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EMPLOYEE BENEFITS CAPTIVES

A Guide for HR and Finance Leaders

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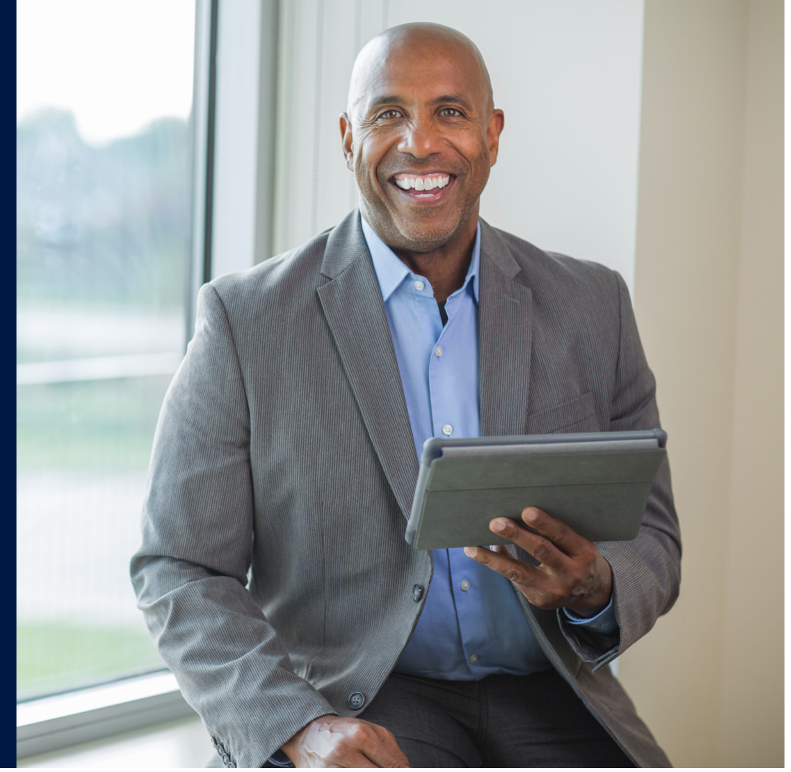
Employee benefits captives are fast becoming a strategic asset for many companies as they promise a level of control, cost predictability, and long-term stability that traditional group benefit plans struggle to match. This whitepaper will explore the concept of employee benefits captives, why they are gaining traction, and how companies can harness their potential. We will dissect the unique advantages captives offer, provide a roadmap for their implementation, discuss potential challenges, and offer a glimpse into the future of this rapidly evolving field.



INTRODUCTION

Historically, captive insurance companies were used primarily by large corporations to insure against property and casualty risks. However, in the past decade, the use of employee benefits captives has soared as companies seek innovative ways to manage risk, reduce costs, and provide competitive benefits packages to their employees.

At its core, an employee benefits captive is a specialized form of self-insurance tied to the risk covered by Stop-Loss. Rather than paying all premiums to a commercial insurance carrier, the company typically pays a portion of premiums to a captive cell, which adds another layer of risk protection and an opportunity to participate in some risk sharing. It is owned and controlled by members of the same or various industry, trade, service, or professional associations to provide insurance coverage to its members. By setting up captives for their employee benefit programs, companies can spread the exposure and mitigate financial risks associated with health and welfare volatility.

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When considering an employee benefits captive, employers must consider factors such as risk appetite, number of plan participants, regulatory requirements, and commercial market conditions. The capitalization and collateral requirements, ongoing operational costs, exposure to loss, and increased management involvement are also important considerations.

THE CAPTIVE'S GROWING POPULARITY

Over the past several years medical inflation has caused most employers to question what opportunities they have to manage cost. After exhausting the supply side of healthcare through decreased benefits, spousal sur charges, etc., employers seem to be running out of options. This is one of the reasons we have seen fully insured membership with the carriers shrink for the past 5 years, as employers search for tools and resources that can manage their medical and rx spend.

