

What Every Healthcare Provider Should Know About Captive Insurance Companies

Presented by ProMutual Group

We are aware that many Massachusetts physicians are considering alternative insurance mechanisms such as a captive or risk retention group (RRG). With the promise of a lower insurance premium, the appeal of switching to such a program can be alluring. Both ProMutual Group and our agents are frequently asked by current and prospective policyholders about the pros and cons of such programs. The following is a discussion of some of the functional and historical aspects of these programs and how we believe that they compare to the conventional bundle of services and risk transfer ProMutual Group and its predecessors have been providing to Massachusetts hospitals and physicians for nearly 30 years.

What are Captive Insurance Companies?

Captives are insurance companies.¹ Fundamentally, from an economic and operational perspective, captives are similar to traditional insurance companies, to the extent that a captive collects premiums from selected individuals and entities, invests its assets, provides services, and, eventually, pays claims. Any surplus or deficiency is either paid to or paid by the owners of the captive insurer, which are, for the most part, the insureds. In most captives the relatively few insureds are the sole owners of the insurer. In some commercial contexts the insureds may be very different populations that have divergent interests.

Insurers, by both economic and legal definition, pool the risk of many insureds through the collection of premiums and make payments for the claims of those insureds as necessary. For healthcare providers, since there are often many years between when services are rendered or care is provided and when claims need to be paid, the long-term solvency and investment acumen of the insurer become almost as important as the insurer's operational skills and service delivery.

Another important distinction is that captives are typically licensed in the state in which they are domiciled. In comparison, ProMutual and ProSelect, as licensed insurers, must meet ongoing regulatory oversight in each state in which they do business.

How Well Have Captives Served Healthcare Providers?

There are not many studies, controlled or otherwise, that measure the relative performance of captives versus commercial carriers in addressing the professional liability needs of healthcare providers. This may be due to the fact that the timeframe commonly used to measure captive benefits is usually shorter than the period necessary to measure the full costs. With claims made coverage, the full cost of claims can take three to five years to estimate. With occurrence coverage, it generally requires at least twice as long to estimate the full costs. For instance, if a captive allowed for below market rates for a group of physicians, the captive would see the revenue and goodwill in a matter of months.

¹ Captives can be owned by a single insured, a group of insureds, or by an association owned by or consisting of dozens, hundreds, or even thousands of insureds. Based principally on their ownership form, captives are frequently referred to, respectively, as single parent, group, or association captives. The 1981 Federal Risk Retention Liability Act, as amended, allows for state regulation of captives that do business as risk retention groups, however, both risk retention groups and captives are regulated primarily, if not exclusively, by the state in which they are domiciled. We believe that potential participants in a captive insurance program should focus on the economic and managerial aspects of such a program, and not simply assume a captive makes sense, provided that the "optimal" structure or domicile is selected.

If a captive is going to generate occurrence losses that are three times the amount of the premium collected, the captive would not know it for six to 10 years. This is potentially a situation where things may look great for years until a financial downfall becomes inescapably obvious.

Actuarial Considerations

The cornerstone of any actuarial analysis is the application of the law of large numbers. Simply stated, the predictability² of losses improves with the number of individual insureds. The law of large numbers and the impact of loss frequency affect all types of insurance. From an insurer's perspective, paying for the losses of an insured that has a low frequency and a high severity of expected losses can be the hardest to predict and may require relatively more capital to underwrite prudently than would other types of risks.

One also needs to be cognizant of the cost structure necessary to service this type of business. Making low cost settlements of nuisance claims, for instance, might encourage a higher than necessary frequency of claims going forward. Such settlements might also impact reinsurer expectations and drive up pricing.

For medical malpractice coverage there are complications present that do not exist for other types of insurance. Casualty actuaries need to assess how juries will react in the future (three to five years for claims made coverage; 10 years or more for occurrence coverage) to allegations of substandard care rendered in the current policy period (also known as a trend factor), as well as understand what future medical costs are likely to be. These factors tend to have a multiplicative rather than an additive impact on claim costs and may make proper reserving, even with the best of intentions, quite difficult.

Underwriting Considerations

Underwriting can be viewed as putting actuarial concepts and theories into practice. The most important underwriting concern is proper risk selection for inclusion within the insurer or captive risk bearing pool. The law of large numbers requires a larger base of insureds in order to improve loss predictability. ProMutual Group has a larger population of insureds than most of the captives operating in the states where it does business.

While both underwriters and actuaries look at historic losses, effective underwriting requires the examination of current factors affecting the risk of loss to assess future likelihood of loss. This examination frequently requires full disclosure by an insured of proprietary new ventures. In the context of captives, typically this information is commonly shared with all participants in order to fairly allocate funding between the participants. On the other hand, ProMutual Group goes to great lengths to keep private, confidential information about the operations of both applicants and insureds private.

