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Growing Role For Captives

COMMERCIAL RISK EUROPE'S CAPTIVE SURVEY 2018

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INTRODUCTION

One of the greatest strengths of the captive sector has been its adaptability. As markets have hardened and softened, as new risks have emerged, and new requirements from companies have challenged the insurance industry, the captive has adapted and taken on all the challenges and changes.

Indeed, a recent AM Best report says the captive market just keeps growing and growing and growing. It states: "The rated captive segment remains exceptionally strong and continues to outperform its counterparts in the commercial casualty segment. The biggest challenge for us was finding new or interesting ways to describe the persistently good news."

The current challenges in the insurance market are also great opportunities for captive insurers. Current conditions suggest that captives should be writing more business and taking on more risks. Firstly, there is the possibility of a hard market, at least in some classes and regions. Then there is issue of some captives finding themselves with surplus capital, partly as a result of Solvency II. Then there are the emerging risks such as cyber, and risks that offer diversification and new opportunities such as employee benefits business. And with the correct reinsurance programme, captives can look to take on more risk and new lines, and grow their businesses.

This report examines all of these issues and explains how captives are in a perfect position to respond to these challenges. And history suggests that they will do exactly that, and continue to provide solutions for their parents.

CONTENTS

Leveraging the power of a captive to manage and govern global employee benefits programmes

Increasing numbers of multinational businesses are using their captive reinsurance companies for managing employee benefits risk. MAXIS Global Benefits Network (MAXIS GBN) looks at the substantial benefits using a captive solution can provide to manage global benefits risks and govern the delivery of insured employee benefit programmes

◇ CAPTIVES FOR EMPLOYEE BENEFITS

Matthias Helmbold
Head, Technical and Services, MAXIS GBN

In the long term, using a captive provides the most cost-efficient solution for providing insured employee benefits (EB) to the workforce of a multinational organisation. Underwriting profits will be for the benefit of the captive, rather than for local insurers or other third-party reinsurers. Also, programmes can be structured in a way that reserves are being held centrally by the captive and premiums can be ceded upfront. This allows the captive to pool the assets required to deliver the local programmes.

RISK DIVERSIFICATION

For existing property and casualty (P&C) captives, there's also the welcome effect of risk diversification by adding employee benefits to the reinsured lines of risk. Depending on the solvency regulations of the captive's domicile, this can have a positive effect on the capital requirements.

Additionally, as many captive managers still have only little or no experience in reinsuring employee benefits, it is important to mention the high-frequency, short-tail and low-impact nature of many employee benefits lines. This allows for a good actuarial understanding of the risks held by the captive and enables the captive to control exposures.

These key benefits alone already provide a strong business case to utilise a captive for the management of insured employee benefit programmes, yet there are further advantages that may be relevant for organisations, but could easily be overlooked by risk managers.

UNDERSTANDING EB SPEND

It is important to highlight the significance for an organisation to know and understand its spend. A surprising number of multinational organisations don't have a good grasp on their overall spend on insured employee benefits programmes, let alone the trends and cost increases they are exposed to year over year. Of course, after the implementation of an employee benefits captive solution, this changes completely. In a captive, all relevant values are typically available on a quarterly basis, allowing multinationals to have the best possible ongoing monitoring and governance.

Things can even be taken a step further by linking programme renewals with the annual budgeting process of the finance function. This way, EB budgets can be directly aligned with next year's premiums, avoiding unexpected surprises for the local, regional and global finance teams. This provides better planning and certainty of the corporation's expenses.

The second aspect to consider is the change of the role the procurement function plays in sourcing local benefit programmes. As the captive centrally underwrites the plans, there's no need for local or regional procurement teams to be involved in pricing conversations. Likewise, the selection process of local insurers changes as the captive becomes a key stakeholder. This means that the primary focus of local and regional procurement and HR teams will be on the adequacy of plan designs and ensuring service levels are met.

Another significant benefit a captive solution provides is control over the terms and conditions, the design and the coverages of its programmes. This allows for central oversight and governance, tailoring programmes to be in line with corporate strategies and the implementation of cost-control features. It also allows for the harmonisation of free cover limits by globally implementing medical underwriting requirements, balancing the captive's risk tolerance against a corporation's desire to provide insurance cover to its employees.

HEALTH PROGRAMMES

The ability to control plan designs is especially relevant with respect to health insurance programmes. Medical trends are typically far exceeding country inflation rates, with premium rates doubling in only a few years in many markets. In fact, these are the only material employee benefit programmes where costs are not directly linked to salary inflation.

Today, many organisations are heavily exposed to these rising expenses and captives can play a vital role in understanding claim trends and the driving forces behind them, as well as then exercising control over these policies rather than leaving the organisation being exposed to these ever-increasing costs.

Ultimately, the captive can be used to finance interventions that influence employee behaviours to improve the health of the workforce. This helps to lower plan utilisation, reduce trends and costs, as well as increase overall staff productivity, health and wellbeing.

