Pros and cons of a captive: Should you do it yourself?

Healthcare providers have been subject to the volatility of the insurance market for years, which has led some to look to the idea of establishing a captive as a way to cut costs, particularly with workers' compensation coverage. A captive can be a great solution in some circumstances, but don't jump without looking first.

A captive insurance company is a property and casualty insurance company established to provide coverage only, or primarily, for its parent company. A captive can be a valuable risk management tool that allows a hospital to more effectively manage corporate risks of all kinds, says Timothy E.J. Folk, vice president with The Graham Co., a healthcare consulting company in Philadelphia.

Captives often are set up to insure risks for which commercial insurance is not available or is too expensive, Folk says. The owner of the parent company is also the owner of the captive, but the captive can be structured so that it is owned directly by the operating company, another person, entity, or a trust, Folk explains.

This structure does not mean, however, that the captive is just a puppet for the hospital or health system. The captive insurance company must act as a legitimate business entity, complying with all insurance regulatory provisions and Internal Revenue Service requirements, Folk says. (See the story on p. 39 for more background on captives.)

The interest in captives is driven by the fact that there is a very limited marketplace to insure a health provider’s risks, which leads to insureds

EXECUTIVE SUMMARY

A captive can reduce long-term costs for a healthcare employer, but it comes with significant risks. A provider must weigh the potential benefits against the costs of covering a large claim.

• Captives might be best for larger, more established organizations.
• Workers’ compensation often is the first focus for a captive.
• Losses can be substantial, but are limited.
insured by the captive are general liability, professional liability, workers’ comp, and automobile liability, Keith explains.

Captives are most popular with for-profit entities because they can take advantage of tax benefits, Keith says. The premiums you pay to your captive become tax deductible, so non-profits have traditionally not been drawn to the captive option. Other benefits, such as being able to direct savings to underfunded programs and projects, and the tightening insurance market are making more non-profits consider forming a captive, Keith says.

With the right claims control processes in place, the captive premium you pay should be similar to what you would pay with a traditional insurer, yet you are able to keep the underwriting profit, Folk adds.

“In addition, while you are waiting for that period of time it takes for losses to be realized, evaluated, and paid, you’re realizing investment income,” Folk says. “At a time like this when providers are being squeezed in so many ways while expenses stay the same or get higher, the more you can explore creative solutions like this, the better off you will be in the long run. A captive truly has the potential to put dollars back in the pocket of the sponsoring organization.”

A captive also takes the organization out of the notoriously volatile insurance market, Folk notes. In the past, insurers with billions of dollars of premiums suddenly have announced that they were not making enough money in that particular market and would not renew any policies.

“That leaves a lot of people without a home, and with so few insurers to choose from in this market, the only option is to take a policy at a very high rate,” Folk says. “In a captive you are subject to a lot less volatility and you are assuring yourself that you have a home through which to procure insurance. It changes the whole negotiation of the insurance procurement process every year because you are no longer at the whim of the carrier. You’re now a business partner with them.”

**SOURCES**


### When is a captive right for you?

Captive insurance companies aren’t for everyone, says Timothy E.J. Folk, vice president with The Graham Co., a healthcare consulting company in Philadelphia.

Risk tolerance is necessary, and you have to be willing to enter into a new line of business, he says. Some people are more content to simply write a premium check and know that another company is handling the claims.

“But if captive is a right fit, it can be a very strong business model that is supportive of the rest of your business strategy,” Folk says.

If a captive looks like a good option, one of the first decisions is what kind of captive is right for you. These are the different varieties of captives:

- **Single-owner captives**: A provider establishes a single owner captive to insure its own risks and the risks of its subsidiaries and affiliates. Some single-owner captives also provide coverage for other, non-affiliated organizations, but this is the simplest form of a captive.

- **Group captives**: These captives are owned by multiple, non-related organizations that serve as the policyholders. The group captive is usually sponsored by a trade group, group medical practices or hospitals, or other professional groups. Group captives can be homogenous, meaning all the members are similar organizations in the same industry, or heterogeneous, meaning the members vary in type. Group captives help spread the risk from any single claim.

