EMPLOYEE BENEFITS REPORT 2015

From the publishers of

CAPTIVE REVIEW

FINANCIAL INCENTIVE
Rising costs push companies towards captive solution

RISK MITIGATION
Key to success for smaller captive owners

LEGISLATION
Regulatory changes allow for previously prohibited captive options

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Introduction

The growth in businesses utilising captives to tackle rising employee benefits costs is a relatively recent phenomenon.

Initially it was only a viable option for larger companies due to the associated regulatory and tax costs, but smaller companies are now discovering ways to make use of the tool.

The proliferation and viability of risk transfer solutions for employee benefits can partly be put down to the increasing desire to diversify and place uncorrelated risks into the captive.

Rising costs, however, due to legislative developments such as the Affordable Care Act and the ERISA rules in the United States have also led businesses to seek innovative solutions to mitigate these costs.

In the *Captive Review Employee Benefits Report 2015*, we analyse the various ways companies are using captives effectively to self-insure or reinsure stop-loss cover, pensions, life and long-term disability costs.

Captive Review speaks to leading industry figures who outline the challenges faced by small to mid-sized businesses entering the captive space and how group captives are being increasingly utilised.

We also explain how the more established stop-loss captive industry has evolved and the advantages this solution continues to offer. At the same time, forward-facing US insurers are launching innovative new programmes specifically designed to be compliant in the complex environment brought by the Affordable Care Act.

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INSURANCE

Constitution is a newly formed company located in Nashville, TN.

The structure of Constitution is that of a Protected Cell Company with independent entities beneath it, called Protected Incorporated Cells. These entities can take any legal corporate form. Under Tennessee law each unit and its assets and liabilities are separate from the actions of the other entities. A legal "ring fence" protects the assets of one cell from creditors of another cell.

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The advantages offered to Constitution's clients include ease of entry and exit, flexibility in cost and regulation in a jurisdiction recognized globally for its business acumen.

M.R. Mead and Company, Inc. is a firm well known for its innovation, credibility and reliability in the world of alternative risk finance. Caitlin-Morgan is equally well known as a successful operator of programs for various professions. By financing their own risk to a larger or smaller degree you have the ability to integrate a more cost efficient tool into their overall balance sheet.

By using Constitution the cells use their money more efficiently because the cells only cover their actual exposure, not funding for a regulatory minimum thereby eliminating having capital that is not producing a return. Constitution offers greater efficiency in the use of your risk dollars.

Now more than ever it makes sense for the successful business owner or association of businesses or high net worth individuals to look more closely at a captive, especially Constitution Insurance Company. We can help you choose the right structure to address your coverage and risk financing challenges and turn a dead balance sheet item into a profit making entity.

Contact Mike Mead, 773-693-4990, or mmead@mrmeadandco.com for more information and to have your questions answered.

CAPTIVE SOLUTION FOR STOP-LOSS COVER

Phillip C. Giles, of QBE, talks to *Captive Review* about the challenges of offering medical stop-loss captive cover in the US

Captive Review (CR): What are the benefits of arranging medical stop-loss cover through a captive?

Phillip Giles (PG): The first and most obvious benefit is being able to reduce the costs associated with delivering healthcare insurance to employees; hopefully, on a long-term basis. The premise of any alternative risk structure is achieving the most appropriate balance between risk assumption and risk transfer to optimise savings while supporting the organisations risk management, financial and business objectives. In most cases, pure self-insurance is the most efficient alternative risk transfer mechanism. Captive participation in an excess coverage (medical stop-loss) that insures a self-insured plan further amplifies the benefits that can be derived from self-funding.

It's almost a way of double-dipping to maximise cost savings on insurance and enhance the profitability of the captive. For smaller employers, participation in a group captive can provide increased access to many of the same captive advantages (increased risk spread, service provider cost leveraging, surplus dividend sharing, etc.) that are enjoyed by larger organisations.

CR: What implications does putting medical stop-loss through a captive have on the parent organisation?

PG: I should first point out that, with exception to group captives, it usually doesn't make sense to form a captive solely for medical stop-loss. The premiums, except for very large employers, are not typically large enough to provide enough economic justification. The primary opportunities will be for employers that already have an established captive to which the stop-loss can be added. Employers that have an existing captive are likely to be self-funding medical benefits already. Adding the stop-loss to an existing captive that primarily writes long-tail coverage, such as workers compensation or liability, can provide a protective 'short-tail' stability hedge by diversifying the captive's risk portfolio.

Just as a captive is used to strategically enhance risk management efforts, adding stop-loss to a captive can also augment an organisation's HR objectives by enhancing the efficiency of how employee benefits are financed and delivered to employees. Although many stop-loss policies will provide coverage that mirror's an employer's plan document, some stop-loss policies may contain exclusions (differences in conditions) that conflict with the plan document. Stop loss carriers will also frequently identify specific individuals having large ongoing medical conditions which may be assigned a higher level of employer risk retention, also known as a 'laser', or may be excluded (lasered) altogether from stop-loss coverage. DICs and lasers are examples of terms and conditions that can be effectively absorbed by a captive to help maintain long-term continuity to self-funded benefit delivery. Surplus derived from the underwriting and investment return from the captive can be strategically deployed to offset future plan costs, used to expand benefits or returned as dividends to the captive owners.

Written by
Phillip C. Giles

Phillip C. Giles is vice president of sales and marketing for QBE North America and oversees accident & health sales and strategic marketing initiatives as well as medical stop loss captive business.

CR: Does medical stop-loss enhance the tax advantages of a captive?

PG: Even though medical stop-loss can provide beneficial portfolio diversification for a captive it should not be considered third-party risk for tax purposes. There are some differing opinions on this however; from my perspective, I don't see how it would qualify. Stop loss provides coverage to the employer for its obligations – i.e. potential liabilities – relative to the self-funded benefit plan. It does not provide any coverage directly to employees. In other words, no third-party risk exists. Employee benefit insurance coverage that pays benefits directly to the employee or to healthcare providers on behalf of the covered person is however considered third-party risk by the IRS. The distinguishing element is determined by whose liabilities are actually being insured, the employer's or the employee's. This was recognised by the US DOL in a November 2014 technical release (US DOL No. 2014-01). Since, I can't give tax advice, and as there have been some conflicting opinions, my recommendation is to always seek guidance from a captive tax attorney.

