Some Problem-Plagued SIGs Make Transition to 'Butterflies'

By Dick Goff

Expose yourself to the beauty of ART: Alternative risk transfer continues to evolve in its ability to solve risk management problems as they emerge through varied regulatory and taxation challenges.

Take the example of self-insured groups (SIGs) that insure workers' compensation risks. As SIIA's P&C members can well attest, SIGs were the ART response to the hard market that diminished the availability of traditional workers' compensation insurance while raising its price to exorbitant levels.

Now, with the last hard market just a distant memory, SIGs continue to thrive for their ability to serve homogeneous groups of businesses with efficient, economical WC coverage.

Yet SIGs now face a variety of challenges that may require a newer form of ART to surmount. For example, we hear that SIGs are diminishing in number in Florida because of lower traditional insurance prices, concerns over joint and several liability, a perceived lack of capital base and challenges to diversification both in product and across state lines.

In New York the Insurance Commission web site provides a regulator's view of the implications of SIGs: "Every member of the group is responsible for each others' losses. In addition to being responsible for the losses of all group members, employers could also be responsible for the losses suffered by other self-insured insolvent groups. The legal term for this is called joint and several liability. It is critical (for potential members) to know who the other group participants will be. Do they have a similar loss experience to yours? Are they of similar size? Who decides who can enter the program at a later date? These issues are critical since all members are joint and severally liable."

Now, that may be an overly pessimistic view of SIGs. Those New York people are known for their focus on the glass being half empty, probably because they already gulped the first half of their soda pop. But the issues the New York Commission raises are not inconsiderable.

Then, take taxation. As Henny Youngman would say, "Take my taxation…please!" Here's an example in which a state and the feds can put a SIG in a tax headlock: California mandates that a SIG keep 80 percent of probable claims in reserve at all times. But the IRS says that any excess of 70 percent of reserves shall be taxed as income. Gulp!

We know of a California-based SIG that is paying north of $1 million a year in this "bonus tax" to the feds. That 10 percent spread puts SIGs squarely between the rock of mandated reserves and the hard place of reserves taxed as income.

There are a couple more ways that California makes life difficult for SIGs. The golden state requires them to post security in cash or letter-of-credit at the level of 135 percent of expected claims. In addition, the state caps a SIG's risk assumption at half a million dollars when many of the groups could easily assume risks of $1 million or more. That leads to excess reinsurance costs for the groups.

But in my view the greatest challenge to the SIG structure is that it must be licensed in each state it does business. The multi-state efficiencies of, for example, ERISA benefits plans are not available to SIGs. This presents a tremendous challenge to those members of a SIG with multi-state operations.

New ART Solution

My agreement with the editor is that I can never gripe about a problem without offering a solution. As I said at the top, ART continues to evolve to meet emerging challenges of risk management whether they derive from regulation or taxation.

I have recently observed a SIG make the transition from that form to a fronted, protected cell captive insurance company that may be licensed in any captive domicile for operation in any other. That's the kind of transition that caterpillars make to become beautiful butterflies.

As an insurance company fronted by an admitted carrier, the new "butterfly" company's captive nature is transparent to regulators – it just doesn't matter to them. Under the protected cell structure that is now available in forward-thinking captive domiciles, owner-members of the company are exposed only to their own losses, and their "cell" is not affected by the losses of other cells.

The fronted captive structure is taxed as a single traditional insurance entity, so it smoothes out taxation issues that may arise through state-federal tension. And capital and reserve requirements are met in the host domicile without further interference by other state jurisdictions.

So, a fronted protected cell captive could well be the next ARTwork that addresses the workers' compensation risk management challenges that SIGs were developed to solve in years past. Or, you can stick with your caterpillars – your choice.

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