

# THE RHA REVIEW

ROUTE TO:

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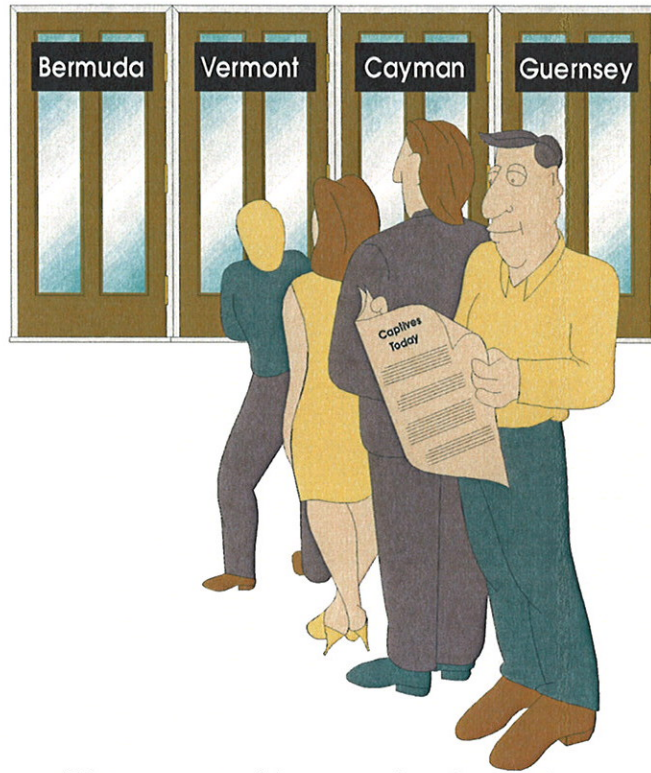
*A publication of Robert Hughes Associates, Inc., an international litigation support, actuarial, risk management and insurance consulting company.*

## CAPTIVATING PREMIUMS

By Donald W. Bendure, MBA, CPCU, RPLU, ARM

Captive insurance companies are once again perceived to be the hot ticket to elite risk management. Corporations want them, states want the income they generate, and now even New York, the bastion of conservative insurance regulation, is jumping on the bandwagon. Not only is New York City getting one, but it is being funded by more than one BILLION dollars from a grant from the Federal Emergency Management Agency. That's significant seed capital even by Texas standards. In its heyday, the Western Company, an oil well servicing contractor, used to have a slogan that became part of the Southwest's lexicon: "If you don't have an oil well, get one!" So it is now with captive insurance companies.

Whether the captive is single-parent-owned or a group captive, the trend now is to update the old business plan and put it to work. Captives are significant tools in the risk managers' toolbox that have been shelved for many, for a number of reasons, since the 1990's: soft markets, taxation issues, demanding



*We can expect to see a steady march of companies that don't have captives to the domiciles of choice in order to get one.*

administration and limited flexibility. These limitations are now being relaxed or eliminated altogether. Both federal and state laws are being designed to attract and capture the premiums that captive insurance companies bring to the economy and to the cash flow of a company.

In May 2004 the U.S. Department of Labor formally proposed the use of a captive by a major Swedish company to reinsure the benefits of

its U.S. employees. Once finally approved, this captive will become the fourth approval in a line of captives that are increasing their non-related-party or outside business in order to meet IRS regulations for qualified tax deductions of premiums. Other U.S. companies that have been given approval for the use of their captives for employee benefits are Columbia Energy Group, Archer Daniels Midland Co. and International Paper Co. The floodgates are now open. We can expect to see a steady march of companies that don't have captives to the domiciles of choice in order to get one.

In March 2004, ACE USA conducted a survey of challenges for risk managers that was reported to

**(CAPTIVATING, continued inside)**

### IN THIS ISSUE:

- ***Captivating Premiums***
- ***From Near and Far***
- ***25th Anniversary***



(CAPTIVATING, cont'd from cover)

the 2004 Risk and Insurance Management Society annual meeting. Their report was very revealing. The ACE

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***“People in places of responsibility are starting to take notice of the potential pitfalls of captive insurance mechanisms.”***

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survey found that 62 percent of all respondent companies are looking for ways to retain more risk. Nineteen percent indicated that they would do this by expanding their use of existing captive insurance companies, and 55 percent expected to use alternative

risk-financing tools, such as captives, in the coming year.

However, there are and will continue to be significant challenges to captive insurance solutions for risk. Captives have been used to help ease the problems in healthcare in recent years. The medical malpractice and hospital professional crisis in 2001 and 2002 made the use of anything but captives prohibitive for many. With these captives having experienced losses for a few years now, the federal government has noticed that it just might have a problem. This concern is made even more important by all of the turmoil experienced in corporate governance, resulting in the Sarbanes-Oxley Act. (See RHA Review, First Quarter, 2003.) People in places of responsibility are starting to take notice of the

potential pitfalls of captive insurance mechanisms.

