HEALTH INSURANCE CAPTIVES

What you should know and what we have learned

Introduction

Captive programs provide a unique opportunity for organizations to form a high-performing group with ownership and control of its insurance program.

Essentially, by forming an alliance with other organizations that are dedicated to maintaining employee health and wellness, a company's risk pool is stabilized, costs are reduced and profits are returned to the captive owners rather than to the insurance companies in the traditional market.

Health insurance captives, also known as medical stop-loss insurance captives, have been around for awhile even though they are still not widely adopted. They can be a successful part of a cost control strategy for clients.

Let's learn more about this theme.

Origins of Health Insurance Captives

Their origins tie back to when large employers (5,000+employees) needed a way to manage healthcare risk across their organization, lower costs for employees and reduce administration and underwriting costs from carriers. Most of these large companies had already successfully utilized the captive concept for other insurance purchases (workers comp., medical malpractice, etc.) and were able to apply the method to their medical stop-loss needs. The size of large companies and their medical claims history yield a high degree of predictability, which in turn means lower risk and cost across the organization. Captives work well for large organizations because they have enough volume to stabilize their risk and allow companies to lower the fixed cost of insurance by returning unused risk fund premiums back to the company.

Once medical stop-loss captives became successful for large employers, they then began to be adapted for smaller and midsize organizations. Volume is critical. Similarly, when an adviser does not have the size or client volume to create their own captive, joining together with other advisers is a seemingly smart way to overcome size-driven limitations. Hence, the introduction of public incubatory captives. Available through wholesalers, public incubator captives also known as group captives, provide access for advisers who want to leverage the captive technique for their clients, but do not have enough volume to build one on their own.

Captive performance varies significantly from wholesaler to wholesaler. While some captives have seen tremendous success and returns, others have failed and tarnished the technique on their way down. If the practice of deploying captive strategies for smaller businesses is legitimate, how can and why does this gap exist?

Group Captive Basics for Small-to-Midsize Companies

A captive for smaller employers can be formed when companies that seek customized plans, but lack the number of employers and employees required to make them financially feasible, join together to purchase medical stop-loss insurance. By using a group purchasing model they are able to act like a larger employer and access the same bulk-buy advantages when creating benefits programs. The plans are typically partially self-funded, share risk and purchase reinsurance together within a tiered structure utilized by the captive program. The Profile typically looks and acts as follows:

- **Tier 1: Employer layer or specific stop-loss risk**

The maximum risk an employer is responsible for on a large claim. Similar to a typical partially self-funded specific deductible plan, this risk layer generally ranges from $10K-$150K depending on the size and risk tolerance of the client and captive member pool.

- **Tier 2: Captive stop-loss layer or shared risk pool**

This shared risk layer sits between the employer risk and traditional reinsurance. It pays members' claims that are over their specific stop-loss maximum, but under the reinsurance deductible. It is funded by a large portion of the reinsurance premiums that members pay to the captive manager. The percentage of premium contributed to the pool is determined by the captive manager or Managing General Underwriter(MGU), who has structured the program, but generally ranges from 45-70% of the total paid premium paid by each client in the captive. The balance of the premium is used to purchase actual reinsurance and cover costs associated with the management and running the captive. Any unused premium in this layer after the policy year is completed typically is returned to the member clients.

◆ Tier 3: Traditional reinsurance layer or excess risk

The reinsurance layer protects the shared risk layer from substantial claims by capping the cost it is responsible for. Typically set at a high limit ($250-750K), reinsurance covers excess costs of a claim after the employer pays their portion (Tier 1) AND the shared layer pays its portion (Tier 2). Since the Affordable Care Act requires no limits, the excess layer has no cap on what it will pay.

