Navigate the Stormy Seas Ahead—A Case Study of a Creative Funding Vehicle for the New Health Care Reality

John Cassell
Senior Partner
Spring Consulting Group,
Merrimack, New Hampshire

Gary Gustafson, CEBS
Consultant
Spring Consulting Group,
Merrimack, New Hampshire

The opinions expressed in this presentation are those of the speaker. The International Society and International Foundation disclaims responsibility for views expressed and statements made by the program speakers.
Current State—An East Wind is Blowing
Captives 101—Weather Forecast Is: “Partly Cloudy with a Chance of Rain”
Benefits of a Captive—Calmer Seas Ahead
Creation of a Captive—Navigation Instructions
Case Studies—Experience from the Sea
Trends—Into the Sunset
Current State—An East Wind is Blowing
Healthcare Cost Escalation

Average Annual Premiums for Single and Family Coverage, 1999-2012

* Estimate is statistically different from estimate for the previous year shown (p<.05).
A Trend Toward Self-Insurance

“82 percent of employers have experienced a growing level of interest in self-funding their group health insurance plans over the past 12 months, 32 percent stating that interest has increased ‘significantly’”

*Munich RE: Business Wire, April 15, 2013*

- Control medical cost inflation
- Avoid Impacts of ACA additional taxes and fees: Health Insurance Industry Fee of 2-2.5% on fully-insured groups

“...groups between 51 and 100 employees are more likely to self-fund in greater numbers when they become subject to the small group market reform rules in 2016”

*RWJ - Factors Affecting Self-Funding by Small Employers; April 2013*

**Growth of Self-funded Plans (All Employers)**

<table>
<thead>
<tr>
<th>Year</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>52%</td>
<td>54%</td>
<td>54%</td>
<td>55%</td>
<td>55%</td>
<td>55%</td>
<td>57%</td>
<td>59%</td>
<td>60%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Captives 101—Weather Forecast Is: “Partly Cloudy with a Chance of Rain”
The Environment is Ripe for Change

*Increasingly, employers are turning to captives to control cost, manage risk, improve investment value and lower taxes.*

- The process is now much easier
  - Obtaining DOL approval for U.S. based benefits is quicker and is not required for all benefits
  - Regulatory guidance has improved due to IRS rulings and court cases

- Employee benefit coverage can be viewed as “unrelated business”
  - Adding unrelated business to an existing P&C captive can improve the captive’s overall financial efficiency and create additional savings

What is a captive?

An insurance or reinsurance company, specifically established to insure or reinsure the risks of its parent or associated third parties
Why are Organizations Interested in Stop-Loss Captives?

- Existing P&C captives and can be extended to other employee benefits
- Improve tax efficiency of existing captives
- Used when multiple employer welfare arrangement (MEWAs) and other group stop loss structures are prohibited or require more capitalization
- Allows heterogeneous entities or smaller organizations to pool coverage
- The costs of forming a captive are able to be spread out among all of the participants
- The risk per participant is lower
- New lower cost captive structures plus current approval precedents make access easier

*Medical stop-loss captives allow self-funded employers to pool excess medical claim costs with other companies to facilitate the purchase of stop loss coverage with higher attachment points, thus effectively lowering the cost of coverage and effectively controlling their health cost expenditure*
Captives are Generally Established to Insure or Reinsure Risk

**Direct Insurance**
- **Parent** pays premiums to captive
- Captive insures parent exposure and pays claims

**Reinsurance**
- **Parent** pays premiums to the front
- Front insures the captive’s parent exposure and pays out claims
- **Insurance Company**
  - The front reinsures the program with the captive
  - The captive pays fronting fees and claims

**Captive**
Types of Captives

- Single Parent (Pure)
- Group
  - Risk Retention Groups
  - Association
- Agency (Broker Owned Captive)
- Rent-a-captive or cell facilities
- Self-insurance trust
- Fronted
- Non-admitted direct write
- IRC 831(b)—small captives
How Captives Work

Where Premium Goes

- **Paid to Reinsurer**
  - Risk Transfer for Aggregate Loss Protection
  - Operating Costs

- **Loss Funds into Captive**
  - Loss Funding—good loss experience stays with captive,

How Losses Are Paid Out

- **Reinsurance**
  - (Aggregate Stop-Loss)
  - $ Max Determined
  - Loss Funding
  - Expected Loss
  - Deductible

- **LOSS FUNDS**
  - Retained by Captive

- **Expected losses paid by Captive**

- **Retained by Business Unit**

**Long-Term Strategies:**
1. Grow LOSS FUNDS by retaining and managing more risk in the captive, lessen dependency on other insurance over-time
2. Accrue value in the captive
Stop Loss in a Captive

The captive protects itself from excess claims by buying cover from an outside reinsurer for individual claims and total claims that could exceed 125% of expected.

