Captive fronting & employee benefits

With employee benefits currently one of the most discussed topics within the captive industry, **Marco Giacomelli** of **Generali Employee Benefits** explains the opportunities EB offers and the need for increasingly sophisticated services

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Today, approximately 60% of Fortune 500 companies operate one or more captives. As much as the utilisation of captives has gained popularity since the mid 1980s, with a steady increase of registered captives in each jurisdiction every year, the focus of a captive operation still centres on very specific business lines.

The most common lines of risk written today by captive insurers and reinsurers are general and professional liability, including worker's compensation, as well as property. Approximately 5% of all premium income written by captives instead pertains to healthcare benefits, and 3% is related to non-healthcare employee benefits (Marsh Single Parent Captive Survey, 2009).

Interestingly, it is estimated that among the above biometric risk classes there are currently only about 80 global programmes worldwide established by active EB networks for managing employee benefits plans through captives.

Most of these captives programmes are operated by captives as reinsurance carriers rather than direct insurance operations, utilising a local fronting insurer and/or a network of fronting insurers to underwrite employee benefits risk.

This approach is essentially justified by the fact that in order to comply with local labour and fiscal regulations, employee benefits contracts must be issued by locally admitted insurers, whereas captive companies are typically established outside each location and can only operate as direct insurers on a non-admitted basis.

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Therefore, the global market for employee benefit programmes to captive appears to remain untapped, and many see considerable opportunities in this market for the future.

Within this specialised market, the typical offering of a global network has historically developed along the fairly basic structure of a pure fronting of local risks, facilitated by an underlying quota share reinsurance arrangement.

This structure effectively addresses the two key drivers for a captive seen as an economic entity:

- Net underwriting margin from the (re)insurance activity
- Return on invested capital

Within a properly structured fronting programme, the partnership between the captive and the fronting network includes certain tools aimed at optimising the desired net underwriting margin through two key aspects: underwriting expertise and control of frictional costs.

In terms of return on invested capital (ROIC), the matter becomes slightly more articulate in the case of a typical risk-based employee benefits captive programme. Under this scenario, it is in fact common for the fronting network to retain all assets pertaining to local technical reserves (claim, IBNR and unearned premium reserves), managing their investment and financial returns on behalf of the captive, while undertaking upon itself the risk/opportunity linked to the investment activity.

In other words, the fronting network often guarantees a nominal interest on retained assets – also known as “funds withheld” in reinsurance parlance – immunising the captive from this investment risk.

This scenario evidently negates the opportunity for a captive to maximise, or at least manage on its own, the ROIC related to investing such assets on technical reserves that, as reinsured liabilities, are present on its books. Hence, several captives nowadays aim for a full transfer of local assets into the captive, where this is legally possible, in order to also benefit from potentially more lenient restrictions on their investment activity, according to the regulatory provisions enforced under the captive's domicile.

The fact that the captive may generate additional financial returns by investing assets transferred by the network implies a certain exposure to investment risk, which in turns translates into a heightened counterparty risk for the network. As a result, under the "assets transferred" model, the network must be able to mitigate its increased counterparty risk by obtaining a suitable financial guarantee on the value of the assets being transferred.

Some among the active worldwide employee benefit networks are, however, pursuing opportunities in captive markets by further developing their fronting capabilities, offering a range of product enhancements and additional services aimed at maximising the above two fundamental drivers, and at the same time adding value both for the captive and its parent.

For the sake of providing a structured, albeit summarised, overview of these developments, it might be useful to classify them as follows:

