MARSH

CAPTIVES: DECISION POINTS AND TIMING FOR PHYSICIAN ROLLUPS

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MARSH & McLENNAN COMPANIES

Captives: Decision Points and Timing for Physician Rollups

Today's Panel

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Captives: Decision Points and Timing for Physician Rollups
Discussion Topics

- State of the Physician Medical Malpractice Market
- Captive Feasibility Process
- Implementation
- Operations

State of the Physician Medical Malpractice Market

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State of the Physician Medical Malpractice Market

- The Medical Malpractice insurance industry was unprofitable in 2019.
  - 107% combined ratio.
  - Sixth consecutive year of underwriting losses.
- Rates increasing in all specialties.
- Specialty insurers have witnessed a decline in market share, driven in part by the rise of hospital and super-group employment of physicians.
- M&A activity among medical malpractice insurers continues.
- Record number of jury verdicts greater than $10 million from 2017- 2019.
- Although claims frequency remains flat at historic lows, severity is on the rise.

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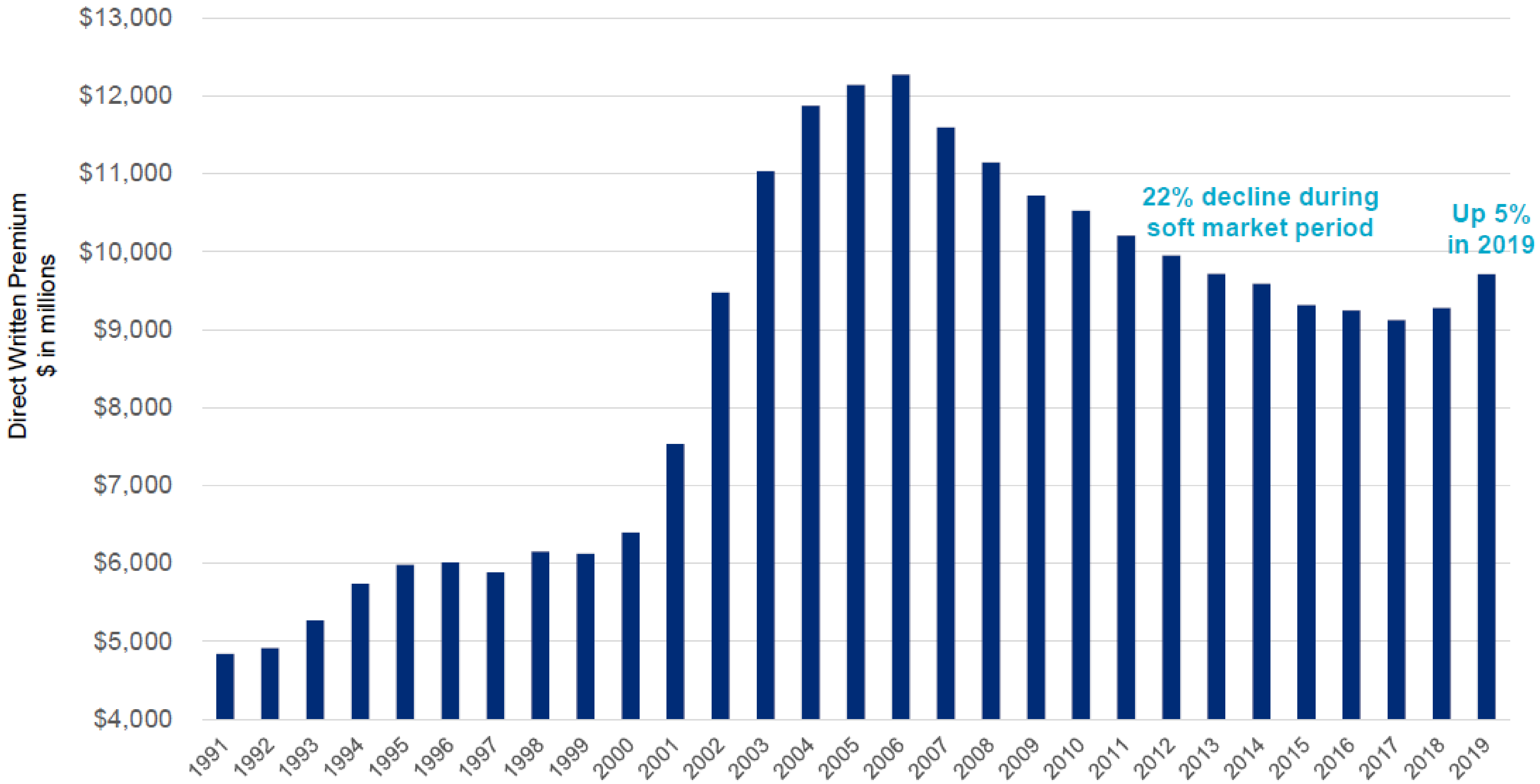
Industry MPL Premiums are on the Rise



