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# Alternative Markets: A SWOT Analysis

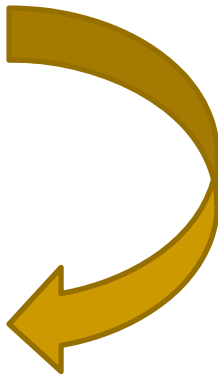
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# Discussion Topics

- Background/State of the Market
- Definitions
- **S**trengths
- **W**eaknesses
- **O**pportunities
- **T**hreats



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# State of the Market

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# State of the Alternative Markets

- Continuing to Grow
  - Less in 2009
  - More emphasis on 831(b) captives
- Shifts on and off shore
  - Big companies coming on
  - Small ones going off
- For some industries the alternative market is the standard market (insures more than 50%)

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# State of the Alternative Markets

- Coverages
  - Increase in personal lines, benefits, and non-traditional coverages
- Many new domiciles
  - Pretenders vs. contenders
- Consolidation
  - Brokers & Captive Managers
- Legislative
  - Possible changes to Risk Retention Act and 831(b) code

# Captives by Domicile

Domicile	Captive Number	Percentage
<u>Bermuda</u> *	958	19.3%
<u>Cayman Islands</u> *	765	15.4%
<u>Vermont</u> *	567	11.4%
<u>British Virgin Islands</u> *	409	8.2%
<u>Barbados</u> *	256	5.2%
<u>Hawaii</u> *	163	3.3%
<u>South Carolina</u> *	158	3.2%
<u>Nevada</u> *	115	2.3%
<u>Arizona</u> *	108	2.2%
<u>Utah</u>	100	2.0%
<u>District of Columbia</u>	40	0.8%
<u>New York</u>	27	0.5%
<u>Bahamas</u>	23	0.5%
<b>Total</b>	<b>4,966</b>	<b>100.0%</b>

Total includes domiciles in Asia and Europe

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# Definitions

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# Alternative Risk Transfer Mechanisms

- Large Deductible Policies
- Single Parent/Pure Captives
  - 831(b) Captives
- Group Captives
  - Association Captives
  - Agency Captives
- Risk Retention Groups

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# Large Deductibles

## ■ Coverages

- ❑ Workers Compensation
- ❑ Auto Liability
- ❑ General & Products Liability
- ❑ Medical and Non-Medical Professional
- ❑ Non-traditional coverages (bare on self-insured retention, limits company's liability)

## ■ Limits

- ❑ \$100,000 and up
- ❑ Some are quite high

# Large Deductibles

## Strengths

- Control of Claims Savings
- Premium Reductions
- Pricing Stability in Markets Susceptible to Strong Cycles
- More Efficient Funding of Stable/Controllable Loss
- Expands Market to Reinsurers

## Weaknesses

- Lack of Tax Deductibility
- Collateral (SIR Layer)
- Lack of Control of Investments
- Requires Proactive Management
- Claims Volatility
- Excess Carrier Risk Margins/ Expected Loss Ratios
- Regulatory (WC)

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# Single Parent/Pure Captives

- Wholly Owned Subsidiaries
- Two Models
  - Brother-Sister Model
  - “Related-Unrelated” Model
    - Owner-Operators, Contractors, Farmers, Dealers
- On- and Off-shore Options Both Used
- Deductible Reimbursement Coverage Common
- Excess Layer less common, but done

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# Single Parent/Pure Captives

- Requires a Captive Manager
- Risk Transfer Approaches
  - Direct Policy by Captive with Excess/Reinsurance Policy
  - Large Deductible Policy with Deductible Reimbursement
  - Combinations with RRGs and/or Reciprocals
    - Use their paper and assume some of the risk

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# Single Parent/Pure Captives

## Strengths

- Control of Claims
- Control of Expenses
- Control of U/W Results
- Control of Investments
- Retained Earnings can be used to expand Risk Management Strategies
- Premiums are Deductible

## Weaknesses

- Requires Proactive Management
- Initial Collateral
- No Guaranty Fund Protection
- Tax Issues

## 831(b) Captives

- Annual written premium of less than \$1.2 M
- Some small mutuals actually qualify as 831(b) elections
- Only taxed on investment income, U/W income is tax deferred
- Commonly used as “wealth management” vehicle for high wealth individuals
- Developing bad reputation as tax shelter and not really insurance

