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It has been 8 years since the historic decision by the Department of Labor (DOL) to allow Columbia Energy to insure its employee benefits in its captive. In this article we look at developments since that deci-

sion and the current trends in insuring employee benefits in captives. The article draws on information presented in our November webinar presented by Michael O'Malley and Jeff Fitzgerald.

Historic International Perspective

Internationally captives have participated in benefits programs for many years. Multinational pooling provides a structure to pool the benefit programs of the local subsidiaries of multinationals through a network contract back to the parent. Captives have been used to underwrite that contract acting as a reinsurer of the network of local benefit insurers. This structure has allowed multinationals to recapture premiums paid to local insurers while increasing transparency and supporting proactive cost containment activities.

In the US, the DOL prohibits transactions with “parties of interest” for benefits covered by ERISA. Until 2000, this precluded captives from participating in their parent companies benefit insurance programs. The Columbia Energy exemption opened the door for ERISA benefits to be reinsured in captives.

Group Life, LTD, and AD&D

The initial DOL exemption applied to a Long Term Disability program. It was followed by Archer Daniels Midland (ADM) and a Group Life program. After these exemptions the DOL created an expedited process (ExPro) for similar transactions. Additional ExPro exemptions have been steady, if modest. 15 additional transactions have been or are being reviewed and approved (Exhibit A) and there is a growing interest among large individual corporations in looking at this financing structure.

All of the approved transactions have involved a single parent captive and large individual benefit programs. The minimum size requirement is usually 5,000 employees and a program size of at least \$1,000,000, although programs as small as 2,300 employees. The benefits covered have been Group Life, Long Term Disability and Accidental Death & Dismemberment.

Two principal advantages have been realized by insuring these benefit programs in captives:

- Cost savings in the captive. Typically the benefit program was fully insured before moving to the captive. By retaining risk in the captive, the employer typically reduces risk financing costs and retains investment income. Reductions can be 10%+ for corporate programs. As the benefit program may be treated as third party insurance for tax purposes, it can also improve the tax deductibility position of the captive.

Exhibit A: DOL Approvals

Parent	Approval Date	Coverage
Columbia Energy	10/2000	LTD
ADM	5/2003	Life Insurance
International Paper	11/2003	Life Insurance
SCA	7/2004	LTD, Life, AD&D
Alcon Laboratories	8/2004	LTD, Life
Alcoa	1/2005	Life Insurance
Sun Microsystems	10/2005	Life Insurance
Astra Zeneca	1/2006	LTD, AD&D
AGL Resources	5/2006	LTD, AD&D
H.J. Heinz	9/2006 & 5/2008	Life, LTD, AD&D
Wells Fargo	1/2007	LTD, Life, AD&D
NiSource	3/2007	Life Insurance
Cephalon	5/2008	LTD, Life, AD&D
YKK	6/2008	Basic Life and LTD
ConAgra	10/2008	Life, AD&D
United Technologies	12/2008	LTD
Deutsche Post/DHL	12/2008	LTD

- Improvement in the benefit program: the greater focus on the benefit program is positive. The procurement process is improved and the program experience is measured and monitored. Overall experience improves as claims, through extension of IDM approach, are now being handled more appropriately.

The structures that have been successfully developed to date exhibit the need for partnership and risk sharing between the captive and carrier, such as a quota share loss agreement. These structures provide the employer with the possibility of upside through good experience, but limit the downside risk through an aggregate cap.

The commercial insurance market is also beginning to respond to the use of captives. In some areas, such as large corporate LTD, some markets are actively supporting captives for fee business as they view the risk as unprofitable.

Post Retirement Medical

In 2004 Whirlpool Corporation applied for an ExPro exemption to insure its post retirement health insurance program in its captive. The transaction was deemed to be sufficiently different to Columbia Energy and ADM and was denied under ExPro. Whirlpool withdrew its application rather than seek a standalone exemption. Coca-Cola has recently announced plans to seek an exemption for its own post retirement medical program. The proposed structure would use an existing VEBA trust to insure the program which would then be reinsured to a South Carolina captive. If approved by the DOL, an exemption is likely to generate interest from other corporations to insure post retirement health benefits in captives.