- **Agency captives**: These captives are owned by insurance brokers or agents and insure some portion of the insurance sold by its agency or broker shareholders.

Group captives help spread the risk from any single claim, similar to the way a standard insurer spreads the risk by having all insureds pay premiums that will be used to pay the claim of one client. But the group captive is not the same as a standard insurer because you, the policyholder, have a say in who can join the captive, explains Christopher M. Keith, a producer with The Graham Co. in Philadelphia.

“This is very much a club-like mentality. The barriers to entry are tougher than a traditional insurance market,” Keith says. “It’s all about their five-year historical loss rate, and you’re not going to let a poorly performing organization into the
The flip side of those high standards is that an organization performing above the average can get the better deal it deserves, Keith says. A hospital or health group that has focused on patient safety and can show low loss rates still might be subject to class underwriting, which yields a rate increase that is higher than if the insurer judged the organization on its own.

“A captive decreases the pool that your underwriter is looking at,” he says. “You get more favorable rates and more control of the underwriting process.”

Retention levels, aggregate levels key

Captive insurance bring risk, but there is limit

Captive insurance agencies require the insured to take on more claims risk, but that risk is not unlimited. Even with a captive, you don’t risk paying entirely out of pocket for a major claim or repeated claims in one year, says Christopher M. Keith, a producer with The Graham Co. in Philadelphia.

The owner of the captive puts a re-insurance carrier on top of it to minimize exposure, and it sets a limit on the retentions it will pay per year, Keith explains. Retention levels can be set depending on your appetite for risk, but it is typical for a captive to set retention levels at about $300,000 per claim, he says. So if a claim is worth $500,000, the captive would pay $300,000, and the re-insurer would pay the remaining $200,000.

A captive also puts a cap on aggregate losses. An example would be a cap set so that if there are five $250,000 losses in the same year, the re-insurer attaches and starts paying first dollar on subsequent claims.

“This is a plan that is appealing to people that have an appetite for risk, have really well-run organizations, and have fairly robust safety and loss control prevention claims procedures in place,” Keith says. “They have their arms around their claims situations or at least have partnered with a broker that does that for them. Their skin is squarely in the game.”

The potential savings can be substantial. When dealing with a traditional insurer, 50 cents of every dollar you spend on insurance is set aside to pay losses, Keith explains. In a year where you paid out only 20 cents per insurance dollar in claims, the insurer keeps the rest as profit.

“Our feeling is that for well-run organizations, you should keep that 30 cents,” Keith says. “You’re going to have to put some risk up to do that, but that’s why it is right for mature organizations. You wouldn’t want to do this with an organization that has been incurring a million dollars-plus a year in losses. It would not be financially viable for them.”

Most captives formed offshore

There are about 5,000 captive insurance companies in the world, with most being sponsored by U.S. entities, according to information provided by Capstone Associated Services in Houston, TX, which assists organizations with setting up captives.

Although sponsored by U.S.-based companies, most captives are incorporated outside of the United States, according to Capstone. A captive insurance company may be formed only with the permission of regulatory authorities in the insurer’s home territory (known as its domicile), and it is monitored by an insurance commissioner.

Capstone notes that many conventional insurance companies began their corporate existence as captive insurers and grew into large-scale insurance companies, including USAA, Highlands, and American General.

Captives can be domiciled and licensed in a wide number of domiciles in the United States and offshore. Captive insurance companies formed outside the United States or offshore can make an IRC section 953(d) election to be taxed as a domestic U.S. corporation. That designation allows a foreign-based captive to receive the same U.S. tax benefits and treatment as a captive formed in any of the 24 U.S. states with captive insurance legislation.

A foreign-based captive generally has a much lower cost of ownership and a far higher degree of flexibility for its U.S. owners, compared to a captive that is formed in the United States, Capstone says. For this reason, most small captive insurance companies with annual premiums below $1.2 million are formed offshore, according to Capstone.

SOURCE

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