Source: S&P Global

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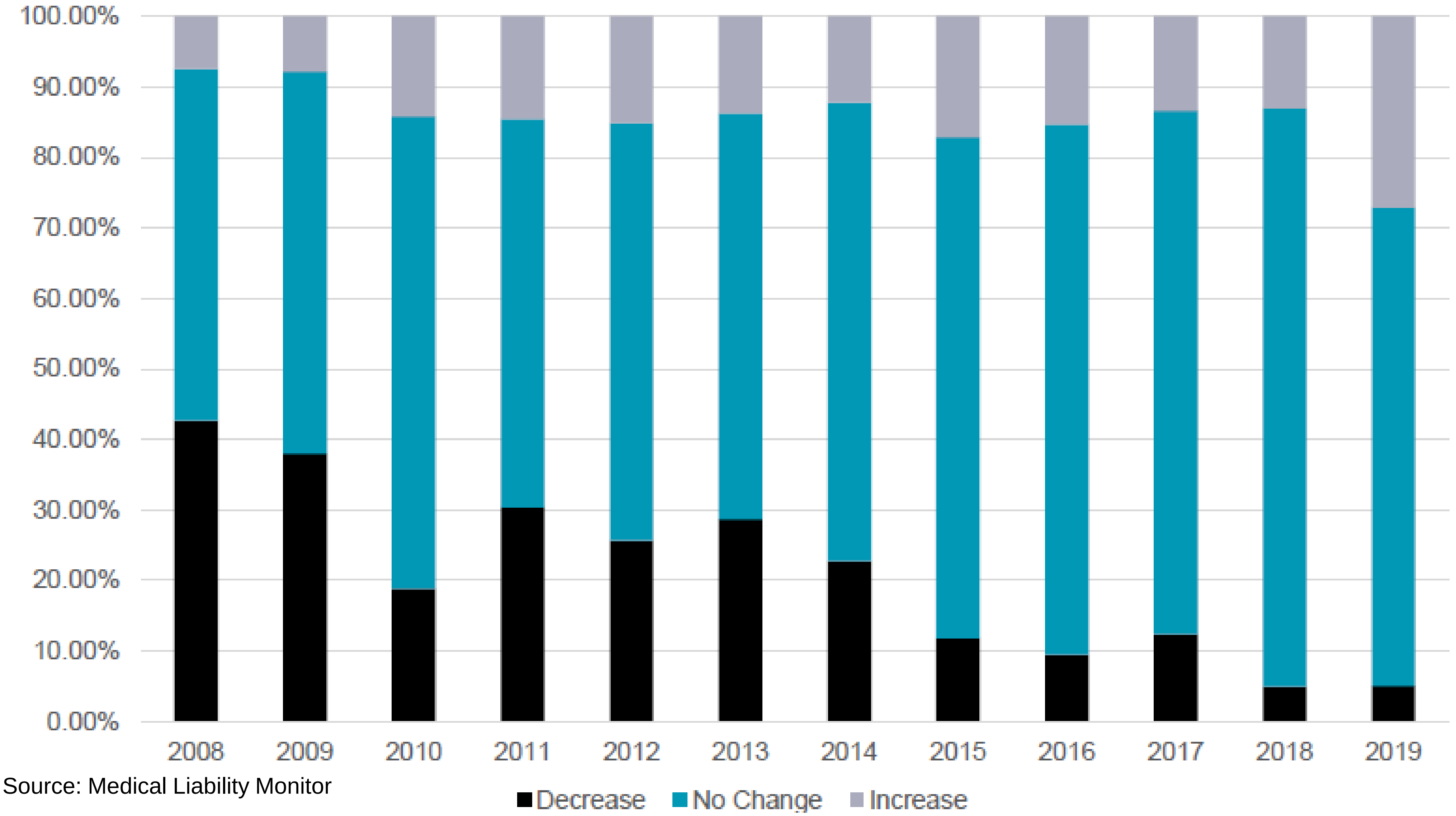
More Insurers are Increasing Their Physician Rates



Source: Medical Liability Monitor

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The Impact of COVID-19

- **Premiums** are on the rise.
- **Claim frequency** has declined.
- **Liability immunity protections** have been enacted.
- **“Halo Effect”** may result.

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Possible COVID-19 Allegations of Negligence

- Failure to diagnose.
- Delay or denial of deemed “elective” or “non-essential” care to patients that is later asserted to be critical in the course of treatment.
- Alleged negligence whereby patients and family members are infected with COVID-19 by “community spread” in a clinic or office setting.
- Alleged negligent mistreatment of COVID-19.

Feasibility Process

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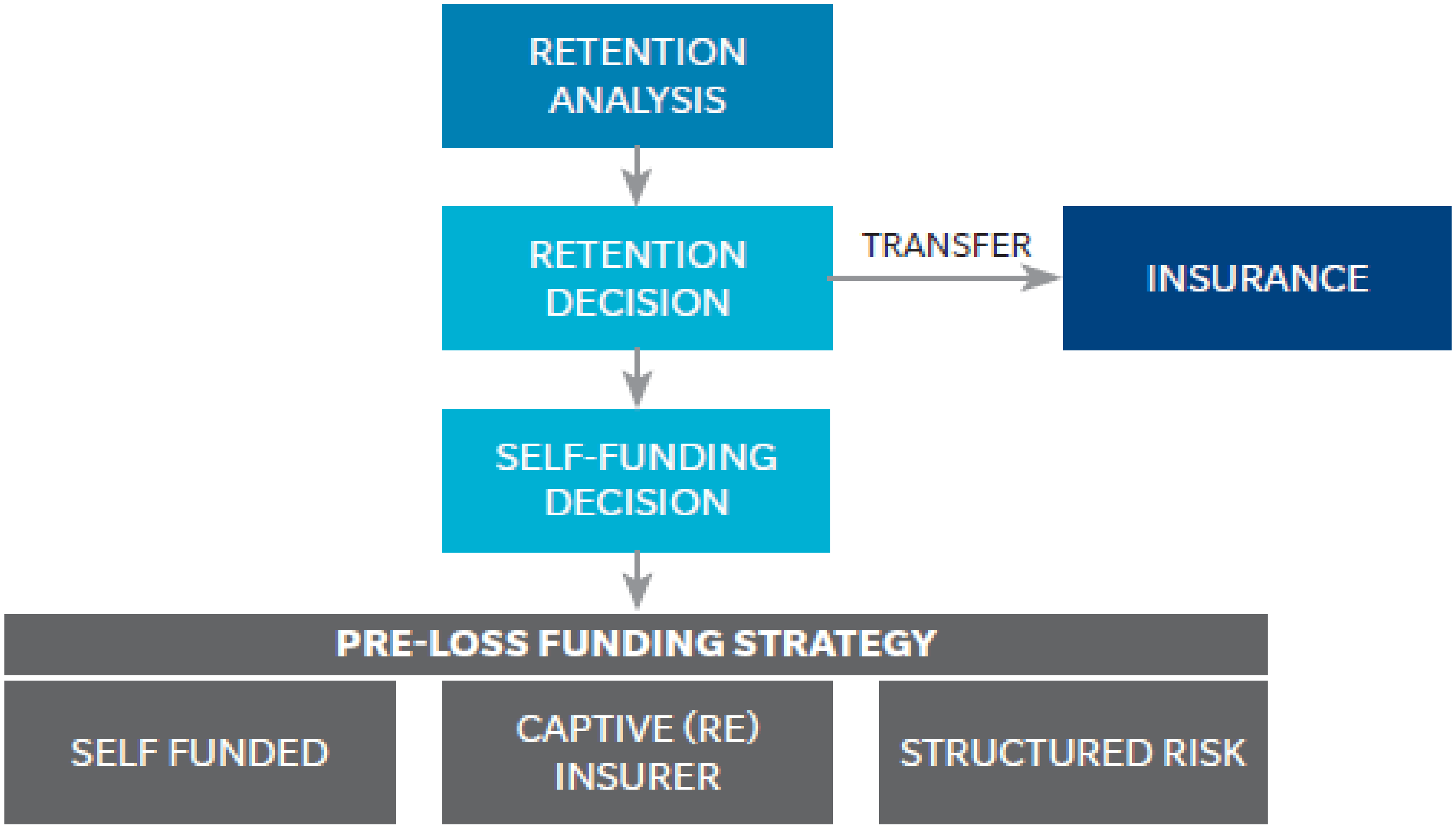
Basics: Retaining Risk Versus Financing Risk



