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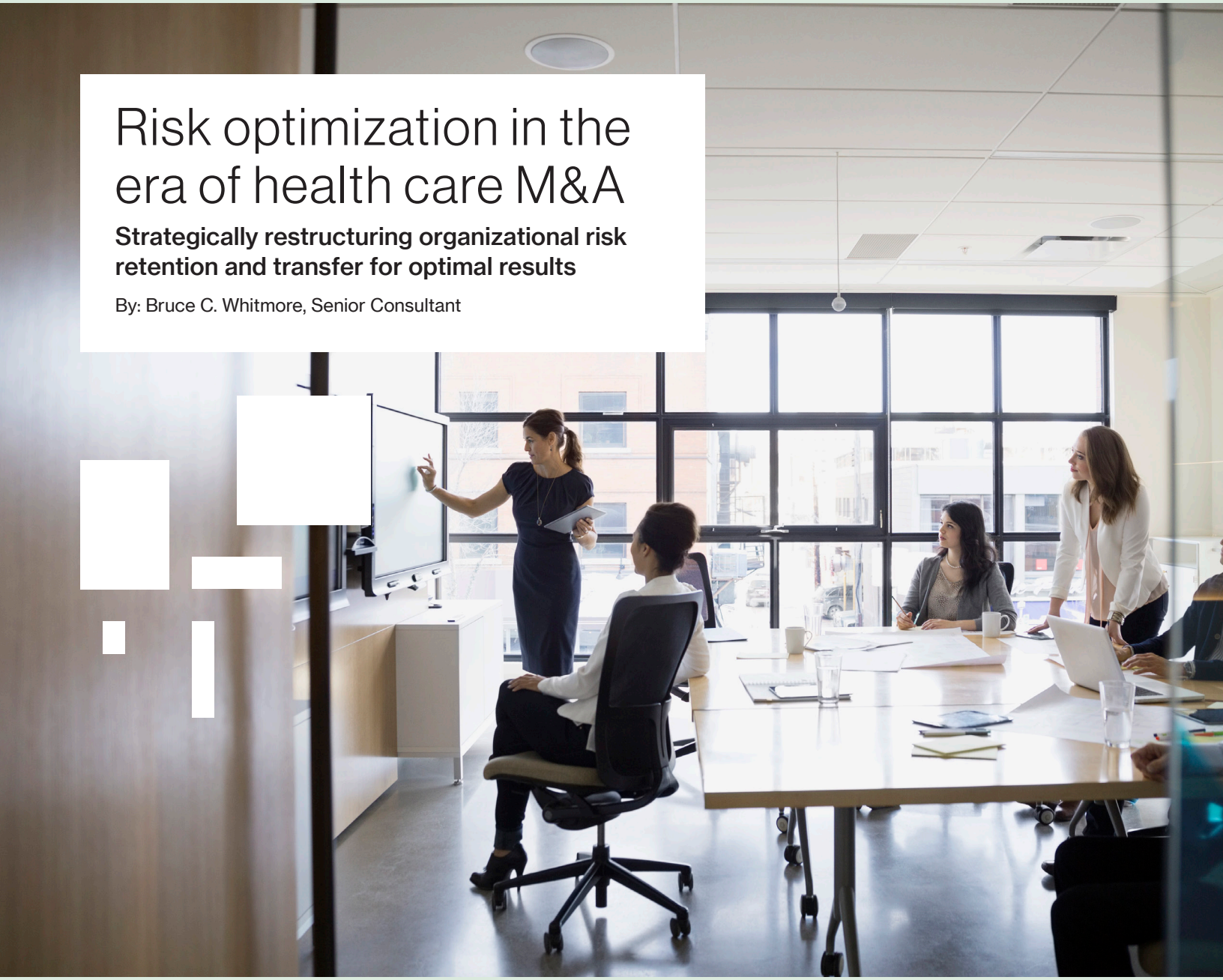
Risk optimization in the era of health care M&A

Strategically restructuring organizational risk retention and transfer for optimal results

By: Bruce C. Whitmore, Senior Consultant



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With health care M&A activity creating larger organizations with greater risk-bearing capacities, the resulting organization and its consolidated captives can retain more risk, more efficiently. Developing the optimal risk retention versus transfer structure necessary to substantively drive down the net cost of risk will require nuanced insights and analytics from a diverse range of risk financing specialists.

Introduction

The health care industry has evolved over the last 10 years due to merger and acquisition activity, spurred on by the goals of the Affordable Care Act, including enhancing patient access to care and reducing health care costs. However, the recent prevalence of horizontal, vertical, national and regional mega mergers have become truly transformational. All these mergers have one goal in common: Achieve market scale to gain financial and competitive advantage.

However, the for-profit health care system sector is demonstrating a different perspective. Many organizations are learning that bigger isn't always better. The benefits of larger scale haven't always paid off quickly (if at all), and organizations have shed hospitals and other struggling assets that have underperformed.

