Vortex offers a viable solution so that employers can optimize the value of retaining their workers compensation risks.

ARTful MEASURES

By Michael J. Moody, MBA, ARM

WORKERS COMPENSATION INNOVATION

Vortex Risk Exchange allows middle-market employers to use captives to control workers comp financing

Financing workers compensation coverage has proved more and more difficult with each passing year. While the introduction of large-deductible programs 10 or 12 years ago has helped many business owners obtain cheaper coverage for their workers compensation programs, they still do not provide the most cost-effective risk financing method. As the Alternative Risk Transfer (ART) market has grown and matured, various different models have been introduced to improve risk financing efficiencies, but most have not filled the bill. In particular, the ART market does not seem to have focused on a captive solution to the workers compensation issues faced by middle-market employers. This is quite surprising since workers compensation is typically the largest property and casualty insurance cost for most employers.

While there are a number of reasons for this situation, it should be remembered that state regulation of workers compensation has been the strictest of all commercial property and casualty coverages. This has slowed innovation within the workers compensation market. However, that is about to change due to a creative approach being introduced by Charlotte, North Carolina-based Atlas Insurance Management. According to Martin Eveleigh, chairman of Atlas, the company has developed a risk pooling mechanism known as Vortex that will focus solely on the workers compensation marketplace. The Vortex program will allow middle-market employers to use dedicated captive insurance companies to take control of their workers compensation risk financing in the most effective way possible.

While the high-deductible programs that are used in today's market have become the rage over the last few years, employers struggle to rein in ever-increasing workers compensation costs. Retention of this risk by the employer can create some adverse consequences. As Eveleigh notes, "while large-deductible programs can lower workers compensation premiums, figuring out how to finance the retained risk in the most cost-efficient way has become a challenge." The problem is that, for tax purposes, the employer can only deduct the amount of the actual claims that are paid during the policy year, while premium saved flows straight to the bottom line as taxable income. With long-tail coverages such as workers compensation, the problem can extend over a number of years.

So what is the solution? Use the premium saved to buy a deductible reimbursement policy from a single-parent captive insurance company.

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If the captive qualifies as an insurer for tax purposes (and this is where Vortex comes in), the premium will be deductible in the year that it is paid. Moreover, the captive can either establish tax-deductible reserves or may even qualify as exempt from income tax on its underwriting profits, depending on its premium volume. As Eveleigh points out, using a captive will usually double the net savings for an employer compared to a high-deductible program that is not supported by a captive.

To qualify as an insurer, the captive *must* be able to demonstrate the presence of risk distribution; in other words, the law of large numbers must operate. For captives writing the risk of just one parent or affiliated insured, this presents a challenge. There is a solution to this issue: "just write third-party risks in the captive." And where are those risks to come from? From other similar captives willing to swap risks. Captives that decide to utilize Vortex will share a primary layer of risk with other pool participants. Each participating captive then buys reinsurance from Vortex Re, a North Carolina reinsurer, and Vortex Re returns a share of its total pool of risk to the participating captive. There are two key benefits from using this approach:

- Exchanging risk through Vortex Re provides reinsurance protection and reduces loss volatility for the captive; and
- Vortex creates risk distribution, thereby allowing for favorable tax treatment for the transaction.

Eveleigh says that the program is open to any business that is currently utilizing either a guaranteed cost approach or a high-deductible program, or even those that self-insure their workers compensation exposure. Minimum levels of retained risk, he states "should be at least $100,000 per loss occurrence." He goes on to advise that "employers should also have demonstrable financial strength, favorable cash flow and be committed to loss control." Prospective participants must provide five years of loss and exposure data to be used for the required actuarial projections. Finally, Eveleigh states that the participant must also be willing to form its own single-parent captive or, if it already has an existing captive, to include the workers compensation exposure in it.

Vortex will be distributed via the independent agency system. Eveleigh says that "the decision was made early on to utilize the independent agency system to market the risk exchange." In that regard, he states that a formal educational effort has been developed to enlighten local agents/brokers of the details of the coverage and how to determine the most appropriate potential participants. One on the keystones of this program, according to Eveleigh, is that it does not require a change in the broker/agent or excess carrier. "We are not interested in disrupting any of the existing relationships." He goes on to mention that "the employer can remain with its current carrier as well as its current agent/broker, and we want to work with them to help achieve the best outcome for all parties."

As outlined above, Vortex is a vehicle that allows employers to pool their workers compensation risk with other exchange participants so that they can achieve favorable tax treatment. Despite recent changes in some tax regulations, most industry experts believe that basic risk transfer requirements remain, so effective risk transfer will continue to be required. At the end of the day, Vortex offers a viable solution so that employers can optimize the value of retaining their workers compensation risks. Vortex will entertain submissions from any agent or broker and provide a cost-effective approach via participation in the risk exchange.

Agents and brokers who are looking for a creative approach to assist their clients to gain the maximum cost savings from retaining a portion of their workers compensation exposure should be aware of the benefits of Vortex and a captive solution. Since this is a new approach, and thus a new product, it is a good time to review how clients' programs are structured and where improvements can be made. Further, the design of Vortex is directed at middle-market accounts. Mid-sized agents and brokers can benefit from the innovation that Vortex affords by providing the most cost-effective approach for their clients and retaining their position as their clients' trusted risk advisor. ■

The author

Michael J. Moody, MBA, ARM, is the retired managing director of Strategic Risk Financing, Inc. (SuRF), a firm that was established to provide consulting services to captive and other alternative risk transfer mechanisms. As a regular columnist, he continues to actively promote the benefits of the ART market by providing current, objective information about the market, the structures being used, and the players involved.