Managing the Cost of Corporate Risk Through Captive Insurance Solutions

Published by The Self-Insurance Educational Foundation, Inc. in cooperation with The Self-Insurance Institute of America, Inc. www.siia.org

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Introduction

Companies face exposure to financial loss due to unforeseen events. Most companies mitigate a portion of this risk through the purchase of insurance. The most common approach is to purchase risk-specific insurance policies from commercial insurance companies. The employer trades the certainty of a small known loss (the premium) for the promise of the insurance company to pay a contingent, uncertain loss.

Increasingly, many small and mid-sized companies utilize another viable risk-financing option that can offer numerous advantages: captive insurance companies. A large percentage of employers have chosen to finance a portion of their insurance risks through captives. Lines of business include workers' compensation, auto liability, property, general liability, employee benefits, and others.

A captive insurance company is nothing more than an insurance company that provides insurance or reinsurance coverage for the risks of its owners. A captive is capitalized, writes insurance or reinsurance premiums, and pays covered claims. Additionally, assets, including loss reserves, are invested, generating investment income for the captive.

While there are nearly as many reasons to form a captive as there are captives, some of the most prevalent reasons are:

- **Reduced Costs:** An employer typically knows its own risks better than a traditional insurance company. A captive may allow an employer to retain a portion of its risk, and reap the benefits of any underwriting income and investment income.
- **Lack of Capacity:** At certain points in the insurance market cycle, some lines of business for some industries (e.g. environmental liability for oil rigs in the Gulf of Mexico) may not be available from commercial insurance companies. A captive may provide the only (or only affordable) coverage.
- **Tax Efficiencies:** An insurance company is typically allowed to take a deduction for loss reserves. This permits an insurance company to more closely match the timing of revenues and expenses, and also allows for the partial deferral of taxes. A captive may allow an employer to receive these same benefits.

Captives continue to proliferate and evolve in sophistication. This publication provides a brief overview of captive insurance companies, and provides real-world examples of successful captive programs.

Captive Overview

A captive insurance company is a broad definition for an insurance company that insures the risks of its owners. Large corporations have used captives for many years, typically in the property and casualty lines of business. Captives continue to displace commercial insurers in some markets as more employers utilize a captive, and the range of exposures insured by captives continues to broaden. Captives have become a viable alternative for smaller organizations through the creation of group captives and Risk Retention Groups.

The Self-Insurance Institute of America, Inc. (SIIA), a non-profit association that represents companies in the self-insurance/ alternative risk transfer marketplace, has compiled and published all of this information.

Commercial insurance is a convenient and cost effective means of financing risk for small to mid size organizations. The purchase of insurance is driven by an aversion to volatility. As a company grows larger, or as more companies pool their risks, volatility typically decreases. A captive can be viewed as a formalized self-insurance program where the owners retain the least volatile portion of risk and continue to purchase traditional risk transfer of the more volatile portion of the risk. The captive becomes the vehicle through which the less volatile (or more predictable) risk is financed.

There are a number of types of captives, which typically reflect the ownership structure of the captive. Typically the companies fall into three main categories:

1. **Single Parent (or Pure captives)**
   These companies are owned by and operated for the benefit of a single parent company. This category is the largest type of captive (as measured by the number of captives).
2. **Group Captives**
   These captives cater to smaller employers and are owned by and insure a group of entities or individuals who typically have similar risks. Association captives, Risk Retention Groups and reciprocals fall into this category.
3. **Rent-A-Captive**
   These captives enable an organization to insure their risks in a captive owned by an unrelated entity for a fee. This type of arrangement is appropriate for entities who are either not large enough to establish their own captive or who want to use it as a "stepping stone". These include 'protected cell' or 'segregated account' companies.

Advantages of Captives

One of the benefits of a captive is the ability to tailor the scope of the captive operations to the unique needs of its owner(s). The advantages of a captive will differ for each application and owner however two of the most common advantages are control and cost.

Control

A number of factors allow an organization to take greater control of their risk financing:

1. **Coverage availability and flexibility.**
   a. Provide coverage when commercial insurance markets will not provide certain types of insurance or may charge unreasonably high premiums.
   b. A captive is not subject to the same degree of regulation that commercial insurers face and has more flexibility in the type of coverage it provides.
2. **Control of essential services**
   a. The captive owner(s) retains control of administrative functions including underwriting, investment management, and claims management.
   b. Risk management and loss control services can be focused on the unique needs of the parent organization and incorporate specific experiences into training.
3. **Control of data**
   a. Accurate and complete data is a critical element of successful risk management. A captive owner can decide which data to collect and is not subject to the limitations of the information management systems of the commercial carriers.
   b. Comprehensive data provides a firm basis for loss projections and can help with reinsurance pricing negotiations.

Cost

A captive can provide a new profit center for an organization while providing predictable pricing.

1. **Stability of insurance costs**
   a. The captive allows an organization to realize insurance costs that are more closely related to their own loss experience and minimize fluctuations from year to year.
   b. Operational expenses that are included in insurance premiums can be controlled and negotiated separately.
2. **Direct access to reinsurance markets**
   a. Reinsurers typically have lower operating costs than commercial insurers and may be able to provide reinsurance coverage that more closely matches the needs of the captive owner.
3. **Tax savings**
   a. Tax savings have become less important to captive owners however some long tail lines of coverage may reduce the tax liability of the captive.

