Funding Medical Stop-Loss in Captives
What You Need to Know
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A Brief Explanation of Captive Insurance

What is a Captive?

A captive is an insurance or reinsurance company, established specifically to insure or reinsure the risks of its owner, also known as its parent company or companies. In some cases, captives are also used to insure the risks of third parties, similar to commercial insurers. Over the course of time, captives have evolved to cover more than parental risks, now covering groups, associations, third parties, like employers and more.

History and Growth of Captives

Captives developed in the late 1800s when a group of New England textile manufacturers were looking for a way to help mitigate rising fire insurance rates. Then in the 1900s, companies began looking for better tax advantages and fewer restrictions, leading to the first offshore captives.

In the 1960s, mutual associations developed, allowing organizations to fund risks by pooling with similar companies. Captive insurance growth surged in the 1970s and 1980s, when the property and casualty market hardened, leading to increased costs. The total number of captive insurance companies grew from 100 in the 1960s to 1,000 in the 1980s.

The number of captive insurance companies continues to rise. In 2016, there are over 6,400 captives worldwide (not counting individual cells within cell companies), up from 5,525 in 2009. About 80% of the Standard and Poor 500 (S&P 500) companies own one or more captive insurance companies.

Throughout the United States, captive domiciles are revising and modifying their legislation to better accommodate employers’ evolving needs. For example, many domiciles are refining their requirements for establishing cell captives, and many are opening up to new lines of coverage, such as employee benefits. Today, over 30 states allow the establishment of captive insurance companies.

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2 Roger Crombie, “The Bermuda Market at 60,” Bermuda Re/insurance, November 2007: 9-14
3 McAndrew
4 “6,408 is the magic number” Captive Review, CaptiveReview.com, 2/23/16.
**Employee Benefits**

**Developments in Employee Benefits**

For most companies, employee benefits represent a significant financial investment. As every human resources director knows, the costs of employee benefits, health insurance in particular, have dramatically increased over the last decade.

Employee benefit costs can comprise as much as 40% of a company's total payroll, which makes the recent trend towards self-funding benefits understandable. Companies of all sizes are quickly realizing the financial, administrative and operational benefits of self-funding. Taking it a step further, funding benefits in captives makes a lot of sense for many companies as it can provide effective, long-term solutions to the rising costs of funding a variety of employee benefits, as well as pension and retiree medical obligations.

**Using a Captive to Fund Employee Benefits**

Thirty years ago, captives were not commonly used for financing employee benefits, as regulatory obstacles and reinsurance restrictions limited eligibility to only the largest of captives.

The US Department of Labor (DOL) must approve the placement of ERISA benefits into pure-parent captives. Many well-known organizations have obtained funding approval, including, but not limited to, Archer Daniels Midland, Alcon Labs, Alcoa, AGL Resources, Astra Zeneca, Banner Health, International Paper, Memorial Sloan-Kettering Cancer Center, Sun Microsystems, and United Technologies.

Many more companies have used captives to fund other non-ERISA employee benefits that do not require DOL approval. Moreover, employer groups and associations are establishing captives to fund employee benefits, thus offering an alternative to the commercial insurance markets and providing an incentive for membership growth.

For companies with property and casualty captives, certain employee benefits may be “unrelated business,” i.e., insurance business unrelated to the captive’s parent. Adding unrelated business to a single-parent captive can improve the captive’s overall financial efficiency; satisfy the need for third party business allowing the parent to deduct its captive premiums from its U.S. federal income taxes; and create additional cost savings.
Regulatory changes have led to increased employee benefit captive funding. Some of these changes include the following:

- Pressures increasing benefits costs overall and employers’ desire to control these costs
- The movement to a fast track DOL application process of approximately 80 days
- Revenue ruling 2014-15 further clarifying the tax status of certain employee benefits
- The development of cell captives creating more turnkey solutions for the mid-market
- A track record of success by those employers that use captives currently

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Advantages of Placing Employee Benefits in Captives

There are several advantages to funding employee benefits in a captive. These include cost savings, increased control, improved risk management, and enhancing a previously established captive.

