



# GROUP CAPTIVES: ARE THEY RIGHT FOR YOU?

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# benefits

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Joining or establishing a group captive is becoming an increasingly popular option for self-funded health plans looking to manage cost increases.

A group of employers in the Northeast has achieved something many businesses would think impossible: They have reined in their health plan increases. The companies, with a combined workforce of 2,500 employees, have put the brakes on rising health costs with average annual increases of just 2% from 2010 to 2015 compared with average annual increases of 8% to 13% during the same period for companies in the same state.

These employers banded together to form a group captive, an option that can offer real benefits for self-funded health plans.

These results may be extraordinary, but they demonstrate the power employers can have over their health care costs. It takes careful planning and good advisors, but many employers can keep a lid on hefty cost increases that are common among traditional fully insured plans, or—in a few rare cases—even lower them. Although lowering costs may be the best-case scenario, many companies are holding down health increases to the level of general inflation.

These results are possible without slashing benefits to employees or

jacking up employee contributions. Employees can retain the same level of benefits as before. The main thing that changes is the way the health plan is funded and structured behind the scenes.

### Self-Funding

Most employers know that self-funding is an effective way to take control of rising health care costs. According to the International Foundation of Employee Benefit Plans *Employee Benefits Survey 2016*, 67.5% of organizations, ranging in size from fewer than 50 to more than 10,000 employees, reported having a self-funded health plan.

Self-funding works this way: Instead of buying traditional health insurance from an insurer, a company pays for its employees' medical bills directly. The company usually purchases medical stop-loss insurance to protect against catastrophic losses from large claims.

Self-funding divides the financial risk into two layers—an employer layer (below the stop-loss deductible) and a stop-loss layer (above the deductible). Most employers hire a third-party administrator to handle day-to-day tasks

such as adjudicating claims, determining eligibility, communicating with plan members and providing customer service.

Why do employers self-fund? The big reasons are transparency and control. Self-funding allows employers to see where their health care dollars are going and gives them the flexibility to design a health plan around their employees' needs. It also brings financial benefits, such as lower taxes and fees.

### The Catch

For all its benefits, self-funding isn't right for all companies. By dividing the risk into an employer layer and stop-loss layer, self-funding creates a risk vs. reward trade-off. To lower its fixed costs, an employer can buy less stop-loss insurance (that is, select a higher stop-loss deductible and transfer less risk), but that can mean more year-to-year volatility. However, if an employer buys more stop-loss insurance (by selecting a lower stop-loss deductible and transferring more risk), then the employer's fixed costs will be higher.

This is why larger companies are more likely than smaller companies to self-fund. Large employers with deeper pockets can afford to select a higher stop-loss deductible, keeping more risk for themselves, and still absorb each year's financial ups and downs. According to the 2016 Kaiser/Health Research and Educational Trust *Employer Health Benefits Survey*, 85% of employers with 1,000-4,999 workers had self-funded plans. Among employers with 5,000 or more workers, 94% had self-funded plans.

So, for many small and midsize employers, self-funding isn't a perfect solution. It provides transparency and

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John C. Garner, CEBS

International Foundation of Employee Benefit Plans. 2015.

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control, but it can lack the stability employers need to budget and plan for health care expenses.

### A Third Way

A group captive can add a third layer of risk to the picture. Sandwiched between the stop-loss layer and employer layer, the group captive acts as a shock absorber for the employer's health claims. Made up of multiple employers, a group captive can provide size and scale for greater predictability.

When a self-funded employer joins a group captive, the employer can retain its most predictable risk layer but still have a layer of insulation from all the larger claims that could threaten the financial stability of the plan.

The group captive, a legal entity comprised of member employers, takes the middle layer of risk as an insurance company. The captive can give small to midsized employers the stability they need. As an extra benefit, employers have the opportunity to benefit financially if the captive's claims are lower than expected. Because of their participation in the captive structure, employers can receive a financial distribution.

### What Is Captive Insurance?

A *captive* is an insurance company created to insure the risks of its owner (or owners). Captives have been around since the 1870s, but the term *captive insurance* was coined in the 1950s when the concept began to grow in popularity. Today there are approximately 7,000 captives worldwide. Virtually all Fortune 500 companies own one or more captive insurers.

How can a company insure itself? Good question. At its core, insurance is simply a contract that transfers risk to another entity—usually an insurance company. That definition of insurance still holds true—There is a risk transfer. A captive is a separate risk-taking legal entity with profits and losses shared by its owner or owners, in the case of group captives.

Once established, a captive operates like any commercial insurance company and is subject to regulatory requirements, including reporting, capital and reserve requirements. Captives typically hire a captive management company to provide regulatory, tax and legal administration.

Historically, captives have insured casualty lines, such as workers' compensation and general liability, but that is

## takeaways

- Joining or establishing a group captive can be an effective way for self-funded health plans to hold down health care cost increases.
- A *captive* is an insurance company created to insure the risks of its owner (or owners).
- The 2016 Captive Insurance Companies Association *Captive Market Study* indicates that medical stop-loss was the second-fastest emerging risk being placed in captives, just behind cyber-risk.
- Advantages of joining a group captive include reduced volatility of costs and the ability to become an active owner of the insured health plan rather than a passive buyer.
- Employers that join group captives also should have a high-performing health risk strategy to help manage health care costs. Tools that can be part of such a strategy include data transparency and predictive modeling.

changing. As employers grapple with providing affordable, quality benefits and complying with the Affordable Care Act (ACA), they are seeking new strategies. Captives are an approach that can work for some employers.

