Employee Benefits and Captive Insurance Companies

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Agenda

• Introduction to Employee Benefit Risk Exposures
• Captive Solutions for US Medical Plans
• Captive Financing of US ERISA Plans
• Pooling Global Benefits
• Future Outlook and Challenges
Employee Benefit Risk Exposures

<table>
<thead>
<tr>
<th>1. Large Global</th>
<th>Plan</th>
<th>Lives</th>
<th>Exposure</th>
<th>Premium</th>
<th>Spend per EE</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>Medical</td>
<td>25,000</td>
<td>Accident Mortality</td>
<td>$250 million</td>
<td>$10,000</td>
</tr>
<tr>
<td>US</td>
<td>Life, LTD</td>
<td></td>
<td>Morbidity</td>
<td>$12.5 million</td>
<td>$500</td>
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<tr>
<td>14 Country Pool</td>
<td>Life, Medical Disability</td>
<td>4,000</td>
<td>$1.5 million</td>
<td>$375</td>
<td></td>
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<tr>
<td>Rest of World (est.)</td>
<td></td>
<td>23,000</td>
<td>$8.5 million</td>
<td>$375</td>
<td></td>
</tr>
<tr>
<td>Global</td>
<td>Retirement</td>
<td></td>
<td>Longevity</td>
<td></td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>2. Mid-Market US</th>
<th>Plan</th>
<th>Lives</th>
<th>Exposure</th>
<th>Premium</th>
<th>Spend per EE</th>
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</thead>
<tbody>
<tr>
<td>US</td>
<td>Medical</td>
<td>200</td>
<td>Accident Mortality</td>
<td>$1,000,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>US</td>
<td>Life, LTD</td>
<td></td>
<td>Morbidity</td>
<td>$60,000</td>
<td>$300</td>
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<tr>
<td>US</td>
<td>Retirement</td>
<td></td>
<td>Longevity</td>
<td></td>
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</table>
US Employee Benefit Costs

<table>
<thead>
<tr>
<th>Private Employer Costs</th>
<th>%</th>
<th>$ / hour</th>
<th>Per EE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages &amp; Salaries</td>
<td>69.4%</td>
<td>$21.82</td>
<td></td>
</tr>
<tr>
<td>Mandated Benefits (WC, SS, Medicare, Unemployment)</td>
<td>8.0%</td>
<td>$2.51</td>
<td></td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Healthcare</td>
<td>7.7%</td>
<td>$2.42</td>
<td>$4,834</td>
</tr>
<tr>
<td>Paid Leave</td>
<td>6.9%</td>
<td>$2.17</td>
<td>$4,332</td>
</tr>
<tr>
<td>Supplemental Pay</td>
<td>3.5%</td>
<td>$1.10</td>
<td>$2,197</td>
</tr>
<tr>
<td>Life &amp; Disability Insurance</td>
<td>0.5%</td>
<td>$0.16</td>
<td>$314</td>
</tr>
<tr>
<td>Retirement</td>
<td>4.0%</td>
<td>$1.26</td>
<td>$2,511</td>
</tr>
<tr>
<td>TOTAL</td>
<td>100%</td>
<td>$31.42</td>
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</table>

EXAMPLE: 200 employees = $12 mm payroll w/$1mm medical benefit payments
By buying insurance for 100% of the risk, the carrier receives the full premium, but takes on the risks and potential rewards of the insured’s loss experience.

Instead of paying insurer profits and expense loads on the most predictable losses, the insured takes responsibility for deductibles or Self-Insured Retentions.

The insured may prefer to enhance control over the claims management and bear more risk, subject to enterprise’s risk appetite.

Deductibles or Self Insured Retentions may still be utilized, but the captive accepts risk up to moderate levels of volatility and transfers large losses to the excess carriers.

1. Single-parent captive with other risk types
2. Cell captive with or without other employers
3. Group captive with shared ownership
Stop Loss Group Captive

• aka Health Insurance Group Captive
• Provide employer access to self insurance without the traditional risk and volatility
• Transparency
• Group purchasing dynamic
• Control over Underwriting
• Better experience rating
Typical Captive Member Characteristics

- “Medium” sized employers – 50 to 400 enrolled ee’s
- 80% come from Fully Insured programs
- 20% come from Self Insured programs (this is new trend)
- Privately held
- Entrepreneurial
- Have had “dammit” moment
- Want to control healthcare costs
- Unwilling to rely on “system”
Fully Insured Challenges