Health Insurance

One of the most active area for captives in recent years has been group health insurance. Individuals and employers continue to see on-going price increases at a time when property and casualty insurance premiums have been decreasing. This, and the rise of group captives in the P&C market, has led to increased interest in retaining a defined risk on health insurance programs. While large employers are often fully self insured, smaller companies remain either fully insured or retain a stop loss retention on their own self funding. These groups are looking at pooling mechanisms which include group, agency and association captives. Group structures provide a mechanism to aggregate premiums providing group purchasing power and the ability to share risk. The reasons for their formation are similar to those in the property and casualty market:

- **Cost savings over time** There is an expectation that policyholders will capture the profit that was built into the layer of risk. This retained underwriting profit can be used to offset medical inflation.
- **Investment income** Retaining investment income in the captive is attractive to employers.
- **Underwriting input** Employers have input into underwriting decisions, while benefiting from being part of a broader group.
- **Increased transparency with the carrier** Since the employer is both an insured and a reinsurer, it is hoped they are able to gain more transparency and control of the program structure.

A key issue with any ERISA benefit is the party of interest concern. The DOL exemptions have been required to address this in a single parent captive. A group captive can overcome this problem by removing individual employers from direct ownership of the captive. The captive may be owned by a third party such as an association, agency or sponsoring organization. Exhibit B shows coverages which have been insured in agency and association captives.

Exhibit B: Captive Health Programs

Agency Captive Programs

- Limited Medical
- Stop Loss
- Pharmacy
- Dental
- Vision

Association Captive Programs

- Fully Insured Major Medical
- Limited Medical
- Stop Loss
- Occupational Accident

Risk Retention Groups—RRGs have been structured to provide medical stop loss insurance through a contractual liability coverage form. While this approach has the advantage of removing fronting costs and collateral requirements, it is uncertain whether the contractual liability form will remain an acceptable coverage for RRGs. Recent litigation in the State of California has raised questions of whether the intent of the Risk Retention Act is tort and not contractual liability. In that specific case, the RRG ended up procuring a fronted policy rather than issuing direct.

RRGs continue to provide medical stop loss coverage and several states are in the process of reviewing those programs. This issue will continue to develop as companies look for cost effective benefit solutions while looking to avoid front fees.

Keys for Success—The factors governing the success of a health insurance group captive are similar to those of any group captive. They include:

- Participation of several groups that create a combined benefit program of \$3,000,000 or more annually.
- The ability to aggregate individuals and groups together. Any group needs cohesion that exists outside of the captive.
- Access to historical information is critical to underwriting and structuring a program while obtaining it from the carrier can be challenging.
- Clear understanding of what they are using the captive for and a long term outlook regarding its success.
- Open communication with internal departments as benefits are often the responsibility of Human Resources whereas captive participation has been controlled by Finance and Risk Management. These departments have to work together and they may not have done so in the past.
- Access to a combined and efficient network and administrative support.
- Access to favorable reinsurance terms.

Conclusion— Every potential participant should be made aware of the potential ERISA issues involved in a health insurance program.

As the definition of health insurance lines may include ancillary, limited, major medical and stop loss there are options available to nearly every group. Since ancillary, limited and stop loss has the most defined exposure, much of the recent activity has been focused in those markets. Major medical coverage can be the largest insurance expense and is often the least managed. As most group captive health insurance programs are less than three years old, their benchmarked benefit have yet to be determined. P&C group captives and self funded health insurance plans have been proven to be cost effective. Lower health care costs over time and increased transparency with an insurance carrier create a favorable scenario for the future of these programs.

