.

Forward-looking executives view group captives as a long-term financing mechanism that will pay them dividends over the long run, according to Herbers. He says these programs not only help control costs, but also leverage investment income generated from investing premium funds in a vehicle large enough that it provides diversification.

Herbers spots a potential for the emergence of more heterogeneous group captives that bring together “like-minded people who are all trying to manage their risk using best practices.” ■

Bruce Shutan is a Los Angeles freelance writer who has closely covered the employee benefits industry for more than 25 years.