Captive Insurance Opportunities for Healthcare Organizations

Captive insurance companies continue to increase in popularity across industries and have been enthusiastically embraced by healthcare organizations. In this piece, we will highlight the basic features of captives and the key factors to consider when considering their potential benefits.

A Captive Entity: The Basics

A captive insurance company is an insurance company set up and wholly owned by a non-insurance company to act as a direct insurer or reinsurer for its parent company and/or its affiliates. Captives are used in a variety of organizations, ranging from Fortune 500 companies to nonprofits, and are generally appropriate for organizations who incur at least $500,000 in annual insurance premiums. Typically, the primary reason to create a captive is to provide improved risk management, as captives can make financing risk more cost effective and ultimately reduce an organization's total cost of risk. There are now more than 7,000 captives worldwide. They have proven to be an effective tool to control and manage risk for the last 100+ years.

What is a Captive?

1. A captive is a separate legal entity that is established and licensed as an insurer and is established primarily to insure a proportion of the risks of its sponsor — often a corporate parent, group or association.
2. It is a risk-bearing vehicle. It can be either an insurance or a reinsurance entity.
3. In addition to being used for insuring or reinsuring the risks of its parent and affiliates, a captive can also be used to insure or reinsure the risks of third parties, such as customers, suppliers or subcontractors.

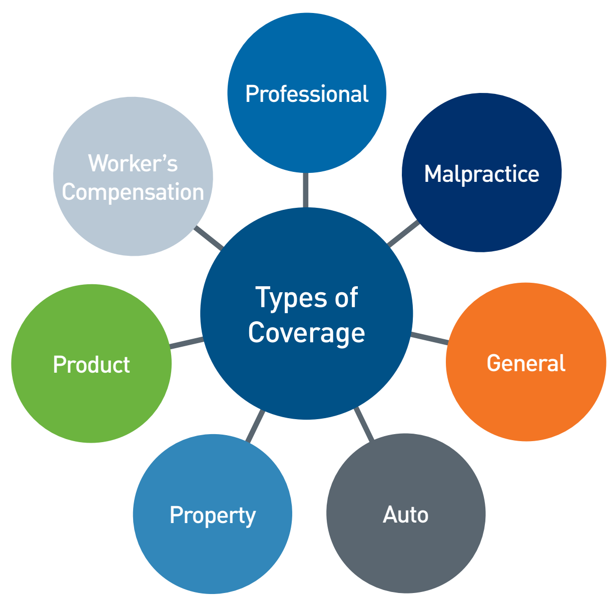
The Key Parties:

Organizations typically engage outside service providers to assist in the creation and ongoing management of a captive, and these services are typically tailored to each parent organization's needs. These providers along with local officials of the chosen domicile may include (but are not limited to) the following parties:

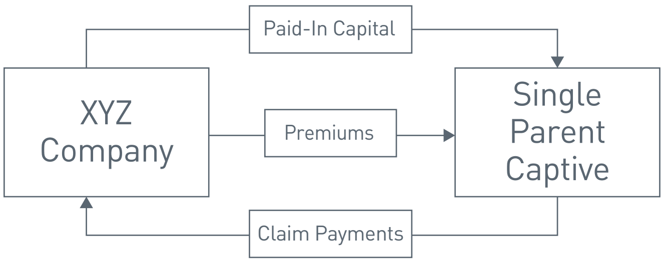
- Management Company
- Investment Manager
- Local Regulator
- Accountant
- Legal & Tax Advisors
- Audit & Actuarial Professionals

Types of Coverage:

There are several types of coverage considered more "traditional" insurable risks and could include the following:



Basic captive insurance structure is illustrated here:



Benefits of a Captive

The benefits of a captive include the ability to tailor coverage to the needs of the organization, better take advantage of often predictable insurance market cycles, provide potential tax advantages, offer creative risk solutions, allocate costs to business units, deploy employee retention tools, provide coverage that the commercial markets do not, and consolidate risk management. We dig into a few of these benefits below.

Increased Insurable Risks

One of the many benefits of a captive insurance company is the ability to customize the insurance coverage to the needs of the organization. In addition to the standard types of coverage, captives are increasingly being used for these specific types of risk as well:

- Cybersecurity
- D&O and E&O
- Intellectual Property
- Mold & Pollution
- Construction
- Collection Risk
- Credit Risk
- Exclusions

In particular, cyber-attacks are unfortunately becoming more common within healthcare due to the sensitive nature of data. This has only increased demand for cybersecurity insurance, which has seen a 161% increase in gross written premium (GWP) since 2016.[1] A common practice for healthcare organizations who find cybersecurity either too expensive or inaccessible due to multi-factor authentication requirements is to include a certain threshold of cyber risk protection within a captive and then reach out to the reinsurance market for a now obtainable and more cost-effective 2nd layer of protection.