One such strategy is to look at the demand side of healthcare – lowering employer and employee risks using wellness programs, focused point solutions and population health management. A company that can manage claims through better benefits plan utilization can realize more favorable pricing through both lower trend and increased marketability.

Companies are drawn to employee benefits captives for several potential advantages:

- **Increased Control and Transparency:** Operating a captive provides companies more control over the entire insurance process, from claims handling to service provider selection. This increased control and transparency can lead to more efficient administration and better management of benefit cost.
- **Customized Benefits Design and Tailored Solutions:** The flexibility to tailor employee benefits programs to meet the specific needs of their workforce can lead to more effective benefits strategies, improved employee satisfaction, and enhanced talent retention.
- **Financial Incentives:** Carrier and contractual stability, and the potential for surplus funds to be returned to member companies during profitable periods are drawing customers from both fully insured pools and bundled ASO providers.

THE ANATOMY OF EMPLOYEE BENEFITS CAPTIVES

To appreciate the potential of employee benefits captives, it is crucial to understand how they operate and the different structures available.

- **Formation of a Captive:** Several companies with similar risk profiles decide to form a captive insurer that operates as a separate legal entity.
- **Risk Pooling:** Member companies contribute funds to the captive insurer. These funds are pooled to cover health insurance claims of the employees from the participating companies.
- **Customized Policies:** Captive health insurance allows member companies to tailor insurance policies to their needs. This flexibility often leads to more cost-effective coverage.
- **Risk Mitigation:** The member companies share the risk, which can lead to potential cost savings. In good years with low claims, surplus funds may be returned to the member companies in the form of dividends or distributions. In years with high claims, the program remains stable through layers of risk sharing.
- **Regulation and Compliance:** Captive insurers are subject to regulatory oversight and must adhere to laws governing the insurance industry in their respective jurisdictions.

Captive insurance companies function by insuring the risks of their parent company or companies. They can either accumulate the risk and associated profits for the benefit of their owners or diversify their risks through reinsurance. Captives are licensed and regulated entities, forming a critical part of the parent company's risk management process.

Distinguishing the Types of Captives

There are several types of captives, each tailored to different needs and preferences:

- **Single-parent captives** are wholly owned by the insured and provide coverage to the parent company's employee benefits plans.
- **Rent-a-captives** are a cost-effective alternative for companies not yet ready to establish their own captive.
- **Group captives**, on the other hand, involve multiple stakeholders coming together to share risks and resources.

Additionally, the strategic focus of a captive insurance model varies by their intent. This can range from homogenous captives, which cater to similar types of businesses or risks, to heterogeneous captives that support a diverse array of industries and risk profiles. There are captives designed to accommodate larger groups using higher risk layers, employing performance distribution models to optimize risk management. Furthermore, certain captives emphasize point solutions, addressing specific risks or coverage gaps.

When considering a captive insurance solution, it's important to thoroughly explore the various structures, weighing the advantages and disadvantages of each to identify the most suitable option for the organization's specific needs.

Challenges of Captive Health Insurance

While potential upsides exist, employee benefits captives aren't for everyone:

- **Initial Setup Costs:** Creating and managing a captive can be costly and may require both insurance and risk management expertise and additional investments.
- **Limited Risk Pool:** The success of captive insurance depends on the financial stability and commitment of the member companies.
- **Commitment:** Typically, the intent is to stay with the captive, employers are committing to the model more than the lowest premium opportunity.
- **Regulatory Compliance:** Captive insurers must navigate complex regulations and may need to meet stringent capital requirements.

ESTABLISHING A CAPTIVE

The advantages of employee benefits captives go beyond simple risk aversion. They can be a catalyst for innovation and transformation in the way companies view and deliver employee benefits. However, establishing an employee benefits captive can be a lengthy and intricate process. It requires a strategic partnership with insurance and financial advisors and substantial preparation.

Identifying Risks

The goal of a risk assessment and feasibility study is to ensure that the captive arrangement will meet the company's objectives through stability, sustainability, cost-effectiveness and compliant with all regulations.

