

**Workshop N*****ALTERNATIVE MARKET OPTIONS FOR
CONTRACTORS*****Presented by****Kate Westover
President
Captive Advisory Services**

In a hard insurance market, alternative markets receive a lot of attention. Captive insurance companies and risk retention groups become buzzwords in insurance circles to describe nontraditional risk-sharing arrangements. But how does a contractor that isn't large enough to form a wholly owned captive locate these "alternative" markets? This session will highlight contractors' real alternative market options, from group captives and rent-a-captives to construction-specific risk retention groups. Find out what risk-sharing options you really have, which groups you might qualify to join, and a host of other information that will help you make informed alternative market decisions.



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Kate Westover
President
Captive Advisory Services

Ms. Westover is presenting Workshop N, "Alternative Market Options for Contractors," on Wednesday. She is president of Captive Advisory Services, an Argonaut Group Company. She provides consulting and captive program structuring services for insureds and their brokers, insurers, or reinsurers.

She has more than 15 years' experience in the captive insurance industry. Before forming Captive Advisory Services, Ms. Westover was chief operating officer of Strategic Risk Solutions Vermont, a subsidiary of Strategic Risk Solutions (SRS), a Credit Suisse group company. Prior to that, she was president of American Risk Management, one of the leading captive management companies in Vermont, now part of Aon.

She is author of *Captives and the Management of Risk*, published by International Risk Management Institute, Inc., in 2002, as well as articles in other IRMI publications.

Ms. Westover serves as Barbados International Business Representative, working to assist organizations in the structuring of enterprise risk management and other alternative risk financing programs utilizing Barbados's financial services sector capabilities. She is a former member of the Board of Directors of the Vermont Captive Insurance Association, serves on the Vermont Captive Advisory Board, and has served as an adviser to the Washington, D.C., Department of Insurance and Securities. She has taught insurance courses for the Vermont Insurance Institute at Champlain College, and is a frequent speaker at a number of industry conferences and workshops.

Ms. Westover holds bachelor of arts and master of arts degrees from Oxford University, England, and holds a broker's license for life, accident and health, and property and casualty. She earned her CPCU designation in 1991.

Notes

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ALTERNATIVE MARKET OPTIONS FOR CONTRACTORS

Kate Westover
Captive Advisory Services

I. What is the "Alternative" risk transfer market

A. Types of captives

1. Single parent
2. Group owned
3. Association
4. Rental
5. Agency

B. Non-captive options

1. Deductibles
2. Self-insurance
3. Retro rating

II. Types of captive programs

A. Direct writing

1. Self-procurement laws
2. Coverage compliance

B. Assumed risk

1. Fronting
2. Collateral

C. Ceding risk

1. Specific and aggregate excess
2. Finite risk reinsurance

III. The benefit of captives compared to non-captives

A. Cost: reduced through

1. Higher retentions—retain profits
2. Lower losses—increase profits

B. Control: increased by

1. Unbundled services—improved services
2. Management focus—access to loss data

C. Capacity: used for

1. Coverage flexibility—risk retention
2. Stable premiums

IV. The disadvantage of captives compared to non-captives

- A. Cost: increased by
 - 1. Cost of capital
 - 2. Loss of cash flow
- B. Control
 - 1. Requirement for risk sharing
 - 2. Time requirement
- C. Capacity
 - 1. Dependence on fronting/reinsurance
 - 2. No cheap insurance

V. ART options for contractors

- A. RRG Programs
- B. Fully funded RACs
- C. The small captive option
- D. CCIPs and wrap-ups

VI. How to choose your ART

- A. Feasibility studies
- B. Captive formation and operating costs

The Alternative Risk Transfer or “ART” market

The alternatives to guaranteed cost insurance

- Provided by commercial insurers
 - Licensed in state where risk is located
 - May or may not provide “rated” paper
- MGAs and Third Party Administrators (“TPAs”)
- Captive insurers
 - Typically non-admitted and non-rated

Commercial “ART” Options

- Dividend plans
- Retrospective rating
- Deductible plans
- Qualified self insurance/SIGs
- Purchasing group programs

Retrospective Rating

- Premium is loss sensitive
- Insured has per occurrence and aggregate retention
- Insured loses cash flow
- Filed rating plans—minimum size requirement for insured