CR: Does a stop-loss captive require DOL approval?

PG: Any employee benefit insurance (other than voluntary coverages) that provides

coverage directly to an employee will require an ERISA Prohibited Transaction Exemption (PTE) from the DOL for inclusion into a captive. Since the self-funded medical plan itself is not part of the captive, it does not require a PTE. Medical stop-loss is not recognised by the IRS as a plan asset and, as I mentioned, it insures the employer rather than the employees, it is not considered employee benefit coverage and also would not require a PTE. The fact that medical stop-loss insurance is not considered employee benefit coverage was also recently affirmed by the same DOL technical release.

CR: How much can the increased interest in a captive solution be put down to the Affordable Care Act?

PG: I wouldn't say that ACA was the driving factor but it certainly helped accelerate the interest and speed of growth. Self-insurance of healthcare benefits has sustained considerable expansion prior to ACA – from 48% of all employers in 2000, to more than 60% currently. With some mandated provisions within ACA being pre-empted by self-funded plans, coupled with the financial efficiencies of self-funding, has encouraged more employers, of all size ranges, to explore self-funding as an option. With that, the opportunities for placing stop-loss into a captive have and will continue to increase. There are also improved opportunities for smaller employers, as long as they are able to effectively establish a self-funded plan, to participate in group captives.

CR: How has the regulatory environment altered in the US during 2014 and how does this affect employee benefit costs and programme planning?

PG: The regulatory environment toward self-funding or stop-loss captives has not changed drastically over the past year; however some things are being more appropriately defined. Since an employer's self-funded benefit plan, by its very nature, is deemed by the US Department of Labor, not to be engaged in the business of insurance, it cannot be regulated by the states as insurance. Medical stop-loss, conversely, is insurance and the DOL has recently affirmed, via the technical release that I previously mentioned, that it can be fully regulated by the states. That's the same position that I have always maintained and supported. Some states may elect to set minimum specific and aggregate deductibles (most at $20,000 specific and 120% aggregate) for medical stop-loss policies. This may prevent some smaller employers from self-insuring their healthcare however, given that only .03% of all self-funded employers have a specific deductible of less than $20,000, the number of employers that will actually be affected by minimum specific deductible mandates will be negligible. For reference, 80% of self-funded employers have a specific deductible of greater than $50,000 and the median specific deductible across all plans is $85,000. Although I don't necessarily agree with using a hard minimum floor as the basis for determining an employer to be self-insured, I personally don't believe $20,000 is completely unreasonable. I should also mention that some states have established specific minimums of $10,000 or $15,000 so there is still a regulatory variance as of today. I can actually remember – let's just say it was a while ago – that some states would only allow casualty companies to write medical stop-loss. So, in some regards, the regulatory environment is actually easier now. In my opinion, the regulations have not really changed inasmuch as they are being more appropriately defined, which provides less ambiguity in some areas.

CR: Medical stop-loss captives remain popular solutions; is the proliferation of onshore US domiciles encouraging further formations and is there an advantage to domiciling onshore rather than offshore?

PG: Unlike captives that provide employee benefits requiring a DOL PTE, a medical stop-loss captive is not required to be domiciled onshore. Since more offshore captives have made the 953(d) election to be taxed as a US-based corporation, the advantages of incorporating offshore have eroded. In reality, most stop-loss coverage will be held within an existing captive so the domicile decision becomes automatic. In most cases, the existing domicile will only require an expansion or amendment to the original captive business plan and ensure that appropriate surplus has been established to accommodate the new line of business.

Domicile selection for group captives is a bit different. More of these are being established solely to write stop-loss and as such, the incorporations have gravitated to domiciles that are friendlier to and familiar with the nuances specific to group captives such as Cayman, Bermuda and Vermont.

> "In my opinion, the regulations have not really changed inasmuch as they are being more appropriately defined, which provides less ambiguity in some areas"

INCORPORATING PENSIONS

James Hudston and Stephen James, of Mercer, explain the advantages and challenges of including pension plans within your captive

As evidenced by this special focus on employee benefits from *Captive Review*, there is considerable interest from many employers on incorporating employee benefit risks into a captive. Often when we talk about employee benefits in a captive context, we talk about insured employee benefits such as group life and health. The vast majority of companies that have placed employee benefits into a captive have focused on these benefit types because they are the simplest and cheapest to include within a captive arrangement – although the process does come with its own challenges.

The focus of this article is on the more innovative use of captives to finance and manage the risks associated with defined benefit pension plans. Many defined benefit plans are seen as legacy remuneration vehicles but the combination of low interest rates, asset volatility, complex pension regulations and accounting standards mean in many instances that this legacy is having a profound impact on corporate balance sheets, whether through volatility, inefficiencies or curtailment of financial flexibility.

Two major transaction types have evolved over the past number of years and others are being considered as corporates begin to understand the potential application of captives to defined benefit pensions:

- A funding solution which transfers the management of a scheme's assets and liabilities to the captive
- A longevity risk transfer solution for hedging the risk that members live longer than expected.

Written by
James Hudston

James Hudston is a senior consultant in Mercer's Financial Strategy Group based in London. He specialises in advising clients on the use of evolving marketplace technology for the efficient financing and risk management of defined benefit pension plans.

Written by
Stephen James

Stephen James is a principal within the Mercer International Consulting Group, based in London. Along with his expertise on a broad range of global issues, he leads Mercer's support to companies on employee benefit captive solutions outside of the United States.

