

“Alternative Risk Transfer Basics:  
How to begin to understand the issues surrounding captives”

During times of rising insurance premiums and difficulty in finding insurance coverage at all, insurance buyers have looked at captive insurance mechanisms and other alternative risk transfer techniques to help provide some options. The problem is that at times these concepts seem mysterious, overly complicated and are often sold as the “magic bullet” that will solve all of the issues facing buyers of insurance. The purpose of this article is to provide a basic primer on what captives are, the various types and the pros and cons of why they are used. Keep in mind that this information will barely scratch the surface of a broad topic but hopefully will allow firms evaluating these concepts to begin to frame questions that will help in deciding whether these concepts fit for them. Hopefully an understanding of the terms commonly used and some of the issues the Insurance marketplace is dealing with in 2002 will be helpful to firms deciding on what risk transfer techniques they should be implementing. Note that the taxation issues and the deductibility of premiums and expenses will not be dealt with in this article. This is a very complicated area that should be addressed with attorneys and accountants experienced in this area.

First let us dispense with some of the basic terms used when discussing captives. The following are descriptions commonly used:

- Captives: All types of captives are insurance companies that are owned by their policyholders usually created to insure their own exposures to loss.
- Single parent captives: Owned by one company and insures that company and its subsidiaries exposures.
- Group Captives: Two or more policyholders that are unrelated to each other own group captives. Heterogeneous policyholders or homogeneous policyholders can own group captives. Captive participants do not have to be in similar operations to join together in a captive. There are pros and cons to either approach.
- Fronting Insurance: Insurance policies are issued on behalf of captives through licensed insurance companies to meet state filing requirements and financial responsibility requirements. The fronting insurer is ultimately responsible for paying the claims through its policies and relies on reimbursement of funds from the captive and its reinsurance.
- Reinsurance: Provides insurance for losses in excess of what the captive can sustain for specific losses and aggregate losses (total losses paid out during a policy period for the captive).

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- Risk Retention Groups (RRGs) are groups that are formed as a result of the “Liability Risk Retention Act” in the mid-1980s. These groups are limited to providing insurance for liability coverages and do not include property, workers compensation or other non-casualty coverage. Several reasons why RRGs are formed is they can be a direct writing insurance company that have lower fixed expenses since a fronting insurance carrier is not required to issue policies. Special and unique coverage not available in the insurance marketplace can be provided through an RRG since they are not subject to state rate and form filings.
- Risk Based Capital: Captives are required to have financial capital beyond premiums. They are standalone insurers and must comply with regulations to insure that funds are available to meet the ultimate obligations of the policies issued on behalf of the captive.
- Domicile: Where a captive is licensed and formed. Popular off shore domiciles include Bermuda, Cayman Islands and Ireland to name a few. On shore domiciles are states that have enabled captive legislation to operate within the specific state. Vermont is very active in captive regulation and oversight. Many states allow captives. The reasons for choosing specific domiciles range from tax issues, types of coverage allowed, experience of the regulators, capital requirements, investment restrictions, etc.

Much has been written about the causes of the hard insurance market for property and casualty coverage for nursing homes and retirement communities that is going on right now. There is a tremendous amount of activity exploring the feasibility of alternative risk transfer methods for healthcare facilities. It is important to examine the pros and cons of the approach so there is not an overly optimistic analysis that a captive concept will solve all problems that the current insurance market cannot solve. It is important to always keep in mind that a captive is strictly a risk financing technique designed to pay claims and expenses on behalf of its policyholders. Some of the litigation trends that helped create some of the crisis for healthcare facilities, particularly in Florida and Texas, will not be mitigated by whether the risk financing is done through purchase of a risk transfer insurance policy or by participating in a captive mechanism.

There are many advantages to captives. The concept is designed to be a long-term solution for providing insurance coverage that is not entirely dependant upon the insurance company swings in the marketplace. The ability to dampen the external factors that affect insurance company decisions on how they allocate their risk based capital to

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maximize shareholder return can provide more stability to policyholders over time. Captives can be structured in a very focused approach to provide tailored services on clearly defined issues that are prioritized by the policyholders. The traditional captive approach to services has been an unbundled approach where service providers are chosen specifically for their expertise within their specialty. Claims services, loss control services, legal defense and captive services can be evaluated and negotiated separately.

The financial aspects of captives can be beneficial to the policyholders since the underwriting profit and investment income on cash balances including loss reserves are credited to policyholders accounts. The premiums charged by captives are not market driven (some policyholders suspect that the insurance industry is overcharging current premiums to cover prior years' shortfalls to recover losses as quickly as possible) but actuarially driven by analysis of the captive participants.

If homogeneous captives are formed the potential of partnering with facilities of similar mission and attributes can lead to intangibles of best practices among the group. The focus can evolve to the appropriate issues such as residents, standards of care and not just searching the marketplace for premium reductions. Alternative Risk Transfer can change the behavior of facility management and employees towards loss prevention and safe practices which can evolve into a stakeholder mindset. Specific compliance programs can be implemented across the captive group to achieve common objectives.