The risk assessment phase identifies the risks associated with providing employee benefits through a captive. These risks include underwriting risks, credit risks, market trends, operational risks, and legal and regulatory compliance risks. By understanding these risks, companies can develop strategies to mitigate them effectively. It involves analyzing historical claims data for current and new participants, market trends, and regulatory landscapes to predict potential challenges the captive might face.

The feasibility study builds on the risk assessment by evaluating whether a captive can practically and financially meet the company's needs for providing employee benefits. This involves detailed financial projections, including potential savings on insurance premiums, the capital needed to set up and operating a captive, reserves and IBNR and the financial resilience required to withstand adverse claims experiences. Also, this stage considers tax implications, the captive's legal structure, and governance issues.

Selecting Service Providers

Selecting the right service providers is crucial. When sharing risk, all business partners must have the same goals for the program and be firmly committed to its success. Each owner's financial stability and business principles need to be in alignment. The same can be said for the business partners selected to build and support the program. This includes captive managers, actuaries, legal counsel, and auditors. These professionals play a significant role in the successful establishment and operation of the captive and should be chosen with the utmost care.

Securing Buy-in from Stakeholders

Obtaining buy-in from stakeholders, particularly within the C-suite and the board, is a necessary step. Communicating the value proposition of the captive, addressing any concerns about risk and compliance, and showcasing the potential long-term benefits are essential for securing support for the initiative.

It's imperative not to view the integration as a one-time task but as an ongoing process. Regular reviews and adjustments will ensure the captive remains valuable and effective.