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## 831(b) Captives

- Still need to pass bro-sis or unrelated-related tests
- Lots of manuscripted coverage for currently uninsured risk (publishers liability, product recall, reputational risk, loss of license, contingent business income)
- Lots of combination programs with group captives and RRGs

# 831(b) Captives

## Strengths

- Tax advantage
- Clever Generational Transfer Ideas
- Additional coverages
- Minimal Regulatory
- Minimal Expenses
- Plays really well with RRGs and Groups
- Opt in/Opt Out

## Weaknesses

- Premium limit
- Current reputation
- Naïve Capital
- Loss Volatility
- Insurance Tests

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# Group Captives

- A mechanism for a group of homogeneous or heterogeneous risks to 1) individually self insure some risk, and 2) collectively self insure, or pool, some risk (risk transfer).
- Some take advantage of industry niche
  - ❑ Emergency Room Doctors
  - ❑ Roofing Contractors
  - ❑ Crop Dusters
  - ❑ Truckers

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# Group Captives

- Best practices result in extremely streamlined underwriting processes
- Fronting carriers are essential
- Some use current member referral as key element of new member recruitment
- Funding is heavily experience rated

# Group Captives

## Strengths

- Operational efficiency, lower expense ratios
- Large ones compete actively in middle markets
- Competitive pricing advantage
- Responsive pricing
- Broker/agency plant
- Nice balance between self-insurance & pooling

## Weaknesses

- Usually assessable
- Hard to wind up
- Real problems when things go bad
- Reserve allocations are non-trivial
- Accounting can be complex
- Founders vs. new members
- Large vs. Small

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# Association Captives

- Group captive with tie to association
  - ❑ Chamber of Commerce
  - ❑ State Association (e.g., Auto Dealers)
  - ❑ Local Group (e.g., MAMADocs)
  - ❑ Company Vendors/Dealers
  - ❑ MGA Controlled Program (Athletic Leagues)
  - ❑ Hospital and Associated Docs
  - ❑ Value added benefit to members

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# Association Captives

## Strengths

- Value Added Service to Members
- Industry expertise for homogeneous
- Stabilize costs

## Weaknesses

- Issues for large members
- Issues for poor performing members
- Capital
- Equity

# Agency Captives

- Insurance Company Capitalizes Captive Jointly Owned by Insurer and Agency
- Agent Writes Business on Insurer Paper
- Insurer Ceded first \$250K/occurrence into Captive
- Agency owns share of captive results!
- Advanced Contingent Commission/Agency Compensation

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# Agency Captives

## Strengths

- Huge incentive to Agent
- Invisible to Insured
- Negligible Frictional Cost
- Minimal Regulatory, esp. offshore

## Weaknesses

- Formation Costs
- Downside to Agent

# Risk Retention Groups

- Governed by National Risk Retention Act
- Enacted to provide availability and affordability to distressed liability markets (products, medical professional liability)
- Liability only – no property, workers comp., etc.
- Most regulatory oversight governed by state of domicile (Huge advantage in certain states)
- Application process akin to captives
- Some domiciles have very favorable regulations

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# Risk Retention Groups

- In many cases, can write direct business
- Can receive rating for rating agencies
  - Some use smaller rating agencies
- Fast response to really disrupted markets
  - NJ Medical Malpractice
  - Western state home builders

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# Risk Retention Groups

## Strengths

- Often don't need fronting carrier
  - Can front for pure & 831(b) captives
- HUGE Regulatory Advantage on Rates
- Serve specific markets really well

## Weaknesses

- Liability Only
- Reputation of ratings
- Lack of Guarantee Fund Protection
- Regulatory (WI)
- More financial reporting than captives (sometimes really funky)

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# Threats - General

- Exodus of middle markets accounts
- Real cost differences, especially as markets harden (cue Hartwig presentation)
- Coverage flexibility, especially for unusual or currently uninsured needs

# Threats - Specific

- Large Deductible Policies more volatile and harder to underwrite for less premium
- Agents with Agency Captives will skim best business to the captive they own
- Group Captives have distinct advantages over comparable middle markets insurers
- Unfair playing field
  - Rates (RRGs)
  - Regulatory (several)
  - Tax (831(b))





