Captives and Employee Benefits: The Emerging Partnership Between Risk Management and Human Resources

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THE ERISA INDUSTRY COMMITTEE

Captives & Employee Benefits - Background and Context

- What is a "Captive"?
  - Special-purpose insurance company established under special statutes/regulations of a domicile
  - Recognized as separate corporate entity for legal and tax purposes
  - No separate physical existence beyond its chartering documents, insurance licenses, books and records, bank accounts, etc.
  - Typically insures P&C risks of the captive's corporate parent and/or its affiliates
  - Some captives insure the captive owner's customers, suppliers etc. (e.g., a franchisor may establish a captive to insure P&C risks of franchisees)

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Why do Companies/Trade Associations/Other Entities have Captives?

- A few of the reasons:
  - No commercial market for certain specialized risks
  - Commercial market often fails to price risk realistically
  - Better risk reporting and control
  - Access to reinsurance markets through the captive (“buying insurance at wholesale prices”)
  - Tax deduction of claim reserves *prior* to actual payment of claims
    - Captives may (if certain conditions are met) deduct unpaid claims reserves
    - However, IRS requires that the captive have adequate “unrelated business”, i.e., business other than the parent’s P&C risks, in order to deduct unpaid claim reserves
    - Employee benefits counts as “unrelated business”

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Employee Benefits & Captives
. . . the "Old Days"

- Prior to year 2000, the Dept. of Labor ("DOL") *effectively* prohibited captive placement of US employee benefits risks/programs
  - Limited exceptions to the DOL's general prohibition were of little/no practical use to most companies
- Some examples of what could be done with captives even before 2000:
  - Benefit programs not subject to fiduciary regulation by the DOL, e.g., foreign benefits and executive benefits
  - Medical stop loss coverage is generally not regarded by the DOL as an employee benefit program

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Some of the Possibilities . . .

- Life
- Disability
- Post-Retirement Health (“OPEB”) Funding
- Active Health (in certain special situations)
- Executive Benefits

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Employee Benefits & Captives Post - 2000

- DOL began approving captive transactions involving US employee benefits under the following circumstances:
  - Pre-approval of DOL
  - Fronting carrier with reinsurance to captive
  - Fronting carrier fully liable for all benefit claims even if captive unable/unwilling to pay reinsurance claims to fronting carrier
  - Fronting carrier rated “A” by Best (however, we understand that “A -” is now acceptable)
  - Captive has a US presence (either US domicile or US branch)

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Employee Benefits & Captives Post 2000 (Cont'd)

- Benefit enhancement
  - Examples:
    - Death benefit limit increase
    - Accelerated death benefits
    - AD&D riders providing education/training benefits for children of deceased
    - Will preparation
    - Rate reductions on supplemental coverage

- Independent fiduciary approval
- Notification to affected participants (DOL requires a mailing of notices)

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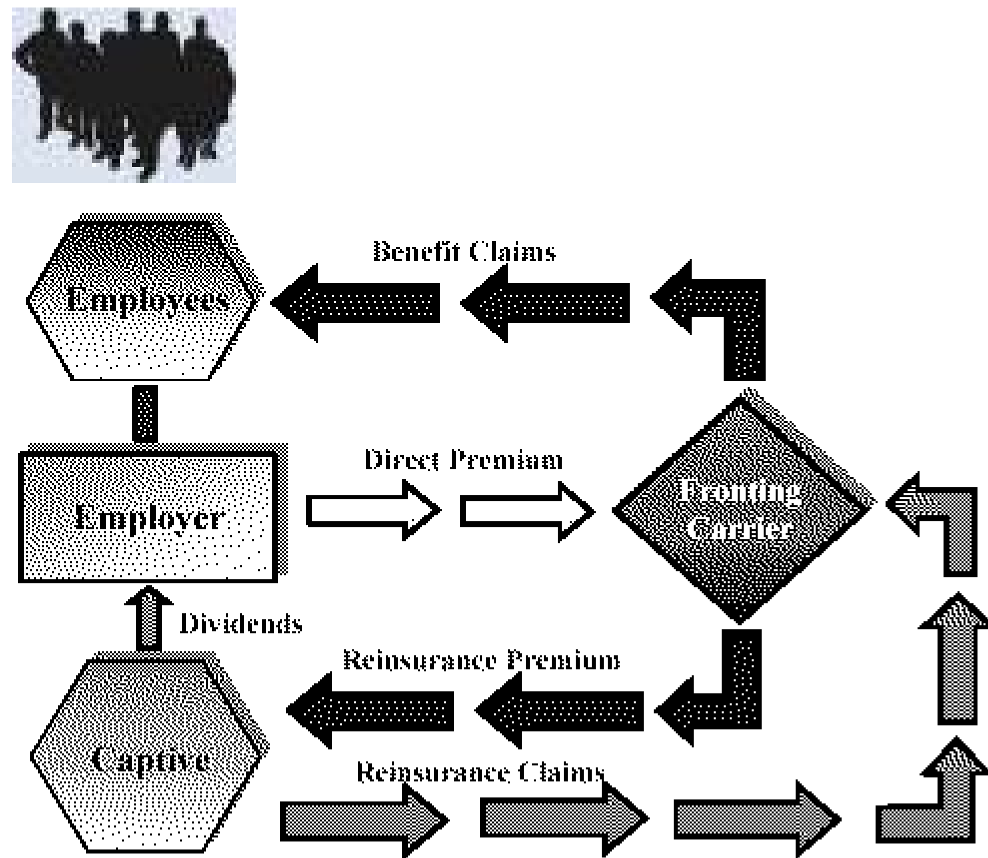
The Mechanics of an Employee Benefit Captive Transaction



