The “Captivation” of Employee Benefits
How Captives Can Reduce Costs and 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, while significantly reducing the cost of financing enterprise risk. Under current U.S. federal tax law, captives are effectively permitted to deduct contingent losses on an accelerated basis.

The use of captives has steadily increased over the past several years—and the list of potential applications keeps growing. During the past decade, many employers have reinsured their employee benefit plans (e.g., group term life and long-term disability) through captives. Although U.S. benefit reinsurance transactions have attracted the most attention, there have been a number of transactions involving global benefits.

Many companies are insuring all or a portion of their medical stop-loss coverage through captives.

There are many reasons for the high level of interest in using captives to insure or reinsure employee benefits risks. Inclusion of employee benefits risks in the captive can diversify the captive's risk portfolio, thus reducing volatility of the overall underwriting experience. In addition, the enterprise’s long-term employee benefit delivery costs may be reduced from retaining a more economically efficient level of employee benefit risk.

In the normal course of events, simply reserving for the expected claims of a company in the financial accounts does not result in a current tax deduction for the annual accruals – only actual claim payments are generally deductible. While the mix of business insured by the captive relates only to risks of the group of companies owned by the parent or parties related thereto, there is an opportunity under U.S. tax laws to obtain current tax deductions for the annual accruals (i.e., the annual premiums paid to the captive, while the captive may deduct a reserve for future expected claims) under certain circumstances.

For instance, including employee benefits in a captive may provide an opportunity to take advantage of special tax concessions provided by U.S. tax laws in cases where the captive takes on business for parties unrelated to the parent. When a benefit plan is financed through a captive, the plan members insured can be argued to be considered “unrelated third parties” for tax purposes, which can be useful in substantiating favorable tax treatment for the larger book of business of the captive under Subchapter L of the Internal Revenue Code.

Deciding whether employee benefits are appropriate for the captive should begin with a high-level evaluation of the proper role of the captive in the parent’s overall enterprise risk management strategy. Employee benefits risks should be considered within the larger context of overall enterprise risk.

Most large enterprises should carefully evaluate the potential risk management advantages, as well as other potential financial advantages, of including employee benefits risks in captives.

As the world’s leading captive manager and consultant, Aon regularly works with employers to make these assessments.
Background on Captives

A captive is a licensed insurer whose business consists 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). Thus, captives do not (and cannot) offer insurance for sale to the general public. Because of the limited functions of captives, they are subject to different, and more lenient, regulatory requirements than commercially-licensed insurance carriers.

Not all states or other legal jurisdictions permit establishment and licensure of captives, although, over the last several years, there has been a veritable explosion in the number of jurisdictions that have enacted captive legislation. The jurisdiction in which a captive is established and licensed is referred to as the captive’s “domicile.” The choice of domicile is one of the key strategic decisions entailed in establishing a captive, as the potential domiciles vary widely in terms of the specific regulatory requirements by jurisdiction.

There are a number of possible ownership structures for a captive insurance program. In the most common, the captive is wholly-owned by a parent corporation, and the captive insures the risks of the parent and/or the parent’s other corporate subsidiaries. However, other structures are both possible and increasingly common. For example, in some structures, the captive is owned by a non-profit organization organized under Section 501(c) of the Internal Revenue Code, and the members of the organization purchase insurance from the captive. In some situations, the captive is owned (directly or indirectly) by the owners of a privately-held group of businesses, and the captive insures those businesses.

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 the policyholder (the parent, affiliate, etc.)
- Collecting premiums
- Disbursing claim payments
- Preparing balance sheets and income statements
- 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 they are not engaged in the business of insuring the general public.

Traditionally, the risks placed with captives have been coverage for property/casualty or workers’ compensation. However, it has become more common for an employer, or group of employers, to insure or reinsure one or more employee benefits programs to a captive.

The major reason for establishing a captive is to reduce or control the costs of managing the risks. A captive can be an effective tool for reducing risk management costs when:

- The risk is one that the enterprise desires (for any of a variety of reasons) to cover under an insurance policy, and
- The commercial insurance marketplace either is unable to underwrite the risk, or it charges excessive premium rates (i.e., retains substantial margins) for the particular risk under consideration.
Additionally, in many countries outside the U.S., insurance is subject to local regulations that artificially increase the premiums and/or add “frictional” costs to the insurance transaction, such as the required adoption of overly conservative technical bases in premium determination, mandatory use of brokers (sometimes with substantial commissions), etc.

