



MARKET BRIEFING

Group Captives - Competing in a Soft Market

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Newport Risk Services

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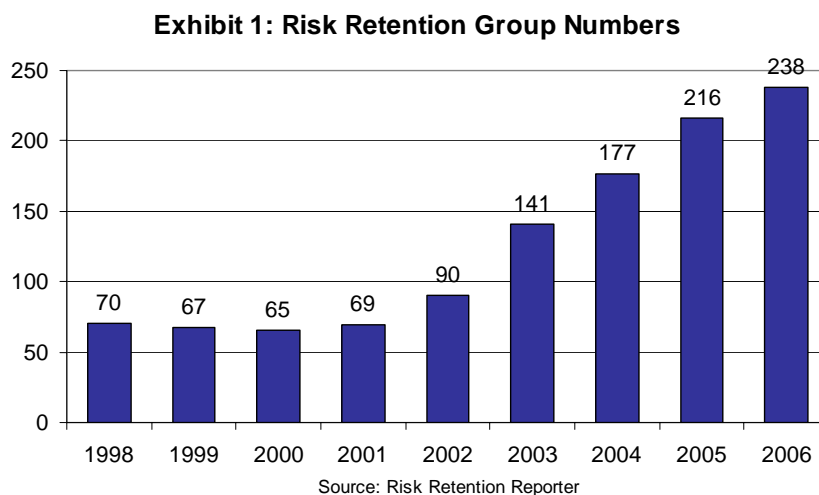
For questions about this market briefing or services provided by Newport Risk Services, please contact Andrew Berry at andrew.berry@newportrisk.com, 401 608 2391

Introduction

Softening commercial premiums are putting pressure on group captives to retain members and remain viable. In this briefing we analyze the competitive challenges facing group captives, their inherent competitive advantages and strategies to compete. The briefing is focused on group captives including risk retention groups¹. The discussion also applies to other group risk financing mechanisms such as governmental pools and self-insured workers compensation groups.

Captive Growth

Unlike single parent captives, group captives typically require the grouping of its members to provide the size and stability for the individual members to be able to retain risk. As such it acts as one of the few alternatives to commercial insurance available to middle market insureds. A hardening of commercial market premium rates will fuel interest in the alternative of group captives. This phenomenon was well demonstrated after the terrorism attacks of 9/11 which led to an acceleration of the hardening of commercial insurance premiums which began in the late 1990s. With increased premium rates and restrictions in coverage there was a significant growth in group captives. Exhibit 1 shows the growth in the number of risk retention groups (RRGs). The number of RRGs had been slowly declining during the soft market of the 1990s. This trend rapidly turned around after 9/11. 2002 alone saw a 50% plus increase in RRGs. Increases in numbers have continued ever since with only a modest slow down in growth rates in the last couple of years.



