

A Deep Dive into the Casualty Group Captive Space with Duke Niedringhaus and Rob Walling

Duke Niedringhaus with the Captive Practice Group at J.W. Terrill, a Marsh & McLennan Agency LLC Company, interviewed **Rob Walling**, Principal and Consulting Actuary with Pinnacle Actuarial Resources.

Pinnacle is the leading actuarial firm for the casualty group captive industry. This interview highlights some of the most compelling stats of this fast growing segment of the insurance industry. The A/B captive formula created by Pinnacle in 1985 has proven to be the most efficient mechanism to finance long tail casualty exposures of Work Comp, General Liability and Auto. This interview provides insight into some of the more technical components of the group captives, as well as differences compared to the self-insured work comp industry. The minimum premium for group captives is only \$150,000.

(DN) Pinnacle provides actuarial services for the majority of casualty group captives nationally with thousands of middle-market clients. Do you see any trends where group captives outperform insurance industry data regarding loss development, fatalities and medical control?

(RW) There are several ways to assess whether captives are outperforming traditional admitted insurance for middle-markets businesses. Middle-markets businesses that go into group captives almost never return to traditional insurance. Companies that embrace the more proactive approach to controlling insurance costs that group captives offer tend to continue using captives, even if they leave the group captive to form a single-parent captive or other structure. The other factor is claims performance. We recently completed a study for the leading provider of group captive consulting services. We found that their group captive members had half the expected number of workers compensation fatalities and only 61% of the expected number of lost time claims when compared with their peers, according to Bureau of Labor Statistics data. These are significant numbers of real lives which are not tragically impacted by workers compensation claims.

(DN) You separate your loss projection into a frequency (“A”) fund and severity (“B”) fund. Generally, the A fund limit has migrated from \$100,000 to \$125,000 over the past 20 years. In the self-insured workers compensation industry we have seen retentions double over 20 years from \$250,000 to \$500,000+. Given the surge in medical inflation and skyrocketing drug costs, how has the group captive industry experienced such a minimal increase in the “A” fund threshold?

(RW) The difference between the frequency and severity fund limits is primarily an assessment of the losses that are stable and predictable. This allows the group captive member to fund any losses in excess of the loss pick while retaining the benefits of favorable experience. The severity layer has enough randomness and volatility in the claims experience that the risk is more appropriately pooled among group captive members. In the aggregate, this experience typically outperforms the industry and therefore all members benefit. While we have seen some upward creep in the frequency layer based on these criteria, it has not dramatically increased.

(DN) The self-insured work comp markets are all looking to capture 10 years of loss data. The group captives continue to work off 4 years plus the current year. Considering you are doing loss projections on challenging exposures such as general liability and California work comp, do you see the group captives expanding the loss data for each account?

(RW) When pricing a self-insurance program, there is constant tension between trying to increase the credibility of the data reviewed and making sure the data is relevant and responsive to current experience. Often times, a middle-market business's experience from 6-10 years ago represents a different company, with different operations and different people in key positions. We have found over the past 20+ years of performing tens of thousands of these funding studies, is that five to six years of experience performs quite well in terms of balancing the two goals of stability and responsiveness.

(DN) Efficient reinsurance is a highlight of the group captive industry. We know that in the work comp industry, the majority of losses slowly migrate into the excess layer over 5-15 years. How would you describe the profitability of group captive reinsurance over the past 25 years?

(RW) The real proof of the profitability of the reinsurance component of the group captive space is the number of carriers interested in fronting and/or providing reinsurance coverage for group captives. Well-designed group captives with a core of members that are seeking to take control of their insurance costs are typically finding a number of available fronting and reinsurance markets.

(DN) The maximum formula for group captives is A fund + A fund + B fund (2 x A + B). What percentage of group captive members would you expect to annually hit the 2 x A + B maximum?

(RW) The whole point of having the frequency layer assessable at up to two times the expected losses is to have a significant consequence in the event that a member has adverse claims experience. It should not be likely that a member has frequency layer losses in excess of two times their loss fund. Historically, the number of members that exceed 2A in frequency layer losses are on the order of 3-5%.

(DN) As a broker focused on the group captive alternative, we are always convincing our umbrella underwriters that this is preferred umbrella business to insure over an engaged captive member. Can you give some perspective on how group captives successfully control losses exceeding the \$1,000,000 primary casualty layer for auto and general liability?

