

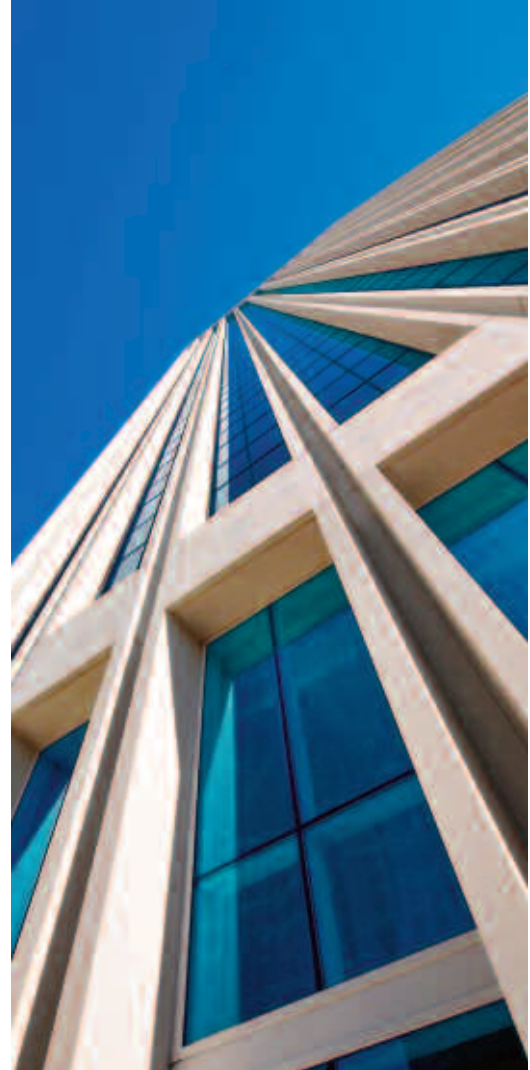
## GROUP CAPTIVES: A CONSTRUCTION INDUSTRY ALTERNATIVE

When it comes to insurance, few industries know real frustration as well as our construction brethren. The diehard construction-friendly insurance community is a small fraternity that, although sincerely committed to the industry, sometimes balks at changing economic circumstances or emerging risks. Compounding the problem is that few industries are as dependent on insurance and risk management; a contractor's ability to win work and protect profit margins heavily depends on efficient and stable insurance relationships. But insurance is cyclical and reactionary, times change, risks change, underwriters move on and cynicism can threaten harmony. So insureds naturally start to question the value of an insurance relationship, weighing historical premiums paid against the benefits gleaned, recalling the annual renewal uncertainties and lamenting the time consumed in negotiating, binding and reconciling every aspect of coverage. It's against this backdrop that many contractors become wary of the traditional marketplace and look for alternatives. One such alternative is the group captive insurance company.

Group captives have been an insurance alternative in the construction industry for many years and can be a positive force in advancing longer-term insurance strategies. Willis provides group captive solutions for its construction clients, so in this issue of *Blueprint* we address how these special insurance entities work and highlight an example of one of our group solutions for contractors.

Unlike single-parent or pure captives, group-owned facilities directly compete with traditional insurance markets (as opposed to merely funding the retained or uninsured risks of its owners). These captives are specifically designed to underwrite the risks of their owner-insureds (participants, if you will) in such a way that loss exposures are transferred via a communal risk pool or through reinsurance or, more commonly, both. Because the insureds are its owners, participants play an active role and are beneficiaries in the underwriting and investment performance of the captive.

**Group captives come in a number of different forms with different missions and operating characteristics, each designed to meet a specific constituency or risk strategy.** They may



emphasize either participant size or a single industry, such as construction, and will either provide an array of traditional coverages or insure very specific, hard-to-place risks only. Many group captives are formed and marketed by professional trade associations, insurance companies, brokers and agents as well as other independent captive service providers. Typically offering primary Casualty insurance – Workers' Compensation, Automobile Liability and General Liability – the actual policies are usually issued (fronted) by an admitted, highly-rated commercial insurance carrier.