The ultimate goal is to leverage these advantages into a business advantage that will enable an organization to compete more effectively in its core business.

Disadvantages of Captives

A captive insurance company may have some negative consequences for an organization, which can include:

1. Need for dedicated internal resources and their associated costs. These costs include time spent by management on oversight of the captive that could be spent on the core business along with travel and other related costs.
2. Capitalization costs include monies contributed to capitalize the captive along with the cost of Letters of Credit and the funds necessary to support them.
3. Service provider dependency. Most jurisdictions require a captive to employ an approved captive management company and other service companies such as auditors and accountants necessary to comply with the financial and licensing requirements.
4. Need for a fronting company and the associated costs. Captives may find themselves requiring a fronting company in order to issue policies in certain jurisdictions. These arrangements require a fee to be paid to the fronting carrier and may require additional collateral to support a program.
5. Possibility of worse than expected claims activity and inadequate loss reserves, which require the diversion of funds from operating activities to strengthen the captive balance sheet.

These potential disadvantages should all be considered in the initial feasibility study for the captive in order to properly balance the perceived advantages.

How to Determine the Viability of a Captive Insurance Program

Most all states require the submission of a business plan as a part of the application process. It is this business plan that will lay out all aspects of the proposed captive program and will be the fundamental document used by the licensing state to assess its future viability. The typical elements of a captive business plan are:

- Program Objectives and Summary
- Plan of Operations
- Listing of Service Providers
- Underwriting Guidelines
- Actuarial Pricing Study
- Pro-Forma Financial Projections

It is the pro-forma financial projections that will indicate the overall financial viability of the program. Some states require that these projections be prepared by a Certified Public Accountant. Others will allow the projections to be prepared either by a CPA or a qualified actuary. Financial projections normally include both expected case and adverse case scenarios. The adverse case scenario allows the state to see exactly how much surplus strain the captive can withstand before it falls below minimum capital and surplus requirements.

Financial ratios play an important role in judging the overall viability of a captive program. The National Association of Insurance Commissioners has developed the so-called IRIS ratios to test the overall financial strength of property and liability insurance companies. One of the more important IRIS ratios that will be applied by the captive regulator is the premium to surplus ratio. This ratio measures the surplus capacity of the captive by comparing it to the net premiums written. For example, many captive programs require that the financial projections show a premium to surplus ratio of 3:1 or less. That is, the maximum amount of annual net written premium cannot be more than 3 times the captive's combined capital and surplus. The regulator may also apply other tests of capital and surplus adequacy.

It is important for the captive owner to understand that most measures of financial viability of any insurance program hinges on the adequacy of capital and surplus. While this may not be the case in other forms of business enterprises, in the insurance business it is critical. Depletions of capital and surplus below regulatory requirements will demand that such deficiencies be quickly replenished. If not, the captive may suffer serious consequences from its regulator.

Another important element of financial viability is the existence of a good reinsurance program to back up the captive in the case of unforeseen losses. Most captive programs will commence with a traditional excess of loss reinsurance program, in which a reinsurer will accept responsibility for losses that exceed the retention layer assumed by the captive. Regulators must approve the reinsurers that stand behind a captive program.

Operational viability of a captive program will depend on the following:

- Board structure and involvement with important governance and oversight functions. Board oversight typically includes appropriate committees (e.g. Audit, Underwriting, Claims, Investment, etc.).

- Management experience. Captives may be managed by outside parties such as contract program managers, managing general agents, etc. Alternatively the captive may elect to employ its own chief executive who will in turn deploy the necessary personnel and systems required to conduct efficient management. Many captives have suffered greatly by employing contract managers or executive staff who do not possess the required expertise in the management of insurance activities.
- Professional service providers. Experienced independent auditors, actuaries, captive managers and attorneys are a requirement of most captive regulators. In addition contract claims managers (called TPAs), underwriters, risk managers and reinsurance brokers may also be required or recommended by the regulator. As in the case of selecting experienced and qualified management, the selection of qualified service providers can make (or break) a captive program.
- Sales and marketing. For pure captives, sales and marketing is normally not a critical function. However for group captives and Risk Retention Groups (RRGs), sales and marketing is usually extremely important to the viability of the captive program. Captives (especially RRGs) may either write direct to the market or employ licensed agents and brokers. In the case of the utilization of agents and brokers (called producers), the importance of the selection of producers with direct experience in the line of insurance to be sold by the captive cannot be overstated. Many group captives and RRGs were never able to reach their potential simply because of the inability of the captive to successfully bring the program to market.

Once a captive has become operational, it is the important internal control functions that will ensure that the program stays on track. Such internal controls should provide for comparisons of actual results to the business plan. As goals and objectives are not met, the captive's management will require the experience and flexibility to implement necessary changes in operations to assure the future viability of the program.

Getting Started to Create a Captive/RRG

Feasibility Study

Forming a captive is fairly straightforward. A captive is a business, and like any new business, it should be subjected to a rigorous analysis of the costs and benefits, pros and cons. The feasibility study should not be thought of as 'something the regulators require' but as a dynamic document that is the mechanism used to explore, validate, and refine the approach. Many companies hire outside service providers to help compile the feasibility study, but the sponsoring organization will do itself a disservice if it is not thoroughly engaged in the process.