Softening Commercial Market

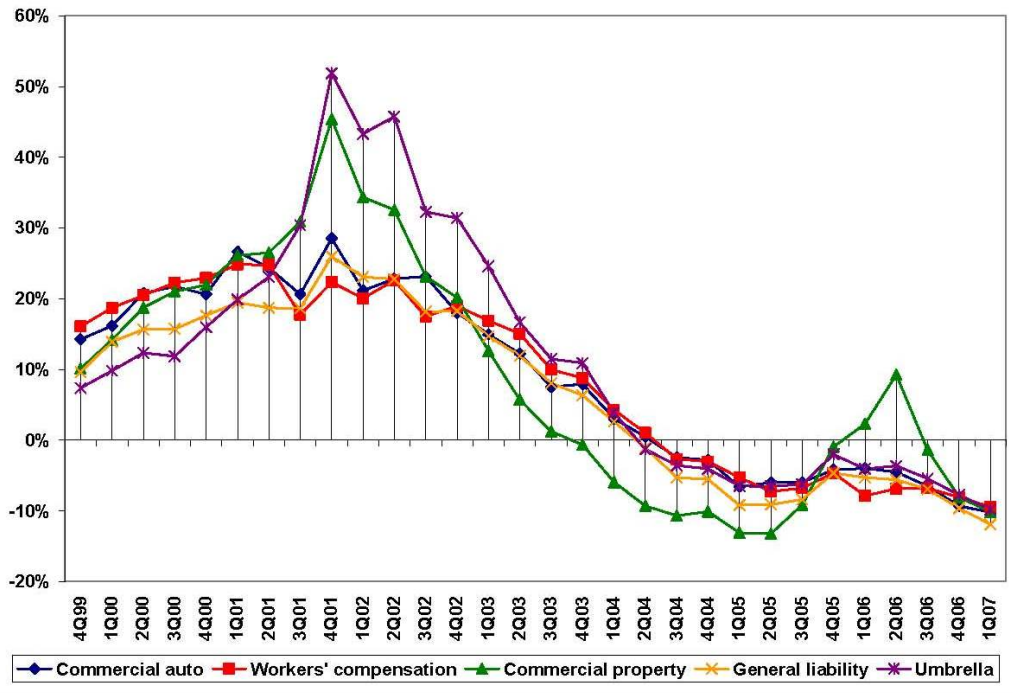
Unlike the early part of the decade, what we are currently seeing is a softening of the insurance market. The Council of Independent Agent and Brokers reported a continuing decline in commercial premiums for its first quarter 2007 survey results. The survey which is compiled quarterly showed average premium rate decreases for the first quarter of 11.6%. Premium charges are at their lowest point since they peaked in the fourth quarter of 2001 following the 9/11 terrorist attacks (Exhibit 2). Decreases are being seen in all lines of coverage, with commercial property rates now in decline following the spike in rates following the 2005 hurricane season.

¹ Where we use the term “captives” in this briefing, we are talking only of group owned captives and risk retention groups, not single parent or other forms of captive.



Exhibit 2

Average Commercial Rate Increases by Line

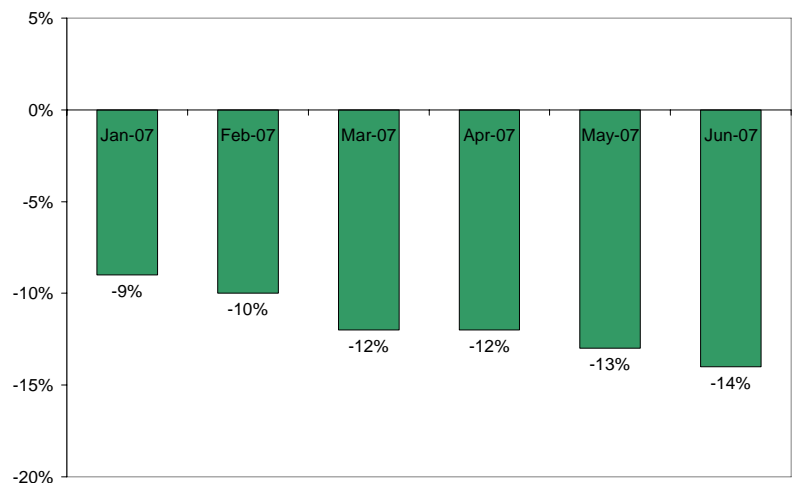


Source: Council of Insurance Agents & Brokers. Chart prepared by Lehman Brothers Equity Research.

The speed of rate decreases also appears to be increasing. Marketscout which produces market premiums statistics on a monthly basis, says June showed a 14% decline in premiums averaged across all lines. The rate of decline has been consistently increasing during 2007 (Exhibit 3).

Both of these analyses show that premiums have been declining consistently since late 2004 with the exception of property premiums which showed a blip following the hurricane losses in 2005. Most observers agree that rates are likely to continue their decline absent major catastrophic losses or deterioration in investment returns. The expected continued decline is driven in large part by the large influx of capital into the insurance market post 9/11 and then post hurricane Katrina. The industry has shown tremendous resilience in replacing capital lost to major catastrophic events. The promise of increased premium rates and

Exhibit 3: Marketscout Insurance Market Barometer 2007



underwriting profit following these losses has attracted new capital. Increasingly this is coming from hedge funds which are providing a ready source of replacement capital to the industry. These investment vehicles are typified by a short investment horizon and the need for a liquidity event. The new (re)insurers need business to achieve these goals. Competition for business among new entrants and existing parties will continue to drive down premium rates.

