Using Captives to Manage Employee Benefit Risk
Canadian, US, and Global Perspectives

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Session Objectives

This session will examine captive utilization for Employee Benefits in 3 sections:

1. **Canadian Case Study**: A description of a Life and LTD captive, how it was designed, and why it has been successful

2. **US Trends**: A view of what’s new in the US with a few practical examples

3. **Global Trends**: A view of captive utilization outside North America
Canadian Case Study
The Client

• 36 shareholders, each a private corporation, own an organization located entirely in Canada
• The shareholders also own a captive domiciled in Bermuda which is managed by the organization
• Captive offers P&C, creditor Life and Disability, and other financial and insurance products to Canadian Customers
• Same industry, typically high disability risk, standard mortality risk
The Client

• Employer group sizes range from 15 to over 500 employees in approximately 150 companies
• Total group size about 4,500 employees
• Wanted to utilize their Captive for Shareholder Employee Benefits
How Did We Proceed

• Did modelling of Plan Sponsor’s plans to determine feasibility
• Contacted the Insurance Market to test interest
• Only one Insurer’s Actuary was willing to consider the Plan
How Did We Proceed

Reviewed

• Potential funding methods for each benefit
• Required risk mitigation in Canada and with Captive
• Best benefits to flow to the captive
• Regulatory requirements
• Marketing
• Administration, etc.
Considerations For Design

• Client did not want a long liability tail
• Wanted offshore participation with no high risk benefits unless upper end risk mitigated
• Mix of onshore and offshore risk sharing
• Full benefit package, custom made for each shareholder
• Marketing to include mix of local brokers and direct sales at shareholder initiation
Considerations For Design

• Administration to include all the online and electronic capabilities in the greater insurance market, etc.
• Customized material
• All benefits that are available in the insurance market
• Reporting, audit, detailed plan review and evaluation methodologies
• Shareholder renewal; one common renewal for all on common date, or staggered individual renewals dates?
Treaty and Financial Approach

Used Funds Withheld Arrangement

• Flipped the traditional reinsurance arrangement -- excess risk is held by the ceding company and initial or primary short term risk held by the captive.

• Was easier for compliance with the Office of the Superintendent of Financial Institutions (OSFI) rules regarding use of unregistered reinsurers
Treaty and Financial Approach

Used Funds Withheld Arrangement

- Other methods would require the use of Reinsurance Trust Arrangements which eventually transformed to Reinsurance Security Arrangements
- Avoided the need for a letter of credit or access to a deposit of significant funds or other forms of collateral acceptable to OSFI
- Reduced the actuarial and accounting requirements at the Captive level
Offshore Design

Life Insurance

• Full mortality risk up to Large Claim Pooling limit
• Waiver of Premium fully insured with Ceding Company, no long term liability
• Normal reserving requirements for IBNR
• Captive Shareholders shared in total claims experience dependent on contribution
• Non participating shareholders received no benefit
Life Gross Premium
Less Expenses, Tax, Commission, Captive Capital Charge

Captive - Received Premium
Less Paid Claims and IBNR plus interest
Equals Net Earned Premium
Ceding Company - Received Premium
Less Paid Claims, IBNR, Waiver Reserves
Equals Net Earned Premium
Offshore Design

Long Term Disability

• Full morbidity risk for the first two years of claims payment
• DLR and IBNR Reserves established for two year risk, but held by insurer
• Captive Shareholders shared in total claims experience dependent on contribution
• Non participating shareholders receive no benefit
LTD Gross Premium
Less Expenses, Tax, Commission, Captive Capital Charge

Captive - Received Premium
Less Paid Claims, DLR, IBNR plus interest
Equals Net Earned Premium
Ceding Company - Received Premium
Less Paid Claims, DLR, IBNR, Waiver Reserves
Equals Net Earned Premium
Onshore Design

AD&D
- Participate in pool of 150,000 lives through a casualty carrier

STD (Short Term Disability)
- Insured or ASO at shareholder option

Extended Health Care and Dental
- ASO (self-funded)
Onshore Design

Stop Loss and Out of Country Medical Assistance

- Participate in a large pool for spread of risk

Critical Illness

- Insured with casualty underwriter

Second Opinion Medical Services, Employee Assistance with specialty providers
Why This Design?

• The Captive allowed for sharing risk
• It was simple and it eliminated long-term liability
• Did not create undue risk for a relatively small group
• Allowed for the participation in risk in an affordable, saleable model
• Allowed all shareholders to replicate their existing coverage while sharing in risk in a manageable form
Startup

• First shareholder of about 80 employees came on risk January 1, 2006
• Plan grew slowly but steadily and is now about 3,000 lives
• Below optimum level of model, but has become stable and profitable to the Captive, although still subject to variances quarter to quarter
Ongoing Operation

Plan is reviewed from all risk areas:

• Offshore returns
• ASO savings
• Marketing fees received
• Capital Charge received
• Reduced administration fees

For Captive alone, cumulative savings of 24.5% on $3.6 million of premium
Benefits of This Arrangement

• Significant Canadian and Offshore gains through accumulation of capital charges, administration and marketing fees and underwriting gains
• Shareholders have control of the benefit plan and ever inflating costs of benefits
• Extended Health Care and Dental cost savings in ASO arrangement gives Shareholders full control of one of the most problematic benefit plan areas
Benefits of This Arrangement

• High-end risk flows to ceding insurer, or other third party insurer’s products, keeping long term liability limited
• Has complimented their other products for shareholders
• Attraction for potential additional shareholders
• It is an easy approach to employee benefit offerings
Challenges

• Still challenged with normal politics of insured known costs compared to potential risk for some shareholders. Fear element is breaking down and more groups are engaging in the plan

• Potential instability of LTD for a smaller group essentially self funding 2 years of LTD benefits
Challenges

• Most Canadian insurers are not prepared to look at this type of reinsurance arrangement so options for change of the ceding company are limited.

