MSL Captives
An SRS Company

# Medical Stop-Loss: COST Series

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# Executive Summary: The COST Framework in Group Captives

The COST framework—Community, Ownership, Stability, and Trust—plays a vital role in the management of group captives, particularly in the context of employer healthcare costs. Each component of this framework offers distinct benefits and is essential for the effective functioning of a group captive. The series of articles delve into how these elements contribute individually and collectively to the success and sustainability of group captive insurance programs.

### Community

The first element, Community, emphasizes the collective nature of group captives. It highlights how a community of like-minded employers can share insights, validate cost containment strategies, and support each other in managing healthcare costs. By leveraging a community of solutions and a network of peers, employers benefit from shared experiences and resources, enhancing their ability to control costs and improve care quality.

### Ownership

Ownership shifts the perspective from purchasing insurance products to actively managing and owning the risk. This shift encourages more strategic thinking about long-term healthcare cost management rather than short-term insurance buying tactics. As owners, employers gain the ability to influence captive operations, prioritize long-term stability over the insurance renewal cycle, and make decisions that align with their broader business goals.

### Stability

Stability addresses the inherent volatility in stop-loss insurance, which protects against high-severity, low-frequency claims. Group captives help mitigate this volatility by pooling risks across a diverse set of employers, smoothing out the financial impact of high-cost years against the collective strength of the group. This stability is crucial for predictable budgeting and financial planning.

### Trust

Trust is critical in ensuring that the captive operates transparently and in the best interests of all members. It involves careful selection of service providers, clear and fair compensation structures, and equitable governance practices. Trust within a group captive fosters a transparent environment where all participants are informed and engaged in the captive's operations.

Together, these elements form a robust framework that supports the strategic management of healthcare costs through a group captive structure. By focusing on Community, Ownership, Stability, and Trust, employers can optimize their healthcare investments, enhance their control over insurance operations, and achieve more predictable, manageable healthcare costs. This series provides a comprehensive overview of how embracing the COST framework can transform an employer's approach to healthcare cost management, aligning it with broader business objectives and fostering a cooperative, stable, and transparent insurance environment.

# Understanding an Employer's Total Cost of Care

Health insurance represents a major line item in an organization's financial statements and is often perceived as one of the most challenging costs to control. However, for many mid-sized and larger companies, the actual insurance cost is a minor component of their healthcare expenditures.

Since the implementation of the Patient Protection and Affordable Care Act (ACA) in 2010, the percentage of employees in self-insured plans has ranged between 58 and 60 percent, according to the Employee Benefit Research Institute. This data suggests that a majority of U.S. employers are self-funding their employee healthcare costs, rather than relying solely on purchased health insurance plans.

In a self-funded health plan, employers typically secure stop-loss insurance to mitigate financial risks from significant health claims attributable to an individual (specific coverage) and an accumulation of claims (aggregate coverage). Depending on the deductibles for specific and aggregate claims, stop-loss insurance may represent only 25% to 33% of total healthcare spending. If an employer participates in a group captive insurance program, the percentage of actual risk transfer can be less than 10%.