- **Improved cost savings**
  - Control employee benefit premium costs
    - Estimated potential savings for employee benefits in captives vs. commercial insurance are as follows is generally between 5-20%
  - Reduce frictional costs (commissions, taxes, risk charges, insurer profit, administration) and underwriting savings
  - Capture investment returns
  - Improve cash flow and centralize investment of reserves
  - Improve management reporting and understanding of risks

- **Increased administrative control**
  - Design coverage and provisions of benefits
  - Improve data management and loss cost management

- **Improved risk management**
  - Manage a centralized risk pool
  - Purchase stop-loss reinsurance to manage exposure to catastrophic loss
  - Quantify the financial benefits of wellness initiatives and specific loss prevention programs

- **Enhanced a property & casualty captive**
  - Increase reserves and reduce dependence on commercial markets
  - Improve spread of risk; portfolio diversity
  - Add third party insurance business potentially creating tax-deductible captive premiums

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7 Savings are estimated from CICA 2009 International Conference
Employee Benefit Funding Opportunities

A wide range of employee benefits may be funded through a captive. Benefits that pay out over multiple years (e.g. long-term disability and retiree medical), provide cash flow stability and loss predictability. Lines such as group life insurance, which can be very profitable for commercial insurers, offer the captive the same profit potential.

Captive solutions can be used to fund benefits covered by ERISA or those not covered by ERISA. ERISA benefits are primarily the benefit plans sponsored by and contributed to by employers, such as retirement, group life insurance, health, and welfare plans. These plans are subject to federal oversight, under the auspices of the DOL.

Non-ERISA benefits are often benefit plans targeted to a specific population, such as supplemental retirement plans for executives or stop-loss. These do not require DOL approval for captive funding.

Since the Patient Protection and Affordable Care Act (PPACA) prohibits insurers and self-insurers from placing limits on employee benefits, many self-insured employers find themselves assuming additional liabilities because medical coverage is now an unlimited liability. A captive is an ideal vehicle in which an employer creates an annual aggregate limit, known as stop-loss coverage, and purchases excess (unlimited) coverage from the commercial markets above the captive's aggregate retention.
Medical Stop-Loss Captive Funding

Healthcare reform, increasing costs, lazered coverage and leveraged trends are causing many employers to reconsider their stop-loss options. These include employers who are fully insured considering a move to self-insurance and current self-insured employers.

Healthcare reform mandates have led to many employers to review the cost of their medical insurance programs including funding alternatives and the need for additional stop-loss coverage. Deciding to insure medical stop-loss and fund it in a captive has proven to be a great way for employers who self-fund their health coverage to add a layer of protection from excessively high individual or aggregate health claims and meet ACA requirements.

Medical stop-loss is not considered first dollar health insurance benefit and thus stop-loss captives are not subject to Department of Labor approval in the United States like many benefits are. Also, by funding stop-loss in a captive, an employer gains access to lower-cost reinsurance they might otherwise not be eligible for as a direct purchaser.

How Medical Stop-Loss Captive Funding Works

The following graphic depicts a typical medical stop-loss captive funding approach:
Self-insurance with stop-loss saves money through elimination of carrier profit, premium taxes, improved cash flow as the employer holds on to the claim lag between date of service and date of payment, exemption from state mandates (though not from ACA mandates) and reduced administration fees as these are bifurcated from the claims costs.

As claim costs are not completely predictable, self-insured employers are usually able to budget fairly closely to actual costs through the purchase of a well-designed stop-loss program.

Claims unpredictability generally arises from variance in the number of large claims for any one claimant and the cost per large claim.

The purchase of specific stop-loss insurance coverage protects from claims on any one individual exceeding a threshold amount, say $200,000, in a given year. Larger employers choose specific stop-loss attachment points as high as $350,000 to $750,000 while smaller employers may choose stop-loss levels of $30,000 to $100,000. An actuary can best recommend an appropriate attachment level to assure a small likelihood of claims exceeding a tolerable risk level, such as 110% or 125% of expected.

