Captive for Employee Benefits

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This article is based on a master thesis finalising studies in Business Administration at the University of Uppsala. The objective of the thesis is to describe captive arrangements for employee benefits and to distinguish areas important for the implementation of a captive program. Within these areas guidelines are presented to facilitate the creation of an efficient solution and to enhance the knowledge of a relatively seen unexplored employee benefit financing method.[1]

1. Introduction

Traditionally captives have been used for insurance of property-casualty business. In recent years corporations have however, due to the rapid growth of employee benefit costs[2], started to investigate the possibilities of including employee benefit risks in their non-life reinsurance captives. Most companies with significant exposure abroad participate in multinational pooling, offered by insurance networks. Multinational pooling enables the corporation to combine its local insurance contracts under one central financing mechanism to obtain a more favourable experience rating and spread of risk. The idea of captive for employee benefits has derived from companies wanting to go a step further than pooling; achieving e.g. cost reduction and a greater degree of control.

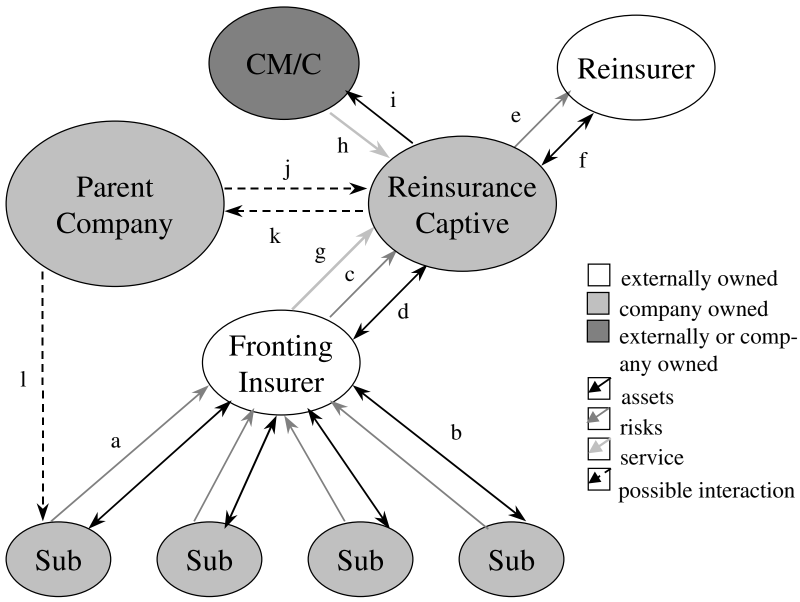
The main reasons for considering captive for these risks are the same as the reasons for forming a captive for property-casualty risks i.e. cost savings and increased investment income. By taking more risk internally, the risk charges taken out by the insurance companies, which are considered to be unreasonably high, are reduced and cost savings are achieved. Exclusion of brokers and group buying further can lower costs. Increased investment income comes from the increased cash flow, and the expectation that the captive owner can get a higher rate of return than the traditional insurance company is able to provide the company with. Moreover enhanced risk management control of benefit financing and the possibility of spreading the captive's overall risk are important positive effects of placing the employee benefits in the captive.

Although the increased interest in using this risk-financing tool for employee benefits, few companies have adopted the idea. The reasons for this might be that the captive solution for employee benefits is a novel approach for parties managing the captive, due to the specific nature of life insurance risks compared to other lines of insurance. Further reasons could be that profit margins are not as large as for property-casualty insurance, that there are co-operation difficulties between risk management department and human resources departments, and that the regulations in countries where the company has employee benefit programs are complicated and diverse.

It has become apparent that there is a need for information concerning reinsurance captive arrangements for employee benefits. Companies considering the captive approach want to know how other companies have set up the arrangements, and how potential problems can be solved. Corporations with already established solutions are also interested in how they can develop and improve their programs.

Figure 1. briefly describes how an arrangement is set up. The subsidiaries of the company insure their risks (a) by paying premiums (b) to the fronting insurer (or fronting infurers) in return of insurance cover. The fronting company() reinsures upon agreement the entire risk or part of the risk (c) to the reinsurance captive, and transfers the premiums as well (d). The reinsurance captive retrocedes the risk (e), which exceeds its retention with reinsurers on the international reinsurance market who receive premiums in return (f). Claim payments go in the opposite direction. When loss occur the subsidiaries receive indemnity from the fronting insurer (b), the

Figure 1. Actors and their Interactions in a Captive Reinsurance Arrangement for Employee Benefits



fronting insurer goes to the reinsurance captive for a refund (d) which then receives compensation from the reinsurer on the reinsurance market (f).

