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Medical Professional Liability Insurance - Transitioning from Commercial Markets to Captive Insurance

Decision Points, Captive Options, Transition Process

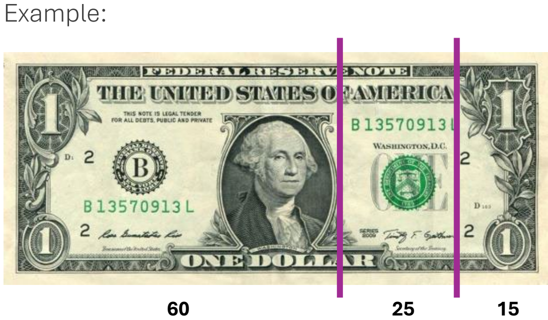
Medical professional liability (MPL) insurance provides coverage to healthcare providers and healthcare entities – hospitals, clinics, physician groups, etc. – against the financial risks of practicing medicine. The financial risks include the cost of legal defense, as well as damages that may be awarded in a lawsuit settlement or verdict. Most organizations that self-insure MPL coverage use a captive insurance company because they have the size, financial strength, and risk tolerance to do so.

What is required to make the captive decision and get started? This position paper explores the decision points, options, and the process of migrating MPL coverage from the commercial market to a captive insurance company.

Premium in the Commercial MPL Market

Every dollar spent on MPL insurance in the commercial market does not equate to a dollar's worth of coverage protecting the organization. That premium dollar is managed into ratios that gauge whether the insurance company is profitable or not.

A combined ratio is a measure of profitability: 100% is breakeven, less than 100% is profitable, and more than 100% is not profitable. A combined ratio includes a loss ratio (incurred losses) + an expense ratio (expenses necessary to run the company). Example:



Loss Ratio = 60% For every dollar in premium, the insurer pays out sixty cents in losses.

Expense Ratio = 25% For every dollar in premium, the insurer uses twenty-five cents for expenses (salary, rent, etc.)

Profit = 15% Premium not used for losses or expenses are profit.

In this example, the insurance company has a combined ratio of 85%, made up of a loss ratio of 60% and an expense ratio of 15%. For every dollar spent on "insurance" only sixty cents goes to insurance "coverage". The cost saving advantage of self-insuring using a captive is clear.

In addition, a captive provides:

- tailored coverage
- more control over claims and litigation
- potential investment income
- focused risk management

First Things First: What is a captive insurance company?

A captive insurance company is a formal and regulated form of self-insurance in which a parent company owns its own insurance company that insures the parent company against future losses. The parent company pays premiums to the captive, which then assumes the risk and pays claims, as necessary. Companies form captives in jurisdictions with favorable insurance regulations and tax rates, like Bermuda and the Cayman Islands. Captives can provide more coverage and pricing flexibility than the commercial market.

Decision Points: When is a company ready for a captive?

External market conditions – higher premiums, lack of capacity, larger deductibles, more stringent policy terms – often drive the decision to begin the process of self-insuring risk by using a captive insurance company. The decision is also driven by the maturity of the organization and its willingness to own and manage its own risk.

The biggest motivator and indicator of readiness is the need for control – control of premium, control of coverage, control of claims and litigation, control of risk management.

To gauge readiness, it is important to conduct a captive feasibility study, which is used to evaluate potential costs and benefits associated with starting and operating a captive.

A captive feasibility study will consider several factors, such as:

- current insurance cost and loss history
- type of risk exposure
- financial strength related to its ability to fund a captive
- regulatory and legal requirements associated with operating a captive in various domicile options
- experience and ability of risk financing / claims management and staff
- savings that can be achieved over time compared to commercial insurance

Once a captive feasibility study is conducted, a more definitive sense of readiness will be apparent.

What is the premium threshold to consider a captive?

$1,000,000+ in annual premium for MPL insurance to a commercial carrier is a common threshold for consideration of a captive insurance program. Plan to pay about 10% of captive premium annually, or in this example $100,000 to run the captive insurance company. The expenditure is used to fund actuarial, legal, captive management, auditing, risk management, etc.

Options:

Depending on the need and strategy, several captive structures can be considered, including:

- Single-parent captives are created and owned by the business to insure only its own risk.
- Group captives are available for certain industry sectors.
- Cell captives allow different entities to insure their business interests in a segmented (cell) of an existing captive. A third party, like a captive management firm, usually sponsors these. There is a benefit from not having to start a new captive, but must contribute to the operating costs.
- Risk retention groups (RRGs) are captives that are only domiciled in the United States and can be an efficient vehicle for healthcare business entities.

Regarding premium and policies, the captive can utilize a:

- Direct written captive program, in which the captive is licensed and can issue policies directly to insureds on a foreign or a non-admitted basis where allowed.
- Reinsurance fronted captive program, in which a licensed commercial insurer issues policies on behalf of a captive without absorbing the captive's risk. By using a fronting company, the captive insurer does not have to maintain a license in the domicile where the business is written. This structure also helps in states where patient compensation funds require local domiciles for MPL coverage.

Process:

Once the company has conducted a captive feasibility study, selected a domicile, hired operational vendors, and decided on the structure of the captive, itis ready to submit the regulatory application, which includes the captive application form, business plan, actuarial study, pro formas, incorporation and legal documents, parent company financial information and organization structure, draft policy forms, directors and officers information and affidavits.

The timeline for this process will vary based on captive domicile and structure.

Utilizing Experts

It takes experts like Symphony Health to help navigate this process. Symphony Health is comprised of industry specialists who have deep knowledge, experience, and proven success in developing and managing alternative risk financing mechanisms for its clients. Instead of paying premium to the commercial market year after year, Symphony Health clients enjoy a significant asset addition to their balance sheet, which replaces these expenses. They enjoy a strategic cost advantage over their competitors, serving to grow and solidify their financial business and serve their mission more effectively.

For more information on how to engage in a new strategy and direction, please contact:

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