Medical Stop-Loss Captives A Comprehensive Overview

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I). Introduction:

For the past decade, the relentlessly increasing cost of healthcare and an uncertain regulatory environment have lifted employer self-funding of medical benefits and medical stop loss to be among the insurance industry's premier growth segments.

At the inception of the Affordable Care Act (ACA) in 2000, only about 48% of U.S. employers self-funded their employees' healthcare coverage. Throughout the past decade, the percentage of self-insured employers has risen sharply to more than 60%, where it has remained. With the growth in self-funding, there has been a commensurate expansion in the Medical Stop Loss (MSL) market itself. The MSL market has more than tripled in size during the ten years since the inception of the ACA from an estimated $7 billion in 2010 to more than $25 billion as of 2020.

As with any market that experiences growth driven by increasing costs and widespread inefficiencies, captives tend to flourish. Consequently, the MSL captive market has become one of the insurance industry's most dynamic expansion segments.

II). MSL Captive Market Overview:

Most of the self-funded market growth has come from employers having less than 500 employees, with an even more significant growth percentage coming from employers with fewer than 250 employees. This has proved to be a boon for group captives, which primarily target the 50 to 500 life employer segments. For employers of this size, the ability to retain risk and achieve significant cost stability from a self-funded health plan becomes more difficult on a stand-alone basis. Group MSL captives provide these smaller employers with an enhanced ability to optimize their self-funded healthcare plans.

Larger employers that have an established single-parent captive for property and casualty lines are increasingly expanding the use of their captives to include medical stop loss. Converting segments of retained risk into layers of MSL can be used to effectively enhance the risk and financial profile of an existing captive and further distance the employer from an overreliance on more traditional risk structures.

The MSL captive market's precise size measurement is challenging to ascertain as carriers do not typically segregate or identify MSL premiums attributable to captives in their reported MSL results. The Self Insurance Institute of America (SIIA) sought to conduct a market survey to measure the MSL captive market size; however, not enough carriers (or MGU / program managers) were willing to share the data necessary to deliver credible results. Empirical research suggests that group captives currently represent more than $2 billion of the overall MSL market (estimated to be $25 billion). The expansion in self-funding since ACA has resulted in a pattern of proportional captive growth that closely parallels the growth profile of the traditional self-funded market.

Increased Profitability:

Historically, MSL captives have outperformed traditional MSL coverage in terms of both loss ratio and participation persistence. Increased risk retention, tightly managed participation requirements and prudent risk selection leads to a better performing pool of risk.

Continued regulatory and healthcare economic uncertainty will drive continued growth in self-funded healthcare and change the MSL market's scope and profile. As the self-funded market environment continues to evolve, the use of both group and single-parent captives for MSL will continue to expand.

III). Benefits Of Funding Medical Stop-Loss Coverage Through A Captive:

The first and most apparent benefit is the potential cost reductions made possible on a long-term basis. The primary objective of a properly structured alternative risk program is to achieve the most appropriate balance between risk assumption and risk transfer. Retaining predictable (and budgetable) segments of risk while transferring more unpredictable layers of risk to a (re)insurer provides an effective conduit to optimize savings, while simultaneously supporting the organization's risk management, financial, and business objectives.

Captive participation in the excess coverage (Medical Stop Loss) that reinsures a self-insured employer will amplify the benefits derived from self-funding alone. For smaller employers, participation in a group captive can provide increased access to many of the same advantages (increased spread of risk, service provider cost leveraging, surplus dividend sharing, etc.) that are enjoyed by larger organizations with a single-parent captive.

Since the underwriting variables for each employer and captive are different, it is challenging to provide potential cost-saving figures. That said, another important objective of a properly structured alternative risk program is to distance the employer from an over dependence on more volatile, or cyclical, standard insurance markets to promote long-term stability and sufficiently reduce the cost of risk over time.

Increased continuity with benefit objectives:

Stop-loss captives should not be viewed strictly as a mechanism for saving money on the cost of stop-loss insurance itself, but rather as a contributing component within a more holistic strategy for reducing the overall cost of delivering healthcare benefits. It is also essential to understand that the use of a captive does not change the nature or pricing of stop-loss risk. The captive only adjusts who holds specifically defined segments of the risk.