Competitive Challenge

Falling commercial premium rates put competitive pressure on group captives. The environment in which many of these captives were formed has been reversed and members are being lured back into the commercial market. Group captives face some specific challenges in competing with the commercial insurers.

1. **Pricing Flexibility:** a captive has less flexibility in setting its loss pick. Captives, particularly immature captives, are conservatively funded. With relatively low capitalization compared to commercial insurers, captives have little buffer to absorb adverse loss fluctuations. While they have the option, either implicitly or explicitly, for an additional capital call, such a move could be devastating for the captive particularly in a soft commercial insurance market. Losses must be paid out of premiums. With higher capitalization, a commercial insurer has more flexibility in pricing according to market conditions rather than purely on an actuarial basis. Newly capitalized (re)insurers seeking market share have the greatest flexibility in their pricing strategies. (Re)insurers need to meet regulators' and rating agencies' solvency tests, but for those with new capital there is usually room to maneuver before concern about solvency measures.
2. **Economies of Scale:** commercial (re)insurers usually have the benefit of larger books of business compared to group captives. This provides more predictability in the loss experience of the book. (Re)insurers should be able to price closer to the expected losses of the group with less margin for volatility. Captives with a smaller more volatile book need to include a margin above expected losses to cover the volatility or reflect this in their capitalization or reinsurance structures. These economies of scale should also have a beneficial impact on the non-loss or frictional costs paid by commercial insurers, although as we will show later in this briefing most operate at higher expense ratios than captives.
3. **Captive Success:** group captives are often the victims of their own success. With their own capital at stake and a focus on risk management initiatives, members are often able to improve their loss experience while they are in the captive. This makes them attractive targets for commercial insurers, who may take a more aggressive view of the insured's improving loss trends in premium pricing than the captive would be able to.

Strategies to Compete

With this increasing pressure from the commercial market, how do group captives compete? Fortunately a group captive has several key advantages which it can use to effectively compete in the soft market.

Frictional costs

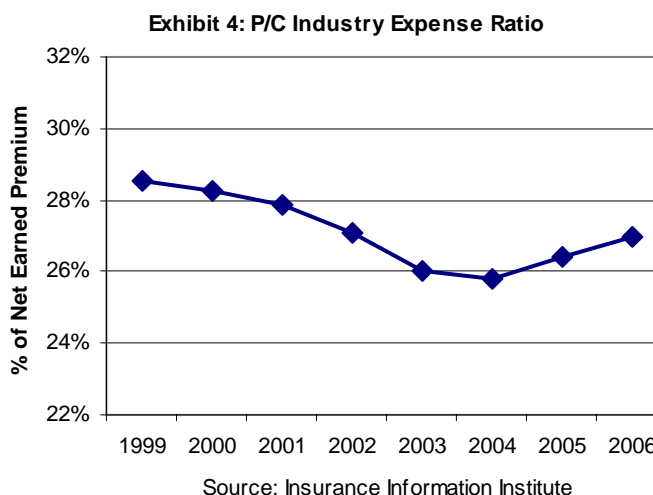
Captives should and typically do operate at expense ratios lower than their commercial insurance company counterparts. This is due to the ability to unbundle services and introduce



competition for service components such as claims handling, loss control and even policy administration. Captives also have a greatly simplified distribution channel compared to commercial insurance. It should be easier for an insured to do business with its own company than an unrelated commercial insurer. Off-setting these advantages are the diseconomies of scale in spreading some fixed costs over a smaller book of business.

For the purposes of comparing expense ratios, we are excluding the costs of aggregate and excess insurance or reinsurance for both captives and the commercial insurers. The resulting expenses are limited to acquisition costs, administrative costs – both underwriting and claims management – fronting and taxes.

The expense ratio for the property casualty industry over the past 8 years has ranged from 25.8% to 28.6% (Exhibit 4). Higher ratios tend to be seen in softer market cycles when there is less overall premium to absorb expenses. By contrast, Tillinghast's Recognized and Accepted Standard for captive expense ratios is 20%. This implies the captive should have a 5-10% cost advantage over the commercial insurer. The captive standard applies across the industry and there is variation between different structures. However, based on where the commercial industry is, a captive expense ratio greater than 25% will remove much of the frictional cost advantage and make the captive more susceptible to competition from commercial insurers.



