CAPTIVE & INSURANCE BUSINESS TRANSFER CONFERENCE

OKLAHOMA CITY

Group Captive

Eric Pach, President at Envision Captive Consultants, LLC

Daniel Linton, Senior Consulting Actuary at Pinnacle Actuarial Resources

Jonathon Stark, Director at SRS Advisors

OKLAHOMA INSURANCE DEPARTMENT

Eric Pach, MBA, ACI, CRM, CIC, CRIS, MLIS

- President of Envision Captive Consultants
- Associate in Captive Insurance designee
- Worked with over 60 group captives members
- Experience includes developing new group captives and single parent captives
- Named as an Emerging Leader from Captive Insurance Times

envision
Captive Consultants

Group Captive Industry Trends

- Outlook: “Hot!”
- Property & Casualty + Stop Loss Captives
- Innovation is still falling behind
- Providers: Boutiques, Agencies, and Private Equity
- Still offshore heavy
- More carrier options

Why a Group Captive?

2010: Deep into Arizona's Recession

Historical loss history & successful risk management

$500,000 Premium 15% Loss Ratio

Why a Group Captive?

- Quantitative Reasons:
  - Access to captives for middle market companies
  - Spread the expenses
  - Inherent risk transfer
  - Opportunity to earn underwriting & investment incomes
  - Unbundled services
- Qualitative Reasons:
  - Perspective towards risk changes
  - Peer group resources and mindset (sprints)
  - Becomes a business strategy

