CAPTIVE INSURANCE PROGRAMS

Turning your Workers’ Compensation
Premiums into Profits

HUB International
Insurance Services

York Alternative Risk Solutions
The battle over higher minimum wage is over. During 2015, fourteen cities, counties and states approved a $15 minimum wage through a combination of local laws, executive orders and other methods. Several dozen ballot or legislative proposals were introduced around the country, 16 of which have carried over into 2016.

Higher wages are here to stay. The time has passed to talk about the fight to stop them. The real question now is how we deal with their unintended consequences.

**WORKERS’ COMPENSATION: THE BEST PLACE TO START**

There are many key costs tied to payroll, the most expensive of which is workers’ compensation.

Insurance carriers offering this coverage base their ratings and premiums on the historical loss trends of their insureds. If a company’s loss ratio (total losses divided by total premiums) decreases, their rate and premium charged will decrease - eventually. Guaranteed cost providers must watch their loss ratios change over time before corresponding rate adjustments are put into effect. However, this could take years to happen.

**THE SOLUTION FOR RIGHT NOW**

But there is a way to take some control of this situation, and it’s available to businesses today - a solution that not only addresses the inflexibility of traditional insurance markets to respond to regulatory changes, but also allows a business to return to their bottom line the rewards of good risk management practices: a captive insurance program.

For the restaurant industry, it’s a good time to take a look at the relief captives could offer. Consider the following:

- When a $10M payroll increases to $14M due to outside forces, with absolutely no changes in man hours, the captive insurance model provides a way to hold ground against the inevitable rise in payroll-related insurance costs.
- When a business works hard to create a safer workplace that results in fewer claims, a captive insurance program rewards that effort by returning profit to the business instead of their carrier.
- And, because the captive insurance model provides a greater say in how claims are handled, as well as the availability and price of coverage, a business can immediately regain a greater degree of control over their profitability.

Market, regulatory and wage inflation forces may be working against the restaurant industry right now, but there is a way to fight back - a tool that will help keep workers’ compensation costs from spiraling up alongside wage increases, and give greater control over insurance premiums and profitability.
There are multiple ways a business can take more control over their insurance program, but they all share a common, distinguishing factor from the traditional options provided by insurance carriers. Alternative risk solutions are ‘loss sensitive’ programs. That means the ultimate cost of a program is determined by what your actual losses cost. There’s a premium component, but it’s really driven by the cost of your claims, your losses and the expenses of managing those claims. When compared to the traditional, guaranteed cost market, a company with a strong safety program that does a good job managing their losses can benefit greatly from an alternative risk solution. These ‘loss sensitive’ programs fall into a few different categories: large deductible programs, self-insurance, retrospective programs (or ‘retros’ as we call them) and captive programs. Eligibility varies.

For instance, premium thresholds can be in excess of $1 million for large deductible programs and retros can also be out-of-reach from a pricing standpoint for many middle market companies. Self-insurance is typically a process driven by state qualifications and can be more appropriate for sizable companies. When it comes to middle-market companies, the best option is often a captive program. For those wanting greater control over their insurance program and costs, the group captive program has become the predominant vehicle for companies in the under $1 million premium range.

**WHAT IS A CAPTIVE?**

A captive is an insurance company created and wholly owned by one or more non-insurance companies to insure the risks of its owners (example: a group of restaurants, builders or transportation companies could form a captive). Captives are a form of self-insurance (with full reinsurance protection) whereby the insurer is owned wholly by the insureds. They are typically established to meet the risk management and insurance needs of the owners or members. Captives are the fastest growing segment of the commercial insurance marketplace, and for good reason. These programs can bring tremendous benefits to their owners, such as:

- **Underwriting Profits** that directly enhance a company’s profitability.
- **Greater Control over claims that are paid** - There’s not a business operating today that hasn’t felt the frustration of having to pay a claim that they would have preferred to fight. When a business owns its insurance program, members have a greater say in what claims are paid and which are settled.
- **Greater control over providers and vendors** - As a member of a captive insurance program, you also have a greater say in who is servicing your account, your claims and how that service is handled. If the job isn’t getting done properly on the loss control side of things, you have the ability to replace that vendor. That may or may not happen when an insurance carrier is in charge. And that control extends to the choice of carrier, also. As a group, you can decide to shop around and find the coverage, pricing and terms that work best for you. You have control over who handles and services your insurance program.
- **Other benefits** - such as full insurance and reinsurance protection, and coverage which is designed to meet the insurance requirements of your business (for Workers’ Compensation, General Liability, Property & Auto Coverage).
Together, these factors add up to provide the lowest net cost for insurance - the hedge so many businesses need today to remain competitive and combat current market and regulatory pressures.