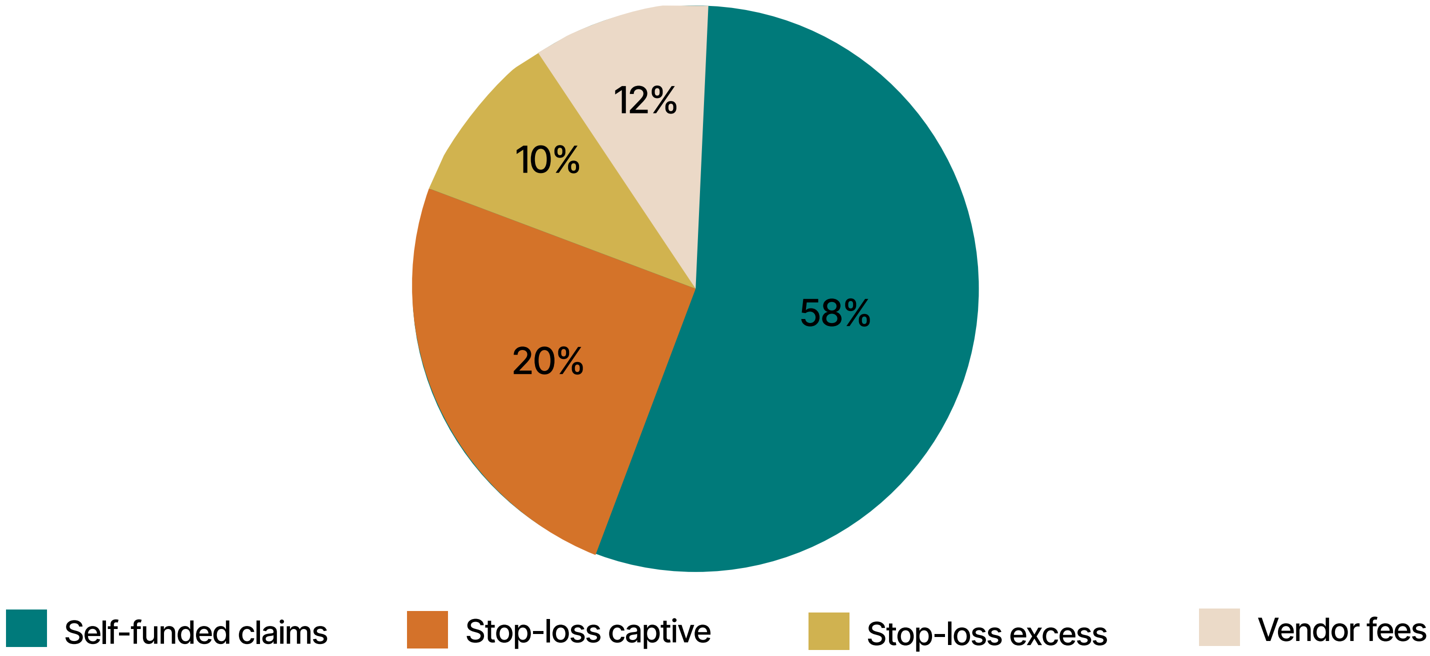
Instead of focusing solely on health insurance costs, employers should examine the total cost of care. This metric is commonly used by healthcare providers to assess the cost-effectiveness of their services but is equally relevant for employers providing healthcare benefits. The practice of providing health insurance benefits to employees dates back to the Stabilization Act of 1942, which, due to wage controls, led employers to offer health benefits as a non-wage compensation. Today, offering health insurance is essential for U.S. employers to attract and retain talent, despite the rising costs and complexities involved. While the majority of US employers are self-funding employee healthcare, few are using the total cost of care metric to measure and manage these costs.

The total cost of care for an employer encompasses several components:

**Self-funded claims:** These are often the largest expense in employer healthcare programs, making up 55-65% of total costs, even with moderate stop-loss insurance retentions.

**Administrative and vendor fees:** Managing a self-funded plan involves significant administrative overhead and requires specialized vendors for managing medical and pharmacy benefits. These fees, which can rival the costs of risk transfer, usually constitute 10-15% of total cost of care.

**Stop-loss insurance:** Providing both specific and aggregate coverage, this insurance kicks in at about 125% of anticipated claims under the self-funded arrangement. Despite its volatility, group captive arrangements can provide stability and access to cost containment strategies, making up 20-30% of the total cost of care.




### Long-Term Perspective

Shifting from a focus on annual health insurance expenses to a comprehensive view of the total cost of employee care represents not only a metric change but also a strategic shift. Health insurance is typically purchased annually, emphasizing short-term financial planning and risk management.

However, adopting a total cost of care metric allows employers to acknowledge and measure the long-term financial responsibilities of employee healthcare. This metric also facilitates the assessment of various cost containment strategies that can impact long-term expenses.

### TCOR Comparisons

Chief Financial Officers and Risk Managers might find parallels between the total cost of care and the Total Cost of Risk (TCOR), a concept developed in 1966 by Douglas Barlow at Massey-Ferguson. TCOR includes insurance premiums, self-insurance costs, risk control expenditures, and administrative costs, mirroring the components of the total cost of care for employers. This similarity provides a familiar framework for organizations to integrate total cost of care metrics into their strategic financial planning.

# The COST Advantage of Group Captives: Community

In our previous article, we highlighted the benefits of adopting a Total Cost of Care model for employers to accurately assess and manage healthcare expenses for their employees beyond just health insurance costs. Taking this strategic approach further, how do group captive structures support self-funded employers in optimizing their total healthcare expenditure?

Understanding that managing healthcare costs is a marathon and not a sprint is crucial. Group captives provide a sustainable funding mechanism for stop-loss insurance, facilitating a long-term strategy rather than being constrained by annual insurance renewal cycles. Central to this approach is the COST (Community, Ownership, Stability, Trust) advantage. This series begins by exploring the Community aspect of group captives.

Self-funding empowers employers with visibility and control over their healthcare costs—a significant shift for those transitioning from fully insured plans. This newfound transparency opens up extensive possibilities for cost management but can also be daunting. Many mid-sized employers may not have in-depth healthcare expertise and prefer to concentrate on their primary business activities, necessitating reliable and effective support systems. Here, the community aspect of group captives becomes invaluable.