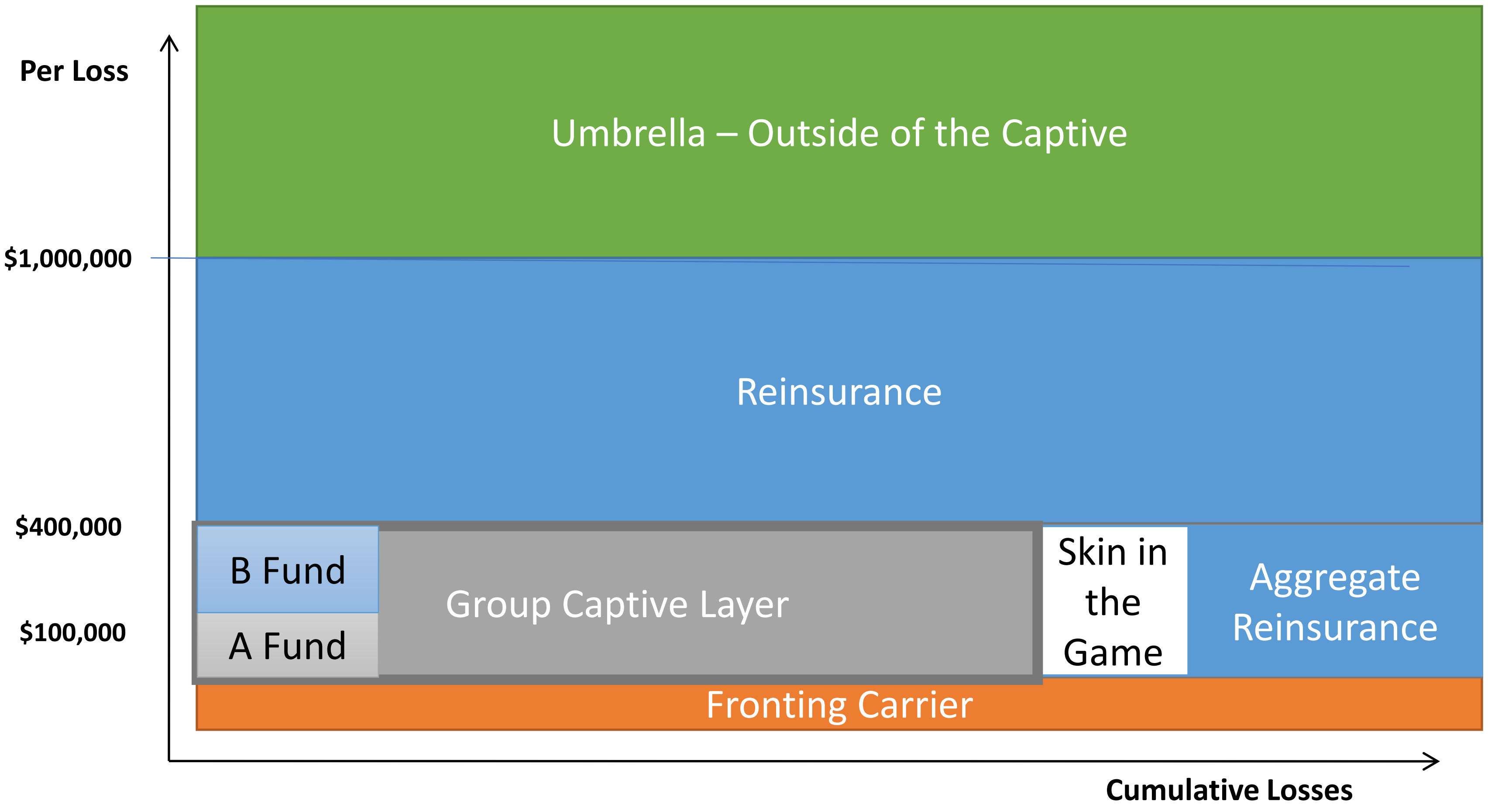
What is a Group Captive

Informal Definition:

A group captive is a privately licenses insurance carrier who’s purpose is to minimize the insurance costs of its owners or members.

Each member has responsibility for their own losses first, but contribute a small portion of their premium to share in losses with other members.

Understanding the Structure



Daniel Linton, FCAS, MAA

- Senior Consulting Actuary
- 16+ years of experience in pricing & reserving
- Significant experience with single parent and group captives
- Partnered on engagements for captives domiciled from Hawaii, to Oklahoma, to the Cayman Islands
- Serves on the American Academy of Actuaries Workers Compensation Committee
- Serves on the Actuarial Standards Board of the Casualty Actuarial Society

PINNACLE ACTUARIAL RESOURCES

Breakdown of Funded Layers

- A Layer, or Frequency Fund, is computed using experience rating techniques using each member's actual claims experience to maximum extent possible
- B Layer, or Severity Fund, is computed using a combination of exposure/experience rating, and relies to maximum extent possible, on claims experience for the group as a whole

How it Works

- Each member has an assigned loss fund in both A Layer and B Layer
- As claims emerge, the claim dollars are apportioned to each bucket
- If the A Fund Layer fills up, member is assessable up to one more A Fund
- If a second A Layer level fills up, amounts above that are risk shifted outwardly to all other members (that have room left in their A Fund layer)
- Other captive members absorb these amounts in their own A Layer as if they were their own losses
- The B Layer is a risk shared layer
- If claims in B Layer exceed member's B Layer amount, those $s are risk shared with other members.

Loss Funding Approach – A Layer

Member #1

		Reported Losses		Selected		Trended
Line of Cov.	Period	Total Limits	Excess of $100,000	Ultimate Losses	Payroll (00's)	Loss Cost
(1)	(2)	(3)	(4)	(5)	(6)	(7)
WC	*2022*	$162,182	$0	$410,738	$915,750	$0.437
	2021	242,487	0	256,652	936,443	0.261
	2020	278,952	0	291,656	900,711	0.302
	2019	579,087	30,756	554,579	862,829	0.608
	2018	441,950	25,330	419,752	840,285	0.463
	2017	330,067	19,670	311,302	814,434	0.347
		2,034,725	75,755	2,244,679	5,270,452	0.400

Loss Funding Approach – A Layer

Member #2

		Reported Losses		Selected		Trended
Line of Cov.	Period	Total Limits	Excess of $100,000	Ultimate Losses	Payroll (00's)	Loss Cost
(1)	(2)	(3)	(4)	(5)	(6)	(7)
WC	*2022*	$53,010	$0	$229,950	$438,971	$0.511
	2021	411,314	0	425,801	520,323	0.778
	2020	238,395	14,916	232,975	507,054	0.428
	2019	175,478	0	178,685	485,683	0.348
	2018	603,966	145,888	460,838	465,132	0.919
	2017	333,906	29,654	304,992	460,347	0.601
		1,816,069	190,458	1,833,242	2,877,509	0.605