**A SHORT HISTORY OF CAPTIVES**

Many people don’t realize that captive programs have been around for over five decades. The term “captive” was coined by Fred Reiss, known as the father of captive insurance, when he formed American Risk Management in 1958. During this time, US regulations made it too expensive to form and operate captives in the United States. Bermuda ultimately assisted Mr. Reiss in forming the first modern day captive in 1962. By the end of the 1960’s there were over 100 captives formed, with Bermuda and the Cayman Islands being the leading domiciles.

By 1978 Bermuda became the first country to formally establish the captive industry with comprehensive legislation, licensing and oversight procedures. The growth trend continued and by the 1980’s there were about 1,000 captives, operating mostly outside of the US.

Today there are over 7,000 captives operating in the world with more than $10 billion in annual premiums. Bermuda is still the largest domicile, with over 900 captives. However, there are now over 2,000 captives domiciled in over 30 states in the United States.

The tremendous growth in captives domiciled both in the US and worldwide can be seen in both large organizations (over 90% of Fortune 500 companies own captives) and mid-sized companies. Group Captives, which insure mid-sized companies, are the fastest growing segment of the captive marketplace.

Today, the market is comfortable with and widely embraces captive programs as a viable alternative to traditional insurance programs. This is due in great part to the large number of domestic captives, and the structure imposed on them through formal regulation and oversight.

**A SUCCESS STORY: THE RESTAURANT FRANCHISE CAPTIVE PROGRAM**

The Restaurant Franchise Captive Program (RFCP), a division of York Risk Services Group, is an excellent example of a group captive that was formed for the benefit of restaurant franchisees. This program began in the midst of California’s ‘hard market’ in 2004, at a time when workers’ compensation insurance rates were skyrocketing, forcing many employers out of business.

Two franchisees - one a Carl’s Jr. and the other a Denny’s - partnered to start the RFCP and began writing insurance business on July 1, 2004. The primary goal of this venture was to gain control of their own insurance costs. By getting access to and embracing claims management and safety services, they were able to drive the cost of their workers’ compensation, general liability and property insurance to the lowest possible level.

Now, after almost 12 completed program years the RFCP has been phenomenally successful in delivering:

- A successful, growing captive insurance program with over $20MM in annual premiums.
- Underwriting returns to members of $10.4 million to-date.
- Historical loss ratios of 30% compared to 55-60% industry norms (this is the ratio of claims costs to premiums paid - so lower is better!).
- Over 2,000 locations in over 30 states.
- Over 20 restaurant brands insured in the program.

Captive insurance programs have gained acceptance as a smarter way for many companies to buy insurance.
A CAPTIVE PROGRAM THAT EXCEEDED ALL EXPECTATIONS
The RFCP program has more than exceeded the expectations of the members when they formed it back in 2004.

As a result of member efforts working with their program manager and broker to manage claims and safety issues, they’ve received millions of dollars in underwriting income that went right to their companies’ bottom line, increasing overall profitability. The RFCP members have literally turned what was a business expense into a profit center.

Getting into the Restaurant Franchise Captive Program was one of the best decisions I’ve made as a business owner. I have been in the program since its start in 2004, and the RFCP has done more to enhance my profitability than any other single thing I could have done. I couldn’t be happier.

Michael Borchard – President
M & N Foods, LLC (Carl’s Jr. Franchise)

HOW DOES A CAPTIVE WORK TO SAVE YOU MONEY?
It’s a frustration we hear over and over in the marketplace; a business pays, say $500K in premium to their insurance carrier, and in spite of their hard work in keeping claims low, premiums rise again the following year with the carrier pocketing the profit. Business owners are understandably outraged. With a captive insurance program, that won’t happen. Here’s a bird’s eye view of how it works:

When you pay a dollar of traditional insurance premium to your carrier, roughly:

• 40% goes to the carrier’s overhead and operating costs.
• 60% is set aside to pay for losses and for the carrier’s underwriting profit.