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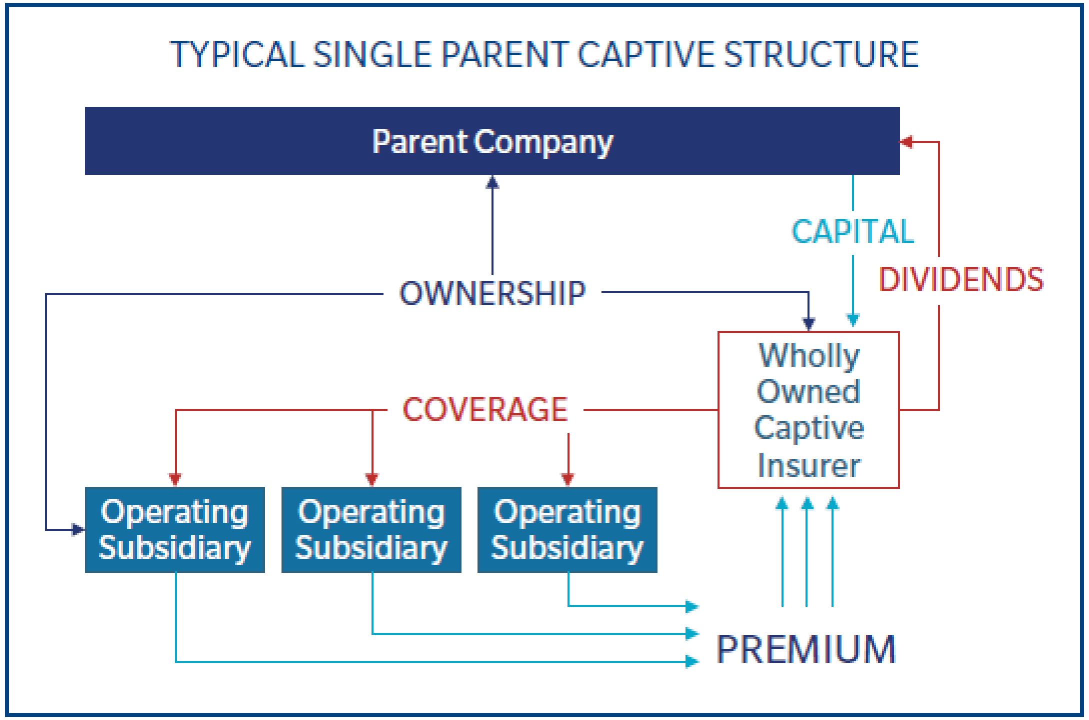
What Is A Captive? Widely Accepted Definition

A captive insurance company is a **bona fide** licensed insurance or reinsurance company owned by a non-insurance company and which insures or reinsures the risks of its parent or affiliated companies.

Simply put – it is a formalized mechanism to **finance self-insured** risks.

The decision to retain risk by the organization has already been taken.

Structure



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Key Considerations in Evaluating a Captive

- Actuarial analysis – loss forecasting and premium pricing.
- Reinsurance.
- Capitalization.
- Tax issues.
  - Obtaining federal income tax treatment as an “insurance company.”
  - Domicile premium and state self-procurement taxes (Dodd-Frank Act).
- Long term commitment and opportunity cost.
- Ability of captive to withstand deviation from expected losses.
- Exit issues as liabilities are long-tailed in nature (plan the end at the beginning).
- Additional time and resources to implement and operate captive.
- Start up and annual ongoing captive general and administrative costs.

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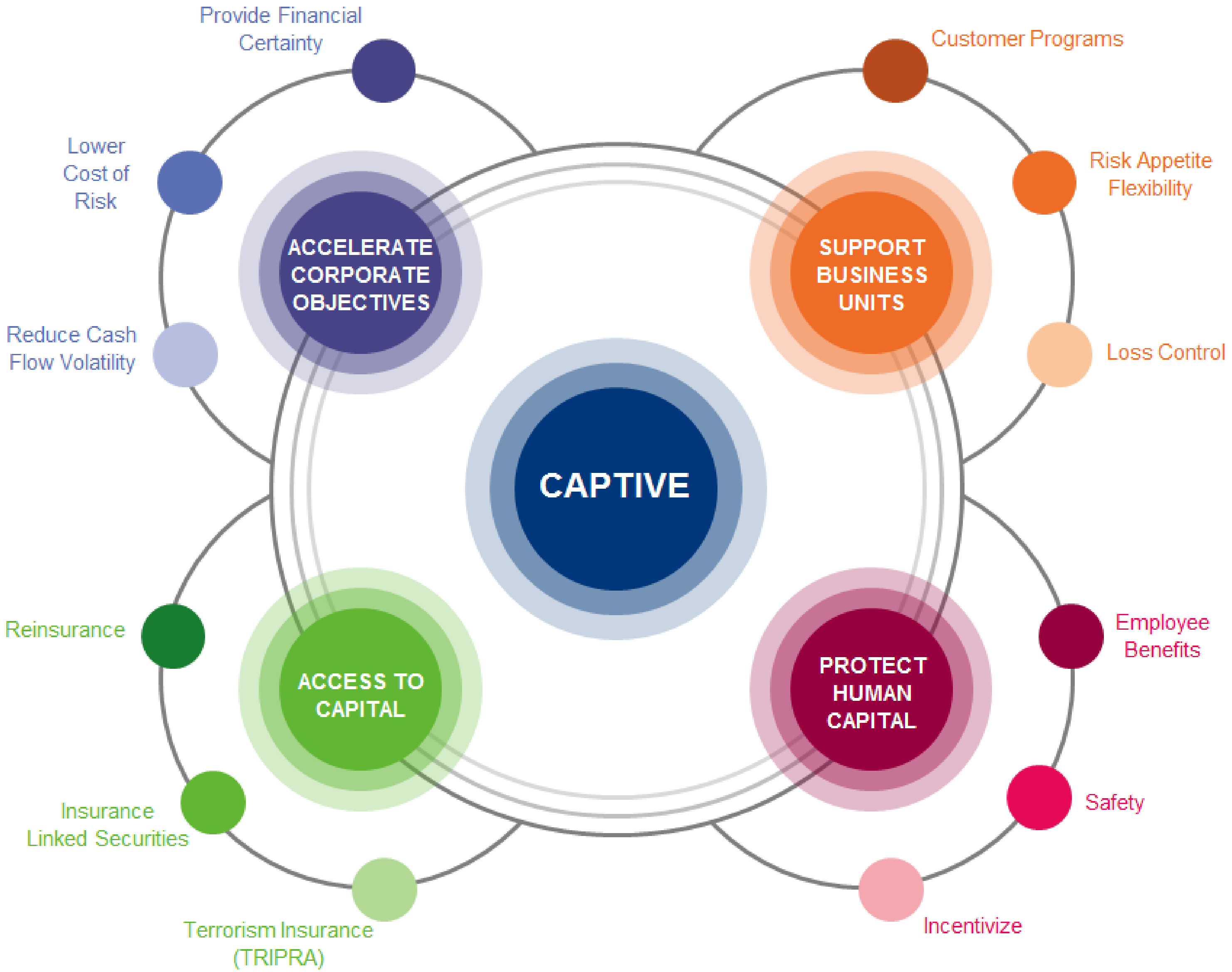
How Captives Serve as a Risk Management Tool