To summarise, leveraging the captive infrastructure that is already in place in the majority of corporations brings great financial and non-financial benefits. With the services global benefits networks are providing to their clients, there is little reason global risk managers shouldn't explore the addition of employee benefits risk to their existing captive programme. Any corporation that wishes to globally control their spend and to efficiently govern their programmes centrally should consider a reinsurance to captive approach for their insured employee benefits plans.

Employee benefits—making the most of a captive's potential

◇ BENEFITS

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There has been much written and debated about the benefits of captives writing employee benefits business, from cost savings to better control of the benefits programme, as well as the non-correlated business providing capital efficiencies under Solvency II. An ever more internationally mobile workforce and the trend towards more central control over employee benefits mean there is huge potential for captives to write this business.

But how big an undertaking is it for a captive to start writing employee benefits business? Is it a big commitment in terms of time and effort? "There's no denying it's a big undertaking," says Damian Ross, regional manager – UK, Ireland and Nordics, Generali Employee Benefits Network. "The process of deciding whether to go down the captive route in the first place involves a considerable amount of time and effort. For a start, you need to get all stakeholders across the company – HR, finance, risk, legal, compliance and possibly the CEO – talking and in agreement."

Then there is the feasibility study. For this, he explains, you will require the assistance of a consultant and it involves gathering certain data in respect of employee benefits globally. Then you need to involve the regulator, in order to obtain a life licence for the relevant jurisdiction, and finally you would need to select a global network partner that has the necessary length and breadth of experience and reputation. He says that from initial concept to implementation, it can take a minimum of about one and a half to two years.

Matthew Latham, global head of captive programmes, XL Catlin, AXA XL division, agrees that covering employee benefits in a captive does require a significant commitment of time and effort. "Compared to traditional P&C coverages, involving a captive in employee benefits implies a significant mobilisation of the group, including in-depth coordination between the risk management and human resources teams on new and technical subjects. It also requires collecting high-quality data about employees; this can be a challenge for some big, international companies with multiple oper-ating units. These challenges notwith-standing, employee benefits prog-rammes typically have less volatility and higher premiums – that can be a net benefit for captives."

The coordination between risk management and HR is an issue, according to Nuno Simao Antunes, senior vice-president, head of multinational – EMEA, AIG: "It is still a question of establishing the bridge between human resources and risk management, and getting the dialogue going between the two departments." He adds that companies have to have a very robust and flexible solution for employees to attract and retain talent. "It can be difficult to create a global programme for employee benefits. Many companies buy employee benefits policies in each territory, and so that has to be brought together first into a global

16

"These challenges notwithstanding, employee benefits programmes typically have less volatility and higher premiums – that can be a net benefit for captives..."

15

programme. The market hasn't evolved in the same way or to the same extent that the P&C market has, in terms of being able to bring the global programme together."

THE PROCESS

The actual process of a captive starting to write employee benefits business involves two steps, according to Matthias Helmbold, head of technical and services at MAXIS Global Benefits Network. "First, the required licences to reinsure life risks need to be obtained from the regulator in the captive's domicile. As life risks typically require a locally licensed insurer to front the business, there are virtually no direct writing captives in the employee benefits space. The common approach would, therefore, be to establish one or several reinsurance treaties with employee benefits networks as the second step."

He says these networks will then be able to cede any employee benefits risks that are placed with the networks' fronting insurers around the world to the captive. "These networks also provide extensive services around the management of the reinsured employee benefits risks that allow captives to govern these programmes effectively," he notes.

Instead of using an employee benefits network, the captive could choose to directly implement reinsurance channels with local fronting insurers. Mr Helmbold says this is an option for very large contracts that are placed with a company that does not participate in an employee benefits network, and that the multinational company would not want to place with a network insurer. However, he explains that this is not seen as a viable approach on a broader scale as the number of reinsurance relationships that need to be managed in such a case would place a massive administrative burden on the captive.

Ciarán Healy of the Willis Towers Watson captives team says they have seen a number of approaches taken by companies to initiate an employee benefits portfolio in their captive, including:

- Providing protection on some non-insured, trust-based plans, such as medical stop-loss
- Reinsuring a large, marquee contract such as expatriate plans
- Designing and direct writing a relatively simple life or disability policy
- A fully blown, internationally fronted arrangement through the use of the multinational insurance networks.

STRUCTURING A PROGRAMME

For a wide-ranging international portfolio, the typical structure is to reinsure through a network of local fronting insurers. Mr Healy says this is due to three key reasons:

- Local insurers have the appropriate licences required to write the domestic business
- In some markets it is typical for the insurer to settle tax liabilities with regards to the insurance
- The local insurers are more than risk-bearing partners – there is an extensive service model supported for the employers but also the employees, such as communications, portals, claims payments and so on.

He explains that there are six formal international fronting networks readily reinsuring portfolios of multi-local insurances to captive structures, with more insurers also reinsuring on case-by-case arrangements.

Employee benefits risks would typically need to be placed with network insurers in the local markets in order for them to be reinsured to the captive, says Mr Helmbold. He warns that the number of employee benefits networks being used needs to be carefully chosen, as more networks mean more reinsurance relationships that need to be entertained. And he stresses that it is also important to achieve a good geographical match between the business locations of the multinational and the network's fronting insurers.

