Employee Benefit Captives
Their Role in Managing Enterprise Risk

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Executive Summary

Captive insurance companies, or “captives,” are widely-used enterprise risk management tools that can produce attractive financial returns for their parent companies. Captives can significantly reduce the parents’ costs of financing enterprise risk. In addition, under current U.S. federal tax law, captives are effectively permitted to deduct contingent losses on an accelerated basis.

During the last few years, many employers have decided to reinsure their U.S. employee benefit plans (e.g., group term life and long-term disability) with their captives. There are probably a number of reasons underlying this apparent trend. A captive’s risks can be diversified, and the volatility of the captive’s financial experience thereby reduced, through the statistical “risk portfolio effect” achieved by including employee benefits risks in the captive. In addition, in some cases, the enterprise’s long-term employee benefit delivery costs may be reduced through the captive’s retention of a more economically efficient level of employee benefit risk. Furthermore, the inclusion of employee benefits in the captive may constitute “unrelated third party business” for tax purposes, which can be useful in substantiating the captive’s favorable tax treatment.

The analysis of whether employee benefits are appropriate for the captive should commence with a higher-level evaluation of the proper role of the captive in the parent’s overall enterprise risk management strategy. The employee benefits risks of the enterprise should be considered within the larger context of overall enterprise risk. As the world’s leading captive manager and consultant, Aon has been working with its clients to address these issues.

The U.S. Department of Labor (DOL), which regulates the placement of U.S. employee benefit risks into captives, has established a standardized and expedited procedure, referred to as “EXPRO,” that permits the DOL to grant advance approval of certain standardized types of transactions, including certain transactions involving the placement of employee benefits risks into captives. Pursuant to EXPRO, Aon files applications on behalf of its clients with the DOL, obtains the necessary approvals from the DOL, and implements the placement of benefits risks in the client’s captive.

The answer to the question of whether a captive should include employee benefits risks will, of course, vary, depending on the facts and circumstances of the specific situation. Most large enterprises should now be carefully evaluating the potential risk management advantages, as well as other potential financial advantages, of including employee benefits risks in captives.
Introduction

This monograph from Aon is being made available to our clients’ senior finance, risk management, human resources, and legal/compliance executives. These decision-makers from disparate professional backgrounds are becoming ever more collaborative and innovative regarding the use of their companies’ captives for purposes of managing enterprise risks, securing employees’ benefits, and reducing employee benefit delivery costs. As a result, they need a single, concise, and reliable reference that can serve as a convenient point of departure for further examination of the business issues involved in the placement of employee benefits risks in captive insurers. We trust that this monograph will satisfy this need.

In preparing this monograph, we have drawn upon Aon’s diverse experience and expertise in the captive and employee benefits areas. We wish to extend our special thanks to all of our Aon colleagues, far too numerous to be mentioned here, whose direct and indirect contributions to this monograph are greatly appreciated.
What Is a Captive?

A captive is a licensed insurance carrier that is controlled by a parent corporation (the “parent,” also referred to herein as the “enterprise”) and whose business consists primarily of insuring or reinsuring the risk exposures of the parent, the parent’s affiliates, and/or other entities having an especially close business relationship to the parent (such as the parent’s customers or vendors). Traditionally, the risks placed with captives have typically encompassed coverage for property/casualty or workers’ compensation. However, it is no longer particularly remarkable for an employer to insure or reinsure one or more of its employee benefits programs to a captive.

Although the captive insures only the parent’s risks (or risks of entities having a close business connection to the parent), the captive generally functions like a regular commercial insurer by:

- issuing policies to its policyholder (the parent, affiliate, etc.)
- collecting premiums
- disbursing claim payments
- preparing balance sheets and income statements, and
- complying with the regulatory requirements of the jurisdiction in which the captive is domiciled.

However, generally speaking, captives are not regulated nearly as stringently as commercial insurance carriers because captives are not engaged in the business of insuring the general public.
Managing Enterprise Risk with Captives

Typically, the major reason that an enterprise establishes a captive is to reduce or control the enterprise’s costs of managing its risks. A captive can be an effective tool for reducing risk management costs when the:

- enterprise is faced with a risk that (for any of various reasons) must be covered under an insurance policy, and
- external commercial insurance marketplace either is unable to underwrite the risk or charges excessive premium rates for the particular risk under consideration.

(Obviously, any business decisions based on results obtainable in the commercial insurance market should be properly supported by objective analysis.) Under such circumstances, an enterprise’s risk manager looks to the enterprise’s captive to provide a cost-effective solution to the problem of financing risk.