Interview with an Icon: D. Hugh Rosenbaum

2008 saw SRS celebrate its 15 year anniversary. To mark the occasion we are interviewing leading figures in the industry (“icons”) to present their perspective on the development of the industry over the past 15 years and their thoughts for future development. The first of our series of interviews was held with Hugh Rosenbaum, retired Principal of Tillinghast—Towers Perrin, former editor of Captive Insurance Company Reports and Chair of the World Captive Forum.

180: What developments have you seen in the use of captives over the past 15 years?

DHR: The “penetration” of captive usage into almost every large corporation and most of the other large insurance-buying entities has been encouraging. Those who purport to know how many actually use or own captives claim figures like “75% of the Fortune 500” and “80% of the FTSE 100” own one or more captives. Of course this means single-owner captives only. This percentage is higher now than it was when I stopped counting them 7 years ago, when it was nearer 45% and 50%.

180: You say “purport to know”. Do you believe those figures?

DHR: These kinds of figures are too low or too high, depending on a number of factors. The first is that in the past few years I think that 100% of large organizations of all kinds have been exposed to promoters of captive insurance. Those who don’t actually identifiably own one have a file or feasibility study showing why they don’t. So one might say that the captive “market” is completely saturated. It’s not, of course, as evidenced by the number of new formations every year.

Another reason why captive “statistics” are too low, speaking again for single-owner captives, is that they do not take into account the ownership and use of cells in protected cell structures, or accounts in rent-a-captives (there are still some of these doing business). Cells alone number some 1,700 by my reckoning, which is fully 25% of captives plus cells (1700/6700), so there are at least some of those single-owner captive users hiding out in cells, where secrecy and confidentiality still reign supreme.

The main reason why captive statistics are all over-stated has to do with the inclusion of all kinds of entities that aren’t captives at all in the total figures. Imagine what the revised, lower domicile figures would be if one deleted producer-owned reinsurance companies, entities owned by commercial insurers, and cell company sponsors, not to mention SPVs and commercial ventures set up in captive domiciles!

And then there are group captives, including RRGs, that are more and more being viewed by regulators as being no different from commercial insurance companies as regards financial ratios and governance. There are some 900 of them, depending on what you count as a “captive”. The penetration factor here is still low, and the field is still wide open for a lot more of them, although they tend to be formed during hard markets, not the prevailing soft market of 2008.

180: You developed a set of captive standards at Tillinghast. What you think about the on-going efforts to create captive benchmarks?

DHR: There still aren’t any reliable captive insurance benchmarks, in spite of efforts by CICA to collect some, and the pronouncements of AM Best about financial benchmarks for captives. Those independent sources are both small samples of the universe of captive insurance companies, about 150-200 companies, and many of these multiple-owner captives, in both cases. But there are no “standards” for benchmarking captives, except for the ones I initiated almost 20 years ago, now updated in the form of Tillinghast’s TRACS.

180: What changes have you seen in the servicing business?

DHR: The captive management and servicing industry has grown by leaps and bounds during that same 15-year period, to a total I estimate more than \$500 million for the managers alone, another similar amount for the accountants and actuaries, and about \$100 million for the domiciles. It’s a billion-dollar business, which explains the promotional activities that mark today’s captive insurance company gatherings and conferences.

But my regret about all the vested interests now entrenched in this money-making business is that the promoters of captives have replaced all the nay-sayers. In the old days it was a lot more exciting to help a client start a captive in the teeth of resistance from his broker, the tax people, and his own insurers than it is now, when I mainly have to help clients fend off propositions and proposals that arrive from all quarters.

180: How have captive structures changed?

DHR: Except for the arrival of segregated cells, captive structures haven’t changed that much over the past 15 years. What has mainly changed over the past 15 years has been the transition from the “do-it-yourself” nature of captive insurance to the much more regulated, more service-oriented situation of captive insurance today. The original idea of handling your own underwriting, your own claims, and your own investments, with many handling their own administration and governance, too, has turned into a more professional environment where experts in all these areas are engaged in helping captive owners get it right, to avoid unnecessary surprises. It’s more costly these days, but it is still saving the clients money.