From the viewpoint of an insured, that dollar is spent. Even if your business is diligent about risk management, and through focused safety practices you keep claims low, the fruit of those efforts will remain with your carrier. That premium dollar is for you, paid out and gone.

But in a captive insurance program, that same premium dollar can deliver very different results. Because you ‘own’ your insurance program, you have more control over its profitability. As a result, when claims are lower due in great part to accident prevention and safety measures you take, a portion of that dollar comes back in the form of profit. Your business, not your carrier, benefits.
HOW MUCH IS RETURNED AS PROFIT?
The lower your overall losses, the more profitable the program, and the greater the amount returned in the form of profits. The average loss ratio for members of the Restaurant Franchise Captive Program today is 30% - three out of every ten premium dollars is paid to losses.

This loss ratio demonstrates the member’s focus on strong safety programs and processes, selective underwriting and the effectiveness of loss control in claims management services.

Using a hypothetical annual insurance premium of $500K, that 30% loss ratio would translate to program profit of $150K. The chart below shows income that would be returned to members at various loss levels:

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<th>Losses/Loss Ratio</th>
<th>Member’s Income (Example)</th>
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<tr>
<td>$0 / 0%</td>
<td>$300,000</td>
</tr>
<tr>
<td>$50,000 / 10%</td>
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</tr>
<tr>
<td>$450,000 / 90%</td>
<td>($150,000)</td>
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THE POTENTIAL BENEFITS AND RISKS
As the chart illustrates, companies whose loss history demonstrates a consistent focus on workplace safety will do well and profit accordingly. Additionally, the RFCP model caps the downside risk. If a member experiences a year of higher claims which exceed the amount set aside in their loss fund, their total amount paid out for claims will never be more than 90% of annual premium. Using our current example, that translates to $450K (90% of the $500K annual premium). Since $300K of that amount was already funded, the maximum additional member outlay, or risk ‘gap’, would be $150K.

To be sure, a captive insurance program is not for everyone. But for an organization with a strong culture of safety, the upside potential can far outweigh the downside risk. In the case where there were zero dollars of claims, a member would get their entire loss fund of $300K returned. The return on their investment/risk is $300K/$150K risk gap, or 200%. Even performing as an average member, with a loss ratio just above 30%, the return on their risk would be in the range of 100%.

After over a decade of experience with this program, we can say with confidence that the combination of strong underwriting guidelines, attention to loss control practices and expert claims handling have consistently yielded a greater degree of control, marketplace stability and underwriting income for our members.

SUMMARY
If you’re reading this paper, you’re most likely living the problems outlined herein. You have experienced the frustration of paying insurance premiums to providers who pocket the profits that resulted from your good risk management practices. You live with the looming threat of rising minimum wages and all that implies for your business. And you may have accepted as fact that control over your claims process is not yours. But now you know otherwise. Captive insurance is a tool that can help, and you have a good, basic understanding of how it all works.

The next step is to learn the difference it can make for your business. Thank you.
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Everett Newman, Jr., a 30-year veteran of the Property and Casualty Insurance industry, is Managing Vice President of York Alternative Risk Solutions. His responsibilities include the overall management of Captive Program operation, Captive Program formation and management services to a wide variety of industry groups. York’s customers have long reaped the benefits of Everett’s experience with Captive Programs; having served as President of two large regional insurance brokerage firms and as the National Hospitality Industry Practice Leader for a large national brokerage, he brings a wealth of knowledge to every transaction.

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Zach Kuperman is an insurance professional at HUB International, ranked as one of the world’s 10 largest insurance brokers. He specializes in providing large deductible, captive and tailored property and casualty insurance solutions to the hospitality and food industries. Clients include large, national franchisors and franchisees as well as local concepts that are just beginning. Additionally, he has built a transactional platform to provide due diligence and insurance placement services for acquisitions of any size that removes the burden of insurance selection on complicated transactions.