Consider a few illustrative examples. Suppose that an enterprise has a $10 million risk. The enterprise desires to retain the first $2 million layer and place as much as possible of the $8 million remaining risk in the commercial marketplace. However, suppose also that no viable commercial market exists for coverage between $4 million and $8 million. Unless the gap between $4 million and $8 million can be filled with a policy issued by a licensed carrier, it may not be possible to obtain commitments in the commercial marketplace with respect to the remaining coverage layers. This is where the captive can be quite useful. A policy issued by the captive can plug the gap between $4 million and $8 million, thus permitting the placement of the remaining coverage layers in the commercial marketplace. In addition, the enterprise could accomplish its objective of retaining the first $2 million layer by also insuring it through the captive. As discussed later, the placement of a parent’s risks in a captive is generally treated, for financial accounting purposes, as retention of the risks by the parent; thus, insuring the first $2 million layer through the captive is tantamount, from a financial accounting standpoint, to the parent’s retention of those risks.

Moreover, many enterprises seek to gain access to global reinsurance markets, because it is sometimes possible to cover risks at considerably lower cost through a reinsurer than through a primary carrier. However, reinsurers typically deal only with insurance companies and do not issue policies directly to enterprises requiring coverage. The captive can address this issue by issuing the coverage to the parent and then reinsuring to global reinsurance markets.

Furthermore, in “hard” markets where coverage is unavailable or the premium rates for available coverage are high, a captive affords the enterprise the flexibility to insure or reinsure less risk in commercial markets and more risk in its captive. For example, a captive may be established for the purpose of insuring a portion of the parent’s workers’ compensation liabilities. Under the captive insurance arrangement, the captive
would issue a policy to the parent to cover a deductible layer of the parent’s workers’ compensation coverage—say, losses up to the first $1 million. Losses in excess of $1 million could be placed in commercial markets. All administrative services related to the workers’ compensation program could be outsourced (perhaps, though not necessarily, to the vendor of the excess coverage). The parent enterprise is thus able to reduce its insurance costs by reducing the coverage placed in expensive external markets.

These examples should suffice to convey some of the typical reasons that enterprise risk managers find captives to be such valuable and versatile tools for reducing the enterprise’s cost of risk. We would also point out, however, that enterprises often use their captives for business reasons unrelated to obtaining risk management cost savings. In many cases, one of the main reasons for placing risks in a captive is to facilitate the implementation of a systematic and transparent approach to recognizing enterprise risk and imputing the costs of such risk to the enterprise. Thus, the adequacy of a captive’s reserves (i.e., the liabilities that the captive recognizes with respect to future contingent indemnity payments) must typically be certified by an independent actuary, the captive’s premiums are computed with reference to these reserves, and the captive must keep books and records that are subject to review by the insurance commissioner of the captive domicile. Many risk managers, and their upper managements, believe that the requirements imposed on captives have the beneficial side effect of also imposing discipline and accountability on enterprise risk management.

Furthermore, under appropriate circumstances, a captive may provide significant tax advantages to its parent. As will be discussed below, the parent’s premiums to the captive may be tax-deductible by the parent at the time the premiums are paid, even though the loss covered by the captive is still contingent and has not yet actually resulted in a claim under the policy issued by the captive. In the absence of a captive, it is generally impossible for a company to deduct a reserve for an unpaid liability until all events necessary to determine the existence and the amount of the liability have actually occurred.1

The captive also permits administrative services to be unbundled from risk underwriting. Thus, the enterprise can select an outside vendor to administer the risk program, while also retaining financial risk in the captive.

Many risk managers, and their upper managements, believe that the requirements imposed on captives have the beneficial side effect of also imposing discipline and accountability on enterprise risk management.
Just How “Separate” Is a Captive from Its Parent? (Financial Accounting and Tax Considerations)

It is beyond the scope of this monograph to fully discuss the financial accounting and tax treatment of captives. However, below we will draw attention to a few points regarding the extent to which Generally Accepted Accounting Principles (“GAAP”) and the Internal Revenue Code (“Code”) regard a captive as an entity separate and distinct from its parent. These “separateness” issues have arisen frequently with regard to captives, due to the desire of many parent enterprises to insulate themselves from the captive’s liabilities, as well as to deduct premiums paid to the captive. There are significant restrictions under GAAP regarding a parent’s ability to distance itself from liabilities assumed by the parent’s captive, and there are restrictions under the Code regarding the circumstances under which a parent may deduct premiums paid to the captive.

Financial Accounting Considerations

A few different financial accounting regimes apply to captives. First, captives are generally subject to the domicile’s statutory insurance accounting requirements. Furthermore, captives must report their results to their parents in accordance with GAAP.

Under Statement of Financial Accounting Standards (“SFAS”) 94, “Consolidation of All Majority-Own Subsidiaries,” the financial statements of a captive must be consolidated under GAAP with the parent’s financial statements. Thus the captive’s financial results are rolled up into the parent’s results.

Tax Considerations and Employee Benefits

Almost without exception, our clients must heed the tax consequences of financing risk through their captives. Under the Code, employers are not permitted to deduct a reserve that has been established with respect to a future contingency because such deductions are generally permitted only after “economic performance” has occurred with respect to an accrued obligation.