Employee benefits programmes often comprise a number of different benefits, but most are well suited to be written through a captive. Employee benefits risks are mostly short-tail, low-impact risks, with annuities obviously being an exception, says Mr Helmbold. "Pricing of these risks is well understood and they allow a captive to diversify the insured risks. With adequate protection in place, depending on the size of the captive reinsurer, the exposures in terms of high sums insured or concentration risks, captives are well suited to write all lines of employee benefits risks and can add significant value for the multinational employer for all employee benefits lines," he says.

> **"Instead of using an employee benefits** network, the captive could choose to directly implement reinsurance channels with local fronting insurers..."

Mr Healy points out that employee benefits insurances are a mix of lump sum, annuity and ongoing claims profiles, and the captive structure needs to understand their potential profile to ready itself for reserving and consequences of moving fronting insurers. "Traditionally, what we term as 'risk benefits' (broadly life, accident, disability) are more profitable when we assess them in the feasibility study and are often considered to promote the financing business case for inclusion in a captive structure. For medical benefits, while margins are traditionally lower than 'risk benefits', the medical trend of about 9% per annum globally shows that focus needs to be applied on understanding the underlying risk profile and looking for initiatives and change practices to improve

17

Steady interest in employee benefits

According to Marsh, among its managed captives, interest remains steady for writing employee benefit coverages, such as group life, multinational pooling for health and disability, and voluntary benefits such as homeowners and auto. Marsh's 2018 Captive Landscape Report: 50 Years of Risk Financing Innovation report, says interest will continue to increase in this area as rising medical costs globally remain a significant expense for organisations. Among its managed captives, 6.6% are already writing employee benefits, 15.7% are currently considering it, with 19% likely to consider it. The number of Marsh-managed captives insuring multinational pools for benefit risks has increased by 550% in the past five years, driven by the significant expense of rising medical costs.

According to Lorraine Stack, a senior vice-president with Marsh's Captive Solutions Practice: "As businesses continue to seek ways to control these rising costs, one strategy that many are using is to insure employee benefit programmes through their captive insurance companies. According to our 2018 Captive Landscape Report, in 2017 the increases in Marsh-managed captives writing employee benefits were: 35.7% for multinational pooling, 21.8% for employee benefits, and 14.3% for medical stop-loss."

She adds: "We expect continued growth in captives writing multinational employee benefits over the next three to five years. Companies are generally looking to create efficiencies and gain control as they face the triple threat of medical insurance cost inflation, an ageing workforce, and a shift in responsibility for providing benefits from governments to corporations. Human capital is an organisation's most valuable asset, and captives offer creative ways to protect it, including funding employee benefits, enhancing safety programmes, and rewarding risk-reducing behaviours."

The report explains that it can take multinational organisations a relatively long time to consolidate benefit contracts in different countries for the purpose of insuring or reinsuring them through a captive: "Generally, benefit programmes are provided to local subsidiaries and groups of employees through multiple insurers or network contracts, some of which may be multiyear. Given the increasing interest in funding employee benefits in captives, however, we expect growth to continue."

It adds that voluntary benefits, including homeowners, automobile liability, and umbrella liability, also are experiencing steep growth in Marsh-managed captives.

The report concludes: "As medical cost inflation rises worldwide, employers are seeking ways to gain control of benefit costs. Captives provide a means to create health and wellbeing programmes and collect data on employee populations to stem cost increases and improve health."

16

the underlying health and modes of support from the insured."

Mr Ross adds: "Essentially, with a captive you're trying to achieve control, by taking the risk on centrally. It therefore makes sense to include as many employee benefit programmes as possible in the captive. However, there's a play-off between control and profit. So it depends on the priorities of the captive."

He explains that some aim to just break even, but they receive their data centrally and that enables them to effect good risk management practice with regards to local employee benefit programmes, which is particularly relevant to healthcare programmes. "On the other hand, some may not be as concerned about the control aspect, prioritising profit instead. These captives, therefore, have to be more selective on which contracts they take in, taking only contracts that are sustainably written and are expected to result in profit," he says.

Nuno Simao Antunes

GROWING INTEREST

So has the oft-talked about potential for captives writing employee benefits business translated into actual examples, or is it still a relatively niche area involving large captives? There does appear to be growing interest from companies around using their captives to write employee benefits.

Mr Antunes says that in terms of the intrinsic characteristics of employee benefits, it should be something that makes sense for a captive. "There is no doubt that the potential is there for continued expansion into captives. There are challenges, but it is happening – there are captives that are transacting hundreds of millions of dollars of employee benefits premium, and I can only see this market continuing to expand," he says.

There are now about 90 employee benefit captives in place globally, says Mr Ross. "This might seem like a small number but when you consider that clients need at least 5m in risk/employee benefit spend before implementing, it becomes clear that these kind of arrangements are at present being put in place by only the biggest global players. However, we see growing interest from clients."

Mr Healy concurs that there are close to 100 captives including a multinational portfolio of employee risks, with many more providing medical stop-loss or one-off arrangements. "The interest we see is higher now than it has ever been, both from established employers but also the newer high-growth businesses, and so we believe it is an area we will see material growth from in the near future," he says.