MONOGRAPH
PREPARED BY THE MONOGRAPHS TASK FORCE OF THE AMERICAN SOCIETY FOR HEALTHCARE RISK MANAGEMENT

The basics
of captive insurance programs

Published July 2003
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FOREWORD

Two monographs published in 2002 by ASHRM spoke to ways that health care facilities might address problems caused by hard insurance market conditions. Exploring alternative risk financing techniques requires the risk manager to understand captives – the topic of this primer.

"Basics of captive insurance programs" is aimed at all risk managers. Even if they are not now involved in captives, they should be aware of the positives and negatives of the opportunity.

As finance specialist Judy Hart, quoted in the May 2002 monograph **"Perspectives on the state of the insurance market,"** put it: " A self-insured program, whether via a self-insured trust or a captive insurance company, places the burden of risk (at least in the primary layer) on the health care organization. Effective risk management and claims management are mandatory in this scenario and require a commitment from the top down in an organization. This commitment is executed by the risk manager."

This monograph is presented in a question-and-answer format, with additional resources listed at the end.

INTRODUCTION

Captive insurance companies have been around for many years. Those who have been in risk management fewer than 10 years may not have heard of them, nor probably ever had to concern themselves with learning about captive insurance. The main reason that captives have not been talked about much is because risk managers lived in a "soft" insurance market world for so long. In the pre-2002 market, insurance brokers were breaking down doors to give the best rates seen in 20 or 30 years.

Today's risk management world is seeing a significant change. The market has "hardened" for many reasons. Now the insurance brokers aren't breaking down the risk managers' doors to quote low rates. They are only coming to the doors to write up rate increases, higher deductibles and more policy exclusions – if they choose to knock at all.

Risk managers, CEOs and CFOs need to know their options. One option to explore for potential fit is formation of a captive insurance company. The following Qs & As may assist risk managers in determining if a captive is a viable option for their situation.

What is a captive?

A captive is an insurance company whose primary purpose is to supply insurance coverage to cover its owners' risk.

WHAT TYPES OF CAPTIVES ARE THERE?

* **Pure captive** is a wholly owned subsidiary established primarily to insure the risk of its parent company.

* **Associate captive (risk pool)** has two or more parent companies with similar risk exposures.

* **Group captive** has two or more parent companies that do not have similar exposures.

* **Risk retention group (RRG)** is a purchasing group consisting of many owners created to obtain insurance for all owners of the group through a commercial market.

* **Domicile** is the home (place of incorporation) of the captive and where the tax laws apply.

* **Onshore captive** is located within the United States.

* **Offshore captive** is located outside of the United States

When should the risk manager consider setting up a captive?

A captive must be thought of as an actual insurance company. It is important to make sound decisions on what risk to invest in as well as to determine if the risk exposure being considered can be controlled. Risks that cannot be controlled or managed may be better handled by transferring them to a commercial carrier.

Which is better: onshore or offshore?

Offshore captives based in the Cayman Islands and Bermuda are popular because of the support services and favorable regulatory climates. Certain functions, including board meetings, are required to be conducted offshore. Offshore can be attractive because the capital requirements are usually more favorable to owners. Capital requirements relate to the amount of initial investment to start the company. Onshore captives have become more popular in Vermont and Arizona. Onshore can be attractive because of easier ability to conduct business within the United States. In most onshore arrangements, there are requirements to have more capital and reserves in place than offshore requires.

How does the risk manager perform due diligence in determining if a captive makes sense for a health care organization?

First, the organization's leadership needs to establish a tolerance for taking on risk. Senior management needs to fully support the overall plan to manage risk within the organization. This includes risk control, risk assessment and claims management. It also includes adequate resources to conduct these services.

How is the captive premium determined?

Determining funding (premium) of a captive calls for a conservative approach for long-term success. The standard way to determine liability projections is to conduct an annual actuarial study. A captive manager with offices in the domicile (i.e., Vermont or Bermuda) will be contracted to perform accounting and administrative functions. Legal counsel and annual audit service will also be necessary. The final determination on premium will be influenced by the actuarial results, regulatory environment, audit process and needs of the owner.

How does the risk manager's job change when owning a captive?

The biggest difference in working with a captive insurance vehicle versus a commercial insurance contract is managing claim reserves. With a commercial policy, a potential claim is reported to the carrier and it sets reserves and manages the claim process. In a captive arrangement, the risk manager is much more involved and accountable in the claims process. Proper claim reserves must be set, and reporting of claims and proper management of claims is critical. The risk manager needs to have an internal infrastructure to manage this process or contract to have it done for them by an outside company.

The other major impact is that the risk manager is very much involved in the writing of the policy and deciding on exclusions and coverage for the policy. Again, the risk manager must have these skill sets available internally or work closely with his/her insurance broker and captive management company to achieve this task.

What are the biggest advantages of a captive arrangement?

The captive arrangement has many advantages. It gives the risk manager the sense that he or she has control of the insurance premium dollars. Premium dollars are spent to manage the risk and not spent to add a profit margin to a commercial insurance company. It can prove to be a return on investment over time. If the claim experiences are as expected, the captive will be capable of performing very well financially.

In most captive arrangements, the parent company can receive dividend returns and obtain loans from the captives.

The biggest plus in owning a captive is the ability to tailor the coverage for the risk to be covered. It is easier to include coverages that may not be available with commercial insurance companies.

What are some disadvantages of a captive arrangement?

Managing a captive means taking on a significant risk. The decision to form a captive must be a long-term commitment. Starting a captive calls for access to capital dollars to establish the captive and be available for claim liabilities. It does not make sense financially to set up a captive with the idea of reverting to a commercial policy when the market turns around.

RESOURCES

The Risk Management Handbook for Health Care Organizations (3rd Ed.). San Francisco: Jossey-Bass, 2001. (catalog #178160). $99.95 for ASHRM members, $129.95 for non-members. Available at www.ashrm.org or at (800) AHA-2626.

ASHRM Monographs: "Perspectives on the state of the insurance market," May 2002, **"Building a better submission: How to get the best insurance quotes,"** December 2002. Download the PDFs at www.ashrm.org.

ASHRM audio conference tape: "Team Risk: building a collaborative approach," June 2002. (catalog #WS-178838). Cassettes: $159 for ASHRM members, $209 for non-members Available at www.ashrm.org.

ACKNOWLEDGEMENTS

Daniel Conner, CPA, ARM, *Risk Management Specialist, Cassady, Neeser & Brasseur, South Bend, IN*
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This monograph is part of a series of timely summaries on critical risk management issues presented by the Monographs Task Force of the American Society for Healthcare Risk Management. ASHRM monographs are published as PDFs at www.ashrm.org. Reproduction for distribution without permission is prohibited. Request permission via e-mail at ashrm@aha.org.

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