



Employee Benefits & Captives – A 2020 Perspective

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Employee Benefits and Captives

Today's health care environment is one of continued medical plan cost escalation due to a myriad of factors as indicated in Aon's 2021 Global Medical Trend Rate Report¹ which include: global population ageing; overall declining health standards; poor lifestyle choices; and reliance on employer-sponsored health plans. Coupled with the impact of COVID-19, this places enormous pressure on health care markets, with increased direct costs and escalating future costs as deferred care and treatments return to pre-pandemic levels. The magnitude and timing of the impact on employer health plans will vary by region, industry, and demographics; but rising costs and increased prevalence of chronic medical conditions will continue to be a global issue. Prudent employers should be examining strategies to better manage their Total Cost of Risk, both from a risk benefits perspective including, among others, life and disability and from a health care cost perspective and reduced employee productivity perspective.

Understanding and focusing on health care strategies is imperative in ensuring employers are able to receive necessary data to implement appropriate wellness strategies for their specific employee populations. Employers that have this relevant data may benefit from the strategy of a captive insurance company to finance employee benefit programs. In this paper, Aon examines the use of a captive for certain areas of global employee benefits and the advantages that may be derived from an effective long-term risk financing plan.

Employee benefits are programs offered by an employer to its employees determined by market prevalence and/or regulations in their respective countries. As referenced in this paper, there are generally four major types of employee benefits employers offer: medical insurance, life insurance, disability insurance, and retirement plans.

¹ Aon's 2021 Global Medical Trend Rate Report was conducted among 107 Aon offices that handle employer-sponsored medical plans in each of the countries in the report.

What is a Captive?

A captive is a bona fide insurance or reinsurance company owned by a non-insurance company parent which primarily insures or reinsures the risks of its parent and/ or affiliated companies, usually formed in a specialized regulatory environment - a domicile.

At a very basic level, a captive is a form of risk retention (much like a deductible) that is used to aggregate premium and losses for its parent owner and its subsidiaries. Deploying a captive as a risk retention vehicle can make risk financing more cost effective - and ultimately reduce the Total Cost of Risk - by retaining risk that the insurance market has priced at a high rate and capturing underwriting profit. Ultimately, captives can cover myriad risks and can be a tool to help contain the insurance premium budget that is allocated to a risk management and/or human resources (“HR”) department and to pay for the company’s retained losses.

Once established, a captive operates in the same manner as a commercial insurance company and is subject to statutory regulatory requirements, including reporting, capital and reserve requirements. However, most domiciles have specific captive regulations that are less stringent than those applied to commercial insurance companies.

Captive Use for Employee Benefits

According to Aon’s 2019 Global Risk Management Survey², employee benefit risks captured within a captive have grown in popularity globally, with the health/medical space leading the charge.

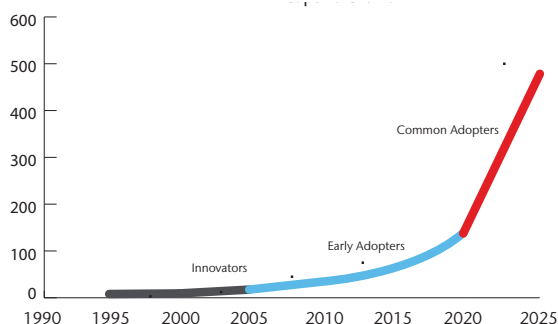
Captive Participation in Employee Benefit Programs

Insurance Program	Current Usage	Growth/Usage within 3 years
Employee Benefits excluding Health/Medical	15%	16%
Employee Benefits including Health/Medical	13%	24%
Life	12%	12%

Source: Aon’s 2019 Global Risk Management Survey

To date, organizations utilizing a captive to finance employee benefits can generally be categorized as having an advanced approach to both risk finance and levels of risk maturity.

Chart 1 – Growth in Employee Benefits in Captives



Source: Aon’s Internal Data

The growth curve of the utilization of a captive to finance employee benefits suggests that this approach will become more widespread in the short term.

² Aon’s Global Risk Management Survey is designed to offer organizations the insights necessary to compete in an increasingly complex business environment. The 2019 edition gathered input from 2,672 respondents from countries and companies of all sizes globally.

