



Arthur J. Gallagher & Co.

Reducing Risk. Raising Expectations.™

# Alternative Risk Financing... Options to More Control

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# Alternative Risk Financing Agenda

- Traditional Insurance Structure
- Conditions That Drive Alternative Risk Considerations
- Current Healthcare Marketplace
- Alternative Risk Financing Approaches
- What is a Captive?
- Types of Captives
- Captive Advantages/Disadvantages
- Pre-Qualification Criteria
- Captive Operational Tasks
- Final Considerations



# Traditional Insurance Structure

## Guaranteed Cost

- Hospital or Medical Group purchases medical malpractice insurance coverage from a commercial insurer and retains zero or a small amount of the risk themselves.
- The benefit of this approach is that the cost is fixed and is therefore predictable in the short-term for the one-year duration of the policy period.
- The downsides to this approach are:
  - Not predictable over the long-term, subject to peaks and valleys of the marketplace
  - Generally is the most expensive risk financing option
  - Drain to operating cash flow and is a “sunk” cost (i.e. no return for positive loss experience)
  - Underwriting profit for positive loss experience (actual losses less than premiums) and investment income inure to the benefit of the insurance company.

# What Makes up your Premium with Conventional Insurance

Insurance premiums charged by an insurance carrier are priced to include, at a minimum, the following costs. Certain costs are specific to an insured's risk exposure, while other costs are fixed and shared amongst all policyholders of the insurance carrier:

- **Anticipated Claims Costs:** estimated amount to pay for claims expected to arise, usually evaluated for each insured based upon its own loss history, nature of operations, and industry averages
- **Claims Handling Costs:** estimated amount to pay for claims adjusters (either in-house or out-sourced)
- **Catastrophic Insurance Protection:** insurance carriers rarely retain the entire risk of loss themselves; they will seek to transfer the portion of losses excess of certain levels to other insurance carriers (reinsurers), who in turn charge a reinsurance premium for assuming this portion of the risk.
- **Commissions:** paid to insurance agents or brokers
- **Sales & General Operating Expenses**
- **Premium Taxes, Boards, Bureaus & Assessments**
- **Profit – Return to Shareholders**



# Conditions That Drive Alternative Risk Considerations

- The Hospital or Medical Group has had a history of adverse loss experience.
- The Medical Malpractice insurance market is or has hardened.
- Your State is or is becoming a crisis State.
- Your organization sees the benefit to retaining risk.



# Current Healthcare Marketplace

## Current HPL / MPL Market

- Market remains well capitalized and competitive
- Continued competitive pricing for both HPL and MPL
- Acquisition/Consolidation of MPL carriers will continue
- Increase in hospital employed physician exposure will effect HPL renewal pricing
- Carriers expanding coverage and terms to stay competitive
- Developing products for ACO Managed Care exposures
- Physician markets developing products to compete in hospital space
- Future of Health Care Reform Act still under attack
- 2012 Presidential Election could have large impact



# Alternative Risk Financing Approaches



# Option 1: High Deductible / SIR Approach

- The insured could elect to retain a portion of the medical malpractice risk themselves through either a high(er) deductible or self-insured retention under its purchased insurance policy.
- **Pros:**
  - Reduces premiums paid to the commercial market. Therefore volatility of the market is not as disruptive.
  - Shifts capture of underwriting profit on the portion of risk retained, and investment income from insurer to insured.
  - Short-term cash flow benefit, as funds related to the SIR layer, that would normally be paid to insurer as premium, are now held by the insured and paid over life of claim.
- **Cons:**
  - Insured hospital or medical group needs to provide evidence of insurance coverage, often times including disclosure of any deductibles or SIRs. Significant SIR limits may be a cause for concern in satisfying evidence of insurance requirements.
  - Losses in the SIR layer would be accrued as liability with no offsetting insurance recoverable/receivable.
  - Actual losses in the SIR layer could end up being more than the premium reduction. Because loss cost are estimated actuarially until such time that all claims are closed and paid, the actual results may not be known for a long period of time and will fluctuate over time.
  - Payment of claims in the SIR layer will directly impact operating cash flow causing cash flow volatility.