Choose a Domicile

A captive is a licensed, regulated insurance company. There are multiple states that will license and regulate a captive, and there are also many international countries that also provide these services. The choice of a domicile is driven by a number of factors, including, but not limited to, line of coverage, type of captive, geographic proximity/attractiveness, and regulatory environment. Captives typically meet with more than one domicile in an attempt to refine the selection.

Choose Vendor Partners

A new captive is rarely fully self-managed and therefore relies on professional service providers to operate the company. The types of vendors include, but are not limited to, attorneys, accountants, actuaries, investment managers, and program managers. The captive industry is mature and there is a large availability of quality service providers. Some captives prefer to make selections based on recommendations of their peers or insurance advisors, while others prefer to engage in a more formal bid solicitation process.

Application Process

Once the business plan/feasibility study is completed, a domicile chosen, and service providers selected, a company can apply for a license. The application process varies by domicile, but it is typically focused on the financial viability of the captive. Regulators will often stress test the captive's assumptions, to ensure that the captive can continue to operate safely, even if all assumptions do not turn out to be accurate. At the end of the application process, a captive is capitalized, granted a license, and permitted to begin operations. The application process can take as little as a month and it can also extend to over year.

An Introduction to Captive Insurance Success Stories

In the preceding pages you have read how captive insurance works and the advantages it offers to employers who wish to take a more proactive approach to managing the cost of risk. We would now like to introduce you to several captive insurance "success stories" to illustrate how captives are utilized in the real world.

While these stories were peer-reviewed by members of SIIA's Alternative Risk Transfer Committee to help ensure accuracy, because of confidentiality restrictions, SIIA/SIEF cannot independently verify the validity of some specific information included as part of the stories. In this regard, SIIA/SIEF does not explicitly or implicitly endorse any of the entities referenced in the following stories.

With this disclaimer provided, we do believe that you will find these success stories to be very interesting and help you better understand the potential uses for and benefits of captive insurance programs.

Creative ART Builds and Buoys California Homebuilders' RRG

If timing is everything, a few sympathy cards should be heading toward Preferred Contractors Insurance Company (PCIC), a risk retention group for homebuilders in Carlsbad, California. Even the pleasant environment of that San Diego County beachfront community couldn't shield PCIC from the worst housing crash in U.S. history.

But the success of PCIC in apparently being able to ride out the recession can be traced to its unique and inventive structure of alternative risk transfer. Applying the most advanced ART forms has enabled the young RRG to succeed in an economy where others have failed.

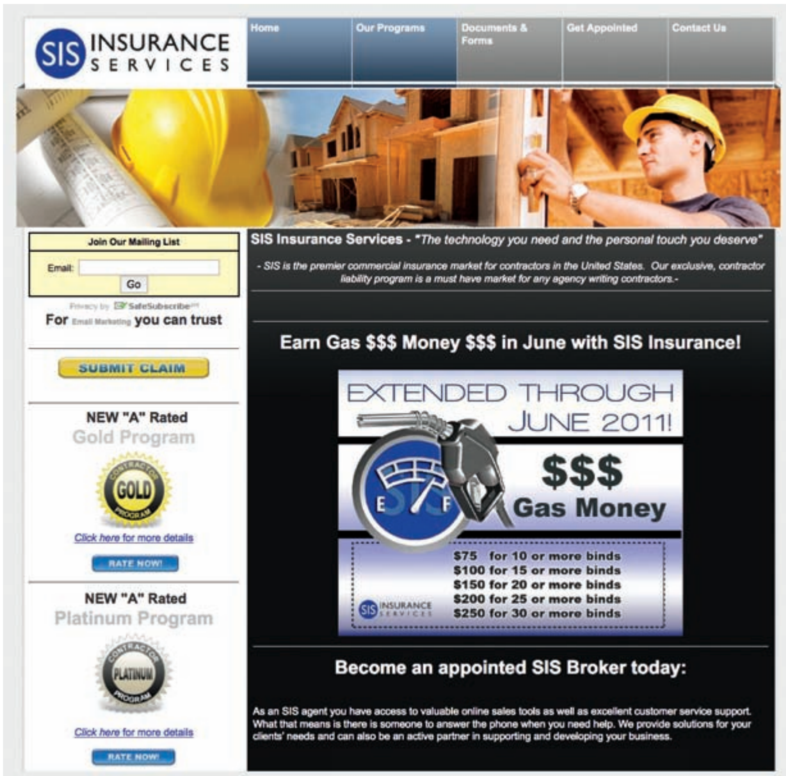
PCIC was licensed in Montana in 2006 and quickly attracted members, now nearing 10,000 contractors in 21 states. The total premium for succeeding years has been a model of consistency: $10.6M in 2007, $11.6M in 2008 and $11.0M in the worst housing crash year of 2009. And all the time remaining below a 3:1 premium to capital & surplus ratio.

"We had to think outside the box even while the business of our members is building them," says Dave Pike, CEO of SIS Insurance Services, the management company that administers PCIC.