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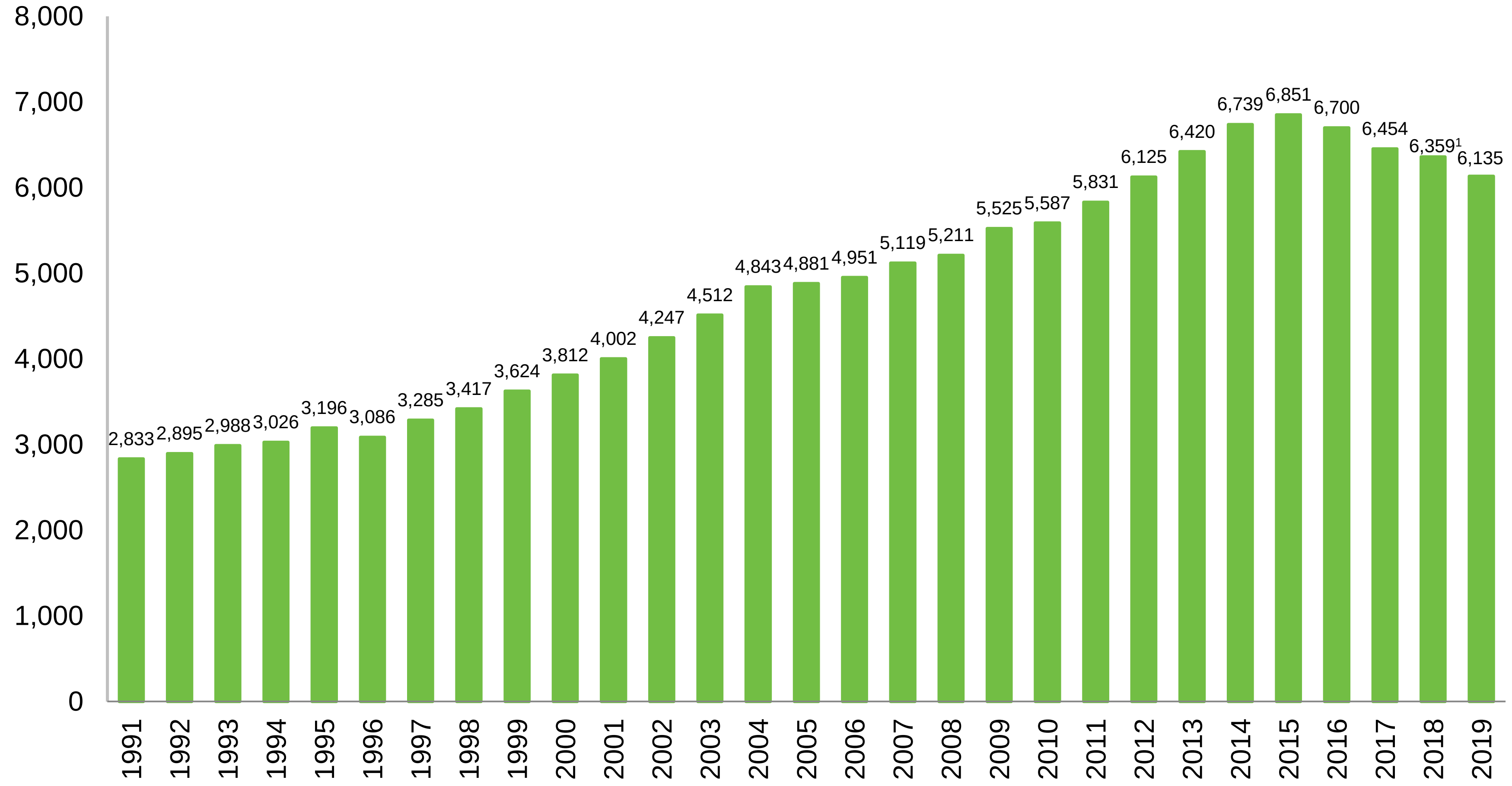
Number of Captives Worldwide YE2019



Source: Business Insurance, 2020 Captive Managers & Domiciles, Rankings + Directory: 8
*2018 is restated. (1994 to present), Source: Insurance Information Institute (1991-1993)

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Types of Captives

Single Parent (largest sector)	• Wholly owned by one parent company.	• Insures or reinsures the risks of its parent, affiliated entities, or chosen unrelated parties.
Group/ Association	• Owned by multiple companies or an association, and insures or reinsures the risks of the group.	
US Branch	• A division of a single parent captive that is usually formed in the US (as a branch of a Bermuda or Cayman captive).	• Allows a company access to TRIA and US employee benefit coverages that are required to be in a US domicile.
Risk Retention Group **(US only)**	• Regulated under US federal legislation, licensed in one state, and able to operate in all 50 states on a registered basis.	• Can only write liability lines of risk, not workers' compensation (WC).

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Types of Captives

Rent-A-Cell

- Formed by a third-party sponsor that “rents” cells to outside companies.
- Liabilities and assets of each cell are separate from other cells.
- Each cell owner is usually required to capitalize that particular cell.
- There are three forms of Rent-A-Call captives:

Protected Cell Company (PCC)	• A single legal entity comprised of a core, and a number of segregated parts, or “cells, ” each of which is completely independent and separate from the other cells, as well as from the core of the company. • A PCC is formed by a sponsoring entity who manages the PCC through a board of directors and provides minimum regulatory and operating capital (the “core”).
Incorporated Cell Company (ICC)	• An ICC is very similar to a PCC except that each ICC cell is individually incorporated which means that each ICC cell is in fact its own legal entity. • Many domiciles currently only offer PCC legislation.
Segregated Cell Captives	• Segregated Captives are an offshoot of rent-a-captives or Protected Cell Captive (PCC) – they are a typically a single entity, but the assets and liabilities of its individual cells are protected from each other. • They offer the benefits of a group captive but with lower startup costs. • Often formed by organizations that are too small to access normal reinsurance markets directly.