Just as a captive is used to strategically enhance risk management efforts, adding stop loss to a captive can augment the organizations human resource reward objectives by improving the efficiency of employee benefits financing and delivery. One primary purpose of a captive is to provide coverage or facilitate capacity that is disproportionately expensive or otherwise unavailable within traditional or standard insurance markets. Although some stop-loss policies will provide coverage that mirrors an employer's Plan Document, many stop-loss policies contain exclusions that conflict with the Plan Document. Stop-loss carriers will also frequently identify specific individuals with significant, on-going medical conditions and exclude (aka "laser") them from stop-loss coverage. Policy exclusions and lasers are examples of terms and conditions that can be effectively absorbed by a captive to help maintain long-term continuity to self-funded benefit delivery.

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IV). Primary Types of MSL Captives

The MSL captive market has two distinct segments that generally mirror the same structure as the more traditional casualty captives. Single-parent captives and group captive structures, with some variations, are becoming widely used.

1). SINGLE-PARENT CAPTIVES:

A single-parent (pure) captive is formed as a subsidiary of another entity, referred to as the "parent" (i.e., a single owner), to insure the risks of its parent. Single-parent captives can be a highly effective mechanism for financing risk within coverage segments where the employer is likely to outperform traditional insurance markets. Single-parent captives are typically established by large employers having more than 1,000 employees, and more than 90% of employers this size self-fund their employee health care benefits. The addition of MSL is among the easiest and most efficient ways of expanding the use of an established single-parent captive.

Different Healthcare Headwinds for Large Employers

Before the Affordable Care Act (ACA), many large employers would not need to purchase MSL coverage as the ability to define a lifetime benefit limit, typically $1 million, within the benefit plan would serve as a de facto stop loss by capping losses at a level that could be manageably assumed by a large employer. However, a cause-in-fact extension of ACA's mandate for unlimited benefits was an almost immediate increase in large, potentially catastrophic medical claims. Large losses attributable to conditions such as angioedema, complex cancers, hemophilia, multiple sclerosis, and treatment regimens that include emerging specialty pharmaceuticals have resulted in multimillion-dollar claims with an astonishing regularity. Employers assuming higher specific deductibles become proportionally less vulnerable to insurance market volatility as the specific deductible increases. More large employers must now purchase high (unlimited) layers of MSL coverage to limit their potential exposure to large on-going claims and cap their financial obligations to the benefit plan. Larger self-funded employers that have an established single-parent captive for casualty lines are frequently expanding the use of their captive to include MSL.

MSL by itself would not typically generate enough premium to justify forming a captive solely for this coverage; however, it can be used to enhance the effectiveness of a captive and amplify the benefits associated with self-funding.

Single-Parent Structures:

There are three basic structures for a single parent MSL captive. Because MSL is not a statutorily mandated coverage, a ceding insurer is not typically required or needed for a single-parent captive. The captive can manuscript and direct issue an MSL policy to the employer.

Captive direct issue: The captive can direct issue a policy for the entire coverage amount (e.g., unlimited risk excess of $500,000). The captive then transfers the layer of risk that it does not wish to retain to a reinsurer (e.g., unlimited risk excess of $1,000,000).

Captive issued with MSL Policy: The captive will direct issue a policy for only the amount of its retained risk layer (e.g., $250,000 of risk excess of $500,000). The captive – or employer – then purchases a traditional MSL policy (or possibly reinsurance) for the remainder of the risk provided by the self - funded plan (e.g., unlimited risk excess of $750,000).

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IV). Primary Types of MSL Captives *continued*

Fronted MSL Policy: The employer will purchase a traditional MSL policy for the full amount of risk (e.g., unlimited risk excess of $500,000). The MSL insurer then cedes a layer of policy risk to the captive (e.g., $250,000 of risk excess of $500,000). This fronted approach requires collateralization for the risk layer assumed by the captive, which will incur an additional ceding (aka front) fees. This approach is not as practical as the other two, but it may have relevance in some specific situations.