If the ART components employed by SIS were viewed as a homebuilding blueprint, they would appear as a foundation supporting several structures:

PCIC RRG – SIS worked for more than two years to form the primary risk retention group after the firm had served as a wholesaler for an earlier-established RRG. "We saw that model as an attractive business and made a couple of false starts before working with the Taft Companies," Pike said. Taft, a captive management firm based in Baltimore, guided PCIC in becoming licensed in Montana as a risk retention group.

Reinsurance – Insuring excess possible losses by PCIC members proved problematic in the traditional reinsurance market because of California's litigious reputation for housing defects claims as an example, plus it being a startup program. And SIS preferred not to be just a sales arm for PCIC members' excess insurance, but to have "skin in the game." Goff designed a separate captive, Pacific Re owned by SIS, which would take a 60% layer of PCIC members' $250,000 retention. Preferred Risk Intermediaries sourced excess coverage above $250,000 to $1 million, and in further $1 million increments to a $5 million cap from a London consortium of Lloyd's and British companies.



Protected Cells – Under licensing as a protected cell captive, "silos" may be established to separate insured entities from the losses of other insureds or the captive as a whole. For example, Pacific Re protected cells are owned by qualifying PCIC agents and wholesalers who are able to form their own PCIC component. "These firms are able to establish a reinsurance cell of the PCIC program for themselves without the major investment, bureaucratic hoops or delays attendant to formation of a new RRG," said Phil Salvagio, chief operating officer of SIS.

Preferred Contractors Association – PCIC issues master policies to this trade association providing liability insurance to each of its separate small contractors groups comprised of artisan firms in services such as HVAC, carpentry, concrete, door/window installation, drywall, electrical, masonry, tile, painting and others. SIS offers coverage to these members for $1 million per occurrence for a flat annual premium of $750.

To stretch the homebuilding analogy, even the best structure won't succeed without the right interior features. SIS has simplified its online application process at www.sisinsure.com. Agents or wholesalers are able to apply, receive quotes and execute binders during their first visit to the website.

"When people call us they don't talk to a robot voicemail system," Salvagio says. "We know we have to be responsive because we can only be as successful as the clients who are working with us."

SIS also offers a workers' compensation program for California members along with commercial vehicle insurance. "We're all from retail agency backgrounds and would have done just fine," Pike said. "But with the opportunity to start a significant multistate insurance company through an ART structure we have built something that we never could have attained otherwise."

"When people call us they don't talk to a robot voicemail system. We know we have to be responsive because we can only be as successful as the clients who are working with us." – Phil Salvagio

Student's Dream Finds Reality In Nonprofits' RRG Network

Some businesses are founded after years of strategic planning and development. Others spring fully-realized in their creator's mind, maybe as a brainstorm during a homework assignment. Some take both launching pads, as the reader will learn.

It may be a gross simplification to equate a master's thesis at UC-Berkeley with "homework," but that was the experience of Pamela Davis as she pursued her master's degree in public policy at the University of California's flagship campus in the mid-1980s.

"My thesis had to be about a real client's problem, not just something theoretical," Davis recalls. "I learned that there was a foundation looking for someone who could research and write about the terrible difficulties nonprofits were having obtaining liability insurance. The foundations thought something was wrong with the nonprofits, but I found that it was the fault of the commercial insurance companies."

Without any prior experience in insurance or risk management, Davis proposed in her thesis that instead of relying on commercial insurance companies that were inconsistent in their willingness to provide affordable insurance (especially during such a hard market as was experienced in the 80s) the nonprofit sector actually could take control of this important financial service, and make sure they were paying their fair share and no more. Further, her dream was to engage nonprofits in risk management by providing a variety of free or highly subsidized management services as part of the insurance purchase.

That is exactly what has happened. Davis now heads the Nonprofit Insurance Alliance Group, comprised of a charitable risk pool for nonprofits in California, a risk retention group under the federal Liability Risk Retention Act (LRRA) for nonprofits outside of California, and a captive to reinsure property and auto physical damage. Together they insure 10,000 nonprofit organizations in 26 states and DC. She is president and chief executive officer of the following nonprofit companies based in Santa Cruz, California:

- The Nonprofits' Insurance Alliance of California (NIAC), founded in 1989 and now serving more than 7,000 nonprofit organizations in California. It is rated A VII (Excellent) by A.M. Best with $184 million in assets and $17.1 million dividends paid to members since 2007. It is expected to exceed $100 million in surplus this year.
- The Alliance of Nonprofits for Insurance (ANI) Risk Retention Group covering 3,000 nonprofits in 25 states and DC. It was founded in 1999 with $10 million in funding shared by the David and Lucille Packard Foundation and the Bill & Melinda Gates Foundation.
- The National Alliance of Nonprofits for Insurance (NANI), a captive reinsurer. It reinsures property and auto physical damage for NIAC and ANI members.
- Alliance Member Services (AMS), which serves as the supporting organization for the others. It provides all products and services at cost, and is essentially a zero-profit nonprofit. AMS has a wholly-owned subsidiary that acts as master broker for the property and accident coverage to the nonprofits.