However, if a captive retains the risk, it may be permissible for the captive to immediately deduct the reserve for the contingent obligation and for the employer to immediately deduct the premiums paid to the captive. (The captive recognizes income with respect to the premiums as they are received.) The net result is often a significant acceleration of tax deductions with respect to the contingent obligations that have been placed in the captive.
Historically, the Internal Revenue Service (IRS) has shown great reluctance to embrace the notion that a parent’s consolidated group can deduct a captive’s loss reserves. The IRS has continued to issue pronouncements that raise concerns for enterprises that seek to deduct captive loss reserves. However, the courts have repeatedly held that captive loss reserves are tax-deductible when the subsidiaries cover sufficient amounts of unrelated risks to enable the captive to shift and distribute risk in accordance with the economic principles of insurance. Presumably in response to the courts’ relatively greater receptivity to loss reserve deductions for captives, the IRS began to express a somewhat greater willingness, under some circumstances, to acquiesce to such deductions.

On September 28, 2007, the IRS stunned the captive community by issuing Proposed Regulation § 1.1502-13(e)(2)(ii)(C), which, if it had ultimately been adopted, would have generally disallowed the loss reserve deduction taken by a captive for risks of corporate affiliates insured by the captive. Thus, for example, the Proposed Regulation would generally have prevented a captive from taking a reserve deduction for the parent’s property or casualty risks. However, in the face of intense opposition from tax practitioners and industry groups, the IRS officially withdrew its proposed regulation on February 20, 2008.

Under currently applicable tax principles, obtaining favorable tax results for a captive generally depends, to a great extent, on whether the captive is regarded as constituting a bona fide insurance enterprise. Under current law, one of the key requirements that a captive must satisfy in order to be considered a bona fide insurance enterprise is that the captive must insure substantial amounts of risk attributable to “unrelated parties,” i.e., parties deemed, for insurance taxation purposes, to be unrelated to the captive or to its corporate parent. (Risk from unrelated parties is often referred to as “third party risk” or “third party business.”)
A widely-applied rule of thumb is that a captive has sufficient unrelated third party risk to be regarded as a bona fide insurer if the captive obtains at least 30% of its insurance business from third party sources. Presumably, this rule is derived from the holding in the case of Harper Group v. Commissioner. Recent IRS pronouncements appear to strengthen the inference that the presence of third party risk in a captive can be helpful in substantiating deductions for premiums paid to the captive on account of the parent employer’s property and casualty risks.

In the early 1990s, the IRS permitted an employer to deduct the employee benefit premiums it paid to its captive. Under the circumstances presented in these rulings, the IRS would presumably have disallowed these insurance premium deductions if the underlying employee benefits risks had not constituted third party risk. Consequently, the captive community now generally views employee benefits as third party risk. As discussed previously, such third party can be helpful in establishing the captive’s status as an insurance company under Subchapter L of the Internal Revenue Code.

A captive having substantial employee benefits risks may be permitted to deduct loss reserves for property casualty as well as employee benefit coverage. In Rev. Rul. 2001-31, the IRS stated that it would henceforth evaluate captive insurance arrangements “based on the facts and circumstances of each case.” To date, the IRS has not published any explicit guidance with regard to the tax treatment of captives that reinsure employee benefit programs. Obviously, therefore, there can be no assurance that the IRS will necessarily reach a favorable conclusion in any particular situation.
Structure of a Typical Employee Benefit Captive Transaction

Based on publicly-available information, as of this writing, thirteen corporations have sought to reinsure their group benefit programs (e.g., group term life insurance and long-term disability) to their U.S.-domiciled captives. We believe that these transactions are being implemented for a number of business reasons, which we will discuss below.

First, however, we should briefly summarize how these transactions are structured. (These transactions are regulated by the DOL, and, accordingly, must be structured in a specific manner that satisfies the DOL’s requirements.) In these transactions, an employer sponsors employee benefit programs, such as group life insurance and long-term disability coverage, for its employees. In a typical transaction, the employer will request its life insurance carrier (the “fronting” carrier) to reinsure the employer’s coverage with the captive. After implementation of the transaction, the employer pays premiums to the fronting carrier, which in turn pays reinsurance premiums to the captive. The reinsurance contract between the fronting insurer and the captive is an indemnity reinsurance arrangement, which means that the fronting insurer will be liable for any by the employer’s captive despite the reinsurance contract. Following the implementation of the transaction, the configuration of the employer’s insurance and reinsurance arrangements may be diagrammed as follows:

The intended effect of the reinsurance transaction is to shift the employee benefits risks, as well as the premiums, from the fronting carrier to the captive. Of course, the fronting carrier does not perform its functions gratis but charges various servicing fees and requires posting of collateral, or a letter of credit, to assure the captive will discharge its obligations under the reinsurance contract.
Employee Benefit Captives: Their role in Managing Enterprise Risk

Why Have Employers Been Reinsuring Employee Benefit Programs to Captives?

