

# ▶ CAPTIVE REINSURANCE

An Innovative Approach  
to U.S. Employee Benefits



**THIS IS NOT A POLICY OF WORKERS' COMPENSATION INSURANCE. THE EMPLOYER DOES NOT BECOME A SUBSCRIBER TO THE WORKERS' COMPENSATION SYSTEM BY PURCHASING THIS POLICY, AND IF THE EMPLOYER IS A NON-SUBSCRIBER, THE EMPLOYER LOSES THOSE BENEFITS WHICH WOULD OTHERWISE ACCRUE UNDER THE WORKERS' COMPENSATION LAWS. THE EMPLOYER MUST COMPLY WITH THE WORKERS' COMPENSATION LAW AS IT PERTAINS TO NONSUBSCRIBERS AND THE REQUIRED NOTIFICATIONS THAT MUST BE FILED AND POSTED.**



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## INTRODUCTION

An important corporate function is reducing exposure to risk. Very often, corporations purchase insurance on the commercial market to protect their interests. In some cases, a company may not be able to acquire the coverage it needs to cover certain risks, or the premium may be prohibitively expensive. In these cases, companies can consider using a captive insurance company to achieve their risk-management objectives.

A captive operates similarly to a commercial insurance company. However, the primary role of the captive is to insure or reinsure the risk exposure of the parent company and its affiliates. Employers may gain tax and investment advantages by owning a captive.

This white paper will provide background on the formation of captives and explain how a captive reinsurance arrangement can be used for employee benefits.



A major challenge faced by today's employers is how to maintain a competitive benefits package while containing or reducing costs.

# CAPTIVE INSURANCE COMPANY DOMICILES

There are over 6,900 captive insurance companies located around the globe. The United States has over 3,000 captives, more than any other nation. Bermuda has the second largest number of captives with approximately 800.\*

## United States domiciled captives

One-fifth of the approximately 3,000 U.S. domiciled captives have chosen to locate in Vermont. The top United States domiciles are ranked in the chart below.\*

### Largest U.S. Captive Domiciles\*

Ranked by number of captives at year-end 2015

Rank	State	2015
1	Vermont	596
2	Utah	450
3	Delaware	323
4	Nevada	202
5	Hawaii	197
6	Montana	196
7	District of Columbia	193
8	South Carolina	167
9	Tennessee	127
10	Arizona	110

\* Source: 2015 statistics, Business Insurance, February 29, 2016.

# CAPTIVE REINSURANCE THEN AND NOW

Businesses, including many FORTUNE® 1000 corporations, have been using captive insurance companies to manage a variety of risks for over 50 years. These risks include property, casualty, and workers' compensation insurance.

## The first 40 years of captive reinsurance

During the 1960s, companies began to set up captive insurance entities to insure the risks that the commercial insurance marketplace was unwilling to cover completely or would do so only at excessive premium rates. In some cases, a company would retain part of the risk, placing the remainder with a commercial insurance carrier.

## The introduction of employee benefits

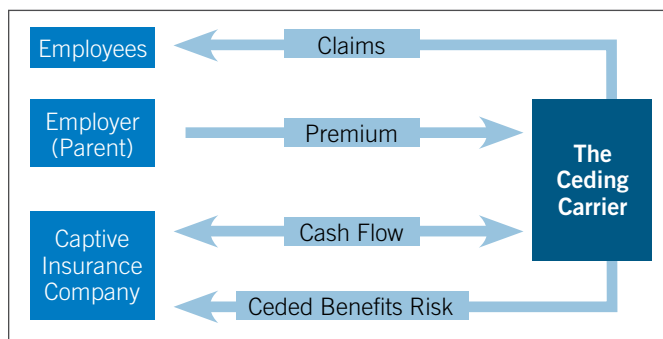
Funding employee benefits through a captive is considered a Prohibited Transaction by the United States Department of Labor (DOL) because ERISA prohibits transactions between a "party-in-interest" to an employee benefits plan and "the plan." ERISA considered a captive, controlled by the employer, to be such a "party-in-interest" and designated such an arrangement as a Prohibited Transaction. Columbia Energy filed and received the first Prohibited Transaction Exemption (PTE) in 2000 and was then able to fund its employee benefits through its captive. We will provide additional details later in this paper.

## STRUCTURING EMPLOYEE BENEFITS THROUGH CAPTIVE REINSURANCE

The diagram below illustrates the structure of a captive reinsurance arrangement that is established to manage employee benefits, such as group life or disability insurance plans.