The fronting insurer provides the captive with service consisting of, among other things, the issuing of insurance policies on a direct basis with the local subsidiaries (g). The captive pays a ceding commission to reimburse the fronting insurer for its costs (d). When the captive then retrocedes part of the risk to the reinsurance market, by paying premiums, a ceding commission is paid to the captive, which recognises its costs (f)

The captive management & consulting provider (CM/C) is either one entity or two separate entities, owned partly or not at all by the company, and provides the captive with service. The service consists of management service needed continuously such as administration or accounting and consulting service bought for specific proposes (h). These services are paid for by the captive (i).

When the captive accepts the underwriting risk of the employee benefits, the overall savings in premiums or additional investment income in the captive, may not be enough according to rules in the domicile, and therefore additional capitalisation of the captive might be needed (j). The surplus which hopefully is generated from the captives business and which is not kept in reserves, can be returned to the parent company (k), and dependent on decision by the parent company, be returned also to its subsidiaries (l).

2. Evaluation of the captive solution

Before implementing the captive solution the company needs to ascertain that this solution is the best employee benefit financing alternative for the corporation. A preliminary study should therefore be conducted investigating existing insurance arrangements and verifying that the objectives of placing the employee benefits in the captive are compatible with the original objectives of the property-casualty captive. The audit should establish the costs for premiums, retention and other expenses and also examine whether there are reserves to be transferred from current insurance arrangement to the captive.

It further has to be established that the company has the right size and structure for the arrangement to be profitable.

The opinion varies concerning the number of employees covered that a company ought to have to use a captive for their employee benefits. The number ranges from 3000-8000 employees covered. The annual premiums have to be above USD 1 M (Howard 1996). For smaller and medium size companies it will not be possible to achieve meaningful cash flow and cost savings that will justify the time and expense of implementation and ongoing administration of the captive (Banham 1995). The corporation also has to estimate whether it has a natural spread of risk. A concentration of employees to few places makes the corporation vulnerable to single events, such as an accident in a factory with thousands of employees. Events like that could seriously damage the captive and the corporation as a whole and thus, with that type of company structure, the use of captive for employee benefits might not be the right risk management solution. On the contrary, companies with an even spread of employees over numerous locations normally should be well suited for the captive solution. (O'Neill 1998)

The organisational structure of the company might influence the outcome of a captive program. If a captive program for employee benefits shall be successful it is important that the company has control over its benefit programs on a local subsidiary level (Howard 1996). In corporations with a decentralised structure, the local subsidiaries generally have their separate employee benefit programs and the local human resources staff takes all decisions regarding these plans. Following this, a decentralised company structure might make it more difficult if a company wants to implement a captive program for its employee benefits. In these cases either the corporate risk manager or the corporate human resources manager will have to spend much time, negotiating with and convincing local subsidiaries to get them involved in the captive idea (Van den Nieuwenhuysen 1998). In centralised companies an implementation of a captive program for employee benefit risks probably would be easier since local subsidiaries generally have less autonomy than in a decentralised organisation. Such companies also usually have centralised control over costs and data, which would ease e.g. the review of the claim situation within the corporation before implementing the captive program. (Henderson 1998)

The advantages by using a captive for employee benefits can, to a greater or lesser extent, be achieved by using financial solutions other than a captive (Hunter 1993). Therefore, the company should consider other alternatives before making the final decision. By e.g. pooling the company achieves a number of advantages that can be gained also by the captive solution such as control advantages and possibility to purchase insurance on an aggregate basis for a number of countries (Hunter 1993). Following this a company needs to consider what additional advantages can be gained by using the captive in comparison to multinational pooling (Shimer & Sloss 1993). Also there are a lot of companies that do not manage their pools effectively since they still approach their insurance operations in a decentralised manner with the parent exerting little control over the local subsidiary (Zolkos 1994). For such companies an alternative solution can be to improve the existing multinational pooling arrangement.