The captive holds reserves for the employer to pay individual claims over each member’s retained risk SIR.

The captive provides a secure way to self insure health risks.

Employer retains some risk to reduce their overall costs.
# U.S. Employee Benefit Offerings

<table>
<thead>
<tr>
<th>Health &amp; Welfare</th>
<th>Voluntary</th>
<th>Fringe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Defined Contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-Ret Life</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-Ret Medical</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medical</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life Ins.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Drugs</td>
<td>STD(^1)</td>
<td></td>
</tr>
<tr>
<td>STD(^1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dental</td>
<td>LTD(^2)</td>
<td></td>
</tr>
<tr>
<td>LTD(^2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prevention, Disease Mgmt</td>
<td>Workers’ Compensation</td>
<td></td>
</tr>
<tr>
<td>Sick Leave</td>
<td>Other Leave</td>
<td></td>
</tr>
<tr>
<td>Workers’ Compensation</td>
<td>Other Leave</td>
<td></td>
</tr>
<tr>
<td>Holiday</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vacation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time Off</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auto/homeowners Insurance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Products</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgages</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long Term Care</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Critical Illness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Executive Benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multinational Pooling, Expatriate Global Assistance</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Short Term Disability
2. Long Term Disability
3. Flexible Spending Accounts
4. Employee Assistance Programs
   (mental health, legal assistance, etc.)

**Typical Non-ERISA**

**Typical ERISA Plans**

✓ = Typical Captive Programs
<table>
<thead>
<tr>
<th>ELEMENTS</th>
<th>INSURED PROGRAM</th>
<th>CAPTIVE PROGRAM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance Purchase</td>
<td>Yes</td>
<td>For catastrophic loss only</td>
</tr>
<tr>
<td>Pricing Model</td>
<td>Marketplace-based pricing, no return for controlling losses</td>
<td>Loss-based funding, performance driven, potential for profit return</td>
</tr>
<tr>
<td>Volatility</td>
<td>Cyclical</td>
<td>Longer-term, more stable</td>
</tr>
<tr>
<td>Savings</td>
<td>Accrue to insurer</td>
<td>Accrue to insured through risk management and loss control</td>
</tr>
<tr>
<td>Investment Income</td>
<td>Accrue to insurer</td>
<td>Accrue to insured</td>
</tr>
<tr>
<td>Insured Management Involvement/Effort</td>
<td>Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>Upside Potential</td>
<td>Only win if premiums exceed premium losses</td>
<td>Lowest cost of claims</td>
</tr>
<tr>
<td>Services</td>
<td>Bundled with insurer</td>
<td>Unbundled</td>
</tr>
</tbody>
</table>
Who Should Consider a Captive?

<table>
<thead>
<tr>
<th>Companies with...</th>
<th>Should not consider, if...</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Good risk management</td>
<td>- Poor risk management/</td>
</tr>
<tr>
<td>- Long term commitment</td>
<td>high loss ratios</td>
</tr>
<tr>
<td>- Financially sound</td>
<td>- Short term outlook or</td>
</tr>
<tr>
<td>- Driven by an interest in financing assumed risk</td>
<td>price driven</td>
</tr>
<tr>
<td>positions</td>
<td>- Financially weak</td>
</tr>
<tr>
<td>- Reasonably predictable insurance risk</td>
<td>- Highly volatile or</td>
</tr>
<tr>
<td>- “Transforming” transactions</td>
<td>catastrophic exposures</td>
</tr>
<tr>
<td></td>
<td>without the support of</td>
</tr>
<tr>
<td></td>
<td>stable lines</td>
</tr>
</tbody>
</table>
# Key Considerations When Forming a Captive

<table>
<thead>
<tr>
<th>Captive Type</th>
<th>Captive Legal Structure</th>
<th>Domicile</th>
<th>Tax Issues</th>
<th>Regulatory Compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Pure</td>
<td>• Stock</td>
<td>• Vermont</td>
<td>• Deductible premiums</td>
<td></td>
</tr>
<tr>
<td>• Group</td>
<td>• Mutual</td>
<td>• Bermuda</td>
<td>• Insurance accounting</td>
<td></td>
</tr>
<tr>
<td>• Fronted</td>
<td>• Reciprocal</td>
<td>• South Carolina</td>
<td>• Deposit accounting</td>
<td></td>
</tr>
<tr>
<td>• Direct</td>
<td>• Cell</td>
<td>• Cayman</td>
<td>• Accelerated deduction</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rental</td>
<td>• Washington DC</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Staff Impact

### Human Resources
- Same carriers and networks
- Access to transparent data
- Expert support for health data/trends, health reform and legal issues