But before any of that, as a newly minted Master of Public Policy in the late 1980s, Davis had to pull together a business plan and gain startup funding – and, of course, survive an earthquake.

"I didn't know anybody in the business and I had never read an insurance policy," Davis recalls. "Twenty years ago there wasn't anyone doing this. I found an actuary who would make some wild guesses and a reinsurer who would take a gamble with me." She worked two years to gain financing including $1 million in loans from the Ford Foundation and six other California foundations.

Finally, in the fall of 1989 she made the leap to founding NIAC in a small Santa Cruz office. She was moving boxes and computers into the new office on October 17 when the building started to shake violently and the power went off. That was the earthquake that interrupted a World Series game just north in San Francisco, and destroyed many Bay area buildings and highways. Santa Cruz was the epicenter.

"Nothing was really damaged in our office and we found a Pacific Gas & Electric service man who restored our power in three days," Davis remembers. "We wrote our first policy two weeks later on November 1 and we have turned a positive net income every year after the first full year."

But a major obstacle was still ahead. The federal tax status of a risk pool comprised solely of tax-exempt charitable nonprofits was unclear. California had granted NIAC state tax exemption, but not the IRS. NIAC challenged the IRS in federal Claims Court to clarify its federal tax position. "The Claims Court found against us and said the law was unclear and that Congress needed to clarify it," Davis says. In response to that decision, California retroactively revoked NIAC's state exemption and sent a tax bill for more than NIAC had ever made. (The state treated NIAC as a corporation, not an insurer, and disallowed reserves.) Suddenly her company faced life without either federal or state tax-exemption and a looming multi-million retroactive tax bill from the state. What's a young entrepreneur to do? This one mounted a years-long campaign for an act of Congress that would firmly establish her organization's tax-exemption.

"We couldn't afford a lobbyist for the first few years," she says. "I built up lots of frequent flier miles back and forth to Washington. In 1996 we sensed that a tax bill might move and I visited a top DC lobbying firm and said 'I can't afford

you but this is a great issue for you to be involved in as a public service.' One of their top people took us on for a bargain basement fee because, she told me, 'We don't get many chances to do something this good.'"

The new law governing the tax status of charitable risk pools for 501(c)(3) organizations, clearly including NIAC, was enacted on January 1, 1997. Davis then had to immediately turn around and lobby California for another year to get legislation passed to enable the state to re-grant NIAC's tax-exempt status. Davis commented that she was so cocky after the federal legislative win (and so out of money to spend on lobbyists) that she handled the California bill herself. One senior legislative aide in Sacramento told Pamela that it was the most expert handling of a bill he had seen in 20 years.

Now Davis manages a nonprofits' self-insurance network that extends coast to coast and continues to grow. Tellingly, the $10 million investment in surplus by the Packard and Gates foundations was never spent, and has grown by an additional $20 million.

Captive Success Stories

Archway Group Captive Eliminates Concern About Market Fluctuation

Some critics of the captive insurance concept contend that the expenses of forming and operating a captive aren't justified over periods of market fluctuation that can average out in favor of commercial policies.

"The great thing about the captive is that market fluctuation is never part of the equation," counters Rob Forsyth, president of the company that operates the MotoMart chain of gasoline and food centers in six Midwestern states and a member of the Archway Insurance Ltd. group captive for 15 years.

"We've had good years with single-digit loss ratios and bad years with high losses and in every case the captive is a better way to insure," Forsyth says. "I've forgotten all about market fluctuation because it no longer matters. Members of Archway can easily save $200,000 to $300,000 a year in premiums by controlling their losses and managing their claims effectively."

Forsyth has served in many volunteer positions including president of the George Town, Cayman Islands, based Archway, which is currently comprised of 95 members in 22 U.S. states. His company, based in Belleville, Illinois, led the trend that transformed gas stations into highway oases with convenience stores, prepared foods often provided by a quick-service national chain, and some with a car wash.

"Most of the members of Archway aren't in my same business, but the good thing is that we all have workers' compensation issues to solve, we all have vehicles to insure and most of us have general liability to consider," Forsyth says. "Archway's loss control training and processes have improved the operation of my business tremendously."

Archway members' policies are issued by the Hartford. Archway reinsures Hartford for a primary $350,000 coverage layer that includes workers' compensation, commercial automobile and physical damage, and general liability. Reinsurance for excess losses is provided by the Hartford and by Ace Tempest Re.

"Archway was established in 1994 as a solution for middle market businesses who did not have the capability of forming their own captive. Through a group captive program they can gain many of the risk management advantages of Fortune 500 companies," says Denis Wiener, senior vice president and principal of consultant firm Captive Resources, LLC of Schaumburg, Illinois. These include improved cash flow, return of underwriting profits and investment income on loss reserves, and direct access to the reinsurance marketplace.

Wiener points out that the captive's long-term cost control strategies have the extra benefit for members of avoiding insurance market cycles. Even in the recent softening commercial market Archway has enjoyed its greatest period of growth. In the most recent five-year period membership has grown 69%, average annualized premium is up 27%, total assets have increased by 35% and dividends of more than $18 million have been distributed to members.

MotoMart President Forsyth relates that while he has served in various volunteer capacities including a term as the captive's president, he has always maintained touch with progress of the loss control committee. He says that Archway's risk control strategies have resulted in MotoMart locations becoming safer for employees and also cleaner and more attractive for customers.

