Employee Benefit Captives

An Alternative to Traditional, High-Cost Plans

A Whitepaper Presented By

Cypress BENEFIT ADMINISTRATORS
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Executive Summary

First used more formally in the 1950s after World War II, captive insurance companies, also referred to as “captives,” are long-established structures designed to transfer and manage the different types of risks faced by employers in various industries. Data show that captive arrangements can result in significant financial gains for parent companies or members over the long-term and may also substantially reduce the rising costs of financing risk.

While the number of captives has progressively grown in recent years, the scope of risk applications continues to widen. Historically, companies have used captives to facilitate the management of predictable property and liability risks, such as workers’ compensation or malpractice. As health insurance costs continue to rise throughout the United States and businesses search for ways to combat these skyrocketing expenses today, captive insurance has become a more standard way to manage another type of risk: employee benefits.

There are several reasons a company might consider forming – or joining – a captive insurance company. In addition to impacting the volatility of claim expenses normally experienced in the commercial insurance markets managed by traditional carriers, there are opportunities to receive financial gains through underwriting surplus, investment income and tax costs.

Deciding whether or not to participate in a captive is a major decision that should be considered carefully by each business. Any related discussion should start with a thorough evaluation of how a captive would operate in managing your company’s risk. A comprehensive assessment like this should be done to address the fundamentals of captive structures and to weigh all of the advantages and disadvantages involved.

Although there are many different types of captives with far-reaching applications these days, this white paper will focus specifically on employee benefit group captives.

For more information on other types of captives, contact Cypress Benefit Administrators at any of its five regional offices.

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Background & History of Captive Insurance

Introducing the Captive Concept
The first example of the captive insurance concept dates back over 500 years to a time when ship owners in London exchanged names and documented the worth of their cargo on paper. They formed the first known private agreement on record to share and transfer the risk – better known today as a captive – in shipping fleets.

As captives continue to expand to new areas and markets on a global scale, industry experts predict that these insurance structures are only in the early stages, with much more growth to come.

A Timeline
- **1800s** – Textile manufacturers in New England experience elevated fire insurance rates and form a group for all to share in the risks
- **Early 1900s** – The Church Insurance Company was created by the Episcopal Church to manage the risks of multiple member churches
- **1950s** – Captives increase in number after the industrial soar following World War II; Frederic M. Reiss, also known as the “father of captive insurance,” implements the captive insurance concept for his first client in the mining industry
- **1960s** – Nearly 100 captive insurance companies exist, with Bermuda and the Cayman Islands serving as the main financial centers across the globe
- **1970s** – Bermuda is the first country to employ full legislation and licensing regulation for captive insurance in 1978; the Cayman Islands follow suit with legislation specific to the healthcare field
- **1980-1990s** – Approximately 1,000 captive insurance structures exist, with the majority formed and residing in locations outside the U.S.; Vermont becomes the top U.S. captive domicile
- **2000 to present** – Over 30 states organize and operate captive insurance companies; an estimated 6,000 or more captive structures exist today
What is Captive Insurance?

An Alternative to Traditional, High-Cost Plans

While defined in many different and often complex ways, in terms of employee benefits, captive insurance is a risk vehicle alternative to the more traditional, high-cost group insurance plans. It is a form of self-insurance that is partially funded by employers and allows members — versus commercial carriers — to benefit from underwriting and investment profits as well as potential tax savings.

Consider this more general definition from the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guides:

“Wholly owned subsidiaries created to provide insurance to the parent companies.”

Another interpretation from Towers Perrin (the company that merged with Watson Wyatt in 2010 to form Towers Watson):

“A closely held insurance company whose insurance business is primarily supplied by and controlled by its owners, and which the original insureds are the principal beneficiaries. A captive insurance company’s insureds have direct involvement and influence over the company’s major operations, including underwriting, claims management policies, and investment.”

No matter the technical definition you go by, a captive is simply another form of alternative risk transfer. Put another way, it is a more formalized type of self-insurance for parent companies and, in some cases, affiliate firms.

In years past, captives were limited to accommodating large corporations with predicted risk. This is no longer the case today. With the development of new structures and clarification of IRS tax and accounting issues, captives are expanding to other insurance lines like employee benefits. They have become the preferred solution for many Fortune 500s and public and private companies of mid to large sizes, as well as groups of individuals across the United States.