Under such circumstances, an enterprise’s risk manager looks to the captive to provide a cost-effective solution to the problem of financing risk.

There are other reasons for reinsuring employee benefit programs to captives:

- 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)

Captive Applications

Some examples of captive applications include:

“Missing Layer” of Coverage: Suppose that an enterprise has a $10 million risk. It wants 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 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 be impossible to obtain commitments in the commercial marketplace for the remaining coverage layers. This is a situation where the captive is useful.

A policy issued by the captive can bridge the gap between $4 million and $8 million. In addition, the enterprise could accomplish its objective of retaining the first $2 million layer by also insuring it through the captive. As explained 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 retaining those risks.

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

Flexible Risk Retentions: In “hard” markets where coverage is unavailable or the premium rates for available coverage are high, a captive gives the enterprise the flexibility to insure or reinsure less risk in commercial markets and more risk in the captive. For example, it may establish a captive to insure 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 to the vendor of the excess coverage). The parent enterprise is thus able to lower its insurance costs by reducing the coverage placed in expensive external markets.

**Monitoring and Controlling Cost of Risk:** Captives can be used for business reasons unrelated to cost savings. In many cases, one of the main reasons for placing risks in a captive is to have 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. 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 senior leaders, believe that the requirements imposed on captives have the beneficial side effect of imposing discipline and accountability on enterprise risk management.

**Favorable Tax Treatment:** Under appropriate circumstances, a captive may provide the parent organization with significant tax advantages. As noted below, the parent’s premiums may be tax-deductible 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 captive’s policy. 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 amount of the liability have actually occurred.1

Employee benefits risks should be considered within the larger context of overall enterprise risk.

**Financial Accounting and Tax Considerations**

It is beyond the scope of this white paper to fully discuss the financial accounting and tax treatment of captives. However, below we draw attention to a few salient points arising under the Generally Accepted Accounting Principles (GAAP) and the Internal Revenue Code (Code). We will discuss how, under GAAP, a corporate parent cannot generally insulate its balance sheet from liabilities assumed by the parent’s captive. We also will discuss how, under the Code, there are restrictions on the circumstances under which the captive’s claim reserves may be deducted. For tax purposes, the captive is generally consolidated with its corporate parent.

**GAAP Requirements:** A few financial accounting regimes apply to captives. First, captives are generally subject to the domicile’s statutory insurance accounting requirements. They also must report their results to their parent organizations in accordance with the GAAP under which the parent discloses consolidated financial statements. For US companies, consolidated financial statements under U.S. GAAP are generally required.

Under Statement of Financial Accounting Standards (SFAS) 94, “Consolidation of All Majority-Owned Subsidiaries,” a captive subsidiary’s financial statements must be consolidated under GAAP with the parent’s financial statements. Thus the captive’s financial results roll up into the parent’s results.
Tax Considerations and Employee Benefits: Almost without exception, employers must heed the tax consequences of financing risk through their captives. Under the Code, they are not permitted to deduct a reserve that has been established for a future contingency because deductions are generally permitted only after “economic performance” has occurred with respect to an accrued obligation.2

However, if a captive retains the risk, and if the captive is treated as an insurance company under Subchapter L of the Code, the captive may immediately deduct both the reserve for the contingent obligation and 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 for the contingent obligations that were placed in the captive.

Historically, the IRS has shown great reluctance to embrace the notion that a parent’s consolidated group can deduct a captive’s loss reserves.3 It has continued to issue pronouncements that raise concerns for enterprises that seek to deduct captive loss reserves.4 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.5

Presumably in response to the courts’ relatively greater receptivity to loss reserve deductions for captives, the IRS began to express a somewhat greater willingness to acquiesce to such deductions.6

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 it insures. 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 on whether the captive is regarded as constituting a bona fide insurance company. Under current law, one of the key requirements for being a bona fide insurance company is to insure substantial amounts of risk attributable to parties deemed, for insurance taxation purposes, to be unrelated to the captive or the corporate parent. (Such risk from unrelated parties is often referred to as “third-party risk” or “third-party business.”)

A widely used 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 case of Harper Group v. Commissioner.7 The IRS appears to concede, as a “safe harbor,” that a captive having over 50% unrelated risk has sufficient unrelated risk to constitute an insurance company under Subchapter L of the Code.8

In the early 1990s, the IRS permitted an employer to deduct the employee benefit premiums it paid to its captive.9 Under the circumstances presented, 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,10 which, as previously discussed, can be helpful in establishing the captive’s status as an insurance company under Subchapter L of the Code. 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.”
Structure of a Typical Employee Benefit Captive Transaction

Based on publicly-available information, as of April 2010, 21 corporations have obtained the approval of the U.S. Department of Labor (DOL) to reinsure their U.S. group benefit programs (e.g., group term life insurance and long-term disability) to captives. We believe they are doing so for a number of business reasons, discussed below.