ADVANTAGES OF A SINGLE - PARENT MSL CAPTIVE:

Expand the utility of an existing captive:

MSL is typically added to a captive that has been established for long-tail business lines such as commercial auto liability, general liability, professional liability, and workers compensation. As a short-tail line of business, MSL can serve as an effective risk and financial hedge by providing beneficial diversification of a captive's coverage portfolio. This is contrasted with long-tail coverages for which it may take several years to close out a given policy year and to finalize the declaration of any surplus attributable to that policy year. Conversely, an MSL policy term can usually be closed out and finalized within six months after the close of the policy period. Even though MSL can provide some risk portfolio diversification, it generally should not be considered third-party risk for tax purposes.

Enhanced cash flow management

Converting segments of retained risk into layers of MSL coverage and formalizing the funding of those layers in the form of regular or monthly premiums is more efficient from a budgetary reporting and accounting perspective than paying claims out of general assets or funding through a trust.

Recognize and deploy surplus more efficiently:

Accumulating surplus derived from underwriting profit and investment gains can be efficiently deployed in any number of ways: offset plan costs, expand or enhance benefits to employees, reduce employee contributions, hold in reserve for on-going or future claims, or return as dividend distributions to the captive parent. The captive also allows flexibility for the use or deployment of surplus in contrast to formal trusts (such as a VEBA or 501(c)(9) trust), which limit funding levels and restrict how assets may be used.

Establish and build reserves:

This is increasingly important especially in an era of rapidly increasing instances of large, potentially catastrophic (multi-million dollar) healthcare claims. Most self-funded employers will invariably experience large, ongoing claims that would likely be isolated (aka "lasered") for a higher specific deducible, or wholly excluded, by a traditional MSL insurer. A captive must be able to have funding set aside to absorb these types of large, ongoing claims. Establishing reserves will allow the captive to gradually assume more significant amounts of risk, in the form of a higher specific deductible, and further distance the employer from an unnecessary reliance on traditional insurance mechanisms and related market volatility.

IV). Primary Types of MSL Captives *continued*

Highly efficient structure:

Since MSL is not a mandated coverage, a ceding insurer is not required. The single parent captive, acting as an insurance carrier, can manuscript and issue an MSL policy directly to the parent/employer. Since there is no ceding insurer, there is nothing to collateralize. The captive, as an insurance carrier, can then purchase any insurance amount in the form of reinsurance, rather than an excess insurance policy. The combination of no front, no collateral, and reinsurance (rather than a commercial MSL policy) contributes to a significant reduction in the program's gross-to-net expense structure, which promotes higher profitability.

Enhanced ability for risk control:

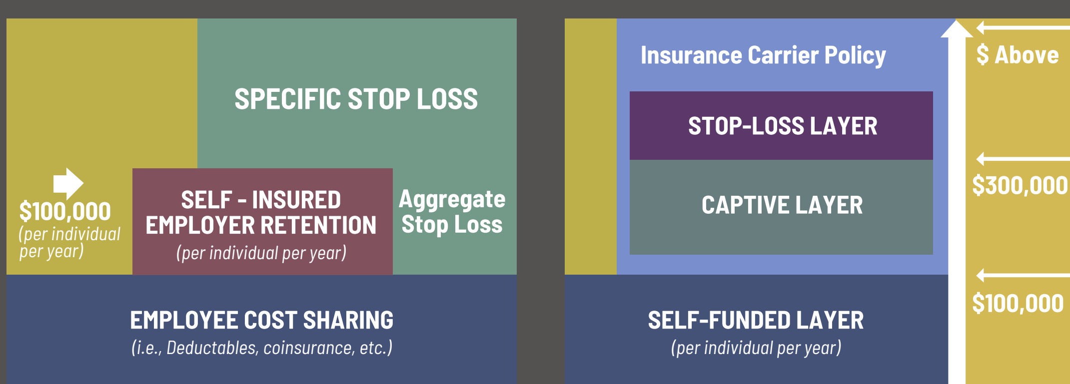
Incorporating the use of a captive provides increased latitude in terms of plan design flexibility and risk control. The self-insured employer can manuscript the plan document according to specific financial needs and employee benefit objectives. Risk and cost reduction initiatives, such as biometric screening and wellness initiatives, referenced based pricing, narrow networks, and direct provider contracting, can be incorporated into the plan design to reduce the financial risk to the self-funded plan and captive.