To compete, captives should be aggressively managing their frictional costs. Commercial insurers are pursuing measures to improve operational efficiency to offset declining premiums. Captives need to be doing the same thing to maintain and enhance their competitive advantage. This is particularly important for any captive with an expense ratio above 25%.

Tactics to manage frictional costs include:

- Writing direct where possible to remove the cost of fronting. The market for fronting is improving, but these services will still cost 7-10% of premiums. Some of this relates to the costs of underwriting the program. A direct writing captive will need to provide these services itself, although the cost of doing so should only be 3-5%. Writing direct should yield savings of approximately 5% of premium. It may be possible for a captive to underwrite directly by operating outside the US. Several offshore captives have achieved this by structuring insurance transactions to take place offshore and outside the jurisdictions of US insurance regulations. A RRG is another option to allow a group captive to underwrite direct. This is limited to liability lines of coverage. Interestingly RRGs have continued to flourish as commercial insurance premiums have softened (Exhibit 1). The lower cost structure of the RRG allows it to compete more effectively. Even in the soft market the cost advantage exists to justify new RRG formations. Converting to an RRG structure for liability risks is also a viable structure for many group captives to consider.



- Unbundling services to focus on the costs of the individual service components. Introducing competition into these areas can drive down the overall costs. In theory there should be cost benefits in packaging services together. However without subjecting the individual cost components to market competition, costs can be higher under a package program. Insurers are also recognizing this and beginning to unbundle services themselves. Many insurers have moved to using third party claims administrators rather than in-house claims handlers. The ability to unbundle will be dependent on the structure of the captive program and the policies of the fronting insurer and reinsurers.
- Managing service providers to avoid service creep. Many group captives have no internal resources and rely on external service providers to run the company. The only direction provided to the service providers comes from the captive's Board of Directors, all of whom are non-executives. Without strong oversight, there is a danger of service creep among providers, both in the scope and depth of services. Service firms want to provide high quality services and satisfy their customers. There is a natural tendency to do more to satisfy the client unless told not to. Service creep can lead to redundancies and services and costs out of line with the captive's expectations.
- Automating or re-engineering processes: the process for an insured to interact with a company in which it is a shareholder or member should be easier than interacting with a commercial insurer. Most group captives though follow the traditional distribution channel in the insurance industry with the routing of information through the parties in that channel. There are opportunities to streamline this process. One example where this is achieved is in the timing of premium payments. At the insistence of owner-insureds, captives typically receive premium funds much faster than commercial reinsurers. There are other opportunities to streamline the administration of captive programs between owner-insureds and the captives.

Furthermore as most group captives cover homogenous risks, similar to program business in the commercial market, there may be opportunities to automate the underwriting process and improve efficiencies. There is an increasing level of automation in the underwriting of small commercial and middle market business. Program business with a number of similar transactions is an ideal candidate to automate. With commercial insurers investing in this level of automation, captives should also be looking at opportunities for automation. Some fronted programs may benefit from automation efforts by the fronting insurers, but direct programs or those written through an MGA should consider automation opportunities to keep up with activities elsewhere. There are many low cost solutions which could help captives in data gathering, managing certificates of insurance, communication with members, and even policy issuance.

- In-sourcing some activities: for larger mature captives, hiring staff and in-sourcing some activities may reduce costs. It will also give captive owners more control over the operations of the captive. This will have additional benefits in bringing focused risk management activities to the members and providing resources to better co-ordinate and manage outside vendors. Initial in-sourcing activities should focus on managing the relationship with current and prospective members and overseeing the operational activities of the captive (underwriting, program administration, claims management, loss control). The captive can subsequently look at pulling more of these operational activities in-house.