Typical Captive Employee Benefits Programs

Captive participation may be considered for many different types of benefit plans provided by an employer group. How a captive is deployed will depend on many factors, including, among others, employer and captive risk appetite and tolerance; number of plan participants; local regulatory requirements and commercial market conditions; and in respect of pricing, capacity and coverage plans. An overview of the types of plans that can be considered for a captive are set out below. Divided between US and non-US plans, they are ordered by the ease of conversion from a traditional fully insured plan (or self-funded plan) to one with captive participation. A successful employee benefits policy within a captive will be one with, generally speaking, a minimum global employee count of 5,000 and at least USD \$3-5 million in employee benefits premium spend.

Benefits of Captive Participation

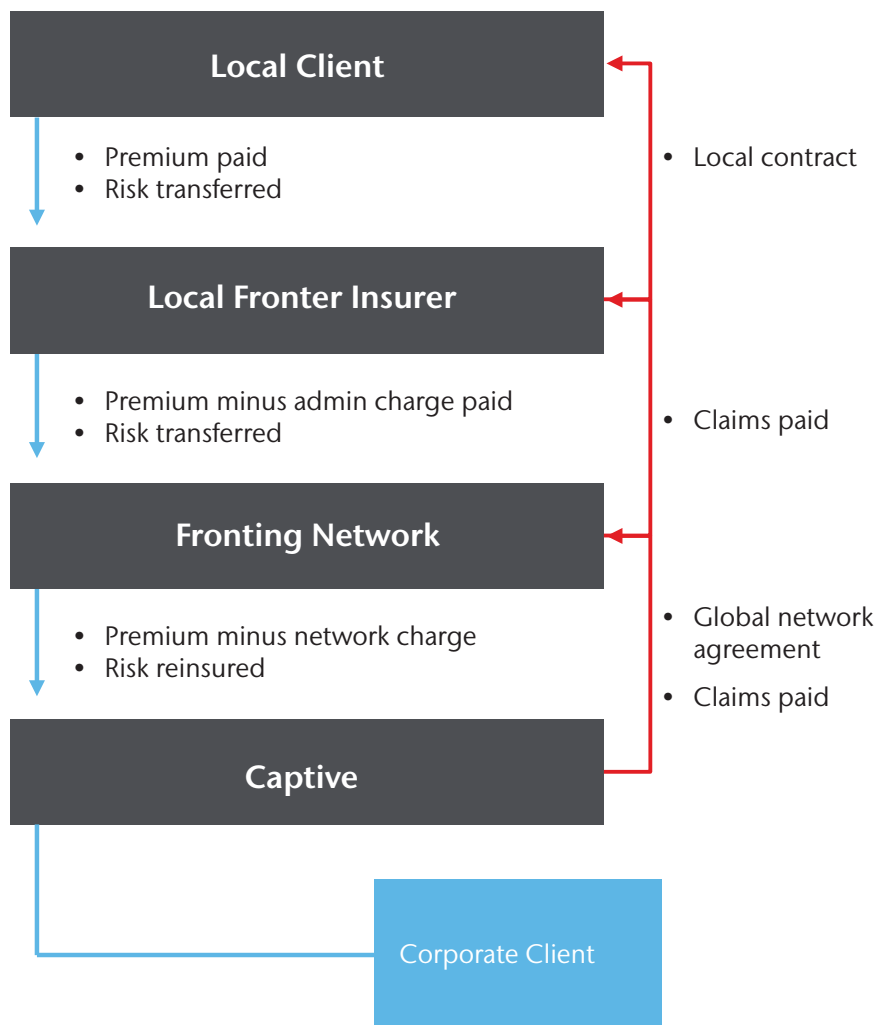
- Overall healthcare plan cost reductions and improved risk management governance
- Reduced reliance on commercial insurance markets for insurance coverages
- Greater control and flexibility over benefit plan design
- Creates opportunity for additional revenue streams and profits for the captive
- May create third party risk which may assist in cash flow acceleration and overall tax planning in the US
- Enhances medical and disability claims reporting using the captive as a centralized data portal to provide better line of sight and more control on claims and overall benefit governance

Non-US Based Risks

When multinational employers assess whether reinsuring benefits in a captive is beneficial, they tend to focus on non-US benefits as a first step due to the ease of inclusion of benefits, as compared with US employee benefits.