The captive, as the MSL insurer, can manuscript the MSL policy to mirror the employer's plan document and the reinsurance agreement can be scripted to follow the form of the MSL policy. This enhances the continuity between each insuring document and reduces the likelihood of grey-area claims, policy gaps, and ambiguities between the (re)insuring contracts.

Data collection and usage:

MSL captives typically have increased access to more data from their plans. Using the data can help identify claim trends and specific cost drivers to help the employer implement more targeted cost reduction initiatives.

Traditional MSL /Self-funded Plan | **Single-Parent Captive**



IV). Primary Types of MSL Captives *continued*

2). GROUP CAPTIVES:

While market fluctuations impact employers of all sizes, small to medium-sized employers, especially those with less than 500 employees, are particularly susceptible to excessive market volatility. For employers of this size, the ability to retain risk and achieve significant cost stability from a self-funded health plan becomes more difficult on a stand-alone basis.

Over the past decade, group MSL captives have been used to provide smaller self-insurers with enhanced ability to optimize the effectiveness of their self-funded healthcare plans. Most group MSL captives have been proven to deliver a significant level of success by effectively managing and broadly diffusing risk. Even though MSL, by nature, is not a "pooled product," the concepts of pooled underwriting can be applied to a unified group of self-funded employers that are participating as the reinsurers of a shared MSL portfolio.

Success for a group captive is predicated on the quality and engagement levels of its membership. The increased collaboration and engagement among like-minded employers provide the platform for leveraging innovation in plan design, proactive risk control, and cost mitigation initiatives. A more discerning approach to membership selectivity and a more active risk management engagement of members is likely to yield superior performance results. The expected market conditions will increase the effectiveness of group captives to spread risk and reduce vulnerability to increased market volatility.

Group Captive Structures:

A group captive is a legal entity jointly owned by a group of unrelated companies and formed primarily to insure its member-owners. There are generally two types of group captives: Heterogeneous (dissimilar industries) and Homogeneous (similar industries). The objective of both types of group captives is to enable a grouping of mid-market employers to replicate a single large employer's risk profile to spread risk, promote stability, and achieve leveraged cost savings from different service providers.

Heterogeneous Programs:

These programs are comprised of a wide variety of industry classes and generally require more employer groups to achieve an appropriate spread of risk among its diverse membership. A larger size and risk spread are necessary to mitigate the increased risk variability and the potential for increased underwriting volatility, caused by differing demographics among the participating employer populations. For example, the risk profile of the employee population of a 100-employee-life professional services firm is much different than the risk profile of a 100-employee-life construction firm. Both could be members of the same heterogeneous group captive, though size and risk spread must be appropriately proportioned to achieve sustainable stability.

Most group captive market growth has emanated from heterogeneous "open-market" captive programs, representing the largest segment of the group MSL captive market. Open-market programs are typically sponsored by specialty program administrators and are open to new members who meet the sponsor's eligibility guidelines established for entry. The average member size within this category generally is smaller than in other group captives and is typically between 50 and 250 employees (lives). These programs primarily target fully-insured employers and use the group captive program as a conduit to ease the transition to self-insurance for smaller employers. Program value is predicated on delivering increased stability and protection (reduced market volatility, mitigation of lasers, potential dividend returns, etc.) that employers of this size would have difficulty attaining as individual self-insurers.

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IV). Primary Types of MSL Captives *continued*

Heterogeneous captive programs have a broad scope, ranging from a dozen members to several hundred members and anywhere from $2M to $200M of premium. An "average" program may have two dozen members and $15M to $20M of MSL premium. It is important to note that smaller employers, especially those transitioning from a fully-insured structure, have less underwriting predictability in this size range. Given the smaller average member size and differing risk demographics, open-market heterogeneous captives need to achieve both the size and appropriate spread of risk that will enable them to hedge the increased volatility.

There has been increasing interest in the formation of more tightly controlled "selective access" heterogeneous programs. The structure of these programs is similar to more ubiquitous "open market" programs with a few distinguishing characteristics. Selective access programs generally limit placement access only to a well-defined broker or producer network. The risk profile also tends to favor slightly larger accounts (150 to 500 employee lives) and existing self-insureds, instead of a higher volume of smaller accounts (50 to 250 employee lives) transitioning from a fully-insured structure. These programs are also increasingly being formed as "high performance" groups by larger independent agencies or agency networks. (Note: High performance groups are outlined in more detail below.)