1. Risk-based product enhancements
2. Additional services
3. Optimisation of processes and frictional costs

1. Risk-based product enhancements

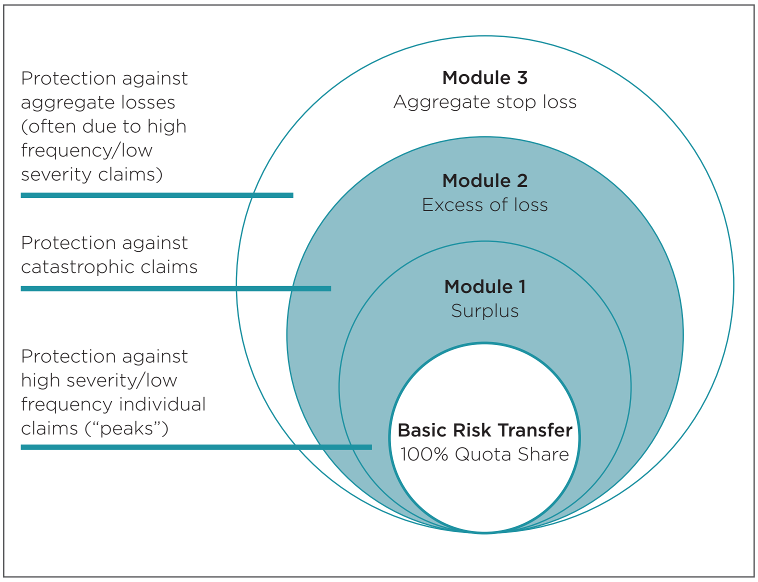
We already illustrated how the most prevalent, yet most basic captive fronting model is built upon a quota share transfer of risk from the local carrier to the captive, through a fronting agent which typically is a central insurance/reinsurance vehicle managed by a global network.

One of the limits of this model is that effectively it assumes that the captive, as the ultimate reinsurer of each accepted local risk, has a near infinite risk appetite. This is evidently not true, and in fact several captives have built a comprehensive retro-protection programme in view of their limited risk appetite. Yet, it might be more effective and economically viable if such retro-protections were offered directly by the network providing the basic risk transfer service.

The purpose of a retro protection programme is to – obviously – protect the captive's P&L statement and balance sheet from unexpected claim trends, which might impair its bottom line and, potentially, its own solvency.

In a risk management framework, therefore, a retro-protection programme addresses the two fundamental attributes of risk (i.e, frequency, severity), through a combination of proportional and non-proportional reinsurance, provided by the network effectuating the initial basic quota share risk transfer, and applied on the whole portfolio being transferred to the captive.

An effective combination of such risk protections in the context of a portfolio of employee benefit risks can be arranged as follows:



The advantage of arranging such retro-protection programmes through the network is that the captive can benefit from the most competitive pricing for these reinsurance schemes, thanks to the economies of scale leveraged by the network in managing a larger book of business on behalf of the captive. Another important factor in optimising the cost for the above features, is that the net premium rates for each line of cover, be it surplus, catastrophic excess of loss or stop loss, are calculated by the same entity which is managing, and insuring at a local level, each participating local scheme. The wealth of information in terms of individual data, concentration of risk information etc., which is therefore immediately available to the network and which will allow for the most competitive premium rates, might not be as easily accessible by competing third parties.

2. Additional Services

Most market players observing the evolution of the captive market, and the relatively slow penetration of EB programmes into this market, have noted that a proactively managed captive programme requires a number of highly specialised competencies, not only within the network that provides its basic or more advanced fronting services, but also, and perhaps most importantly, within the captive itself.

In particular, many observe a cultural shift in the sense that the field of employee benefits, which has long evolved as an area of expertise for human resources and benefits & compensation professionals, in a captive programme context becomes an area of critical interest and, sometimes, concern, for risk managers and finance professionals instead.

Certain networks have therefore facilitated this cultural shift by offering a range of additional reporting services, which integrate the accounting information provided by a typical risk transfer format, thus providing captive owners and their advisors with a further and deeper level of understanding of the type of risk the captive is reinsuring.

Of particular relevance in this context are the additional reporting services available for healthcare insurance coverage: healthcare costs are rising sharply worldwide, and they are driven not only by claims experience endemic to each locally fronted contract, but also by each local healthcare trend, being defined as the combination of:

