Continuing our Primer with the Example of Liability Coverage Similar to Med Stop-Loss

By Dick Goff

Last month we began a review primer of alternative risk transfer that focused on the possible benefits of forming a captive insurance company to manage an organization's risks. We promised that this time we would discuss alternative forms of captives and show examples of their versatility along with how to get started forming a captive to help your clients realize the benefits of the ART world.

Forms of Captives

While many captive insurance companies are owned and controlled by their insureds that is not always the case. But they may take various forms:

Single parent captives are owned and controlled by one company and insure the risk of those companies and/or their subsidiaries.

Association captives are formed for generally two purposes. The first would be where an association already has a successful sponsored insurance program that allows it to benefit from assuming some risk. The second would serve as a type of rent-a-captive that may or may not take risk itself, but sponsors the captive on behalf of its members.

Risk retention groups that are enabled and protected by the federal Liability Risk Retention Act are a form of group captive that may be licensed in one domicile to operate in all states. At present risk retention groups are limited to liability exposures. SIIA formed the American Risk Retention Coalition (ARRC) to lobby Congress to expand possible coverage of RRGs to include property insurance, excess workers' compensation and other forms of coverage. That advocacy work is current and ongoing.

Agency captives are formed and controlled by insurance brokers who have chosen to participate, together with insurance companies, in the risks of their own clients.

Protected Cell Captives

Within a captive, exposures may be separated by insureds or risks. These are called protected cell captives. In these, cells of risk are "protected" from the insured risk exposures and liabilities of other cells. Protected cell design structures are flexible in makeup. As examples, they may be made up of single insureds, controlled books of business, homogeneous groups or by line of coverage.

Captive Bookends: Fronting Carriers and Reinsurers

Most states require a traditional insurance company to “front” the policies of a captive, retaining responsibility for the captive’s regulatory and statutory compliance and ultimate financial responsibility to the insureds. **Fronting companies** may issue policies and provide attendant services or allow the program administrator to do so with or without other professional service providers. Stable pricing and consistent coverage availability can be achieved through a long-term partnership between the captive and fronting company. In practice, the insured pays a premium to the fronting company, which in turn cedes to the captive a proportional part of the premium as stipulated in the reinsurance agreement between the front and the captive.

Reinsurers accept risk of the captive beginning at an agreed attachment level, serving as a “stop-loss” insurer. Reinsurance may be provided by the fronting company or from within the reinsurance marketplace.

Versatility: Unique Corollary to Medical Stop-Loss

In a unique application of ART, a new Montana-domiciled captive will provide a type of liability insurance to several hundred California auto dealers that will indemnify their excess employee health benefits losses. Here are the details:

As background, AdComp is a California-domiciled self-insurance group (SIG) that provides workers’ compensation coverage to 271 California auto dealers. AdComp’s success is reflected by the fact that through 2006 it has returned dividends approaching $10 million to its members.

The auto dealers all have ERISA self-insured employee benefit plans, so they sought the same kind of group coverage that AdComp provides for their workers’ compensation coverage. Their strategic objective was to bring savings to their employee benefit plans while improving employee coverage.

AdCompMed was formed in Montana as a risk retention group (RRG) to serve the California group of auto dealers with liability coverage for their benefits plans. Unlike traditional stop-loss insurance that provides specific and aggregate excess coverage, AdCompMed provides contractual liability policies to the employers that guarantee reimbursement of their costs at optional attachment points.

AdCompMed provides $1 million of excess coverage per employee, optional to a maximum of $5 million. The company has a contract with a life insurance company to reinsure $750,000 of the $1 million, with higher limits available.

In addition, AdCompMed has formed a protected cell captive insurance company to insure the first $250,000 of loss on a quota share at a 60/40 split. The California auto dealers each have the option of taking coverage in a protected cell of that captive.

This model is even more cost-efficient than regular stop-loss insurance on an ERISA plan and it is protected from state assessments on health plans because it is liability insurance indemnifying only the employer.

Getting Started With a Captive

A captive insurance company becomes operational upon licensing by an offshore or domestic captive domicile (domestic only, in the case of risk retention groups). Formation of a captive typically requires the services of a captive manager to serve as quarterback of the application process and professional service providers including actuary, accountant and legal advisor.

The domicile license application requires evidence of sufficient capital assets, an actuarial report, business and investment plans, along with specific required forms. Annual reports and audits are required by the licensing domicile and an annual board of directors meeting is usually required to be held within the domicile.

Formation of a captive insurance company is a financially beneficial form of alternative risk transfer for organizations with significant exposures, an appropriate appetite for risk and an entrepreneurial view of risk management.

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