**Community of Solutions:** One of the principal benefits of self-funding is the capacity to implement cost containment strategies directly affecting healthcare expenditures. These strategies might include pharmacy benefit management with high-cost drug protocols, specialized medical management programs, organ transplant carve-outs, and data analytics for early identification and proactive management of high-cost conditions.

For employers new to self-funding, the range of options can be overwhelming. It's crucial to understand what services are essential and their cost-effectiveness. Often, vendors charge based on per employer per month (PEPM) or per plan participant per month (PPPM) rates, which can significantly inflate costs, especially for infrequently used services. Percentage of savings payment models aligns vendor and employer interests but require careful negotiation regarding the terms of shared savings. Group captives excel in assembling panels of cost containment experts and securing favorable pricing through collective bargaining.

**Community of Peers:** Despite the advantages of cost containment strategies, navigating self-funding can feel isolating. This is where a community of peers within a group captive proves beneficial. Being part of a group captive allows employers to connect with others facing similar challenges, share successes, and validate the effectiveness of cost containment vendors. This collective experience not only reduces the sense of isolation but also aligns financial interests among members, fostering a supportive network that is financially incentivized to help each other succeed. The risk-sharing aspect of group captives creates a financial bond among members, enhancing cooperative efforts to manage healthcare costs effectively. Additionally, group captives provide benchmarks for healthcare costs and introduce a healthy competitive element among members.

# The COST Advantage of Group Captives: Ownership

In the second installment of our series on the COST advantages of group captives for managing employer healthcare expenses, we focus on the "O" in COST: Ownership. In the realm of stop-loss insurance, differentiation among carriers and providers has diminished, turning into a commoditized market competing primarily on price.

Consequently, employers and brokers often find themselves locked in short-term buying tactics, navigating from one renewal cycle to the next. This focus on stop-loss premium as a key component of total healthcare costs does not support a long-term strategic approach to managing an employer's Total Cost of Care.

Joining a group captive for stop-loss insurance transforms the employer's role from a mere buyer to an owner of the insurance company. This shift brings a new perspective on how to manage healthcare costs over the long term:

**Rethinking the Lowest Rate:** While securing the lowest stop-loss rate might seem advantageous, the perspective changes when one becomes an owner within a captive. Start-up ventures rarely succeed on underfunding, and similarly, overly aggressive rate cuts in a captive can jeopardize the required reserves.

Captives, which are typically conservatively funded, recapture the benefits of cost containment through the distribution of surplus once proven effective. This approach requires a conservative budgeting strategy, akin to planning for self-funded claims, where employers might budget at last year's levels rather than banking prematurely on promised savings from new cost containment vendors.

**Standard Terms like No New Lasers and Rate Caps:** These terms are common in stop-loss proposals and are used to reassure employers that (1) the costs for future high-cost claimants will not be pushed back on the employer and (2) any premium increases to absorb the additional cost will be limited. As buyers, this sounds like a great perk, allowing employers to transfer the risk of costly claims to insurers. However, within the captive, the dynamics shift. Owners must consider the collective risk and the implications of accepting terms that might benefit one member at the expense of the group. This strategic shift can lead to more prudent, collective decision-making about risk acceptance and management.

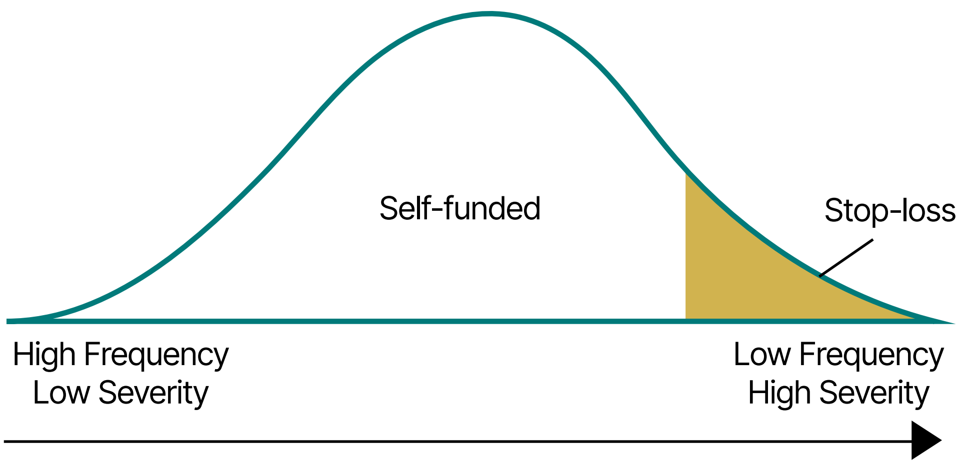
**Claim Payments and the Ownership Perspective:** In traditional insurance settings, claims processing can become adversarial, with parties aiming to "win" by maximizing claims paid versus premiums. In a captive, this dynamic changes. Employers view claims from both the buyer's and owner's perspectives, focusing on equitable claims processing and addressing underlying healthcare costs. This dual perspective fosters a more cooperative and cost-effective approach to managing healthcare expenses.