# Alternative Excess Risk Considerations

The following are not new concepts, but represent some proposed risk financing alternative options that we have negotiated for certain clients where the risk profile allowed us to maximize the value of these options:

- **Commutation Provision:** This program allows our clients to review their historical loss experience and determine whether they need more insurance coverage for that policy year. Prior to the termination of the policy, the client has the option to take back the risk that was transferred during the policy period in exchange for a partial refund of premium.
- **Integrated Insurance Program:** This program provides a single block of coverage to address all risk needs. This structure has been available since the early 1980's and predominantly driven by hard market cycles. This option requires manuscript policy forms and insurers are limited.
- **Multi Year Program:** Clients can save significant premium by stretching their higher limits of liability to cover multiple years of exposure instead of one year since higher limits of liability are often not utilized.
- **Dual Towers:** This concept is to separate the coverage structure for general and professional liability so that they can be structured independently of each other. The dual tower of coverage will usually be excess of the underlying exposures and their respective primary policies, such as Directors and Officers liability heliport liability, and commercial automobile liability.
- **Swing Plan:** This is a standard risk transfer mechanism with additional risk towers whereby the client will participate in incremental losses up to a pre-determined maximum retention.



## Option 2: High Deductible / SIR Approach with Captive Reimbursement Policy

- The insured could elect to utilize a captive insurance company as a funding mechanism to prudently fund for retained risks now rather than paying for retained risks on a pay-as-you-go basis.
- Under this scenario, the captive serves as a mechanism to set aside a “loss fund” for SIR layer claims by providing a “SIR reimbursement” insurance policy. The insured receives “reimbursement” coverage for claims occurring in the SIR layer and pays the captive a premium for this coverage.
- The captive collects a premium generally equivalent to the amount of losses expected to be incurred.



# High Deductible / SIR Approach with Captive Reimbursement Policy

- Pros:
  - Converts an unpredictable cash flow (claims paid as needed) to a fixed cash flow (insureds pay fixed premium to the captive)
  - Provided that the captive structure meets requirements for risk shifting and risk distribution under IRS revenue rulings, the captive could deduct both paid and unpaid claims estimates.
- Cons:
  - A captive is a separate legal entity that will require management oversight, costs to operate, and contribution of capital.
  - A captive reimbursement policy provided to your insureds may become subject to state-based self-procurement premium taxes
  - A captive reimbursement policy may not provide satisfactory evidence of insurance coverage.



# What is a Captive?

As a limited purpose insurance company formed primarily to insure the risks of its owner or affiliated companies, each captive operational structure involves at least these elements:

- Captives can only be formed in jurisdictions having captive-enabling legislation. These captive domiciles are located throughout the world, including Bermuda and Cayman Islands, as well as throughout the U.S. such as Vermont, Hawaii, Washington D.C., South Carolina, Arizona, and Nevada.
- Captives operate as insurance companies: as such, coverage offered by a captive is evidenced by an insurance policy. However, captives are considered admitted carriers only in the domicile in which they are incorporated, and are typically not “rated” insurance carriers.
- As an insurance company, the captive bills and collects premium. A captive’s premium is typically set at a level to cover its expected claims costs plus its operating costs.
- Captives are separate legal entities, governed by its own officers and directors. Also, as a separate legal entity, it must have its own capitalization base where the required capital amount is generally determined by the regulators in the domicile in which the captive operates.
- Captives are formed primarily to insure its owner and affiliated companies. Thus, a captive can be viewed as a form of formalized self-insurance.
- Because a captive is formed for such “limited purposes,” it is not regulated as rigorously as a conventional insurance company. For example, capitalization requirements for a captive are significantly lower than capitalization requirements of a conventional insurer.
- Captives generally have no employees; hence all of the typical “insurance company” functions are outsourced to third parties, such as the insured’s broker, dedicated program managers, captive domicile managers, and other specialized vendors. Such functions could include:
  - insurance program administration, including premium and rate determination, underwriting, policy development, policy issuance, and premium invoicing.
  - actuarial analysis
  - claims handling
  - cash & investment management
  - financial reporting
  - regulatory reporting, including liaison and communication with captive domicile regulators