Takeaways – A Layer

- Experience rating the A Layer promotes equity amongst members
  - Reduces the risk to adverse selection
- Allows members to have a benchmark relative to their peers
  - Provides an incentive to improve loss control
- Allows members that outperform to reap benefit of lower than expected losses
  - Excess A Fund layer $ amounts are eligible to be returned to member as dividend

Loss Funding Approach – B Layer

All Members

Policy Period (1)	Ultimate $100,000 Losses (2)	400 x 100 Incurred (3)	Estimated Ultimate (4)	Severity Layer % Trended (5)	Severity Layer % Current (6)	Severity Layer % Benchmark (7)
2022	$10,068,463	$0	$5,328,193	54.0%		
2021	7,731,503	463,575	3,764,468	50.7%		
2020	8,159,438	953,620	3,301,963	42.9%		
2019	7,553,279	1,038,731	2,786,984	39.9%		
2018	7,783,146	1,864,202	3,463,385	49.1%		
2017	5,622,653	684,406	1,524,669	30.5%		
Total	46,918,483	5,004,533	20,169,661	45.6%	45.7%	56.7%

Putting it All Together

Member (1)	Payroll (00s) (2)	A Layer Loss Cost (3)	A Layer Funding (4)	B Layer Ratio (5)	B Layer Funding (6)	Total Loss Funding (7)
#1	$950,000	$0.400	$380,000	45.7%	$173,660	$553,660
#2	450,000	0.605	272,250	45.7%	124,418	396,668
Total	1,400,000	0.466	652,250	45.7%	298,078	950,328

What if Member #2 Improves?

Member (1)	Payroll (00s) (2)	A Layer Loss Cost (3)	A Layer Funding (4)	B Layer Ratio (5)	B Layer Funding (6)	Total Loss Funding (7)
#1	$950,000	$0.400	$380,000	45.7%	$173,660	$553,660
#2	450,000	0.500	225,000	45.7%	102,825	327,825
Total	1,400,000	0.432	605,000	45.7%	276,485	881,485

Decreased $47,250

Decreased $21,593

Where it Can Be Confusing

- If all members' losses in A Layer exceed 2x total A Layer, then overflow dollars may be paid from the B Layer
- If all members' losses in B Layer exceed the total B Layer, then overflow dollars "drop down" to A Layer and are allocated pro-rata as if they were A Fund losses
- Maximum responsibility for captive member is 2xA + B; aggregate coverage provided by fronting company results in shift of all future claims away from captive
- Amounts above aggregate are rare – situations almost always involve high frequency/low severity situations (such as construction defect) or systematic underfunding in A/B Fund layers

Loss Funding Concerns

- How can an individual members' claims experience be deemed fully credible for future loss fund projections?
- How to handle loss free years?
- Incomplete data / deductibles / multiple locations / recoveries
- How to handle "unusual" claims
- How to handle operational changes
  - Changes in company management
  - Acquisitions/divestitures
  - Changes in company loss control, safety, risk management programs
  - Significant growth

Jonathan Stark, CPA, ACI

Director

Strategic Risk Solutions

- Shareholder of SRS
- Associate in Captive Insurance designation
- Certified Public Accountant
- Responsible for the delivery of SRS Advisory services to clients based in the Western United States

Why Do Group Captive's Require Collateral?

- There are three primary reasons why group captives require collateral. The first two are related to the group captive's relationship with the fronting company as a reinsurer.

- Credit Risk to Fronting Company: Group captives operate as reinsurance companies behind commercial carriers that are issuing the policies to the insureds. The commercial carrier is responsible for the payment of claims whether or not the reinsurance company can reimburse it for the risk ceded to the reinsurer. As a result, commercial carriers require collateral to eliminate credit risk from the reinsurance company (group captive).
- Schedule F: In order for the commercial carrier to take credit for the reinsurance ceded to the group captive reinsurer, it must have collateral to offset the liabilities ceded. I.e. without collateral, the balance sheet of the commercial carrier could not subtract the liabilities associated with the risk sent to the group captive reinsurer.

