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A guide to what's hot in the world of captives and ART



Strategic Risk Solutions

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The State of the Market for Healthcare Captives

This quarter's newsletter takes a look at captives in the healthcare industry. In the lead article we examine the continued growth of healthcare captives. This article draws on information presented by Bill Cassetta and Julie Robertson of Honigman Miller Schwartz & Cohn LLP in our April 2008 webinar.

The Origins of Self-Insurance

Historically healthcare institutions have been concerned about the reimbursement of their costs under Medicare and other third party payment mechanisms. This made institutions risk averse preferring to pay a guaranteed premium which would be treated as an allowable expense rather than retain risk. While cost reimbursement remained an important consideration, institutions' risk-taking position began to change in the 1970s as self-insurance became an acceptable method of financing professional/general liability for Medicare cost reporting purposes. Once accepted, self-insurance expanded, particularly among tax-exempt institutions, which were not concerned about trying to create a tax deductible structure. Lenders and lessors also became comfortable with the structure.

In this initial phase the typical method of self-insuring was in a Trust. Under this structure, an independent fiduciary held the funds used by the institution to pay professional and general liability claims. The Trust provided favorable reimbursement treatment as well as several benefits to the institution over commercial insurance:

- Loss experience: the sponsor (or hospital) could benefit directly from improved loss experience. Even for loss sensitive insurance programs, the commercial insurance market doesn't reward good experience or punish poor experience dollar for dollar. The Trust gave the healthcare institution the most reward for its risk management efforts.
- Investment income: the sponsor retained the investment income and funds were invested per the sponsor's policy. Medicare didn't really restrict the way that funds could be invested except that the investment had to be consistent with whatever state law was applicable
- Tax treatment: there was favorable tax treatment for tax-exempt organizations

The Emergence of Captives

By the mid-1970s, Medicare cost reimbursement rules had changed, permitting use of captives. Until then captives were not available as an alternative to institutional providers. Captives

provided institutions with additional flexibility compared to a Trust. The most significant initial advantage was the ability to pool risk beyond the professional and general liability risk exposures of the institution. With a captive, pooling became possible with other institutional providers and physicians. It was also possible to pool other risk exposures, such as workers compensation, with the professional and general liability exposures. As a formalized risk bearing entity, a captive provided access to the commercial reinsurance market.

One of the first healthcare captives established was formed by the Harvard medical institutions. The structure of the Harvard captive pooled the risk of its physicians and other providers with the institution, including the sharing of a single limit of liability. This structure became the model for many other tax-exempt healthcare institutions. The Harvard captive was also instrumental in establishing Cayman as a domicile as discussed below.

Second Wave of Growth

From the 1990s through the present, a number of factors spurred a significant growth in captives among those sectors left out of the first wave. This growth was driven by both changes in the insurance industry and the healthcare delivery system.

Insurance Industry Changes

- The *Humana* decision provided new captive opportunities for taxable institutions for which tax deductibility was important.
- The passage of the Federal Risk Retention Act in the late 1980s provided more options for captives. The RRG structure allowed smaller institutions and physicians to come together to pool risk. It also provided captive owners with an attractive onshore option and removed fronting costs.
- The hardening of the market in the late 90s and early 2000s fueled the growth in captive formations.

Healthcare Industry Changes: The most significant change was how physicians began organizing themselves. Previously physicians had been organized in small offices with one or two providers. They lacked the resources and financial strength to retain risk and were reliant on the commercial market. That changed in the 1990s with the consolidation of physician groups

with the combined group acting more like an institution than a collection of professionals. These groups had more capacity to retain risk and became viable candidates for captive formation. At the same time there was an explosion in physician staffing companies and management companies needing insurance solutions which spread across a number of states. Commercial markets were often unable to provide a solution for them.

The Market Today

Today captives have become the predominant risk financing structure for tax-exempt and taxable healthcare institutions. Trusts are no longer as common as they used to be as they don't have the flexibility of a captive. In certain situations, however, a Trust may be the optimal choice, used alone or in tandem with a captive. A Trust may also be a good first step in the self insurance world for smaller organizations, particularly where tax deductibility is not important. Trusts are typically less expensive to establish and operate than captives.

The market for healthcare captives is mature with captives seen across most sectors of the industry. Some would argue that the market is saturated. Although formation rates have declined in the soft market, smaller regional providers continue to express interest in forming new captives. For existing captives, the soft market is providing an opportunity to improve their programs. This may include reduced reinsurance costs and improved coverage, including batch coverage for multiple claims arising from the same event. One of the biggest challenges is using surplus or releasing loss reserves as healthcare captives have generally been successful with good loss experience. Many captives are looking at ways to use that surplus to insulate themselves from the next hard market.