Need for Fronting Arrangement

Due to local country tax and labor law rules, the use of a fronting insurer is almost always required in non-US countries. A captive needs a licensed insurer(s), referred to as a fronting insurer(s), to issue and service insurance contracts that are locally compliant. The fronting insurer(s) subsequently cedes/reinsures some or all of the risk to a captive. The following is a typical structure of a global non-US employee benefits captive:



The role of the fronting insurer, whether a single global insurer or a network of fronting insurers, is key to the success of a global employee benefits plan. Among the principal functions performed by the fronting insurer are local underwriting processes. As part of this process, the fronting insurer receives requirements, census and claims information directly from the local operations as part of the usual annual placing process. Using this data, the local fronting insurer provides a captive with the proposed premium and other renewal terms which the captive then uses to establish the final risk-based premium, from which the fronting insurer then implements and executes via a local contract of insurance.

The premium set by a captive is required to satisfy the regulatory provisions of the various local countries to which the fronting insurer must also adhere. Premiums must reflect the contract risk level, are subject to local tax regimes, and must be generally equivalent to any fully insured model which a local insurer would provide.

Types of Non-US Employee Benefits

The ease of inclusion of non-U.S. employee benefit risks in a captive is listed below.



Factors that are driving non-U.S. employee benefit risks in a captive are:

- Global employee benefit cost reduction pressures on multinational companies
- Intensification of corporate benefit governance objectives
- Ineffectiveness of pooling solutions to provide optimal local pricing, along with attractive participation in financial and underwriting results

For an organization to successfully execute on their global financing strategy utilizing a captive, it is important to coordinate with various stakeholders from within the parent organization. The successful execution and management of a captive feasibility study will require the input and collaboration across all the major corporate functions, including: Finance, Procurement and HR (benefits). Each function will be positioned to provide a distinct perspective and will help ensure cost synergies are met, and employee satisfaction is retained and enhanced.

Captive reinsurance of employee benefit programs establishes a global standard of local retentions, risk financing levels and overall risk tolerance and appetite for employee benefits plans for the parent organization. In the absence of a coordinated captive strategy, many of these data points and financial metrics may be scattered throughout the parent organization in a disorganized manner and result in inefficiencies and additional costs.

A captive reinsurance employee benefit program may provide the following benefits to an organization's Finance and HR departments:

- Market competitive benefit programs that support the organization's strategy
- Gatekeeper captive consultants that reinforce captive communication and execute on the captive process at local level
- Support captive's pricing strategy for employee benefits to obtain market consistency and ability to soften pricing volatility
- Enhanced healthcare analytics to drive health and wellbeing strategies for the organization that will support their employee value proposition.

US-Based Risks

There are many US-based employee benefits that can be covered in a captive. Some are relatively easy to include, while others require regulatory approval involving substantial analysis, outside consultants, time and investment. Those requiring more effort, time and investment are governed by the Employee Retirement Income Security Act, 1974 ("ERISA") and generally include health and medical benefits.

The relative ease of inclusion of U.S. employee benefit risks in a captive is listed below, with medical stop loss program being a relatively easy program to underwrite in a captive and health/medical being the most difficult.



Medical Stop Loss

As many employers self-insure their employee's health insurance program, some have turned to medical stop loss ("MSL") policies to limit the severity of losses. This policy provides a layer of coverage above the employer group self-funded healthcare insurance and helps protect against catastrophic specific or aggregated events. Coverages generally include medical benefits and prescription drug costs. For many employers, it is a worthwhile exercise to determine if a portion or all of the MSL coverage being purchased could be covered in a captive insurance company.

A captive MSL program is generally relatively simple to implement as no fronting carrier is typically necessary, and no advance approval from the Department of Labor ("DOL") is required. There is also limited financial exposure. MSL risks are deemed to be "short tail", and generally indemnify medical claims in excess of the policy's attachment points, which are typically paid within one year of being paid or incurred (depending on how the program is structured).

