BY CHRISTIAN MORENO & MARK E. MORRIS

HEALTH CARE CAPTIVES: *The Truth Behind the Pitch*

Contractor CFOs and human resource (HR) teams are well-versed in managing workers' comp risks and claims, but medical plan risk is a whole other proposition that can be random, unpredictable, and more complex to manage. For years, larger employers have turned to self-insured plans as a solution due to better pricing terms and lower taxes, less margin lost to insurance carriers, and more employer control over the plan design.

Increasingly, small- to mid-size groups are joining with like-minded employers to form group medical captives. At their core, the goal of medical captives is to address the stop loss market access/dysfunctionality at the smaller end of the employer market, which is accomplished by providing a lower specific stop loss attachment point for employers with approximately 100-300 employees. These captives are sold with a promise to keep medical costs steady and more predictable from year-to-year by spreading the risk among multiple small- to mid-size employer groups.

But do all group captives live up to their promises? How should employers evaluate and avoid pitfalls? With all of the excitement, growth, and sales pitches in this space, it can be hard to discern exactly how these structures work and for whom they are delivering the most value.

Medical Captives: A Primer

Just as group captives can help small- to mid-size contractors house and pool risk while keeping costs down, medical captives aggregate the buying power of smaller employers to get better health plan pricing, terms and conditions, rate caps, and "laser" protection. However, medical plan captives are much less predictable from a cost perspective.

Chris Hyder, CFO of Tennessee contractor Summers Taylor, saw this lack of predictability firsthand and exited a medical group captive after just one year. "I was led to believe by our broker that we would have a similar experience

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in the medical captive as we did for our business lines captive," said Hyder. "Unfortunately, we did not see the savings I anticipated."

While contractors generally have expertise in risk management for both casualty and benefit plans, there are key differences between these two categories of risk and thus the group captives that underwrite them. Here are a few important distinctions:

- An employer can craft its own medical plan design and determine, to some extent, what is covered and what is not. There is no such flexibility on workers' comp or third-party liability claims.
- Employees and employers share in the cost of the medical program; employees do not pay casualty insurance premiums.
- Employees have strong opinions about their health coverage since it has a big impact on their daily lives, but they don't typically spend much time focusing on the coverage offered by their employer for workers' comp or auto liability.
- Levers used to lower medical claim costs are often perceived as taking value away from an employee's health plan.
- Medical risks can be addressed with wellness programs to some extent, but it is typically much more random and less controllable at the employee level. Casualty risks can be greatly mitigated with good safety procedures.
- A medical captive covers only 15% of total plan costs, so employers still need help managing the 85% outside of the captive spend. With a casualty captive, risk is typically transferred on a first dollar basis.

These differences show where the lines between the two captives become blurred. The underlying factors that apply to business lines simply don't apply to medical. For example, there is a significant degree of cost volatility and randomness to medical claims – with single claim events sometimes exceeding $1 million – that introduce cash flow risk/financial exposures that are unacceptable for small- to mid-size employers.

While safety programs and solid risk management can reduce exposures in most other lines, for example, a premature birth with three months in the NICU simply can't be managed down to zero. Larger employers can absorb this type of risk and volatility from thousands of employees on the plan, but the same is not true for smaller employers.

Building a Medical Captive That Works

Medical captive plan designs are most easily summarized in layers.

Employer Plan Design Layer

First, each employer designs a specific plan for its employees. The members share in the expenses, up to a certain point, like they would in any group health plan.

Captive Layer

Next, each employer selects its own desired level of self-insurance stop loss deductible (e.g., $50,000 per claim). Premiums for that stop loss contract are paid to one carrier, which enables larger group pricing. The stop loss carrier then reinsures a layer of risk to the captive that is pooled with other employers.

While captive members share some risk in this layer, this allows for premium stabilization for the group. Joining with like-minded employers that want to employ techniques to manage claims and trends is the linchpin of a successful captive program.

Reinsurance Layer

This layer belongs entirely to the reinsurer, which is the captive sponsor. The reinsurer sets the terms and absorbs the losses above the stop loss amount set by each employer. Here is where the economies of scale happen; there is a functional and healthy market for this level of risk in the reinsurance market. The collective buying power of the captive allows these employers to access the markets – and at a risk appropriate level in combination with the captive layer discussed earlier.

If the captive performs well, then dividends can be paid back to each employer at the end of the plan year.

Larger accounts that typically have annual losses in excess of $1.5 million will, in many cases, be better off to craft their own insurance program as opposed to combining with others in a group captive. Those larger clients will often have the ability to utilize a wholly owned captive.

Is a Captive Right for Your Company?