One such battle is now being

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***“Captives need to be run like REAL insurance companies (or better), with independent opinions regarding how they stack up against their peers.”***

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waged by the U.S. Department of Housing and Urban Development. In April 2004, the House Financial Services Committee met with industry officials regarding HUD's pro

(CAPTIVATING, continued opposite)

## FROM NEAR AND FAR



U.S.A. – According to a report published in *Best Week*, the Insurance Services Office, Inc.'s, Property Claims Services unit reported that U.S. catastrophe losses for the first quarter will reach about \$963 million. Four major winter storms in January and one spring storm in March were responsible. The State of New York suffered the highest amount of losses, estimated at \$135 million.



Chicago – *Business Insurance* announced that Christopher E. Mandel of the United States Automobile Association is its risk manager of the year. Mr. Mandel is the 27<sup>th</sup> recipient of this prestigious award. The criteria and judges panel can be seen in the April 24 edition of *Business Insurance*.



Austin, Texas – *Ballard v. Farmers Insurance Co.*, the Texas mold case that sent shivers through the insurance industry in June 2001, when the initial jury verdict came down in favor of the plaintiff to the tune of \$32 million, has been settled. The original award was later lowered to \$4 million in actual damages by the appeals court.



(CAPTIVATING, cont'd from opposite)

posed ruling that governs mortgage insurance programs for nursing homes and other long-term care health facilities. HUD has proposed that, in order to qualify for mortgage insurance under its programs, any captive insurance company that

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insures the professional liability of the facility being insured must carry a Best Insurance rating of “A” or better.

This requirement is curious on several levels. I applaud HUD for realizing that it should be concerned about the financial well-being of its mortgage holders’ insurers, as should all stakeholders, not the least of whom should be the residents of the facilities. However, the Government Accounting Office released a report in 1994 entitled the “GAO Ratings Study for Insurance Ratings,” which concluded that of several rating agencies, A.M. Best was not necessarily the agency of choice. Furthermore, most insurance companies must be in operation for at least five years before a rating can even be assigned.

Regardless of which rating agency is used - Best, Weiss, S&P or Moody’s - certain pitfalls have been brought into the light of day that are a concern with captives. They are just as susceptible to poor corporate governance as any other entity, if not more so. They are susceptible to poor claims and investment practices because they are so closely held.

They are targets for expense cuts and resource reductions because they can be expensive to operate in demanding economic conditions.

Captives need to be run like REAL insurance companies (or better), with independent opinions regarding how they stack up against their peers. Isn’t it interesting that the Internal Revenue Service has the same feelings on this subject?

The financial stability of captives is difficult to evaluate, primarily because they are closely held by either a single parent or a group. With the future for captives looking so strong, it would behoove all stakeholders to keep this outlook positive by affirming the quality of captive management. A saying among underwriters is, “The perfume of the premium can oftentimes overcome the stench of the exposure.”

HUD is on the right track, and for this it should be given credit for trying to prevent yet another healthcare insurance crisis. Even though the healthcare industry is writhing with anxiety over its proposed requirements, without adequate third-party confirmation of captive

management, there will be more than the usual defaults, due in part to captive failures. One solution to the present crisis would be the implementation of a “preliminary rating” structure for captive insurance companies that don’t have the years of loss experience under their belt for an agency’s full rating assignment.

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***“Responsible captive management is both attainable and necessary if we are to avoid the pitfalls of the next wave of captive insurance solutions to corporate finance.”***

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Another would be for outside directors to oversee the critical aspects of the financial affairs of the captive, just as there is a call elsewhere for more outside directors on corporate boards.

Responsible captive management is both attainable and necessary if we are to avoid the pitfalls of the next wave of captive insurance solutions to corporate finance. We can help attain this end by making sure that captives are given the study and resources they deserve, both before and after implementation. RHA

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ADDRESS SERVICE REQUESTED

## A Milestone is Reached

2004 marks the 25<sup>th</sup> anniversary of Robert Hughes Associates, Inc.


Bob Hughes formed Robert Hughes Associates in the early months of 1979 in order to provide insureds and self-insureds with responsive, innovative and objective counsel regarding their insurance and risk-based needs.

While RHA has continued to provide those services and meet these objectives, it has also grown into a much more diverse organization. RHA now provides not only

traditional insurance and risk-management consulting, but also expert witness services, insurance archaeology, fully credentialed actuarial services, custom insurance program design, and insurance company management services.



We thank you for your business in the past and hope to serve you long into the future.

For more information, please contact John Oakley at (972) 980-0088 or [joakley@roberthughes.com](mailto:joakley@roberthughes.com). 

### THE RHA REVIEW

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