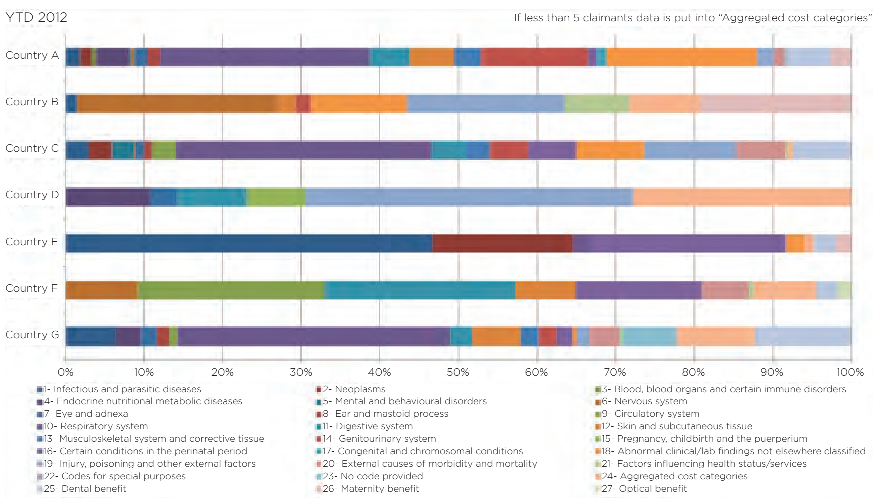
- Medical inflation, typically well above local CPI (Consumer Price Index) in each country
- Changes in health-related technology (for example, new and more expensive diagnostic devices being utilised)
- Changes in health benefit utilisation patterns (for example, increased annual frequency of certain health exams)

It is of paramount importance for captive owners and risk managers alike to be able to gain a deeper understanding of the loss trends affecting the medical contracts their captive reinsures, and this can be achieved by relying on additional reporting which indicates the impact of paid and incurred claims in each country, by benefit class and diagnostic category.

The importance of timely and reliable health reports goes beyond any immediate financial considerations, in that these are of great value in helping to shape the whole company's attitude with regards to the health and well-being of its employees. For example, a sufficiently detailed health report can be utilised by the company's HR to detect instances of poor working conditions, employee lifestyle (insurgence of diabetes cases), or possible policy abuse at local level (abnormal trends in prescription drugs utilisation or caesarean section frequency).

An example of such reports is:

3.1/ Comparative Distribution of Paid Amounts by Diagnostic Category



Of course, the ability to provide such a comprehensive and accurate reporting suite represents a considerable competitive advantage for the fronting network, and today not all market players can claim to have achieved such goal.

3. Optimisation of processes and frictional costs

Whilst the two key areas illustrated above represent clear and executable developments in the captive market, provided that the entity that claims to offer them has acquired sufficient expertise to reliably do so, there are a range of enhancements of no less importance which cannot be classified so rigidly, and which for the sake of conciseness we shall group under a third category:

- Availability of Service Level Agreements (SLAs)
- Cooperation with captive for audit exercises at local and central level
- Flexibility in providing competitive options for collateral and financial guarantees

The availability of SLs should be one of the key features of a holistic approach to providing captive fronting services. In order to be effective, the SLA should capture service deliverables both at a central level, i.e. deliverables for which the network shall be accountable within the perimeter of its central organisation, as well as guarantee local service deliverables on behalf of each participating local insurance carrier.

This entails an often complex underlying set of SLAs stipulated between the network and its own associated insurance carriers, whose deliverables therefore can be incorporated into the "main" SLA with the captive.

In order to be effective, the SLA must contain a set of metrics relevant to the captive's intended purposes, they must be reasonable within the context of the risk being transferred and they must be measurable: this latter point is particularly important, as the metrics set is associated to a scorecard, whereby failure to attain a minimum score will trigger a financial penalty, often in the form of a reduction of fronting fees.

Recent developments in the financial sector and the introduction of new measures to guarantee transparency and reliability in all financial transactions have also prompted captives to become very proactive in auditing all their providers, and in particular fronting network.

Therefore, one of the key facilities that a network aiming at establishing a constructive and long-lasting partnership with each captive must be able to offer is the availability and cooperation during these audit exercises, both at central and local level.