Domiciles: the Healthcare Perspective

Initially healthcare captives looked to either Bermuda or Cayman as a domicile. Cayman became the most common jurisdiction for healthcare providers early on following the acceptance of the Harvard captive for medical malpractice in the mid 1970s. Although Bermuda was the more established domicile, Cayman offered some advantages, including:

- A willingness to allow hospital sponsored physician programs; and
- A more favorable reimbursement impact due to flexible capital requirements

Now there are more domicile options available, including a number of onshore alternatives. Vermont, as the leading onshore domicile, has a strong healthcare captive sector. Several of the newer onshore domiciles have picked up healthcare captives, particularly risk retention groups and physician groups. However, Cayman remains the domicile of choice for both for-profit and tax-exempt captive owners due to the experience of the professionals involved. Understanding the unique business needs of the healthcare industry is a major advantage for Cayman.

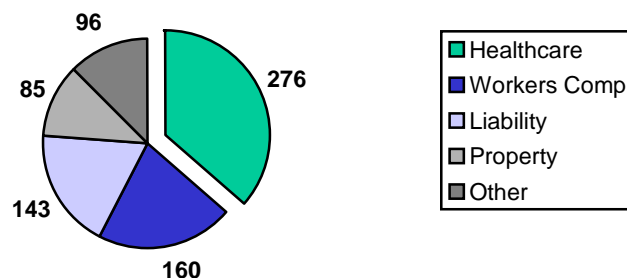
Cayman Islands & Healthcare

The landscape for Healthcare captives in Cayman today includes:

- Not-for-profit healthcare institutions
- Large for-profit healthcare systems
- Small and mid-size healthcare systems or hospitals
- Group excess programs for healthcare institutions
- Long-term care facilities
- Physician groups
- Managed care entities

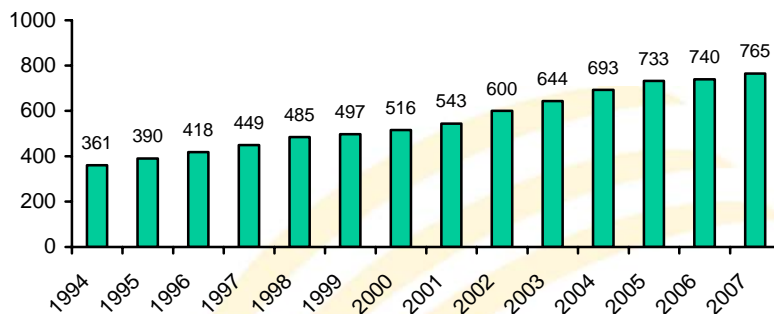
Of Cayman's 760 active licensed captives, 276 or 38% of all captives in the Cayman Islands are in the healthcare industry, making Cayman the largest healthcare domicile in the world and making healthcare the largest business sector for Cayman captives (Exhibit 1). Healthcare accounts for approximately \$3 billion in premium income (out of a total of \$8 billion in premium income), and \$11 billion in assets (out of a total of \$34 billion in assets).

Exhibit 1: Cayman Captives by Line of Business



Cayman has experienced steady growth in captives, adding approximately 400 active captives over the past 14 years (exhibit 2). The highest growth was seen in 2002 during the hard market when 97 new licenses were issued. Despite the maturity of the healthcare captive market, Cayman continues to see new formations of healthcare captives. Healthcare has accounted for 40% of new formations over the last several years. Many of these new captives are being formed by smaller regional institutions with approximately \$1.5 million to \$2 million in premium. One of the reasons they have formed is to offer insurance to their physicians, although with rates starting to come down some of those captives are having a hard time keeping those insureds.

Exhibit 2: Number of Active Captive Licenses



Re-domestication

This has become a hot topic and many owners are re-evaluating their choice of domicile. For a captive formed in the hard market, this is a natural step to take as the captive reaches maturity. Despite the discussion, there has not been much movement out of the traditional healthcare domiciles of Cayman, Bermuda and Vermont. This could change as the newest jurisdictions develop. Where there has been movement it has usually been due to problems of perception about being domiciled offshore.

Rather than re-domesticate, some captives have supplemented their offshore presence by also forming an onshore captive. A typical structure is to create an onshore Risk Retention Group to front for the offshore captive. This allows the insurance program to be offered directly in states where the insureds are located. It also removes the need and cost of fronting carriers, freeing the captive from high collateral requirements. The offshore captive can continue to write coverages that the RRG is unable to write (*e.g.*, workers compensation, or coverage to non-owners). For many owners this structure represents the best of both worlds.

Considerations for Tax-Exempt Institutions

Much of the captive world is geared towards taxable captive owners. In the healthcare industry many of the institutions are tax-exempt. This creates some unique considerations in structuring and operating their captive insurance subsidiaries.

Insurance for Tax Purposes

For most tax-exempt institutions the objective is for the captive program NOT to be treated as insurance for tax purposes. This is because:

- Premium deductibility is irrelevant
- It eliminates FET in payments to offshore captives
- It bolsters arguments for exemption from federal income taxation for onshore captives

As a result captive programs for tax-exempt organizations often include elements that would be considered bad facts in the taxable world. These include:

- Modest capital/surplus: tax-exempt organizations typically only contribute the minimum capital and surplus required in the domicile. The lack of capital is compensated for by:
 - Retrospectively rating premium
 - Parental guarantees
- No profit motive: many tax-exempt organizations use a break-even structure which combined with the retrospective premium rating removes any profit in the captive.
- Modest amount of “third party risk”
- Fewer outside/independent directors
- Tax reporting consistent with “no insurance” treatment

Domicile Considerations

Most tax-exempt healthcare institutions form their captives offshore. This is due to:

- Tax advantages for tax-exempt organizations forming a captive outside the US to insure third party physicians. In a US State that captive would be subject to federal income tax on its entire book of business including the hospital portion, unless it was able to obtain a separate ruling. This is difficult to obtain when there is a significant portion of third party business. There remains an advantage to tax exempt entities which does not exist for taxable entities.
- Lower capital and surplus requirements offshore
- Absence of local premium taxes
- A concentration of healthcare captive expertise offshore, particularly in the Cayman Islands.

