National Underwriter
BUYERS REPORT

Captives: Just What The Doctor Ordered For Medical Stop-Loss

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THE RISK CHARACTERISTICS of medical stop-loss make it a reasonable exposure to place in a captive insurer because of the relatively limited nature of the risk and short duration of payment. There are potentially significant cost savings and other administrative advantages to be realized.

Although losses may occur in a particular year, over time cost should be less to retain stop-loss in a captive than to insure that risk in the external commercial stop-loss markets.

When calculating administrative expenses, the target loss ratio used by an underwriter of a commercial medical stop-loss policy will be 65-to-75 percent—reflecting substantial administration expenses and underwriting gains for the stop-loss underwriter.

A captive would have a lower cost structure with regards to:

- Sales expenses (both internal marketing support and payments to external agents).
- Overhead expenses.
- Insurer profits and contributions to surplus.
- Underwriting services and claims adjudication.
- Premium taxes—lower for a captive than for a commercial insurer.

Meanwhile the advantages of a captive include:

- Administrative simplification.
- Stability of premiums.
- An end to one-sided contractual provisions.
- Flexibility in coverage design.
- Risk diversification (placing stop-loss in a captive can improve the overall risk distribution with the captive).
- Acceleration of tax deductions.

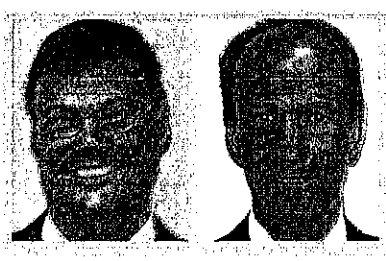
On this latter point, if the captive is structured so as to be considered a bona fide insurance company for U.S. tax purposes, the premiums paid to the captive can be tax-deductible. In the absence of the captive, health claims may be deducted only when paid, plus a reasonable reserve for incurred but unreported claims; a separate reserve for future large claims would not be deductible.

Meanwhile, a large employer that may not need (or be willing to pay the cost of) stop-loss insurance to limit overall risk could use stop-loss issued by a captive to improve the budgetability of medical costs for its operating units.

There also are some potential disadvantages of captive stop-loss. These include:

- **Risk**—captives do not shift risk away from the employer. A captive is nothing more than a convenient method of managing the risks that the employer has chosen to retain.
- **Additional expenses**—including actuarial services, captive management and claim adjudication, which must be procured separately if risks are retained in a captive.
- **Ancillary services**—such as medical management of potential large claims and access to specialty networks for expensive surgical procedures.

The process of placing stop-loss in a captive is no more difficult that other types of risk commonly insured by a captive, assuming the employer has already established a captive to insure other corporate risks. Setting up a captive solely to provide stop-loss insurance would probably not be economically viable.



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Because stop-loss coverage is generally not subject to ERISA, it would not be subject to the special requirements designated by the U.S. Department of Labor in order to comply with ERISA's prohibited transaction exemptions. For example, the captive would not need to be licensed in the United States; the stop-loss policy could be issued directly by a captive domiciled in Bermuda or some other foreign location.

The first step in the process would be to analyze the risk. Prior-loss history, known claims and actuarial tables would be reviewed to project the losses that would be incurred. This loss projection, as well as the probability of various ranges of losses, would be compared with the cost of purchasing stop-loss from a commercial insurance company.

An analysis would also enable the employer to determine the appropriate level of risk to transfer to the stop-loss policy--including trigger thresholds that would apply under the stop-loss policy.

The actuarially determined amount of reserves would need to be calculated. The reserves reflect additional capital that will need to be available to the captive to cover the possibility of unexpected losses.

Once regulatory approval has been obtained, the captive will issue a policy to the employer. The policy will specify the terms under which claims will be paid.

Ongoing, the captive would receive premiums and process claims as it does for any of the other risks it has assumed.

Stop-Loss 101

FOR THOSE NEW TO THIS TYPE OF COVERAGE:

▸ **What is medical stop-loss?** It's a policy provision that limits the maximum amount payable on a claim.

▸ **Why do risk managers buy it?** Plan sponsors take the coverage to reduce financial volatility associated with health benefit costs.

▸ **Who's covered?** Medical stop-loss insures the employer (not the employee). There is no contractual or insurance relationship between the stop-loss carrier and the beneficiaries covered by the employer's medical plan.

▸ **How does it work?** Stop-loss generally indemnifies medical claims in excess of the policy's attachment points, which can be either/both "specific" or "aggregate," within a one-year policy coverage period.

▸ **How "specific" is it?** "Specific" stop-loss provides protection against large individual claims--for example, by limiting the employer's liability to the first $100,000 of claims paid on behalf of any one claimant during the plan year.

▸ **What about "aggregate" covers?** "Aggregate" stop-loss provides protection on the overall claims paid under the plan during the plan year.

▸ **How much is it?** The cost of stop-loss coverage is determined, to a significant extent, by the amount of capital available to underwrite the risk. Once a stop-loss policy is incurred and paid, a commercial carrier will often adjust future stop-loss renewals to shift cost to the employer.