CLARITY

WHITE PAPER

# Healthcare Captives and RRGs

## Therapy for Healthcare Captives and RRGs

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The use of captive (owner-insured) insurance companies in healthcare has become increasingly mainstream as a means of managing the financial risk exposure associated with healthcare delivery. Approximately 75% of hospitals have some form of alternative risk financing for their professional liability insurance, and 60% of all funding for liability exposure for healthcare providers is in the non-traditional market.

The reasons for the shift away from commercial medical malpractice insurance to alternative risk financing relate to industry conditions that have existed for some time:

- Commercial markets have been inconsistent in their approach to the medical malpractice line of business over the last 30+ years;
- Liability in healthcare is more about the high cost of a claim than it is about having high frequency of claims and therefore coverage is needed to fund this potentially high cost;
- Healthcare providers have the ability to manage their risk exposure, but seldom get "credit" for doing so from the commercial markets;
- Economically, healthcare providers have found that the ability to secure reinsurance of their captives instead of excess insurance layers over primary policies has saved them money and cut some of the frictional costs of doing business.

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It's been a great run for those healthcare organizations that have entered the alternative markets. Even today, after several years of soft pricing for liability insurance, new captive insurance companies and Risk Retention Groups (RRG - a specialized form of a captive insurance company) are still being formed and owners have found ways to manage the level of retained risk by taking advantage of low prices in the commercial reinsurance markets. In short, healthcare providers who have made the decision to 'bet on themselves' and create their own insurance companies to insure their professional liability risk have succeeded in more effectively managing their financial risk as measured by lower costs of insurance and greater control and predictability of premiums paid.

There currently, however, are storms raging in the macro financial world and in the insurance industry that require more vigilance than normal by owners of these successful captive insurance companies. The uncertainties in today's landscape signal an excellent time to pause and consider potential threats, pitfalls and defensive strategies. Let's look at some of the more prominent ones:

1. **Reinsurance Markets**. Many owners have taken advantage of low prices in the global reinsurance markets, and some have even partnered with reinsurers in the formation of their companies. The current global economic downturn has had an impact that will place considerable stress on the financial statements of commercial reinsurance companies as they report results in 2009. Even companies that have had good loss experience from healthcare may still show financial stress. This will force a change in attitude and pricing. As a result, captive and RRG owners need to prepare for changes in their retention strategy.

2. **Being Over-advised**. Many owners use a multitude of advisors for their captives and RRGs. When stress begins to show, beware of the inevitable finger-pointing that will ensue (overtly or covertly). This is one reason to advocate one advisor for most functions in order to focus accountability.

3. **Investment Performance.** Those same advisors that reached for yield or pushed for diversification into equities within the captive's investment portfolios with results that negatively impacted capital and surplus to captive and RRG owners (the leverage effect) may be reluctant even now to opt for safety and security of principal. Owners must be insistent on capital preservation strategies.

4. **Governance.** Now may be the right time to consider an unrelated third party director for owner-insured companies in healthcare. A dispassionate third party view is probably a good complement in these times to the expert advice received from outside consultants and administrators.

5. **Regulatory Creep.** Anticipate more scrutiny from regulators as the commercial market poises for a turn. Add just one captive or RRG insolvency to the general industry conditions and additional attempts to increase regulation will be assured. Some of the things that are already appearing are:
    a. <u>Reporting requirements.</u> States are passing legislation or enacting regulations, at a level not seen before, to increase reporting for captives and RRGs around claims reserves and payments.
    b. <u>Subrogation.</u> Health insurance providers and Medicare are enacting rules that require reimbursement from liability companies (including captives and RRGs) for medical expenditures covered by medical malpractice awards (over the beneficiary's lifetime); this may well result in increased claims payments and administrative costs for owners as well as commercial carriers.
    c. <u>Security requirements on reinsurance.</u> States are looking hard at the National Association of Insurance Commissioners (NAIC) standards for how reinsurance is treated on financial statements. As the market changes, expect more security requirements for non-admitted reinsurers for domestic captives and RRGs.

*Expect more scrutiny around off-shore vehicles generally.*

6. **Tax Issues.** The new administration in Washington understandably will be looking for new ways to enhance revenues. Expect more scrutiny around off-shore vehicles generally and closer examination of whether a captive is really a self-insurance vehicle or a true insurance company to justify deductibility of premiums paid by the sponsor. This can become a real problem in the future because if the company is deemed to be a 'self insurance' program, the tax benefit of deductibility of premium paid for that insurance coverage disappears. The test is

whether the captive has sufficient unrelated third party business in addition to the business written on behalf of the owner/sponsor to qualify as a bona fide insurance company. There is at least one special purpose reinsurer, Dorada Reinsurance Company Limited, located in the Cayman Islands, that provides healthcare-related captives reinsurance and access to third-party business to mitigate this emerging risk.

Another issue for off-shore captives relates to the payment of federal excise taxes on "first leg" reinsurance transactions between a non-U.S. company writing U.S. source business and a foreign reinsurer. In 2008, the IRS clarified its position on the enforcement of the FET rules, provided guidance on the types of transactions contemplated, and granted amnesty to companies that agreed to comply and report in the future. Expect audit scrutiny and enforcement penalties in the future.

*Times are changing rapidly, but for vigilant owners the need and utilization of these vehicles will continue to grow and the lines of business underwritten will expand.*

Healthcare organizations, whether for-profit or non-profit, have been effective and growing users of alternative risk financing vehicles over the past 20+ years and have generally shown excellent results. By utilizing focused and experienced advisors and conservative strategies healthcare providers can continue to enjoy both the financial and control benefits of owning their own captive insurance companies and RRGs. Times are changing rapidly, but for vigilant owners the need and utilization of these vehicles will continue to grow and the lines of business underwritten will expand.

Clarity Group, Inc. designs, develops and operates captive insurance companies and RRGs for a variety of healthcare providers. For more information on these services, please visit our website at www.claritygrp.com or contact Rick Ulmer at rulmer@claritygrp.com

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