With the basic concepts of medical captives addressed, consider the following characteristics when trying to determine if medical captives are a fit for a specific business:

- *Pro Self Insurance:* If currently fully insured, a company must first be open to the self-insure concept and, in turn, accept some vibration in monthly/quarterly cash flows rather than guaranteed monthly costs through premium.
- *Long-Term Planning & Patience:* Those entering a captive must take a medium- to long-term view and, over time, a captive ***should*** outperform other vehicle options for this size group. But be aware that every year will not be a home run.
- *Vendor Selection Flexibility:* If you are tied to one local health plan network and are set on staying there, a captive may not be for you because the network will not "unbundle" stop loss from their claims administration.
- *Financial Appetite:* Most captives require a capitalization fee to get started. Do you have the cash?

Key Components for a Successful Captive

If you're ready to take the next step in considering a medical captive for your company, here are some key components to ensure success:

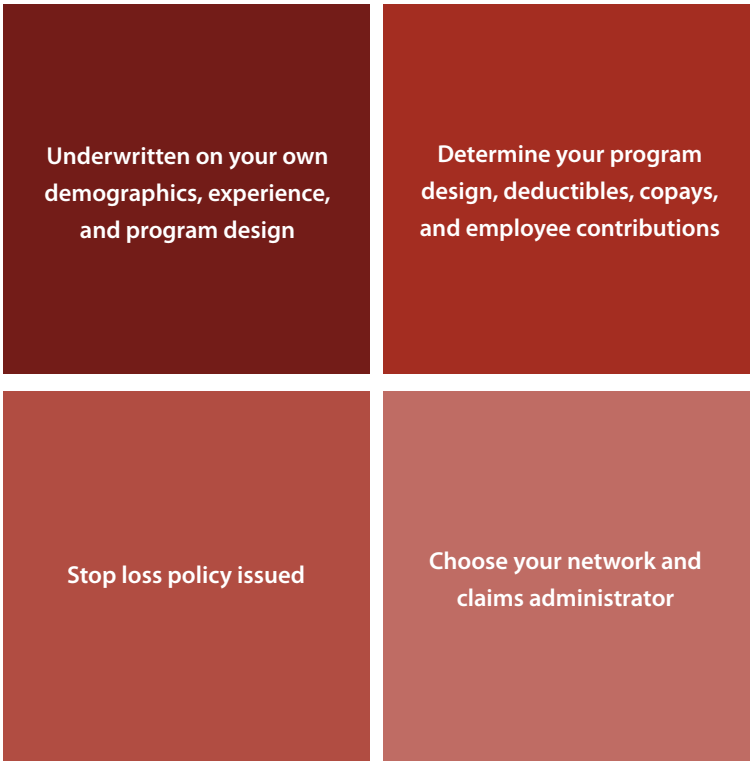
Administration

There needs to be some flexibility in who administers your medical plan. Many of the major medical administrators (e.g., Cigna, Blue Cross & Blue Shield, and United Healthcare) have become less willing to allow employers to carve out pharmacy benefit management and stop loss insurance unless the employer reaches a specific employee count threshold. This required "bundling" of services can partially mitigate an employer's self-funded savings opportunity. Know which vendors are available and have the ability for you to weigh in on the options.

Network Pricing & Access

The majority of costs for the medical plan will be from paid medical claims. As a result, both the employer and selected administrator *must* first ensure the health plan network of

Exhibit 1: **Captive Advantages**



Advantages

Cost stability
- + Avoid market swings
- + Rate stability
- + Reduce margins

Self-funding efficiencies
- + Avoid typical fully insured taxes
- + Reduce fixed costs

Lower stop loss rates
- + Group buying power
- + Market leverage on rates and terms

Claims transparency
- + Needs-based strategies
- + Risk patterns identified for medical/prescriptions
- + Focus on cost drivers

The monetary value gained during our four years of captive participation is significant...BUT POSSIBLY THE BEST SIDE EFFECT WE'VE SEEN IS THE ENGAGEMENT OF OUR STAFF IN NEW WELLNESS INITIATIVES, which ultimately results in a healthier and happier workforce.

physicians and hospitals meets their access and discount/cost needs. Most administrators offer several broad Preferred Provider Organization (PPO) networks, and a fairly straightforward analysis will ensure which one is a fit. If you don't get this right, you may negate any expected savings in the captive, or worse, actually increase your costs.

Pharmacy Benefit Costs

Many captives secure favorable pricing and cost transparency terms for their customers. Costs for this benefit sometimes exceed 25% of the total medical plan spend. With increased availability of gene therapies and other high-cost medical treatments, a strong, transparent, and auditable pharmacy benefit manager contract is a key tenet in strong captive financial performance.