### Employees
- No noticeable change
- Minor and seamless transition of services
- Improved employee support services
Group Captive Program Development

**Funding**
- Health Insurance Funding
- Improved Risk Management
- Bulk Purchasing
- Other Risks—Life
- Disability
- Retiree Health Pensions
- Life

**Health Management Initiatives**
- Wider Health and Wellness Initiatives
- In House Primary Care
- Health and Disability

**Additional Participants**
- Health & Productivity Management

**Healthier, More Productive Employees**

**Performance Measurement**
- Improved Benefits Value and Cost Management
- Continuous Improvement
- Tighter Controls and Risk Management

11A-17
PROGRAM STRUCTURE

- **Buying Power**
  - Creates cost savings that increase as the group expands

- **One Central Point of Contact**
  - Enrollment
  - Billing
  - Employee interface
  - Employer data

- **Control**
  - Premium volatility reduced via claims pooling and large scale

- **Choice**
  - Members can choose to self insure some of their own risk to save cost

- **Flexibility**
  - Select plans
  - Select employee contribution
  - Maintain existing broker relationships

- **Transparency**
  - Financial and performance data
  - No hidden costs

- 5-8 custom health plans
- Best in class health management and wellness
- 1-2 carriers
- Full data analysis for management/benchmarking
- Active member involvement in decision-making and design
Benefits of a Captive—Calmer Seas Ahead
Summary of Captive Advantages

Manage Costs

- Accelerate cash flow through premiums, claims and reserves
- Reduce frictional costs (commissions, taxes, risk charges, administration)
- Capture investment return
- Improve cash flow and centralize investment of reserves

Increase Control

- Design coverage and provisions of benefits
- Improve data management and claim cost management
- Remove insurer’s profit loading
- Improve management reporting and understanding of risks

Improve Risk Management

- Operate and manage a central risk pool
- Implement appropriate stop loss reinsurance to manage peak risks
- Reduce overall cost of risk
## Employee Benefit Cost Savings Using Captives

<table>
<thead>
<tr>
<th>Program</th>
<th>Estimated Savings*</th>
<th>Frictional Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term life insurance</td>
<td>10% - 15%</td>
<td>Commercial insurance</td>
</tr>
<tr>
<td>Retiree medical</td>
<td>3% - 15%</td>
<td>Accumulated Post-Retirement Benefit Obligation</td>
</tr>
<tr>
<td>Long-term disability</td>
<td>15% - 25%</td>
<td>Commercial insurance On self-insurance, accelerated deduction of claims cost and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>tax effective investment accumulation on reserves</td>
</tr>
<tr>
<td>Multinational pooling</td>
<td>10% - 15%</td>
<td>Commercial insurance</td>
</tr>
<tr>
<td>Active medical stop loss</td>
<td>10% - 12%</td>
<td>Cost of stop loss</td>
</tr>
<tr>
<td>Executive benefits –</td>
<td>10 + %</td>
<td>Net cost resulting in higher yield on investments</td>
</tr>
<tr>
<td>Deferred compensation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>COLI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Split dollar replacement</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* These are typical savings that our clients have experienced in the past; actual performance may vary.

Other advantages are similar to property/casualty captive funding e.g., broader coverage, stability against market fluctuations, improved service, direct access to reinsurers, and increased control.
Creation of a Captive—Navigation Instructions
The Fundamentals must be Sound

Effective Captive Program

- Understanding of Risk
- Profitability over Time
- A Sound Business Plan
- Access to the Right Insurance Markets
- Good Analytics
- Expert Management
How to Establish a Captive

- Conduct a feasibility study
  - Loss history
  - Risk/reward discussion (potential benefits)
  - Minimums: solvency, capital requirements, premiums
  - Ownership options
  - Financial analysis
  - Legal: DOL requirements, taxation, and incorporation

- Actuarial review
- Select partners
- Incorporation
- Captive licensure
- Capitalization
- Reinsurance/insurance contracts
- Service provider agreements
- Seek DOL approval? 1 year out?
Premium Deductibility

Issues:

- Taxable vs. tax exempt organizations
- True insurance vs. not true insurance
  - True—premiums paid to captive are deductible
  - Not true—Premiums not deductible
  - Risk transfer and risk distribution
    - Required for true insurance

*Single owner captive premiums are not deductible!*
Case Studies—
Experience from the Sea
Case Study 1: Group Captive Feasibility Study

Organizations

- 25 employers with approximately 9,000 total employees spend $110M per annum on health insurance

Situation

- By funding their stop loss health insurance through a captive, the group will conservatively save over $6M

Anticipated Results

- 5 year net present value savings exceed $30M
- Additional savings are anticipated from:
  - Better health management
  - Reduced reinsurance costs
  - Further savings on administration
Case Study 1: Group Financial Projection

