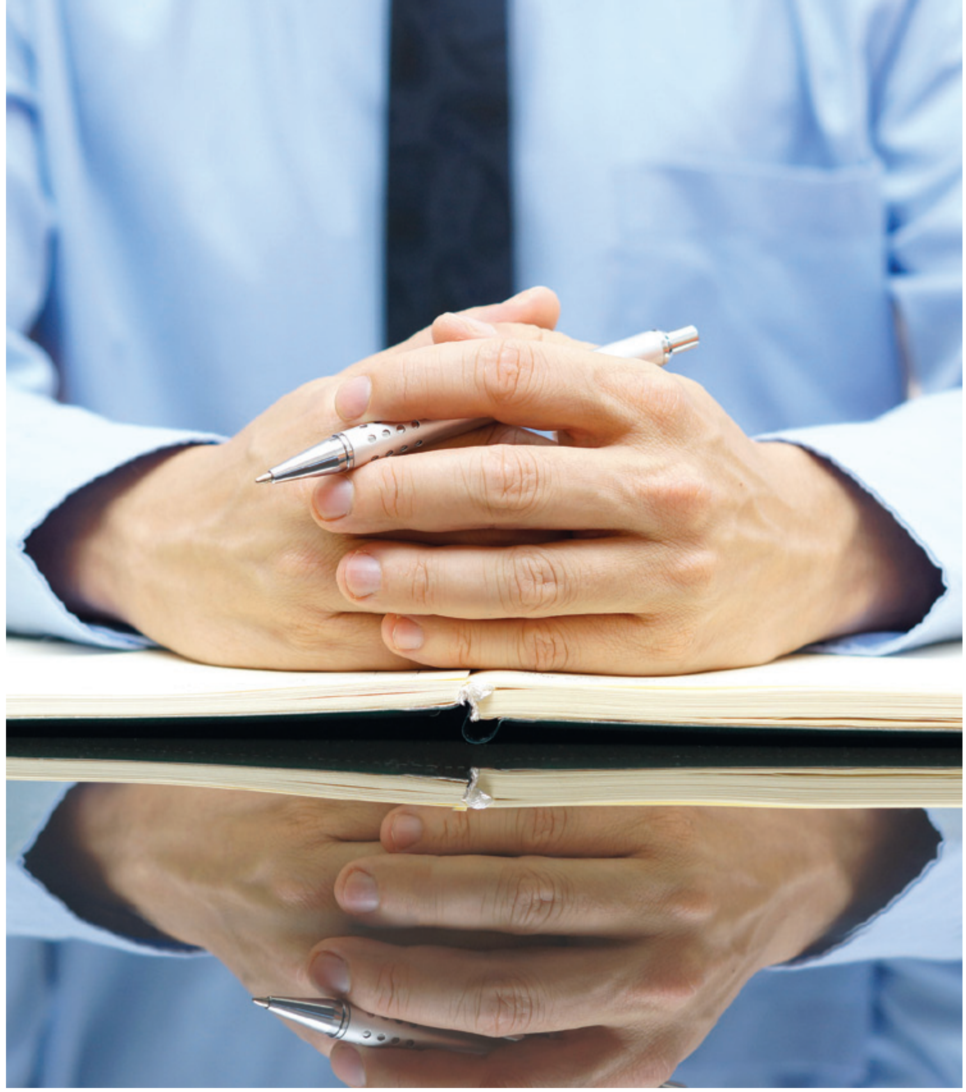

5 Fast Facts About Captives for Brokers

Editor's Note: This is the first of a three-part monthly series leading up to SIIA's national conference in October that is geared toward educating brokers and advisers on alternative risk transfers involving captive insurance solutions. The aim is to address any concerns and misperceptions, as well as better prepare them to answer client inquiries about these arrangements, particularly in small and middle markets.

There's no denying that brokers have tremendous depth of knowledge about a myriad of issues affecting their employer clients, but captive insurance solutions may not necessarily be one of them. The topic is not easily understood and can be prone to misconception. Here are five fast facts about captives for the broker community to consider, with key assists from **Jerry Messick**, CEO of Elevate Captives and **Martin Eveleigh**, chairman of Atlas Insurance Management, both of whom are members of SIIA's Alternative Risk Transfer Committee.