- ▶ The parent company/employer owns the captive insurance company.
- ▶ The ceding carrier is positioned between the captive and the employees.
- ▶ The ceding carrier provides all the typical employee benefit services including premium collection, claims processing, and customer service.
- ▶ The ceding carrier cedes some or all of the employee benefits risk to the captive according to the terms of a reinsurance agreement.
- ▶ A trust or a letter of credit is funded to protect the ceding carrier and to ensure the ceding carrier receives full statutory reinsurance credit.
- ▶ The ceding carrier charges a ceding expense.

### The Ceding Carrier Chart



## ADVANTAGES OF USING A CAPTIVE FOR EMPLOYEE BENEFITS

### Cash flow

With a traditional non-participating employee benefits plan, the employer purchases group life or disability coverage from an insurance carrier and pays regular monthly premiums to the carrier. If there is lower than expected claim experience, the insurance company gains additional profit (underwriting gain). In a captive arrangement, the captive can receive the underwriting gain.

### Investment gain

The captive may also retain some of the required reserves needed to ensure that all employees will receive the benefits that are due to them. Because the captive holds the reserve(s), the captive earns interest on those funds. They may be able to earn more investment income on their own than would be credited to them by the insurance company under a traditional arrangement.

### Tax benefits

To obtain the tax advantage, the captive must maintain a degree of separation from the parent company that controls it. The degree of separation is based on the amount of unrelated third-party risk held by the captive, generally considered 30%. The Internal Revenue Service accepts employee benefits plans as unrelated third-party business. When a captive meets the diversification guidelines, the parent company may be able to fully deduct the premium costs of the property and casualty coverage as well as the employee benefits. **The Prudential Insurance Company of America (Prudential)** does not provide tax, legal, or accounting advice. Therefore, companies should consult their own tax, legal, and/or accounting advisor.

### Risk and diversification

In addition to being considered unrelated third-party risks, large employee benefit plans tend to be predictable, providing an important offset to the less predictable nature of other risks. Diversification within the captive — the combination of property and casualty risk plus employee benefits — allows the employer/captive to better manage their total risks and offers potential cash flow and tax advantages.

## REGULATIONS AND COMPANY COMMITMENTS

The DOL has established regulations that companies must meet to fund employee benefits through a captive.

### Obtaining a Prohibited Transaction Exemption (PTE)

In 2000, Columbia Energy asked the DOL to grant a PTE, so it could use its captive to fund employee benefits. The DOL granted Columbia Energy the first PTE for this purpose (PTE-2000-48). In 2003, Archer Daniels Midland received approval for a similar transaction.

If a company applies for an exemption that is similar in nature to exemptions that have been previously approved by the DOL, the DOL will evaluate that application under an expedited process called EXPRO (PTE 96-62). Under EXPRO, companies will receive an accelerated, tentative approval, usually within 45 days, when their request is similar to requests that have already been approved. EXPRO transactions generally become final within 75 to 90 days after receiving the application.

Some key DOL requirements for companies that use a captive for employee benefits include:

- ▶ The employer must use a ceding insurance carrier with a rating of at least “A” from A.M. Best.<sup>†</sup>
- ▶ The transaction must be reviewed and approved by an independent fiduciary.
- ▶ The premium paid by the parent company to the ceding carrier must be reasonable.
- ▶ Participants in the plan must be notified of the transaction.
- ▶ The captive must be in a United States domicile or be the U.S. branch of a foreign captive.
- ▶ Participants in the plan must receive benefits enhancements.

<sup>†</sup> Of the 15 ratings A.M. Best extends for claims paying ability, A++ (Superior) is the highest, F (In Liquidation) is the lowest.

## IMPLEMENTATION AND MONITORING

The key to an effective implementation is an alignment and partnership between Risk Management and the Benefits Department. Risk Management will evaluate the risks and ensure the proper infrastructure and capital are in place to leverage the benefits of the captive reinsurance transaction. The Benefits Department will determine that the insurance plan and carrier are providing the best value for their employees. Both roles are critical for a successful captive transaction.

There are three main stages to establishing a successful employee benefits captive reinsurance program. These stages are Client Preparation, Pre-Implementation, and Execution.

### Client Preparation

Most employers will start by hiring a captive consultant to assist with several steps including risk assessment, selection of the independent fiduciary, structuring the captive transaction, and helping to prepare the DOL application. Part of this work includes a feasibility study so the client can determine if the captive reinsurance transaction will be financially viable.