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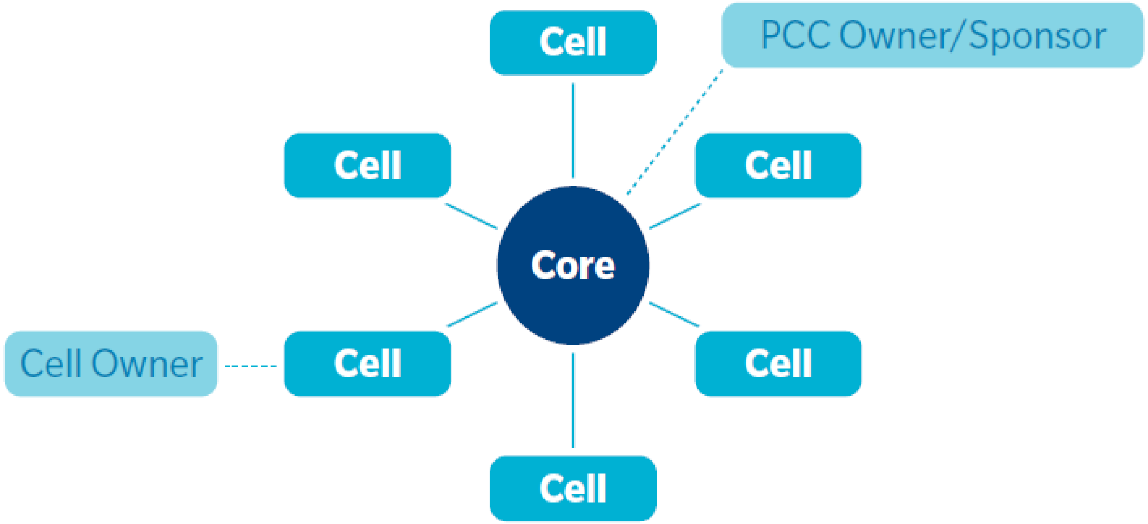
Protected Cell Captive (PCC)

- A Protected Cell Captive (PCC) is a type of captive insurance company regulated under special legislation in its domicile (onshore or offshore):
  - Other types of captives include single parent or pure captives, group captives, and risk retention groups.
- A PCC is a single legal entity typically sponsored by an insurer, insurance broker, or agency:
  - The sponsor contributes core capital to license the entity and typically provides the board of directors.
  - The company is divided into a number of cells and a core.



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Cost Issues for Consideration

Captive Feasibility Study	Fees on average range from US$35,000 to US$75,000.
Start Up Costs	Regulatory, legal, actuarial, and implementation fees (approximately US$40,000 to US$50,000 depending on domicile).
Annual Operating Costs	Regulatory, legal, actuarial, audit, and captive management fees (approximately US$80,000 to $125,000 per year).
Captive Domicile Premium Tax	Only imposed by select onshore captive domiciles.
Offshore Government Fees	Applies in some offshore jurisdictions such as Bermuda and the Cayman Islands.
Self Procurement Tax	US state premium tax imposed on an insured by its “home state” when procuring insurance from a non-admitted insurer such as a captive (tax due by state ranges from 0 to 6% which may be imposed on the total US premium at the “home state” rate or assessed on allocated premium by state at the individual state tax rates (home state would collect and allocate the tax out).
Capitalization	Typical premium to capital ratio required ranges from 3:1 (more severity type risks such as property) to 5:1 (more predictable risks such as casualty) and may be met through cash or a letter of credit depending on domicile.
Opportunity Cost on Funding Captive Premium	Ability for captive to mirror investment returns on cash flow used to support premiums versus if cash had remained with parent company.

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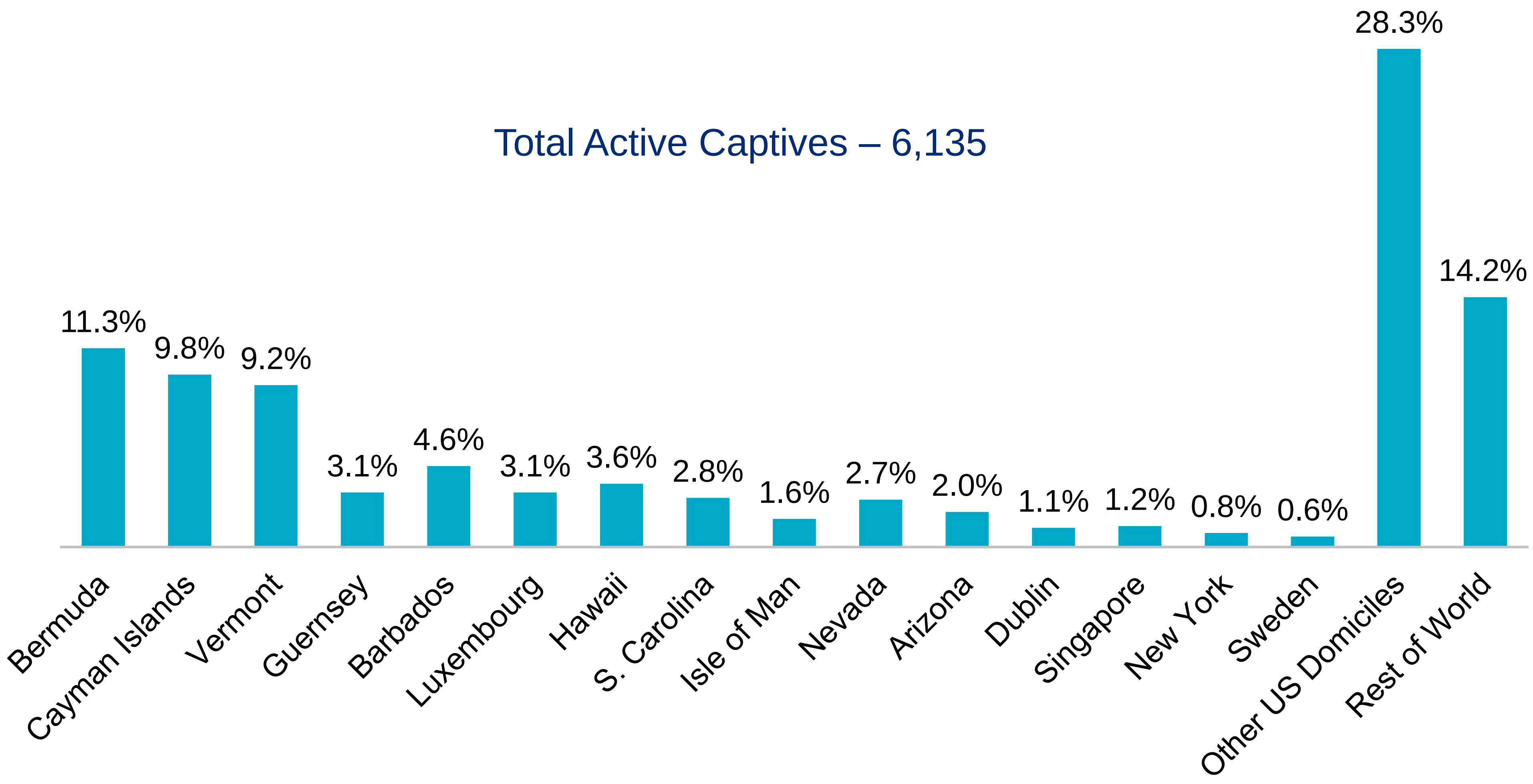
Global Captives by Domicile Year-End 2019