First, however, we should briefly summarize how these transactions are structured. (Transactions involving benefit programs covering U.S. employees 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 U.S. employees. In a typical transaction, the employer will request that its life insurance carrier (the “fronting” carrier) reinsure the employer’s coverage with the captive. After completing 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 continues to be liable for any employee benefit claims incurred while the group employee benefit policy remains in force, regardless of whether the captive honors its reinsurance obligations.

After completing the transaction, the employer’s insurance and reinsurance arrangements may be diagrammed as follows:

The transaction is invisible to plan participants. The fronting carrier continues to provide all administrative service interactions with participants, such as claims adjudication. Participants have no direct contact with the captive, nor are benefit payments dependent on the captive’s financial solvency.
The result 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 instead charges various servicing fees and requires posting of collateral, or a letter of credit, to assure the captive meets its obligations under the reinsurance contract.

Many risk managers, and their senior leaders, believe that the requirements imposed on captives have the beneficial side effect of discipline and accountability on enterprise risk management.

Risk Diversification

We believe that risk diversification for the captive, with the concomitant mitigation of 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 is 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 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, a captive generating $10 million in premium). It has issued a policy on Exposure A, which has expected losses of $9 million that could vary between $7 million and $11 million.

The variability or risk of Exposure A is therefore 22% (standard deviation divided by expected loss). Here, the captive would require a reserve surplus of $2 million to provide reasonable assurance that it could pay its full potential losses on Exposure A ($9 million from the premium, plus $2 million of reserve surplus). Suppose further that the captive has accumulated a total reserve surplus of $6 million, i.e., $4 million in excess of the $2 million required reserve.

Now suppose the enterprise wants the captive to accept 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 a captive, the combined variability is reduced. Instead of needing $7 million of reserve surplus, the captive needs only $5.4 million. Inasmuch as it already has $6 million in reserve surplus, the 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, the captive could pay dividends to the enterprise, thus enabling it 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 are not often correlated with casualty risks 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>Exposure C ($ million)</th>
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<td>Expected Loss</td>
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<tr>
<td>Risk</td>
<td>7-11 (22%)</td>
<td>4-14 (56%)</td>
<td>12.6-23.4 (30%)</td>
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<tr>
<td>Required Reserve</td>
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Cost Savings on Benefit Delivery

Under some circumstances, the reinsurance of employee benefit risks to the captive may 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.

There are three main conceptual components of potential cost-savings:

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

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

Premiums Based on Experience: Cost savings come from 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 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 they can get savings from captive reinsurance arrangements.

These arrangements aim to capture the results of claim experience (both favorable and unfavorable) with 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 is no guarantee that savings will necessarily be achieved, particularly within a short time horizon.

**Risk Charge Reductions:** A second potential source of cost savings is 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 in insurance in the commercial marketplace and are applicable even if the underlying pure risk premium is assessed correctly. To the extent that the employer is willing 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 potential cost savings 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 long-term disability insurance program, it makes assumptions about the interest rates that will be earned on the assets set aside to fund the reserves (liabilities). Its interest assumptions are almost invariably 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 a captive, the carrier pays reinsurance premiums to the captive, which, at least in theory, enables it 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 often insist on terms for the reinsurance arrangement that preserve a substantial measure of the revenue that would otherwise be obtained by holding the reserves. For example, the insurer may require a posting of collateral, or service fees associated with the captive transaction, or perhaps other charges, that have the net effect of retaining an 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 large.

Potential savings from benefit captive reinsurance arrangements 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 risk to the captive) will have to be compensated for its role in implementing the transaction; the compensation paid can reduce the attractiveness of the transaction from the employer’s perspective. Further, any other significant transaction costs should be considered in evaluating the feasibility of obtaining benefit delivery cost savings.
U.S. Regulatory Requirements for Employee Benefit Captives

Prior Approval from the DOL
Employers generally insist on obtaining prior DOL approval for U.S. employee benefit captive arrangements because they may constitute “prohibited transactions” under the Employee Retirement Income Security Act (ERISA) of 1974, as amended. 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 associated penalties are so severe that most employers are unwilling to take risks 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, then submits an application package substantiating that the EXPRO requirements are 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. Further, 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 those of other employers that have previously filed with the DOL.