Archway's program includes frequent member loss control site visits by the captive's risk control provider

"Most of the members of Archway aren't in my same business, but the good thing is that we all have workers' compensation issues to solve, we all have vehicles to insure and most of us have general liability to consider." – Rob Forsyth

Gallagher Basset Services as well as semi-annual workshops that focus on training in risk control and claims management. Members conduct a peer review of all members' risk control data at their regular Board meetings. Claims information is web-based, which allows all members to remain current with their losses, and is updated in real time.

"The Archway program provides great incentives to do what the business should be doing anyway to control losses," Forsyth says. "The kicker is the financial rewards. Every other form of insurance can provide dividends for low claims, but in the commercial programs you're playing according to their formula. In the captive, you're not limited by somebody else's idea of rewards."

MotoMart has a long history of self-insuring employee benefits under an ERISA plan, and sought the same kind of program to manage other risks, Forsyth relates. "Self-insurance was clearly a superior method for benefits and I wanted to find that same kind of control for other aspects of the business.

"No matter what kind of losses you have in a given year you're at the mercy of the carriers to renew commercial policies," he says. "After a bad year for losses your premiums go through the roof."

Forsyth was among the first company executives to join Archway after it was formed in 1994, "Archway was created from the need of businesses to obtain adequate insurance coverage at an affordable cost," according to a statement in the firm's 2009 annual report that continued: "The original members perceived that the commercial insurance market was not responsive to their needs, and provided little information about internal costs and profits."

Archway operates with unbundled services, according to consultant Wiener of Captive Resources. "If members aren't happy with a service provider they can ask us to resolve any issues or ultimately find another provider," he says. "That makes all the service providers accountable for member satisfaction." Fortunately, Archway enjoys long term relationships with its service providers, thus providing stability of services to the Archway members.

After 15 years Forsyth says that MotoMart is committed to the group captive concept long term: "The end result of belonging to Archway is that I have controlled a cost that is otherwise uncontrollable," he says. "It's a good feeling to know that I'm earning my salary on one aspect of my business while also improving my company from top to bottom."

AEIX Helps Hospitals Reduce Medical Malpractice Exposure

Risk retention groups have largely been credited with reining in the medical malpractice crisis of earlier decades by providing a self-insured alternative that solved the challenges of price volatility and limited availability of commercial insurance. A current example is found in the American Excess Insurance Exchange (AEIX) risk retention group that provides excess coverage

A 20-year founding member of AEIX is Fairview Health Services of Minneapolis, a $2.8 billion company that includes hospitals, physician groups, long term care facilities, in-home care services, managed care and the University of Minnesota's academic hospital.

"If it's in the health care arena we're doing it, and prone to all the risks associated with that," says Jim Fox, Fairview's senior vice president and CFO. Fox says that Fairview has been self-insured since 1975 as it responded to the challenges of medical malpractice insurance.

Self-insurance and being part of a risk retention group such as AEIX should not be viewed as quick-fix strategy according to Fox: "Anybody in self-insurance, captives or risk retention groups must have a long-term commitment – a fundamental philosophy to manage costs and funding over a long period of time."

Along with the positive economic benefits of RRG participation (each insured entity shares in ownership of the company), Fox believes that a major consideration is being able to manage claims on a long-range basis. "AEIX manages claims and develops programs to work for better clinical results to reduce our risks," he says. "These are areas where a lot of money can be saved."

AEIX is licensed in Vermont and managed by Premier Insurance Management Services, Inc., a division of Premier Inc. based in Charlotte, North Carolina. Premier is a performance improvement alliance of more than 2,400 U.S. hospitals, sharing information from one of the nation's largest healthcare information repositories and providing a leading healthcare purchasing network.

AEIX wrote $29 million of premium this year for 19 member hospital systems. The member hospital systems operate approximately 95 hospitals and 18,000 facilities located in 21 states. Assets at year-end 2009 were $392 million with a surplus of $165 million.

The financial stability of AEIX is a major factor in the improvement of members' risk profiles according to Carl Herde, vice president of finance and CFO of Baptist

"These new-found relationships, in organizations other than my own, have provided me the opportunity to make improvements with numerous initiatives as the membership has provided me with a different group of peers that I wouldn't otherwise have been able to access." – Marcie Williams

Healthcare System of Louisville, Kentucky, whose five hospitals comprise the state's largest healthcare provider.

Herde says that for his organization medical liability is relatively stable compared to historic levels. "We have had good claims experience over the last several years," he says, adding that prospective members in AEIX must exhibit strong risk management programs and a proactive approach by management. Herde is a member of the Finance Advisory Committee that manages both excess surplus distribution and investments of capital.

"Short of national tort reform things are going about as well as we can expect," Herde says. He notes that savings on liability claims have been achieved in recent years due to quality improvements in the areas of obstetric care and emergency department services.

Member-owners of AEIX decided to devote part of their surplus to quality improvement programs for better patient care and to reduce liability risks. They invested $1.6 million in a Perinatal Safety Initiative based on Premier's nationwide information network, and followed that with an investment of $1.35 million for the ongoing Emergency Department Safety Initiative. AEIX members thus share quality improvements that may otherwise be eliminated from hospital operating budgets due to cost pressures shared by all healthcare systems.