Homogeneous Group Programs:

These captives can be smaller because their underlying risks and underwriting profiles are similar, so the size needed to achieve an appropriate spread of risk is not as large as it is with heterogeneous groups. Group captives are especially effective when formed by closely aligned groups of like-minded employers within the same industry and similar risk profile. The average individual member size within homogeneous industry groups tends to be larger than in heterogeneous "open-market" groups, trending towards employers having from 200 to 500 employee lives and a favorable experience track record as an existing self-insured. Credit unions, food and beverage distribution, hospital and healthcare, scholastic and higher education, hospitality, transportation, and manufacturing are examples of industry-specific niches served by homogeneous group captives. A typical program may have 10 to 12 employer members with a 250 to 500 employee life average member size. Some can have 25 (+) members, accommodating a size range of 100 to 1,500 employee lives. Opportunities exist for industry-specific trade associations to sponsor a group captive as a benefit for a closely tied and engaged membership.

High Performance Groups:

High-performance groups can be either heterogeneous or homogenous in terms of composition. As its name would imply, a high-performance captive would be open only to established self-insurers with a consistent track record of exceeding specific performance benchmarks. A grouping of high-performing self-insurers can further enhance the ability to hedge market and claims volatility, reduce plan expenses, and produce increased surplus margin advantages to members. As with other forms of group captives, these are most likely to be formed by large brokers, third-party administrators, or associations having a large pool of existing self-funded clients.

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IV). Primary Types of MSL Captives *continued*

Group MSL captives are not MEWAs

Group captives are not Multiple Employer Welfare Associations (MEWAs), and that is an important distinction. In a MEWA, premium contributions from several employers are commingled into a single trust or custodial account and used either to purchase insurance or pay claims directly to providers or employees. All MEWA funds are controlled and managed by a centralized administrator, leaving room for little or no control by employers. MEWAs are also heavily regulated by the few states that permit them.

In a group MSL captive, each employer establishes a separate self-funded benefit plan and purchases a separate (individual) MSL policy. There is no comingling of plan assets, nor is there joint risk-sharing among the benefit plans of different participating employers. Each employer maintains full control of their benefit plan, including the ability to set funding levels, and select and appoint plan administrators, third-party administrators (TPAs), and other related service components. The captive participates only in the MSL coverage, which is separate, and not directly connected to the benefit plan itself.

Mechanics of a Group Captive:

Group captives will normally be required to have an authorized carrier issue an approved MSL policy to its member-owners. In most cases, captive insurance companies are recognized as "non-authorized" insurers by the National Association of Insurance Commissioners (NAIC) and by states. Since the states regulate MSL insurance, most will require that any entity acting as an insurance company must be an authorized insurer, and appropriately licensed by the individual state(s), to issue an insurance policy to non-affiliated entities (i.e., group members). Therefore, most group captives are typically structured behind a ceding insurer, which issues an MSL policy, and then cedes risk to the captive as a reinsurer.

Within a group captive, each employer establishes a separate self-funded plan for their employees and purchases MSL coverage according to their risk appetite. The MSL is purchased from the common insurer or reinsurer that will provide coverage to each participating employer in the captive. The actual captive participation level will be determined by the collective risk appetite of the insured members and can be structured on either an excess or quota-share participation basis.

The basic structure of a group MSL captive is relatively simple:

- The group participants select a common MSL ceding insurer to provide coverage separately to all members.
- Once a viable participation commitment (critical mass) has been achieved, each employer will establish and maintain an individual self-funded healthcare plan. This will include choosing the desired plan design and all related service components, such as third-party administrators (TPAs), provider networks (PPOs), and the like. Although each employer's plan is designed and maintained separately, the size advantages of the group can be leveraged, if related components are collectively obtained from common providers.
- Each employer purchases specific and aggregate MSL coverage, according to their risk appetite. The MSL policy is purchased from the common insurer that will provide coverage to each member of the captive.