The optimal employer profile criteria for an MSL captive program are:

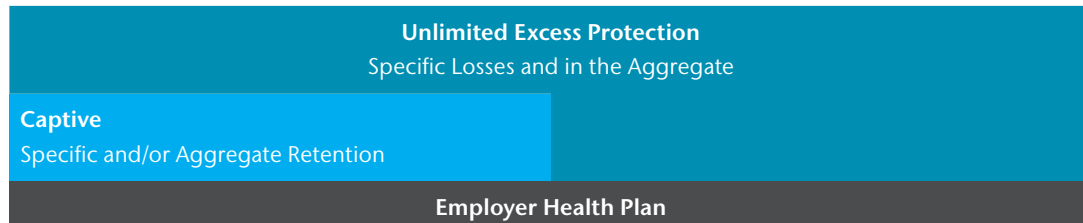
- 2,000 – 20,000 total employees
- Already owns a captive (U.S. or offshore domicile), or are examining the feasibility/desirability of a captive
- Currently purchases MSL coverage in commercial insurance markets
- Concerned about containing health benefit costs
- Desire to avoid excess volatility in health benefits costs.

A captive can provide MSL benefits to employers by:

- Allowing the employer to control more of the MSL risk and the cost of self-insuring medical benefits for its employees
- Utilizing a mechanism to spread the cost of the risk over a reasonable time period
- Produce savings by retaining the insurance premium and underwriting profit that the commercial market was retaining (typical savings in the 10-30% range)
- Accessing the reinsurance markets to purchase specific and aggregate protection to limit the captive's exposures (which may reduce the overall premium spend).

The chart below illustrates a typical use of a captive in an MSL program.

Chart 2: Potential Captive Program Structure



Voluntary Benefits

Voluntary benefits are, by definition, voluntary to the employee. They tend not to be governed by ERISA and are designed to provide financial security and help protect employees from large medical deductibles, co-insurance or legal expenses. Coverages include, among others, critical illness, hospital indemnity, legal expenses, forms of warranty, auto/home and pet insurance. Premiums are generally funded by the employee.

Many employers are considering the inclusion of voluntary benefits in a captive due to the impact that these types of programs can have on employee health and financial wellbeing, the effect on employee morale and retention due to the real and perceived value of investment by employers in an employee benefits plan, and the additional underwriting revenue that these programs can bring to a captive portfolio.

US Health and Medical Benefits

Insuring employee benefits through a captive is considered a “Prohibited Transaction” under ERISA. US DOL approval is required for a captive participation in such a program. Coverages can include, among others, employment and retirement medical benefits (medical, dental, and vision), group term life, and long/short term disability.

To date, a limited number of companies have insured ERISA governed employee benefits in their captives. There are many challenges when exploring this option as ERISA benefits are regulated by DOL and approval can be challenging, costly and lengthy to achieve. Previous applications have involved costs (legal, tax, and advisory) in excess of US\$500,000 and can take over 12-18 months to achieve success. Healthcare and medical risk costs are rising and retained risk needs to be adequately funded at all times which can be challenging for an employer to maintain. Most captive insured benefits will need to be ‘fronted’ by a licensed insurance company and then reinsured to the captive that involves some operational complexity. An employee benefits captive requires additional oversight and management and best practice requires collaboration with HR functions to properly consider employee impacts and to ensure buy-in at all levels and functions of the organization. ERISA benefits captives must be domiciled in the US or be a US branch of a non-US captive and must be ‘seasoned’ (minimum issuance of audited financial statements).

Department of Labor Process

The DOL had ceased issuing Prohibited Transaction Exemptions (“PTE”) during 2018 while they reviewed the entire application process including the Expedited Process³ (“ExPro”). Under the ExPro procedure, the DOL must act within 45 days of a company’s request for an arrangement, such as funding employee benefits through its captive, which would normally be prohibited by ERISA. Since 2019, the DOL has begun to review applications again, although ExPro approvals have been discontinued with only full, detailed applications considered while the DOL revisits and revises its current regulations.

Updated DOL Requirements for Applicants

The DOL requires applicants to provide a complete and accurate benefits assessment that the applicant expects to achieve (both tax and non-tax benefits) from the proposed structure. The proposed transaction must primarily benefit employees.