Stop-loss rates typically increase well in excess of normal medical trend. So if your underlying program costs have gone up say 8% your stop-loss costs are likely to go up well in excess, for example, 13%. The reason for this is the leveraging impact of the stop-loss coverage and attachment point. This results from the fact that claims that were just under the attachment point in 2012 with regular medical trend will be over the attachment point in 2013 and these will be added to all the trended claims already over the attachment point. To counteract this, employers often regularly increase their attachment levels. Captive funding minimizes these changes.

The most common stop-loss terms cover claims on a paid basis. For self-insured first timers, moving from a fully insured program is typically 12/12 – incurred in 12 months and paid in 12 months. This first year is referred to as “immature” as there are fewer expected claims paid due to the claim lag. The second year “mature” terms might be 24/12 to cover the incurred claims run out from the first year. For an increased price, a terminal liability option may be offered, where upon termination, the employer can purchase additional protection to cover the remaining claim run out.

In the past, stop-loss policies typically included a lifetime limit of $1-2 million. As employers can no longer limit their underlying plans it is important to have this lifetime limit removed from your stop-loss policy if you have not already done so. Stop-loss carriers may still look to impose annual limits. It is important that you make sure any annual limits coordinate with your underlying plan.
A crucial coverage for smaller employers is aggregate stop-loss protection. The typical cost is $5.00 per employee per month or less and protects against actual claims on amounts below the specific attachment point exceeding 125% of expected. Though the likelihood of hitting the aggregate attachment point is small, the cost for this sleep-well protection is cheap.

Aggregate stop-loss should not be confused with another offering to lower price - an aggregating specific deductible. By way of example:

<table>
<thead>
<tr>
<th>Claim Assumption</th>
<th>Specific Deductible</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>$225,000</td>
<td>$75,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>$150,000</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>$225,000</td>
<td>$100,000</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

Often the reinsurer will reduce premium one for one, or $100,000 in this example.

At time of purchase and annual renewal, most stop-loss carriers ask for disclosure statements requiring the employer to disclose an adverse developing claims bid submission to the carrier. Typically they would like this about 30 to 45 days prior to the effective date. The disclosure statement asks for individual detail for potential large claimants based on past claim history, certain diagnosis, etc. If something adversely material shows up, the stop-loss carrier may want to discuss options such as raising the price, putting in aggregating specific deductible or laser (excluding certain individuals or using a higher deductible for certain individuals). Carriers willing to provide final rates earlier may build additional margin into their rates.

Typically, employers purchase stop-loss on a single plan basis. Most coverage is purchased in the commercial market. Some employers purchase coverage from their owned captive reinsurer already providing insurance protections to other risks of the employer. This allows the captive to retain pricing risk margins.

As medical stop-loss risk is generally uncorrelated to the remaining captive risk the overall employer risk profile is reduced through this approach. Furthermore, the stop-loss program can be geared towards the needs of the employer including for example various risk sharing arrangements. The captive will typically purchase reinsurance protection to cover catastrophic claims and perhaps share in the claims risk. Generally carriers writing captive reinsurance protection are experts in this area and are not the usual direct stop-loss writers.
Common Types of Stop-Loss Captives

Stop-loss captives are very similar in structure and nature as their P&C counterparts. Like casualty captives, the two most common stop-loss structures are single-parent (pure) captives and group captives.

Single-Parent Captives

Single-parent stop-loss captives are generally a subsidiary of a parent organization and are established to insure the parent’s risk. Single-parent captives are generally not setup specifically to insure stop-loss risk; rather stop-loss is added into existing captives as an additional line of coverage. This is usually the case due to the size of the premiums and the difficulty a company would have to financially justify a stand-alone medical stop-loss captive.

Adding stop-loss to an existing single-parent captive is one of the common options in the captive industry and one that countless companies are realizing real savings with. With so many employers self-funding their health insurance today and also insuring elements of their casualty risk in captives, this trend is sure to continue single-parent captive funding’s share of the medical stop-loss market will continue to increase.

Group Captives

Often, employers will form a group captive to fund their medical stop-loss. Such an arrangement provides individual members with the financial benefits of captive funding while sharing the overall administrative burden associated with forming an insurance company; thereby retaining stop-loss pricing risk margins. The employer owned stop-loss insurer purchases reinsurance protection as necessary.