Captive solution for pension funding

Outside of the United States, pension assets and associated management functions are typically under the control of local fiduciaries. Stated simply, the captive transaction involves the transfer of these investment assets and management functions to a captive via an insurance contract routed through a fronting insurer. The captive is then responsible for investing the assets transferred to ensure that it can meet the payment obligations to the fronter. Such a transaction is attractive to fiduciaries as benefits are annuitised while also attractive to the corporate sponsor since the cost of annuitisation is not crystalised.

Why might a company want to do this?

The primary benefit of such an arrangement is that it provides the corporate sponsor with control over the investment strategy of the assets. Typically, the fiduciaries of the scheme would have this investment power and it is common for the company to prefer an alternative investment strategy to that pursued by the fiduciaries. For example, in seeking to enhance the security of member benefits, fiduciaries are often minded to increase the degree of matching in the investment strategy but the act of buying bonds to achieve this typically crystalises the likelihood of higher contribution demands on sponsors.

A second major advantage of the structures is that any surplus which arises in future can be returned to the company through a dividend, whereas in many pension scheme structures, any assets that are not required to pay benefits would be trapped in the scheme.

A third significant benefit is the scale economies potentially achieved, in particular if a captive is used to consolidate fragmented arrangements across a number of geographies.

An additional advantage that is currently gaining increased interest in the market is that through a cash flow matching investment strategy, a better balance between returns on the assets and risk can be achieved through a captive than in the existing pension scheme arrangements. This is because a regulatory and contractual arrangement can be achieved where the discount rate on liabilities in the captive can be set to reference the yield on the underlying assets. As a result, solvency requirements and the value of the captive's assets can be structured to move broadly in line with each other, thereby limiting

the risk of requiring additional capital while still hoping to sweat out a reasonable rate of return.

Lastly, a captive solution can provide efficiency savings through consolidating a wide range of risk and financing arrangements into one location where value can be unlocked through an enterprise risk management approach. We see considerable growth potential for captives as an enterprise risk management tool for sophisticated corporates, with pensions risk being an obvious candidate for inclusion in such a program. For example, while there may be no risk transfer from the corporate's perspective in moving pensions risk from a trust to a captive arrangement, a wider range of risk transfer solutions becomes available versus those available to the pensions fiduciary.

Challenges?

The key constraint to the transaction is the need to fully capitalise the captive up to insurance capital requirements. Moving corporate pension obligations into a funding structure involving a regulated insurance entity introduces the requirement to maintain regulatory capital at the outset to cushion against inherent volatility. In the conventional property and casualty captive situation, capital requirements are driven primarily by underwriting performance, which to some extent is predictable. In the pension arrangement however, capital requirements are linked to investment strategy and specifically to the performance of investments which is a far more dynamic measure and subject to short-term volatility.

Frequently, this can require a significant capital injection at the outset of the transaction, which is subsequently returned to the company over time.

A captive solution for pension funding is also a significant transaction that requires substantial resources from the fiduciary and the sponsoring corporate to establish and manage over time. Tax, accounting and choice of domicile are also important considerations for any transaction.

> **"A captive solution for pension funding is also a significant transaction that requires substantial resources from the fiduciary and the sponsoring corporate to establish and manage over time"**

Longevity structure

Pension schemes are heavily exposed to longevity risk, i.e. the risk that members live longer than expected. A longevity hedge market has developed which allows schemes to mitigate this risk. Typically, this has involved a fronting insurer contracting with the pension scheme. The fronting insurer agrees to receive a fixed set of payments from the pension scheme for the duration of members expected lives and in return pays a variable set of cash flows that depend on how long members live. If a member is expected to live to 90 but dies at age 80, then the insurer makes a profit, whereas if the member lives to 100 the insurer makes a loss. Generally, the fronting insurer will retain a relatively small proportion of this risk, with the majority being passed to the reinsurance market.

Under the fronting model the scheme is charged a fee by the fronting organisation and going forward possibly also faces increased costs or reduced capacity for reinsurance. The increased costs and limited access to the reinsurance market is a result of the fronting organisation having its own counterparty credit limits with reinsurers and having to offer the best pricing to a panel of reinsurers rather than being free to place the risk entirely with the cheapest provider.

Two recent transactions, including a £16bn deal with the BT pension fund, have established a different model for accessing the reinsurance market. The pension scheme establishes its own captive organisation which takes the place of the fronting insurer. The captive then contracts with the pension scheme to cover the longevity risk and then passes this risk onto reinsurers directly. In this way, the pension scheme can reduce the fronting fee and place the reinsurance with the lowest cost provider. Transactions undertaken to date have effectively ring-fenced the longevity hedge from any other transaction.

The main drawback of a captive approach is the cost and complexity of managing the captive itself. These costs are broadly fixed and mean that a captive based approach is only likely to work for larger schemes with pensioner liabilities of over £1bn.

Summary

The use of captives in the pensions arena has been developing steadily. A key factor that in our view has prevented the market from moving faster has been the continued fall in interest rates which has served to move the business planning goalposts and increase potential financing costs. However, our view is that the use of captives will grow in the coming months and years, in particular as corporates see the potential for adding pensions to wider enterprise risk management agendas.

EMPLOYEE BENEFIT GROUP CAPTIVES PAY UNEXPECTED REWARDS

Jim Hoitt, vice president of Berkley Accident and Health, discusses the advantages of stop-loss group captives

Employee benefit group captives, also called stop-loss captives, have taken off in the US, aided by changing healthcare regulations. Stop-loss captives, which pool the risk from medical stop-loss coverage, are used by employers who self-fund their employee healthcare plans.

More than 80 million individuals – 60% of workers under the age of 65 – are covered by self-funded health plans, a record high. Many of these employers belong to a stop-loss captive, an increasingly popular way for midsized employers to smooth their cost of healthcare.

Growth of stop-loss captives

First created in the US almost a decade ago, stop-loss captives have grown by leaps and bounds over the past three years, spurred on by the higher costs and regulation of the Affordable Care Act. Today, top national brokerage firms and consultants, as well as insurance carriers and major self-funding industry associations, have incorporated group captives into their portfolio of risk solutions.