Deductible plans

- Insured has rated, admitted paper
- May reduce insurance expenses
- Variability in insured's cash flows
- Insured has per occurrence and aggregate retention
- Credit risk for insurer
- Minimum size requirement

Qualified Self Insurance

- State regulated for statutory coverages
- Minimum size requirements
- Collateral and filings on state by state basis
- No insurance -losses deducted from income as paid
- Direct purchase of stop loss/excess

Purchasing group programs

- Federal Risk Purchasing Groups - for liability insurance only
- Association programs – all lines
- No minimum size for insured
- No risk sharing between insureds
- Buying power but no loyalty to group - just price and/or dividends
- MGA may share underwriting profit

Self Insurance Groups

- Insureds share underwriting profit
- State regulated
- No multi-state operations
- Claims, loss control services and excess purchased on group basis
- Joint and several liability

All of these alternatives either retain the disadvantages of insurance or lose the benefits!

Captive ART Options

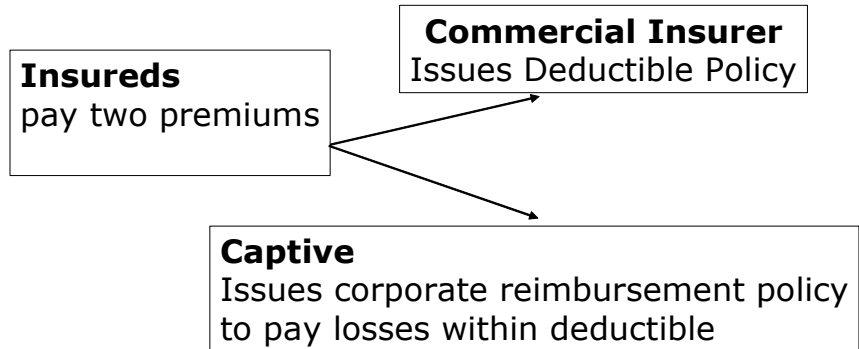
- Affiliated with/owned by insureds
 - Pure/single parent
 - Industrial Insured Group
 - Association
 - Risk Retention Groups
- Non-affiliated
 - Rental
 - Protected or segregated cell cos.
 - Agency owned/PORC

Ways Captives Operate

1. Direct Writing—captive issues policy
 - Used by single owner captives and RRGs
 - May not avoid payment of premium tax
 - Insured must qualify to purchase non-admitted coverage (except for RRG)
 - Possible penalties for illegal insurance activities
 - May not satisfy statutory requirements
 - May not satisfy business requirements

Buying down a deductible

e.g. financing higher WC retentions

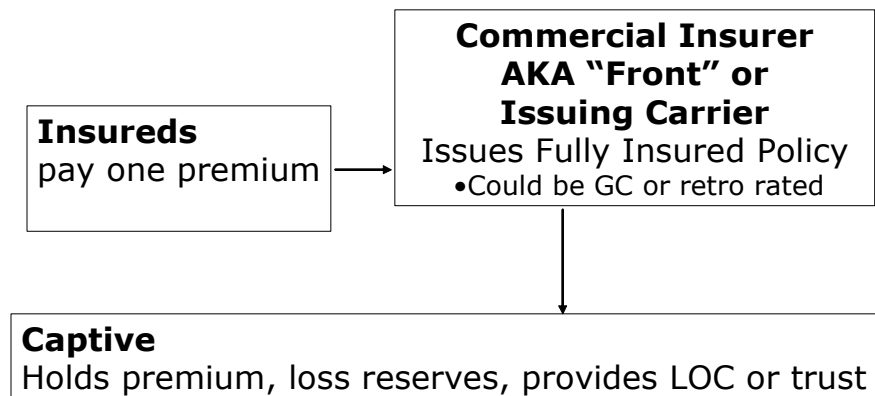


Ways Captives Operate

2. Reinsurance assumed

- "Front company" satisfies statutory and business requirements
- Pure front takes no risk e.g. MGA programs
- If issuing carrier takes risk will set rates, charge "front fees" for services, profit and administration, regulatory expense
- As non-admitted reinsurer, captive provides collateral to front

