Why a group captive may be right for you

George V. Rusu, president and CEO of Captive Resources, extols the benefits of the group captive structure.

If someone asked me who's benefited most from the growth and success of member-owned group captives over the past three decades, I would have one answer: Mid-size premium-paying customers that today enjoy more control over their insurance destiny than ever before.

In today's world, brokers who are not showing their best mid-size customers and prospects the benefits of participating in a group captive are, at a minimum, underserving those customers' needs and running the risk that someone else will. Similarly, risk managers and other purchasers of insurance who aren't at least considering the group-captive option face the possibility of ignoring a better long-term insurance solution for their company.

But who really is a mid-size premium-paying customer? The answer is sometimes confusing because you can't really use sales volume or payroll as your only indicator — they may have no direct correlation to premium size. Today, the middle market is considered to be those companies that typically pay premiums ranging from $250,000 to $3,000,000 for their primary casualty lines of workers compensation, general liability and automobile coverage. In some cases, group captive benefits have been extended to include those paying as little as $100,000 of combined premiums, as well as those paying almost $10,000,000 annually. Therefore, one could argue that group captives and the benefits they offer can apply to a very wide variety and size of companies.

I'm often asked how the trend towards group captives gained such momentum. What are its benefits, and why does its market share continue to grow? Also I'm asked why the group-captive option seems so new to mid-size companies, when in reality they have been in existence for more than 30 years.

The early days

The tendency for buyers of insurance to assume their own risk has been around almost since the start of insurance itself. The developments of "Lloyd's syndicates" and mutual insurance companies (companies owned by the policyholders they insure) have been around a very long time. This risk-taking appetite expanded to large premium-paying companies in the 1960s and 1970s when they began "self-insuring," retaining large amounts of their predictable risk, and then simply passing catastrophic risk on to the marketplace.

This ability to assume limited risk, pass on unpredictable or catastrophic risk to the insurance marketplace and thereby have greater control of one's insurance destiny became the cornerstone of self-insurance.

Unfortunately by the late '70s and very early '80s most large companies that could afford to self-insure already had, and most mid-size companies were considered too small to assume risk. At that time, approximately 18% of the insurable marketplace enjoyed the benefits of "alternative" insurance. Conventional wisdom was that if that number ever reached 25% it would hit a wall for future growth. After all, how many large companies were left that would want such benefits?

In 1981, my business partner and I began working on developing our first member-owned group captive. Our reasoning was simple: if everyone believes that the benefits of self-insurance extend to just the Fortune 500, and there are only 500 of them, why not create a structure to provide these same benefits to the tens of thousands of mid-size insureds craving these same benefits.

While we were by no means alone in this pursuit, most industry observers still believed that captives were for large companies or for those with poor losses. The reality was just the opposite.

Mid-size companies desired to have just as much control over their insurance destiny and cost, along with all the benefits of direct access to reinsurance, TPAs and top-notch risk control companies as their larger counterparts. They also wanted to obtain the return of unused claim funds and interest income that accrued on these unused loss funds. They just didn't have a model by which to achieve it and generally were told "you are too small to take risk" or "it is too complicated to try".

The world of self-insurance has clearly changed for mid-size companies in 30 years. Our first captive started in the early 1980s with nine members and $1,500,000 in combined annual premiums. That captive today is the third largest member-owned captive in the world, with more than 250 members and premiums approaching $200,000,000. When combined, our various member-owned captives now have more than 2,000 members and almost $900,000,000 in annual premiums.

Many others have also had success in this area, and the alternative insurance market now exceeds 50% of all commercial dollars spent in the US. The fastest growing segment in this market remains group captives.

As a result, I challenge the assumption that captives are the "alternative". Since companies assuming risk now represent more than half of the commercial insurance marketplace, they are the norm, and those companies that still buy insurance conventionally are the "alternative" ones.

But how did this change occur in such a short period of time, and what is driving its success?

