A Captive Audience

Provider units reinsuring employees' benefit costs

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An Arizona health system has joined roughly two dozen major U.S. employers, including giants AstraZeneca, Dow Chemical Co. and Sun Microsystems to break into reinsuring employee benefits through a wholly owned insurance subsidiary.

Phoenix-based Banner Health in June became one of the first not-for-profit hospital operators to win approval from the U.S. Labor Department to reinsure employee benefits through a captive insurance company. Memorial Sloan-Kettering Cancer Center, a 432-bed hospital in New York with more than 9,000 employees, scored the industry's first approval in December 2008 to reinsure its group term life and long-term disability policies through its captive insurer in Vermont. Captive insurers are so named because they are owned by the companies they insure.

For Banner, the switch allowed the system with 19 hospitals in seven Western states to diversify risks for its offshore captive insurer, Samaritan Insurance Funding, improve cash flow and lower life insurance costs by an estimated $500,000 per year while increasing the benefits, system executives say.

But in so doing, the system, with $5.5 billion in assets, also expanded its captive insurer's exposure into a little-explored market among the wholly owned subsidiaries: employee benefits.

“We look for opportunities to use the captive as a financial tool to reduce costs through assuming risk,” says Dale Schultz, Banner's vice president of business health, a division that oversees Samaritan Insurance and Banner's contracts with other insurers.

Captive insurers have grown among not-for-profit health systems since the 1970s, largely to fund medical malpractice and professional liability coverage. Peter Jones, managing director of Captive Management Initiatives, a for-profit subsidiary of Catholic Health Initiatives that manages healthcare captive insurers in the Cayman Islands, says he hasn't seen other healthcare captives branch into employee benefits but added that he isn't surprised by such an expansion.

Success with medical malpractice has prompted health captives to consider how they might yield savings from other coverage, such as property and casualty, Jones says. Captive Management Initiatives manages two Catholic health system captive insurers, including that of its parent company. CMI also consults for three more not-for-profit health captives. Jones says life insurance tends to be stable and profitable, though only marginally, making it a potentially attractive target for captive expansion.

Roughly 280 healthcare captives operate in the Cayman Islands, according to statistics released by the islands' monetary authority in early July. The offshore location was home to the first healthcare captive, and it continues to be a popular location because of regulators' flexibility and the islands' experience with healthcare captive insurers.

Tom Jones, a partner with McDermott Will & Emery who did not work with Banner on the deal, says the Labor Department first allowed expanded use of captives to reinsure employee benefits in 2000, under certain conditions, but the strategy has not been widely adopted. “Yes, this is cutting edge,” he says. “This is not garden variety.”

Employers must hire an independent fiduciary agent to confirm the switch is in employees' best interests and that workers are charged market rates for premiums. The Labor Department also requires that captives must be licensed in one state or the U.S. Virgin Islands, employers must increase benefits, and the primary insurer must carry a strong credit rating of A or better.

To reinsure life insurance through its captive in the Cayman Islands, Banner created a branch in the U.S. Virgin Islands: Samaritan Insurance was launched in 1986 to offer hospitals professional and general liability coverage, but expanded the captive to fund directors and officers liability, physician insurance and, for three years, stop-loss coverage for its self-insured health plan.

Banner's decision to shift health benefit stop-loss coverage to its captive underscored that the captive can be an effective alternative when commercial insurers' prices or benefits prove unfavorable, Schultz says.

As a stop-loss provider, Samaritan Insurance assumed the risks for health plan claims between $50,000 and $500,000. Banner analyzed data on claims Samaritan paid out, then adjusted premiums for its self-insured health plan to cover the costs and eliminated stop-loss coverage entirely, Schultz says. And by using its captive for three years before cutting the coverage, Banner also significantly reduced costs from commercial insurance to cover overhead, profit, taxes and surplus set aside to cover unexpected losses.

In addition to the savings Banner expects from reinsuring life insurance benefits through its captive, cash for premiums Banner pays its own insurer remain on the system's books—as does any investment income from the insurers' reserves, he says. Samaritan Insurance reported $177.8 million in assets in 2007, according to the latest annual financial statements for Banner. Samaritan reported $12.3 million in investment income for the same year.

Commercial insurers' premiums include costs for administration, risk, profit, expected claims, plus a little extra in case of unexpected high claims, says Karin Landry, managing partner with Spring Consulting Group, an employee benefit consultant to insurers, including captive insurers and financial service companies, who worked with Banner on its reinsurance deal.

Commercial insurers also profit from investment income gained through premium revenue. By shifting premiums to a captive, employers gain control of profits and investment income, which can be used to pay claims or reduce premiums.

Like any insurer, Banner's captive insurer assumes the risk of unexpectedly high losses, but diversifying its insurance lines should help Samaritan offset losses in one area with gains elsewhere, Schultz says. Samaritan also opted for a stop-loss policy on its life insurance benefits to hedge against significant claims, he says.

Schultz says the captive branch in the U.S. Virgin Islands could also serve as a U.S. outpost for its Cayman operations should Congress pass legislation to curb offshore tax havens. As a not-for-profit health system, Banner's captive insurance company is already exempt from taxes, so the system gained no tax advantage by moving offshore, he says. But Schultz fears that ambitious legislation could impose taxes on the company's Cayman operations despite its tax-exempt status, particularly as the recession has strained state and federal budgets.

Schultz says the premium costs remained flat to cover expanded enrollment in the life insurance benefit, which increased by 8.5% for the year that began Jan. 1. Banner will adjust premiums after its first year to reflect the captive insurer's lower costs and any surplus gained from premiums, he says.

Premiums paid to Banner's previous life insurer substantially exceeded claims paid out, leaving a surplus that went “to someone's bottom line, and it's not ours, or our employees',” says Brent Priday, Banner's senior director of managed care. Surplus premiums over Banner's life insurance claims ranged from $500,000 to $2.5 million annually during a five-year period, according to Schultz.

Limited benefits and poor service under the previous insurer didn't justify the cost, Priday says. The system wrangled with the insurer over paperwork and how quickly claims were paid. Priday described the lack of control in such situations as “embarrassing and frankly offensive.”

Under the captive, Banner increased benefits without raising the premium, Priday says. And claims for life insurance benefits are processed in three to five days, rather than the 30-day average under Banner's prior insurer, he says.