² In our context, it means that the expected loss costs are more predictable for 2,000 physicians than they would be for 200. Assuming \$10,000 in expected losses per exposure unit, one might expect an average loss of \$20 million and \$2 million, respectively. To be 95% certain that there was enough money set aside to pay the resultant claims (usually referred to as the 95% confidence level) one might be asked to set aside an additional \$5 million and \$4 million, respectively. On a percentage basis the capital cost to get an equivalent degree of certainty with a small risk pool is much higher (200% vs. 25% of the premium).

Actuarial predictability of total loss expenses is also a function of loss frequency. Assuming two distinct populations which each had an expected loss cost of \$10,000 per exposure unit, if one was subjected to a \$1 million maximum (probable) loss while that of the second was only \$100,000, it follows that the first population would need more capital to have an equal ability to sustain random fluctuations of loss results.

There is also a possible risk of deadlock in underwriting decision or in connection with the need to publicize confidential information in group captive programs. While legal counsel can be helpful in allowing the parties to reach consensus, because the counsel's client is the captive, not its insureds, counsel's role on behalf of any participant must be quite limited to avoid untenable conflicts of interest. Members in such programs could be subject to majority rule when it comes to disclosure of sensitive information to competitors or with respect to the basis used to calculate premiums.

Commercial underwriters often perform or commission risk management, claims, and other types of audits to discover necessary information. It is important to know whether a program you may be considering will allow or prohibit these practices. Pricing is often affected by the results of these activities. Therefore, a program that allows pricing flexibility often is more desirable than a more rigidly priced program. However, if pricing terms are not determined upfront, reaching consensus on this down the road can prove difficult. It can boil down to a question of allocating costs between participants rather than estimating the eventual cost to the captive for paying the resultant claims or it may be decided by the most forceful or brazen participants creating the rules that favor them. Understanding how these dynamics might influence decision-making is critical in making an intelligent decision prior to joining a captive. Once one chooses to participate in a captive, it is often too late to change how these decisions are made.

In regard to the consideration of captive formation or participation, the most important consideration is whether the potential benefits of participant inclusion outweigh the risks of participant losses. A few questions to ask include:

- Is there an experienced independent underwriter or, if not, can each captive board member make such decisions with the necessary discipline?
- Can physicians who generate both a disproportionate share of revenue and historic losses be excluded?
- How much effort and negotiation time is required to get these decisions made in the environment of required consensus?
- Would it make sense for your organization to join a captive if a critical physician or venture may be denied coverage?

Claims

Managing the claim process is a complex endeavor. While there are independent claim service organizations that have quality people and processes, there is a wide variation in their capabilities and performance. To the extent that they are paid on an hourly or per open file per month basis, their incentive structure may not be totally aligned with the captive's interests. Similarly, many of the best independent claim service firms promote their reserving acumen as a value-added benefit. It can be difficult to know, however, whether claims may be over-reserved initially for self-serving purposes in order to bolster later arguments that effective settlements have been attained. Over-reserving will have an impact on the actuarial process, will impact regulators, and will have a costly impact on the price of reinsurance and excess insurance. Without having a vested interest in the program as carrier claim departments do, even the best-intentioned independent adjuster may have difficulty dealing with these conflicting issues.

This later point, regarding remuneration-based conflicts, can be more significant in the context of dealing with litigation management. Defense counsel is paid predominantly on an hourly basis. Therefore, motivating and empowering counsel to act in the interest of the risk-bearing entities may involve the consideration of other factors. In this context, the claim organizations that send the most business may get better service. All things being equal, the claim service organization or insurance company sending a lawyer or law firm half of its work is in a position to demand better service than the one that only sends the occasional matter. This is particularly important in securing the services of the law firm's most talented attorneys.

Risk Management

Many brokers and other promoters of group captives claim that a principal advantage of such a program is that they facilitate better risk management. While possible, it requires an alignment of a number of factors that tend to be only occasionally present. Initially, while there are a number of organizations that purport to have superior capabilities and track records that provide service to captives on an hourly or retainer basis, many of their assertions of successful interventions are hard to assess. It is difficult to perform a cost benefit analysis in this context where many of both the costs and benefits are qualitative rather than quantitative. Proposing a theoretically helpful change is very different from facilitating its successful introduction. Important questions to ask include:

- Do the firm and individual consultant have experience with your specific practice or organizational type?
- Do they have experience in your state and community?
- Can they provide any data to support the effectiveness of their recommendations?

Risk management units affiliated with insurers often have certain inherent advantages. As with claim departments at insurers, investment in personnel and technology that impact future claim frequency and severity are likely to be implemented on an expedited basis. Since these units work with underwriting and claims, there is an element of collaboration that may be difficult to achieve at freestanding firms. Risk management, as a collegial department at an insurer, benefits from the typically clear implication that noncompliance with its recommendation will be communicated to underwriting personnel and might have an effect on pricing. In the captive setting, even the best risk management consultant may be operating as if one arm is tied behind his/her back if it is necessary to go to the captive board to get authority to diagnose systemic multi-departmental problems or, more importantly, to implement corrective action that may impact physician behavior. Underwriting, claim, and risk management departments at insurers are usually comparatively more able to benefit from their collegial interaction.