(RW) The best practices in group captives provide several ways to prevent large losses. First, there are internal peer-to-peer loss prevention efforts. These often start with a current member interviewing and reviewing the new member's application. Once in a group, watch lists for members with deteriorating results and awards lists for best-in-class risk management create significant peer pressure to improve. Finally, most group captives invest heavily in safety and loss-prevention initiatives. Some of these efforts benefit all members, while others are customized to specific industries (e.g. trucking, staffing) or geographic areas (e.g. California workers compensation issues).

(DN) We recently highlighted a security camera upgrade for a convenience store and the impact on loss trends. This resulted in a favorable reduction in the captive loss projection. What advice can you give to captive members to illustrate that working with Pinnacle on documenting enhanced risk management strategies may warrant a lower loss projection?

(RW) Reflecting changes such as this is a real challenge for actuaries. Actuaries are required by our professional standards to “consider” material operational changes. The problem is, “How much consideration are these operational changes worth?” Most actuaries are, by nature, quite conservative and prefer to “trust, but verify” on this issue. As a result, they tend to miss high on their premium estimates. My advice is to provide as much documentation as possible on the specific measures that have been implemented and on the initial impacts those changes are having on frequency, severity, lost-time claims or other pertinent metrics.

(DN) The 2016 industry outlook by Marsh highlighted that large fleet auto coverage is one of the market challenges. Any perspective on the auto liability line for fleets in the group captive sector for both trucking and heterogeneous risk exposures?

(RW) The underlying issue with large fleet results is at least partially the loss exposures commonly used – vehicle or driver counts. For the last 2-3 years, miles per vehicle have been increasing, this tends to increase frequency per powered unit (or per driver). As miles increase, trucking companies tend to add power units and potentially drivers who may not be as experienced. This can lead to increases in frequency and severity. These phenomenon are quite cyclical and correlated to the economy overall and changes in driver licensing and testing.

More broadly, most large fleets in the United States are already in some form of captive (group captive, risk-retention group or single parent captive) or large-deductible insurance program. Pinnacle alone serves several hundred trucking companies in these types of insurance programs with thousands of powered units. Interestingly, we have seen each of these approaches successfully implemented by large trucking companies. Some of our largest trucking customers use a combination of approaches, say a retained self-insurance primary risk layer and a risk-retention group or single parent captive above that. In the group captive space, we have trucking companies in both homogeneous and heterogeneous groups, sometimes with deductibles below the captive retention. The group captives that serve only trucking risks may benefit somewhat more from a group of trucking companies coming together to develop best practices and trucking-specific safety and loss-control programs.

(DN) One of the great components of the group captives is closing policy years via the internal tail fund after about 5 years. Do you have any insight into the tail fund pricing and underwriting performance?

(RW) A key advantage of the best group captives is giving members cost certainty on old policy years as quickly as practical. The basic approach to pricing this tail fund is to estimate the expected ultimate claims liabilities based on the experience to date and use this estimate as the basis for the tail fund premiums. Most tail funds actually outperform the initial premium estimates, providing a small revenue incentive to current members and instilling confidence in the captive’s ability to successfully resolve claims that take a while to get settled.

It is important to recognize that members of the current policy period underwrite the risk of the tail fund losses. In many instances, but not all, some of these members were also involved selling the liabilities into the tail fund.

(DN) We are really bullish on group captives geared for challenging exposures such as roofing and heavy construction. What is your perspective on managing these severity-driven exposures in a group captive?

(RW) The captive landscape is littered with group captives that tried to provide solutions too difficult to insure industry segments, such as trucking, heavy construction or staffing. But today there are successful group captives for many hard-to- insure markets with significant severity exposure. These programs focus on identification of superior risks in the industry, often using member referrals and reviews, and specifically-designed loss prevention and safety programs to produce superior underwriting results. A disciplined approach to pricing is also essential to their success.

(DN) Group captive growth since 2012 has been incredible, and without any hard market cycle. What are your thoughts on the surge in premiums for this alternative?

(RW) Group captives recognize that medium-sized businesses are more risk-savvy than ever before, and therefore more willing to accept risk. These risk-averse business owners recognize the significant economic benefits they can realize by funding their traditional insurance exposures in a captive insurance company. We are now seeing a wave of expansion with group captive members forming small, single-parent captive insuring enterprise risks (e.g. EPLI, cyber liability, supply chain, and reputational risks) that group captives do not traditionally insure.

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