Although there are often a number of reasons for reinsuring employee benefit programs to captives, we believe that, in almost all cases, the essential considerations have been:

- Diversification of the captive’s risk portfolio, which can significantly increase the captive’s risk-bearing capacity (thus significantly increasing the captive’s value to the parent)
- Potential cost savings on benefit delivery
- Obtaining unrelated third party business to establish the captive’s “separateness,” for tax purposes, from the employer (see discussion in prior section)

Risk Diversification

We believe that risk diversification for the captive, with the concomitant mitigation of the captive’s overall claim volatility, is often a significant motivator for many employee benefit captive transactions. For example, if the employees who are insured under a group life insurance policy are dispersed over a wide geographic area, deaths (i.e., benefit claims) are likely to be independent of one another, as well as independent of the casualty risks insured in the captive. In addition, the amount of any single death claim is likely to be much less than the amount of the parent’s casualty claims that might be indemnified by the captive. In such cases, the overall result of including a large number of independent and relatively low-severity employee benefits risks in the captive will be to reduce the year-to-year volatility of the captive’s aggregate risk portfolio. (This result is based on the portfolio theory of variance reduction by combining uncorrelated risks.)

Diversifying a captive’s book of business allows the enterprise to consider adding other enterprise risks to the captive in order to redress the lack of risk-bearing capacity in the commercial markets or to avoid paying current market premium rates that are judged to be too high in light of the enterprise’s own risk profile. For example, consider Enterprise, which has established Captive generating $10 million in premium. Captive has issued a policy on Exposure A, whose expected losses are $9 million and could vary between $7 million and $11 million. The variability or risk of Exposure A is therefore 22% (standard deviation divided by expected loss). In this simple example, Captive would require a reserve surplus of $2 million to provide reasonable assurance that Captive could pay its full potential losses on Exposure A ($9 million from the premium, plus $2 million of reserve surplus). Suppose further that Captive has accumulated a total reserve surplus of $6 million, i.e., $4 million in excess of the $2 million required reserve.

We believe that risk diversification for the captive, with the concomitant mitigation of the captive’s overall claim volatility, is often a significant motivator for many employee benefit captive transactions.
Now suppose the Enterprise wants the Captive to accept another exposure, Exposure B, which is not priced efficiently in the commercial marketplace (too high). Exposure B has a premium of $10 million and an expected loss of $9 million, and losses are expected to vary between $4 and $14 million. Variability or risk is high at 56%, a reason why commercial placement of Exposure B is difficult. Absent the risk portfolio effect created by diversifying the captive’s risks, the reserve requirement for Exposure B to assure coverage of a full loss is $5 million ($5 million + $9 million = $14 million). Thus, if each exposure were viewed separately, an aggregate reserve surplus of $7 million would be required ($2 million for Exposure A, plus $5 million for Exposure B).

However, because we are putting both exposures into Captive, the combined variability is reduced. Instead of needing $7 million of reserve surplus, Captive needs only $5.4 million. Inasmuch as Captive already has $6 million in reserve surplus, Captive can easily write Exposure B. (Note that, in favorable experience years in which the loss for Exposure B is at the low end of the anticipated spectrum, i.e., $4 million, Captive could pay dividends to Enterprise, thus enabling Enterprise to share in the favorable results.)

As a general rule, combining uncorrelated risks (i.e., having a loss in Exposure A does not cause a loss in Exposure B) results in an aggregate volatility/risk that is less than the sum of the respective volatilities/risks. Employee benefits risks are often uncorrelated, with the captive’s general casualty exposures; therefore, it can often be deemed advantageous, from a risk management perspective, to include employee benefits risks in the captive. Some other typical examples of risks that will often not be correlated with the enterprise’s casualty risks might include TRIA (Federal Terrorism) deductibles and coinsurance, unusual product risks, workers’ compensation, auto liability, and general liability.

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<th>Exposure A ($ million)</th>
<th>Exposure B ($ million)</th>
<th>Combined ($ million)</th>
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<td>9</td>
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<tr>
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<td>7-11 (22%)</td>
<td>4-14 (56%)</td>
<td>12.6-23.4 (30%)</td>
</tr>
<tr>
<td>Required Reserve</td>
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<td>5</td>
<td>5.4</td>
</tr>
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Cost Savings on Benefit Delivery

Under some circumstances, the reinsurance of employee benefit risks to the captive may also reduce the employer’s costs on benefit delivery. While the incremental economic costs and risks associated with including employee benefits risks in the captive should be considered, many large employers may achieve meaningful benefit delivery cost savings.

This section focuses on three main conceptual components of potential cost-savings:

- Premiums based on experience
- Risk charge reductions
- Investment returns on reserve

Captives may also enable greater flexibility in risk share arrangements, as well as separation of administration and underwriting costs (i.e., the enterprise can negotiate fronting carrier’s administrative fees to match services actually required).