The reinsurance captive

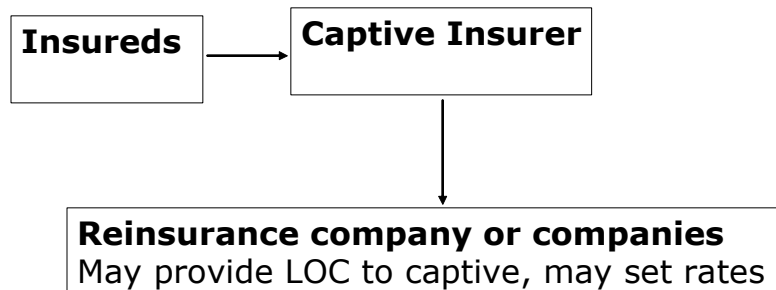


Ways Captives Operate

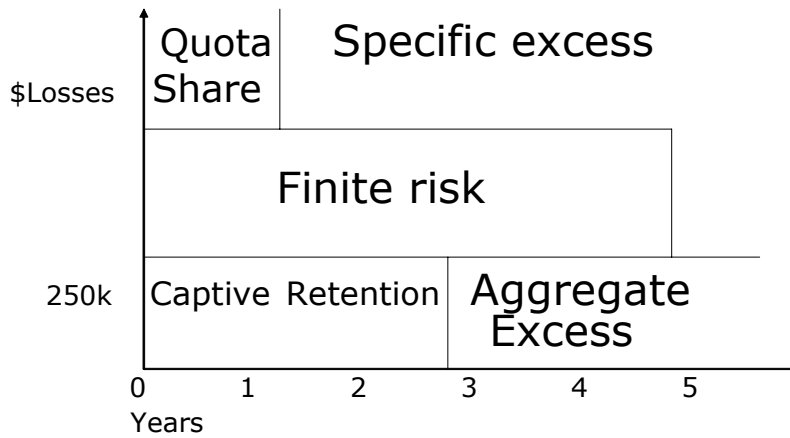
3. Reinsurance ceded

- Captive may be fronted or direct writer
- Captive may “front” or retain risk
- Access to reinsurance may or may not reduce costs
- Reinsurers may pay ceding and profit commission to offset captive expense

The reinsured captive



Types of Reinsurance



Captive Benefits

1. REDUCES COSTS
2. INCREASES CONTROL
3. PROVIDES CAPACITY
4. PROFIT TO SHAREHOLDER

The Cost Impact

- ✓ Acceleration of tax deduction
 - provides “permanent temporary” reduction in cost of financing retained risk
 - captive may defer tax on underwriting income
- ✓ Job costing, charge backs based on incurred losses

The Control Effect

- ✓ Increased risk taking ability reduces reliance on commercial insurance
 - Possible unbundling of services
- ✓ Greater incentive for risk management
 - Access to loss data

The Capacity Result

- ✓ Underwriting profit accumulates as surplus
- ✓ Captive takes more risk, to support primary business activities of captive shareholder
- ✓ Reduced variability in cash flows and vulnerability to market cycles

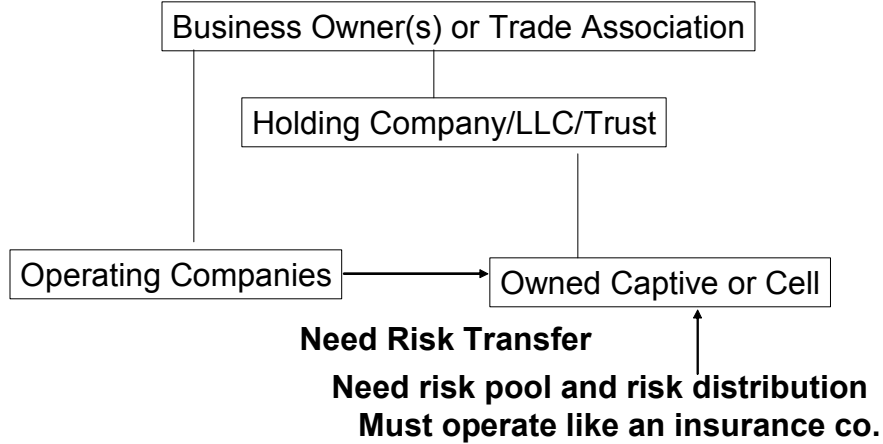
The Disadvantages

- ☒ Cost of capital
- ☒ Loss of cash flow
- ☒ Operating costs
- ☒ Risk distribution
- ☒ Corporate governance
- ☒ Fronting cycles
- ☒ Reinsurance exclusions