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The DOL Approval Process (“EXPRO”)

- Submission filed with DOL:
  - Proposed Transaction Description
  - Benefit Plan Summaries
  - Insurance/Reinsurance Contracts
  - Captive Information
  - Independent Fiduciary
  - Various Other Information
- Tentative authorization 45 days after DOL filing
- Notices to interested persons
- Comment period of 25 days
- Grace period of 5 days
- Final authorization

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Other Considerations . .

- The total cost of the process will vary, depending on the size of the company, benefit enhancements selected, terms negotiated with the fronting carrier, and other factors
- Employee benefits risks are almost always added to an existing P&C captive
  - It would be very unusual for a captive to be established solely for the purpose of bearing employee benefits risks
  - Employee benefits is generally introduced to a captive to complement its P&C risks

So . . . Why Would an Employer Do This?

- Cost savings obtained through additional risk retention
  - Sometimes makes sense to retain risk rather than pay someone else to bear it
  - Cost savings can indeed be achieved
  - However, some claims regarding the magnitude of potential cost savings have been exaggerated
- Flexibility in structuring relationships with employee benefit insurance carriers
- Reduces overall claim volatility in captive

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So - - Why Would an Employer Do This? (Cont'd)

- Tax Considerations
  - If captive is taxed as an insurance company (Subchapter L of the Code), then captive's claim reserves can be deducted before claims are actually paid
  - The captive must have adequate "3d party risk" in order for the captive to be taxed as an insurance company under Subchapter L
    - 30% based on case law; IRS "safe harbor" is 50 %
  - Employee benefits constitutes "3d party risk"
  - Thus, the inclusion of employee benefits risks in the captive can accelerate the deduction of the captive's P&C claim reserves
  - IRS recently mounted, but was then forced to withdraw, a major challenge to captive reserve deductions (proposed consolidated return regulations)

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So - - Why Would an Employer Do This? (Cont'd)

- Post-Retirement Health (OPEB) Funding
  - May afford greater flexibility in utilization of assets presently held in an employer's Voluntary Employees' Beneficiary Association trust ("VEBA")
  - VEBA assets can be invested in a non-cancelable accident & health insurance policy specifically designed to fund OPEB obligations
    - Accumulation of investment income in policy insulated from unrelated business income tax ("UBIT")
  - Policy can then be reinsured to captive
  - To extent permitted by DOL and IRS guidance, amounts reinsured to captive may be redeployed for a number of business purposes
  - FAS 106 accounting treatment preserved

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When Does it Make Sense to Place Employee Benefit Risks in a Captive?

- **The question is**: Do the costs (i.e., DOL filing, benefit enhancement, independent fiduciary) outweigh the advantages (i.e., long-term employee benefit cost savings, 3d party business for the captive)?
- **The answer** will vary, depending on the situation
- A typical profile of a viable situation for US life/disability might be as follows:
  - Substantial P&C claim reserves
  - Additional 3d party business desired
  - Premium volume for insured US employee benefits of $1 million
  - Current employee benefits carrier willing to act as a "front", i.e., to reinsure to the captive

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The Major Issues . . .

- Reaching a sound business decision concerning the placement of employee benefit risks in the captive
  - Feasibility assessment is generally appropriate
- The (sometimes unfamiliar) interaction between Risk Management and Human Resources
  - HR's engagement is essential to accomplish a successful result
- Concerns (often exaggerated) about costs of providing the benefit enhancements that the DOL requires
  - In actuality, the cost of the enhancements is often quite modest
- Lack of familiarity with reinsuring employee benefits from the fronting carrier to the captive
  - A body of experience has accumulated regarding best practices and contract terms

Overview of the Decision Process

- Analysis of advantages/disadvantages of employee benefit captive transaction
- Can/will current carrier front the transaction?
  - If not, willing to change carriers?
- Selection of independent fiduciary
- Benefit enhancement
- Terms of reinsurance agreement with fronting carrier

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Questions?

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