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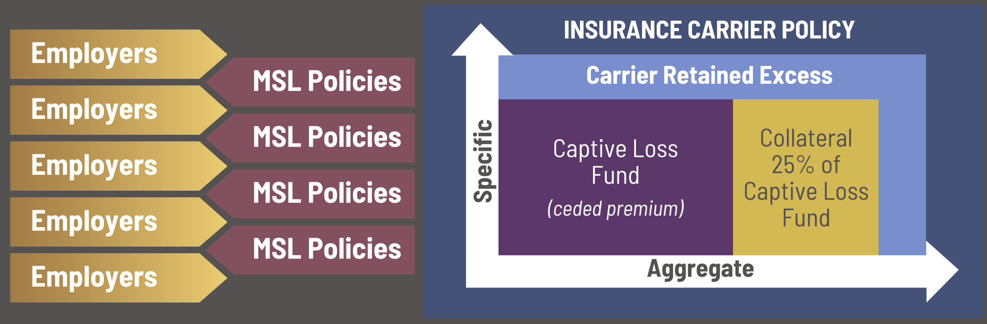
IV). Primary Types of MSL Captives *continued*

- The MSL carrier then cedes a portion of the collective MSL portfolio, attributable to all participating group members, to a reinsurance captive owned jointly by all participating members. (For example, the captive would assume risk participation within the $250,000 excess of $250,000 claim layer or the $500,000 excess of $500,000 claim layer in the collective portfolio.) The actual captive participation level will be determined by the collective risk appetite of the insured members, with agreement from the ceding insurer.
- The captive, in effect, serves as a reinsurer to the insurance carrier that issues primary (fronted) MSL policies of each group member.

Ceding insurance to a captive, which stands behind the ceding or fronting carrier, obviously adds to the captive's gross-to-net expense structure. In this contractual arrangement, because the captive itself is not recognized by the NAIC as an "authorized reinsurer," some level of collateralization, commensurate with the amount of risk ceded to the captive, will be required. However, similar expenses would be part of a traditional self-funded program, and they are ideally offset by the potential unused surplus returns generated by the captive and returned as cost reductions or dividends to the owner-members.

Group Captive Structure



V). Captive Collateralization:

One of the most important components of a captive or other alternative risk program is the amount of collateralization required of the insured(s) by a ceding carrier to secure the portion of risk retained within the program. Within the overall structure of a fronted program, the captive becomes a reinsurer of the ceding carrier issuing the policy. An insurance carrier faces an inherent credit or financial risk when issuing a policy in front of an alternative risk arrangement. To alleviate this credit risk, the insurer will require the posting of collateral commensurate with "risk gaps" to ensure appropriate funds are always available to pay claim obligations incurred by the captive. Collateralization is a requirement imposed on insurance carriers by the National Association of Insurance Commissioners (NAIC) as liabilities and ceded risk amounts must be recognized on the insurer's annual report. The NAIC, via its solvency guidelines, deems a captive to be an ì unauthorized reinsurer. Appropriate collateralization will enable risk ceded to a captive (reinsurer) to be recognized as either an asset or a reduction in liability when reported on the insurers financial statements.

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V). Captive Capitalization *continued*

The primary collateralization – for the premium funding – is automatically facilitated via withholding funds as premiums are paid to the carrier. Premium paid by the participating employers will be held by the carrier as primary collateral for the captive's liability within the reinsurance contract. Additional "gap" collateral is needed from each employer to fund the captive's maximum liability as determined by the aggregate retention defined in the reinsurance contract (typically 125% of ceded premium, so the employer must fund an additional 25% of premium to cover the aggregate corridor). The amount is determined by (or subject to) the corridor in the captive's aggregate retention - typically 125%. Security is provided by Letter of Credit, 114 Trust, or cash for the captive gap.

VI). Surplus and Dividend Strategy

Planning the most efficient use of surplus (accumulated via underwriting profit and investment return), including dividend approach, needs to be contemplated within the initial operating objectives and competitive strategy of the captive:

- Retain surplus within the captive to offset future costs, fund or offset lasers, increase retained risk, enhance benefits, reduce or stabilize employee contributions, fund "premium holidays" or return to members as a dividend.
- Dividend distribution will typically create a (potentially dual) tax event for members. As stated above, it can be much more efficient to deploy surplus to reduce the overall cost of risk financing through the captive.

The primary objective of a group captive is (or should be) to reduce and stabilize the ultimate cost of risk and benefit delivery over time. With that in mind, it usually makes more sense to use the surplus to offset the cost of assuming risk by captive members rather than to return direct dividends.

