Module F Unit 8B

Underwriting Employee Benefits

Purpose

At the end of this unit the participant should be able to demonstrate an understanding of the value delivered by a captive in managing employee benefit ("EB") risks more efficiently and the limitations that are applicable.

Assumed knowledge

Working knowledge of the operation of a captive insurance company.

Summary of learning outcomes
1. Explain which employee benefits are likely to be of relevance to captives
2. Describe how the typical structure of an employee benefit captive is a consequence of the nature of those benefits.
3. Explain the reasons why some companies may decide not to use their captive to write employee benefits.
4. Explain the key requirements for an employee benefits captive to succeed.
5. Describe alternative arrangements to captive structures.

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8.0 INTRODUCTION TO EMPLOYEE BENEFITS

Employee benefits that are most relevant to captives typically include death, disability and medical cover. Death and disability benefits usually provide a lump sum or annuity income in the event of specified occurrences. Medical cover usually provides all or part of the cost of private medical cover. Medical cover can be particularly helpful where there are delays in accessing particular medical needs.

Some types of employee benefit will not be subject to insurance arrangements such as bonus schemes or holiday provisions.

A key difference to other risks that a captive may insure for a group is that the payment of benefits is to employees. As such, using a captive to cover the risks directly would involve a potential credit risk to the employee.

Also, unlike most other risks covered by captives the benefits may qualify as life business (if the duration of the policy exceeds 18 months) rather than general insurance business. Such risks are often subject to different and more significant regulation and in some circumstances require the creation of a separate captive from that writing General Insurance.

Furthermore, certain risks such as death benefits are typically low frequency but high value and subject to accumulation risks as employees may work or travel together.

As with any benefit retained within a captive structure the aim will be to seek to retain profits from premiums net of claims and expense that would otherwise be kept by insurers. However, there may be other specific benefits for a group as well as retaining profits.

- A large group may find it difficult to monitor all the benefits offered in local subsidiaries. Using a captive means that there is a natural location to review and monitor these benefits
- It should be easier for a large group to negotiate improved (and consistent across all territories) terms from fronting insurers compared to the terms that a series of subsidiaries might achieve
- It would be easier to monitor emerging issues such as the impact of Stress or a Pandemic like COVID on staff and the financial consequences.

8.1 TYPICAL STRUCTURE

The use of an employee benefit captive is most common in larger international groups. Such groups are able to manage the complexities involved, have the largest pools of risks (to manage low frequency, high value claims) and gain the most benefits from the pool of information that the captive can collect (for example monitoring benefits provided in different jurisdictions).

Often the benefits are provided to employees through one or more fronting insurers (or networks of fronting insurers). The captive accepts all or part of the risks via a retrocession reinsurance arrangement. This has several potential benefits

- The fronting insurer is better placed to manage regulatory requirements in potentially a range of different jurisdictions
- The employees benefit from insurance provided by a recognised independent insurer
- The captive can focus on the risks it is able and willing to write under simpler regulatory arrangements and without dealing with detailed administration for individual cases
- The captive is not involved in assessing individual cases such as whether a medical benefit can be authorised (thus avoiding the conflict of interest between employer and employee)
- The captive can by negotiation of suitable retrocession terms (or onwards reinsurance) to manage accumulation or other risks

Partnering with fronting insurers does have a cost and this again tends to mean that employee benefit captives are more attractive to larger groups who can manage these costs and also have a more equitable negotiation with large insurers or networks as they are bringing larger pools of risks (and associated premium).

8.2 WHY SOME GROUPS MAY NOT USE EMPLOYEE BENEFIT CAPTIVES

As previously noted above, the nature of employee benefit captives tends to focus such arrangements in larger groups. Even some larger groups may not want to establish such arrangements. The reasons include:

- Employee benefits are typically operated within the control of human resource staff whereas other insurance risks may be controlled by operational or risk management staff. There will need to be a good working relationship between the two groups to successfully operate a captive as it will impact upon both areas
- Employee benefits may be delegated to local levels and it will require support from the senior executives of the group to require local subsidiaries to work within the structures needed to operate the captive
- The perceived benefits may not be sufficient to justify the time spent by senior staff who may perceive that there are other more significant priorities for their time.
- Some benefits may not be easy to manage within a captive. An example would be a dependant's pension benefit. Payments of such benefits require annual valuation and administration for many years. If included within a captive arrangement, the payment may be managed by the fronting insurer with the captive only meeting a lump sum cost on inception of the claim.

8.3 KEY DETERMINANTS FOR THE SUCCESS OF AN EMPLOYEE BENEFIT CAPTIVE

As with any type of captive, a feasibility study would be useful to identify any tangible or intangible benefits.

Tangible benefits could arise from looking at a history of premiums and claims and considering the comparative costs of the captive structure.

Intangible benefits could include a better and more coherent group approach to the provision of employee benefits and their costs.

A clear focus on the benefits to be achieved will help clarify the process needed to establish a captive and the resources needed.

Commitment from the group management will be needed to allocate resources and support the processes needed to establish and operate a captive. The feasibility study should hopefully provide the necessary justification to gather such support.

The necessary management expertise is needed within the group to operate a captive and control costs so as to achieve the targets set.

8.4 ALTERNATIVES

There are some other options that a multinational group may want to consider.

- Some efficiencies could be sought within local arrangements. For example, the group could seek to use its overall size to negotiate more effectively with different local insurers. This is possible but it is likely to be a slow and cumbersome approach involving a range of different insurers.
- The group could seek information on employee benefits claims experience in order to realise some of the benefits that a captive could provide without the cost and commitment

of formal establishment. This is possible but it can be difficult to extract all the information from insurers that may be desired on a prompt basis.

There are multi-national pooling arrangements available via certain providers. In essence these seek to obtain the benefits of a captive on an outsourced managed basis. The pooling provider consolidates information from fronting insurers and calculates a rebate or “dividend” based on the experience of the group. These can be an effective way of seeking efficiencies by generating a reimbursement to the group based on good experience. They do not require explicit management time or the capital support needed for a captive. However, the pooling process can be opaque and it is more difficult to realise the intangible benefits that a captive might provide.

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Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. What employee benefit covers do **not** qualify as General Business?
2. What are the benefits of writing EB in a captive?
3. Why is fronting insurer nearly always involved when writing EB in a captive?
4. Discuss some alternatives to placing EB in a captive

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4. Explain the key requirements for an employee benefits captive to succeed.
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