• Extra 3-6% of taxes compared to Self Insured
• No real/actionable data
• Reducing claims benefits carrier primarily
• Limited control over plan design
• Only looks good when viewing for one year
• Does not limit long-term risk
Self Insurance is Great but Bumpy

• Improves many of the Fully Insured flaws
• Lasers can add significant increased costs/volatility
• Stop loss premiums can increase significantly in any given year
• Specific Limit levels under constant upward pressure
• “No Laser” policy only helps for a year
Group Captive Structure - Administration

• Each member has their own TPA, plan, and stop loss policy
• Members’ terms are based on their experience
• Group decisions related to:
  • Renewal / Service Providers
  • Wellness
  • Plan Designs & Options
Group Captive Structure – Risk Structure

- Each member has their own “small” self insured layer
- Members share mezzanine claims through the captive
- The captive buys catastrophic insurance ("stop loss") for the unpredictable claims
Group Captive Structure

Risk Transfer

Group Captive

Individual Self Insured Retention (SIR) Layer
Group Captive Structure

Catastrophic Insurance & Program Expenses

Captive Layer

Employer Self Insured Layer
Basic Group Captive Structure

• Avoid
  • MEWA (Multi-Employer Welfare Association)
  • Association Health Plan
• Variation
  • Captive Participant(s)
  • Stop Loss & Reinsurance Limits
  • Insured – employer, trust, affiliate
  • Fronting Carrier and Reinsurance
Employer Motivations

- EB Market
  - Frustration
    - Transparency & Cost of Claims
    - Renewal & Credibility
    - Cost shifting
  - Education
    - Cash flow of claims
    - Outcome based wellness
  - Reactive vs Proactive
Employer Objections

- Status quo / inertia
- Too “risky”
- Too new
- More work
- Employee benefits are taboo
Captive Financing of US ERISA Plans

• ERISA-regulated Plans
  • Medical, Pharmacy, Dental, and Vision
  • Life Insurance/Death in Service
  • Long-term and Short-Term Disability
  • Time off, Vacation, and Sick Leave
  • Defined-Benefit and Defined- Contribution Pension Plans
  • Retiree Medical

• Non-ERISA Plans
  • Most supplemental executive retirement plans
  • Other plans offered to select groups of employees, such as expatriates
  • Individual voluntary insurance, if not influenced by the employer
  • Employer-paid stop-loss insurance used to finance medical plans is not governed by ERISA (see DOL Advisory Opinion 92-02A)
ERISA PTE’s

• Captive insurance of ERISA plans is prohibited and requires a prohibited transaction exemption (PTE) from the US Department of Labor (DOL) if:
  • The captive is a “party in interest” or majority-owned by the plan sponsor; and
  • The insurance transaction involves “plan assets,” i.e., contributions by employees or employers to fund the benefit plans

• The DOL will grant a PTE if proper application is made and certain conditions are satisfied

• There are 3 types of PTEs:
  • Statutory: for insurance companies
  • Class: for captives with 50% or more unrelated business
  • Individual: for all other cases
Individual PTE’s

• The DOL has broad discretion in determining whether or not to grant exemptions. Approval is granted if the DOL determines that the exemption meets ERISA statutory criteria. It must be:
  • Administratively feasible;
  • In the interests of the plan, its participants, and its beneficiaries; and
  • Protective of the rights of the plan's participants and beneficiaries.

• There are 2 paths to obtaining an individual PTE:
  • EXPRO: an expedited process that takes 75-90 days, allowable if the application is substantially similar to those already approved by the DOL
  • Customized, based on individual facts and circumstances, for cases that have different characteristics

• See DOL link: //www.dol.gov/ebsa/Regs/PTE_procedures.html
EXPRO

Early pioneers, Colombia Energy and ADM, proposed a set of conditions for their captive reinsurance exemptions that have become the “substantially similar” standard for EXPRO approvals:

- US captive license
- Audited financial statements
- Use of a fronting company
- An independent fiduciary who certifies that the transaction is in the best interests of employees
- A benefit improvement for the plan
  - Typical cost has been less than a 1% increase
  - However, the hurdle for improvements has increased since the first PTEs were issued in 2000-2007
Global Pooling and Captives

- Multinationals have used EB risk pooling solutions for 50 years, and usage has become even more valuable to employers now, given these trends:
  - Rapid growth in the cost and risk of offering employee benefits
  - Employee demand for privately-funded benefits in growth economies
  - Need for data to describe what benefits are offered locally, how much they cost, and what types of risks they pose
  - Centralization of operations and governance to inform plan design decisions and rein in costs

