Spreadsheeting Captives

Traditional employer stop loss policies have become quite commoditized with carriers mainly competing and being evaluated on price. There is not a lot of perceived differentiation around coverage, financial strength, claims paying ability and reputation. The willingness to include terms such as no new lasers and rate caps are a differentiator, although they have become standard within the industry. In evaluating commoditized products, advisers lean towards spreadsheeting quotes by price and any key differences such as lasers, and inclusion of no new laser and rate caps.

But what happens when one or more of those quotes are from a captive? Does spreadsheeting still make sense? In this article we will strongly argue against the use of spreadsheets to evaluate captives or to at least to understand how to break down the different layers of the captive quote, so the comparison exercise is meaningful. A lower cost quote may not be better when the employer is the insurer.

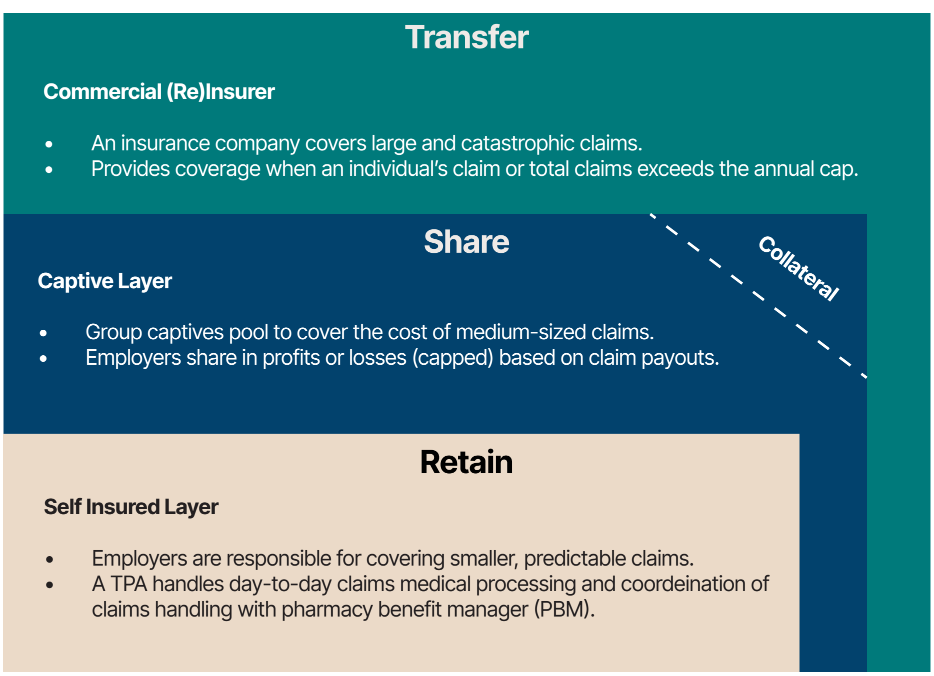
Captive Background

A captive is a licensed insurance company owned by one or more of its policyholders. It is licensed in a domicile under specific captive legislation, which means that it does not rise to the level of a commercial insurance or reinsurance company. Capitalization levels are lower, and regulatory oversight may be more flexible recognizing that the captive is insuring its owners.

Captives have been around for a long time, maybe as long as 100 years. Most of the historical activity has been insuring property & casualty risk. Over the past 10-15 years though we have seen significant growth in the use of captives to insure medical stop loss risk. Large employers may include a layer of their stop loss program in a single parent captive. Middle market employers with anywhere from 50 to 400 employees may use a group captive structure to band together with other employers to insure a layer of the stop loss risk for all participating employers.

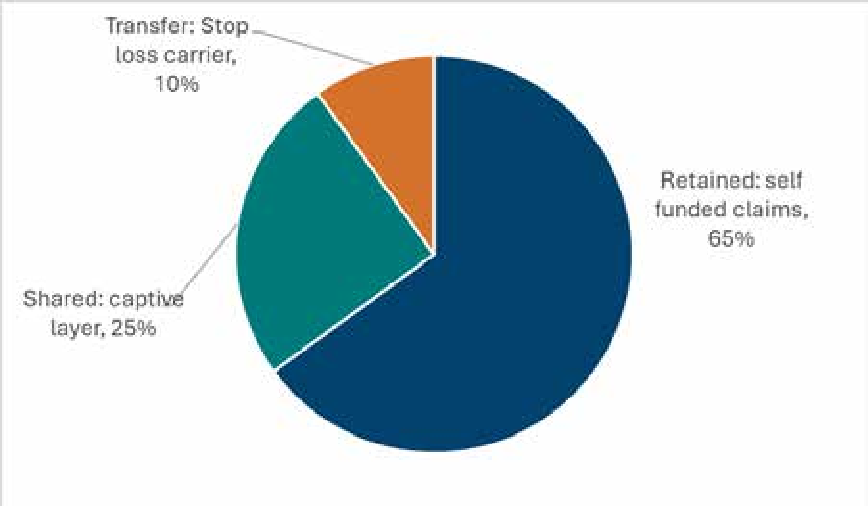
Captive Structures

As captives are not licensed as commercial insurance companies, they typically operate as reinsurers, assuming a layer of risk on the stop loss policy from a commercial insurance company. That captive layer usually has a specific (per claimant) limit and is also capped in the aggregate. Once the reinsurance layer is exhausted, the risk returns to the commercial stop loss carrier. This approach results in a three-layer structure as shown in the diagram.