3. Design of the life part of the captive

The first step in designing the life part of the captive is to investigate the possibilities of including the employee benefits in the existing captive. A separate license for the property-casualty captive to hold life insurance risks, needs to be obtained. The licence is necessary because employee benefits are generally considered as long-term business, which property-casualty business is not. In some domiciles, such as Dublin, it is not allowed to commingle life and property-casualty insurance in the captive. A company with a property casualty captive in Dublin has overcome this problem by creating a life captive subsidiary to the property-casualty. The general lines risks are kept separately from the employee benefit risks and they do not influence each other, but the captives share reserves (Van den Nieuwenhuysen 1998).

3.1 Risk selection

Employee benefits include several insurance covers and the company has to decide which of these risks to reinsure in the captive. Life insurance/Group life and disability insurance is often included in the captive. The claims are few and the business is relatively seen, often quite profitable. Accidental death or dismemberment Insurance, which in reality is a combination of life and disability insurance is often also included as well as medical insurance, which for many companies involve increasing costs. For multinational companies with coverage for many travel days a year, the premium costs for travel insurance is very high and therefore of interest to place in a captive. Using a captive to fund this insurance gives the company flexibility in loss situations. If for instance an employee is injured in a foreign country, the company can decide to bring him back home, whereas an insurance company would use a local hospital. Pensions are the saving part of the employee benefit program, and it is generally not funded in captives. However this is something that is likely to increase. (Boysen 1998)

There is no rule of thumb of how to select the employee benefits. Rather the choice is company and country specific, and dependent on agreements with fronting insurers. Some companies tend to involve those risks which, due to their comparable high premiums and simple administration, are most suitable in the captive i.e. group life and disability insurance. Other companies include as many benefits as possible in order to take maximum advantage of the arrangement.

Risk managers are interested in transferring the employee benefit premiums not for one country, but for all their countries (Howard 1996). Rules and regulations for employee benefits however differ from country to country, which makes it hard to get the knowledge and an overall view of employee benefits worldwide. Local restrictions firstly determine which countries are legally possible to include in the captive. Thereafter the choice of which countries to involve in the captive arrangement is an issue of obtaining a satisfying number of employees covered. Dependent on the company structure, this can be achieved either by involving only a few specific countries where the largest amount of employees are based or involving a large number of countries over which the employees are spread.

To obtain a satisfying number of employees covered is particularly important in the establishment phase. In the continuous development of the captive operations other factors such as negotiations with local insurers, local loss history, knowledge of the subsidiaries and similarity of employee benefits program, also determine the choice of which countries and subsidiaries to include in the captive.

3.2 Risk ceding & risk retention

Concerning the captives risk retention the early captive usage involved placing part of the employee benefit risks in the captive. Companies in recent years have however focused on taking full assumption of the risk on a global level. The desire is to have the fronting insurer reinsure 100 percent of the risk in the captive, and rather buy protection from the reinsurance market. Under the conditions that risk management is confident handling life insurance, that the captive‘s capital level is sufficient in case of losses and that catastrophic reinsurance protection is available, there is no reason not to aim a maximum ceding percentage and retain as much risk as possible within the captive. However legal restrictions and fronting insurers influence can determine the actual percentage taken. Further, difficulties may be encountered concerning the pricing on the reinsurance market of global aggregated protection for employee benefits combined, due to underwriters‘ lack of experience in evaluating these risks.

Traditionally captives have bought stop-loss cover for every single insurance line in the captive, but in these days, and especially for those which include employee benefits, the goal is to protect themselves from multiple hits in different lines in different parts of the world. It, however, seems to be hard for the underwriters to evaluate cross-class aggregate risks world wide in the captive, since they do not have the experience and in-house skills to do this. It means that captive owners must expect difficulties of finding available quotes for cross-class aggregates involving property-casualty classes plus group life and disability (Captive Insurance Company reports 1996). The fact that the portfolio contains risks from all over the world discourage underwriters. Europeans would rather leave out American risks and the Americans would rather leave out the unknown rest of the world. (Howard 1997)

4. Handling negative reactions

As mentioned above reactions from local subsidiaries need to be anticipated, but there are in addition other obstacles due to reactions from various parties.

4.1 Human Resources department and Risk Management department

Implementing a captive arrangement for employee benefits may cause negative reactions within the company because two dissimilar departments are involved. Often before arranging a captive program the responsibility for the employee benefits lay on the Human Resources department which focuses more on design of insurance coverage rather than managing the costs of the benefit insurance. It is however usually people in the risk management department with experience of operating the captive and normally with a property-casualty background, that take the initiative of insuring the employee benefits in the captive. Normally the people in the Human Resources department are unfamiliar with the concepts of risk management and the risk manager on the other hand does not have the full understanding of the nature of employee benefits.

