THE TEAM WITH THE BEST PLAYERS WINS……. Jack Welch

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There's Safety in Numbers…

By William York, VP of Marketing

Small to medium size businesses and their owners face challenges every day. One issue most all can agree on is that controlling their insurance costs and managing the risks inherent in their businesses can be a daunting and expensive proposition. Most recently, these challenges have been made even more difficult as we are facing what is known as a "hard insurance market". Commercial insurers have been raising rates and making certain lines of coverage very difficult to ascertain at manageable costs.

One strategy that has become very attractive to many businesses is a *Group Captive Insurance Company* arrangement. These privately held insurance companies, owned by the insureds themselves, offers the opportunity for business owners to band together with others that face the same challenges, encounter the same risks, and then work together to control claims and reduce overall risk management costs.

A *Captive Insurance Company* is owned and controlled by its insureds. Its primary purpose is to insure the risks of its owners who then benefit from the captive's flexibility in managing risk and also have the potential for the recapture of underwriting profits. *Single-parent captives* have only one owner. *Group captives* are formed when a group of companies, with different owners, jointly own a captive insurance company. *Group captives* can be set up as heterogeneous or homogeneous programs. A heterogeneous captive insures a group of unrelated companies representing different industries. Although they are in different businesses, they share many of the same risks such as workman's comp, professional and general liability, and auto liability. A homogeneous captive is an entity owned by a number of companies in the same industry with similar insurance needs (for example a group of medical practices all having large premium exposure to malpractice risks).

The main benefit of group captives comes from utilizing the law of large numbers. Overall claims experience can be predicted and managed more accurately than if a single company's risks were being covered. Reduced "bounce" (or variation) in claims levels each year allows group captives to retain more risk within the captive and thereby lowers the long-term cost of insuring the group's risks with less coverage needed to be purchased commercially. In addition, because the range of probable losses is narrower in a Group Captive, lower levels of combined surplus are required to operate and, thus, improves the cash flow levels of its members.

Finally, Group Captives require a sharing of losses between its members. This demands that the members control claims and have an ongoing focus upon improving safety and minimizing risk. Each individual member understands that for the Group Captive to operate successfully and profitably, they must do their part in controlling costs and managing risks. Individual members can be voted out (group captives generally have a managing "board" comprised of the member companies), non-renewed, or canceled if they cannot live up to the group's loss control standards.

There are many approaches that can be utilized in Group Captive arrangements. The following example illustrates a structure using three separate loss layers to manage the members' risks - these include a frequency fund, a severity fund, and a fixed cost contribution fund.

Frequency Fund:

This loss layer normally consists of first dollar losses up to certain per claim limits. In this layer of self-coverage, each member assumes initial responsibility for their own losses and risks are not shared. If one company has many small claims, the other members will not be affected. This produces an incentive for members to try to control and ultimately reduce risks wherever possible.

Severity Fund:

This loss layer sits on top of the Frequency Fund and provides a pooled layer for all per claim losses in excess of the Frequency Fund limits and up to the limits retained by the captive. Larger and more unpredictable losses are covered by the fund and provide protection to members for those hopefully infrequent large claims. In many cases, potential losses above this layer are reinsured using aggregate protection (transfer of risk to a commercial insurance company) to avoid major loss expense against the captive pool).

Fixed Cost Contribution Fund:

Premiums allocated to this fund are used to settle both the insurance and administrative expenses of the company. Insurance expenses normally include fronting fees, premium taxes, loss control expenses, and aggregate protection premiums. The fronting insurance company will assume the risk of claims which exceed the severity fund limits and will provide the aggregate layer of protection to the captive. The aggregate protection will normally kick in once the loss funds and LECs for all members have been exhausted.

If constructed and managed effectively, Group Captives are financially advantageous for its members. Unused loss funds (underwriting profits) and investment income are returned to the owners in the form of dividends. This will further reduce overall costs. As the Group Captive matures and the owners enjoy these dividends, it becomes natural for them to continue to focus on loss control in order to grow profits and increase future dividend potential.

Combined with a significant reduction in overall risk management costs, customized benefits, and increased flexibility, a Group Captive is an option that is helping many small to medium sized businesses become efficient risk managers.

Call Independent Captive Associates, LLC to learn how to get started.

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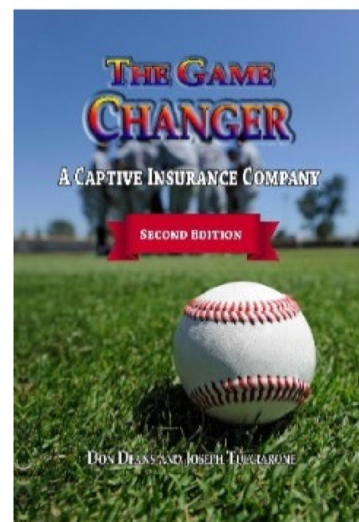

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