Written By Caroline McDonald

Inflation is an ever-present challenge that organizations must deal with. According to the U.S. Inflation Calculator with data from the U.S. Bureau of Labor Statistics, inflation has risen from 1.4 percent in December 2020 to 3.4 percent in December 2023. The cost of living rose from 2.3 percent in 2020 to 6.0 percent in February 2024.

That increase can impact many areas, including payroll, healthcare, the cost of merchandise and equipment, gasoline, and shipping. But most importantly, it can drive up insurance market rates.

INFLATION'S IMPACT ON INDUSTRIES

"Medical inflation is beginning to pick up again. It's forecasted at 7 percent for 2024. It had dipped down to 5.5 percent in 2022," said Mike Madden, division senior vice president at Artex Risk Solutions.

"The places where we are seeing the largest impact on insurance premiums is on the property side, and health insurance and medical stop-loss premiums," Madden said.

On the property side, "driving the property market increases are catastrophic claims from hurricanes and wildfires, as well as replacement costs," he said. "When you are looking at replacement costs, the cost of goods has increased, so replacement costs are much higher than anticipated, and this is driving claims inflation, which is affecting market pricing."

George Papagelis, regional vice president, national accounts at OneDigital, noted, "It's all about claim trends, which is really about inflation. The rise of healthcare insurance has probably been several hundred percent over the last 15-20 years. But when you look at the increase in people's wages, it's more like one-tenth of that, 3 or 4 percent. This is a major issue in the health insurance world, so how do you combat that?"

Papagelis said that the same kind of inflationary pressures we see in groceries and gasoline "are also impacting the cost of healthcare. Health insurance is offered by most employers and is usually one of the top three expenses for those organizations."

Healthcare jumps out, he said, because it's a sizable expense for organizations as well as their employees. Adding to this, "There has been a post-pandemic delay on treatment that has had an impact. People with medical issues often had to put off treatment, leading to worsened cases," Papagelis said.

He observed that there are also new technologies in research and development. "Lastly, there are a lot of new medications now," Papagelis said. "Most are very good and provide a better quality of life for people in some conditions. They also can be very expensive." In fact, some medicines, like gene therapy and stem-cell therapy, "can have a price tag of $3 million."

CAPTIVES STRATEGIES

Randy Sadler, principal at CIC Services, LLC, said that captives are an effective inflation strategy. "The great power of a captive is that it gives you tremendous flexibility."

At the top of the list, he said, is that "If replacement costs for damaged property and damaged vehicles go up – which they have – then insurance premiums will inevitably rise."

That pain has to be shared, Sadler said. "When a business has a captive, whether pre-inflation or during inflation, writing all or part of that premium check to your captive versus to the commercial market allows a business – as long as they can reasonably control losses – to put that money away instead of paying it to the commercial market." It also gives cost control at a time when it's needed, he added.

The first key, Sadler said, "is to have an investment strategy." Captives, he said, will benefit from being taxed as an insurance company, "therefore, you have a solid amount of capital to outrun inflation. If an § 831(a) election is made and your loss reserves are set aside, you can invest those," Sadler said.

Secondly, he added, is having a financial focus and a risk management focus. "You need a financial strategy focus because a well-run captive will build up reserves, so making investments to beat inflation is the second key to winning."

Madden agreed. "We're seeing that our captive owners are reevaluating their investment policies," he said. "Captives tend to have a more conservative investment policy traditionally, but with higher interest rates as a reaction to inflation, a lot of captive owners are looking to get more benefit or to change up their investment strategy."

INFLATION AND HEALTH INSURANCE

Papagelis, who works with captives on the health insurance side, noted that "Companies join captives for many reasons: workers compensation, commercial liability, and in the last ten years, they started using them more for health insurance," he said.

Captives have grown exponentially for a number of reasons, he said. One is that they can help employers to mitigate risk on the pharmacy side, such as the cost of specialty drugs. "You can't always do this when you are fully insured with a carrier, but you can do it when you're self-funded and your own plan sponsor," he explained.

Another reason, Papagelis said, is an increase in cancer claims. "So, what is the center of excellence? A concierge cancer program that not only helps them through that journey in their lives but also helps account for the costs of that situation," he said.

The advantage of a group captive is both qualitative and quantitative, he explained. "Quantitative advantages are being self-funded, more transparent and building a surplus."

The qualitative advantages, "are being part of a group where you are bringing different ideas to the table and sharing them. It is a community, so there is an element of sharing and implementing best practices," Papagelis said. For example, "If there is a prevalence of diabetes, we can put in place a program where people are getting access to resources that can help them manage that disease."

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With these strategies, he noted, most captives have outpaced the traditional markets. "We're starting to see testimonials from employees, where companies are giving back benefits to employees and putting in place centers of excellence to support people with difficult chronic diseases," he said.

"What we're achieving has a positive impact on the company and the employees," Papagelis noted.

HOW IT WORKS

In a group that is fully insured by a carrier, "There is not as much transparency, flexibility or control, so they are stuck doing what the carrier tells them to do," Papagelis said. "It's not a great way to create employee satisfaction."

A captive, he said, is beneficial for employers, particularly in the range of 50 to 1,000 employees.

What a captive does, he said, is to optimize transparency, flexibility, and control. "So, you're joining a pool of other like-minded employers. For the really expensive claims, like gene therapy and therapy for hemophiliac and cancer claims, you're pooling your funds. You're also sharing in the risk and reward of your plan," he said.

The key element of a captive, Papagelis said, is self-funding. "The second is joining a captive where a number of employers are sharing in the risk and reward. If I'm an employer on my own, I might have $300,000 in stop-loss premium, and I might absorb some percentage of that," he said.

With a captive, however, "your $300,000 could be $20 million," he said. This is the case "because, as a group, you can absorb some of the rare high-cost claims that generally drive your renewals. So now the risk of a hemophiliac claim can be absorbed by the group." In the theory of large numbers, he added, "the captive runs in a surplus, which means that employers in the captive get some money back."

Another important aspect is proactive and purposeful risk management. "While a captive may not be a silver bullet, being self-funded and part of a group is a piece that will help everybody," Papagelis said. "It's about looking at the data as an employer: Do you have a high prevalence of cancer or diabetes within your population, and what are some things you can do to mitigate risk?"

Madden noted, "The beauty is that the captive provides employers with more control over claim drivers through risk management activities." On the medical health side, "there are data analytics and the ability to be more creative, both getting in front of claims and also helping to deal with the costs of some ongoing claims activity," he said. ■

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