Similar to other types of self-insurance methods, traditional captive structures are set up to have companies retain some level of risk internally. Different than many forms of self-funding, however, there is some advance funding of risk required in a captive as employers must contribute plan collateral up front.
Captives operate like traditional carriers in the sense that they issue a policy – through a fronting carrier – and then take on the risk of the parent/owner in return for a premium.

**Takeaway Points**

- Captive insurance provides an alternative to managing risk and financing through traditional insurance carriers; it allows employers to join an existing or new risk-management program and the potential to realize significant cost savings.
- The primary role of captive insurance is to insure the risks of parent companies, and in some cases, affiliate firms.
- Captives insure different levels of risk as risk varies on a case-by-case basis for each company.

**How Does A Captive Structure Work When Applied to Employee Benefits?**

For the examples included here, an employer provides employee benefits/health insurance to its staff. The captive structure involves:

- The employer reinsures employee benefit coverage with the captive through a fronting carrier.
- Once implemented, the fronting carrier collects the premium from the employer and the reinsurance premium is paid to the captive.
- The fronting carrier and captive have an indemnity agreement – meaning protected against loss – that makes the fronting carrier liable for the captive even though a reinsurance contract is in place.
Why Form or Join a Captive?

Main Benefits of Captives
- A share of underwriting and investment profits
- Better cash flow management
- Lower overhead
- Reduced volatility in premium increases
- Lower administrative costs
- A greater degree of control

When working with a more traditional commercial insurance carrier, employers often feel they have little control when left to contend with one-size-fits-all plan solutions that don’t necessarily fit their individual needs. For example, annual premiums are typically based on an average community rating instead of a company’s specific demographics ... these premiums are typically due in advance which ties up money that could instead be invested ... there’s limited flexibility in customizing insurance products ... and the cost of premiums keeps increasing so fast that it’s nearly impossible to budget future expenses.

Employers who form or join an existing captive have a much greater degree of control. That’s because:
- Policies are not written based on other companies’ numbers or profitability ratios
- Premium rates reflect the actual loss record and experience of the parent company instead of the industry as a whole
- Captives collect premiums at varying intervals instead of so far in advance, which eases cash flow
- Premiums are invested and parent companies share in the profits
- Captives have access to reinsurance markets
- Overhead and administrative fees are lower

Reasons for Forming a Captive

MINIMIZE INSURANCE COST
Reduce Insurance Costs
Capture Underwriting Profit
Pricing Stability
Purchase Based on Need

IMPROVE CASH FLOW
Retain Premium Dollars
Tax Benefits
Investment Income
Additional Profit Center

CONTROL RISK
Greater Control Over Claims
Increase Coverage
Increase Capacity
Underwriting Flexibility
Access Reinsurance Market
Incentives for Loss Control
How Are Captives Unique?

Because captive insurance is structured differently than traditional commercial insurance and subject to its own set of requirements, there are many financial – and overall business-related – advantages in its various applications. Common examples are:

- Direct Access to Global Reinsurance
- Modified Risk Transfer
- Gap Coverage
- Tax Advantages
- Risk Monitoring/Accountability

**Direct Access to Global Reinsurance** – The global reinsurance markets offer risk coverage at a much lower cost than traditional primary carriers, but they generally only work with licensed insurers versus employers. This is where the captive comes in. Because a captive acts as an insurance company, it is able to issue policies to the parent members. This, in turn, makes it possible to reinsure to these global markets and save significantly on premium costs.

**Modified Risk Transfer** – Captive insurance structures give companies the added flexibility to insure – or reinsure – a smaller amount of risk in the commercial market (higher premiums) and a larger amount in the captive (lower premiums). This is a plus because when the economy is operating in a hard market, it is much more difficult for employers to find the appropriate amount of coverage, and when they do, it is often only available at extremely high rates. For employee benefits, the captive may cover up to a certain amount of loss, and beyond that level, the commercial insurance will kick in.

**Gap Coverage** – When calculating risk and coverage, there can often be a gap in the amounts covered. For example, if a company has $12 million in risk, it may choose to cover the first $3 million, but run into issues when trying to find commercial coverage for the layer between $6 and $10 million. In a captive structure, policies can be issued to cover these gaps so all layers are accounted for.

**Tax Advantages** – In certain situations, companies realize considerable tax advantages through their captives. This is because the premiums paid by the parent company can be tax-deductible once paid, before loss coverage has resulted in actual policy claims. Without a captive in place, these tax benefits are virtually impossible because employers are not able to subtract reserves for any unpaid liability until the full number of occurrences and dollar amount is determined.

