Casualty Loss Reserve Seminar
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Current Issues and Trends in Medical Malpractice

Risk Retention Group and Captive Insurance Company Challenges

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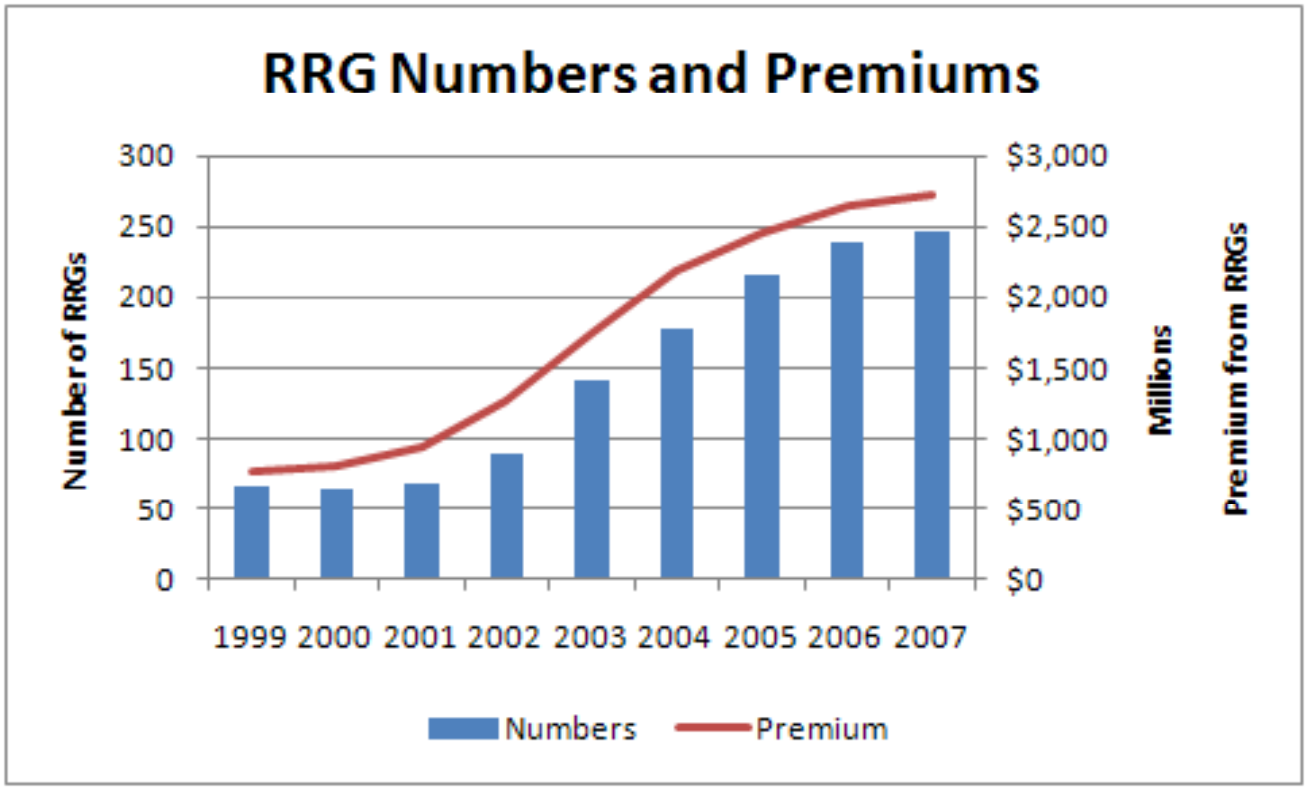
Objective

Captive Insurance Companies (Captives) & Risk Retention Groups (RRGs) face somewhat different challenges than commercial insurance companies. We will discuss some unique reserving and SAO challenges associated with captives & RRGs that write medical professional liability coverage.