Taxation

If the captive qualifies as an insurance company for U.S. federal income tax purposes, then premiums paid to the captive are tax deductible by the insured entity. Also, the captive is afforded special tax treatment which could provide the ability to defer 80% of the unearned premiums and deduct discounted loss reserves.[2] Captive structures, like most transactions, have federal, state, and often international tax considerations and opportunities. Additionally, it is important to consider both the tax treatment of the captive as a part of the organization's group as well as the tax treatment of premium flow. Any organization contemplating creating a captive should first consult with their tax and legal advisors regarding their individual situation.

Cost Control & Decreased Volatility

By creating a platform for an organization's risk management, captives can improve cash flow management and provide investment returns which, through proper captive management, can offer overall insurance premium cost savings. These cost savings can be meaningful as the average healthcare organization's GWP has increased by 73% since 2016.[1] It is also important to note that the size and scale of a captive's assets will often help determine the captive's investment approach. A captive's conservative investment approach at inception will commonly be followed by a risk-adjusted approach as emergence of claims, scale and assets warrant. In return, the building up of a captive's reserve pool will allow an organization to increase its risk-bearing capacity, decrease insurance premium volatility, and may greatly improve the organization's risk profile over time.

Employee Retention

Many healthcare organizations are concerned about the retention of their physicians and staff, and they see a captive's risk mitigation benefit as a way to reduce employee burnout. Outside of saving or improving lives of patients, malpractice is often top of mind for physicians and a strong captive can help to alleviate the financial risk as well as mental strain that can often hang over the heads of staff in healthcare. In the current healthcare worker shortage, organizations are searching for any opportunity to be a more attractive employer or attract

[1] https://insights.aon.com/2021-captive-benchmarking-survey/healthcare/

[2] https://www.captive.com/articles/when-are-premiums-paid-to-a-captive-insurance-company-deductible-for-federal-income-tax-purposes

new talent. Data published by the Association of American Medical Colleges shows the U.S. could see an estimated shortage of between 37,800 and 124,000 physicians by 2034 so organizations need to be proactive in retaining talent.[3] Strong liability protection is one of the few controls that could potentially benefit both the organization as a whole and also provide an incentive for individual employees through better benefits.

Better Decision Making & Transparency

When an organization takes charge of their risk management by creating a captive, they gain a consistent overview of exposures and data summarizing the risks they are underwriting. Instead of outsourcing to an insurance company, an organization obtains a full picture of the exact amount of claims made, premiums paid, and any potential cost savings. This information may assist in making more informed strategic risk management decisions. These advantages include:

- Improved Claims Review and Processing
- Incentive for Loss Control
- Capture of Underwriting Profit & Underwriting Flexibility
- Increased Coverage & Capacity
- Access to Reinsurance Market
- Income Generation
- Asset growth

Unique Considerations & Regulations

Captive operations need to be thoroughly researched, properly planned and customized to each organization. Every organization has different needs; consequently, every captive should be structured differently. Maximizing the benefits of a captive means understanding and responding to the various business needs and concerns within the organization. Additionally, a captive entity, as an insurance company, is subject to complex regulations that often require consultation with an attorney, as well as guidance from captive knowledgeable accounting and actuarial service providers. Furthermore, the domicile for each captive should be carefully selected after considering the advantages and disadvantages of each option. As a result, we recommend working with a captive management company to conduct a feasibility study and analysis before making the decision to create a captive. From there, it is important to find the right partner in a bank as well as an investment advisor who are both knowledgeable with managing captive assets in order to continue to meet the evolving needs of the organization.

Summary

The unique nature of a captive insurance company lends itself to a conservative investment approach at inception. Once properly funded and allocated efficiently on a risk-adjusted basis, a captive can generate not only annual cost savings, but also additional income and improved risk management for the organization. The current market environment lends itself to an opportune time for all organizations to take back control of their risk management and consider the advantages of creating, joining, or reviewing their captive options.

[3] https://www.healthcarefinancenews.com/news/covid-19-recovery-hampered-mounting-physician-shortages-aamc-finds