• Business success created interest in trying to absorb this arrangement into a much larger but less flexible arrangement through a competitive provider. Puts pressure on Shareholders who look at attraction of larger group, but they do not want to lose control of their own plan.
The Future

- As the shareholder group increases, look at increasing retention of risk in the treaty such as moving to 3 – 5 year duration pooling
- Including a portion of AD&D risk
- Increasing Life Large Claim Pooling Arrangement
- Keep it simple and risk mitigation tools at levels that keep the comfort level high for shareholders
US Trends & Examples
US Trends

1. Single Parent captives adding medical stop loss to portfolios
2. Healthcare industry using captives for Medical Excess risks
3. US Department of Labor accepting ExPro applications
1A. Single Parent Captive Medical Stop Loss

- Existing onshore captive used for warranty
- Adding $8mm of medical stop loss and $4mm of workers compensation
- MSL will distribute captive’s risk for capital efficiency and budget stability

Diagram:
- Employer Groups
- Captive (xs of $100K)
- Carrier (xs of $600K)

$75K
1B. Single Parent Captive Medical Stop Loss

- Existing onshore captive used for P&C risk
- Increasing overall retention by firm, but buying down deductibles to protect local operating budgets
# Medical Stop Loss Captive Economics

<table>
<thead>
<tr>
<th></th>
<th>Self Insurance</th>
<th>Captive Insurance</th>
<th>Difference</th>
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<tbody>
<tr>
<td>Expected Claims</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>-</td>
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<tr>
<td>Premium Tax 3%</td>
<td></td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Solvency Capital 4:1</td>
<td></td>
<td>250,000</td>
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</tr>
<tr>
<td>Cost of Capital 0.5%</td>
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<tr>
<td>Actuary</td>
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<tr>
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<td></td>
</tr>
<tr>
<td>Captive Manager</td>
<td>25,000</td>
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<tr>
<td></td>
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### Medical Stop Loss Captive Economics

<table>
<thead>
<tr>
<th>Other Differences</th>
<th>Self-insurance</th>
<th>Captive Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to Reinsurance</td>
<td>not available</td>
<td>• broader market</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• possible lower rates for excess protection</td>
</tr>
<tr>
<td>Risk pooling</td>
<td>not available</td>
<td>• share risk with other divisions, other employers, other lines</td>
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<tr>
<td>Governance</td>
<td>optional</td>
<td>• required as a regulated insurer (reporting, reserving, audit, bylaws, authorities, etc.)</td>
</tr>
<tr>
<td>Focus on Claims</td>
<td>optional</td>
<td>• greater scrutiny?</td>
</tr>
<tr>
<td>Income tax effect</td>
<td>paid claim deduction</td>
<td>• same? Some classify as 3rd party premium</td>
</tr>
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2. Healthcare Industry Medical Excess

- All of these players participate in the cost of medical risk

- Healthcare captives (owned by hospital systems) are beginning to include medical excess risk in their portfolios rather than transfer it to the commercial market or retain it on the hospital or HMO books
2. Healthcare Industry Medical Excess

Below is a sample of products offered by Partner Re, all of which medical risk, which is becoming distributed through the healthcare industry in varying formats.

“**Employer Managed Care Excess of Loss** is uniquely positioned to help health plans adapt by creating and implementing customized, self-funded employer stop loss programs in a managed care setting.”

“**Employer Stop Loss** provides customized products and services for employers and self-insuring plan sponsors to help them manage their healthcare costs.

“**HMO Reinsurance** provides health maintenance organizations with customized reinsurance risk solutions consisting of a combination of financial and medical management programs and services.”

“**Medical Reinsurance** addresses the complex medical risk management needs of insurance companies, captives, and other risk-bearing entities through excess and quota share reinsurance programs.”

“**Provider Excess of Loss** provides financial and medical management solutions to healthcare providers, enabling them to manage medical risk and limit catastrophe losses.”

“**Specialty Medical Insurance/Reinsurance** helps clients address new opportunities such as ACOs, healthcare CO-OPs, specialty carve-outs, healthcare providers accepting bundled payments and other healthcare risk assuming entities.”
3. US Department of Labor ExPro

- Captive reinsurance of ERISA benefits, e.g. Life and Disability, requires a Prohibited Transaction Exemption or “PTE” from the DOL if:
  - The captive is more than 50% owned by the benefit plan sponsor
  - The transaction involves ERISA plan assets

- The DOL is once again offering an expedited process called “ExPro”, based on the 2 PTEs granted in 2014 for The Coca-Cola Company and Intel Corp.

- Although the PTE process is more timely under ExPro, challenges still remain
  - Soft rates for Life and Disability insurance in the US, especially employer-paid coverage
  - Need to offer plan participants benefit enhancements with tangible value
  - Requirement to disclose transaction to all plan participants via Notice Letters
International Trends

1. Focus on Medical risks
   – Comprises 50% to 60% of global benefit expenditures
2. Increased capabilities of networks
   – Better reporting systems – more timely, more medical claims data
3. Growth in multinational pools ceded to captives
   – 79 known captive programs
4. Need for excess protection
   – Mortality risk protection available, but not other lines
5. Growth in China “exploding”
   – Over 20% of Fortune 500 are Chinese but there are very few captives, versus 80% penetration for the rest of the world
   – Local Regulator “CIRC” is exploring ways to expand captive sector
   – Willis is advising CIRC and is leading captive manager/captive consultant (although current model favors self-management)
The Future

- Companies will centralize governance of benefit plans to control costs
- Medical claims can and will be managed
- Better claims data will inform greater risk retention