Claim Example:

Client layer: $25k specific deductible

Shared risk layer: $25k -500k

Excess layer: $500k or more

Claim amount: $650k

Client pays dollars: $1-25K

Shared Layer pays: $25,001-$500,000

Excess layer pays: $500,001- $650,000

The Keys To Captive Success

Two of the most powerful aspects of captives are:

1. The tremendous flexibility of the process and the products; and
2. The large opportunity for returns from unused premiums in the shared risk layer to the employers that participate

Captives can support small employers on level-funded programs, mid-sized employers with more traditional partially "self-funded" programs, or large employers seeking savings in place of a lost fixed stop-loss cost. They can be used for similar employer industries (homogeneous pools) or dissimilar industry employers (heterogeneous pools). Captives can support direct contracting efforts, ACO's, PPO's or reference-based pricing (RBP) clients. All clients no matter what their choice of funding can choose their own plans and networks; and they can all be different. In the right circumstance, a captive can even support all of the above situations in the same pool at the same time.

When a captive works well, employers are able to lower the cost of healthcare--in some cases by 30-40%, for their employees regardless of how many employees or plans they have, all member organizations receive a return at the end of the underwriting year based on their level of participation, rather than their individual loss ratio and it's repeatable year over year. However, as captives have become more popular they have also become susceptible to mismanagement, poor performance, and low or no returns. To ensure a captive is optimized for excellence, it must meet four imperatives: 1) size, 2) like-minded members, 3) adviser alignment and 4) performance-driven compensation and shared risk.

1) Size: The obvious reason for choosing to participate in a captive or group purchasing coalition is the buying power and stability that comes with it, which means employee volume is critical. Captives need to meet a minimum number of employees in order to disperse

risk effectively, reduce volatility over time and increase stability. A starting threshold is about 1,000 employees, That 1000 threshold can be achieved by as little as 4-5 clients but as that number increases, predictability and stability do as well.

2) **Like-minded members:** A single large company purchasing insurance inherently has the safety of numbers. However, it also has insight into its risk and control to improve its performance. It can assess benefits usage over time, identify trends and then take action accordingly, such as implementing claims management, wellness and employee assistance programs; distributing incentivized health surveys; improving environmental factors (air quality, office equipment, and furniture) and encouraging work/life balance. In a broad sense, the clients are "ready" for a captive.

In general, greater volume yields lower costs so when small companies come together to purchase insurance as one, the benefits of bulk buying follow. The challenge and primary risk for a smaller company once it joins a purchasing group is that, while they can control their own employee health and wellbeing initiatives, they can't control those of their member community. In an attempt to lower costs by increasing purchasing power they could be adding risk if they are not well-aligned with the group they are joining.

As an easy example, consider smoking. Smoking-related illness in the United States costs more than $300 billion a year, including nearly $170 billion in direct medical care for adults and $156 billion in lost productivity. If one company out of 10 allows its employees to smoke on their property it increases risk and volatility for everyone else. If nine out of 10 captive members implement smoking cessation programs that are linked to employee plan contributions and other claims management policies and one does not, it puts the entire pool at risk. It is imperative that companies who join together share the same philosophy and practices when it comes to employee health and wellbeing.

Captives or Healthcare Purchasing Coalitions--group purchasing that combine captive insurance techniques with enhanced program offerings and a systematic membership process--that use tools such as feasibility studies, mandated minimum health and wellness program participation and specialty programs like 24/7 independent case management to carefully manage captive membership help ensure members are aligned in theory and practice.

3) **Adviser alignment:** Similar to member compatibility, adviser alignment is also critical to captive success. This approach works best when there are controlled operating guidelines and a connected "wholesale" adviser community. In the absence of a proven adviser structure, a captive or wholesalers can struggle to thrive. What should be avoided, are scenarios where advisers who are doing the right things such as using claims controls, managing risk and only offering membership to qualified organizations can be pooled together with advisers who have minimal experience and are not using appropriate cost controls to ensure proper loss ratios and performance. The result is a frustrated client who does not receive refunds and a great adviser who no longer believes captives are viable, smart options for their clients.

Employee benefits, especially health care benefits, vary greatly from region to region and state to state. Local legislation and regulations, climate, cultural influences, demographics and many other geo-relevant factors contribute to a dynamic benefits environment. This phenomenon makes local advisers imperative to navigate the state laws, local providers and local robust plan designs. However, captives do not share the same boundaries. They can and do span multiple geographies. Any company, anywhere that has 35 employees or more is a candidate for captive membership, but they need a local representative with market expertise to build optimized plans that align with the needs of their specific employee community and meet the requirements of the captive at the same time. In turn, one captive can have many different advisers acting on behalf of many companies in a successful way if they are all working with the same mindset.