All these consolidations and divestitures mean one thing when it comes to managing the cost of risk: ***Change.***

Transformative risk financing strategies

Mega mergers place new demands on the consolidated organization, but they also provide opportunities to develop new, innovative risk financing structures. After all, if the consolidation results in an organization with more assets than its commercial insurers, does buying insurance still make sense? Should the organization consider developing other ways to smooth volatility more effectively?

Establishing a new vision of the organization's risk retention/transfer strategy requires starting afresh. The best way to accomplish this is to engage the major stakeholders in a formal risk financing goals and objectives setting session, virtually disregarding the current structure so as not to taint the outcome.

Goals and objective setting key participants

Determining who should (and should not) participate in the goals and objectives exercise is critical to the success of the project. Clients should consider the value that would (and would not) be added by strategically engaging the following individuals:

- CFO/treasurer
- Chief corporate counsel
- Chief compliance officer
- Chief risk officer
- Chief strategy officer
- Actuary(ies)
- Risk optimization analysts
- Captive consultants
- Alternative risk transfer specialists
- Insurance brokers

The involvement of such a wide range of industry experts might be surprising, but we have found that given their engagements across a wide range of industries, risk optimization analysts, alternative risk transfer specialists and captive consultants can introduce innovative, transformative and nuanced strategies during the discussions.

Goals and objectives setting key deliverables

The output of the session should ultimately include, at a minimum, a determination and definition of the organization's risk appetite post-merger. This will require the stakeholders to answer some key questions, including:

- Has the organization become more or less leveraged as a result of the merger?
  - How much risk can the organization retain on an aggregate basis (as a % of revenues, Days Cash on Hand, or other metrics)?
  - How much risk can the organization now retain on a per-claim basis by line of coverage?
- If the organization incurs losses beyond the selected risk appetite(s), which areas would be most heavily impacted, and what specific ramifications need to be mitigated?
  - Finance & treasury
  - Legal
  - Compliance
  - Operations
  - Reputation
  - Directors & officers
- Does the new risk-bearing capability make the purchase of traditional commercial insurance virtually obsolete?
- Would including the financing of legacy liabilities in the new structure serve to free up surplus?
- Should the primary focus of the organization's risk financing strategy transition from transferring risk to smoothing volatility?

Opportunity for new risk analytics and alternative risk financing

The transformation of the organization's risk-bearing appetite and strategy will very likely demand new risk optimization analytics and alternative risk financing strategies that may require additional expertise not previously tapped in order to answer the following questions:

- Which lines of business should the organization now consider fully self-insuring?
- For the risks that should still be transferred to the commercial market, what limits should the organization purchase on a line-by-line basis, and how much risk should be retained?
- Should and overarching risk financing strategy beyond traditional property & casualty risks be developed to include such lines as employee medical stop loss, provider stop loss, pensions and benefits?
- Should the organization purchase multi-year, multi-line aggregate excess/reinsurance program or are the markets for such programs so few as to increase the fragility of the solution?
- Should captive coverages be crafted to respond, on an aggregate basis, to nearly any confluence of losses including:
  - Wind storm/storm surge, earthquake, wildfire and other catastrophes?
  - Medical professional liability batch claims?
  - Medical device products liability?
  - Regulatory risk?
  - Data breaches?
  - Wage & hour claims?
  - Directors & officers litigation?
  - Pandemic exposure?
  - Reputational risk?
- Should new, creative risk transfer mechanisms be created, including such tools as basket aggregates, catastrophe bonds or other alternative risk transfer mechanisms?
- How are the savings from restructuring the risk transfer mechanisms to be quantified, especially when the losses are very low frequency, but high severity in nature?
- Should changes in the risk transfer strategy be implemented on a step-by-step basis to reduce organizational disruption or simultaneously in order to demonstrate efficiencies to stakeholders more quickly?

Expense of restructuring organizational risk financing

Redesigning the risk retention and transfer structure of a large health care system from the ground up can be overwhelming, and requires critical input from a number of industry experts. Yet, when the solution is finally implemented, the system will almost assuredly purchase less insurance, reduce its risk transfer costs and finance its risks more efficiently. Therefore, the costs involved should be viewed as an investment in reducing the organization's net costs, and not be conflated with brokerage or service provider RFPs. In fact, such studies should be performed prior to engaging in new RFPs so as to focus the questions and resulting answers on the critical service provider strengths necessary to achieve the desired risk financing efficiencies.

In closing...

Transforming the risk retention and transfer structure of large organizations post mega-merger will be a daunting, but rewarding task. Ultimately, it provides the opportunity to rebalance risk financing strategies in light of the strengths of consolidated organization to deliver on the promise of the merger in the first place: To enhance efficiencies, reduce costs, improve competitiveness and enrich patient care.

For more information, please contact:

Bruce C. Whitmore
Senior Consultant
Global Captive/National Health Care Practices
+1 847 404 5092
bruce.whitmore@willistowerswatson.com

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