Representative Sample
25 employers
9,800 employees

Spending $110M on health insurance

Conservative 2011 savings 4-9% depending on group

Full population
60 employers
100,000 employees

Spending $1.2B

Savings of $180-250M per year—improved with volume

Results are pending first year review in 2014!
Case Study 2: Pure Captive

Organization
- Global food distributor with 60,000+ employees

Situation
- Offshore property/casualty captive already in place
- Opportunity to fund its otherwise unfunded liability
- Interested in integrating disability and workers’ compensation
- Leveraged current stop loss program to incorporate additional premium volume; considered direct and fronting placement

Anticipated Results
- Reduced reinsurance costs
- Further savings on administration
- Capture investment income
# Case Study 2: Results

<table>
<thead>
<tr>
<th>Line of Coverage</th>
<th>Captive Savings ($$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retiree Medical</td>
<td>22% of the liability over ten years</td>
</tr>
<tr>
<td>Long Term Disability Stop Loss</td>
<td>21% of the existing premium</td>
</tr>
<tr>
<td>Medical, Dental and Vision Stop Loss</td>
<td>3% of the existing premiums, but leveraged for captive volume</td>
</tr>
</tbody>
</table>
**Case Study 3: Association Healthcare Captive**

**Organizations**

- Education and research-related not-for-profit organizations in Washington, D.C. unable to provide broad coverage on their own

**Situation**

- The goal: to provide access to affordable health insurance and other benefits through a mutual for-profit association captive
- Existing trust funds capitalized the entity which insured run-out policies to cover IBNR and arranged reinsurance with an A-rated carrier
- Members were offered similar coverage to their prior arrangements

**Anticipated Results**

- Reduced reinsurance costs
- The captive formed a related captive management and brokerage operation to serve existing and ongoing member needs
## Case Study 3: Results

<table>
<thead>
<tr>
<th>Captive Component</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Membership</td>
<td>▪ 40+ not-for-profit employers</td>
</tr>
<tr>
<td></td>
<td>▪ 2,000+ employees</td>
</tr>
<tr>
<td>Offering</td>
<td>▪ Four health plans</td>
</tr>
<tr>
<td></td>
<td>▪ Two dental plans</td>
</tr>
<tr>
<td></td>
<td>▪ Life, legal, vision, EAP</td>
</tr>
<tr>
<td>Financials</td>
<td>▪ Assets of over $8 million</td>
</tr>
<tr>
<td></td>
<td>▪ Revenues returned to members (decrease premiums, increased benefits or dividends)</td>
</tr>
<tr>
<td>Administrative Burden</td>
<td>▪ Greatly reduced for individual organizations</td>
</tr>
<tr>
<td>Premiums</td>
<td>▪ Less than 10% inflation over the last three years</td>
</tr>
</tbody>
</table>
Trends—Into the Sunset
Growth of Captives Over Time

10% expected growth in 2013—understated due to increased cell use

Reasons Captives are on the Rise

Market pressures will continue to force employers of all sizes to search for creative alternatives to traditional insurance products.

Growth of employee benefits captive a result of:

- Insurance needs
- Health care reform and other legislative changes
- Business, financial and tax considerations
- Lack of confidence in traditional insurance companies
- Increase in specialist consultants with turnkey solutions
- Brokers see captives as a way of retaining clients and increasing margins by participating in the risk
- More domiciles with more flexible captive legislation
Trends in Captive Use for Benefits

- New captive formations and expansion of existing captives
- Greater domicile choice
- Increased funding of unrelated/3rd party risk
  - Truly unrelated
  - Employee benefits a major investment for many companies
- Post-retirement costs in Europe and US are becoming critical issues where captives are a solution
  - Pensions
  - Retiree medical
  - Stop loss
- Expanded rent-a-captive or segregated cell captive use
- Employee benefits are now a major investment for many companies
- Companies are now seriously looking at captives as a funding vehicle for benefits as blue chip organizations take the lead
Then vs. Now: What has changed?

Ten Years Ago

Captives were rarely used:
- Perceived obstacles
  - Reinsurance restrictions
  - Territorial restrictions, (i.e. US only)
- Relatively few employee benefits reinsured by captives
- Limited HR familiarity with captives
- Insurer reluctance
- Alleged marginal economics

Now

- More people involved:
  - HR, Finance and Risk agendas
  - Everyone knows about it
  - Consolidation of risk financing
  - Network restructuring and changes not aligned with growing market
  - Viewed as the next step in cost savings and control
- Active management increasing:
  - Communications
  - Formal guidelines
  - Annual review and changes
  - Quarterly claims management

What does this mean?

Captives represent an emerging growth area!

11A-37
Questions?