Background - RRGs

- RRGs were made possible by the Federal Risk Retention Act that was passed in 1986
- The Act is Federal legislation that provides a mechanism for an RRG to operate in multiple states under one license
- RRGs can be domiciled anywhere in the U.S.
  - Vermont is the leading domicile with roughly 30% of total RRGs
  - South Carolina, D.C., and Nevada are other popular domiciles

Background - RRGs

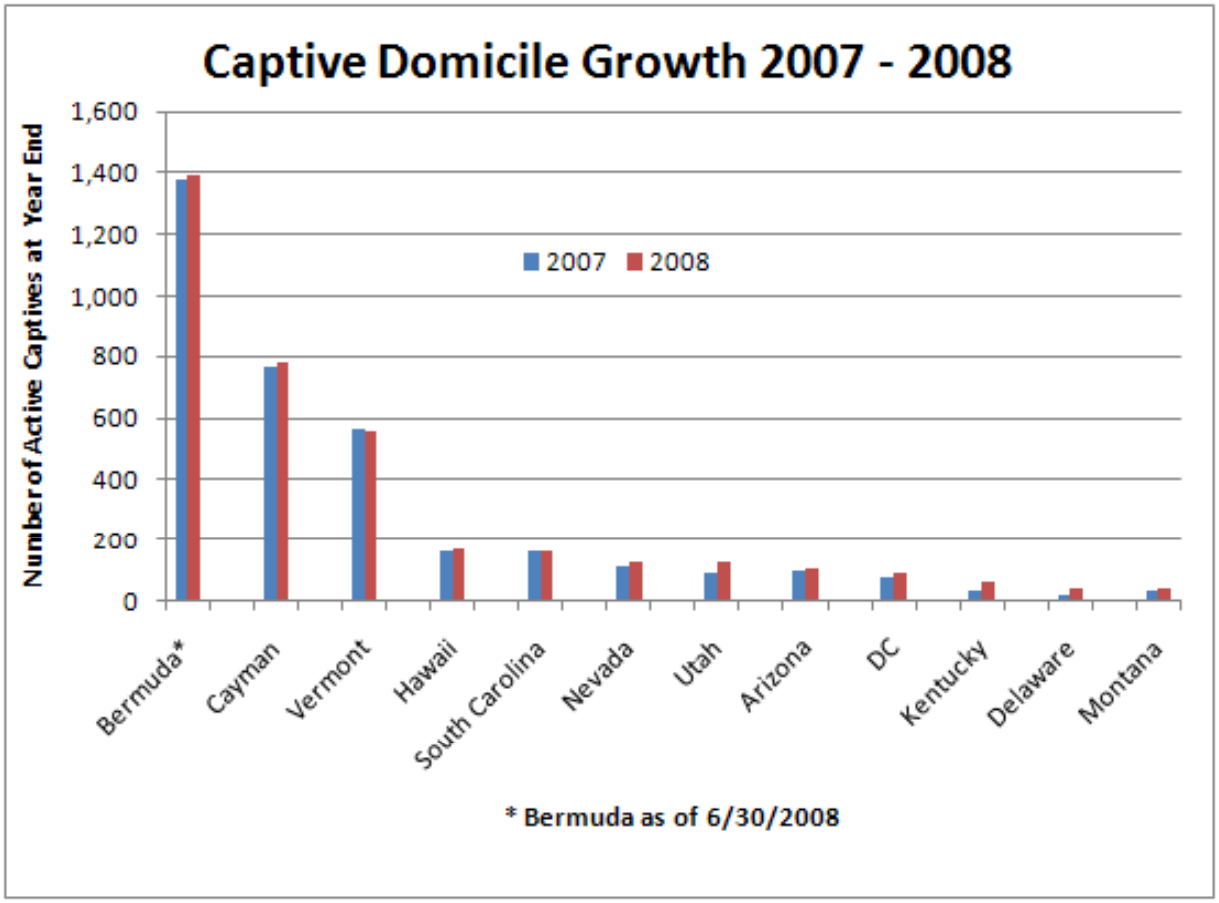


Source: Strategic Risk Solutions Newsletter Q3 2008

Background - Captives

- A captive is simply an insurance company owned by the parent company that underwrites the insurance needs of the parent company and its subsidiaries
- Nearly all major corporations have captives
- More than half of the states have now passed captive insurance enabling statutes, and more than a half-dozen of those states now aggressively cater to the domestic captive market
  - Vermont, Hawaii, and South Carolina are major domiciles for captives
  - Nevada, Utah, Arizona, D.C., Kentucky, Delaware, and Montana are emerging domiciles for captives
- Unlike RRGs, Captives can be formed outside of the U.S.
  - Bermuda and the Cayman Islands are major domiciles for captives