Group medical stop-loss captives are a great way for small and mid-sized businesses to get an extra layer of coverage by banding together with other companies. These group captives can be heterogeneous or homogeneous and, assuming enough companies participate to make it financially feasible, can be setup as their own stand-alone captives. Each member of the group has their own self-funded plans and administration and just buys into the group captive for stop-loss. Typically, these groups can save 5% to 20%.
Who Should Consider Medical Stop-Loss Captive Funding?

While every circumstance is different and anyone considering captive funding should seek the advice of a professional consultant, generally, $1 million in premiums is the threshold for single-parent stop-loss captive funding. For group captives, a total of 1,000 covered employee lives and $2.5 million in premium is the starting point. There are, of course, a number of variable which may dictate a higher or lower entry point for a particular company or group.
Cell Captives: The Right Fit for Many Mid-Sized Businesses for Medical Stop-Loss Funding

For companies that don’t have an existing captive, aren’t large enough for a stand-alone medical stop-loss captive to make sense and/or aren’t interested in forming or joining a group captive, there is an alternative option. Using a cell captive for medical stop-loss coverage is an option that has been exploding, of late among the mid-market. By renting space in an existing captive, covering medical stop-loss, and adding an extra layer of security to a self-funded plan, becomes a much more financially viable option.

What is a Cell Captive?

A protected cell company (PCC) is a legal entity, set up by a sponsor, which is divided up into individually protected cells that are rented out by the sponsor to companies or groups who want to use a captive cell to fund various risks. The sponsor establishes the core of a PCC and the overall PCC structure. Once established, the sponsor also manages the PCC’s day-to-day activities, allowing cell owners to avoid a lot of the corporate and administrative resources typically required for a captive insurance or reinsurance company.

With a PCC, you essentially benefit from pooled administration, but not pooled risk. Each cell in a PCC is independent of and insulated from the others and the core in terms of assets and liabilities. Often, PCCs will allow companies to own more than one cell, and typically each cell is still treated individually.

What are the Benefits to a Cell Captive

There are a number of benefits to insuring your risk using a protected cell company:

- **Easy entry into funding risk** - While you still have to clear the typical regulatory hurdles of setting up a captive which vary greatly depending on the risk in question, a great deal of the administrative time and money that you would typically spend is eliminated since we have already set up the shell entity for you.

- **Economies of scale** - With a protected cell company, you enjoy continued administrative savings due to economies of scale from potentially pooled administrative costs.

- **Professional captive management** - As an owner of a cell, you generally can expect day-to-day management services from professional captive managers.
Is a PCC right for you?

Participation in a protected cell captive is attractive, but not for everyone. Generally speaking, mid-sized companies that are dipping their toes in captive funding are the likeliest participants given the lower barriers to entry and management assistance a PCC offers. That said, there are a number of other reasons why companies of all sizes would strategically use a cell captive to address their risk portfolio. A feasibility study will go a long way in identifying if a company is a good fit for participation in a PCC.
Spring Case Study: Group Medical Stop-Loss Captive Helps Educational Institutions Control Health Insurance Costs

The Challenge:

Every organization struggles with the high cost of insurance, especially healthcare. The challenges of funding health care have increased significantly over the past few years for many American businesses due to the implementation of the Affordable Care Act.

Universities, colleges and other institutions of higher education are under even more intense scrutiny as the cost of education continues to climb. This has left administrators scrambling to find more creative and efficient ways to fund their employee benefits.

The Goal:

To design an efficient and effective stop-loss funding vehicle for a higher education consortium already in collaboration for other joint purchasing and educational initiatives.

The Process:

Spring has been working with a large group of institutions of higher education to pinpoint opportunities for greater healthcare program efficiency and savings. We conducted a thorough feasibility study to identify appropriate funding structure(s) that would meet the goals set by the consortium. From the results, the group determined that the best course of action was to implement a Vermont-based captive insurance entity for medical stop-loss risk sharing. In tandem the consortium, in collaboration with Spring, developed common plan designs and established a core process framework. Each entity within the consortium provides a self-insured health plan with pooled risk sharing above a specified threshold.

The Solution:

A new organization as well as a Vermont-based stop-loss captive was formed to achieve these goals. It was launched on July 1, 2013 with a core of six colleges and universities participating on day one.