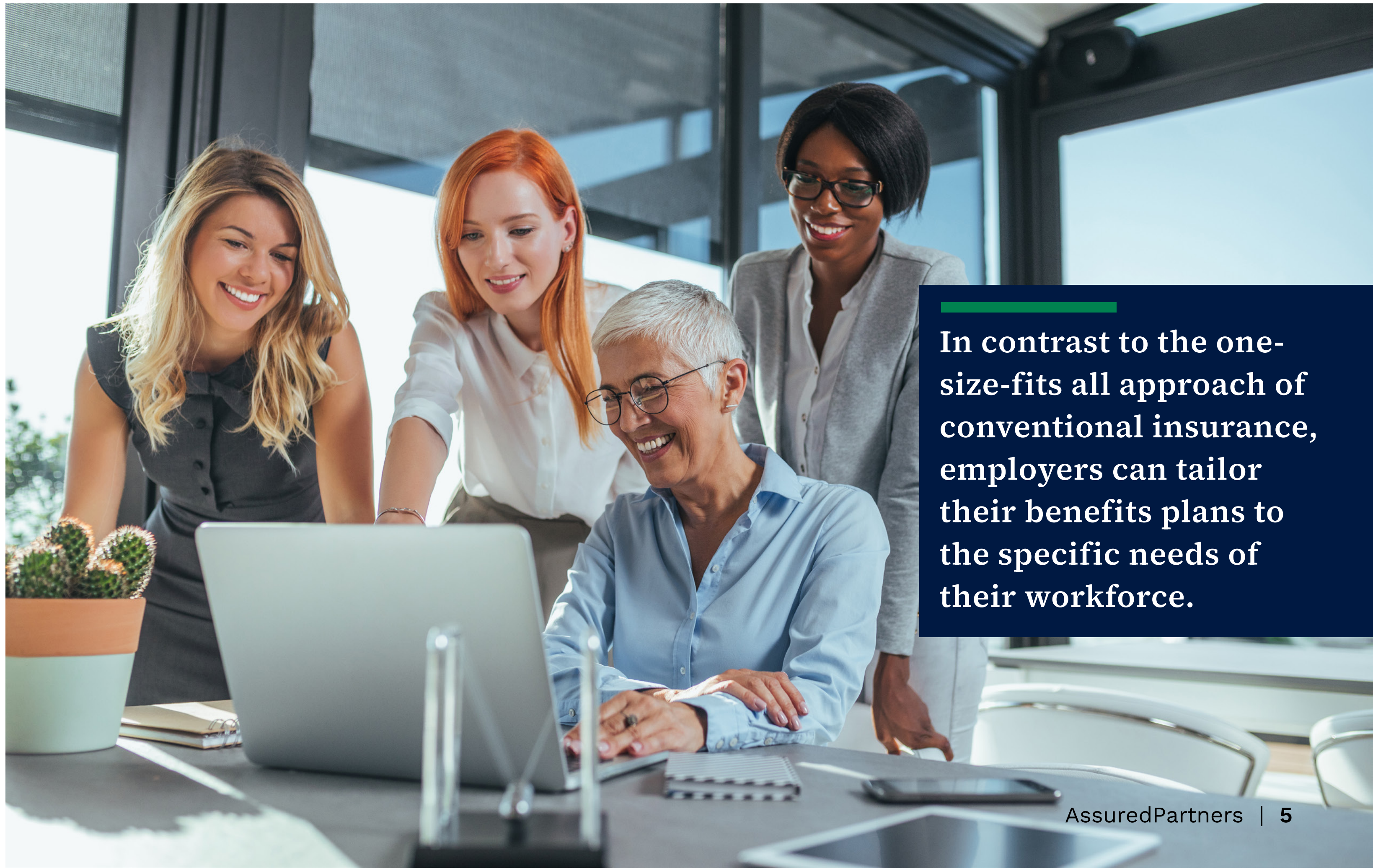
IMPLEMENTING A CAPTIVE

Integrating an employee benefits captive with existing employee benefits programs marks a strategic financial move and a step towards a more sustainable and tailored benefits offering for companies. An employee benefits captive offers many advantages; however, blending a captive into existing programs requires careful consideration, planning, and execution.

The first step in this integration involves a meticulous analysis of the current benefits landscape within the company. It's crucial to understand the existing benefits offerings, the financial implications of these programs, and the overarching goals of the business. This sets the foundation for seamless incorporation, ensuring the captive aligns with the company's need for flexibility, cost reduction, and enhanced employee satisfaction.

Next, developing a comprehensive strategy is key. This strategy should cover the types of risks to be insured through the captive, the structure of the captive, and how it will dovetail with existing benefits to create a cohesive ecosystem. The success of this integration heavily relies on open communication and engagement from all stakeholders involved - from HR and finance departments to employees themselves.

Leveraging technology to streamline this integration cannot be understated. Advanced analytics and data management tools can provide insightful metrics to



In contrast to the one-size-fits all approach of conventional insurance, employers can tailor their benefits plans to the specific needs of their workforce.

track the performance of the integrated programs, forecast potential risks, and tailor benefits that meet the unique needs of the workforce.

Finally, it's imperative not to view the integration as a one-time task but as an ongoing process. Regular reviews and adjustments based on changing organizational priorities, workforce dynamics, and external economic conditions will ensure the captive remains a valuable and effective component of the employee benefits scheme.

Customization and Control Over Plans

Compared to traditional insured group policies, captives allow for a high degree of customization. Employers can tailor their benefits plans to the specific needs of their workforce, promoting employee satisfaction and retention. This is a stark contrast to the one-size-fits-all approach of conventional insurance products.

Companies structure their employee benefits captives based on various factors, including industry, assets, number of employees, and geographic location. The structure is designed to meet the company's specific risk management needs and financial goals. Typically, a captive insurance company is created as a subsidiary of the parent company to self-insure certain risks, in this case, employee benefits.

The captive may be set up as a standalone entity or as part of a larger group, including other subsidiaries or unrelated companies that share similar risks. This allows for risk pooling and sharing among the members, leading to more stability in claims costs and improved risk management capabilities.

In terms of geographic location, some captives are domiciled in the United States, while others choose international locations that may offer regulatory or tax advantages. The choice of domicile is strategic and depends on the regulatory environment, tax considerations, and the operational convenience for the parent company.

Stabilizing and Predicting Costs

One of the most appealing aspects of captives is the ability to stabilize and predict costs over the long term. Since the company is essentially self-insured, cost drivers of the benefits program are better understood and can be proactively managed.