More than a simple funding tool

When stop-loss group captives were first formed, the main focus was on their financial benefits. Of course, there were other benefits as well, such as greater plan control and flexibility, as well as less regulatory creep, but the primary focus was always on the financial advantages.

In recent years, however, those of us in the industry have seen group captives grow into more than just a risk pooling tool. As memberships have grown, we've become increasingly aware of added benefits that are paying off, as group captives become a unique microcosm of free market health care. The key lies in the captive's ability to give employers a more credible set of data to evaluate, negotiate, and implement meaningful improvements to their health plan.

Written by
Jim Hoitt

Jim Hoitt is vice president of sales at Berkley Accident and Health. With over 20 years' experience in the sector, he is responsible for the distribution of Berkley's stop-loss and group captive programs.

Layers of risk

How exactly does this work? Within a stop-loss captive program, each individual employer retains the largest, most opportune portion of their healthcare costs, making up close to 65% of their total risk.

This retained layer represents first-dollar health claims up to the stop-loss carrier's layer, as determined by the employer's stop-loss deductible. The captive, or pooled layer, reinsures the mid-level catastrophic claims from the stop-loss carrier, usually amounting to 25% of the health plan cost pie.

Finally, the largest claims, those rare events that are most catastrophic in nature, are transferred entirely to the stop-loss carrier. It is this combination of stakeholders, each aligned and incented to work together to manage the risk that has enabled captive programs to emerge as much more than a funding mechanism.

We have seen this happen in three ways:

1. Data: window into that middle layer

A single employer with a self-funded plan, along with its benefit consultant, must consider how its single plan results measure up and whether its recent claims activity is worthy of action. An employer that's part of a captive program has the resources of the stop-loss carrier at its disposal. The stop-loss carrier associated with the captive program can aggregate data and compare results from the entire program, eliminating outliers and anomalies.

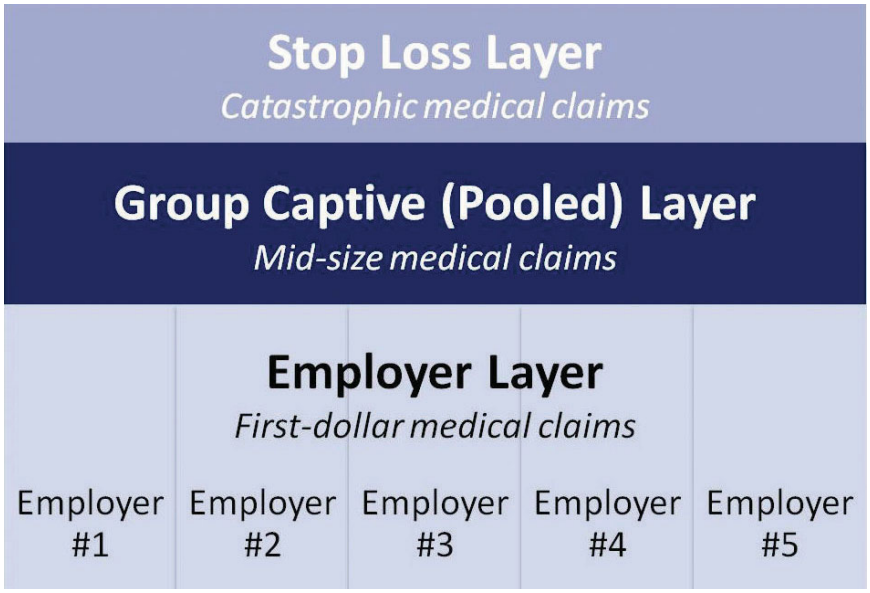
The single employer can focus on its own unique risks, and the collective members of the captive can put their group focus to managing those more credible risks. In this way, the stop-loss carrier becomes a critical centrepiece in developing the captive's blueprint for success.

For example, Berkley Accident and Health analysed the overall claims for three of its captive programs. In one program, the data showed that cancer was the top diagnosis, representing over 50% of the captive layer's losses. The members are now working with our clinical experts to modify their health plan design to include specialised strategies to target and lower cancer claim costs.

Similar data-driven solutions are playing out for other types of catastrophic claims in Berkley's programs, including high-risk maternity, elective surgeries, and emerging pharmacy advances.

2. Best practices: going viral

The culture of the group captive can also be a powerful tool in the total health risk strategy. While a single employer must become an astute buyer of services and advice, a member of a captive program acts both as buyer and advisor.



Regular meetings between captive members allow them to share best practices and discuss the health management tools that yield the biggest payoff. Employers can openly discuss successes and failures, how their employees respond to incentives, and vendors' fees and efficacy. Employers have an incentive to openly share their healthcare game plan, because this feedback can ultimately influence the results of the captive program.

In Berkley Accident and Health's case, we have created an annual three-day event to foster this type of dialogue. Captive members attend general educational sessions, as well as specific member meetings, that are built around the biggest claim risks facing the members. The focus of the conference is on best-practice approaches, innovative solutions, and in-depth case studies of recent pilot programs that are being tested. As a result, Berkley has seen its members implement cutting-edge price transparency tools, domestic tourism incentives, and reference-based pricing programs at a much higher rate than among our traditional, single-employer stop-loss customers.

3. Resources: working together

The third added benefit of group captives lies with the expertise and resources of the stop-loss insurer. Among best-in-class captive programs, the stop-loss carrier treats the pooled layer as if it were its own risk, investing its own expertise and resources to manage it well.

At Berkley Accident and Health, we have seen the best programs develop strong, three-way communication between the single employer, group captive, and stop-loss carrier. Of particular note is the relationship between the employer and stop-loss carrier. When employers belong to a captive program, they are essentially managing an insurance company at a micro level. As a result, it is essential for employers to have direct access to the stop-loss carrier's underwriters, actuaries, clinical expertise, claims adjudicators, and other resources.

We have seen this relationship grown to include other parties, including the employer's third-party administrator, case manager, and pharmacy benefit manager. These parties should be in lock step, always looking for ways to better coordinate claims and improve results in one or all of the layers of risk. In our case, Berkley's clinical risk management staff often becomes the primary glue that brings all of these parties together.