# ARE GROUP CAPTIVES WORTH CONSIDERING?

That's a great question with no stock answer and certainly they are not for everyone. For some construction clients, group captives offer an excellent opportunity to assume more risk, increase risk management discussions and reduce insurance costs. For other clients, the opportunities are more limited.

**The first thing to remember is that a group captive is both an underwriting entity and a pool of risks, very similar to a traditional commercial insurance company; and as such, it is also a going concern and must remain one.** The captive's ability to provide long-term stability to its owner-insureds is only as strong as the captive's ability to assume, manage and minimize loss exposures and contain costs. There are critical elements of the captive to consider, including:

- The financial strength and capacity to 1) assume risk annually with meaningful limits and 2) meet its current and long-term liabilities and obligations
- Size/number of participants: some captives are so large that the element of control by each member is non-existent
- The risk profile of the existing insureds, as well as any legacy risks that may exist from former insureds
- The quality and stability of the fronting and reinsurance relationships
- The quality of the service providers and the availability of risk management, loss control and claim support for each participant
- The cash flows associated with premiums, loss payments and participant equity accounts and their interdependencies
- New participant risk profiles and membership protocols
- The captive's management and corporate governance
- Exit requirements, including loss security, access to equity account funds and future assessment obligations, if any
- The "two hats" axiom that requires each participant to act in the best

interests of the group as a shareholder, as well as in the best interests of their individual companies as an insured (this can lead to lively debates at the captive's board meetings)

- Business culture and philosophy: when doing business with new partners it is highly recommended you meet as many other members or attend a meeting to ascertain that, beyond financial considerations, the relationship would be a good fit

**Companies that are fortunate to become involved with a quality group program that meets both their insurance needs and risk management requirements can find the experience to be very positive.** Good individual loss experience coupled with good group experience will invariably lead to reduced insurance costs as the profits accrete to shareholder (participant) equity. Group environments tend to encourage much broader intrinsic benefits in the form of targeted discussions and implementation of industry best practices. The group also tends to secure lower cost excess coverage (in the form of reinsurance) based on increased purchasing power and pooling leverage.

The Willis Global Captive Practice manages one of the oldest heterogeneous group captives in the Caymans, Alembic. Our consulting and feasibility team can analyze the strength of existing captives and the ability of groups to form new captives. Willis has Captive Management capabilities in all domestic U.S. domiciles, plus Hawaii and Cayman.



# WHAT IS WILLIS CONSTRUCTION'S ROLE WITH GROUP CAPTIVES

The Willis Construction practice responds to our clients' queries concerning group programs in several ways. If our clients are involved with, or considering, a specific group captive, we provide comprehensive assessments of specific issues, concerns and highlight areas for further scrutiny. Our efforts include:

- Conducting cost and cash flow analyses, comparing performance (against other risk financing programs) on either prospective or retrospective basis
- Identifying and contrasting terms, conditions, core risk management services, claim support and security criteria between the captive and other traditional programs
- Assessing the specific operating components, governance and general health of the captive, and objectively communicating our thoughts

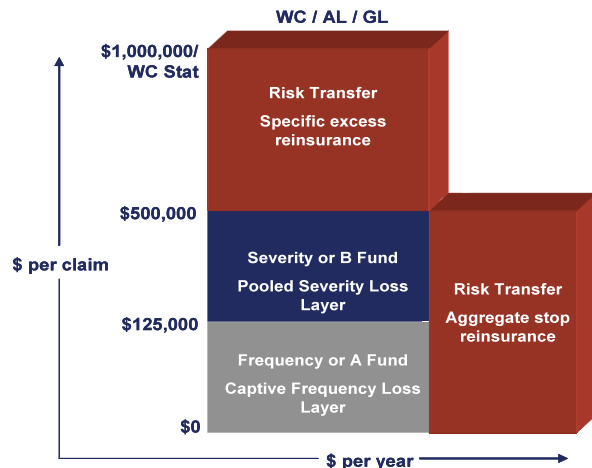
In addition, many existing group programs are open and can be accessed by the brokerage community. Willis maintains such access to a number of industry-based facilities including, for example, American Contractor's Insurance Group. Further, the Willis Construction Practice serves as the program administrator for two high quality group captives dedicated to the construction industry: Construction Solutions (a national captive) and Four Corners (a Colorado-specific captive). We'll focus on Construction Solutions for this discussion.