**Risk Monitoring/Accountability** – Aside from monetary savings, risk managers and leadership personnel often feel that captive structures simply make good business sense. Transferring risk to a captive is an organized, transparent way to manage risk. And because captive reserves are subject to review and certification, companies have a heightened sense of accountability in terms of managing and monitoring risk.
Common Captive Structures

Which Captive is Right for Your Company?
When using a captive as a risk transfer vehicle, different companies have different needs. As captives have evolved over the last several decades, so have their structures. A few of the more well-known captives that exist today include:

- Single Parent/Pure Captive
- Industry-Specific Captive
- Association Captive
- Rent-a-Captive
- Agency Captive
- Protected Cell Captive (PCC)
- Risk Retention Group (RRG)

Single Parent/Pure Captive – These captive structures provide insurance coverage to companies with one owner. They are typically monitored by a risk manager or other financial specialist within the parent company and managed by a domiciled (chosen U.S. or international location) captive manager.

Industry-Specific Captive – A type of captive structure that is owned by multiple companies within one industry. These structures are often formed to address a common insurance problem the industry is facing as a whole and are typically run by a board of directors selected through stockholders.

Association Captive – Created and owned by a trade association or select group of individual members, these structures are widely used by groups with higher liability risk. They are generally managed by a designated financial professional within the association or an outside captive manager.

Rent-a-Captive – Just as the name suggests, rent-a-captives are insurance structures where an established captive offers its services to users on a rental basis instead of requiring the standard capital for ownership. A fee is negotiated – often a percentage of the renter’s premium – and once collected, the captive provides its underwriting, reinsurance and other services to various organizations.

Agency Captive – Becoming one of the lesser-used forms of captives today, these structures are different in that they don’t offer insurance to their owners. They are designed for insurance agents and brokers and are often relied on in hard market times.

Protected Cell Captive (PCC) – Made up of a group of different cells that can represent multiple industries, PCCs are similar to rent-a-captives, but offer capital protection to each cell. This way, if one cell would experience a financial hardship like bankruptcy, the other cells would still be protected.

Risk Retention Group (RRG) – Unique in many ways, RRGs are made up of member-owned companies that operate in the same or comparable business lines. They are formed to pool their risk and must be licensed in at least one state or the District of Columbia. When licensed, members from across the nation are able to join and the RRG can underwrite their risk. This allows members to benefit from more favorable rates and conditions than what may be available in their state. The Liability Risk Retention Act of 1986 makes this possible – it is federal legislation that overrides state-specific laws.
The most common employee benefit captive structure is that of a segregated or protected cell company. The graph below illustrates how claims are funded using this type of structure. While many other structures can be used, a segregated arrangement will provide the most protection of individual company assets and offer the most flexibility for future growth.
 Benefit Savings Potential through Captives

Flexibility Leads to Financial Gains
Many employers are finding that they can save on the cost of employee benefit delivery by reinsuring the associated risk through a captive insurance structure. While all circumstances are different and many considerations must be factored in, captives generally allow more flexibility in risk sharing and save employers on overall underwriting fees and administrative expenses. Here are three of the most common savings opportunities a captive can offer:

- Premiums by Claims History
- Reduction of Extra Risk Charges
- Investment Income Interest

Premiums by Claims History - Oftentimes, the traditional insurance market will charge premiums at a higher rate than what is warranted by an employer’s actual claims history and loss record. Instead of basing premiums on an average cost or community rating, a captive structure considers an employer’s individual demographics, experience and risk profile when premiums are configured.

Reduction of Extra Risk Charges – When calculating premiums, commercial carriers are also known to factor in added risk charges as a means of extra protection. Employers who retain some level of risk through a captive can typically eliminate these extra risk loadings charged by traditional insurers.

Investment Income Interest – Commercial insurers factor reserves into the equation when setting plan rates and must estimate the interest rates for these liability funds. Because interest rates are generally approximated on the conservative side by traditional carriers, premiums come out higher to make up for the difference in lower predicted growth. In a captive structure, premiums are lower and members retain the investment income instead of carriers. Additionally, premiums aren’t paid so far in advance, which can help improve an employer’s cash flow.
Financial Structure: 
Segregated Cell Group Rent-a-Captive – An Illustration

This section outlines the actual reinsurance or stop loss provisions within a segregated cell arrangement. Each individual company, or insured, will have its own stop loss contract that functions just like it would in the commercial market. The key difference is that each company will participate in a sharing of a particular layer of risk, normally referred to as the “middle layer”. Each company will maintain a certain individual specific retention, but then instead of the main reinsurer or stop loss carrier taking the risk above that specific retention, the middle layer of risk is financed by each captive owner. Claims above the middle layer will be financed by the reinsurer. The following section describes this arrangement in further detail.