The benefits

First, member-owned group captives have the benefit of being either homogenous (same industry) or heterogeneous (different industries) in nature. This latter form, the heterogeneous captive, seems difficult for an insured to understand. They might say, "How can different types of businesses share risk?" We typically respond by asking, "What is a well run insurance company?" Isn't it a diversity of risk? Doesn't it have geographical spread of risk, with the best-in-class chosen from each group and then "banded together" within the insurance company? Isn't a heterogeneous captive no different except that the insureds get to own it and derive the benefits of doing so?

We have created and overseen both types and they both work equally well; in fact, we pioneered the heterogeneous captive concept. It is simply a matter of which is a more comfortable structure for each particular insured.

Another important benefit is the flexibility offered by a captive, which is evident in two ways. First, a captive can choose a domicile that best meets its needs. In the early days Bermuda, the Cayman Islands and Vermont were essentially the only domicile choices. In fact, some states that are now captive domiciles opposed "fronting services" for captives, believing it was bad for the industry. As the alternative marketplace has grown, many of these same states have reconsidered and have become captive domiciles. Our firm has used Cayman as our domicile of choice for more than 25 years because we feel the people with whom we work with there understand the needs of group captives better than others.

The second favourable aspect of flexibility is the ability to change a captive's design to meet the needs of its members and/or accommodate changes in the marketplace. As an example, a captive may begin with a $250,000 self-insured retention for any one occurrence, but as the captive grows or if the excess marketplace gets "hard," they may use this flexibility to raise their retention and keep operational costs low. A single $500,000 premium-paying insured simply can't do this. Similarly, coverages can be added or removed as needed.

Perhaps one of the greatest benefits of group captives is direct access to reinsurance and to other service providers. A conventional insured usually buys a policy from an insurance company and is told the cost, who handles claims, how much loss prevention service (if any) is available, who will provide the service, and if there is any potential to receive a premium dividend.

A group captive member (who is an owner!) chooses exactly who his reinsurer and policy issuer are and, if they are ineffective, they can be replaced without changing the rest of the risk control system, which may have taken years to create. Similarly, as part of the group, he purchases claims services from a TPA that best fits his needs, loss prevention services that will help keep claims from occurring and the very best actuary, investment, captive management and brokering services -- all on an unbundled, customised and replaceable basis.

Finally, the owners of a group captive can create a premium funding system that puts them in true control of knowing what their costs are, why their premium is what it is, and how they can get dividends and interest income returned if they do well.

We work in one of the only industries I know of that simply accepts that prices (premiums) are cyclical and that we will have "hard" and "soft" markets for pricing with almost no accountability to the customer (the insured) as to why it happens and when.

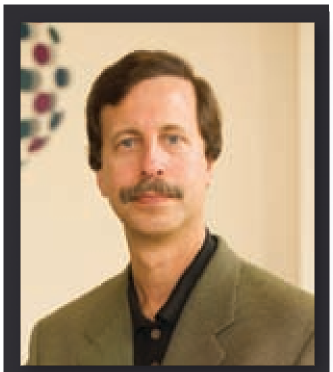
This has become as unacceptable to a mid-size company today as it did to larger companies years ago. Insurance may be the third or fourth largest cost on a mid-size company's P&L statement. Why can they predict their cost of raw materials better than their cost to insure the product they make from these materials?

When we started our first group captive in the early '80s, we decided to use "industry rates" to fund it, assuming the industry must know how to price itself. The results were disastrous, as it was under-funded and immediately in trouble.

Working with the members of this captive, we quickly developed a formula that sets the "A" fund or frequency fund for each member, the "B" fund or severity fund for each, an assessment layer for those members that exceed their frequency, plus aggregate coverage to provide "sleep insurance" if things go badly. Industry observers were very sceptical of our approach, but it has worked well and has been cloned by many group captives.

The use of this funding system has allowed each member to totally control their insurance destiny, as they know exactly what their costs are, the exact components to their cost and their dividend potential. That's all an insurance buyer really wants.

The alternative market has now become the conventional market and a best-in-class mid-size company should see what a member-owned group captive can do for them. CFR



George Rusu, CPCU is the co-founder, CEO and president of Captive Resources.