# Single-Parent/ Pure Captive

- Insures the risk of an owner and its subsidiaries.  
traditionally used by large Fortune 2000 companies
- Client is in control of the operation, lines of coverage, limits and domicile location
- Allows for some direct writing of policies with access to the reinsurance market to follow form
- Captive surplus can be used by owner as it needs:
  - Stabilizing premiums in a hard market
  - Increasing retention levels
  - Insuring new lines or expanding coverage on current lines



# Pure Captive Tax Considerations

- There are **three** areas of tax that impact a pure captive Insurance company
  - **Domicile premium tax** – taxes imposed by domicile jurisdictions, specific rates vary by domicile and range from 0% to .25% of written premium
  - **Self-procurement taxes** – for direct-written programs, rates vary by state
  - **Federal income tax** – to gain recognition as a insurance company the presence of risk shifting and sufficient risk distribution need to be in place

# Pure Captive Applications

- Larger Healthcare Organizations/Larger Premiums
  - \$3MM - \$5MM of premium
- Funding primarily for Professional Liability
  - Primary casualty lines – Workers Compensation, Auto Liability, General Liability
  - Property
  - Directors and Officers Liability
  - Problem Areas – Pollution, Unique Financial Exposures

# Group Captives

- Group of insureds come together to start a Mutual Insurance Company
- Pool 100% of the risk and use the groups purchasing power to reduce fixed costs for all
- Heterogeneous or Homogeneous Memberships
- Members control the program
- One Member = One Director = One Vote





# Group Captives Ownership & Structure

- Capitalization requirement (\$15 – \$36K)
- Collateral required
- Capitalization grants member voting rights
  - One Member = One Director = One Vote
- Two Board of Directors meetings a year
- Two Risk Control Workshops a year
- Documents between the client and the captive legally defining how the captive operates
  - Documents includes a tax opinion
- Director is required to complete paperwork for approval from domicile



# Group Captive Tax Considerations

- Captive Documents include a tax opinion that premium is deductible
- Members returned premium based on good loss experience. Returns are considered income.
- Many Group Captives take the 953d tax election
  - Members **do not** pay Federal Excise Tax (FET) of 1% on premiums and 4% of all loss experience charges
  - Allows for business to be conducted on shore (including board meetings)
  - Captive takes deduction for return of premiums

# Risk Retention Group Captive

- RRG's are insurance companies formed under federal law the Risk Retention Act of 1986.
- An RRG can only write liability lines.
- The advantage of an RRG is they can eventually operate in all 50 states without a fronting carrier.
- They generally write policies on a direct basis and are owned by the insured's.
- The growth in RRG's has been slow in the soft market as coverage has been readily available



# Items to Review Before and During a Feasibility Study

- Long-term commitment
- Adverse development
- Commitment of capital
- Domicile taxes
- Captive fixed operating costs



# The Feasibility Study

- Key Objective
  - A key component of the feasibility study is to help an investor understand their return on investment
- Base Data
  - This objective is best achieved if the captive investor has its own loss experience to use in the study

# Feasibility Study Results

- Analysis of retention scenarios or loss projections
- Program structure
- Capital and collateral requirements
- Project performance
- Domicile analysis
- Tax considerations



# The Captive Formation Process

- Business Plan
  - Forecasts of Annual Expected Losses
  - Program Structure (Premiums, Limits, Capitalization)
  - Proforma Captive Financial Statements
- Selection of Service Providers
  - Captive Manager
  - Legal
  - Auditors
  - Actuarial
- Preliminary Meeting with Domicile Regulators
- 45 to 60 day Process (Most Major Domiciles)