Step I – Self Insurance
- Each employer elects to self-fund its employee health benefits
- Each employer creates and manages its own self-funded health benefit plan
- Each employer pays for claims on behalf of its Plan

Step II – Stop Loss Policy
- Each employer is issued a stop loss policy with both specific and aggregate retention:
  - Policy is issued by an A-rated company, referred to as “Fronting” Carrier
  - Individually rated; no group rates
  - Each employer pays a premium to the carrier for their stop loss policy
  - The stop loss policy reimburses each employer for covered claims above either its specific or aggregate retention

Step III - Captive Structure
- The captive is a reinsurer of the Insurance Carrier and does not issue policies
- Fronting Carrier reinsures the layer between $25,000 per individual and $250,000 to a captive
- The captive receives premium for the layer from Fronting Carrier
- Each employer provides collateral to the captive in case premiums are insufficient
- Fronting Carrier limits the captive’s exposure with a program aggregate
- Unused captive funds are returned to the employers
The illustration below outlines the costs and risk responsibilities for each component in a typical captive structure. While actual values will change depending on the size of the employer/captive owner, it is important to understand how all three components function and where risk is allocated.

### Funding Mechanism (All Sample Values)

<table>
<thead>
<tr>
<th>Claims Layer</th>
<th>Responsibility</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-$25,000</td>
<td>Employer</td>
<td>$0</td>
<td>$734,261</td>
<td>Actual claims as paid</td>
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<tr>
<td>$25,000-$250,000</td>
<td>Captive</td>
<td>$0</td>
<td>$259,431</td>
<td>$37,524 due at inception</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$221,907 in 12 installments</td>
</tr>
<tr>
<td>Over $250,000</td>
<td>Carrier</td>
<td>$196,699</td>
<td>$196,699</td>
<td>12 installments</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$196,699</td>
<td>$1,190,391</td>
<td></td>
</tr>
</tbody>
</table>
Sample Case

Member Company with the following enrollment:
- 45 Employee Only
- 75 Employee Plus Family
- Current Plan: Blue Cross PPO
- Renewal Fully Insured Premium: $1,000,000

<table>
<thead>
<tr>
<th>Captive Structure Comparison</th>
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<tbody>
<tr>
<td>Equivalent Premium</td>
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<tr>
<td>$1,000,000</td>
</tr>
<tr>
<td>Expenses</td>
</tr>
<tr>
<td>Member Retention</td>
</tr>
<tr>
<td>Group Retention (Captive)*</td>
</tr>
<tr>
<td>Total Loss Funding</td>
</tr>
<tr>
<td>Collateral</td>
</tr>
<tr>
<td>Projected Minimum</td>
</tr>
<tr>
<td>Projected Maximum</td>
</tr>
</tbody>
</table>

* All unused Group Retention funds are returned to the employers on a pro-rata basis.

Risk Layer Funding

- $200,000
- $425,000
- $525,000
- $275,000
- $250,000
- $25,000
- Collateral: $150,000

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Ideal Employers

An employee benefit group captive is not a good fit for all employers. Great care and attention should be paid to the advantages, disadvantages, and the significant effort required in determining the feasibility of such an arrangement. Employers that are a good fit generally have the following characteristics:

- Recognize the current path is unsustainable
- Willing to “get their hands dirty”
- Value financial incentives to drive employee behavior change as a good thing
- Entrepreneurial
- Engaged and willing to engage employees
- Willing to be innovators and challenge the status quo
- 50 or more employees insured
- Tired of a lack of transparency, constant rate increases
- Seeking long-term solution, not immediate savings
- Willing to assume risk

Why a Group Captive for Employee Benefits?

Form a New Captive or Join an Existing?

The Top Three Considerations
The decision to form a new captive insurance program or join one already in existence starts with a fairly simple analysis which generally involves the consideration of three main factors: time, money and desire for control. It should then move to a more comprehensive assessment.

Time – Most existing captive structures that are available for “rent” are fairly turn-key, which makes them available for quick entry. The quoting process is relatively fast, usually one to two weeks, and with everything already established, entry can begin within a month or so.

