



# Maximizing Industry-Specific Group or Association Captives and Risk Retention Groups

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Captives and risk retention groups (RRGs) can benefit industry-affiliated groups by lowering costs and, more importantly, avoiding the impact of radical coverage and price changes from commercial insurers. Many groups with similar operations (i.e., hospitals, colleges, universities, industrial parts manufacturers, and retail stores) have recognized insurance cost as an expense they cannot influence in any way. Nothing could be further from the truth, with captives and RRGs being options with significant payback if the captive members with like operations are equally dedicated to investing in risk management.

There are several reasons to invest time and expertise in forming a captive. However, focusing on perceived or realized tax advantage should not be the primary reason for captive formation. Successful captives are formed to capitalize on consistent operational improvements that will lead to fewer claims over the long term, resulting in lower costs than can be provided by commercial insurers. The fundamental belief in the net effect of risk management best practices will allow the most significant return.

Commercial insurers realize profit in three forms: operational efficiency, underwriting profit, and investment return for funds held for future claim payments. Captive owners transfer this opportunity for profit away from the commercial insurers to their members.

The captive formation process is the same for each captive: (1) feasibility study, (2) selection of a captive manager, (3) selection of the captive/RRG domicile, (4) capitalization, and (5) governance. The feasibility study can cost between \$35,000–\$50,000 with the capitalization cost requirement assigned by the selected domicile. Although not necessarily a quantifiable cost, investing the time to be strategic in governance formation, precisely the composition of the board of directors, can provide the necessary member commitments to maximize member benefits from day one.

Strategically populating the board of directors should be considered in terms of size and composition. The captive bylaws should reflect a manageable number of members—from seven to nine. Still, the bylaws should reflect the appointment of at least two independent board members from the insurance industry and outside the captive owners' industry group. Board members for many captives have been harvested from members who are champions within their sector but have yet to learn of insurance company operations. Failing to realize the need for insurance professionals on your board will delay the realization of member benefits or, worse, lead to the failure of the captive.

Three areas of governance generally cause delays in the realization of member benefits: (1) emphasizing dividend payments as the chief indicator of success, (2) failure to construct an investment policy that recognizes the regulatory obligations of the captive, and (3) failure to monitor membership for consistent commitment to risk management.

Prematurely releasing captive surplus to members is frequently the cause of the demise of many captives. Over the past decade, regulatory, inflation, and social influencers have protracted the time to conclude claims. External drivers in the claim adjudication process are only sometimes known at the time of captive formation and will continue to evolve. You cannot count on today's environment to be applied to your claim portfolio. An open claim file is never positive, as the financial outcome can rise over time and is subject to these ever-evolving external drivers. Your actuarial forecast is founded on reserves that, if they fail to be adequate, may result in your using needed surplus for funding dividends. Property claims, for example, have traditionally closed within months of the occurrence. However, final property claims costs are now frequently stalled by the increase in the price of material and labor,

demand surge for labor, and coverage interpretation, with all of these making outcomes less predictable. The maturation for workers compensation claims is now up to 7 years, with general liability claims taking up to 20 years to be brought to a conclusion. Through these years of adjudication, environments change, which could increase the cost. Your captive may be formed for only one coverage, but all claim costs are subject to rising costs in today's environment.

The second noted governance obligation that negatively impacts a newly formed captive is the return on investment of the funds that you hold for future claim payments. Too often, captive boards invest their claim funds as if the funds had the same operational responsibility as the captive members. Bringing commercial insurance expertise to the board will aid the entire board in understanding the regulatory obligation of these funds and help design an investment policy that reflects the importance of the steady preservation of capital. Investing your surplus too aggressively can result in inadequate funds to cover the long-term claim obligations. This will become evident through the annual regulatory measurements of the Insurance Regulatory Information System (IRIS) ratios, which are a series of solvency analytical tools calculated by your captive manager annually. Insurance regulators are responsible for monitoring all insurers' ability to meet their financial obligations to consumers. Failure to pass most IRIS ratios will indicate to regulators that the captive may not have the necessary capital, requiring an unanticipated infusion of funds from members. Risk-Based Capital scores are not universally required but provide an alternative standard for measuring capital adequacy.

The third and most crucial governance responsibility is monitoring member commitment to risk management. Companies that trim operation costs by looking away from safety are not what you want as part of your captive membership. Depending upon your captive structure, one member can bring down the captive, denying the other members promised efficiencies and indirectly providing financial support for a bad actor. The last thing you want to expose your membership to is the need to reenter the commercial insurance space due to a failed captive.

One way to gauge member commitment to risk management is to measure everything possible. All captive managers can advise you of metrics used with other clients in similar industries that have effectively evidenced the continued investment in risk management. Most of these metrics will somehow tie to each member's claim performance. Semiannual reporting of these metrics to the board will allow for identifying each member's commitment. There should be a predetermined policy for when to place members on probation and further transition to an alternative insurance product if their participation is consistently adverse to the group. Members whose participation is below the radar should be called upon to discuss their metrics even when performing for the benefit of the group. Although it is difficult to exit members, do not let a single bad actor prevent the majority of your members from realizing the full benefit of captive formation.

Captives and RRGs have provided a number of industry group with a risk transfer alternative that can benefit its members. It requires a top-down commitment from the board to each member but has proven to be an operational advantage across several industry groups.

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Ms. Moriarty received a bachelor of science degree from Northern Illinois University, a master of business administration degree from DePaul University, and a master of pastoral studies degree from Loyola University. She currently holds the Chartered Property & Casualty Underwriter (CPCU), Associate in Risk Management (ARM), and Associate in Captive Insurance (AIC) designations.