It should also be noted that board level discussion of risk management initiatives can be difficult. Given the multi-year lag between performance improvement and avoided claims, it may be hard to get captives to raise risk management to the top of the agenda.

Marketing

As referenced previously, both the law of large numbers and the benefit of allocating fixed costs widely provide a benefit for larger program scale. Given the accelerated pace of change within healthcare, some participants are going to close their practices, retire, or be acquired. In order to allow for a program to stay at a viable size, replacements need to be solicited, selected, and often times convinced to join. In order to achieve the desired number of participants, special membership incentives may be

offered. Special accommodations offered to new participants may be disruptive to those already in the program. This may provide a challenge for the captive in obtaining the amount of new members needed while keeping the existing members satisfied with their membership terms and role in the program.

Reinsurance

The ability to buy excess insurance or reinsurance is driven by actuarial, economic, and data credibility factors rather than by relationships or the location of the insurer's domicile. Frequently, brokers will claim that having a captive located in Bermuda facilitates reinsurance transactions. That may have been the case in the 1950s but it is usually not an important consideration in today's insurance marketplace.

During hard markets for medical malpractice insurance, when availability of coverage does not meet demand and prices rise rapidly, the impact can be magnified in the context of purchasing reinsurance. When reinsurance capacity is constrained, will established programs like ProMutual Group or a new captive have better access to limited supply? The answer is not dependent on the type of insurance company, but rather its track record of providing credible claim management, effective risk management interventions, accurate reserving, effective underwriting, continuous financial strength, and most importantly, whether reinsurers have made money with the primary risk bearing entity in the past. You need to question broker assertions that captives can buy excess or reinsurance at a lower price than commercial insurance companies.

Finance

Most captives have either overt or implicit accessibility features built into them. If experience proves less favorable than anticipated, additional funds may be needed. These funds may be characterized as assessments or may be in the form of higher future funding amounts. Capitalization is critical in medical malpractice since the length of time to pay claims is so extended.

Captive promoters often times assert that commercial insurer expense ratios are high. They suggest that overhead has no value to the hospital or physician insured. One function of the finance department of an insurance company relates to investment management. More specifically, it is necessary to (a) decide on an investment strategy, (b) implement that strategy, and (c) continuously monitor performance. Outside money managers may only perform the second of these three critical functions. It is important to ask a captive promoter who will perform the other two functions and at what cost.

When Can Captives Work Best?

While many captive promoters give some mention to the inherent need for captive owners and participants to assume the mantle of insurance company board direction and executive management, healthcare providers may underestimate the actual burden involved. With this in mind, and given the numerous areas where consensus is required, a homogeneous ownership and insured population is advantageous. While this necessarily limits risk diversification, contentious "political" decision-making can lead to deadlock on critical issues. Some group captives that have both academic and smaller community hospitals have quite a challenge on deciding on the proper scope of coverage, how to treat non-employed physicians, and on uniformly implementing risk management initiatives.

It can make sense to use a captive when the maximum individual loss amount is low, few specialized services are required, and premiums are high. While risk is commonly transferred for the most expensive claims, the sheer volume of modest to moderately inexpensive claims makes self-administration and payment less expensive.

Captives can also make sense when there is no reasonable alternative. It is clearly better to pre-fund, on a pre-tax basis, than to show balance sheet reserves without having the income statement benefits. Non-profits do not typically care about deductibility of payments. Furthermore, non-profits should get expert advice on whether any overt or implicit subsidy of physicians or other for-profit entities might jeopardize their tax-exempt status. Hospitals participating in the Medicare or Medicaid programs also need to get clear guidance on whether current or anticipated activity might run afoul of the Stark provisions or other Fraud & Abuse³ minefields.

Does a Captive Make Sense for You?

If one is getting good value from commercial carriers and makes reasonable use of the bundled services they offer, the rationale for switching to a captive may be harder to justify. Commercial coverage is probably the better alternative if:

- Having a third-party decide the acceptability and pricing for physician coverage is desirable, and/or
- Management resources are already stretched and capital is constrained.

Concluding Thoughts

We hope that this paper will help you to ask better questions of promoters of captive programs so that the decision regarding your participation is a thoughtful and well-informed one.

³ Federal statutes mandate criminal, civil treble damages, and exclusion from the Medicare and Medicaid program penalties associated with improper payments, or in-kind services, for referrals. Healthcare providers are also subject to private suits, Qui Tam actions, alleging these violations as well as enforcement by state and federal prosecutors and the Office of the Inspector General. Hospitals need to get specialized counsel to address the specifics of any transaction that arguably gives physicians any benefit tied to use of hospital facilities or services. Securing an opinion letter, issued by a prominent qualified law firm, might also be a prudent precaution for any hospital about to enter a program that gives their physicians a below market rate for their insurance.