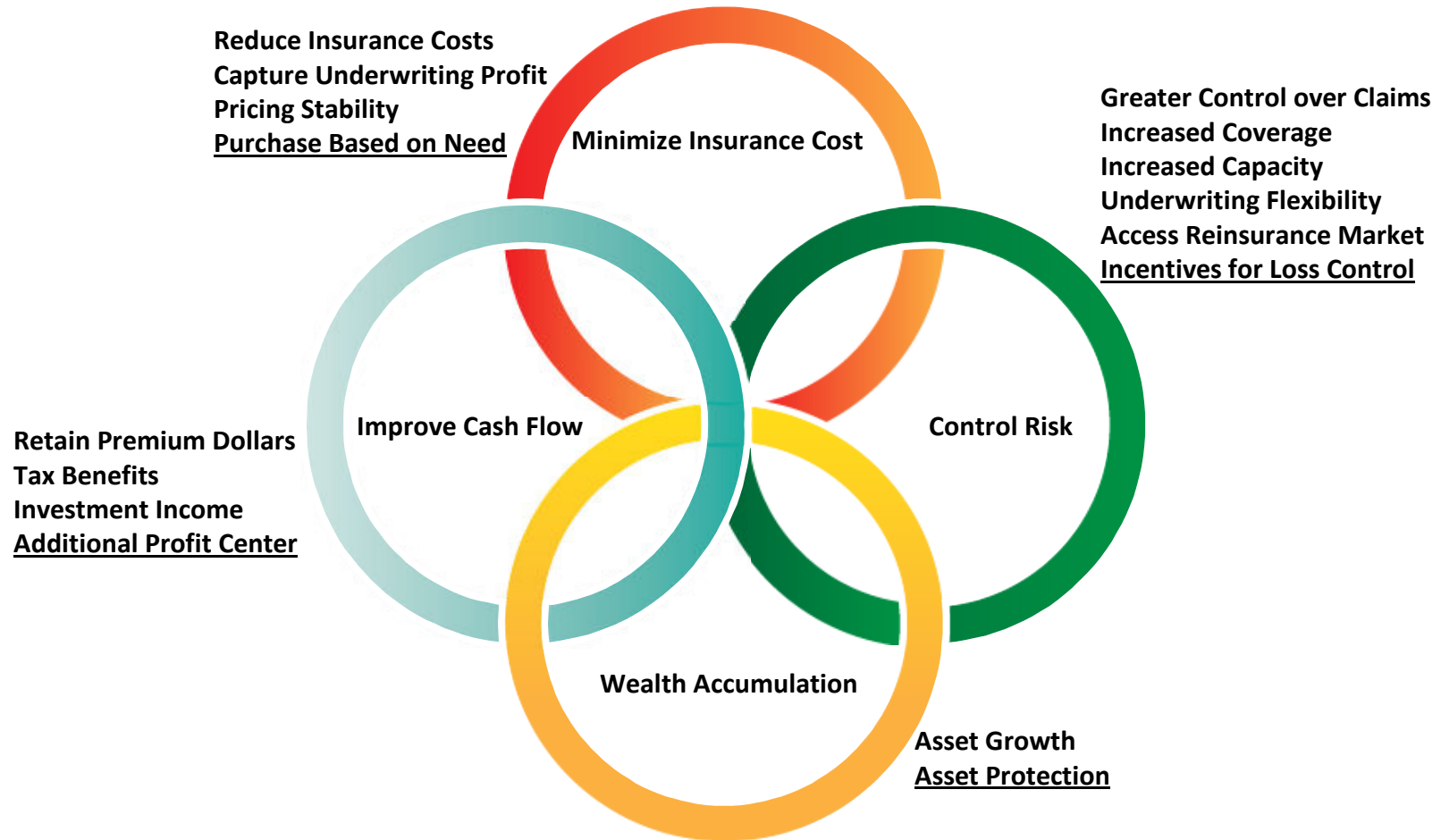


# Costs Related to Forming a Captive

- Feasibility Study or Plan
  - \$30,000 - \$50,000, plus tax planning
- Ownership Cost \$100,000 - \$200,000
  - Domicile taxes
  - Captive management fees
  - Audit fees
  - Domicile meetings
  - Cost of collateral
  - Actuarial fees
  - Legal fees
  - Policy issuance cost



# Benefits of a Captive



# Potential Financial Benefits of a Captive

- Improve cash flow
  - Premiums paid to the captive can stabilize insurance costs
  - Investment income remains in the captive
- Tax advantages
  - Loss reserves, including IBNR (Incurred But Not Reported) are deductible
- Reduced insurance cost
  - Maintain underwriting profits
  - Access to reinsurance markets

# Trends in Use of Captives Physicians Employment

Healthcare systems are moving towards employing physicians who formerly were members of their voluntary attending physician community, usually larger groups/practices which have had near exclusivity with the system.