For employee benefits specifically, captives often provide coverage for high-cost claims, such as catastrophic medical events, through stop-loss insurance. This helps limit the employer's financial exposure while allowing for predictable budgeting for employee benefits costs. The captive may also participate in reinsurance markets to further distribute the risk.

Investing in Employee Well-being

The captive structure encourages companies to invest more intentionally in the well-being of their employees. By capturing and retaining a portion of their insurance premiums, they have a financial incentive to promote healthier lifestyles and prevent risks that could lead to increased claims and premiums.

Since every business has different risks, wellness programs need to be customized to best fit that company's culture. In this instance, the definition of wellness needs to consider all risk factors and potential exposures that can increase claims and, therefore, decrease the overall "health" of the company. The approach is similar to workers' compensation return-to-work or robust P&C safety programs that help reduce the frequency of claims and better control costs.

A holistic approach that manages employee risk versus personal health generates higher returns as wellness and risk management initiatives integrate into the work culture. A strong wellness program can incentivize employees to make healthy lifestyle changes, improve absenteeism/presenteeism, and, most importantly, enhance your employee benefit risk score.

CASE STUDIES IN SUCCESSFUL CAPTIVE UTILIZATION

Case Study 1: Construction

Overview: After being self-insured for 20 years, a West Coast construction company struggled with the volatility inherent in being self-insured, particularly when faced with significant renewal increases due to high claims in bad years. Seeking a more stable solution, they joined an employee benefit captive.

Outcome: Despite experiencing years with high claims that would lead to significant premium increases in the traditional stop-loss market, the captive model provided much-needed stability and more favorable renewal terms, smoothing out the volatility previously endured. Through proactive claims management and leveraging insights from other captive members, the employer managed to keep their claims at or below expected levels every year in the captive, achieving over $1.7M in savings over seven years.

Case Study 2: Healthcare

Overview: A hospice care facility located in the East Coast faced ongoing challenges with its health plan, characterized by unjustified renewals and a lack of transparency. With approximately 180 employees enrolled in their health plan, leadership sought a solution that would offer better financial control and invest in employee well-being.

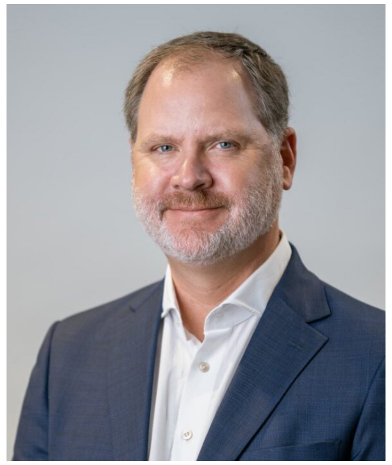
Outcome: The employer's decision to join an employee benefits captive enabled them to adopt an outcomes-based wellness plan focused on prevention and health management. Implementing these initiatives led to significant financial savings, with the employer saving millions of dollars. Beyond the financial benefits, this strategic shift fostered a healthier workplace culture, emphasizing the value of preventive care.

CONCLUSION

Employee benefits captives present a compelling proposition for companies looking to review their benefits strategies and take control of their financial future. With careful planning and consideration of the various factors involved, the rewards in terms of cost savings, risk management, and employee well-being make the journey worthwhile.

> "With fewer options available for mid-market employers and increasing healthcare costs, captives provide a unique solution to this growing problem. My years of developing sustainable healthcare strategies for businesses have been gratifying."

Geoff Christian, MBA, CWCC
Executive Vice President
Employee Benefits Captive Leader



Connect with us today to experience Power through Partnership.

Are you ready to challenge the status quo of traditional insurance for your company? Our team is prepared to guide you through the process of joining a captive. We understand the hurdles you face, and we'll work together to identify what truly matters to your organization. By understanding your company's risk tolerance and commitment to employee well-being, we can design a future where your benefits work for you.

Reach out to us today and discover the benefits of Power through Partnership.

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