Premiums Based on Experience

The employer may obtain cost savings by retaining benefits risks (through reinsurance to the captive) that are perceived less favorably in commercial insurance markets than may be warranted by the employer’s actual claim experience and exposure to catastrophic harm. (For example, the enterprise might realistically believe that its internal loss control programs differentiate its loss experience from that of its peers.) We have clients whose favorable and highly credible overall loss results for the last several years, as well as the wide geographic dispersion of their employee populations, have led them to seriously consider whether benefit cost savings may be obtained through captive reinsurance arrangements. These arrangements aim to capture the results of claim experience (both favorable and unfavorable) pursuant to the expectation that, over time, the aggregate cost of the benefit program will be less than in the absence of the reinsurance arrangement. We caution our clients that, while cost savings might be realized over a long period of time, there can of course be no guarantee that such savings will necessarily be achieved, particularly within a short time horizon.
Risk Charge Reductions

A second potential source of cost savings may be found in the elimination or reduction of risk loadings associated with commercial insurance. These risk charges, which are in the nature of a “cushion” for the commercial insurer, are inherent to the issuance of insurance in the commercial marketplace and are applicable even if the underlying pure risk premium is being assessed correctly. To the extent the employer is willing and able to retain additional employee benefits risks via a reinsurance arrangement, the employer might be able to eliminate the commercial carrier’s loadings associated with those retained risks. (Naturally enough, commercial insurers acting as fronting carriers in reinsurance arrangements invariably fight hard to hold on to the revenues derived from risk loadings.)

Investment Return on Reserves

A third major component of the potential cost savings that may be obtained from a captive benefit transaction is the retention of insurance reserves by the captive rather than the commercial insurance carrier. When a commercial insurer develops rates for, say, a group term life insurance program, the insurer makes assumptions about the interest rates that will be earned on the assets set aside to fund the reserves (liabilities) associated with the program. The interest assumptions made by commercial insurers are always quite conservative (low). When interest rates are assumed to be low, the corresponding premium rates must be set at relatively higher levels. (It takes a higher premium rate to compensate for the lower assumed growth rate of the assets that fund the reserve.) When the commercial insurance carrier reinsures the program to the captive, the carrier pays reinsurance premiums to the captive, which, at least in theory, enable the captive to recover the portion of the primary insurance premium (i.e., the premium paid by the employer to the fronting carrier) that is attributable to the commercial carrier’s low assumed interest rates.

In practice, however, commercial carriers will often insist on terms for the reinsurance deal that preserve a substantial measure of the revenue that would otherwise have been obtained by holding the reserves. For example, the insurer may require a posting of collateral, or an assessment of service fees, or perhaps other charges, that have the net effect of retaining a more or less equivalent amount of revenue for the commercial carrier. Therefore, while some cost savings attributable to interest on reserves may be achievable, such savings are unlikely to be as large as the captive’s parent would ideally like to obtain.

We caution our clients that, while cost savings might be realized over a long period of time, there can be no guarantee that such savings will necessarily be achieved.
Summary

Cost savings may be obtained through employee benefit captive reinsurance arrangements under some circumstances. However, such savings are obtained only if the captive assumes additional risk. Accordingly, the potential savings should be sought only in the context of a long-term risk management strategy that recognizes that claim experience is not always favorable. In addition, the fronting carrier (i.e., the carrier that reinsures to the captive) will obviously have to be compensated for its role in implementing the transaction, and the compensation to the fronting carrier can obviously reduce the attractiveness of the transaction from the employer’s perspective. Furthermore, any other significant transaction costs should also be considered in evaluating the feasibility of obtaining benefit delivery cost savings.
U.S. Regulatory Requirements with Regard to Employee Benefit Captives

Prior Approval from the DOL

Employers generally insist on obtaining prior DOL approval for employee benefit captive arrangements because such arrangements may constitute “prohibited transactions” under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). In particular, ERISA §406(a)(1)(D) prohibits the “transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan.” An entity owned by the employer, such as a captive, is considered to be a party in interest with respect to the employee benefit plan under ERISA §§3(14)(C) and 3(14)(G). Accordingly, the payment of premiums to a captive insurer, which is a party in interest, may constitute a prohibited transaction. The prohibited transaction penalties are so severe that most employers are unwilling to take any risk in this area. (Under ERISA §502(i), the penalty is five percent of the amount involved in the transaction, which, in this case, would be the premium for the year; the penalty is assessed each year the prohibited transaction is outstanding and is owed by the party in interest.) Under ERISA §408 and related administrative guidance, the DOL is permitted to grant exemptions to the prohibited transaction requirements and has established an expedited process, which it calls EXPRO, for handling routine transactions.

Obtaining DOL Approval

Under EXPRO, an applicant merely informs the DOL that it intends to enter into a transaction that is “substantially similar” to previously approved transactions and submits an application package substantiating that the EXPRO requirements are in fact satisfied. Upon submission to the DOL, the applicant receives “tentative authorization,” which starts a 45-day period, within which the DOL may withdraw the tentative authorization. At the expiration of that period, the applicant provides notice to interested persons. Five days after the notice period expires, the authorization becomes “final.” Thus, the time from submission to final authorization under EXPRO is generally less than 90 days.