Source: Business Insurance, 2020 Captive Managers & Domiciles, Rankings + Directory: 8

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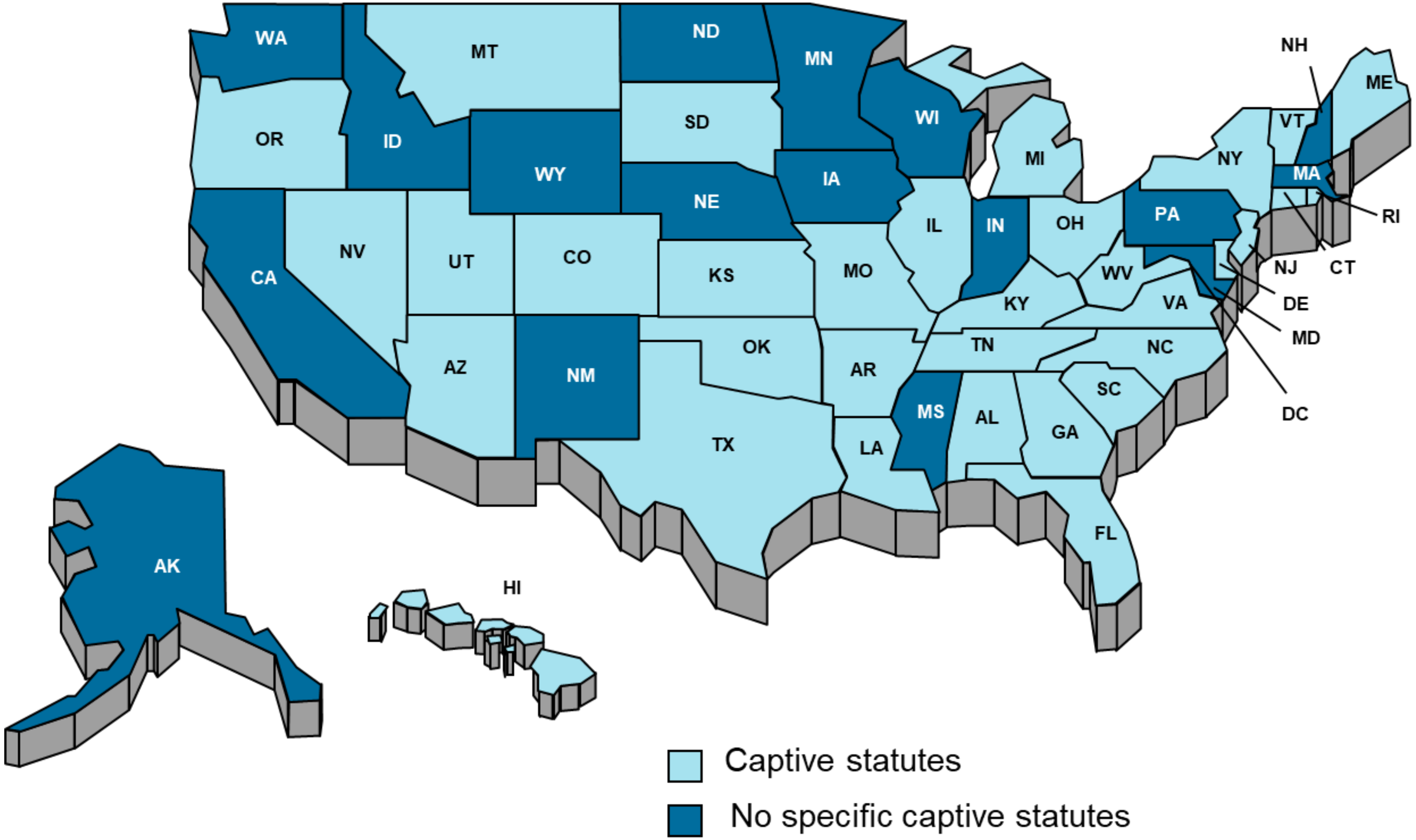
US Domestic Captive Domiciles Year-End 2019



Captive Domicile, Number of Captives

Alabama	48
Arizona	128
Arkansas	9
Colorado	7
Connecticut	17
Delaware	366
Wash., D.C.	104
Florida	0
Georgia	52
Hawaii	231
Illinois	4
Kansas	1
Kentucky	64
Louisiana	0
Maine	3
Michigan	24
Missouri	52
Montana	123
Nebraska	4
Nevada	174
New Jersey	21
New York	49
North Carolina	235
Oklahoma	11
Ohio	6
Oregon	0
Rhode Island	0
South Carolina	179
South Dakota	16
Tennessee	140
Texas	45
USVI	5
Utah	435
Vermont	585
Virginia	0
West Virginia	0

Source: Business Insurance, 2020 Captive Managers & Domiciles, Rankings + Directory: 8 and governmental websites.

