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Commitment Beyond Numbers

Monograph

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Rob's medical professional liability experience includes development of captive solutions for healthcare providers, actuarial studies for patient compensation and birth injury funds, legislative costing studies, surveys of state MPL insurance market conditions, development of predictive analytics using the Medicare Hospital Compare data, review of captive applications, and reserve analyses supporting the financial examination of MPL insurers and captives.

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Innovative Uses of Captives for Health Care Providers

Robert J. Walling, III, FCAS, MAAA, CERA

One of the fastest growing uses of captive insurance companies is small captives providing coverage for low frequency, high severity insurance exposures to health care providers. Several factors are contributing to this growth. The significant changes in how health care is being delivered are creating new and increasing insurance exposures for providers.

Admitted insurance companies are developing insurance programs for these coverages, however, given the lack of data, rates are relatively high and coverage is not always available.

For many years, health care professionals have participated in captive insurance companies as an effective means of financing their medical professional liability insurance and taking better control of these insurance costs. As a result, they are quite familiar with how captives operate and the risks and opportunities they present.

A growing number of health care professionals are expanding how they use captives to address the ever changing insurance exposures they face.

Challenges and a Solution

Health care providers are facing a wide variety of insurable risks beyond traditional medical professional liability.

KEY POINT

Health care professionals are expanding how they use captives to address the ever changing insurance exposures they face.

Electronic medical records requirements create substantial cyber liability exposures. Significant regulatory actions present the need for coverage insuring both defense costs and penalties. Billing audits from health care insurers also present a real risk of defense costs and penalties from the insurer.

As group practices become more prevalent, there is an increased need for coverages to protect the corporate entity and to protect the business from the economic impact of the loss of a key physician and/or loss of referrals from a hospital.

A captive insurance company is one approach physicians are taking to financing these complex and evolving risks.

Captives serve many important purposes in the insurance industry. Key among them are:

- Providing innovative or emerging coverages
- Allowing insureds to retain overhead expense, profit and contingency margins used by admitted insurers in setting their rates
- Enabling an insured to fund coverage that is currently unavailable or not affordable in the commercial insurance market
- Providing a mechanism to finance insurable exposures, especially those with a low frequency of occurring and a high average claim severity.

This makes captives ideally suited to address many of the emerging loss exposures providers face in the current, dynamic market.

Captive Design and Formation

Health care provider-owned captives have a myriad of potential coverages they can consider providing. Common coverage selections include:

- Cyber liability – A greatly increased risk for providers due to Electronic Health Records (EHR) requirements
- Regulatory actions – Particularly HIPAA and FDA actions
- Billing audit expenses – A significant and growing expense to health care providers
- Contingent business income coverage – Loss of income from causes of loss such as the loss of hospital privileges or the loss of referrals
- Professional misconduct – This coverage is commonly excluded from most medical professional liability insurance policies

More general insurance coverages such as Employment Practices Liability Insurance, Directors and Officers Liability, Fiduciary Liability, Employee Theft and Dishonesty, and Loss of Key Person Expense are also commonly included in physician captives. These captives can also provide deductible reimbursement for traditional coverages such as property, general liability, workers compensation and others. The captives may also provide deductible reimbursement coverage for medical professional liability insurance and/or "gap" coverage to insure events excluded by the commercial insurance coverage.

A wide variety of captive types lend themselves to physician captives, largely depending on the size of the insured, the coverages included in the program, the need or lack thereof for risk pooling mechanisms, the choice of domicile for the captive, and the ownership structure of the captive. Series LLC captives, segregated cell or portfolio captives, pure/single parent captives and group captives have all been successfully utilized for innovative health care provider captives.

Onshore domiciles including Vermont, Delaware, Hawaii, and Tennessee and offshore locales such as

A Cautionary Word

It is essential to remember that a captive insurance company first and foremost must be an insurance company.

What does it mean for a captive to be an insurance company? For starters, it must behave like an insurance company; it must set premiums (preferably using a qualified actuary), collect the premiums, invest assets, pay claims, and produce financial statements. In addition, the captive must meet criteria for risk transfer and risk distribution.

Risk transfer is the idea that the captive must assume a reasonable chance of a reasonable loss. In addition, there should be a transfer of both the timing of loss payments and uncertainty regarding the size of the potential economic loss.