Requirements for EXPRO
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 the U.S. branch of a foreign captive)
- Financially sound
- Authorized to reinsure benefits
Protection of Participants
- The arrangements must be structured as reinsurance between the employer’s captive, which functions as the reinsurer, and the fronting carrier, which functions as the primary carrier issuing the policy.
- The reinsurance must be indemnity reinsurance (i.e., the fronting carrier has primary liability for benefit obligations).
- The fronting carrier must have a Best’s “Excellent” rating.
- Participants must be provided with immediate and objectively determinable benefit enhancements (the specific enhancement is negotiated with the DOL; however, previous enhancements are public information, so employers can quantify the incremental costs with a high level of precision).
- Participants must be notified.

Reasonableness of the Transaction
- The plan pays demonstrably reasonable premiums to the fronting insurer.
- Rate setting is similar to the formulae used by other carriers.
- The plan pays no commissions.

Independent Certification
- An independent fiduciary must review and approve the transaction.

Insuring Medical Stop-Loss in a Captive

Employers who are 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 noted below, employers may choose to purchase stop-loss insurance from a captive insurance company owned by the employer, rather than a commercial insurance carrier.

Medical stop-loss is generally not regarded as an “employee benefit program” under ERISA, inasmuch as a stop-loss policy indemnifies the employer from unexpected volatility in the claim costs associated with a self-funded health benefit plan. Unlike employee benefit programs, stop-loss programs may generally be insured through captives without the need for advance DOL approval. Consequently, since there is no need for a fronting carrier (and claims adjudication is relatively simple), coverage can be insured directly by the captive.

Plan sponsors purchase stop-loss insurance to reduce financial volatility associated with health benefit costs. Volatility arises when the employer’s actual health claim experience deviates from expected experience. The cause of the plan volatility is usually the presence of an unusual high number of large claims. In general, there are two basic types of medical stop-loss insurance:

Specific: Provides protection against large individual claims; for example, limits 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 during the plan year; for example, by limiting the employer’s liability to 125% of projected total annual claims. Claims reimbursed under specific stop-loss coverage do not accumulate toward the aggregate stop-loss attachment point.
Claims in excess of specific or aggregate attachment points are reimbursed by the stop-loss insurer. Note that stop-loss underwriters do not typically issue aggregate stop-loss protection unless there is 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 paid within a one-year policy coverage period and are in excess of the policy’s attachment points. The stop-loss policy coverage terms will specify if the policy covers claims that are paid in the policy period but incurred prior to it. A claim is deemed to have been incurred at the time medical service is provided. Claims under aggregate stop-loss coverage are actually quite rare because claims covered under the individual stop-loss coverage do not count toward the aggregate stop-loss attachment point.

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 usually seeks only specific stop-loss insurance and raises the attachment point to the level where 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. Some mid-size employers will choose a middle ground by purchasing specific stop-loss coverage but declining to purchase aggregate stop-loss coverage.

There are several reasons for insuring stop-loss through a captive, but long-term cost savings is the most common. Typically, in the commercial marketplace, 20% to 40% of stop-loss premium is allocated to risk charges, sales and administration overhead, and the insurer’s profit. Over time, retaining this risk should reduce the cost substantially. However, since the corporate entity essentially self-insures the risk of large claims, it may be appropriate for the captive’s stop-loss premium equivalent to include a load during the first three to five years so that the captive capitalizes its stop-loss risk.

In ensuing years, premiums can be reduced to reflect lower or even zero surplus additions. Use of existing surplus to cover unanticipated losses is often necessary in the first three to five years in the event of a significantly greater loss than expected. As part of an incremental risk assessment, the captive may establish a target surplus level. Loss probability modeling can assist in quantifying the risk that the captive faces of encountering large losses (or gains) each year. This information enables the corporation to determine the appropriate risk retention and reserving levels (including the risk-moderating impact of continuing to purchase commercial stop-loss insurance for catastrophic losses).