Why Do Group Captive's Require Collateral? (Cont.)

- The third reason for collateral is to secure the risk sharing obligations amongst group captive members.

- Credit Risk to Other Group Captive Members: When entering into a group captive transaction, you are sharing risk with unrelated parties. Any of the group captive members could have adverse losses over and above the premium paid into the program. As a result, the collateral provides security to all members that each group captive member has additional assets to support poor loss experience should that member be assessed.

Group Captive Collateral

- Group captives typically calculate collateral as a function of the A Fund premium. In year one of most group captive programs, collateral is equal to 100% of the A Fund.

- Year two requires a second collateral deposit equal to 100% of the A Fund for the second policy year. This results in what is referred to as the “Stacking” of collateral, meaning the second policy year collateral requirement is new collateral and cannot be satisfied by the collateral already posted in the first policy year.

- Most group captives require collateral to stack for 2 or 3 years before collateral from the first year is available to meet the collateral requirement for the current year, assuming positive loss experience.

Group Captive Collateral (Cont.)

- Once collateral equilibrium is met, the additional collateral required each year is limited to the collateral needed to support growth in exposure (first year collateral can support fourth year collateral (in a 3-year stack) plus growth (A fund premium year 4-A fund premium year 1).

- When you review a group captive's documents, usually the ongoing collateral requirement will be referred to as "300% of the average A fund balance over the last 3 years" (3-year stack) or "2/3rds of the sum of the A fund premium from the last 3 years" (2-year stack).

Example (3-Year Stack)

Group Captive Renewal Summary - Member A						
Renewal Summary	**2023-24**	**%**	**2022-23**	**%**	**2021-2022**	**%**
A Fund	1,289,824	48.83%	1,252,256	48.83%	1,278,428	48.77%
B Fund	457,027	17.30%	443,716	17.30%	448,034	17.09%
Total Loss Fund	**1,746,851**	**66.13%**	**1,695,972**	**66.13%**	**1,726,462**	**65.86%**
Front Fees	282,556	10.70%	274,326	10.70%	279,258	10.65%
Specific Excess Reinsurance	214,649	8.13%	208,397	8.13%	212,143	8.09%
Claims Admin	97,568	3.69%	94,726	3.69%	96,429	3.68%
Risk Control	26,018	0.99%	25,260	0.99%	25,714	0.98%
Brokerage	130,090	4.93%	126,301	4.93%	128,572	4.90%
Off-Shore Expenses	104,072	3.94%	101,041	3.94%	102,857	3.92%
Operating Costs	**854,953**	**32.37%**	**830,051**	**32.37%**	**844,973**	**32.23%**
Program Premium	**2,601,804**	**98.50%**	**2,526,023**	**98.50%**	**2,571,435**	**98.09%**
Below Line Costs						
Surcharges/Taxes	4,168	0.16%	4,047	0.16%	14,487	0.55%
TRIA	29,161	1.10%	28,312	1.10%	28,835	1.10%
DTEC	3,975	0.15%	3,859	0.15%	4,499	0.17%
Expense Constant	227	0.01%	220	0.01%	250	0.01%
Industrial Aid	0	0.00%	0	0.00%	0	0.00%
Meeting Expense	2,060	0.08%	2,000	0.08%	2,000	0.08%
Total Below Line Costs	**39,591**	**1.50%**	**38,438**	**1.50%**	**50,071**	**1.91%**
Total Premium + Below Line Costs	**2,641,395**	**100.00%**	**2,564,461**	**100.00%**	**2,621,506**	**100.00%**

Collateral Calculation (3 x A Fund Premium)			
Policy Year	**2021-2022**	**2022-2023**	**2023-2024**
2021-2022	1,278,428	1,278,428	1,278,428
2022-2023	0	1,252,256	1,252,256
2023-2024	0	0	1,289,824
Total Requirement	**1,278,428**	**2,530,684**	**3,820,508**

Yellow highlighted figures represent the new collateral posted each year.