Risk distribution is the concept that insurance requires a pooling of risk between insureds. Many of the newer variety of health care captives use pooling mechanisms, reinsurance agreements between similar types of captives providing comparable coverage, to distribute risk between different captive insureds.

Bermuda, the Cayman Islands, and the British Virgin Islands and others are all available for this new group of captive formations.

Pricing Approaches

It is imperative that the premiums for any captive be actuarially sound. This means that they can be neither inadequate nor excessive. Actuaries use several techniques to ensure that a captive's premiums meet these criteria.

Common pricing approaches include:

- Market pricing - based on one or more quotes from admitted insurers for the captive's insured(s) or similar risks and adjusted for differences in expenses and risk margins
- Benchmark pricing - based on industry rate bureaus such as the Insurance Services Office, Inc. and others
- Frequency and severity models - based on assumed claim frequency rates and claim sizes
- Rate on line - based on the number of years worth of premium required to pay one full coverage limits loss (a common reinsurance pricing tool)

These exposure rating techniques may also be modified to reflect actual prior insured experience for the covered risks, whether insured at the time or not. These approaches and others allow the actuary to form the basis for actuarially sound premiums for the captive.

Benefits

Captives providing health care providers with the types of coverages described earlier provide numerous benefits. These include:

- Greater control of currently uninsured or underinsured risks, such as billing audit liability
- Cost certainty for coverages that could dramatically reduce income if uninsured, such as loss of hospital privileges or referrals
- Greater coverage flexibility than is available in the commercial insurance market to meet their evolving insurance needs, such as professional misconduct coverage
- Potentially lower insurance costs than commercial insurance due to reduced expenses
- Control of potential underwriting profits and investment income rather than allowing commercial insurers to realize these benefits
- The ability to build up retained earnings to assume larger amounts of risk within the captive
- Efficient financing for low frequency, high severity risks that can threaten a health care provider's practice

The "T" Word

In the current captive insurance environment, it has become almost taboo to say the word "tax." As discussed previously a captive must first, foremost, and always be an insurance company. However, to ignore the tax implications of a captive insurance company for health care providers is to fail to identify a major benefit of these insurance companies.

Let's assume that the captive is designed in such a way that it is first and foremost an insurance company, meeting all IRS and captive insurance regulatory requirements, such as risk transfer and risk distribution.

Further, let's assume that the pricing is actuarially sound, that is neither excessive nor inadequate. If these assumptions are true, then the captive may have multiple significant tax advantages.

1. The premiums paid to the captive by the health care provider may be tax deductible when they are paid. This could be a significant benefit compared to the covered losses only being tax deductible when they are paid if the risk is not insured.

2. If the captive qualifies for and chooses to make the 831(b) election, the captives underwriting profits, that is the difference between premiums and losses plus expenses, are exempt from federal income taxes.

3. If the captive is owned by certain forms of trusts, then some estate planning tax advantages may be available when retained earnings in the captive are paid out in dividends to the owner.

All of these opportunities require the assistance of a sophisticated tax professional. Pinnacle is not qualified to provide tax advice and the information presented here should be recognized as the basic introduction it was intended to be.

Conclusion

Over the years, captive insurance has proven to be an exceptionally nimble means of addressing insurance needs in evolving markets for sophisticated insureds. In the past, captives have been a safety valve to manufacturers needing products liability coverage, health care providers and hospitals unable to find professional liability at any price, and businesses needing property insurance in areas subject to natural catastrophes.

Today, captives are meeting the evolving needs of health care providers with innovative coverages and captive designs that allow them to take greater control of their risks, reduce the volatility in their balance sheets and better protect their businesses from new and evolving insurable risks.

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ABOUT PINNACLE

Pinnacle Actuarial Resources, Inc. is an independent, full-service actuarial firm that focuses on the property/casualty insurance industry. Our home office is located in Bloomington, Ill., with additional offices in Atlanta, Chicago, Des Moines, Indianapolis and San Francisco.

Our *Commitment Beyond Numbers* philosophy encompasses all of who we are and what we do. It drives us to do whatever it takes to help our clients address their risks, understand the challenges they face and find the right solutions to meet their goals.

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