Stop-loss carriers can bring their risk management expertise to captive members by:

1. Tracking and targeting top catastrophic diagnoses on an annual basis

2. Negotiating with risk management vendors for discounts and favourable contract provisions, not otherwise available to a single employer

3. Identifying and bringing the latest developments to captive members, thereby allowing them to spend more of their time running their core business, not managing employee benefits

Here are two recent examples of this partnership:

• A captive member had an employee who was facing a costly stem cell transplant. The company's third-party claims administrator contacted Berkley Accident and Health to discuss possible cost controls. After a thorough evaluation of the available networks and hospital contracts, we recommended using a centre of excellence network that offered substantial savings, yet with the same high quality of care. By selecting this network, the cost for this expensive procedure was reduced by an incredible $995,000, in 2014.

• A captive member had an employee who was taking two tablets of a high-cost medication. We noticed the same dosage was available in one tablet at a much lower cost and told the member's case manager. The physician modified the prescription at the next refill, resulting in substantial savings to the captive program and the member, who was paying a substantial co-payment.

Conclusion

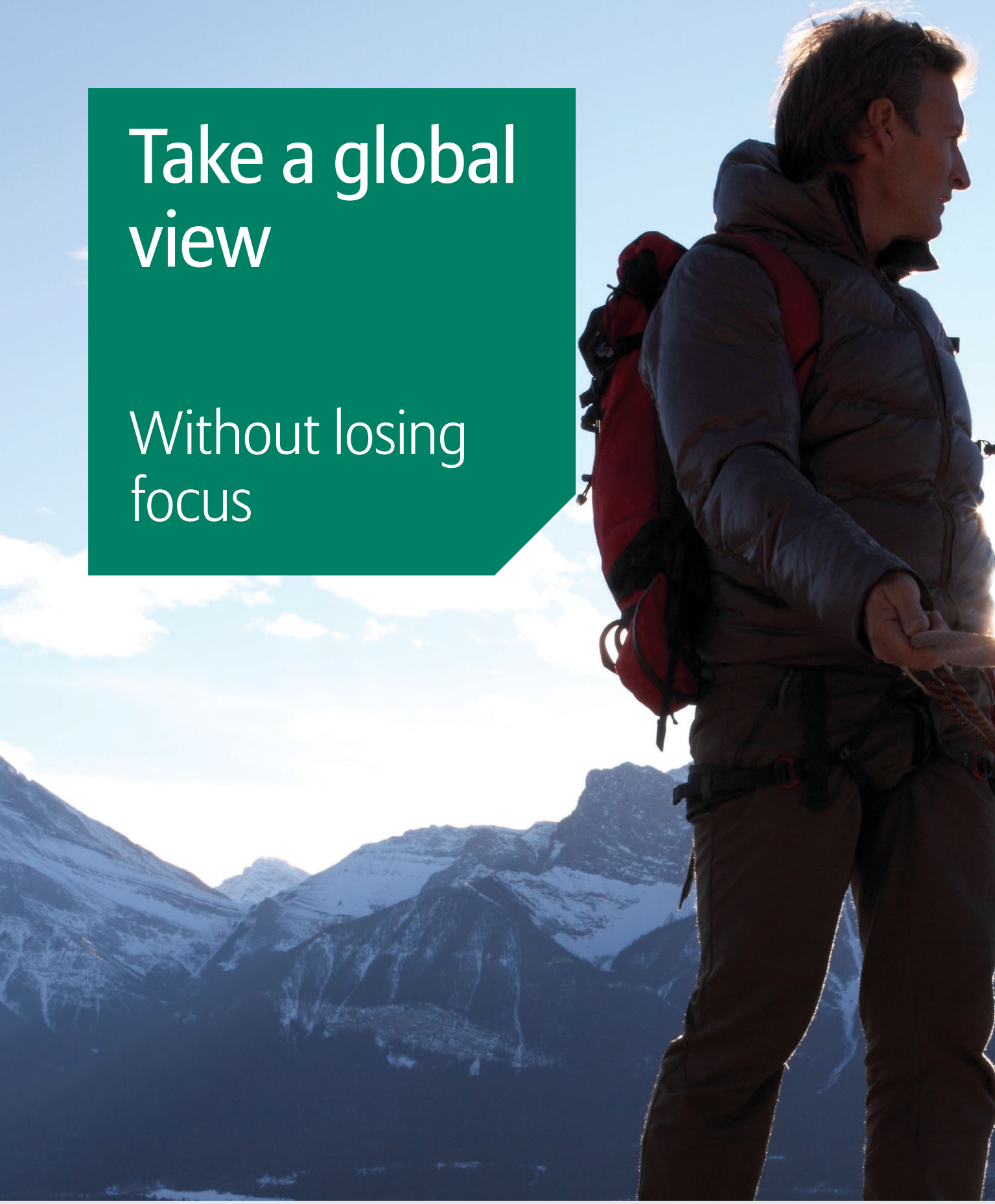
Although stop-loss group captives started as a funding mechanism for employers, we have seen them grow into much more. While it's true that they create greater scale and increase the probability of positive results, we've seen that the entrepreneurial type of employer who joins a group captive in the first place also wants to manage their healthcare costs effectively, like a part of their core business.

When the first employee benefit group captives were first formed, no one could have predicted how they would evolve over time. Fast forward to today, and it only makes sense. Put a group of like-minded employers together and they will use the data, group collaboration, and available resources to customize a best-in-class solution that is tailored specifically to provide healthcare coverage to their most valued asset.

> **"It is essential for employers to have direct access to the stop-loss carrier's underwriters, actuaries, clinical expertise, claims adjudicators, and other resource"**

Take a global view

Without losing focus



UNIQUE NEW PROGRAM COMES TO STOP-LOSS MARKET

Michael R Mead explains the advantages of Constitution Insurance, LLC's Employee Benefit Program, Health Select

Constitution Insurance Company, LLC, a licensed Tennessee protected cell captive, announces the formation of a new program, Health Select. Health Select will offer employers the opportunity to participate in a layer of captive written medical stop-loss above a self-insured layer, and below a traditionally insured stop-loss aggregate.