The preparation and submission of an EXPRO application package involves the expenditure of a certain amount of time and effort. However, the DOL has published detailed administrative guidelines and procedures for EXPRO. Furthermore, once the DOL receives an EXPRO application, it becomes available for public inspection; thus, it is generally not difficult for an employer to pattern its application on the applications of other employers that have previously filed with the DOL.
Requirements for EXPRO

As mentioned above, an EXPRO transaction must be “substantially similar” to previously approved transactions. The EXPRO transactions that have been approved by the DOL have satisfied the following requirements:

Captive Requirements

• U.S.-domiciled captive (or U.S. branch of foreign captive)
• Financially sound
• Authorized to reinsure benefits

Protection of Participants

• The arrangements have been structured as reinsurance between the employer’s captive, which functions as the reinsurer, and the fronting carrier, which functions as the primary carrier that issues the policy to the plan
• The reinsurance has been indemnity reinsurance (i.e., fronting carrier has primary liability for benefit obligations)
• Fronting carrier has had Best’s “A” rating Immediate and objectively determinable benefit enhancements have been provided to participants (this particular requirement is subject to negotiations with the DOL)
• Notification has been provided to participants

Reasonableness of the Transaction

• Demonstrably reasonable premiums paid by plan to fronting insurer
• Rate setting is similar to formulae used by other carriers
• No commissions paid by plan

Independent Certification

• Independent fiduciaries have reviewed and approved the transactions
INSURING MEDICAL STOP-LOSS IN A CAPTIVE

Employers sponsoring self-funded health benefit plans may choose to insure at least some portion of their health benefit risk through a stop-loss policy. Stop-loss policies may be purchased from commercial insurance companies. However, as this article will discuss, there are reasons why an employer may choose to purchase stop-loss insurance through a captive insurance company owned by the employer, rather than from a commercial insurance carrier.

Medical stop-loss is generally not regarded an “employee benefit program” under ERISA, inasmuch as a stop-loss policy indemnifies the employer from unexpectedly volatility in the claims costs associated with the employer’s self-funded health benefit plan. [INSERT FOOTNOTE CITING Department of Labor Opinion Letters 92-02A and 2001-02A.] Consequently, unlike employee benefit programs, stop-loss programs may generally be insured through captives without any need for advance DOL approval.

Overview of Medical Stop-Loss Insurance

Stop-loss insurance is purchased by plan sponsors desiring to reduce financial volatility associated with health benefit costs. Volatility arises when the employer’s actual health claim experience deviates from expected experience.

In general, there are two basic types of medical stop loss insurance (this article does not attempt to address all of the stop-loss variations that exist):

Specific: Provides protection against large individual claims; for example, by limiting the employer’s liability to the first $100,000 of claims paid on behalf of any one claimant during the plan year.

Aggregate: Provides protection on the overall claims paid under the plan during the plan year; for example, by limiting the employer’s liability to 125% of projected total annual claims.

Claims in excess of specific or aggregate attachment points are reimbursed by the stop-loss insurer. Note that stop-loss underwriters will typically not issue aggregate stop loss protection unless there is also specific protection in place. There is usually an overall limit, e.g., $1 million, on the amount of claims that the stop-loss policy will reimburse in any year regardless of the total amount of claims in excess of the attachment points.

A stop-loss policy generally indemnifies medical claims that are incurred within a one year policy coverage period and that are in excess of the policy’s attachment points. A claim is deemed to have been incurred at the time medical service is provided.

Most stop-loss policies will require that claims be paid within a specific period (e.g., three months) following the end of the policy coverage period. Thus, the liability under a stop-loss policy has a relatively short tail.
As the size of the covered population increases, the actual number of large claims (e.g., those exceeding $100,000) tends to converge to the expected number of large claims. Therefore, as the size of the group increases, the employer will usually seek only specific stop-loss insurance, and will raise the attachment point to the level at which the predicted variation in the number of such claims each year makes it desirable to insure this risk. Larger employers (e.g., those with 10,000 or more employees) will often forego stop-loss insurance altogether.

In general, we expect that there will be significant savings through a captive-insured stop-loss program when a long-term view is applied. Typically, in the current commercial marketplace, 20% to 40% of stop-loss premium is allocated to risk and insurer’s profit. It may be appropriate for the captive’s stop-loss premium equivalent to include a load of this magnitude for the first 3 to 5 years, allowing the captive to properly capitalize its stop-loss risk. In ensuing years, reduced or even zero surplus additions may be appropriate depending on claim experience and investment returns of the existing surplus. Use of existing surplus to cover unanticipated losses will often be necessary in the first 3 to 5 years, in the event of a significantly greater loss than expected. As part of an incremental risk assessment, a target surplus level may be established for the captive. Depending on the specifics of the stop-loss program, this surplus level may exceed 100% of the expected annual premium for the year.
Can Executive Retirement Benefit Programs Be Funded Through Captives?