The Premier Alliance Perinatal Safety Initiative is composed of AEIX member-owners, 16 of the country's leading hospitals where 115,000 babies will be delivered over the course of the collaborative. The initiative, which will run through June 2013, seeks to significantly lower the incidence of certain infrequent, though serious, injuries that could result in a wide range of harmful outcomes.

Through the first phase of the project (2008-2009), participating hospitals reduced birth trauma by 11.6 percent, reduced birth hypoxia and asphyxia by 31.4 percent and reduced the Adverse Outcome Index (AOI) by 6.4 percent against the baseline period. The AOI measures the number of deliveries with one or more of the identified adverse events as a proportion of total deliveries.

The Perinatal Safety Initiative has been especially important to Texas Health Resources that operates 13 hospitals and is the healthcare market leader in the Dallas-Fort Worth metroplex.

"Two of our hospitals were included in the Premier collaborative and we were able to take the evidence-based practices and lessons learned to adopt in all our units in order to improve patient outcomes," says Marcie Williams, vice president of safety and risk management.

An important benefit of AEIX membership has been improved communication between the clinical and financial sides of risk management in healthcare institutions, according to Williams. "These new-found relationships, in organizations other than my own, have provided me the opportunity to make improvements with numerous initiatives as the membership has provided me with a different group of peers that I wouldn't otherwise have been able to access," she says.

AEIX members become natural colleagues and allies in adopting quality improvement and loss prevention methods, according to Williams: "As we are member-owned, we're all vested in the process and in sharing quality improvements," she says.

In addition to the obvious financial benefits of stable premiums and participation in surplus, AEIX illustrates the value of risk retention groups being established by Congress as self-insuring groups of homogeneous businesses or professions. Member-owners learn from each other, and share the returns of their team approach to raising quality and preventing losses.

Advanced DC law spurs growth of ASAE captive

A captive insurance law in the District of Columbia that lets captives segregate risks in separate protected cells allowed the American Society of Association Executives (ASAE) to preserve – and then dramatically expand – its program of sponsored insurance for associations and nonprofit organizations.

"We call it our 'save money and make money' program," Dixie L. Arthur, president of ASAE Business Services Inc., says of the ASAE Insurance Co. (AIC) which was formed in 2003 to provide liability coverage packages for association-sponsored insurance programs, including two of its own programs: one for the association office package and one for directors and officers liability.

The association office package (also called the business office package) is comprised of property liability coverage, general liability, business interruption, computer systems, automobile liability, crime/employee dishonesty, workers' compensation and umbrella coverage. It protects the business operation and extends to association meetings, conventions, exhibitions and trade shows.

Under the DC law, risks covered in a protected cell are prevented from adversely affecting the parent captive or any other cell. That's important when the broad scope and potential risks of covered liabilities is considered.

In fact, the risk of trade associations being drawn into liabilities of their members was the cause of ASAE earlier losing its commercial carrier of liability insurance for trade groups. "They were afraid they would be wrapped into legal actions against insured trade associations' members," Ms. Arthur says. "We had the choice of folding our tent or taking a different direction to provide sponsored coverage."

As a former insurance and reinsurance executive, Ms. Arthur updated ASAE's existing captive under the protected cell law and was back in business. "Associations are essentially small businesses so it is difficult for them to get into the market and negotiate coverage and pricing," she says. "But when you aggregate our industry, we're able to provide broader coverage and greater benefits to our members."

Stephen DiCenso of Milliman, which provided actuarial services to AIC when it was being developed by captive manager Beecher Carlson, says, "Property and casualty insurance isn't always an exciting issue. This kind of captive structure gives organizations incentives to monitor costs and not just let their insurance company handle it. It provides coverage and allows you to take a little risk."

ASAE programs are regulated state by state through the fronting carriers, Great American Insurance Co. for the "office" package and The Hartford for D&O liability. AON is the managing general underwriter for both programs.

Ms. Arthur is pleased with the growth of AIC programs – holding steady in terms of premium volume, even under current market conditions. "We're in a prolonged soft market, so premium growth is modest. However, policy counts continue to grow and our retention rates are outstanding for both programs."

She believes that a hardening market will bring associations and nonprofits shopping for value in their coverage. "Having the facility in place before the hard market returns is key," she says. "We've been able to successfully operate both cells in a very soft market. We've tested the model in a soft market and it works."

Ms. Arthur says a similar approach using a captive with protected cells should work for many kinds of multilayer or multipoint organizations such as franchises or dealerships. "The important thing is to get started on the right footing with sufficient premium volume, fully developed loss ratios, solid actuarial analysis and realistic underwriting," she advises.

The ASAE captive is positioned to enable associations to bring their sponsored insurance programs into new cells of AIC. "Actually, there is no limit to the possible growth of cells," Ms. Arthur says. "Each cell is supported by its own capitalization, premium revenue, the risk retention selected by the cell owner and stop-loss insurance to cover claims beyond the retention."