However there are also factors in favor of onshore domiciles.

- Perception: this can be quite significant. Tax-exempt organizations operate with more transparency and may be more sensitive about perceptions of “junkets,” and “exotic locales” than taxable organizations.
- FET: generally, third parties paying premiums to a tax-exempt owner’s offshore captive must pay federal excise tax. This could add as much as 4% to premiums compared to if the captive was located in the US.

Domicile News

Cayman Initiatives to Develop the Reinsurance Sector

On April 30, 2008 the Cayman government announced measures to further develop the reinsurance sector in the domicile. The measures are based on recommendations from the Reinsurance Task Force (RTF) which comprises senior figures in the Cayman Islands Insurance Industry. The recommendations include:

- Promoting commercial certainty for reinsurance firms through provisions in the Immigration law.
- Progressive approaches to the regulation of reinsurance companies in the Insurance Law.

The RTF also urged reinsurance firms who wished to domicile in Cayman to enter into a “social contract” with the Government around career, training and education opportunities for Caymanians.

Cayman has several advantages in attracting more reinsurance firms, including a vibrant captive insurance community, an existing professional infrastructure, experience with reinsurance sidecars and catastrophe bonds and the presence of the hedge fund industry as a source of capital.

The RTF will provide support in the roll-out of the recommendations. “This is an exciting opportunity for Cayman. The professional service sector is firmly behind the recommendations and we look forward to working with the Government as the initiatives are rolled out,” said Seamus Tivnan, Director of Strategic Risk Solutions (Cayman) and member of the RTF.

SRS News

Seamus Tivnan Joins SRS Cayman

In April, Seamus Tivnan joined SRS Cayman as Director. He was previously head of office at Marsh Management Services Cayman Limited.

“Seamus is a leading figure in the Cayman captive community and the industry worldwide. We are excited that he has decided to join our growing Cayman team” said Brady Young, President and CEO of SRS. “We have made a commitment to Cayman as a domicile and have successfully established a strong local presence. Seamus will add to our team allowing us to deliver unparalleled expertise and experience to our Cayman and healthcare clients”, added Young.

Seamus has worked in the captive insurance industry for 17 years, joining Johnson & Higgins in 1991 before moving to Marsh in 1996. He was Head of Office of Marsh Management Services Hawaii for a brief period in 2000 before becoming manager of Marsh's Cayman operations later that year.

He will join Wayne Cowan and Ron Sulisz as co-Directors of SRS (Cayman) Limited. We are very pleased that Seamus has joined the firm and welcome him to SRS.

Office Moves

In April both our Massachusetts and Arizona offices moved. We also opened our new office in South Carolina. The new office locations are:

Strategic Risk Solutions Inc
2352 Main Street
Concord, MA 01742
Tel: 781 487 9800 (no change)

Strategic Risk Solutions (Arizona) Inc
6619 N. Scottsdale Road, Suite 8
Scottsdale, Arizona 85250
Tel: (480) 296-2038

Strategic Risk Solutions (South Carolina) Inc
FountainWalk
360 Concorde Street Suite 106
Charleston, S.C. 29401

Events

SRS will be participating in the following upcoming industry events:

- **June 16-19, Bermuda Captive Conference.** Graham Lamb and Richard Winchell will be attending the conference at the Fairmont Southampton Resort
- **June 17-18, SCCIA, Mid-Year Executive Forum.** Kathryn Marsh and Laura Roemer will be attending the mid-year meeting in Greenville, SC.
- **July 29 – Aug 2, Florida RIMS Annual Education Conference.** Kathryn Marsh and Laura Roemer will be attending the conference to be held in Naples, FL
- **Aug 12 – 14, VCIA Annual Conference.** SRS will be exhibiting at the conference to be held at the Sheraton Hotel and Conference Center in Burlington, VT.

Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

SRS Webinar Series

SRS hosts periodic webinars on topical issues affecting the captive insurance industry. Our provisional schedule of upcoming webinars includes:

- June 19: Metrics that Matter – a Guide for Captive Owners
- July 23: What's New in Vermont?

To ensure you are included on the distribution list for webinar announcements, contact us at info@strategicrisks.com.

Recordings

Recordings of prior webinars are available at our website (www.strategicrisks.com). Recent recordings include:

- RRGs – Opportunities and Challenges
- The State of the Market for Healthcare Captives
- Domicile Unrest: Growing Pains or Change in Direction
- Captives 101
- Captive Market Update: Annual Review

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

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