In addition to cost reduction, insuring stop-loss through a captive:

- Dampens premium volatility that occurs in the commercial market
- Avoids the often contentious issues that arise when filing claims with commercial stop-loss carriers
- Removes one-sided contractual provisions intended to protect commercial insurance companies at the expense of policyholders

Particular care in rate determination must be exercised under contributory plans in order to ensure a proper allocation of premium costs between the employer and the employees.
Captives and Global (non-U.S.) Employee Benefit Programs

Many companies operating across different national borders use “multinational pooling” to manage and contain their aggregate employee benefit costs. A multinational pool is a method of combining the claim experience of insured benefit plans in two or more countries. Contracts are signed with locally admitted carriers, premiums are paid by the local offices, and claims are paid by the local insurers. At the end of each year, the local insurers submit the plans’ financial results to the financial unit of the pooling network. If the plans’ experience is favorable, the multinational company receives a return of the premium paid minus expenses as a multinational dividend. A multinational pool can typically achieve a savings of 10%-15% of premiums paid.

However, multinational companies are always looking for additional ways to finance risk more efficiently and further reduce their expenses. Large multinational companies have been exploring captive solutions for employee benefit insurance. Through a captive, a multinational company with the minimum premium requirements ($5 million) could reduce expenses by $650,000 to $1,000,000 annually as well as benefit from adding third-party business to their existing captive.

The most common drivers in assessing the appropriateness of a captive to manage employee benefits are:

- Increased cash flow
- Increased control of employee benefit expenses
- Potentially lower benefit costs for the employer
- Risk diversification
- Potential additional tax advantages (especially in the U.S.)

When a company utilizes a captive approach vs. a multinational pool, it is most likely seeking a lower risk charge component. In a captive that retains the risk, the difference between a pooling program and a multinational pool is the difference between the insurer’s risk charge (risk cost and profit) and the captive’s risk. In a $1+ million contract, for example, the savings can be substantial.

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 the matrix below indicates, a captive can help in managing employee benefit programs in a number of ways:

<table>
<thead>
<tr>
<th>Approach</th>
<th>How It Works</th>
<th>Advantages</th>
<th>Other Comments</th>
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<tbody>
<tr>
<td>Passive</td>
<td>The captive becomes the contract holder for the pooling contract. As they arise, dividends are paid to the captive. The ultimate disposition of those dividends is determined by the captive.</td>
<td>If the pooling contract is owned by the US employer, the dividend (when paid) may be taxable income to the employer. To the extent that the dividend is paid to the captive, the income tax impact is deferred and might be eliminated depending on the ultimate decisions.</td>
<td>Essentially, there is no risk transfer.</td>
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<td>Agreement</td>
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<tr>
<td>Captive</td>
<td>The captive assumes some risk but is very selective in the nature of the risk considered. Typically, this is accomplished by taking over the management of reserves for certain kinds of benefits, while leaving administration of the underlying benefits to the insurance carrier.</td>
<td>The retention is reduced since the values running through the pooling process are less. Necessarily, this increases the potential for a greater pooling dividend. Greater investment returns can be achieved than might be available from the insurance carrier.</td>
<td>Examples include reserves underlying the insured pension benefits and run-off of claims from coverages in now-closed operations.</td>
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<td>Retention</td>
<td></td>
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<td></td>
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<tr>
<td>Treaty</td>
<td>The captive becomes a “partner” with an insurance carrier, providing benefit coverage through accepting premium and assuming risk. The captive also can take responsibility for administrative tasks, such as claims payment.</td>
<td>In addition to the types of potential gains described above, there is the potential for the captive to share in experience gains as well.</td>
<td>An example might be a very predictable coverage like group life insurance.</td>
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<td>Reinsurance</td>
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Typically, the captive will insure the following lines of employee benefit insurance:

- Group Life
- Group Disability
- Group Accident
- Travel Accident
Due Diligence for Global Benefit Captive Programs

Not all corporate governance structures are conducive to the “captivation” of global benefits.

A company must have a strong central management process in place across all business units to obtain optimal results from a captive global benefit program. Companies with a solid internal communication and control process will avoid the most common impediments to a successful program.

However, other impediments may need to be identified and addressed. For example, the company may be operating in countries where premiums cannot be ceded to a captive or only a set amount can be. Alternatively, the captive might be legally required to have a branch office located within the country and have to obtain governmental approval. It is important to understand the complexities in each location.

A further caveat in case of non-U.S. benefits financed through the captive is that the fronting carrier (usually a sales office of a large global carrier) may not be able to provide all support services on the ground (e.g., employee communication, enrollment support, or even claims administration) as these may have been provided by a broker or consultant to begin with. In these cases, the special arrangements must be made with third parties in order to ensure adequate service to the employees.