Background - Captives



Source: Strategic Risk Solutions Newsletter Q1 2009

Captive and RRG Regulation

- Minimum Capital Requirements – The majority of RRGs were licensed and are regulated under captive laws which have much lower minimum capital requirements than traditional insurance laws
- Inconsistent Reporting
  - RRGs are required to produce the standard yellow blank filing, although some states allow RRGs to use a modified version
  - Non-domestic Captives are not required to produce the standard yellow blank filing
- Other Differences in Accepted Practices – Many practices that are not accepted for traditional insurers are accepted for RRGs and Captives (Letters of Credit, Surplus Notes, Discounted Reserves, etc.)

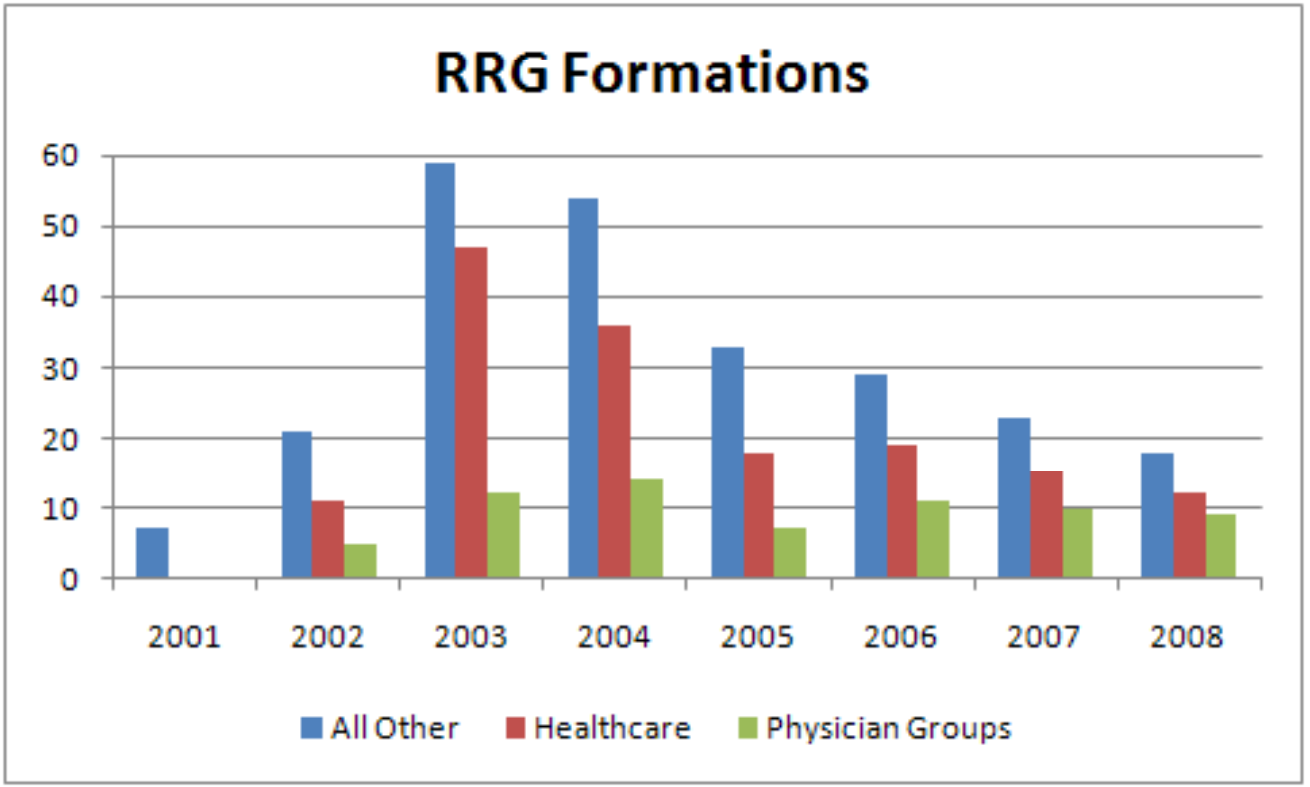
Captives and RRGs for Medical Malpractice