Health Select has agreements with two nationally known, rated and financially secure traditional markets who will offer fronting services if needed, and specific and aggregate stop-loss above your captive.

Your captive will be a protected cell within Constitution, participating with other similar companies to achieve your insurance goals.

The advantages of this program to the employer are many, including the ability to reduce costs compared to other private and government sponsored programs. Additionally you will be able to more directly select coverage that is important to you and your employees.

Health Select also offers large group discounts on administrative services, cost management tools and network access fees.

Further cost savings will be achieved through effective claims management, high-risk member intervention and eligibility for captive surplus distribution. There will be an opportunity to gain a return on a portion of your captive premium through proven high-risk management resources and good claim performance.

Written by
Michael R Mead

Michael R Mead, CPCU, is the president of M.R. Mead & Company, Inc., a captive consulting and management company with offices in Chicago, St. Louis, Indianapolis and Nashville, TN. Mead is also president of the Missouri Captive Insurance Association and past chair and director of the Captive Insurance Companies Association.

Why Health Select?

Partnering with market leaders Health Select is a group captive program allowing employers to take control of their benefit costs. It is a product between being fully self insured and completely self insured. It is intended for high-performing companies to provide stable costs, predictable outcomes and the accountability necessary to produce favourable results.

Health Select offers:

- The benefits of grouping together high-performing companies in a group captive
- A health plan solution designed for the Patient Protection and Affordable Care Act marketplace
- Self-insurance with less volatility
- A stop-loss component that can be structured for greater control over price increases and renewal provisions
- Increased discounts on administrative services, cost management tools and network access fees due to increased volume
- Cost savings achieved through access to industry-leading claims administration, best practices, and risk management tools
- Claim reduction by superior claims management, committed member intervention and eligibility for a premium return based on favourable results.

How Health Select works:

- Each employer joins to form a preferred pool of self-funded benefit clients.
- Each employer maintains their own plan, with your own benefit design, and are responsible for smaller claims their employees incur as well as the administrative fees associated with operating your own plan. When claims costs, as a result of applying cost-management tools, turn out better than expected, you keep 100% of the savings.
- To help control healthcare costs, all participants in the pool agree to use the same benefit philosophies and cost management tools typically available only to larger self-funded clients.
- Mid-size claims are pooled together with the rest of the group to provide a shared layer of claim protection. If the claim experience of the more predictable low-cost, high-frequency layer turns out better than expected, you get to share in the savings.
- The larger, more catastrophic claims become the responsibility of the stop-loss carrier.

Upsides of self-insurance through a group captive

For some employers, the time is right to consider the advantages of a group captive, especially when comparing the performance of self-funded plans to traditional, fully insured medical plans:

- Customised plan design across multiple state jurisdictions
- Best in class medical cost control vendors
- Greater claim data transparency, reported on a monthly basis, suited to your needs
- Lower state premium taxes/Affordable Care Act (ACA) fees
- Tempered volatility through risk pooling, group purchasing and reinsurance protection
- Sharing of underwriting profits on pooled risks across multiple employers

Management of Health Select

Caitlin Morgan and M.R. Mead & Company will manage the Health Select program and provide each participant with:

- Flexibility to choose among eight health plan designs, including traditional plan options
- Access to multiple national carrier PPO networks
- A pharmacy program with a premier national pharmacy benefit manager, delivering rebate transparency discount guarantees and optional trend management programs
- Standardised summary plan description and plan documents for ease of administration and ERISA compliance
- Health risk management programs that are best in class, including clinical prevention services and specialised oncology medical management program
- Easy enrolment — pick a plan, define eligibility, submit enrolment and you are off and running

> **"Constitution's ownership and management are very familiar with forming and managing small captives for businesses which otherwise feel that they are too small in premiums for a traditional captive"**

Preferred characteristics of Health Select participants

- 25 to 500 participating employees
- Strong corporate leadership that values employee health and embraces wellness
- Stable workforce and above average demographics
- Current fully insured accounts with a desire for transparency and avoid some PPACA fees
- Current self-funded groups using a rental network through a third-party administrator or paying high fixed cost with a stand-alone carrier self-funded program.

Additionally, Constitution Insurance Company offers opportunities for small businesses to establish captives within its structure. Constitution's ownership and management are very familiar with forming and managing small captives for businesses which otherwise feel that they are too small in premiums for a traditional captive.

Many firms offering service to these smaller firms have been found lacking in general and specific insurance knowledge leading to problems down the road for their captive owners. This is not the case with Constitution and its managers.

Constitution carefully analyses its prospects to determine their fitness through their financial stability and risk management effectiveness. Only the best are chosen for the program. Each selected candidate has its own cell within Constitution with its assets protected by Tennessee law from the creditors of others. Each cell has its own directors and officers, with assistance from Constitution.

The manager of Constitution can arrange appropriate fronting, reinsurance and third-party services as needs are determined. The cell can even recognise the owner's original agent if desired.

The laws of Tennessee are extremely favourable for the formation and management of captive insurance companies with support for these efforts from the highest levels of state government. The regulators are thoroughly experienced and wish to provide helpful service to their captives and captive owners.

Who we are:

Constitution Insurance Company, LLC, owned by M.R. Mead & Company, Inc., and the principal of Caitlin Morgan, the manager of Health Select. M.R. Mead & Company, Inc., is a long time, reliable and experienced captive manager who has managed many captives in many domiciles for years. Mead manages Constitution Insurance Company, Inc., a nationally known wholesale program manager which has demonstrated outstanding capabilities in several programs for many years.

It is headquartered in Carmel, Indiana, where it is run by Christopher J. Murray, CPA. Murray has served as president and director of the Arizona Captive Insurance Association and been active in the risk retention group field in addition to captives. He has experience in several domiciles, both onshore and offshore.