Is it the chicken or the egg? Captives need the best advisers to be successful, the best advisers need thriving captives to be successful. They both need an engaged, aligned adviser community to be successful. Coalitions or captives that employ a thoughtful approach to their adviser network ensure adviser alignment and foster a productive investment environment that's primed for growth.

4) Performance-based structure is needed: The performance-based structure is needed. The health insurance industry is antiquated in its delivery to employers and, consequently, the way independent advisers access captive pools can sometimes be tricky. In most cases, advisers have to work through a "wholesaler" to enable their client's purchase insurance using captive methods. Wholesaler networks allow independent advisers to access "public pools" or "incubators" for a single client alongside many other independent advisers' clients to reach the optimal size.

This method has been instrumental in the adoption of the captive model but has also contributed to the primary issue that has plagued public captives because of the way captive wholesalers are compensated. Typically, captive wholesalers charge a set percentage of the clients premium for the services and expenses to run the captive (and the program). Their expense is taken off the top and only the remainder of the clients premium is placed in 2nd risk layer (i.e. captive risk or shared premium layer). As an example, if a wholesaler is charging 40% for their services of the program (Underwriting, excess layer reinsurance, claims adjudication, captive access, captive premium taxes), it only leaves 60% of the clients premium to be placed 2nd layer to cover the claims that hit layer. Running a successful loss ratio on only 60% of a client's premium in the 2nd layer can be difficult. As such, captive wholesaler compensation is not correlated to the performance of the pool or could hurt the chances of unused premium being returned to employers.

In a sense captive wholesalers, also sometimes referred to as Managing General Underwriters (MGUs), are compensated based on how big the pool is rather than how well it performs. As a result,

wholesalers and MGUs can be not incentivized to optimize programs or improve performance before they admit them into the pool, which can impact everything from operations to underwriting quality.

When a captive or coalition directly links its compensation--and mandates that wholesalers or advisers also share risk-- to the success of the group of clients in the captive, everyone is motivated to provide the highest level of service, attain a deep understanding of each client's risk, fix problem areas proactively, add cost controls/risk management tools that can help them perform better and, most importantly, save members money. In addition, performance structured compensation also ensures that only qualified candidates are recommended for participation in the captive, which facilitates alignment of members and advisers; and prevents individual advisers from using the captive in ways it is not designed for.

Curated Community-Carefully Cultivated Controls-Compelling Captives

When designed and operated with care, skill, and data, captives are powerful tools for smaller organizations looking to offer their employees better benefits at lower costs. Their success is proven as evidenced by their performance and ability to deliver plans at 40-50% of the cost of the national average and return millions in surplus assets to members. But, not all captives are the same. When evaluating captive options, organizations should consider the following:

1. Are members required to meet specific benchmarks or qualification before they can join? (i.e. health and wellness qualifications, retrospective loss ratios, underwriting requirements)

2. What are the captives guidelines for risk management and claims and cost controls?

3. Are the captive management fees based on performance (i.e. part of the shared risk and vary depending on performance) or volume (i.e. size of the overall premium invested)?

4. Are wholesalers and/or advisers required to share risk in the 2nd layer?

5. Are existing members available for informal conversations and ongoing support?

Conclusions

Health Insurance Captives are the way for firms to beat the Affordable Care Act. Captives are insurance arrangements owned and controlled by its participating employers, and while they may not be new, they can be complicated sometimes.

Captives are powerful tools for smaller organizations that want to offer their employees better benefits without increasing costs too much. Their success is proven as evidenced by their performance and ability to deliver plans. Nevertheless, it's necessary to know all the captives options in order to be able to choose the one that fits better with your needs.

Maybe, this can look like a complicated thing to understand but this ebook should've given you an insight into health insurance captives and help you take the best decisions to your employees.

References

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