VII). Considerations for Evaluating Captive Participation

Making use of an MSL captive is a collaborative process involving the client and their consultant/broker, along with the (re)insurance carrier. Client suitability for captive participation is predicated upon their financial management and employee benefit objectives, followed by the selection of the most efficient structure to achieve those objectives. As stated earlier, self-funding is based on retaining predictable segments of risk, while transferring the more unpredictable risk layers to an insurer. Appropriateness for participation in a captive is determined by an employer's ability to assume additional risk, along with a slight increase in administrative responsibility, to achieve an enhanced reduction in overall plan costs.

In terms of appropriate characteristics, size is the first consideration. Can the entity efficiently (and perhaps sufficiently) assume enough credibly predictable risk to achieve a commensurate return? For single-parent captives, assuming the owner is adding MSL to an existing captive, $1 million of premium is a standard benchmark for minimum appropriateness. For group captives, the minimum threshold is generally ten employer groups, a total of 1,000 lives (averaging 100 lives each), and $2.5 million of premium, with a more homogenous

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VII). Considerations for Evaluating Captive Participation *continued*

(industry-specific) member composition being preferable from an underwriting standpoint. As outlined earlier, the more heterogeneous the group, the larger it needs to be to attain an appropriate spread of risk across various industry classifications and employer sizes.

Expense transparency is a significant consideration when evaluating group programs. It is prudent to avoid any program that does not provide a detailed and unbundled disclosure of the gross-to-net expense structure with complete transparency. Typical fees include fronting fees, reinsurance, taxes, brokerage commissions, program expenses and captive management fees. The greater the fixed program expenses charged to the program, the less funds ultimately available in loss funds to pay claims, be retained as surplus, and eventually returned to members in the form of reduced costs or dividends. A discerning approach needs to be taken when evaluating programs - especially concerning expense structures approaching the mid to high 30 percent range or more, which is relatively common.

Other group captive evaluation considerations should include:

- Length of tenure with the current (and any prior) carriers: Speaks to the stability of the program
- Underwriting guidelines for new members: Admittance standards, minimum acceptable loss history,etc.
- What is the program's history in terms of surplus accumulation, dividend returns, or collateral calls?
- Member requirements for participation in risk management programs, wellness initiatives, etc.
- Exit parameters: Are there any handcuff provisions such as surplus forfeitures? What is the timeline for the return of collateral?
- What is the voting voice of members: Do they have input on the direction, structure, surplus allocation, membership standards, service providers, etc.?

Whether a single-parent or group captive, all employers should demonstrate the following: appropriate financial stability, a willingness to assume risk, and a commitment to sound risk management and the promotion of improved employee health and wellness. As stated earlier, MSL captives should not be viewed strictly as a mechanism for saving money on the MSL premium, but rather incorporating the use of a captive as a contributing component for reducing the overall cost of delivering healthcare benefits. A long-term commitment by the employer is essential.

VIII). State, Federal, and Domicile Regulatory Considerations:

For MSL captives, it is important to differentiate self-funding and MSL insurance from the healthcare insurance plan itself. This distinction is essential because the captive is a separate entity, unconnected to the actual benefit plan (The Plan) provided to employees. The U.S. Department of Labor (DOL), by way of the Employee Retirement Income Security Act (ERISA), has regulatory jurisdiction over The Plan itself, but does not regulate insurance. Within a self-insured structure, the employer assumes the financial liability for all of The Plan's claim obligations. MSL coverage, purchased by the plan sponsor, does not insure The plan; rather, it indemnifies

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VIII). State, Federal, and Domicile Regulatory Considerations: *continued*

the sponsor for its claim obligations to The Plan. In this regard, the DOL only regulates a plan sponsor's responsibilities as they relate to overall plan administration and the delivery of benefits to employees. Individual states regulate insurance, including MSL. However, since The Plan is self-insured (and specifically deemed by ERISA not to be insurance), state insurance mandates are preempted and are therefore not applicable to The Plan itself.