1. What They Do

The common denominator between captives and self-insurance is a quest for greater cost control beyond traditional insurance vehicles or fully insured arrangements and in most cases, the aim is to supplement coverages and increase deductibles.

Written by Bruce Shutan

Captive insurance companies, also known as special purpose insurance companies, are privately owned, legally formed entities that insure the risks of one or more companies owned by the captive's founders. Off-shore jurisdictions, many of which are in the Caribbean, represent one of three key worldwide markets alongside Europe and the U.S.

According to the Marsh Survey Group, U.S. companies own 57% of the world's captives, which comprise more than 20% of worldwide corporate P&C coverage and captives represent between $55 billion and $60 billion in annual premiums. More than 90% of Fortune 500 companies use captive insurance companies and all 30 companies listed in the Dow Jones Industrial Average index have captives, though there's growing interest among small and midsize employers to duplicate what their larger counterparts have done in this area.

There are many types of captives:

- Single-parent captives that underwrite only risks of related group companies.
- Diversified captives that underwrite unrelated risks in addition to group business.
- Association captives that underwrite the risks of members belonging to an industry or trade association as the name suggests.
- Group captives that underwrite the risks of a homogenous group of businesses that are otherwise unrelated.
- Agency captives that, also as the name suggests, insurance brokers or agents form and control so that members can participate in high-quality risks.
- Rent-a-captives that provide access to captive facilities with the help of insurance companies without members needing to capitalize the arrangement.
- Special purpose vehicles that reinsurance companies use to issue reinsurance contracts to their parent and a bond issue to cede risks to capital markets.
- Risk retention groups involving a "liability" only insurance company owned by its policyholders.
- Protected cell captives that separate assets and liabilities from a company's main or "core" assets.
- Enterprise risk captives that individuals form to provide insurance coverage for often unrecognized exposures that otherwise would reside on a corporate balance sheet.

2. Ideal Candidates

Captives aren't for everyone, but they do appeal to profitable companies that fit certain criteria and have proven to be an enormously powerful financial planning tool among small and midsize firms, which account for the fastest-growing segment of businesses using these programs.

CAPTIVE WORKSHOPS TARGET BROKERS *at* SIIA CONFERENCE

For a deeper dive into the nuts and bolts of captives, employee benefit brokers and advisers have an opportunity to attend several targeted workshops at SIIA's 35th Annual National Educational Conference & Expo on October 18-20th in Washington, D.C.

The world's largest event focused exclusively on the self-insurance/alternative risk transfer marketplace will feature an entire educational track on captives included among 40 sessions.

Three of the eight sessions on captives will be devoted exclusively to the broker community.

They include the following topics:

- What Brokers Need to Know About Stop-Loss Captive Programs
- What Brokers Need to Know About Property and Casualty Group Captive Programs
- What Brokers and Financial Advisors Need to Know About Enterprise Risk Captives

In addition, there will be a workshop explaining SIIA's more proactive approach on reacting to legislative or regulatory threats to captives that periodically surface, as well as highlight what has been done over the past year, what to expect in the years ahead and what role brokers can play in terms of wielding political influence.

Why Brokers Should CARE *About* CAPTIVES

In the film "Field of Dreams," Iowa farmer Ray Kinsella, portrayed by Kevin Costner, heard a voice that whispered, "If you build it, he will come." That line essentially sums up a key message to benefit brokers and advisers about the use of insurance captives for their employer clients.

Jerry Messick, CEO of Elevate Captives and a member of SIIA's Alternative Risk Transfer (ART) Committee, says if brokers do not bring captives to their clients as a value-added service, then it's highly likely someone else will.

Captives can provide them with "a dependable, consistent and low-friction, high-margin source of revenue" that doesn't require marketing to multiple carriers every year in continuously soft market or tremendous account management resources, he explains.

Indeed, these arrangements offer brokers a chance to "separate themselves in increasingly commoditized brokerage space," observes **Jeffrey Fitzgerald**, Vice President, employee benefits for Innovative Capital Strategies and ART committee member. He says captives also lead to "greater persistency and stability in renewal" and "create a safe space" for employer clients to share ideas and best practice with other owners.