Ownership in this context extends beyond the captive itself; it encompasses a broader ownership of the healthcare responsibility employers assume for their employees. By owning this responsibility, employers can more effectively manage the total cost of care, ensuring the sustainability of competitive healthcare benefits for their employees.

# The COST Advantage of Group Captives: Stability

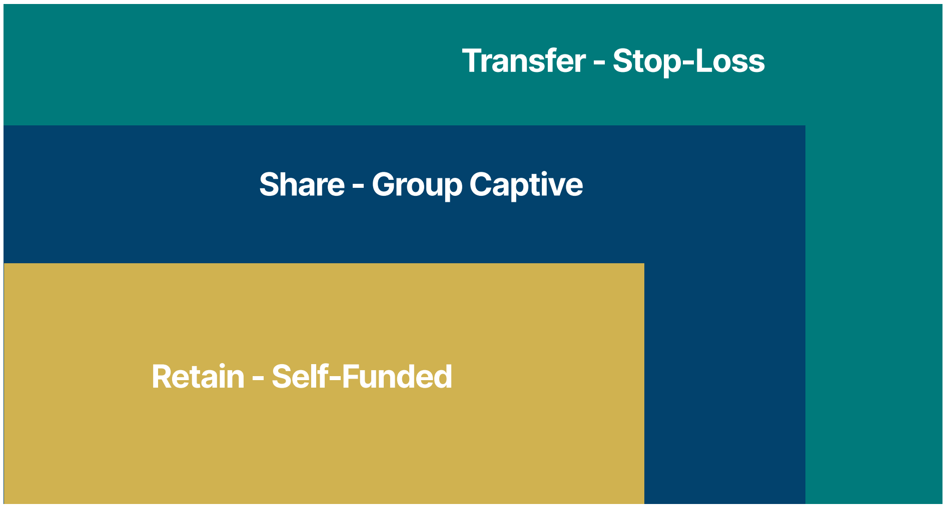
In the third installment of our series exploring the COST advantage of group captives in managing an employer's total cost of care, we delve into the "S" for Stability. Medical stop loss coverage can exhibit significant volatility, with health insurance claims spanning from high frequency and low severity to low frequency and high severity.

The inherent unpredictability of catastrophic claims makes them suitable for insurance coverage, while it is more cost effective to self-fund more predictable, frequent claims avoiding the additional administrative expenses and profit included in insurance premiums. The positioning of stop loss insurance is illustrated in the claims distribution below.