- Retain layer: this is the employers self-funded claims under the specific deductible of their stop loss policy. The employer is solely responsible for the claims under this layer.
- Shared layer: this is the captive layer and risk in this layer is shared across all the employers participating in the captive. The participating and/or operating agreements of the captive detail the terms of how risk and surplus is shared in the layer.
- Transfer layer: this is the layer above the captive, which is insured by the commercial stop loss carrier and applies after the shared captive layer has been exhausted.

The split in cost between these layers will vary depending on the program structure, but a typical allocation of cost between the layers would be:



Evaluating a Quote

How do you evaluate a quote across these three layers? In the retained layer the employer is paying for the claims directly and will apply a budget to what is expected. Typically, budgets are conservative so a higher number may be better, although that will not be given by the stop loss quote. An aggregate corridor will though and the lower the aggregate the more protection is being given to the self-funded claims. If the employer experiences a bad year, it will pay less.

The risk transfer layer is more straightforward as you are comparing premiums in the layer. It is important though to identify what is being paid for risk transfer rather than look at the stop loss premium as a whole, which will include premium being ceded to the captive, your own insurer.

The shared layer is more complicated. This is your own insurance company and your own money. Is a lower premium or a higher premium better in this layer? Generally, the more funding that goes into this layer the better, but it needs to be assessed within the total stop loss premium.

Finally, there is the complication of lasers and aggregating specific provisions. These provisions are designed to keep responsibility for known conditions with the employer and not to include them within the stop loss insurance. Insurance is designed to cover unknown future events and includes a layer of administrative expense and insurer profit. It is more appropriate and cost effective to pay for known costs directly.

So what happens when you have captive stop loss quotes where one has imposed a laser and another has not? For traditional stop loss this would be an easy answer. The quote that doesn't have the laser is better. It is not so clear when there is a captive involved. The laser is protecting the captive, the shared risk layer. Not imposing the laser means the captive is absorbing more liability. Is that factored into the premium going into the captive? If not, you have underfunded the captive, the employer's own insurance company, and you are more likely to have a collateral call.

Example

To simplify the example, we have assumed the employer does not elect aggregate coverage.

	Carrier A	Carrier B	Difference (A-B)
Spec Deductible	100,000	100,000	
Captive Retention	300,000	300,000	
Stop loss premium - captive	1,000,000	1,100,000	(100,000)
Stop loss premium – excess	350,000	400,000	(50,000)
Total stop loss premium	1,350,000	1,500,000	(150,000)
Laser imposed	500,000	0	
Employer's laser share	400,000	0	400,000
Captive's laser share	0	300,000	(300,000)
Total cost inc employer laser share	1,750,000	1,500,000	250,000
Total cost inc captive laser share	1,750,000	1,800,000	(50,000)

In the example, both carriers quote the same structure, $100,000 spec deductible with a $300,000 captive layer above that. There is a high-cost claimant with estimated treatment costs of $500,000. Carrier A lasers the individual for $500,000 (an additional $400,000) above the spec deductible). Carrier B absorbs the laser and charges slightly higher stop loss premium in both layers. How do you compare these quotes?

• Total stop loss premium: if you just compare the quotes on total stop loss premium, Carrier A is $150,000 more competitive than Carrier B.

• Captive layer: factoring in the captive layer, the comparison becomes more complicated as $100,000 of the additional cost for Carrier B is going to the captive, so it is more adequately funded than under Carrier A's quote.

• Employer laser liability: Carrier A imposes a laser and this results in an additional potential liability of $400,000 to the employer. Adding that to the total cost now makes Carrier B's quote look more competitive as it didn't impose the laser.

• Captive laser liability: the problem with just analyzing the laser at the employer level, is that the laser is also protecting the captive, which is collectively the employers' own money. Under Carrier B's quote $300,000 (the full spec limit) of the laser is absorbed by the captive with only an additional $100,000 in premium to pay for it. Adding the amount of the laser absorbed by the captive to the total cost leads us back to Carrier A as the more competitive option.

The captive layer is a shared risk layer, so the employer isn't directly paying for the laser costs but shared with the other captive participants. The decision on which quote is more attractive may be a question of how connected the employer feels to the captive – does this really feel like their own company and their own money? If you replicate this across multiple employers and view this as an owner of the captive, then Carrier A should look the more attractive.

Conclusion

Confused? Me too. The multi-tiered structure of the captive quote including retained and shared risk layers does not lend itself well to spreadsheeting. Is higher or lower funding in the captive layer preferable? That answer may be different for a larger open market program than a more closely knit group captive. Key takeaways are:

1. Carefully look at the relative funding and liability in the captive layer. When the carrier is quoting the captive layer, remember this is the employers' own money. Is the carrier under-funding the captive layer to compete on the overall stop loss premium?

2. How much is being charged for the risk transfer layer? This is the part of the quote that is true insurance premium. As a captive owner, you want to maximize the amount of the stop loss premium that is going to the captive and specifically the claims fund. Those funds are available to pay claims in the captive layer and for return to owners if claims experience is good.

The decision to join a captive is about taking control of the long-term cost of care. It is not about shopping stop loss insurance annually for the lowest deal. As both a buyer of insurance and an owner of the insurance company, you want risk to be adequately priced and stable from year to year. Underpriced risk is a warning side for becoming an owner of that insurance company. With stability in your stop loss premiums, the focus should be on managing the underlying cost of care through proactive cost containment initiatives.

For more information please contact MSL Captives on our website at www.mslcaptives.com or by email at info@mslcaptives.com.