Consequently the intrusion of risk management department into areas traditionally handled by the human resources department and their different working objectives, are possible hurdles in the process of creating a successful program. Co-operation and communication from the beginning is important and by developing a program with divided responsibility areas, the conflict can be mitigated and communication made easier. The evident solution is that human resources department assumes responsibility for the design of coverage, while risk management department handles the financing.

A financial incentive as in an immediate premium discount and the possibility for human resources staff to participate in the selection of fronting insurer are examples of successful strategies through which a company can go a step further in order to ascertain full support from human resources department. These strategies are particularly suitable when a company has many subsidiaries with high level of autonomy that need to be persuaded to join the captive project.

4.2 Fronting insurers, trade unions or employees

When involving a reinsurance captive in the financing of employee benefits, the risks of these insurance are ceded from the direct insurer to the captive. Therefore the role of the insurance company in a captive arrangement for employee benefits, becomes that of a fronting insurer. Acting as fronting insurers the insurers see the profitable part of the business being taken away and they consequently adopt a negative attitude towards captives. This is apparent in tough negotiations with fronting carriers, which is a continuous problem for the companies. They are naturally to a greater or lesser extent dependant on their fronters and can therefore not ignore this party.

The optimum business relation is where the company can stipulate the conditions, but also where the insurer is motivated to put effort into its tasks. An example of how to create such a situation is to have a selection process where potential fronting insurers compete to win a contract implying a considerable amount of business. The company can ascertain that the insurer which best meets the demands is chosen, and that it is willing to make the arrangement work. In the continuous business relation with the fronting insurer, the company ought to evaluate the services provided in order to keep the arrangement competitive.

One advantage of having an insurer to front the captive arrangement is that employees will see no actual change in their relation to the insurer. Although the risk is taken by the captive, the employees still receives confirmation of insurance cover directly from the local insurance company and not from the captive. Thus, it is possible to keep the same relationship between the employee, the local subsidiary and the insurance company as before. The fact that the local insurer still issues the insurance policies is important in the negotiations with labour unions. (Boysen 1998)

When changing insurers or in other cases when the captive project is discussed employees or trade unions might express concerns about benefits being influenced by the captive‘s financial status. Captive representatives therefore ought to be prepared to explain how the arrangement is set up and assure these parties that this is not the case.

5. Arrangement of service facilities

The company needs to establish service facilities concerning fronting, management and consulting.

5.1 Fronting facilities

Since it has been revealed that fronting insurers can influence important choices like employee benefit selection, selection and risk retention an efficient fronting arrangement is of value for the company. It is desirable to have the fronting facilities provided on a co-ordinated basis through one or two insurers (Bawcutt 1991, 97). Fronting arrangements for employee benefits are generally set up in three different ways: with the use of a network and independent local insurers (Fronting Solution 1), having solely independent local insurers (Fronting solution 2) or by using only a network (Fronting solution 3). With the use of the first or second alternative, administration is considered to be larger and thus the arrangements costly and complicated, in comparison with the third option. Further, the use of the two former alternatives brings about limited negotiation-power over independent local insurers. (Van den Nieuwenhuysen 1998)

With the ambition to include benefits in several countries a network as fronter is appropriate, which then plays a role as a co-ordinator and information provider. The network handles the international co-ordination between local subsidiaries, and the expertise of the insurer in each country can be taken advantage of. It is the local insurers that issue the benefit contracts and have the responsibility to ensure compliance with local market regulations and practise (Wright 1994). At the end of the reinsurance period, the network headquarters normally will deliver a statement to the captive company including information about e.g. premiums collected locally, claims occurred, expenses and local dividends (Nacinovich 1998).

Currently there are 10 networks operating worldwide. The structure of these varies from case to case. Some are formed by one single insurer with units in many countries; Swiss Life is one example of this type. Other networks are partnership between two big insurance companies, for example AIG-Winterthur and Aetna-Generali. These partnerships often includes one US insurance company and one European insurer, which means that their joint coverage typically ranges over a broad territory. There are also some networks that involve more than two insurers, for example Insurope that is a joint venture between five European insurance companies.