There has been significant movement into captives over the past 15 to 20 years and some projections of market share are that the captive premium volume exceeds 50% of total risk bearing premium in the United States. It is critical to balance the advantages of these alternatives with the downside of captives. Just as insurers fail because of mismanagement or improper utilization of capital captives have suffered the same fate. The key issue is that captives do not inherently eliminate exposures to litigation and claims although an increased focus on loss control and risk management can affect outcomes (that same focus can be applied in insurance programs also).

Part of the difficulty in forming a captive is establishing a large enough critical mass of policyholders with good loss and exposure data to establish an actuarial confidence in the predictability of outcomes for claims. Typically the starting point for

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forming a captive is in the \$5,000,000 range of premium even though some have launched programs as low as \$3,000,000. The lower the premium the higher the risk in forming a captive because of the statistical confidence of the potential outcomes. Remember that most captive programs focus on casualty and workers compensation lines of coverage rather than property coverage and excess umbrella liability coverage. The key is to assume losses within the working layer of the exposure (that portion that is predictable) and reinsure losses outside of the normal range of expectations while earning investment income on reserves held for future claim payments.

The attraction of underwriting profit is strong in forming a captive but there is no guarantee of profit and past performance does not predict with certainty future results but only provides an indication. That is a concept that a firm evaluating a captive concept needs to keep repeating, “ Analysis of past performance is no guarantee of future performance”. This is especially the case when there is unpredictability of legal trends occurring. In the face of changing perceptions of negligence in the healthcare arena this can create similar uncertainty that insurers are facing. The financial impact of profits is not realized immediately but over the long-term life of the captive. Usually underwriting profits are not returned to policyholders’ accounts until 3 to 5 years minimum. This requires ongoing capitalization of each policy year until underwriting profit begins to offset this obligation.

The investment income that is illustrated in captive feasibility studies should be reviewed carefully. The funds that need to be held in reserve are usually required by the domicile to be liquid and in short term instruments. Typically captives with cash balances of under \$20,000,000 perform under the market indices of insurance company portfolios because the flexibility to diversify funds is not available. Any investment income projection in this financial market over 3% is an aggressive assumption.

Start up cost of aggregating loss data, performing an actuarial feasibility study and performing a policyholder selection process can be costly. The key is evaluating who your partners are in a group captive concept. What are the requirements for participation and what are the demographics of the group? Is there a comfort level among the participants that there are common goals and values to be shared? Usually there is a joint

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and several liabilities among the participants within a group captive for the obligations of the captive. It is important to make sure that everyone is on the same page as far as expectations of the captive and the goals and objectives to which everyone is committing their organization.

Another issue to consider in participating in a group captive is the logistics of participating. Usually there is a common expiration date which could require a mid term cancellation of a fully insured program. Are there cancellation penalties? What are the claim reporting provisions for liability? Are there coverage gaps or changes in terms and conditions? Can property coverage be obtained on a standalone basis at the same level of cost? Can all of the filings be met through a captive mechanism for governmental agencies? The cost of defense for losses is generally treated as a supplemental expense not included in the loss amount for fully insured programs. It is important to factor that into the perception of what an insurer is actually paying rather than looking at the amount of incurred loss on a claims report. Under a captive mechanism the responsibility of funding the defense cost is included, which the policyholder is responsible for in the loss retention in the policy.

The expenses within the cost structure of a captive traditionally range from 30% to 40% of premium. The balance of the premium is used to pay claims and earn investment income. Components of the expense include the Fronting fees to an issuing insurer, Reinsurance (Specific and Aggregate), Captive management fees, Underwriting expenses and actuarial services, Claims handling, Taxes and Loss control services. The ability to set the premium to have the net amount after expenses cover the expected incurred losses of the group in a predictable manner is what ultimately drives the success of the concept. The long-term commitment is essential of the policyholders because the potential gains are only realized over the long haul. If the captive mechanism is looked at as a short-term marketplace solution until insurance premiums drop below the captive costs it is not a formula for success.

There are considerations to evaluate in this current marketplace. The reinsurance marketplace that is driving insurance companies' premiums for healthcare facilities will impact the fixed expenses and the capital requirements of captives. Reinsurance

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companies are also looking to provide much higher attachments to projected incurred losses. The ability to totally withdraw from the insurance marketplace via a captive is not there right now.

The traditional fronting relationships of the past where an insurance company rents its policy to a captive for a small fee are coming under scrutiny. The availability of “pure fronting” relationship is shrinking. Most insurers are looking to participate in the exposure through both underwriting disciplines and premium sharing. This will impact the potential savings to captive participants. The overriding concern is the credit risk of captives and reinsurance receivables to which fronting carriers are exposed. As noted earlier, investment income is very low in this market also which impacts captive profitability.

The key issue is to balance as objectively as possible the potential solution that a captive approach can bring with the risk reward of participation. Keep in mind that for many entities the ability to transfer risk to a third party rather than forming their own insurance operation is still a feasible option. Captives can be a very effective tool for risk financing but very careful analysis and a clear understanding of all of the issues surrounding the transaction is critical to the ultimate success of the venture.