The new organization was developed based on the belief that collaboration among best in class institutions would create a mechanism for leveraging economies of scale to significantly improve health care buying power, provide efficiency in program design, administration and funding creating a platform for true population health management based on the needs of its members; it has certainly accomplished all of this and then some!
The Results:

At inception the consortium had 6 member schools. The number of entities has doubled in two years and represents 9,200 members. Collectively, working rates have increased by 1.9% over two years compared to a medical trend of 7% – 8%. In addition, on top of the tightly controlled rates, 2% of total working premium was returned as savings to members.

As this organization enters year three, it is strong and has set very ambitious goals. The member institutions are focused on furthering their strategy to provide quality care with more participant involvement. In addition further collaboration on disease management, wellness and Rx costs are on the short-term roadmap in order to support an effective and healthier workforce.

This group approach is a truly groundbreaking solution in an industry where each college is unique with very specific human resources expectations. The success in year one of this new organization has made it a trailblazing model for the higher education community and other similarly situated industries, going forward.
About Spring

Spring, provides a full range of strategic consulting services to institutions in the insurance and financial services industry; broad consulting and brokerage capabilities to employers; and funding solutions for benefit programs, including the use of captive insurance facilities and the day-to-day management thereof.

Spring was formed in March 2004, through a management buyout of the US insurance and financial services strategy consulting practice of Watson Wyatt, LLP.

Our Unique Expertise

Spring has works with employers of all sizes to design, implement, fund and improve their employee benefit programs.

Spring brings our clients unmatched expertise in the area of employee benefits design, alternative funding and captive management. The Spring team has been providing a full range of employee benefit and captive program administration services, including underwriting, pricing, reserving, claims processing, financial management and administrative services to employee benefits captives for more than 10 years.

To help ensure the success of our consulting engagements, Spring has under its roof a full arsenal of resources, tools and strengths to benefit our clients. These include:

- Award-Winning Broker-Agents. We have been developing innovative, cost-saving employee benefit solutions for clients of all sizes for decades and have been recognized be some of the industry's top publications and organizations for our work
- Captive Specialists. We have expertise in developing captive insurance strategies in employee benefits for our clients that seek cutting edge alternative risk financing solutions. With our precedent-setting captive strategies, we have helped shape the employee benefits captive world in the United States as we know it today
- Recognized Experts. You want the best in the business — people who have worked with FORTUNE 500 to small business clients to solve problems creatively. Our consultants are recognized leaders in the design and funding of captive insurance solutions, and can bring to bear their collective knowledge, insight and industry connections for this project
- Strategic Solutions. You need answers that will be long-term solutions — ones that take into account not just the problem of today, but to anticipate and plan for the challenges your organization will face tomorrow
- Effective Teamwork. You need a committed, proactive team with the ability and resources to deliver service. You want experts who can transfer their knowledge
of complex issues to the your team easily and effectively

- Predictability. You need straightforward advice tailored to your specific business issues. You want no surprises in both our working relationship and the results we provide you

- Focus on Business Objectives. You need a team who understands your business well and is dedicated to delivering services that add value to your business — a firm that understands the complexities of issues ranging from financial forecasting to actuarial funding and its impact on short- and long-term budget and financial plans
What’s Next?

Spring is a recognized leader in benefit captive consulting. There is no other firm out there that is experienced in developing innovative medical stop-loss funding programs using captives. Our team of consultants, legal experts and actuaries can help you determine if a captive is the right place to fund your company’s medical stop-loss. We have extensive experience working with single-parents and setting up group captives.

If you’d like to explore stop-loss captive funding further, the next step is a quick discovery discussion with a Spring consultant to find out more about you or your group’s needs and determine if a feasibility study is warranted. Contact us today to set up a free consultation.

Contact Information

Spring Consulting Group LLC
30 Federal Street, 4th Floor, Boston, MA 02110
Phone: (617) 589-0930; Fax: (617) 589-0931
insight@springgroup.com
www.springgroup.com

LinkedIn: spring-consulting-group-llc
Twitter: @SpringsInsight
YouTube: Spring Consulting Group
SlideShare: SpringConsultingGroup