She foresees the time when associations will become more comfortable with sharing in risk, or having "skin in the game." "Most associations do not own the books of business for programs that they sponsor," she says. "Most have 'vanilla' royalty revenue from sponsored insurance programs and many agreements do not require the sponsored partner to provide detailed reports about the program such as who the customers are, policy limits, loss ratios, premium details, etcetera. So, many associations are at a disadvantage in these kinds of deals because they aren't fully engaged in the program."

Ms. Arthur points out that associations that have good relationships with their program providers are welcome to invite them to participate in establishing AIC cells with no outward change in the associations' programs or endorsed partners.

"But the biggest hurdle of all is that many associations are risk averse and don't have the staff expertise to manage a cell. At AIC it's already here waiting for them. They can own their own captive insurance company without the burdens of building the structure and selecting service providers. Capitalization and startup costs are also mitigated." – Ms. Arthur

Public Housing Gains Services, Advocacy Through Its RRG and Related Companies

The world of public housing – largely invisible for much of the society – gained far more than affordable liability insurance 23 years ago when the Housing Authority Risk Retention Group (HARRG) was formed.

In a situation familiar to many industries and professions, public housing faced a liability insurance crisis in the mid-80s as many insurers walked away from the market or raised premiums to unaffordable levels. During a 1985 meeting of the Council of Large Public Housing Authorities the possibility of forming a risk retention group under the four-year-old federal Liability Risk Retention Act (LRRA) was raised, and two years later HARRG was licensed in Vermont.

Now HARRG is among the largest risk retention groups according to the Risk Retention Reporter ("RRG Power 50" list in 2008), an A-rated company ("Excellent") by A.M. Best, with 750 public housing authority members, $296 million in assets and $34.5 million in premiums (2009).

And along the way, HARRG and its related companies have continually provided additional products and services that have contributed to public housing efficiency, safety and security.

"It was always our goal to provide much more than liability insurance – that was the cornerstone we could build on," says president and chief executive officer Daniel Labrie who has been with HARRG since its earliest days, starting as an underwriter.

"We always took a broad view of our responsibility to this industry," Labrie says. "From the beginning we wanted to have a company that offers all the products and services public housing authorities need to protect themselves."

Based in Cheshire, Connecticut, the company continues to thrive as a risk retention group because of the advantages the LRRA provides in being able to operate in all states under federal exemption, according to CEO Labrie: "Economically, the RRG structure is much more efficient than having to be licensed and regulated in each state," he says.

HARRG writes a broad range of liability insurance coverages: general liability; public officials' errors and omissions; law enforcement; lead-based paint; mold liability; employee benefit administration liability; and primary excess auto liability.

Because the LRRA currently allows only liability coverage, HARRG was soon joined in the organization by entities that provide additional insurance products and services:

"We always took a broad view of our responsibility to this industry. From the beginning we wanted to have a company that offers all the products and services public housing authorities need to protect themselves." – Daniel Labrie

- Housing Authority Property Insurance (HAPI), a Vermont mutual company providing a range of property, casualty and liability coverages to public housing authorities.
- Housing Enterprise Insurance Company, Inc. (HEIC), a Vermont stock company that provides insurance and risk management services to low- and mixed-income "affordable housing" entities that are not in the public housing authority programs.
- Housing Insurance Services, Inc. (HIS), an agent, broker, managing general agent and surplus lines broker to various insurance companies. It provides insurance products to public housing authorities and mixed-income housing entities not provided by the other companies.
- Housing Authority Insurance, Inc. (HAI), a nonprofit association whose membership includes public and affordable housing entities. HAI provides access to a risk management video library, loss control bulletins and risk management publications along with risk management training programs. Its advocacy work extends to legislative and regulatory issues to help improve the political environment of the public housing industry.

- Housing Investment Group, Inc. (HIG) owns two subsidiaries, Satellite Telecommunications, Inc. and Housing Telecommunications, Inc. that combine to deliver training and educational programming to public housing authorities through proprietary Web-streaming technologies.

HARRG claims a majority of the public housing insurance market, hovering just above 55 percent, and its renewals average about 97%. During the recession year of 2009, HARRG grew in every financial measurement, and dividends to members actually exceeded claims and related expenses.

"We manage in a very conservative way," CEO Labrie says. "For example, we operate our own claims department and I believe that specializing in a single industry makes us very knowledgeable and efficient in managing claims."

Labrie cautions that a good year for public housing doesn't mean a good year for the general economy. "Demand for public housing is far beyond capacity – that's the bad news," he says, citing waiting lists of two to five years in some markets. "With budget restraints and the political climate, demand will always be there."

HARRG was instrumental in an economic impact study of public housing that proved projects are worth their investment in job creation and economic development. "We found a multiplier of two times the investment in the economic value of public housing development," Labrie says. "Public housing is far more than just a subsidy program for local communities."

Through its technology-based training programs, HARRG provides educational content to public housing authority personnel in subjects that range well beyond the focus of liability insurance to include all operational and maintenance subjects including OSHA workplace safety and Section 8 funding.

"Our Risk Control Plan was instituted the first year of operation in 1987, and it has grown and gained momentum ever since," Labrie says. "It's a tailor-made program for housing authorities, covering all possible risks from top to bottom, with a long term view. We have taken risk management of public housing a long way in these 23 years."