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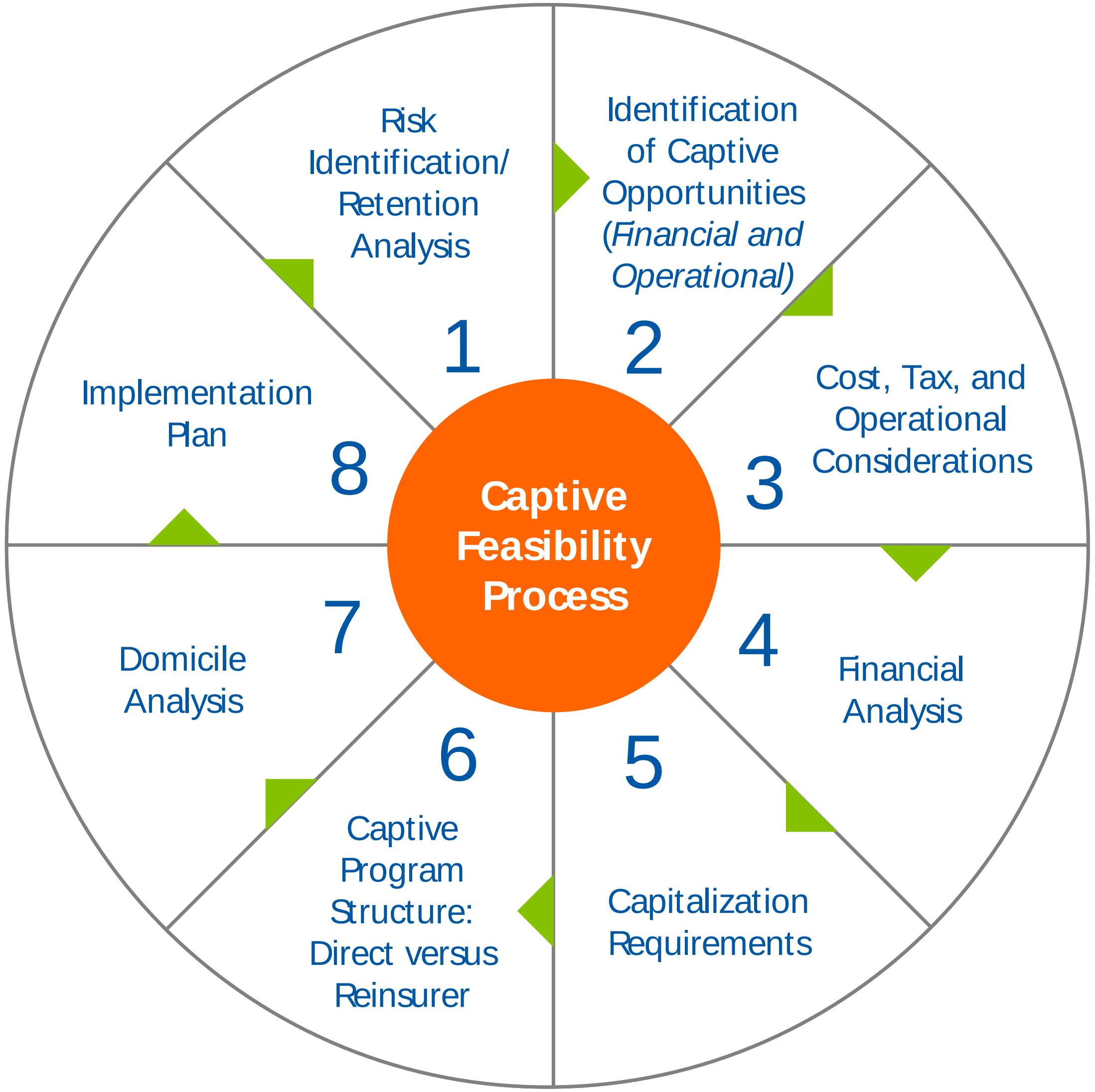
Feasibility Study Process Steps



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Next Steps

Minimum Data Required for a Feasibility Study

- Make decision to proceed with a strategic review of the captive.
- Marsh proposal for feasibility study:
  - 30 to 90 days to complete project.
- Information request will be designed by Marsh and sent to the client:
  - Parent company financial information.
  - Company organizational chart of legal subsidiaries.
  - Tax rates (US, global rates).
  - Insurance summary (noting retentions by line of coverage).
  - Allocation of payroll and revenue by state.
  - Rate of return on parent’s cash flow.

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Exit Strategies

- Run-off mode:
  - The captive **does not write any coverage** in the future.
  - The captive **remains licensed and subject to ongoing regulation and audit** until all outstanding claims are paid.
  - The parent would incur **ongoing operational expenses** on a reduced basis.

- Captive shuts down immediately and liquidates:
  - **Commutes all outstanding liabilities back to parent** (permitted for only direct placements), or transfers the obligation for the outstanding liabilities to a third-party insurer.
  - Once all liabilities have been extinguished from the captive, the parent will then need to **file a petition** to the Department of Insurance (Captive Department) to dissolve the company.
  - The parent **avoids the ongoing cost** to keep the captive operational in future years.
  - Should the parent decide to transfer the liabilities to a third-party insurer for a premium, they should **weigh the risk margin assessed** for loss volatility by the insurer **against the savings** associated with not incurring ongoing operational cost to keep the captive open.

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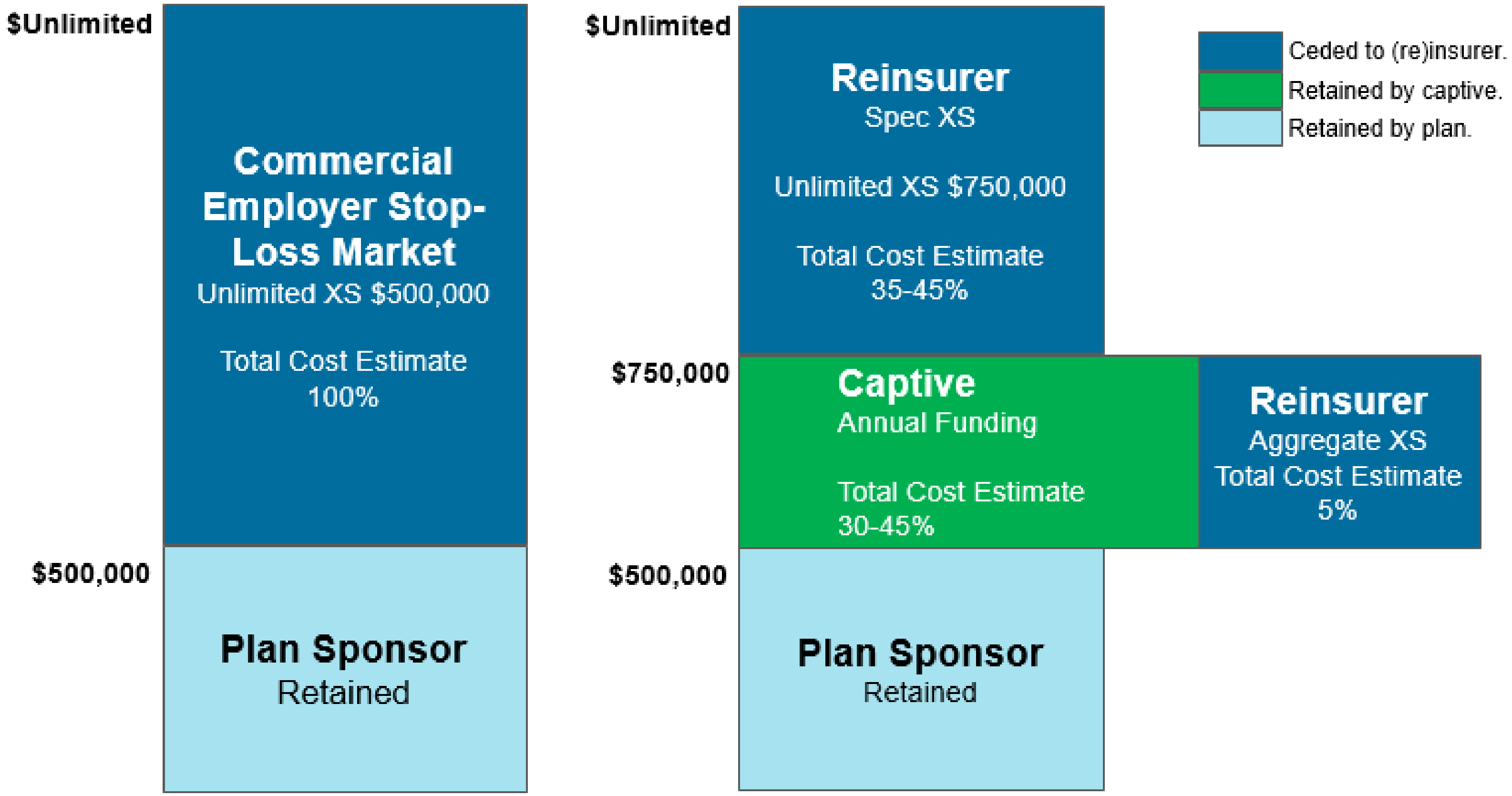
Stop-Loss Options Coverage Illustration Example