180: Are there any structures you would have liked to see developed or should have succeeded but didn’t?

DHR: I have experienced the arrival and disappearance of several joint-venture efforts of captive owners, which is the structure I thought most likely to succeed. Groups of captives, operating in concert, I thought, would provide even more leverage than single captives, even single group captives. But I was wrong – and that is my main disappointment. CIRCL, and the Bermuda Risk Exchanges were good ideas, as were some of the aspects of pools like the first one, Hopewell. There should have been much more cooperation and risk-taking together. And the association of Captive Insurance Companies was never able to muster enough influence to launch “their own fronting company”, either. These are my main regrets about captive structures.

180: What developments do you expect to see in the future?

DHR: It is my opinion that the really dramatic increase in activity in the “captive business” in the next few years will be in the creation of and use of more of these cells. Why? Because they offer some of the original advantages that stand-alone captives used to be able to offer: lower costs, lower capitalization, confidentiality, and, in some ownership jurisdictions, tax advantages.

SRS News

Brady Young Profiled in Captive Review

In November, Brady Young was interviewed by Gavin Bradshaw of Captive Review about Strategic Risk Solutions’ evolution into a “brand-name independent captive manager”.

The article discusses the firm’s origins within Arkwright Mutual, transition into an independent captive manager and subsequent expansion into new domiciles. It also discusses some of the current trends affecting the captive insurance industry and projections for the future.

The full article may be viewed on our web-site at www.strategicrisks.com

Derick White to Lead New Risk Retention Group Practice

In August, SRS announced that Derick White has been appointed to lead its new risk retention group practice. The risk retention group practice was recently launched to co-ordinate services provided to risk retention group clients across the firm.

“Derick has a wealth of experience in the regulation of risk retention groups. He is a natural choice to lead our efforts in this area” said Brady Young, President and CEO of SRS. “In addition to Derick we have brought into SRS a number of individuals, including Ann Wick and other new hires in South Carolina and Arizona, who have extensive RRG experience. This is an expanding sector for SRS and we are keen to bring the full range of our expertise to our clients and the RRG market. The industry practice under Derick’s leadership will allow us to do that” added Young.

SRS Expands Employee Benefits Practice, Focus

In September, SRS expanded its employee benefit consulting operations with the addition of Jeff Fitzgerald, as Associate Director. The addition is part of SRS’s increased focus on the use of captives for health insurance and employee benefits.

“We are seeing a lot of interest in using captives to fund health in-

surance. Most of that interest is coming from groups where the ability to pool risk through a captive makes it possible to self-fund health benefits,” said Michael O’Malley, Managing Director of Strategic Risk Solutions. “Jeff will help us develop our consulting capabilities and practice in this area”

Staff News

Courtney Flynn has joined SRS (Cayman) as an account executive. Courtney is a Certified Public Accountant with 11 years combined experience in auditing, financial reporting, and captive management. She was formerly an Account Manager and Assistant Vice President with Marsh Management Services in the Cayman Islands. We are pleased to welcome Courtney to SRS.

Jeff Fitzgerald has joined SRS as an Associate Director in our Charleston, SC office. Jeff was formerly with Roundstone Management Company where he was active in forming and managing segregated cells to insure health benefits for groups, associations and agencies.

Events

March 8 – 10, CICA: Michael O’Malley will be presenting on Domicile Selection at the upcoming CICA conference at Indian Wells, CA.

Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

SRS Webinar Series

SRS hosts monthly webinars on topical issues affecting the captive insurance industry.

Don’t miss Brady Young’s annual update on the captive industry during our January webinar. To receive invites to this and other webinars, contact us at info@strategicrisks.com.

Recordings

Recordings of prior webinars are available at our website (www.strategicrisks.com). Recent recordings include:

- Captive Taxation—the Latest Developments
- Employee Benefits in Captives—the Next Chapter
- Financial Market Turmoil—What’s it Mean for Captives?
- Financial Ratings for Captives—The View from AM Best

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

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