Example (3-Year Stack – Year 4 Illustration)

Group Captive Renewal Summary - Member A								
Renewal Summary	**2024-2025**	**%**	**2023-24**	**%**	**2022-23**	**%**	**2021-2022**	**%**
A Fund	1,328,518	48.83%	1,289,824	48.83%	1,252,256	48.83%	1,278,428	48.77%
B Fund	470,738	17.30%	457,027	17.30%	443,716	17.30%	448,034	17.09%
Total Loss Fund	**1,799,257**	**66.13%**	**1,746,851**	**66.13%**	**1,695,972**	**66.13%**	**1,726,462**	**65.86%**
Front Fees	291,032	10.70%	282,556	10.70%	274,326	10.70%	279,258	10.65%
Specific Excess Reinsurance	221,088	8.13%	214,649	8.13%	208,397	8.13%	212,143	8.09%
Claims Admin	100,495	3.69%	97,568	3.69%	94,726	3.69%	96,429	3.68%
Risk Control	26,798	0.99%	26,018	0.99%	25,260	0.99%	25,714	0.98%
Brokerage	133,993	4.93%	130,090	4.93%	126,301	4.93%	128,572	4.90%
Off-Shore Expenses	107,194	3.94%	104,072	3.94%	101,041	3.94%	102,857	3.92%
Operating Costs	**880,601**	**32.37%**	**854,953**	**32.37%**	**830,051**	**32.37%**	**844,973**	**32.23%**
Program Premium	**2,679,858**	**98.50%**	**2,601,804**	**98.50%**	**2,526,023**	**98.50%**	**2,571,435**	**98.09%**
Below Line Costs								
Surcharges/Taxes	4,293	0.16%	4,168	0.16%	4,047	0.16%	14,487	0.55%
TRIA	30,036	1.10%	29,161	1.10%	28,312	1.10%	28,835	1.10%
DTEC	4,094	0.15%	3,975	0.15%	3,859	0.15%	4,499	0.17%
Expense Constant	233	0.01%	227	0.01%	220	0.01%	250	0.01%
Industrial Aid	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Meeting Expense	2,122	0.08%	2,060	0.08%	2,000	0.08%	2,000	0.08%
Total Below Line Costs	**40,779**	**1.50%**	**39,591**	**1.50%**	**38,438**	**1.50%**	**50,071**	**1.91%**
Total Premium + Below Line Costs	**2,720,637**	**100.00%**	**2,641,395**	**100.00%**	**2,564,461**	**100.00%**	**2,621,506**	**100.00%**

Collateral Calculation (3 x A Fund Premium)				
Policy Year	**2021-2022**	**2022-2023**	**2023-2024**	**2024-2025**
2021-2022	1,278,428	1,278,428	1,278,428	1,278,428
2022-2023	0	1,252,256	1,252,256	1,252,256
2023-2024	0	0	1,289,824	1,289,824
2024-2025	0	0	0	50,090
Total Requirement	**1,278,428**	**2,530,684**	**3,820,508**	**3,870,598**

Yellow highlighted figures represent the new collateral posted each year.

Year 4 new collateral is offset by the release of year 1 collateral such that new collateral in year 4 is limited to the difference between year 1's A Fund premium and year 4's A Fund premium.

Group Captive Surplus

A Fund Surplus

- A Fund captive surplus is generally calculated as follows:

- A Fund premium -
- A Fund losses +
- A Fund assessments (if A Fund losses are worse than expected) +
- Transfer from B Fund (if assessment is maxed out) -
- Deficit Reallocation (payment of other members' losses) -
- Transfer to B Fund (transfer to cover B Fund excess losses) =
- A Fund Balance

B Fund Surplus

- B Fund captive surplus is generally calculated as follows:

- B Fund premium -
- B Fund losses +
- Transfer from A Fund (if B Fund losses are worse than expected) –
- Deficit Reallocation (to cover other members' losses) –
- Transfer to A Fund (transfer to cover A Fund excess losses) =
- B Fund Balance

Group Captive Surplus (Cont.)