## Risk

Changing risk profile of health System (risk transfer and risk retention issues)

How do we deal with tail coverage for incoming physicians

## Solution

Segregated Captive

Segregated Captive

## Value

Provides focused energy on changing risk profile

Segregates physicians risks from hospital risks which may enable differentiated risk retention and transfer solutions

Segregates tail risks from system risk to enable specific risk transfer or LPT later in life cycle and to monitor performance of portfolio



# Trends in Use of Captives Outsourced Administration

Healthcare systems are providing community physician practices with outsourced billing, operational and administrative services, usually with a requirement to procure insurances

## Risk

Self-insured trust model does not  
does not allow for inclusion of non-  
employed risks

## Solution

Captive

## Value

Provides infrastructure for taking on third parties such  
as exclusive groups, joint ventures and managed  
physician groups

Aligns physician insurance program to system insurance  
program



# Final Considerations

1. Do you have access to your loss data?
2. Are you willing to commit capital to a new enterprise?
3. Does your organization have an entrepreneurial spirit to embrace a new enterprise?
4. What is your expected rate of return on your invested capital?



## Recent Study at U.S. Teaching Hospital (Lee et.al)

- 74% of referring ED Physicians and 74% of radiologists underestimated CT's radiation dose.
- 92% of patients given a CT in the ED thought the radiation dose was similar to or at most 10 times that of a regular x-ray.
- What's the answer?



# Answer:

- A typical CT exam delivers a radiation dose between 100 and 400 times that of a single chest x-ray!
- CT's simply present higher risks to patients than wrong site surgery or surgical burns.
- Joint Commission Sentinel Event: "Radiation therapy resulting in 25% greater dose than anticipated.
- Media attention, American College of Radiology, FDA



# What Are The Regulatory Limits For Patient Doses?

- The NRC sets a regulatory limit for annual occupational exposure to radiation. However, there are no regulatory limits for patients receiving doses from medical procedures.
- Medical Practitioners are responsible for keeping doses as low as reasonably possible.
- Special risk for pediatric patients





# What Can We Do:

- Understand doses. Displayed values on scanners is the Dose Length Product (scan preparation and calibration).
- This is not the effective dose. (age, body dimensions etc.)



# Typical Doses

- Head CT: 75 mGy
- Ab CT: 30 mGy
- Ped Ab: 20 mGy
- Chest CT: 25 mGy
- Brain Perfusion: CT: <500 mGy
- Anything above 500 mGy is very, very high!



# Additional Risk Considerations:

- Ensure technologists are trained to understand reference doses for typical exams.
- Must be empowered to question doses or patient concerns (more than one CT recently?)



# CT Continued

- Have CT's been evaluated by Health Physicist? Meet them.
- Consider QI Project:
  - Are doses on scanners?
  - Laminated Cards?



## Additional Risk Considerations:

- Consider accreditation (ACR)
- Encourage physicians to ask, “what other diagnostic tool is available?” before scheduling routine CT exams.



# Linear Accelerators

- Recent events where patients were harmed by radiation spilling over cone.
- Stereotactic Radiosurgery (SRS) one of the fastest growing radiation therapies.
- Problems include: complexity of system, miscommunication between different software and hardware manufacturers.

# Linear Accelerators

- Missouri: 76 patients over-radiated due to calibration error.
- No requirement for accidents or near misses to be reported. “We didn’t know there was a problem”.
- American Society for Radiation Oncology has called for establishment of first central database for the reporting of errors involving linear accelerators



# Interventional Radiology

- Dose Management and Patient Safety
- Identify, inform and obtain informed consent for high dose procedures.
- Develop real time dose monitoring communication between technologist and interventional radiologist.
- Establish program to track patients with high CD