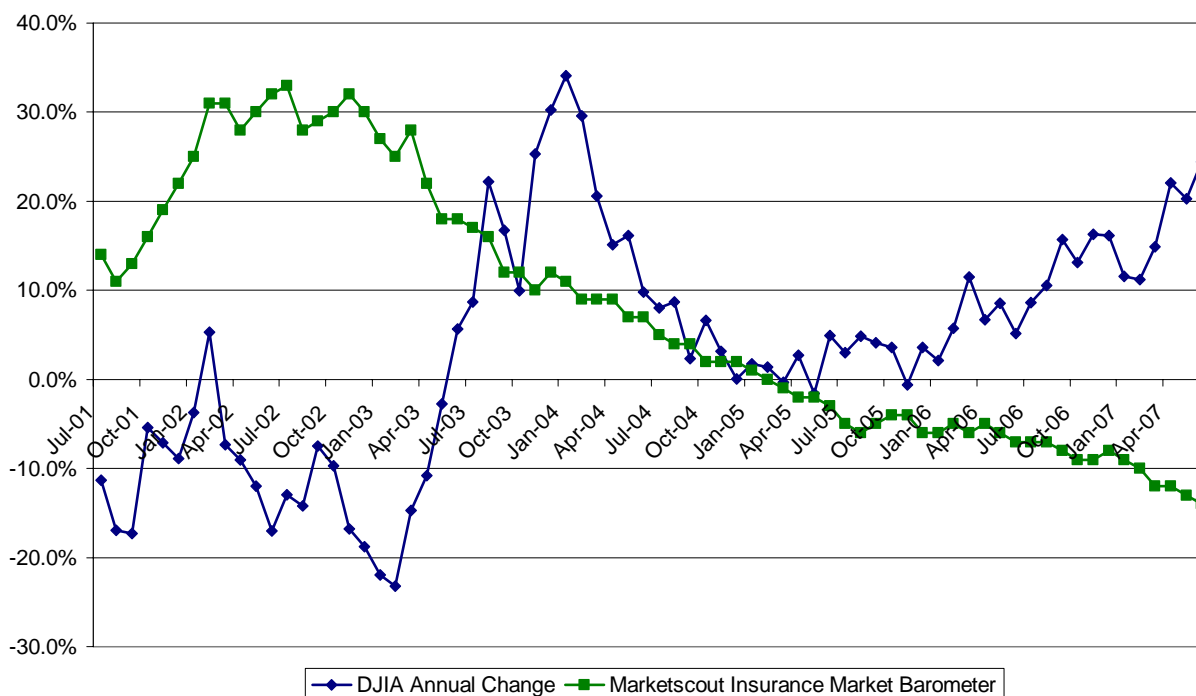


Surplus

The good news about captive members being targeted by commercial insurers is that their loss experience has probably improved while in the captive. That should have resulted in the captive earning surplus. This surplus can be used as a tool to assist the captive in competing with commercial insurers.

Firstly, the captive should consider using some of the surplus in a more aggressive investment strategy. Stock market returns are improving as premium rates are falling. Investment income becomes a key component of an insurer’s net income in soft markets. Exhibit 5 shows a monthly comparison of the annual change in the Dow Jones Industrial Average against the Marketscout insurance market barometer. The two have a moderate inverse correlation with a correlation coefficient of -0.6. This does not imply that commercial insurers are investing purely in equities or that improving stock market returns is the reason for softening premiums. However improving stock market returns will increase insurers’ investment income and offset declining premium rates and underwriting income. Captives should adopt a similar strategy to match insurers’ investment performance.

Exhibit 5: Stock Market Performance & Premium Rates



Correlation Co-efficient: -0.6

The property casualty industry’s investment performance has ranged from 9.5%-14% of premiums over the past 8 years (Exhibit 6). Matching the commercial insurers’ investment income can be achieved with only modest investment returns. An annual yield of 4.5% will generate investment income of approximately 14% of policy year premium on typical general liability payout patterns. This level of return and higher can be achieved by taking a more aggressive strategy with some of the captive’s unencumbered surplus, investing in equities and



other higher yielding securities. Such a strategy should still provide sufficient conservatism to protect the core capital base.

Surplus can also be used as incentives to retain members. Surplus can be returned to members who renew with the captive in the form of premium credits. This encourages members to remain in the captive and helps bridge the gap between the actuarial premium rates and what the market may be charging. The loss of surplus on leaving can also lock members into captive programs. A punitive exit provision is fairly typical and appropriate given the on-going liability the captive and its remaining members will face from the departing member's years of participation in the captive.