Background of Executive Retirement Benefit Plans
Nonqualified executive retirement plans are established by employers to supplement the employer-provided retirement and pre-retirement deferred compensation benefits that are provided to a select group of management or highly compensated employees under the employers’ qualified deferred compensation plans and to supplement the voluntary, tax-favored savings opportunities available to these individuals. Since executive benefit plans are generally not subject to the fiduciary requirements of ERISA, they could be placed in a captive without the necessity of obtaining advance approval from the DOL.

Typically, nonqualified plans are merely backed by the employer’s promise to pay the participant compensation at some future date, with either: (1) no assets of any kind being maintained in connection with the plan or (2) any assets maintained in connection with the plan being either general assets of the employer or assets that are set aside from the employer’s general assets but that remain subject to the claims of the employer’s bankruptcy and insolvency creditors.

So-called “rabbi trusts” are often used to increase the security of executives’ non-qualified retirement benefit programs. A rabbi trust established by the employer with an independent trustee is designed to (1) provide employees with some assurance that their promised benefits will be paid while (2) preserving the tax deferral that is at the heart of unfunded deferred compensation plans. To accomplish these objectives, the rabbi trust is irrevocable (i.e., the employer is permanently unable to retrieve assets that have been contributed to the rabbi trust), and the trust’s assets remain subject to the claims of the employer’s general creditors in the event of the employer’s insolvency or bankruptcy.

Using the Captive to Finance Executive Benefits
The captive could issue a policy to the employer or to a rabbi trust established by the employer. The policy would indemnify the trust in the event the assets in the trust ever fell below a level specified in the policy issued by the captive.

The employer could advance-fund nonqualified benefits in a rabbi trust using employer stock, thus avoiding any initial cash outlay. For example, at the start of year 1, the employer could place enough stock in the trust to cover a percentage (say 110% or 120%) of the end of year 1 projected benefit obligation (“PBO”). If the funded ratio of the rabbi trust subsequently fell below the funded level specified in the contract, the captive would indemnify the rabbi trust so as to replenish the trust’s assets. The annual premium would vary, depending on the nature of previous years’ loss experience.
What Issues Should Be Considered Before Placing Employee Benefit Risks into a Captive?

We do not believe that an enterprise should begin by asking, “Should we place employee benefits into our captive?” Rather, we believe the first questions should be, “Why is the captive valuable to us, and how could the captive become even more valuable to us?” It might be worthwhile to include employee benefits risks in the captive if its productivity could be enhanced thereby. Often, as discussed above, a rationale for placing benefits risks in a captive is found in the diversification of the captive’s risk portfolio so that the captive may assume additional property and casualty (P&C) risk. The viability of this rationale will depend, to a great extent, on the company’s current utilization and objectives for the captive.

The tax position of the captive obviously has a major impact on the captive’s value to the parent. Therefore, the tax ramifications of including employee benefits risks in the captive should be evaluated, particularly the issue of whether the employee benefits coverage would constitute unrelated business that would bolster the parent’s ability to deduct premiums paid to the captive. This issue is obviously interrelated with the risk diversification of the captive. For example, the inclusion of employee benefits may have the simultaneous effects of: (1) diversifying the captive’s risks, and (2) substantiating tax deductions for premiums paid to the captive.

As discussed above, we believe that savings in benefit delivery costs should also be examined. A good place to start is to examine historical loss and expense experience for the coverages under consideration in order to get a feel for the patterns of financial results. However, it would definitely not be advisable to reinsure benefits to the captive merely because the loss ratios for the past several years happened to be favorable. The credibility of the underlying claim data should be assessed. In addition, it is important to realize that past experience often sheds no light at all on the possibility of catastrophic losses, which must be gauged by considering such issues as the geographic dispersal of the covered population. The interactions between employee benefits risks and the captive’s other risks should be analyzed. Furthermore, the transaction costs of implementing the transaction (fronting fees, etc.) should be evaluated carefully.
Conclusion

Many enterprises are now examining the placement of employee benefit risks into their captives. We believe that, while employee benefits risks may have an important role to play in the enterprise’s captive, enterprises should also avoid focusing on employee benefits in isolation. There is a bigger risk management picture that should be considered.

Generally, we recommend that a client’s first step should be to identify and profile its enterprise risks. This analysis provides the client with the expected loss, optimistic and pessimistic loss scenarios, and any “outliers.” The evaluation would include not only individual risks but also the entire aggregate portfolio of enterprise risks. Employee benefits risk is certainly one of the risks that should be factored into this analysis.

Once the enterprise’s risk-bearing capacity is determined, the enterprise must then decide how much risk to assume, in the captive or otherwise, and how much to transfer to commercial markets. Once that decision is made, the next step is determining how to most efficiently fund the risk assumed; the captive is one option among several.

Placement of employee benefits risk in the captive can reduce the volatility of the captive’s financial results, reduce the enterprise’s long-term benefit costs, increase the enterprise’s flexibility in determining how much risk to assume and how much to farm out to commercial markets, and establish the “separateness” of the captive for tax purposes. However, an employee benefits captive arrangement should be evaluated from a long-term perspective.
Employee Benefit Captives: Their role in Managing Enterprise Risk

Endnotes

1  U.S. v. General Dynamics Corp., 481 U.S. 239 (1987), and Internal Revenue Code §461 (h) and the regulations thereunder.

