Captive Insurance Can Be Tool for Enterprise Risk Management

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A captive insurance company can be a valuable enterprise risk management (ERM) tool if structured properly and focused on risk management.

Captives are wholly owned insurance subsidiaries structured to insure the risks of their parents. If the captive covers only one healthcare entity, it is known as a single-parent captive, and a captive covering more than one entity is known as a group captive. Either way, it is structured to fund its parent's risk. It operates outside the commercial marketplace, which enables it to fund any predictable risk — not just traditionally insurable risk. This enables the risk-centric captive to be a valuable ERM tool.

Not Just a Checkbook

Captive regulation is designed to ensure solvency and liquidity, but also provides the flexibility needed to address its parent's unique risks and risk financing goals. However, a captive requires capital and may be expensive to operate. Therefore, a captive that is not risk-centric can be a very inefficient risk management tool. A properly managed risk management-centric captive, on the other hand, can help drive the parent's ERM program.

A captive used as a "checkbook," with the primary purpose to support a fronted insurance program, is not ERM or even traditionally risk management-centric. Furthermore, it may be an inefficient use of capital and credit needed to collateralize the commercial front's credit risk. There may be other risk financing solutions that would not consume capital, and available lines of credit, that should be considered.

An ERM or risk management-centric captive is one that is used to promote risk management within the parent organization. To this end, the captive's board should be a diverse group providing a multidisciplinary approach to captive and risk management. Each board member should bring expertise needed to manage the captive properly, such as finance, parental operational knowledge, law, and risk management. The captive board meeting agenda must include detailed presentations about program structure, analytics, underwriting, reinsurance, and detailed reports about the parent's claims, loss prevention, and loss reduction programs.

The board also will spend time on the captive's strategic planning to determine how the captive can be used to increase support of the parent's risk management program, enabling it to meet its business goals. This requires an understanding about risk identification, assessment, and the parent's strategic goals and risk profile.

Captive Can Be Transformative

Therefore, the mission of an ERM-centric captive requires it to have a transformative effect on the parent's corporate risk management program and strategic business goals. A captive that proactively and proficiently improves its parent's risk financing and risk control program is transformative because it is contributing to the growth of the parent's and its stakeholders' value. Regardless if the parent is for-profit or nonprofit, increasing stakeholder value is essential for any organization's long-term resilience, competitiveness, and strategic growth.

The captive should be linked inextricably to its parent's ERM program. The question is: How do we appropriately measure a captive's effect on ERM?

One quantitative measure of a captive's contribution to stakeholder value is the return on capital invested by the parent or insured/member (also known as the shareholder) in the captive. If the return on capital invested in the captive is greater than the member organization's weighted average cost of capital, then the captive is creating economic value. But is this a fair analysis?

Value Added Analysis Can Work

The risk management value-added analysis is more complicated than that. According to a quote from Captive Insurance Company Reports in August 2012, ERM can turn currently unidentified and potentially consequential business or insurable risk into a quantifiable portfolio of expected loss that can be predictably funded. Again, because a captive operates outside the commercial insurance marketplace it can be used to fund all risks, not just insurable risks, if these retained risks are predictable and properly funded to manage cash flow variability.

Of course, the captive must be appropriately capitalized. Furthermore, the captive is an insurance company and can transfer risk to the reinsurance market, traditional or funded by the capital markets. A captive, therefore, is a perfect risk management tool to support its parent's strategic and ERM program.

Aim for Proactive, Transformational

How does this happen? To be proactive and transformational, a captive must have a positive effect on both risk financing and strategic business goals. Risk financing goals should focus on strategic risk financing, not simply seeking the cheapest deal or playing market cycles. For example, a firm must ensure that it can pay for its losses over the long-term regardless if it is transferring, retaining, or using a hybrid of transfer and retention to fund its portfolio of expected losses. If a firm retains a portion of its risk, then it must ensure that it has the funds to meet its self-insured liabilities and can manage cash flow variability (fluctuation in interest income and expected losses).

Moreover, the risk financing program must comply with all local insurance regulations and customs, contractual obligations, and bond covenants. The overall risk financing goal is to reduce the cost of risk or diminish its growth at a rate less than a selected financial benchmark such as the growth of revenue, earnings before interest and taxes (EBIT), net income, or surplus for nonprofits. Because the captive is an insurance company with access to the reinsurance market, it can manage expected loss variability and assist the parent's ability to manage a portfolio of risks addressing risk interdependency, minimizing budgetary and earnings volatility.

Healthcare providers have used captives to fund traditional pure risks, such as medical professional liability and workers' compensation, for more than four decades. But the dynamic nature of the healthcare industry requires a strong ERM program to manage risk and grow stakeholder value. A strong captive board that follows best captive management practices will contribute to the ERM program by improving risk culture and enhancing risk communication, addressing inherent and residual risk with a focus on the source of risk, cost drivers, and claims and risk management practices.

Addresses a Variety of Risks

Specifically, a transformative captive can be used to address a variety of enterprise-wide risks such as third-party liability, business interruption, human capital, regulatory, medical stop loss, catastrophic property loss, and cyber/privacy risks, by funding the predictable layer of risk, and transferring the less predictable portion of these risks to the reinsurance or capital markets. Therefore, the captive becomes a valued risk management partner for its parent because its board meetings (operational and strategic) will improve the risk management dialogue focusing the parent's senior management on cost of risk drivers, and all enterprise-wide risks. Additionally, emerging/evolving risks continually present new challenges to the captive for drafting captive coverage statements, forecasting expected losses, and underwriting the insurance program. This also assists with making the case for investment in improved risk and claims management practices.

Captive Board Helps Communication

It also helps when the captive has a board that understands its role, and proactively improves risk communication between the parent and the captive as a product of robust and state-of-the-art captive board meetings. Furthermore, the entrepreneurial captive can contribute to improving the parent's strategic relationships within its alliances that address population healthcare needs, such as community-based physicians or other healthcare partners, by offering these stakeholders fair market value insurance coverage and relevant risk management services. This entrepreneurial employment of the captive will enhance the healthcare provider's ability to increase market share and improve its strategic relationships.

The test for an ERM-centric or transformational captive is one that enables the parent to meet its risk-financing goals, positively affect its ERM program, and achieve strategic business goals by providing a platform to centralize and focus the parent's risk management program when driven by a highly skilled multidisciplinary risk-oriented captive board.

Again, this captive board will create a strong risk management communication channel to the parent. And this will enable the parent to address the interdependency of its risk by better managing risks as a portfolio. The captive's mission is to fund this portfolio of risk and stimulate strong risk management practices increasing the efficient use of risk capital. Strengthening risk management practices should be a natural outcome if the captive holds its parent/insured accountable for its losses as well as loss control and claims management processes through its board reporting and underwriting/cost allocation methodology.

Whether a single parent or group captive, it should be able to reduce cost of risk by pooling previously decentralized exposures for the healthcare system, its affiliates, and partners. Finally, reduction in the parent's cost of risk should grow the captive's retained earnings, which then can be used to leverage the funding of new or growing exposures, including emerging and evolving risks.

Does the captive facilitate the parent's risk financing strategy to enable achievement of its risk financing goals and consequently contribute to the accomplishment of its strategic business goals? If so, then the whole program is truly transformational because the parent has met the risk needs of its stakeholders while growing the firm value regardless of the return on capital invested in the captive.