With regard to renewal retention, brokers have an opportunity to grow their book of business by connecting clients with a program they feel invested in and "most employers who participate in captive programs stay for multiple years," adds **Michael Madden**, division Senior Vice President for Artex Risk Solutions, Inc. and ART committee member.

Ideal candidates include those with real risks or a need for risk management and commercial insurance, low-to-moderate frequency of risks with high severity, lines of coverage that are difficult to place in the commercial market and coverages that force high retentions (i.e., hedge fund errors and omissions).

Other candidates who stand to benefit include companies that have the need for "customized" policy language, $1 million or more in operating profits, a desire for asset protection, wealth accumulation and preservation in conjunction with a solid captive platform and businesses with multiple entities or ones that can create several operating subsidiaries.

In addition, captives will make sense for companies that would rather use their own risk capital than the price they would otherwise pay with commercial insurance carriers as a strategy to combat excessive prices, expenses or limited capacity associated with the traditional market. They also recognize that as these programs mature and more capital is accumulated, risk retention will improve along with the stability of prices and available coverages.

3. The Process

Captives involve a combination of risk assessments and planning. The first steps to forming a captive require that a risk review or feasibility study, along with an actuarial study, be conducted to assess whether the program will be a good fit for employer clients. It's also critical to formulate a business plan, as well as submit an application, formation and licensing to a state insurance commissioner. Another key component is to engage the administrative services of a third-party, while a qualified underwriter would identify suitable risks for which a captive can provide coverage.

When done properly, all of this legwork has the potential to pay considerable dividends down the road. It's important to remember that captives become profitable when legitimate risks that have a low probability of occurring are identified and insured, whereas insuring risks that

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Your credit card bill would show up in the mail stating nothing more than:

...that's it?

I bet you are on the phone within seconds.

You would DEMAND to know what the charges were for, whose idea it was to send out such a shady bill, and then you would get that person on the phone and tell them you are canceling the freaking card. As a savvy consumer you know the burden of proof falls on the retailer and not on you—so you have every right to ask for verification.

Of course they want to keep your business, so they kindly offer you 20% off of your bill.

Feel better? **ABSOLUTELY NOT!**

A discount on a bill with no details?

Double-shady.

You see where we are going. It is insanity; no one would put up with it. Guess what makes this even better? Just like that credit card, the burden of proof falls on the hospital, so why, for the love of common sense, is no one making that phone call?

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have a high probability of occurring would undermine the captive's financial performance and goals.

Here's an example of how a captive actually works. Let's say seven restaurant owners pay varying levels of premium as part of a homogeneous group captive retaining $250,000 of risk with a frequency fund covering all losses up to $100,000 per claim and severity fund handling losses of more than $100,000 up to $300,000.

One member with two claims of $62,500 each can expect a potential return of $65,000 since the claims are less than $100,000 and also less than the premiums allocated to the frequency fund. Another member with two claims at $150,000, which exceed the frequency fund limits and a third claim of $15,000 requires additional calculations. Frequency losses would total $215,000 (i.e., $15,000 + $100,000 + $100,000) while severity layer losses would equal $100,000 (i.e., $150,000 - $100,000 for each claim) – meaning total claims exceed the member's frequency fund premiums by $95,000.

The captive would pay the excess amount, but bill this member a loss experience charge at the end of the year. And while severity fund losses exceed the member's premium allocation, they would be shared among captive members within the severity layer in proportion to the member's allocation of the premiums within the fund, thereby ensuring that each member assumes proportional risk in the pooled layer.

4. Red Flags

By helping employer clients assess their need for a captive, brokers can ensure that red flags will be raised before any long-term commitment is made in error. Problems likely will arise, for instance, if the captive is only interested in tax benefits, there's no true meaningful risk to substantiate a captive and no independent development of premium charged, it makes immediate investments in life insurance and there's a captive domicile with little credibility.

5. Exit Strategy

It's critical for brokers to initiate discussions of an exit strategy up front and not in five years because the captive, as previously suggested, requires a long-term commitment from each of its members. Other steps related to an exit strategy include the need to establish an objective and model of perpetuity for partnerships (i.e., captive ownership mirrors firm ownership), agree to include the captive with the sale of a business, maintain the generational asset transfer via trust ownership and include "soft landing" depletion of assets with large claims payouts.

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