Complex Claims Management & Stop Loss Contract Provisions

Foundational to the success of any captive is managing/reducing large claims vibration. These large/complex claims can be detrimental to the financial performance of the captive and can impact renewals for the group overall. Well-managed captives employ clinical expertise to ensure there is limited fraud, waste, and abuse in all claims but also enact processes/automation that trigger payments and clinical protocol reviews (by physicians) for the largest and most complex claims. The captive then secures best-in-market contract terms for the reinsurance of the captive, which limits laser exposure and renewal increases (and, again, smoothing the risk of volatility/shock to the captive).

Member Engagement, Wellness & Steerage

Network access and discounts are only part of the story of incentivizing members to utilize the right resource/supply of care. Providing relevant cost and quality information to the member is usually a priority of most top-tier captives. Using the available digital health/engagement platforms with an integrated wellness program and incentive structure cements the risk management picture and engagement for the captive.

For example, according to Chris Anderson, CFO at Hoefer Wysocki (a 130-life architecture and design firm with offices in Kansas and Texas), the wellness program offered through its captive was of particular value. "The monetary value gained during our four years of captive participation is significant," he said. "But possibly the best side effect we've seen is the engagement of our staff in new wellness initiatives, which ultimately results in a healthier and happier workforce."

It's important to note that a successful captive/insurance arrangement represents only *part* of the value to the employer. In order to extract both financial and risk management efficiencies, there must also be a well-thought-out and articulated vendor configuration. This ensures not only administrative/risk tools that are Best in Class, but also serves to aid in securing like-minded, risk-managed employers to share the costs.

What Are the Blind Spots?

An internet search for "group medical plan captives" will produce a litany of advertising and (often misleading) analyses of these new vehicles. Further, there is little publicly available data on the long-term efficacy and growth/percentage market share for captives. Add in financial complexity and industry jargon like mezzanine layer, traunch, and capitalization, and things get even more confusing.

Here are four aspects of which to be aware when shopping for a captive:

Financial Transparency

Ask about all fees involved and whether or not the captive is required statutorily to disclose every fee before you sign on. These fees can sometimes be hidden, and they add up. If the captive has been around for a while, ask about dividend

payment decisions and the historical track record of the captive to date. It's also important to ask if the captive has any dividend payout conditions/restrictions.

Stop Loss Contract Provisions

Quality captives offer employers multi-year protection through a multi-year rate cap and no new laser contract provisions. It should also offer industry standard language in areas such as plan mirroring (if the administrator/plan pays the claim accurately, then it is eligible for reimbursement under the stop loss policy). The captive should also ensure a "gapless" contract, so there are no gaps in coverage during the transition into or out of the captive. These can be tricky, misleading, and costly if done wrong. Finally, the captive should have built-in services – which should be funded by the stop loss carrier, not the employer – to help with complex claim cost reduction.

Vendor Configuration & Flexibility

Since prescription drugs can sometimes represent 25% or more of total medical spend, a top-notch pharmacy benefit manager is key to a successful captive. You need to know all the costs involved, whether rebates are given, and if pricing audits are conducted. You should also dig into the available third-party administrator and network options. Make sure you understand all cost/network details before selecting. These vendors support the administration and much of the value/savings to the medical plan, so these must be key considerations.

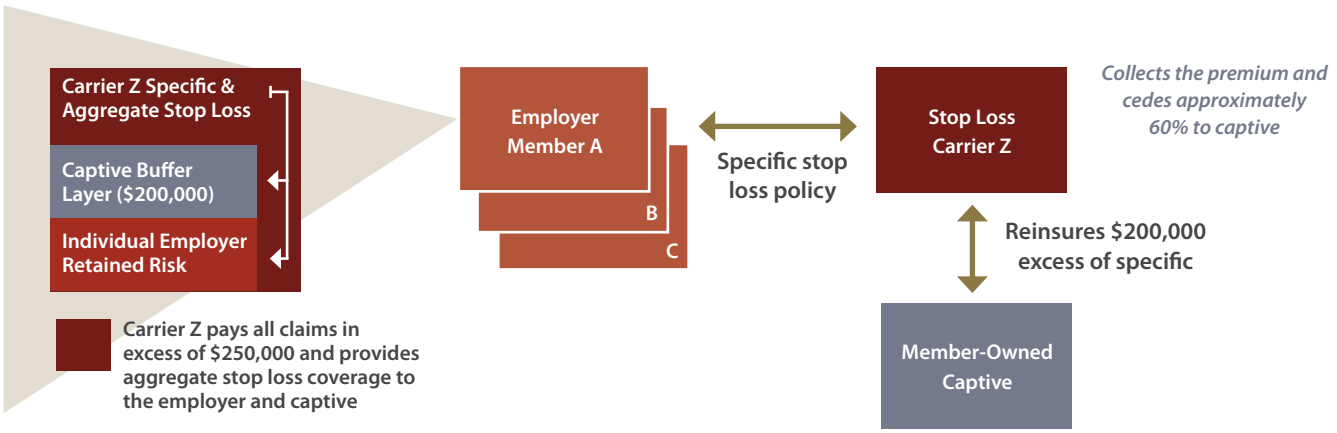
Another important element for some employers is the wellness program; how is it configured, implemented, and supported for all captive members?