Total Surplus

- Total Surplus available for distribution is calculated as follows:

- A Fund surplus +
- B Fund surplus +
- Contribution to operating expenses –
- Actual operating expenses +
- Investment Income –
- Tail fund profit (loss) –
- IBNR Reserves =
- Total surplus available for distribution

Dividends

- In a group captive, dividends are not typically available for distribution until the third policy year is complete.

- At this time, surplus from the first policy year is typically available for distribution assuming the aforementioned calculation results in positive surplus.

Group Captive Surplus Example

(Note: This example does not reflect IBNR)

Member Experience Summary							
Member Summary	**2015/2016**	**2016/2017**	**2017/2018**	**2018/2019**	**2019/2020**	**2020/2021**	**Total**
Underwriting	2,222,799	2,168,684	2,660,409	2,696,753	2,839,163	2,673,567	15,261,375
Gross Premium	0	0	0	0	0	0	0
Cash Flow Deferral	2,222,799	2,168,684	2,660,409	2,696,753	2,839,163	2,673,567	15,261,375
A Fund							
Net Premium	1,165,469	1,122,576	1,349,191	1,365,819	1,425,855	1,363,641	7,792,551
Losses Paid	(341,575)	(663,032)	(446,729)	(713,188)	(829,981)	(297,683)	(3,292,188)
Loss Reserves	0	0	(89,619)	(34,370)	(56,334)	(50,953)	(231,276)
Profit or (Loss)	823,894	459,544	812,843	618,261	539,540	1,015,005	4,269,087
Assessments	0	0	0	0	0	0	0
Transfer from B Fund	0	0	0	0	0	0	0
Deficit Reallocation	(52,151)	(29,747)	(62,853)	(21,389)	(16,518)	(479)	(183,137)
Transfer to B Fund	0	0	0	(71,111)	0	0	(71,111)
							0
A Fund Balance	771,743	429,797	749,990	525,761	523,022	1,014,526	4,014,839
B Fund							
Net Premium	359,593	360,153	438,870	445,320	477,520	424,708	2,506,164
Losses Paid	0	(84,882)	0	(28,390)	(33,809)	0	(147,081)
Loss Reserves	0	0	0	(488,041)	(65,650)	0	(553,691)
Profit or (Loss)	359,593	275,271	438,870	(71,111)	378,061	424,708	1,805,392
Transfer from A Fund	0	0	0	71,111	0	0	71,111
Deficit Reallocation	(260,547)	(197,944)	(169,740)	0	(56,158)	(25,618)	(710,007)
Transfer to A Fund	0	0	0	0	0	0	0
B Fund Balance	99,046	77,327	269,130	0	321,903	399,090	1,166,496
Total A&B Funds	870,789	507,124	1,019,120	525,761	844,925	1,413,616	5,181,335
Contribution to Operating Costs	697,737	685,955	872,348	885,614	935,788	885,218	4,962,660
Actual Operating Costs	(769,408)	(753,551)	(947,132)	(947,338)	(987,137)	(909,473)	(5,314,039)
Investment Income	313,880	319,698	415,036	335,019	216,838	219,989	1,820,460
Dividends	(585,019)	(119,808)	0	0	0	0	(704,827)
Tail Fund Profit/(Loss)	(11,392)	(3,577)	15,164	13,326	21,288	60,727	95,536
Equity/Surplus Balance Before IBNR	**516,587**	**635,841**	**1,374,536**	**812,382**	**1,031,702**	**1,670,077**	**6,041,125**

Total Equity Calculation	
Capital	36,000
Cash Security	0
Pledge of Investment Income	0
Investment Income on Capital & Security	133,824
Distribution of Investment Income	(59,513)
Unpaid Assessments	0
Cash Flow Deferral	0
Closing Costs Recoverable	0
Letters of Credit	2,683,056
Dividends Payable	0
Total Equity	**8,834,492**