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HOW EMPLOYEE BENEFITS CAN STRENGTHEN YOUR CAPTIVE

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OVERVIEW

Captive insurance companies have long served as a prominent tool for enterprise risk management. Countless corporations have leveraged captives to handle risks that commercial markets struggle to address efficiently or may not cover at all. In recent years, an increasing number of companies have integrated employee benefit plans into their captive insurance structures, driven by various motivations:

- Enhancing risk diversification
- Achieving cost reductions
- Optimizing tax benefits
- Streamlining cash-flow management
- Maximizing returns on reserves

This evolution underscores the versatility and efficiency of captive insurance in managing a broad spectrum of risks.

ADDRESSING ERISA ISSUES

Before delving into the rationale for migrating employee benefits into a captive insurance platform, it's crucial to address matters governed by the Employee Retirement Income Security Act of 1974 (ERISA). When integrating employee benefit risks into a captive insurer, strict compliance with ERISA and Internal Revenue Service (IRS) regulations is paramount, as these issues fall under the oversight of both the U.S. Department of Labor (DOL) and the IRS.

Improperly structured captive arrangements could potentially be classified as "prohibited transactions" under ERISA, as amended. ERISA Section 406(a)(1)(D) explicitly prohibits the "transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan." An entity owned by the employer, such as a captive, is recognized as a party in interest in relation to the employee benefit plan according to ERISA Sections 3(14)(C) and 3(14)(G).

To address the party in interest issue, employers should proactively seek a prohibited transaction exemption (PTE) before implementing this type of structure. Responding to the growing popularity of this approach, the DOL has established an expedited procedure, often referred to as "EXPRO," to facilitate the implementation of these programs. The timeline for this process, from initial submission to final authorization, typically spans around 90 days. This timeframe is contingent on the ability to furnish all necessary notifications and ensure that the situation aligns with prior approved transactions. Achieving substantial similarity is generally straightforward, as previous submissions and approvals are part of the public record and readily accessible.

ENHANCING RISK DIVERSIFICATION

For companies with a history of employing captives to manage and finance general liability risks that are challenging or cost-prohibitive in commercial markets, the addition of employee benefits to their coverage portfolio can yield advantageous results in terms of risk diversification.

In many cases, the risks absorbed by a captive exhibit a high degree of variability, which directly impacts the required reserves for supporting these risks. The greater the variability, the more substantial the reserves the captive must hold. Introducing uncorrelated risks into a general liability risk captive can have a positive influence on reserve requirements and reserve management.

Employee benefit risks, among the risks that can be integrated into a captive insurance company, tend to exhibit higher frequency but lower severity. This characteristic results in reduced volatility associated with these risks and contributes to the overall reduction in the captive's risk volatility. Even within the realm of employee benefits, diversifying risks remains vital, such as by incorporating annuity risk (including deferred annuities or pensions in payment) alongside life risk.

OPTIMIZING TAX BENEFITS

A primary objective of a captive insurer is to secure full deductibility of premiums paid to the captive. A viable strategy to enhance the tax treatment of an existing captive involves introducing unrelated risks to the captive's portfolio, thereby reinforcing its status as a genuine insurance entity.

Concerning employee benefit risks, the IRS permits the complete deductibility of premiums paid to a captive, recognizing employee benefit risks as unrelated risks to the captive. The industry standard currently advises allocating approximately 30 percent of the captive's premium to employee benefit risks. This allocation solidifies the captive's status as a legitimate insurance enterprise under Internal Revenue Code Subchapter L.

In the context of employee benefit captives, there are additional tax considerations, especially for multinational corporations introducing non-U.S. risks. It's crucial to note that non-U.S. risks are exempt from ERISA regulations. To maintain this exemption, segregating non-U.S. risks into an offshore entity is a prudent strategy. When implementing this approach, careful attention should be paid to controlled foreign corporation (CFC) rules, particularly IRC Section 953(d). Depending on the scale and nature of risks, particularly pension risks, passive foreign investment corporation (PFIC) rules should also be considered.

OPTIMIZING RESERVE RETURNS

Captive insurance can significantly enhance an organization's return on reserves, particularly in comparison to traditional commercial insurers. Commercial insurers often base premium rates on conservative assumptions about the investment returns they can generate on their reserve portfolios. These conservative, low-return assumptions contribute to higher premium rates.

This impact becomes especially relevant when a company considers reinsuring bulk pension annuities. In such cases, a company with a competitive edge in managing credit-based asset portfolios can establish a leveraged spread business, leveraging the management of reserve assets and employing proper portfolio hedging strategies. It's crucial to understand that long-tail risks, like pension annuities, exhibit sensitivity to interest rates and, especially for UK-based pension risks, inflation rates. Implementing effective asset-liability matching (ALM) models is essential for managing pension-related risks on a significant scale.

CUTTING COSTS EFFECTIVELY

Captive insurance for employee benefit plans offers the advantage of reducing various cost components typically associated with commercial insurance contracts. One such cost is the "risk charge," an additional cushion used by most insurers in addition to the actuarial cost representing the pure risk involved.

Moreover, organizations can minimize costs by directly accessing reinsurance markets for any risks not retained within the captive. Rather than paying "retail rates" embedded in commercial carrier premiums, direct access to the reinsurance market allows for "wholesale rates."

When the captive directly writes the risk, it can eliminate commissions from the contract. This is especially appealing when employing a captive-sponsored life insurance contract for funding non-qualified executive compensation plans, as these plans have historically been funded through expensive and underperforming variable life insurance contracts with commissions sometimes reaching 90 percent or more of the first year's premium. Removing these costs, along with high administrative fees, 12(b)1 fees, and management fees within the contract, can lead to significant savings.

EFFECTIVE CASH-FLOW MANAGEMENT

Commercial insurers typically set premiums based on aggregated data related to industry groups or other indicators. They also decide when to collect premiums and release reserves or dividends.

One key benefit of positioning employee benefit risks in a captive is the enhanced control over cash flow. It enables precise management of premium levels, timing, and claims payments, which can lead to substantial cost savings. Premium levels are tailored to the company's group-specific experience.

While there are initial setup costs, administrative expenses, and yearly compliance costs, the long-term benefits can significantly outweigh the initial investment.

SUMMARY

Employers with a captive insurance platform, whether domestic or offshore, experienced in property and casualty risks, can enhance their captive's performance by incorporating employee benefit risks. Conducting a straightforward analysis of the existing structure and modelling the effects of adding employee benefits could yield significant benefits.

ABOUT WISTERM

Wisterm (English: /Wis'terum/) is a British-American multinational financial services firm that provides a range of risk-mitigation products, including commercial risk, investment, wealth, retirement, employee benefit, and reinsurance solutions, as well as boutique consulting.

Wisterm currently operates in the Americas and Europe. Wisterm works with businesses of all sizes to optimize their organization, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

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Ryan is Wisterm's Global Accident & Health Leader and Reinsurance Deputy Partner. For over 20 years he has been regarded as an industry leader with significant global and technical experience. Based in London, Ryan leads a high-performance international team responsible for the development and deployment of Wisterm's strategies and services. In addition to his role on the board of directors, he serves on Wisterm's Executive Committee.

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