In addition, the company needs to determine the financial aspects of the plan, whether any multinational pooling programs exist, and how to proceed with bringing the employee benefit programs into the captive.

It is important for a captive program to be properly protected from the risk taken. The captive manager needs to decide what level of risk he or she is comfortable assuming and what the reinsurance needs to be to protect that level of risk. If the captive is comfortable with a risk assumption of $250,000 and determines that the largest potential claim liability from a single event is $5 million, then the captive needs to purchase excess loss protection of $4.75 million.

A widely used 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.
Key considerations for a global captive employee benefits program are summarized below:

<table>
<thead>
<tr>
<th>Lives</th>
<th>Premiums</th>
<th>Control- Ideal Scenario</th>
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<tbody>
<tr>
<td>Over 5,000</td>
<td>$5 million USD of employee benefit premium</td>
<td>• Existing multinational pools in place</td>
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<td></td>
<td></td>
<td>• Centralized processes for governance and procurement of benefits</td>
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<td>• A multinational pool combines insured benefit plans in two or more countries.</td>
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<td>Premiums are paid by subsidiaries on a local basis, and claims paid on a local basis.</td>
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<td>At the end of the year the local insurers involved submit the results of the local</td>
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<td>plans to a network.</td>
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<td>• A financial account is then drawn up showing premiums paid minus claims, insurer’s</td>
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<td>retention reserves, interest, non-rated premiums, local taxes, local dividends and</td>
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<td></td>
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<td>commissions. If the experience is favorable, then there will be a surplus in the</td>
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<td></td>
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<td>multinational account, payable to the client as a multinational dividend.</td>
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Post-Retirement Health (FAS 106) Obligations Funded Through a Captive

In April 2010, the DOL granted its final approval for an interesting captive transaction in which FAS 106 post-retirement health obligations were reinsured to a captive. Under this situation, the employer maintains a health benefit program for approximately 5,000 retirees and dependents. The retiree health plan is funded by a Voluntary Employees’ Beneficiary Association (VEBA) trust, which, pursuant to the transaction, purchases a non-cancelable accident and health medical policy from an insurance carrier. The policy essentially provides stop-loss coverage for the VEBA, within certain corridors set forth under the policy. By pre-arrangement, the policy is reinsured to the employer’s captive insurer.

This transaction is the first of its kind, and, consequently, was not eligible for EXPRO processing. Instead, it was processed and approved under the DOL’s regular (i.e., non-expedited) exemption procedure, which took a number of months.

We believe that a number of issues should be carefully evaluated before using a captive to fund FAS 106 post-retirement health obligations, which are of very long duration (often decades). Such an evaluation should take many factors into account, including the impact of health care reform legislation and anticipated macroeconomic conditions.

Risk diversification for the captive, with the concomitant mitigation of overall claim volatility, is often a significant motivator for many employee benefit captive transactions.

Issues to Consider 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 can it become even more valuable?” Often, a rationale for placing benefits risks in a captive is diversification of the captive’s risk portfolio so that it may assume additional property and casualty risk. The viability of this rationale depends on the company’s current utilization and objectives for the captive.

The tax position of the captive obviously has a major impact on its value to the parent. Therefore, the tax ramifications of including employee benefits risks in the captive should be evaluated, particularly 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 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.
We believe that savings in benefit delivery costs should be examined. A good place to start is to examine historical loss and expense experience for the coverages under consideration to get a feel for the patterns of financial results. However, it is not advisable to reinsure benefits to the captive merely because the loss ratios for the past several years happen 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 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 as well. Further, the transaction costs of implementing the transaction (fronting fees, etc.) should be evaluated carefully.

### Conclusion

Many enterprises are examining the placement of employee benefit risks into their captives. We believe that, while employee benefits risks may have an important role in captives, employers should avoid focusing on employee benefits in isolation and instead focus on the bigger risk management picture and a long-term perspective.

Generally, we recommend that a client’s first step 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 to determine how to efficiently fund the risk assumed—a 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.

For more information on captive strategies, contact George F. O’Donnell at +1.732.302.2168 or george.odonnell@aon.com.
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 Revenue Ruling 2002-89.


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

13 See Department of Labor Advisory Letters 92-02A and 2001-02A.

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Aon provides fully integrated risk management and employee benefits consulting services to clients that are evaluating and implementing employee benefits captive arrangements. Aon’s Benefit Funding Strategies practice is comprised of highly experienced professionals with backgrounds in risk management, underwriting, law, and public accounting. At the intersection of Risk Management and Human Resources, 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).

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