INFLATION COSTS IMPACTING CAPTIVE INSURANCE

Written By Caroline McDonald

The rising prices of goods and services, healthcare, wages, increasing litigation and the lingering effects of pandemic supply chain issues, are impacting companies across the nation, contributing to inflation.

According to U.S. Labor Department data published February 14th, the inflation rate for the United States for a range of goods and services rose by 6.4 percent for the previous 12 months, down slightly from a rate of 6.5 percent in 2022.

HOW INFLATION IS AFFECTING CAPTIVES

Rising wage costs and higher prices could impact key metrics used for measuring performance of captive insurance programs, including loss rates and claim frequency, explained Amy Angell, Principal & Consulting Actuary at Milliman in Chicago.

"Higher claim costs, particularly in property and some liability lines of business, have resulted in the need for higher captive funding levels," she said. "And the effect of inflation is still making its way through open liability cases." She added that captives writing liability coverages need to monitor their experience and assess reserve levels on an ongoing basis.

Because captives are part of a larger risk management program that includes commercial excess insurance partners,

"Many single-parent captives have increased their policy limits to accommodate higher retentions and to help make the overall insurance program more cost effective," Angell said.

She noted that no industry is immune from the effects of inflation. The impact on an individual organization depends on "the mix of operations insured, and the coverages offered through the captive," she said. "Certain operations, such as commercial trucking and property exposures, have seen cost increases across industries." Organizations that have experienced labor shortages and high employee turn-over may be seeing a greater inflation impact, Angell said.

One line of coverage seeing heavy impact from inflation is automobile.

"The auto line of coverage is a standout," said Sandra Springer, senior vice president, director of marketing for Captive Resources, in greater Chicago. "Inflation rates applicable to new vehicles, and parts and equipment, since Jan. 1, 2020, were up 14-15 percent. In the fourth quarter of 2022, they were significantly outpacing overall inflation rates," she said.

Angell noted that the climb of commercial auto liability, auto physical damage, and property coverages is due to higher costs of materials and repairs as well as greater involvement of plaintiff attorneys.

"Social inflation and attorney advertising is affecting a broad array of coverages," she said. Those include employment practices liability, professional liability, construction liability, and premises liability for high-traffic retail operations.

MAXIMIZING CAPTIVE USE

Maryellen Vargas, consulting actuary at Milliman in Chicago notes that employers using captives may have greater incentive, "to implement programs that can help manage claim costs and therefore combat inflation."

Angell added that captives are a valuable part of an overall risk management strategy, as using a captive to its maximum, "means continually reviewing the coverages and coverage limits being offered through the captive."

Tracking and understanding the impact of inflation on exposure bases is important, she said. For example, "payroll may be increasing due to higher average hourly wages, sales may be increasing due to inflation, and total insured value may be increasing with higher property valuations." Increases in the exposure bases, "may not correlate one-to-one with expected increases in insured costs," Angell said.

The captive also should evaluate its own premium rates to ensure that they are reflective of the current average inflation level of the exposure bases. "And if the commercial market has increased premium rates ahead of loss trends, or not adjusted for the anticipated effect of the inflation-adjusted exposure bases, this may represent an opportunity for the captive to offer higher coverage limits," Angell said.

INFLATION AND HEALTHCARE CAPTIVES

Medical inflation on average is higher than general inflation. Milliman reports in its white paper, "Medical Inflation: Drivers and Patterns," that two trends emerge:

- Medical inflation patterns often, but not always, follow a similar but lagged pattern to general inflation.
- Annual medical inflation tends to be higher than its general counterpart (1.7 percentage points higher, on average).

Inflation, Vargas said, is impacting most parties involved in the U.S. healthcare system – from providers to health plans and employer plan sponsors.

> "We primarily see the impact of inflation on healthcare unit cost trend," she said.

Healthcare inflation is driven largely by rising costs on the provider side, "that flow through the rest of the healthcare system," Vargas said. The causes are similar to those in other sectors, including increasing labor costs, supply costs, and other operational costs. An added component is the high costs often attached to emerging healthcare treatments and technologies, she said.