As a recognized insurance entity, a single-parent captive can direct-issue an MSL policy to its parent (the employer). Since the captive is only providing coverage to its parent, this is more of a financial sheet transaction rather than an actual insurance arrangement and is not subject to state insurance regulations. Domicile regulators, however, will require the captive to issue a formal MSL policy, establish appropriate capitalization and surplus ratios, and charge appropriate rates commensurate with the MSL risk assumed by the captive.

Group captives, because they are comprised of unrelated entities, typically need to have an authorized insurer (ceding/front carrier) who will issue filed and approved MSL policies to members.

All captives need to be appropriately authorized and licensed for the line of business by their domicile of incorporation. A formal business plan would need to be submitted to the domicile and approved by the domicile regulator.

Employee Benefit Captives and DOL approval

Any employee benefit insurance coverage that provides coverage directly to an employee will require an ERISA Prohibited Transaction Exemption (PTE) from the U.S. Department of Labor (DOL) for inclusion of that coverage into a captive. Since the self-funded medical plan itself is not part of the MSL captive, it does not require a PTE. MSL is not recognized by either the DOL or the Internal Revenue Service (IRS) as an employee benefit coverage or as a plan asset, and, as mentioned previously, it insures the employer rather than the employees. Since it is not considered employee benefit coverage, and since neither the DOL nor ERISA has regulatory jurisdiction, a Prohibited Transaction Exemption (PTE) does not apply to an MSL captive, and is not required from the DOL.

IX). Risk Management Initiatives

Just as self-insured casualty programs utilize loss control techniques to improve employee safety and mitigate claims, it is imperative for self-insured health care plans to employ effective cost-containment measures. Most of the traditional risk mitigation efforts have focused on plan-level initiatives. Programs such as utilization review, large case management, and directly negotiated provider discounts have long-standing proof of their effectiveness for reducing the cost of claims after they occur. Newer initiatives, such as employee wellness programs and predictive modeling, strive to preemptively reduce claim expenses by improving the overall health of the employee population. Increasing employee wellness will significantly decrease the cost of providing employee health care coverage not immediately, but over time, as the effects of the wellness program mature. More progressive plans incorporate elements such as referenced-based pricing, virtual (telemedicine) care, and medical tourism into their design, as additional cost-reduction techniques.

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IX). Risk Management Initiatives *continued*

For MSL captives, it is especially important to direct risk control attention towards higher-cost claims that have the potential to penetrate both the employer's and the captive's specific layers. As stated at the beginning of this document, the frequency of large claims has increased significantly in the post-ACA environment. Initiatives that employ the use of designated centers of excellence (COEs), specialty pharmaceutical management, and organ transplant coverage, among others, can generate significant savings within the captive's risk layer.

There will be some increase in fixed costs associated with the implementation of some risk management initiatives; however, the savings generated by the corollary reduction in claims costs - a much more significant expense - will offset the initial costs over time.

X). Conclusion

Interest in self-funding and MSL captives will continue to grow as medical costs continue to rise and an uncertain regulatory environment threatens the amount of control employers can maintain within more conventional insurance structures. Properly structured captives can significantly reduce and stabilize the cost of MSL coverage and facilitate enhanced benefit delivery for many employers.

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About the Authors

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Phillip C. Giles has more than 30 years of Accident and Health and Property and Casualty alternative risk experience and leads business development initiatives for MSL Captive Solutions.

In 2020, Phil was named Reinsurance Specialist of the Year by Cayman Captive Magazine. In 2017, Phil was presented with the Captive Professional of the Year recognition at the U.S. Captive Awards. He has been named to Captive Review's Power 50 listing of most influential individuals in the worldwide captive insurance industry and is a regular content contributor to several industry publications.

Phil holds a bachelor's degree from Western Illinois University, as well as the Certified Employee Benefit Specialist (CEBS) professional designation from the International Foundation of Employee Benefit Plans and the Wharton School of the University of Pennsylvania.

About MSL Captive Solutions, Inc.

MSL Captive Solutions is the insurance industryís only platform dedicated exclusively to the development and delivery of comprehensive (re)insurance and service solutions for medical stop loss captives.

We operate independently to work closely with all qualified brokers, consultants and captive managers to structure customized single-parent and group captive solutions that meet the specific risk and financial objectives of their self-funded clients.

Our stop loss captive solutions are designed to achieve the most efficient balance between risk assumption and risk transfer to reduce market volatility and optimize savings.

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