### Pre-Implementation

Once the client has decided to move forward, they must select the ceding carrier, decide on benefit enhancements to the plan, hire the independent fiduciary, and submit the application to the DOL.

Companies can visit the DOL website to find examples of benefit enhancements that have been approved in the past. Some of these include:

- ▶ Improved death benefits
- ▶ Free will preparation
- ▶ Free financial counseling for beneficiaries
- ▶ Spousal and child tuition support
- ▶ Childcare benefits
- ▶ Non-revocable, fully covered lifetime retiree benefits

## Execution

Once the application is finally approved, the company needs to work with the ceding insurer to create and finalize the critical documentation that shapes the transaction. A group insurance contract needs to be established, if one is not already in place. Then the reinsurance agreement needs to be signed, which clarifies the financial obligations between the ceding insurer and the captive insurance company. Next, the captive has to establish collateral to ensure the ceding carrier can receive full statutory reinsurance credit.

This protection can be provided through a Trust Agreement (most common), where the captive funds a trust with the appropriate amount of assets and the ceding carrier is the beneficiary of the trust. Another possible method is a Letter of Credit (LOC), which is a financial guarantee issued by a bank that ensures the funds are available, if requested. Lastly, Summary Plan Descriptions (SPDs) need to be updated for the benefit enhancement.

## Ongoing captive management

Once the captive reinsurance arrangement is implemented, there is a reporting and settlement process throughout the year. Each month or quarter, the ceding carrier reports the premium that was received, the claims that were paid, and any adjustments to required reserves. Depending on the financial activity, the ceding carrier will either collect additional money from the captive or send money to the captive. There is a report at the end of the year reconciling the full year's transactions. The frequency of reporting is very important to ensure that both parties are clear on the insurance risk and have the appropriate reserves in place to protect against that risk. The exchange of premium can also provide a cash flow benefit to the captive, if claims come in lower than premium paid.

## WHY CHOOSE PRUDENTIAL FOR CAPTIVE REINSURANCE?

If you are contemplating moving your employee benefit program into a captive, it makes sense to consider Prudential. We are a leading insurance carrier for life and disability insurance benefits<sup>1</sup> and we have been a ceding carrier for captive arrangements since 2004.

Prudential's Advanced Markets Group, underwriters, actuaries, implementation team, and distribution team have the experience and capabilities to assist with the evaluation, implementation, and ongoing services required to fund employee benefits through a captive.

### We have the strength of the Rock<sup>®</sup>

For more than 140 years, Prudential Financial has helped individual and institutional customers grow and protect their wealth. Today, we are one of the world's largest financial services institutions with operations in the United States, Asia, Europe, and Latin America. We also have one of the most recognized and trusted brand symbols: The Rock<sup>®</sup>, an icon of strength, stability, expertise, and innovation.<sup>2</sup>

### Our ratings by the rating agencies

The Prudential Insurance Company of America's insurance financial strength ratings<sup>‡</sup>:

Standard & Poor's	Moody's	A.M. Best	Fitch Ratings
AA-	A1	A+	AA-

For the most recent ratings, please visit [www.investor.prudential.com](http://www.investor.prudential.com).

**For more information on Captive Reinsurance, contact your Prudential Representative.**

<sup>‡</sup> Ratings as of November 15, 2016.. AAA (Extremely Strong) is the highest of 24 ratings that Standard & Poor's extends, the lowest being R (has experienced regulatory action), and is a measure of claims-paying ability. Aaa (offers exceptional financial security) is the highest of 21 ratings that Moody's extends, the lowest being C (having extremely poor prospects of ever offering financial security) and is a measure of financial security. A++ (Superior) is the highest of 15 ratings that A.M. Best extends, the lowest being F (In Liquidation), and is a measure of claims-paying ability. AAA (Exceptionally Strong) is the highest of 21 ratings that Fitch Ratings extends, the lowest being D (Distressed) and is a measure of insurer financial strength. Ratings are not an indication of any variable portfolios' performance, which fluctuates with market conditions. Ratings are not a guarantee of future financial strength and/or claims-paying ability.

1 LIMRA, 2014 Annual Surveys of U.S. Group Life and Group Disability Insurance.

2 "Our Company." Retrieved on 12/9/16 from <http://corporate.prudential.com/view/page/corp/31826>.

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