- The interest in captive reinsurance of pools derives from:
  - Better access to risk exposure and claims data for self-management of EB liabilities
  - Opportunity to blend predictable EB risks with non-life risks
  - Potential to reduce Solvency II capital requirements with diversified risk portfolio
  - Access to reinsurance market products for excess protection on a blended basis
# Prevalence and Usage

<table>
<thead>
<tr>
<th>Network</th>
<th># EB Pools in Operation</th>
<th># EB Captives Fronted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allianz</td>
<td>100</td>
<td>11</td>
</tr>
<tr>
<td>Generali</td>
<td>459</td>
<td>28</td>
</tr>
<tr>
<td>IGP</td>
<td>825</td>
<td>8</td>
</tr>
<tr>
<td>ING/AIG</td>
<td>143</td>
<td>0</td>
</tr>
<tr>
<td>Insurope</td>
<td>647</td>
<td>0</td>
</tr>
<tr>
<td>Maxis</td>
<td>182</td>
<td>21</td>
</tr>
<tr>
<td>Swiss Life</td>
<td>435</td>
<td>1</td>
</tr>
<tr>
<td>Zurich</td>
<td>100</td>
<td>10</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,891</strong></td>
<td><strong>79</strong></td>
</tr>
</tbody>
</table>

*As reported by the Networks

- Most EB pools include these benefit risk exposures:
  - Mortality (death benefits to survivors)
  - Disability (income replacement)
  - Accident (lump-sum benefits)
  - Sickness (primary or supplementary medical and drug payments)
- Some pools include risk-related elements of retirement plans, such as survivor annuity benefits
- US benefits are rarely included
  - Federal regulations prohibit profit-taking by employers
  - Some pools include medical stop loss which reimburses employer payments
Pools Transfer Risk And Drive Results

- Pools aggregate employee benefit liabilities and reduce the per-unit cost of benefit risk and related insurance services.
- Pooling is designed for global companies who want to take a proactive approach to employee benefit financing and have the volume and scale to drive lower costs for their operating entities.

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Corporate Parent

Operating Entities

Network Partners

Network Pool 1

Network Pool 2
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- Corporate Parent - sets global terms and conditions with one or more pooling networks.
- Operating Entities - purchase local policies and transfer risk to pooling Network Partners.
- Networks - reinsure the premiums and risks, combine underwriting experience in the pools, and pay underwriting dividends to the Corporate Parent.
Value of Pooling

• Information and Control
  • Better understanding of risk exposures and claim trends
  • Transparent pricing: claims + expenses + taxes + risk charges
  • Coordinated, efficient communication via central relationships
  • Service Level Agreements to enforce quality performance

• Cost Savings
  • Reduced administrative expenses and risk charges by 200 to 500 basis points
  • Opportunity to recover underwriting margins of 5% to 10%

• Local Benefits
  • Secure, highly-rated local insurers
  • No required changes to benefit plan designs
  • Higher underwriting limits without medical evidence
Sample Captive Program Structure
Captive insurance program with multi-line reinsurance, cross-class aggregate protection, reinsurance market participation

* Multi-line / Multi-year Insurance Program
  - 1 - 3 years
  - Blended captive retrocession protection for Property quota share, Liability, Financial or Special Lines, and Life EB

** Cross Class Aggregate Stop Loss
  - Additional captive protection
  - For Non-life (P&C) and Life Employee Benefits

Diagram from Zurich, July 2015
Emerging Trends and Issues

• Competition among the 8 pooling networks
• More global data available, especially medical claims
• Better systems and reporting
• Risk analytics to measure exposure, spot trends, and optimize risk retention and risk transfer
• Focus on minimizing premium rather than maximizing dividends
• Use of Captives
Practice & Value

Where does one start?

• Clearly depends on the client, but always with the HR team!
  • HR teams are the owners of the EB risks
  • Risk Managers are the experts for insurance solutions
  • Appropriation of the HR language, regulations... is key for the Risk Manager
  • Appropriation of the risk optimization solutions... is key for the HR Manager

• Value to both HR and RM
  • Managing data and risks to prevent and lessen losses
  • Local HR advantages include increased flexibility with regards to underwriting, e.g. nuclear, chemical & biological events coverage, high risk sports, ex-gratia payments
  • RM advantages include risk-capital optimization by reduction in capital requirement via risk diversification