The networks also differ in the way they are organised with respect to their local partners. Some of the networks use their own subsidiaries throughout the world. Others use non-related affiliates as partners. The fact that some of the networks have their own subsidiaries might give them a competitive advantage in a captive arrangement in comparison with those who only have partnerships with other local insurers. This, due to the importance of the network‘s control over their local insuring partners, enabling co-operation in an efficient manner. (Henderson 1998)

The network can also be used to assume risk that the company for the time being does not want to place in the captive. One example of this can be benefit programs in newly acquired companies. These insurance will be kept in the pooling arrangement until the captive management have obtained a full understanding of how the benefit program works. Further, including and excluding contracts in the captive can be organised with the network so that undesired risks, such as small, unfavourable or e.g. medical insurance contracts and pension contracts stay in the pool. (Van den Nieuwenhuysen 1998)

When choosing networks selection criteria such as; number of countries covered by the network, the willingness of operating the program, reputation and qualities of local insurance offices, can be of help for the company. As mentioned before having a selection process where networks compete to get the contract have further been shown to be effective when making the decision of direct insurer. The company can through this ascertain that a competitive alternative is chosen.

In order to achieve a satisfying fronting arrangement a company needs to be prepared to change the traditionally used insurer. Transitional costs of changing existing benefit financing arrangement may however be apparent. Because of the long-term nature of many benefit contracts, it might be hard and costly to change insurer and surrendered contracts will impose penalties on the captive. Further consequences such as the need of investment in time and effort and the breaking of relationships, might make companies reluctant to the idea of changing insurer and accordingly obtain a more efficient fronting arrangement.

5.2 Captive management & consulting facilities

The company can choose to manage the captive itself, or to buy the necessary service from an outside organisation. When managing the captive within the company, an existing organisation can be used or a new separate organisation can be set up. When including employee benefits in the captive, a new management organisation is usually not established. The way to manage the life part of the captive depends on the way captive management is set up for the property-casualty captive.

One problem with moving employee benefits is that those involved in the captive operation typically come from a property/casualty focus and might not have full understanding of how benefit systems works. The insurance of employee benefits within the captive will introduce business practice and concepts new to captive management with the effect that buying in extra resources for administration might be necessary. The increased need of administration with the employee benefits is present in the setting-up phase, as well as on an ongoing basis, and includes functions like claims handling (Hunter 1993).

Since a captive management company often is used for property casualty insurance, it must be judged if their knowledge of life insurance is sufficient. The company‘s knowledge is however to a greater or lesser extent important, depending on what the tasks are. The administration and accounting of life insurance is similar to that of property-casualty insurance and therefore special skills for this new insurance line are not really necessary. If however the work involves e.g. underwriting, legal issues or consulting services life insurance skills are required.

Captive management companies very knowledgeable in property-casualty coverage might not have much experience with employee benefits. It can be a long and painful learning process for the captive manager to figure out how employee benefits are different to property- casualty coverage (Howard 1995). Even for large captive management companies, time and capacity is needed to acquire knowledge about life insurance business and the various regulators for life insurance in different countries (Persson 1998). Therefore not all offer services such as structuring the arrangement.

For consulting services companies can use external companies other than captive management companies. Employee benefit consultants are in some way often involved in the captive arrangement for employee benefits, mostly in the initial phase when implementing the idea. The impression is that the different opinions concerning the need of consultants depend on the scope of the programs and the companies‘ eagerness to independently manage the arrangements.

6. Summary

Before forming the captive solution for employee benefits, a company fulfilling the necessary size criteria ought to compare the captive advantages and disadvantages with other financing alternatives. In order to take full financial advantage of the captive solution, the company should aim a maximum ceding and retention percentage, and include as many employee benefit risks as possible. Obstacles hindering the achievement of such an effective solution are fronting insurers‘ influence, legal restrictions and for decentralised companies, subsidiaries‘ resistance. Consequently these problems need to be anticipated and prevented. Moreover, reactions from human resources departments, which see their responsibilities taken away, have to be acknowledged. Finally, concerning the most important service facilities, the fronting insurer should carefully be selected and the existing captive management organisation should be used.

7. Notes

1 “Captive for Employee Benefits” Master thesis, Department of Business Studies September 1998. Authors: Maria Nilsson & Sofia Tesfazion, Tutor: Carl G. Thunman

2 *Employee Benefits* are defined as: Benefits offered an employee at his place of work by his employer, covering such contingencies as medical expenses, disability, retirement, and death, usually paid for wholly or in part by the employer. These benefits are usually insured.

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Apart from further secondary, sources mainly consisting of articles from business journals, industry magazines and Internet, the thesis is based on a study of eight international companies’ captive arrangements for employee benefits.