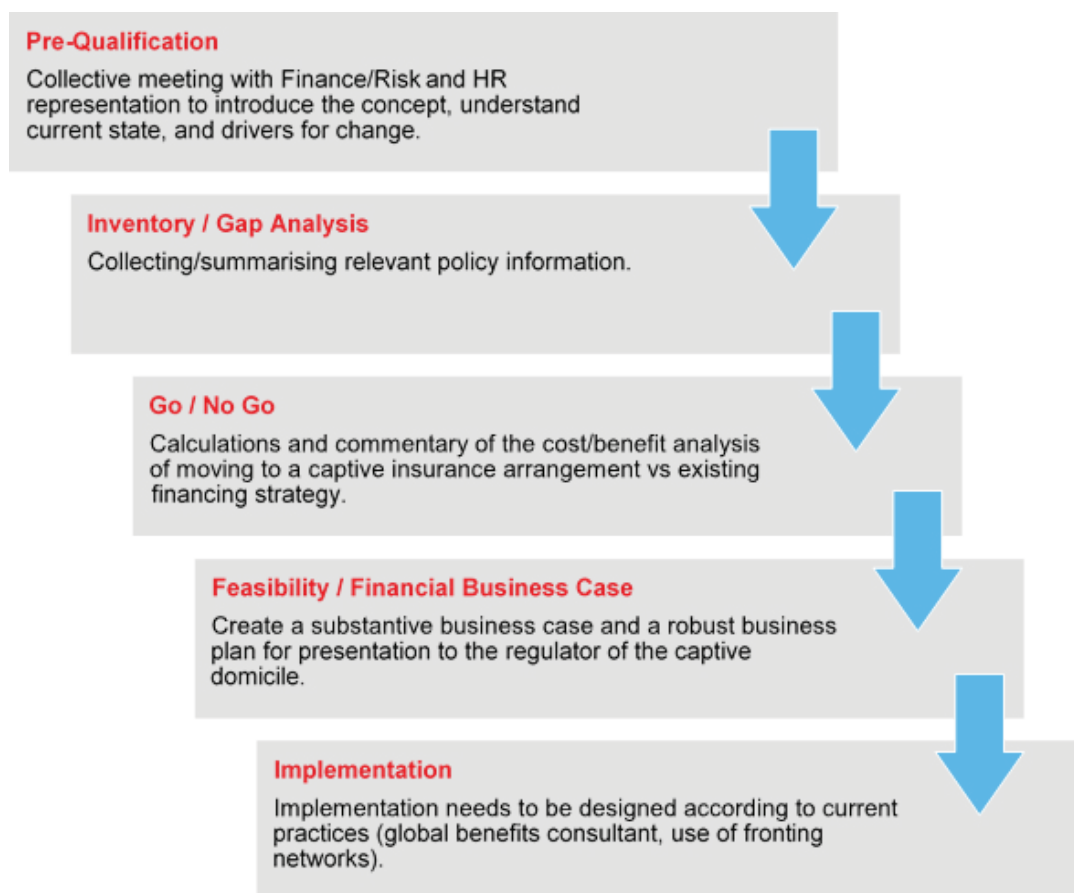
The DOL also requires an independent fiduciary to certify in writing that the proposed structure will primarily benefit plan participants, create real and substantial additional benefits for them, not be offset by reductions in benefits/salaries elsewhere, and be in compliance with ERISA (including prudence/loyalty provisions) and applicable law.

Further, the DOL requires an ‘A’ rated fronting insurer to reinsure risks to the captive.

A report must be filed annually with DOL and made part of the public record.

³ The Department of Labor Expedited Process is a regulatory procedure that employers use to seek approval for employee benefit funding in a captive insurance company. Under the procedure, the Department of Labor must act within 45 days of a request for such an arrangement. There is no time limit imposed for a response for non-Expedited Process requests for approval.

Steps to Employee Benefits Captive Formation



The Way Forward for Employee Benefits in Captives

Many employers are benefiting from utilizing captives for some of their employee benefit risks. A captive can be an effective and efficient way for an organization to finance risk and reduce its total cost. It can assist in aggregating data so employers can make informed decisions and draw conclusions for the company and its employees. Global (non-US) employee benefits programs are growing in popularity and have provided companies with greater control and flexibility in program design and improved risk management. For US risks, MSL coverage in captives has provided employers some pricing relief from the market. Voluntary benefits in captives have become more popular in the US. However, ERISA governed employee benefits are sought after less frequently in captives given the onerous and time-consuming process for DOL approval. Only very large companies with specific programs may benefit from embarking on this journey.

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