- Typical placements realize 5% to 25% in hard dollar (realized now) savings under the captive-based program.
- Additional savings available in unspent captive layer funding (soft dollar potential).
- No change in protection from large losses from plan sponsor perspective.

Implementation

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Implementation: Post-Feasibility Initial Steps

- Select captive insurance manager and domicile attorney.
- Obtain legal and tax consultant advice re structure/ownership.

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Implementation: Application for Licensure and Legal Entity Formation

Getting Started

- Choose and reserve Captive name with domicile regulator.
- Select Directors and Officers.
- Complete biographical affidavits.
- Prepare incorporation and governance documents (Articles of Incorporation/Bylaws).

Addressing the Details

- Prepare business plan.
  - Description of coverages, deductibles, coverage limits and rates.
  - Risk/loss prevention programs.
- Select auditor and actuary.
- Prepare Pro Forma Financials and Actuarial Feasibility Study.
- Confirm amount and type of capitalization.
- Draft insurance policies/ reinsurance agreements.

Last Steps

- Meet with domicile regulator to discuss conceptual plan.
- Finalize application and submit to domicile regulator.
- File for permission to form legal entity from domicile regulator.
- Proceed with filing incorporation documents to formalize legal entity.
- Hold organizational meeting (generally via written consent).

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Implementation: Application Review and Licensure by Regulator

- Approx. 30 day application review process.
- During this time, finalize organizational steps (set up bank accounts, capitalize, issue stock).
- Obtain insurance license and begin writing insurance.

Operations

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Sample Captive Governance Committee Structure

CAPTIVE SUBSIDIARY
CAPTIVE'S BOARD OF DIRECTORS

UNDERWRITING COMMITTEE

- Set policy language.
- Set strategy and timeline for underwriting other exposures.
- Evaluate occurrence and aggregate levels based on market conditions and corporate goals.
- Consider reinsurance needs/application.
- Address domicile regulations.
- Review applications for coverage.

CLAIMS AND RISK MANAGEMENT COMMITTEE

- Establish insurer-driven "best practice" guidelines for coverages underwitten by the captive, including:
  - Loss control.
  - Claims management (TPA).
  - Claims litigation and settlement.
- Evaluate quality of RMIS claims detail to assist with pricing support, focusing loss prevents services, etc.
- Consider cost allocation techniques that reward business unit controls.

FINANCE AND INVESTMENT COMMITTEE

- Oversee actuarial year-end reports, address impact with other two committees.
- Oversee financial report consolidation processes; address YE audit work.
- Create and adjust investment policies.
- Provide guidance for effective utilization of equity.
- Provide planning and management oversight of captive's relevant tax issues.

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Role of a Captive Manager

- **Accounting/financial** operation and review.
- **Investment** coordination and review.
- **Regulatory coordination**, communication and compliance.
- **Audit** coordination.
- **Service provider** coordination.
- **Insurance** management, policy and contract review, and issuance.
- **Claim** tracking.
- Provision of directors and local **representation**.
- Provision of captive **policies and procedures**.
- Management **information** reporting.
- **Solvency and liquidity** review.
- Coordination of **reinsurance** market access.
- **Consulting, benchmarking**, and **strategic advice**.
- Company **secretarial**.
- **Corporate governance**.

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Operating a Captive Facility

	KEY ITEM	CLIENT ROLE
FINANCIAL REPORTS AND EXAMS	Captive annual report	Review report and provide approval to captive manager to execute and file.
	Captive audited financials	Travel to domicile (if required) to review final draft and sign management representation letter.
	Actuarial certification of loss reserves	Provide exposure and loss data to independent actuary.
	Five year financial projections	Provide projection information (such as exposures and financial assumptions).
	Periodic examination by regulators (every three to five years)	Review final draft and advise captive manager of any concerns — board of directors review final report at the next directors meeting.
TAX	Captive premium tax submitted (if required)	Board reviews captive premium tax return at next directors meeting.
UNDERWRITING	Insurance program changes	Notify captive manager of any desired changes to existing business plan.
	Insurance policies and reinsurance agreements	Provide details of desired insurance coverages for new and existing policies, and, on an annual basis, provide captive manager with copies of overlying coverages related to any deductible reimbursement program.
INVESTMENTS	Minimum capital	Make a capital infusion to achieve regulatory compliance in the event of a shortfall in the minimum capital required.
	Intercompany loans	Communicate to captive manager the desire for an intercompany loan and remit monthly interest payments.
	Shareholder/policyholder dividends	Communicate to captive manager desire to issue a dividend and declare a dividend at next directors meeting (contingent upon regulatory approval).

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Operating a Captive Facility

	KEY ITEM	CLIENT ROLE
CORPORATE GOVERNANCE	Directors and officers	Communicate any changes of directors and officers to captive manager.
	Collect conflict of interest disclosures from all directors and officers	Captive owner's directors and officers sign and return disclosures at the annual directors meeting.
	Board meetings	Work with captive manager in scheduling meeting, setting agenda, attending and participating in meeting.
OTHER	Interim financials	Provide captive manager with monthly paid loss and case reserve information, premiums at the beginning of the year, and periodic IBNR adjustments.
	Accounts payable/accounts receivable	Forward miscellaneous invoices to captive manager for settlement and initiate monthly transfer of monies for intercompany interest on loans.
	Annual budget	Confirm premium forecast information and review budget.