The Power of the Group

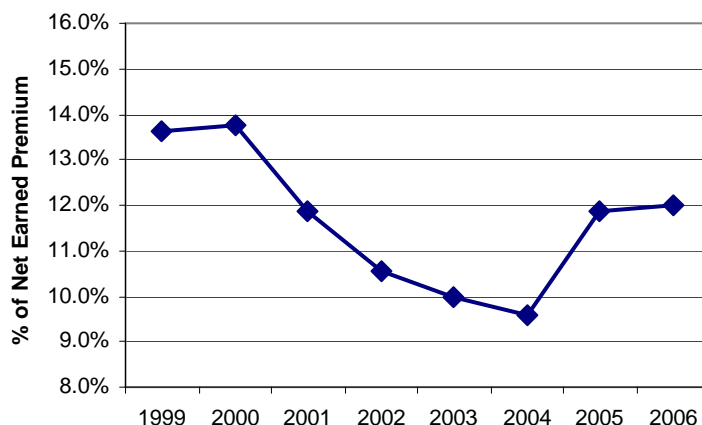
The strength of group captives is in the cohesiveness of the group. This can not be replicated easily by a commercial insurer. Nor can the benefits of the group be replicated by individual insureds. During times of competition it is important that the captive stay close to its members and maintain the cohesiveness of the group.

Firstly, ensure that there is strong and clear communication between the captive and its members. The long-term benefit of the captive needs to be emphasized. Insurance is a zero sum game. In the long-run you pay for your own losses. The key issue is which risk financing mechanism (a) minimizes the cost of financing the losses, and (b) provides the greatest incentive to minimize losses? The captive should win on both counts. The lower frictional costs and the retention of investment income make the captive a more efficient risk financing vehicle than the commercial insurer. Having skin in the game should provide a greater incentive to reduce losses than buying insurance. These structural advantages need to be clearly communicated to and understood by the members. Any perceived premium advantage from a commercial insurer will either be a short-term phenomenon and/or will not hold up after allowance for investment income.

Secondly, the captive can enhance the added value of group membership through member services. These services may be directly focused on the risks insured within the captive or in ancillary areas. The ability to network with other members and benefit from best practices in an exclusive club atmosphere is a valuable benefit which strengthens the cohesiveness of the captive and makes it more resilient to external competition. Investing in member services is another potential tactical use of surplus to counter competition.

Finally, if the captive is unable to match short-term market pricing there is the option of arbitraging the market. This is more effectively done as a group than as individual buyers, for a couple of reasons:

Exhibit 6: P/C Industry Investment Income



Source: Insurance Information Institute



- Economies of scale: the group will have greater negotiating power than an individual insured. From a technical perspective the group provides the (re)insurer with a better spread of risk and more predictable loss experience. The group should be able to benefit from pricing based on its own experience, whereas an individual insured will most likely be subject to the insurer's standard book rates.
- Market access: the captive can act as the conduit to the reinsurance market. This may open up additional markets which the individual member could not reach. It may also provide a more efficient access point to the market.

Arbitraging the market protects the captive's capital and keeps the group together over the long-run. It allows the group to seamlessly resume risk taking as future market conditions warrant. Complete arbitrage of the market, in which the program is 100% reinsured, is rare. However, partial arbitrage is common. This is seen in lower excess of loss and aggregate reinsurance attachment points.

Group captives are difficult to put together. Once formed they present an efficient and effective risk financing structure for their members. Over the long-run they will have structural advantages to commercial insurers in reducing frictional costs and incentivizing loss control activities. Looking at exit strategies and losing members to the commercial market leaves these insureds exposed to the vagaries of future market cycles. Stepping up to the competitive challenge and preserving the membership of the captive will provide members with stable long-term insurance protection and control over their insurance costs.

About Newport Risk Services

Newport Risk Services is a management consulting firm dedicated to the needs of the insurance industry. We provide strategy, business process and operational consulting services to insurers, service providers and alternative risk financing vehicles.