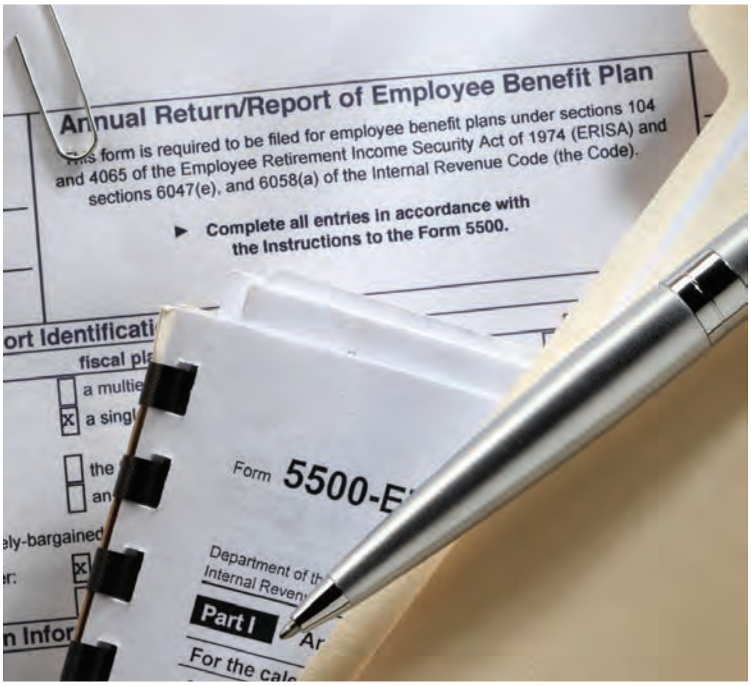
The successful network shall employ personnel who are familiar with most contemporary audit procedures, and who can therefore ensure the required degree of assistance, understanding and flexibility to a captive's audit team.

Finally, a fundamental aspect of captive programmes is represented by the counterparty risk incurred by the fronting network when entertaining financial transactions with a risk-bearing entity such as a captive.

Through the typical quota share risk transfer of a captive programme, the network is effectively switching to the captive the insurance risk embedded in each local EB scheme it has insured, and replacing it with a counterparty risk represented by the captive's own solvency status.

In concrete terms, this risk can materialise when, as a consequence of a particularly severe loss, caused for example by a catastrophic event affecting multiple insured lives, the captive is no longer able to meet its financial obligation to reimburse the fronting network for this loss, and might even default and declare bankruptcy.

There are a number of financial tools available in the market to protect the network against this risk, and they are generally classified as "collateral", or captive financial guarantees.



"HEALTHCARE COSTS ARE RISING SHARPLY WORLDWIDE, AND THEY ARE DRIVEN NOT ONLY BY CLAIMS EXPERIENCE ENDEMIC TO EACH LOCALLY FRONTED CONTRACT, BUT ALSO BY EACH LOCAL HEALTHCARE TREND"

The most popular and widely accepted form of collateral nowadays is a letter of credit (LoC), usually provided by a bank, with the network as beneficiary, followed by a large margin by a parental guarantee (PG), provided by the captive's ultimate parent, as the guarantor, to the network as the beneficiary.

It is estimated that about 65% of captive financial guarantees today are in the form of a LoC, while around 5% are PGs. The small number of PGs can be attributed to the fact that a PG, when given, waives a captive's status as an entity "at risk" from an insurance point of view; this, compounded with the fact that many captives are domiciled in fiscally favourable jurisdictions, has implied that the presence of a PG might jeopardise the captive's preferential fiscal status in its jurisdiction.

On the other hand, while LoCs are still a popular and widespread form of collateral, they are undeniably expensive, especially in the current financial climate.

This has prompted the most active networks in the market to seek other options in terms of collateral, or financial guarantees, which can be robust enough to provide financial security in the event of a captive's inability to meet its obligation, sufficiently simple from a legal point of view, and more competitively priced when compared to a LoC.

Among these instruments we can list the introduction of insurance and reinsurance trusts, more or less closely patterned after the so-called "Reg 114" trusts firstly introduced in the state of New York, pledged cash or securities accounts, accounts with a pledge contract in favour of the network as the sole beneficiary, whose assets are segregated from any other preferred or ordinary creditor claims, and risk-based forms of self-insurance in lieu of a true financial guarantee, such as the insolvency premium.

All these instruments feature advantages and drawbacks when compared to more traditional forms of guarantees, and it is fair to say that to date there isn't an ideal, universally accepted and cost effective form of collateral available through the financial market.

In conclusion, the employee benefit captive services market is a fascinating one, where the continuing infusion of new competencies drawn from the traditional insurance world, as well as from the financial, risk management, IT & technology and legal sectors is shaping the need for new and more sophisticated services, all with a common denominator: flexibility and customer centricity.