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BENEFITS ALL ROUND

Global corporations are increasingly turning towards the captive to pool their employee benefit spend, but why and how is this done?

Traditionally captive insurance companies have been utilised for the property and casualty exposures of large multinational companies, but key stakeholders within the alternative risk transfer space have been looking for new ways to develop the industry.

While discussion and debate around the options available to middle market companies is useful and valuable for the industry to move forward, for large and established captive owning organisations new lines of insurance that benefit their business and enhance their captive is an area they are keen to explore.

Employee benefits still remains a scarcely written line through the captive, with only around 100 thought to be including the risk in their programmes.

"Initially, the early adopters were the trailblazers," Lorraine Stack, business development leader – EMEA Asia Pacific, Marsh's Captive Solutions Group, tells *Captive Review*.

Written by
Richard Cutcher

"However, what we are finding now is companies are realising themselves that the accumulative costs of employee benefits on a centralised basis is quite significant and there are advantages in pooling and ceding to the captive."

One of the early obstacles in putting together, or even considering, the implementation of an employee benefits programme that encompasses multiple offices across a number of territories is collaboration between the risk management and human resource divisions.

Traditionally employee benefits falls under the remit of human resources and so the risk manager may not be aware of the programmes in place.

Equally, the HR department may be unaware the company owns a captive or may not have considered the potential cost advantages of pooling all employee benefits spend.

"We are finding that less and less now," Stack added. "There is an acceptance that employee benefits spend is significant for corporates. As they look to get their arms around the spending, the introduction of efficiencies involving the captive structure is an attractive option."

In this regard, it is also important to get engagement from a member of the C-suite so there is one individual responsible for the implementation of a programme, rather than it becoming lost between two functions.

"The ROI is always the difficult bit to quantify but there is more awareness among CFOs that there are long-term benefits"
MATTIEU ROUOT

Country nuances

As with any multinational programme, the devil is in the detail. Designing a programme that pools employee benefits spend centrally can be complex, as each office will likely have different policies and have to adhere to varying regulations.

The health priorities for employers and employees will also vary from country to country and even city to city.

The Maxis Global Benefits Network (GBN) is a partnership between European AXA and North American-based MetLife that works with multinational clients to piece together a global programme.

As well as providing fronting services, GBN will work with the captive owner to implement wellness programmes for employees in a bid to promote healthy living and ultimately lead to a reduction in healthcare spend.

"It is not a one size fits all approach," Mattieu Rouot, president, Maxis Global Benefits Network, tells *Captive Review*.

"Any wellness programme needs to be implemented with local engagement. For example, in Bangladesh, a wellness programme may just be being able to provide a healthy meal for each employee. But then in another country it may be focusing much more on diabetes and its causes because it is a big issue there."

From the Maxis experience, those companies most engaged with their employee benefits programme are those that have a captive.

In the main, this is down to a greater understanding of what they are insuring having gone through the process of pooling and speaking to each office.

A clear path towards demonstrating a return on investment (ROI) is also set out and, for this, engagement with the CFO is important.

"The ROI is always the difficult bit to quantify but there is more and more awareness among CFOs that there are long-term benefits to implementing programmes," Rouot adds.

"It has been demonstrated that of the S&P 500, those companies with wellness programmes in place have outperformed the others by 3% to 5% in terms of share price. When we present those figures to companies, they become more engaged."

Eric Butler, chief health and wellness officer at Maxis GBN, says that when putting together these programmes it is important to use a combination of public health data as well as information gathered from your own corporation's claims experience and other sources.

It is also important not to get lost in the granular detail of employees and miss what the larger numbers are telling you.

"Healthcare is best understood in large numbers, and the mistake is drawing too many conclusions when looking at a population of 50-100 lives," Butler says. "You could have a small firm with 50 employees and relatively low claims, but that experience may just be random good luck due to the volatility of small numbers. They could in fact all be just a pork chop away from a heart attack."

Risk diversification

Adding employee benefits to a captive can also provide operational advantages, especially in regards to the increased capital requirements that come with Solvency II.

If a captive is predominantly writing property, casualty and liability lines then bringing in employee benefits can produce some capital credit.

"There has been interest in the short-term products and health insurance is a short-term product," Butler adds.

"Health insurance can really help with Solvency II because it is short-term risk. Some captives in the past were less interested in employee benefits, but it is becoming more popular."

On the captive management side, Stack says she has also heard Solvency II and a desire for further risk diversification as key reasons why owners may be more open to exploring employee benefits.

"It has definitely come up in conversations. For example, companies in the energy sector that may have volatility relating to property and liability in their captive portfolios," she says.

"Including something that has a risk profile like employee benefits, which is low catastrophe, high frequency – similar to workers' compensation – and is consistent, offers diversification and stability to the portfolio."

With this in mind, it is primarily captive owning companies that are exploring the employee benefits route in most detail.

While some companies that do not already have a captive in place have made enquiries as to whether pooling their employee benefits spend may be advantageous, more often than not it is most viable for large multinationals.

By definition, these types of firms will already have a captive in place.

"It takes a long time, but for those who do it is absolutely worth it"
LORRAINE STACK

"A single parent captive is quite a commitment anyway so the stretch from no captive to captive can be more difficult if it is coming from the employee benefits side," Stack says.

Bringing the employee benefits line into the captive can also be a long process, as various offices may need to wait for previous local agreements to expire.

"Once the structures and pooling partners are in place and the captive programme has been implemented, it can still take some time for premium to flow in," she adds.

"It may take two to three years for all captive suitable premiums to be incorporated into the structure, but for those who do it is absolutely worth it."

CAPTIVE SOLUTIONS FOR SME EMPLOYEE BENEFIT PLANS

Johnston Group's vice president, business development, John Moore, outlines the ways businesses of all sizes can enjoy the benefits of captives

Captives have traditionally been used for the provision of property and casualty benefits, medical coverage such as medical stop loss, catastrophic protection and other financial vehicles requiring insurance elements. However, using a captive for employee benefits has been approached more reluctantly in the past because of legislative and tax issues in some countries, the perceived need for multinational pools or very large employers for proper spread of risk and the lack of focus on employee benefits.