Options for Contractors

- Trade association programs
 - Liability, Builder's risk
- Risk retention groups
 - Liability, Warranty
- Cell captives
 - All lines
- Small captives
 - All lines

Ownership structures

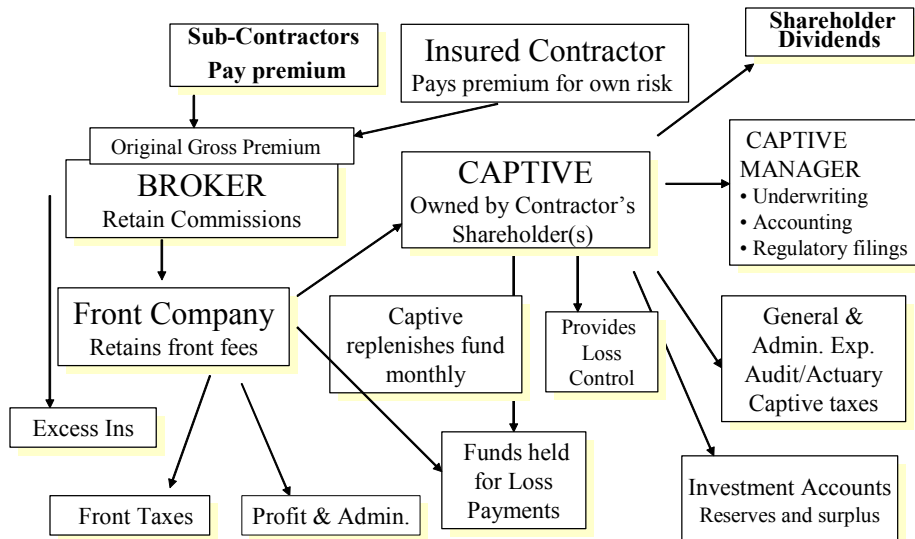


Sources of unrelated risk

- Subs (but can you manage the risk?)
- Customers (but can you transform a non-insured risk into an insurable event?)
- Employees (but its not as easy as casual Friday!)

How well do you know the risk?
 (Can you avoid risk concentration, moral and moral hazards.)

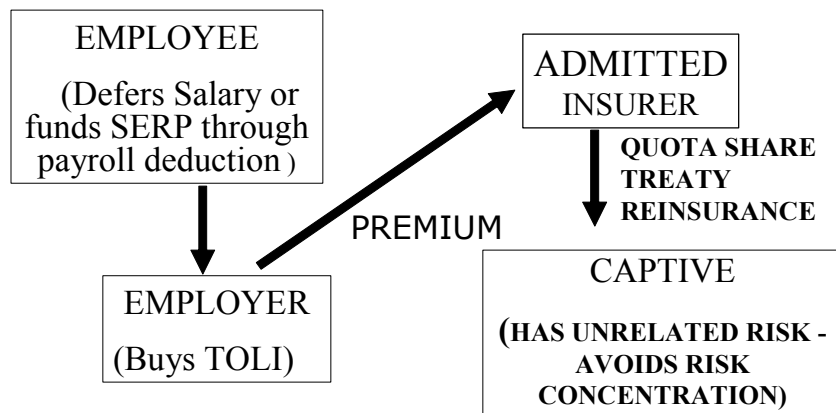
THE CCIP FLOW OF FUNDS



Warranty Coverages

- IRS won't allow deduction for "self insurance"
- Customer must pay premium
 - Need for front (unless using RRG)
- Need actuarial basis for setting premium

Corporate Owned Life Insurance - CAPTOLI_{sm}



Selecting your ART

- Feasibility Analysis/Domicile Choice
- Business plan
 - Ownership and organization
 - Operating structure
 - Financial projections
- Sources of information
 - Captive.com
 - AM Best

Organizing and Operating Costs

- Actuarial \$ 5,000 - 40,000
- Legal 3,000 - 40,000
- Capital 120,000 – 10,000,000
- Manager 25,000 - 100,000
- Taxes
 - Premium
 - Excise
 - Income

Time Frame

- Feasibility analysis 1-6 months
- Business Plan, Application 1-6 weeks
- Incorporation, Capitalization 1-3 weeks
6 wks – 9 mths.
- Average Formation Time
 - Cells – 1 month
 - Single parent – 3 months
 - Group or association – 6 months