2  See U.S. v. General Dynamics Corp., 481 U.S. 239 (1987), and see also Code §461 (h) and the regulations thereunder.


5  See, e.g., Gulf Oil Co. v. Comm'r, 89 T.C. 1010 (1987), aff'd on this issue, 914 F.2d 396 (3d Cir. 1990); AMERCO v. Comm'r, 979 F.2d 162 (9th Cir. 1992); Harper Group v. Comm'r, 979 F.2d 1341 (9th Cir. 1992); Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135 (Fed. Cir. 1993).

6  See, e.g., Revenue Procedure 2002-75, 2002-52 I.R.B. 997, which discusses the IRS' increased receptivity to considering situations involving deductions for captives. Revenue Procedure 2002-75 also mentions several other IRS pronouncements in this area.

7  979 F.2d 1341 (9th Cir. 1992).

8  See Rev. Rul. 2001-31, 2001-26 I.R.B. 1348, which, inter alia, obsoleted Rev. Rul. 88-72, 1988-2 C.B. 31. In now-obsolete Rev. Rul. 88-72, the IRS had ruled that, notwithstanding the captive's substantial unrelated risks, the coverage of the parent's risk was not insurance.


12  See Prohibited Transaction Exemption (“PTE”) 96-62, which sets forth the EXPRO procedures and guidelines.

13  The odd name for this type of trust was derived from the fact that the first such trust was established for a rabbi by his congregation.
Aon’s Employee Benefit Captive Practice

Aon provides fully integrated risk management and employee benefits consulting services to clients that are evaluating and implementing employee benefits captive transactions. Aon’s employee benefit captive practice consists of highly experienced professionals having backgrounds in risk management, underwriting, law, and public accounting. Our consulting services run the gamut from risk identification through risk quantification, mitigation, alternative risk financing solutions, transaction structure and design, negotiations with insurance carriers, and compliance (including filings with regulatory agencies).

Aon, through its operating entities, is the world leader in all aspects of captives, risk consulting, and employee benefits:

**Aon Insurance Managers (AIM)** manages captives for over 1,300 clients worldwide. As the world’s largest captive manager, AIM has had extensive experience in all the US domiciles, and can make well-informed recommendations regarding appropriate domiciles for employee benefits captives. AIM has had extensive experience in establishing US branches for existing offshore captives, and in establishing separate stand-alone US-domiciled captives to write employee benefits.

In any captive transaction, AIM brings to the table unequalled experience and insight. Its insurance and accounting personnel are thoroughly familiar with standard reinsurance agreements proposed by fronting carriers, and are often able to recommend beneficial revisions to such agreements. AIM is steeped in many years of insurance regulatory experience, and regularly facilitates client meetings with regulators, prepares clients for such meetings, and provides support to clients during such meetings.

Services provided by AIM include the preparation of the questionnaires, business plans, pro forma financial statements, and incorporation documents pertaining to the captive, biographical affidavits, legal documents, and “Statement of Benefits” letters. AIM coordinates the activities of all parties involved in a captive transaction until the licensing process has been successfully executed.

**Aon Risk Finance and Captive Consulting** specializes in analyzing alternative risk financing mechanisms, including captives, and has over 400 risk consulting clients worldwide. The financial analysts at Aon Risk Finance and Captive Consulting can provide objective and well-reasoned analysis of a range of potential alternatives, including captives, for financing risk.

**Aon Consulting** has an employee benefit consulting practice that is ranked among the top global employee benefit consulting organizations. Aon Consulting is unique among major employee benefit consulting firms in that it is closely integrated with world-class captive risk consulting organizations (i.e., Aon Insurance Managers and Aon Risk Finance and captive Consulting).

**Aon Risk Consultants** supports our captive and alternative risk consulting resources through actuarial and financial modeling.

Aon’s client list includes the world’s largest corporations (public, private, state-owned) and spans nearly all markets — pharmaceuticals, mining, manufacturing, retail, utilities, construction, technology, finance, professional services, and many more.
Employee Benefit Captives: Their role in Managing Enterprise Risk

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ABOUT AON

Aon Corporation (www.aon.com) is the world’s #1 choice for risk advice, insurance brokerage and human capital management, delivering long-term value to clients through inspired, independent thinking and inventive, personalized business solutions that have tangible impact on the bottom line. The Aon team of 36,000 colleagues in more than 500 offices and 120 countries goes to work every day with a singular purpose of helping clients or helping their colleagues help clients.

Aon Consulting Worldwide (www.aon.com/hcc) is among the top global human capital consulting firms, with 2007 revenues of $1.352 billion and 6,335 professionals in 117 offices worldwide. Aon Consulting is shaping the workplace of the future through benefits, talent management and rewards strategies and solutions. Aon Consulting was named the best employee benefit consulting firm by the readers of Business Insurance magazine in 2006 and 2007.

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