Building a new captive program takes considerable time—at least 12 months, but it could easily take 18 months before being ready to launch. When building a new program, a potential entity must first obtain critical mass, usually at least seven employers and 1,000 employee lives, and then follow several steps:

- Conduct a feasibility study/financial analysis
- Complete captive applications
- Select a domicile and apply
- Interview and select program vendors, including TPA, PBM, UM, DM, Network, Captive Manager, Actuarial Firm, Investment Manager, Auditors and an Attorney.

Most employers of mid-range size usually prefer to select a captive program already in existence to achieve their goals.

Money – With captives, there is give and take. For turnkey programs like rent-a-cell captives, most of the legwork has already been done. Therefore, these programs come with a premium in return for convenience. Additionally, in terms of financial returns, they will generally be less than those under a program built from scratch. Conversely, under a new program, there is more opportunity for positive financial return, but the timing is a significant consideration.

Control – Perhaps one of the most important aspects of either type of approach is that of control, or more particularly, the desire to have all of it or the willingness to take a more passive seat at the table. With a new program, an owner can control absolutely everything from the selection of the Captive Manager right down to the language of the underlying benefit plan. Under an existing program, there is still a certain element of control, but most decisions have already been made. To make changes to a captive program already in place, a larger group of existing owners typically needs to cast a vote.

<table>
<thead>
<tr>
<th>Costs of Various Captive Service Providers</th>
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<tbody>
<tr>
<td>Service Provider</td>
</tr>
<tr>
<td>----------------------------------------</td>
</tr>
<tr>
<td>Captive Manager</td>
</tr>
<tr>
<td>Actuary</td>
</tr>
<tr>
<td>Auditor</td>
</tr>
<tr>
<td>Bank (Letter of Credit)</td>
</tr>
<tr>
<td>Investment Manager</td>
</tr>
<tr>
<td>Attorney</td>
</tr>
<tr>
<td>TPA</td>
</tr>
<tr>
<td>Consultants</td>
</tr>
</tbody>
</table>
A Successful Captive Program

As with any insurance program related to employee benefits, there are multiple aspects within a captive structure that will determine its overall success rate – some are controllable, some are not. A solid, long-term strategy and flexibility are two of the most important factors, along with:

- **Financial security** – A captive with financially solid owners is much more likely to withstand any hard economic times and have the means to keep up with the collateral and premiums owed, no matter the situation.

- **An informed, committed team** – To be successful, captive partners need to be on the same page with a shared vision and goals. They also need to be focused on the long term and realize that it will take time for a captive to reach its full potential for success.

- **Emphasis on predictable loss** – The owners of captives know their industry best and, in most cases, should focus on insuring their own predictable risk.

- **Loss control/containment** – Captives are most successful when cost containment is at the forefront and members are working to minimize claims. Maximum savings are realized when everyone is doing their part, so it’s important to keep an eye on partner performance and hold all parties accountable.

- **Record of positive returns** – A captive insurance structure won’t result in significant savings overnight, but a successful one will return gradual financial gains in the form of underwriting surplus, investment/interest income, tax benefits and more.
Conclusion

Expanding in number and scope for the last several decades, captive insurance structures are becoming more commonplace for businesses of all sizes in a wide range of industries like employee benefits.

Captives can provide significant benefits over time and serve as a sustainable solution for transferring risk when designed and implemented properly. They are complex structures, though, and all factors must be considered when forming or joining one as captives are subject to different regulations and tax requirements than plans offered through traditional carriers.

Placing employee benefit risk into a captive program can often reduce the extreme volatility experienced in the traditional commercial market. It can also lower your long-term employee benefit costs while increasing the flexibility and control of risk management. Captives can also provide many financial gains that are not otherwise available in the traditional market.

To ensure long-term objectives, captives can have strict requirements for both entry to and exit from the program, including underwriting guidelines, biometric screenings and wellness plans. They may also include cost containment and risk management measures such as fraud and abuse detection/prevention, incentives for biometric achievement, predictive modeling algorithms, medical tourism, patient advocacy and more.

As with other factors, vendor and partner selection is critical to ensuring that all parties have the same vision and goals and are committed to supporting a program for the duration.

For more information on captive Insurance, including program details on CypressCap through Cypress Benefit Administrators, please contact Tom Doney at tomd@cypressbenefit.com or 877-236-0844.