- The Medical Malpractice insurance market is localized and somewhat independent of market cycles. There continue to be areas that are not well served by the commercial market opening the door for Captive and RRG formation.
- Some hospitals and health systems utilize both a domestic RRG and an off-shore Captive for their Medical Malpractice program.
  - Domestically licensed RRGs can provide insurance policies to meet financial responsibility laws
  - Off-shore Captives used to be more commonly used than they are today

Captives and RRGs for Medical Malpractice

- Healthcare and physician groups represent a large percentage of RRGs formed over the past several years
- Although RRG formations have declined in recent years, formation of healthcare and physician group RRGs has remained relatively constant
- There are currently roughly 250 active RRGs and approximately half of these are related to healthcare or physician groups
- The use of Captives for medical malpractice remains common
- Premium has been growing at roughly 10% per year for physician owned RRGs

Captives and RRGs for Medical Malpractice



Source: Strategic Risk Solutions Newsletter Q2 2009

Reserving Challenges

Captives and RRGs are often allowed to carry Letters of Credit, Surplus Notes, and other types of assets not allowed for traditional insurance companies.

Assets such as Letters of Credit that do not generate investment income can become an issue in combination with discounting (see following example).

Reserving Challenges

Example: Invested assets are in risk-free investments yielding 3.0%

1) Undiscounted Reserves	$5,000,000
2) 3.0% Discounted Reserves	$4,500,000
3) Surplus	$1,000,000
4) Total Liabilities = (2) + (3)	$5,500,000
5) Letter of Credit	$3,000,000
6) Other (Invested) Assets	$2,500,000
7) Total Assets = (5) + (6)	$5,500,000
8) Investment Income = (6) x 3.0%	$75,000
9) Total Investment Rate = (8) / (7)	**1.4%**

Reserving Challenges

Captives and RRGs tend to be used to cover:

- One line of business (for example Medical Malpractice only)
- A very specific group of similar insureds
  - All at the same location or very similar locations
  - Similar specialties of physicians or few hospital specialties
- Often a relatively small group of insureds (compared with an insurance company situation)

Reserving Challenges

These cause reserving challenges because:

- Medical Malpractice is a highly volatile line of business with great variability in size of losses
- Lack of applicable industry sources of information for the specifics of the RRG or Captive
- No spread of risk across regions, lines of business, underwriting groups, etc.
- Credibility issues

All of these lead to a much larger range of reasonable estimates. This, along with lower minimum capital requirements, can lead to audit issues depending on the audit firm's range of reasonable estimates.

Reserving Challenges

Captives and RRGs are used to cover the parent company (or the physicians that own the RRG). Thus they are operated for a purpose other than profit and this tends to lead to a bias in favor of lower premiums.

This bias in favor of lower premiums increases the probability of needing a premium deficiency reserve.

Statement of Actuarial Opinion Challenges

- Lower minimum capital requirements for Captives (used for the majority of RRGs also) make choosing a materiality standard important/tough
- Lower minimum capital requirements along with the volatility of Medical Malpractice make it much more likely to have to declare a Risk of Material Adverse Deviation
- Modified yellow blanks (some RRGs) or no yellow blanks (offshore Captives) do not allow for the common SAO wording and structure
- Schedule P Reconciliation is impossible with no yellow blank and can be difficult for RRGs or Captives only insuring their parent health system if the parent's fiscal year is not calendar year

Questions?