### Why Do Employers Join a Captive?

Self-funded employers typically decide to join a group captive because of the:

- Traditional advantages of self-funding, plus additional advantages since the passage of ACA
- Greater scale for predictability
- Reduced volatility
- Transfer of less risk to an insurance company
- Ability to collaborate with other like-minded employers
- Ability to become an active owner of their insured health plan, rather than a passive buyer
- Sharing of best practices for health risk management.

### How Do Employers Join a Captive?

There are three steps to joining a stop-loss group captive.

1. **Self-fund.** The employer decides to self-fund, creates and retains control over its own health plan and pays for claims on behalf of its plan.
2. **Buy a stop-loss policy.** The employer buys a stop-loss policy (with specific and aggregate coverage), selects its own deductible, pays stop-loss premiums to the in-

## The Mechanics of Group Captives

An employee benefits captive is designed to insure the risk of a group of employers. A captive is a risk-taking entity with profits and losses shared among its participating members.

The captive's risk starts at a low, predetermined, specific stop-loss deductible and extends up to a higher specific cap, where a stop-loss carrier then assumes the risk.

If the members/owners of a captive don't have as many losses as anticipated, they will receive a distribution in the form of a dividend or contractual payment. In a traditional stop-loss insurance program, that money would not be returned and the insurance company would keep it as profit.

In addition, the captive pays a captive manager to manage day-to-day operations. Captive members must pay for this fixed expense. They also pay policy premium, which covers all liabilities above the specific stop-loss deductible. This is also a fixed expense and includes stop-loss premiums (paid to the stop-loss carrier) and captive layer premiums (paid to the captive).

Members must fund shortages that may occur in the captive. Similarly, if there is a surplus, the members share those surpluses.

surer and gets reimbursed by the insurer for covered claims over the specific and aggregate deductibles.

3. **Join or establish a captive.** The employer signs a captive agreement, the stop-loss insurer contracts with the captive for reinsurance and the captive receives premium for the middle layer from the insurer. Each employer-member provides collateral to the captive in case premiums are insufficient and pays a management fee to the captive. The captive insurer limits the captive's exposure with a program aggregate, which protects the entire captive program, ensuring that if the captive exceeded its total loss obligations, the remaining losses would be the responsibility of the stop-loss insurer. Each employer shares in the financial results, and unused funds from the captive may be given back after the end of the program year. (See the "Mechanics of Group Captives" sidebar.)

Joining an established captive can be a cost-effective way for an employer to go. A variety of organizations have created turnkey captive programs that allow employers to join without any capital investment. While the individual makeup and structure of each program are different, the objectives are similar. Organizations that create turnkey programs include stop-loss carriers, captive consultants and general underwriter companies.

Forming a captive, on the other hand, generally requires a more substantial investment but allows for more control over governance of the member process. Employers should work with their brokers to determine which approach is right for them.

### Are Group Captives Right for Everyone?

Captives are not a panacea. They will not automatically lower costs and yield savings. Employers shouldn't join a captive just to avoid a big rate hike over one year.

Instead, to be successful, employers should join a group captive as part

of a larger focus on employee health risk management. This must be a long-term commitment to creating a high-performing health plan using innovative techniques. Some examples of forward-thinking tools used by many captive members include data transparency, biometric screening, on-site clinics, predictive modeling and telemedicine.

The beauty of the captive structure is that an employer joins together with other like-minded employers. Through the collaborative environment of the captive, employers can share best practices that benefit their employees.

This is a three-legged stool—a self-funded health plan with stop-loss, group captive membership and a high-performing health risk strategy. An employer must create a comprehensive strategy built on these three components in order to benefit from the opportunity the captive creates.

As evidenced by the significant growth in this market, many employers have begun to realize the power of this overall strategy. Industry associations, like the Self-Insurance Institute of America, along with various employee benefit trade journals, have recognized medical stop-loss group captives as a true risk management solution for small and midsized employers. The 2016 Captive Insurance Companies Association *Captive Market Study* indicates that medical stop-loss was the second-fastest emerging risk being placed in captives, just behind cyber-risk.

Of course, there are downsides to any financing arrangement. Employers should ask their advisors about potential downsides of a particular arrange-

ment and find out about any issues that have happened with a particular program in the past.

### Tips When Considering a Captive

Companies considering joining or establishing a stop-loss group captive may want to:

1. **Think long term.** Captives are a long-term financial strategy, not a benefits strategy. Companies shouldn't expect instant savings. Some years will be good, others bad, but over the long term there are financial perks (improved cash flow, lower taxes and reduced insurance fees) not available with a fully insured health plan.
2. **Pick a trusted partner.** Companies should thoroughly check a firm's credentials and find out who all the players are—the stop-loss carrier, the captive manager and any others involved. How long have they been involved in stop-loss captives, and how diverse is their business? Do they have supporting resources and an established infrastructure for reporting, communication and account management? And finally, do they have published results of existing captives or references from existing members?
3. **Know who the other members are.** Because a company's results are tied to the other members' results, companies should make sure they understand who the other members are. Ideally, a captive is comprised of like-minded employers committed to health risk management. Companies should ask how potential members are screened and what the membership cri-

bio



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teria are. Before joining an established captive, companies should make sure they have a thorough understanding of why the captive was established and of its goals.

4. **Know thyself.** Companies should make sure they have the right characteristics for captive membership: approximately 50-500 employees, good communication with employees on health care costs, willingness to implement robust health/wellness programs and financial stability to take on a portion of the health plan risk.

Self-funding alone allows employers to gain control and transparency over their health plan. Group captives add stability by spreading risk across a larger group of employees. Finally, a comprehensive health risk strategy tailored to employees can maximize financial opportunity. ❹