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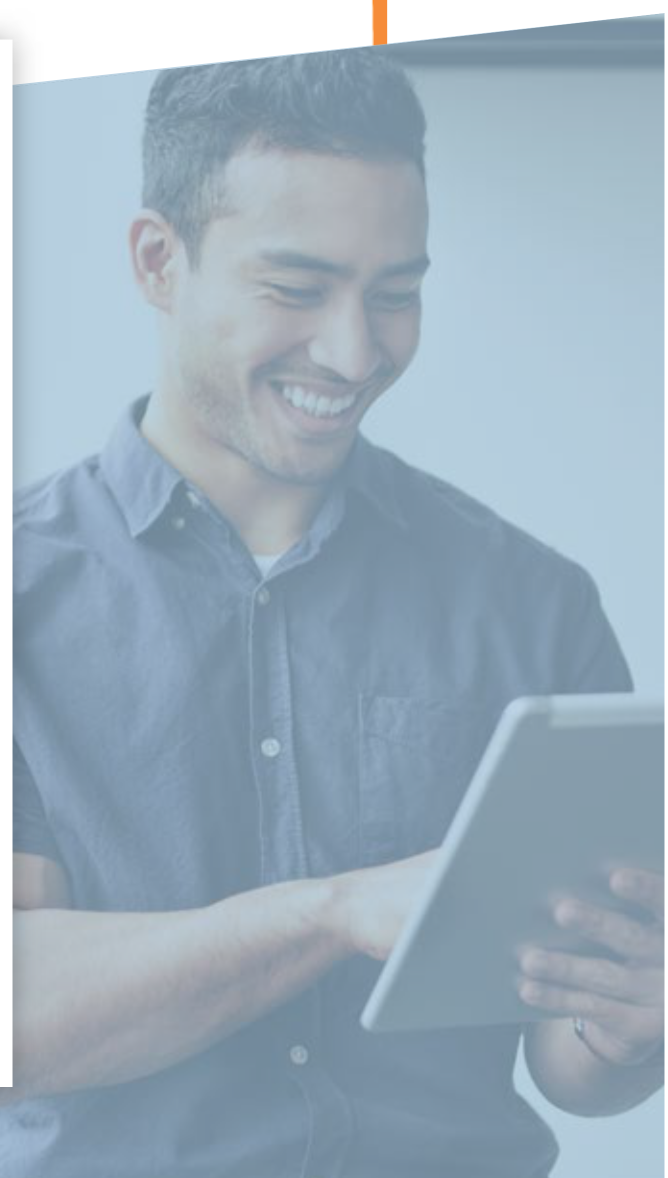

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Vargas added that while the impact of healthcare inflation on those employers that purchase healthcare may not differ significantly by industry, "One key differentiator will be the provider reimbursement structure inherent in the provider network being accessed," she said.

Networks that have reimbursements based on Medicare's payment structure or on negotiated fixed fee amounts, such as per diems or per admission payments for hospitals, "will be less impacted by healthcare inflation than networks whose reimbursement is calculated as a percentage of billed charges," Vargas said.

CAPTIVE STRATEGIES

"The best claim remains the claim that does not happen," Angell said. "Investment in safety and risk management programs that address the root causes of claims can help to lower both the frequency and severity of claims."

Another strategy is to align the captives with the incentives of the insureds. "For example, increasing member deductibles in a group captive program or adjusting the internal charge-back program for a single-parent captive," can help in achieving better adoption of important safety and risk management initiatives, she said.

Also helpful is more frequent monitoring of loss experience, which can help alert captive management to changing trends in the data, "and to avoid surprises at year-end," Angell explained.

Because captives may have experienced declines in invested asset values in 2022, reviewing capital adequacy levels is an important step in the financial management of the captive, "particularly in light of the greater volatility that may have been introduced with the addition of new coverages or higher policy limits," she added.

GROUP CAPTIVES A SOLUTION FOR INFLATION

The Insurance Information Institute reports in its study, Group Captives: An Opportunity to Lower Cost of Risk:

> Participation in a group captive can help companies save on insurance costs and provide access to extensive risk management resources, including industry-specific expertise. These attributes are a source of value in the best of times, and today's inflationary conditions may increase their appeal for certain types of companies.

Attention to risk management and safety is important for member companies with a goal of keeping their losses lower within the captive retention, said Sandra Springer, senior vice president, director of marketing for Captive Resources in greater Chicago. This can "help to lower their individual premiums since those are based on the member company's own loss experience," she said.

Springer noted that an industry hit hard by inflation is construction. "Worker shortages, higher materials costs, supply chain interruptions and housing shortages are among the issues impacting the industry and contributing to rising prices," she said.

Construction is also, "the largest industry segment among the group captives we support – there are over 2,000 construction companies across the U.S. in our client captives," she said, adding that demand for group captive insurance remains high in this sector, "as a long-term cost management solution."

Inherent features of the group captive model help member company insureds to continually drive down costs, she explained. "The model focuses companies on risk management and safety and provides them with numerous services and resources to support their efforts," Springer said.

The typical result is lower losses, "which results in lower costs over time from lower premiums and dividends received for better-than-expected loss performance," she said.

Some of the group captives have also increased their primary limits. "This all helps to control the captive's excess insurance cost – at a time when excess insurance costs have been increasing exponentially in the marketplace," Springer said.■

Caroline McDonald is an award-winning journalist who has reported on a wide variety of insurance topics. Her beat has included in-depth coverage of risk management and captives.