Fronted Programs Provide Professional Services Along With the Financial Rewards of a Captive

By Dick Goff - *September issue "Self-Insurer"*

As a longtime member of SIIA – I won't say how long, but I distinctly remember when documents were produced on typewriters – I was pleased last year when the organization announced that it would add ART to its mission statement, now phrased as "To protect and promote self-insurance and alternative risk transfer." All of us here at the ART gallery were pleased to be included.

But I believe it's worth noting that ART is and has always been part of the self-insurance universe – not an additional element being lately added. ART, essentially, is the label for ways organizations can share in the responsibilities and rewards of risk management.

For many years ART has meant more to the property and casualty side of our industry than the employee benefits side. That's why I facetiously noted in last month's column the reluctance of benefits people to adopt ART mechanisms. It wasn't entirely their fault, however. The Department of Labor has just recently begun to allow captive insurance companies to cover benefits if they meet DOL criteria.

In my August column I noted four ART structures that are open to involvement by traditional self-insurance service providers and promised to drill down into the details of each. So, this month we'll talk about the first mechanism I listed, fronted programs.

A fronting company is the captive's underwriting partner. It underwrites and issues coverage policies and may provide policyholder services and claims management as if all coverages were fully-insured or allow them to be "unbundled" to qualified independent service providers. In most cases it provides the captive's reinsurance if required.

Being technically a reinsurer is really the defining characteristic of a captive in a fronted program. In a cash-flow model, the insured company pays its insurance premium as usual. Then the insurer cedes to the captive its share of premium for the amount of risk the captive itself retains. The fronting company may also provide reinsurance for limits in excess of the captive's retention.

CFOs often like captives better than qualified self-insurance programs because of their ability to deduct premium paid, as in fully insured programs. In the self-insured model, tax deductions don't occur until claims are paid. (Naturally, no prudent reader will take a magazine columnist's word for this, so seek tax guidance from your trusted advisors.)

The advantage of using a fronting company is that it also retains responsibility for the captive's regulatory and statutory compliance, which includes the ultimate financial responsibility for all coverages reinsured within the captive.

Most captives can be formed for less than $100,000 to cover the costs of a feasibility study and all required professional implementation services that include actuarial, legal and accounting services plus the captive's filing and licensing fees. Annual management fees are typically a small percentage of net premium ceded to the captive.

In a protected cell captive – in which any number of "silos" or "mini-captives" can be established to keep revenues and risks separate from all other cells – all costs are chargeable to the cells that are analogous to individual insureds. Protected cell captive examples include many kinds of homogeneous groups such as franchisee networks, membership organizations or single corporate insureds.

The same kind of protected cell captive could be designed to provide employee benefits to clients of a TPA or insureds of an MGU – does that ring a bell with anyone who thought captives would compete rather than enhance a self-insurance service provider's business? In a captive fronted or direct writing program, each cell would be individually underwriten according to its chosen retained risk, and individually reinsured for catastrophic risk. Change the wording from "reinsurance" to "stop-loss" and the picture clarifies for benefits people.

Meanwhile, in a fronted program the insureds receive all the services traditionally provided by insurance companies along with the financial benefits of owning a captive. It's pretty close to the ideal win-win situation.

Next month – if we all come back from Miami – I'll explore the second ART mechanism, direct writing captives.

Dick Goff is president of MIMS International, Ltd., specializing in forming ART companies and managing them through its affiliate, The Taft Companies. He may be reached at rcgoff@mimsintl.com or 800-899-1399.