Exit Clauses

While exit from the captive is of course no one's intent upon entry, understanding the exit clause is key to the evaluation and comparison. What are the rules for participating in the dividend(s), if any, upon notification of exit? Perhaps most important, ensure the captive contract language explicitly states the portability or "neutrality" of the broker consultant/intermediary. Many captives allow for the transfer of captive data/performance and intermediary status at the member company – i.e., the captive is independent of the broker.

However, recent "productization" of captives has ushered in a new era of proprietary captives that limit employers' options and force a severing of both the captive/stop loss coverage together with a change in advisor/consultant. This can create unnecessary risks and financial exposures while the employer seeks to replace the stop loss coverage. Due to the strong market and availability of competitive unrestricted/

Exhibit 2: **Captive in Action**



Example (Employer Member A)

- Carrier Z issues a $50,000 stop loss contract to Employer Member A
- Carrier Z reinsures the next $200,000 to the captive
- Carrier Z provides stop loss on individual claims above $250,000
- Carrier Z also provides aggregate stop loss for the employer and captive layer, establishing a maximum cost
- The captive layer is the only risk that is shared, and each employer prefunds the maximum cost

non-proprietary captives, there should be little leverage to enlist in one that dramatically restricts employer options. Be sure to get this in writing in the beginning.

Hyder has a cautionary tale about misleading captive structures. "The captive we joined was clearly used as a tactic to lure us into a long-term relationship with a broker, which was not made clear up front," he said. "The broker tried to strong arm us into staying with a promise of future dividends. I'm definitely open to the concept of joining another captive, but I would ask for more specifics next time."

Captives & the COVID-19 Effect

The COVID-19 crisis of the past year underscores the unpredictability of medical claims and patterns. Despite COVID-19 sending millions to U.S. hospitals, overall medical spending was down in 2020.[1] An actuarial study of Lockton's book of business found that health care spend in 2020 was 2.8% lower than expected, with over half of the impact due to decreased surgical procedures. This was also the year where cancer diagnoses decreased for the first time in years – most likely because of missed or delayed screenings.[2] Because of this, a previously undiagnosed cancer may now require more complex, costly treatment, or a delayed surgery may return to the plan in a later time period. When most Americans are vaccinated and there are no longer barriers to receiving health care safely, employers may see a 2-3% increase in claims. The underlying volatility in claims costs for an employer-sponsored medical plan is a key consideration for employers considering self-insuring – whether with a captive or not.

Endnotes

1. Cox, Cynthia & Amin, Krutika. "How have health spending and utilization changed during the coronavirus pandemic?" The Peterson Center on Healthcare and Kaiser Family Foundation. December 1, 2020. *www.healthsystemtracker.org/chart-collection/how-have-healthcare-utilization-and-spending-changed-so-far-during-the-coronavirus-pandemic/#item-covidhealthspendingutilizationcollection_3.*
2. Kaufman, Harvey W.; Chen, Zhen; & Niles, Justin. "Changes in the Number of US Patients With Newly Identified Cancer Before and During the Coronavirus Disease 2019 (COVID-19) Pandemic." *JAMA Network Open*. August 4, 2020. *jamanetwork.com/journals/jamanetworkopen/fullarticle/2768946.*

Captives: What's Next?

Health benefits are a major spend for contractors, and navigating all available options is complex and ever-changing.

While the captive market for the small- and mid-sized employer has picked up steam and gained in market share, the proof of concept has yet to fully bear itself out. Market share often grows dramatically as products move from early adopters to a mass audience, similar to what happened with private health care exchanges in 2012-14. These have since fallen out of favor as the underlying value proposition was not fulfilled.

What is clear now is that the financial benefits of self-insuring have driven many employers to dive in. As this market matures, there will be less variability in the underlying offerings and potential "gotchas" of each captive. This will make the environment less perilous, and hopefully widen the net on employers that stand to benefit from such structures.

While the captive model is not for every fully insured employer, those who approach with caution, gather the data, and truly evaluate short- and long-term goals will have the most success. ■

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