## CONSTRUCTION SOLUTIONS

Construction Solutions (CS) is a broad-based (general or specialty) contractor group captive established in 2001. The captive is open-access and does not restrict applications advanced on behalf of new members by non-Willis brokers and agents. The participants (owner-insureds) of CS govern the captive and consider each new entrant based on a rigorous assessment of the candidate's risk profile and general corporate quality. The captive maintains formal contracts for necessary management, investment and risk support services from industry-respected, independent third-party professionals. Willis acts solely as the insurance broker and insurance program administrator for CS and its placements. All service providers are paid a fee for their services and are not equity owners.

Construction Solutions uses the 'A / B Fund' loss layer design that is the industry gold standard for group captive operating structures. Risk layers are segregated based on per-loss occurrence severity. Each participant has their own A Fund. This structure allows for an effective balance between participant loss retention in the A Fund, efficient funding of large losses through pooling in the B Fund capped by excess and aggregate reinsurance.

The above diagram is a simplistic rendering of the CS structure. Premiums are established by the fronting carrier, Liberty Mutual, based on an individual insured's historical loss and exposure data, coupled with the captive's operating and reinsurance costs as determined on a group basis. Liberty issues each individual insured a guaranteed cost (or



first-dollar) insurance policy in order to evidence coverage. The captive assumes the premiums under a reinsurance agreement with Liberty, with a portion of those premiums used to secure excess and aggregate stop reinsurance.

Participation in any group captive should always be viewed as a long-term commitment. For CS, each insured purchases capital stock in the captive and participates in the overall loss and operating performance of the group. The funding of the A & B funds is tracked separately for each member, thus allowing for accumulation of individual funds as loss experience proves favorable. It should be noted, however, that these same accounts are subject to assessments if the group's combined losses exceed certain thresholds, a safety mechanism common to group captives. For CS, the potential assessments associated with any given policy year are capped at one times the insured's initial A fund. For more detailed information, please contact Craig Ream (contact information below).

# FINALLY

Group captives have a long history of productivity, having helped build the current insurance industry, as many group captives evolved into the world's largest underwriters (ACE, XL, etc.). If you're considering a group captive for your company's insurance and risk management program, we offer some words of advice: **Do your due diligence so you won't regret the outcome.** Risk is risk and the cost of risk can never be less than the sum of the expected losses, to ultimate value, plus the fixed costs for operating a captive and securing reinsurance. Make sure any comparisons undertaken that contrast a group captive against more traditional commercial programs are measured side by side with consideration of all material variables and your company's risk management requirements. It can be difficult to separate the apples and the oranges – Willis Construction can help.



## CONTACT

For more information on Construction Solutions contact

**Craig Ream**

412 586 3536

[craig.ream@willis.com](mailto:craig.ream@willis.com)

For other alternative risk financing solutions, including captive questions related to construction, contact

**Caroline Koenraad**

404 224 5073

[caroline.koenraad@willis.com](mailto:caroline.koenraad@willis.com)

**Charlie Woodman**

404 224 5034

[charlie.woodman@willis.com](mailto:charlie.woodman@willis.com)

For general information about group captives, contact

**Randy Boomgarden**

312 288 7075

[randy.Boomgarden@willis.com](mailto:randy.Boomgarden@willis.com)

For information on Willis Captive Management capabilities, contact

**Les Boughner**

208 264 2064

[les.boughner@willis.com](mailto:les.boughner@willis.com)

For captive consulting information, contact

**Sean Rider**

212 915 7865

[sean.b.rider@willis.com](mailto:sean.b.rider@willis.com)

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