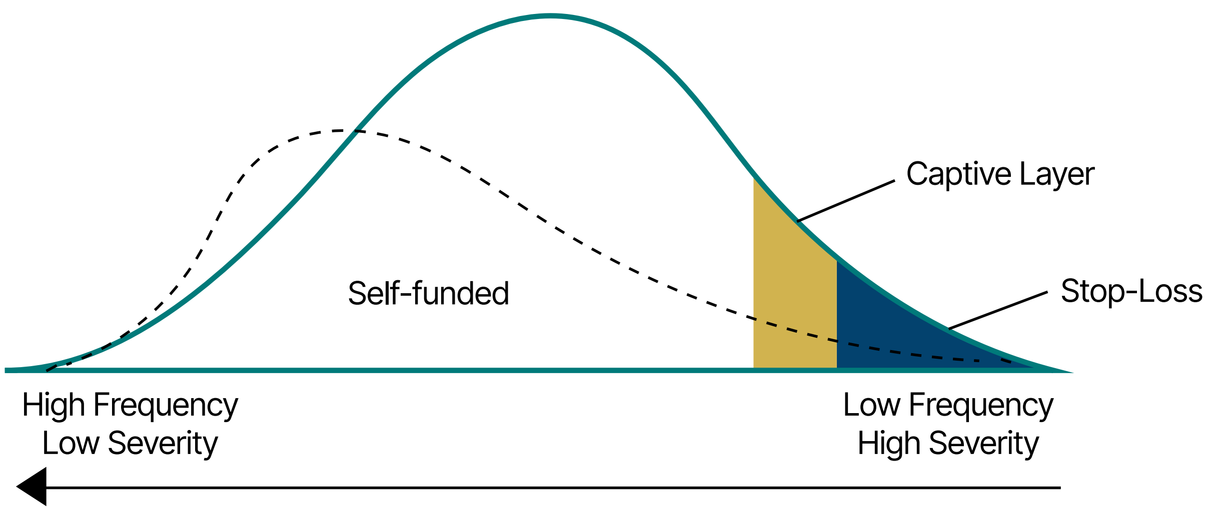

Stop loss insurance is designed to shield against catastrophic claims. These high severity, low frequency claims are inherently volatile, leading to fluctuating experiences from year to year. Large, infrequent claims can result in uneven "lumpy" claims experiences, impacting the pricing and availability of stop loss insurance. Premiums may spike following bad years, and despite good years, they seldom decrease equivalently, if at all. This can lead to a cycle of inflated pricing over several years due to the volatility in claims.

A group captive offers a practical solution to manage this volatility. By pooling stop loss claims across multiple employers, the negative impacts of a bad year for any single employer are mitigated by better years from others. This collective approach helps smooth out the effects on renewal pricing of stop loss coverage for all participants. Within the captive, an employer facing a challenging year may not receive distributions, but benefits from the overall stability provided by the captive's shared risk and collective purchasing of excess coverage.




The graphic illustrates how group captives categorize claims into three segments: retain (predictable claims), share (stop loss claims within a certain threshold), and transfer (catastrophic claims). The captive acts as a buffer, spreading some costs in the shared layer and collectively purchasing protection for true catastrophic events in the transfer layer.

**Impact of Cost Containment:** As discussed in our previous article on Community, group captives enhance cost containment strategies to manage healthcare costs. Effective cost containment can shift the overall distribution of healthcare costs towards more predictable, manageable events.




For instance, direct primary care models, which operate on a fixed monthly fee for access to primary care services, can significantly impact routine medical costs, the high frequency, low severity claims. But what impact does this have on less frequent higher cost claims? Greater access to primary care often results in earlier diagnosis and treatment, potentially reducing the frequency and severity of claims that escalate to catastrophic levels. Even if you cannot convince a stop loss carrier of the direct impact on catastrophic claims to merit a decrement on the stop loss rate, being part of a group captive allows for the recapture of savings from these shifts in cost distribution, benefiting the entire cost curve.

# The COST Advantage of Group Captives: Trust

In the final installment of our series on the COST advantages of group captives in managing an employer's total cost of care, we focus on the "T" for Trust. While Community, Ownership, and Stability address general characteristics of group medical stop loss captives, Trust concerns the selection and operation of a specific captive.

**Selecting the Right Service Providers:** Trust within group captives begins with confidence in the service providers. Issues often arise when a program prioritizes the interests of service providers over those of employer participants, who bear the actual risks. Essential questions include the selection process for these providers, the control that participating employers have over them, and the feasibility of terminating a provider's services if their performance is unsatisfactory.

A fundamental aspect of trust is whether employers can continue working with trusted existing vendors within the captive or must switch to unfamiliar ones that may not align with their expectations.

**Transparent Compensation Structures:** Understanding the compensation structure of vendors within the captive is critical. Group captive programs often embed vendor compensation into premiums or add per-employer-per-month (PEPM) charges, which can escalate costs for services that may not be utilized regularly. The transparency of compensation, including any overrides—additional earnings that brokers or agents might receive based on the volume or performance of their business with a carrier—is crucial.

Employers should be fully informed about all compensation facets, including the specifics and limits of percentage-based savings charges.

**Evaluating Participant Composition:** Trust also extends to the composition of the employer group within the captive. Successful captives often involve employers who have pre-existing relationships, whether through industry associations, regional affiliations, or shared service providers. This familiarity can enhance cooperation and stability, although it's important to balance this with the benefits of diversifying risk across a larger group.

**Governance and Control:** The governance structure of the captive is a cornerstone of trust. Employers should know who controls the captive, the decision-making process, and the rules governing membership and risk sharing. This includes understanding how distributions are made, whether they are based on individual performance or a collective metric, and how risks are allocated during less favorable periods.

Effective governance and clear, transparent policies ensure that all participants are treated fairly and equitably, fostering a supportive and cooperative environment that benefits all members.

Active engagement and transparent governance are critical in building and maintaining trust within a group captive, enabling participants to effectively manage their total cost of care through collective effort and mutual support.

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To discuss your captive options, please contact us at info@mslcaptives.com.