This has changed in recent years because of, in part, the consistent growth in the cost of employee benefits and the need for the inclusion of unrelated businesses in a captive. Changes in legislation and the approval of previously prohibited arrangements in the United States are also now fuelling the use of captives in the US to either reinsure or insure employee benefits.

Written by
John Moore

John Moore is vice president, business development with a third-party administrator (TPA), Johnston Group Inc. He has held a variety of roles in the industry including underwriting executive and chief underwriter with two major insurers, over 11 years in consulting and management with two international consulting firms.

However, even with the change that is occurring in the international and US markets, the use of captives for small to medium-sized employers has not been on the radar for most organisations. Management of risk is the greatest concern. There are ways that the sharing of risk for employee benefits can be approached that not only mitigates risk for small to medium-sized companies, but also allows them to realise significant benefits that can flow from this type of arrangement.

Hurdles for US captive

Companies in the US have always been confronted by ERISA rules, which make using a captive more challenging for employee benefits. The need to have less than a 50% ownership by a single employer in a captive

makes it difficult for a single employer using a captive for other products to include employee benefits in their captive's portfolio. There are a number of previously prohibited transactions that are now eligible for exceptions, which opens opportunities for single parent captives. However, most small to medium-sized employers will not be in a position to form a single parent captive and would have to participate in association, industry or rent–a-captive arrangements. Using these other types of captive arrangements would allow an offshore arrangement to be used for employee benefits.

Depending on the structure of the captive, employers may still be able to maintain control of the design of their own insurance programmes. The financial advantages of insuring or reinsuring employee benefit risks in a captive varies by the employer's jurisdiction, and each employer should determine if it will work for them in their respective regions. This article will concentrate only on mitigating risk for small to medium-sized employers in a captive.

Can it be done?

How could a smaller captive owner use its offshore arrangement to include benefits in its portfolio? Could a group of smaller or medium-sized employers, who are or become part of a group captive, take advantage of their offshore company for their benefits? Here are a few ideas using an example of a single employer of around 4,000 employees, or a group with 4,000 employees collectively.

The major issue for smaller employers is how to mitigate risk while still sharing reasonably in the risk. The requirement for collateral makes a freestanding reinsurance arrangement potentially more costly to not only set up but also maintain, as the risk increases. The easiest and least difficult to set up is a 'funds withheld' arrangement where a front or ceding insurer manages the risk internally, establishes the reserves and ensures the administration and claims payments are managed in the most efficient way. The captive can take on the role of the reinsurer, but would change the typical reinsurance arrangement by having the initial risk flow to them and the excess risk rest with the front or ceding insurer. How might that happen? Let's use the example of life and long-term disability benefits.

Life

A captive wants to cover the majority of the risk for the employee benefit life plan and does not want to have a long-term liability or take on high life amount risk with the plan. To accomplish this, the captive could take the initial risk of the life benefit and have life benefits over a pre-determined level, covered by the front insurer.

For example, if the captive wishes to cover life benefit risk up to $100,000 of life insurance, all the benefits for each employee under $100,000 would be covered by the captive and any benefits in excess of $100,000 would be the risk of the front or ceding insurer. The front insurer would collect the premium, and subtract all expenses allocated to the captive and front company, leaving the net premium to pay claims and cover reserves. The net funds are sent to the captive or funds are requested as in any reinsurance arrangement.

The waiver of premium benefit intrinsically has a long-term liability and to avoid any long tail for the captive, this could be fully held by the front insurer. Retaining this liability would mean that if the benefit arrangement were to be wound up in the captive, either the liability would need to be run off or the risk sold to another provider or the front insurer. Experience has shown that this type of arrangement manages risk well and produces significantly positive results for small to medium-sized employers.

LTD

Long-term disability is more problematic as it inherently has long-term liability and can be subject to significant fluctuation in paid claims experience and reserve requirements. Mitigating the long-term risk and smoothing the fluctuations in claims experience and the attached reserve needs will allow small, medium and even larger employers to enjoy benefits from a product that can be so unpredictable.

What are the issues of risk that an employer would be concerned about? Claims duration, high claims payments, reserve requirements and relatively unpredictable experience. One method of mitigating the risk is to limit the claim duration liability, which at the same time will limit the reserves that need to be held for the risk. If the treaty between the front insurer and the offshore captive was established with a fixed claim duration being ceded to the offshore and the front insurer retaining the longer-term risk, the long-term liability and reserve liability would fall to the front or ceding company and the offshore captive would have a manageable claim duration.

As an example, if we take the 4,000-employee organisation, and set up a normal LTD plan, a claim duration could be set to two years for the captive and the remainder would fall to the ceding company. As in the above life example, the premium, claims and reserves attached to the two-year risk would be assigned to the captive. After claim payments for a disabled employee have reached two years, the claim and associated risk would flow to the ceding company and the risk associated with that claim would end. The ceding company again would collect the premium, make claim payments and provide the necessary disability management without the corresponding requirement of the captive to acquire those skills. For an arrangement of this type, premium allocation to the captive could range somewhere between 40% and 55%, depending on the expected claims experience and associated calculated risk.

> **"Could a group of smaller or medium-sized employers, who are or become part of a group captive, take advantage of their offshore company for their benefits?"**

This philosophy could be used more widely as the captive includes more benefits, building on the success of these arrangements. Mitigating risk is what is required by the small and medium employers to ensure that an employee benefit captive arrangement is successful. For those smaller companies that are currently using a captive, setting up this type of arrangement is not difficult. Finding a willing front or ceding insurer may be. For those companies that are not currently using a captive, investigating this option will be a bit of work, but the rewards will be worth it as the plan is set up recognising the company's level of comfort with taking risk. The greatest thing that will be obtained by this arrangement is control, something that has been lost in the employee benefit market, with the rising cost of benefit programmes.

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