



BENEFITS PERSPECTIVES

Current Issues in Employee Benefits

Risk considerations for funding U.S. group life and disability insurance programs through captives

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Large employers that sponsor group term life or long-term disability (LTD) programs may be motivated to enter into captive insurance arrangements to fund these benefits. Doing so offers potential reductions in costs, greater control over invested assets, and possible tax savings. The decision to use captives for providing group life and LTD insurance programs, however, should be made only after performing a thorough evaluation of the underlying risks, because they are very different from those dealt with by traditional captives that have focused primarily on property and casualty (P&C) risks.

This article presents an overview of the evolving captive insurance market for large benefit plan sponsors and discusses some of the more significant risks that employers contemplating these funding arrangements should consider.

The market for captives today

Changes in the state insurance regulations and marketplaces over the past 25 years have given way to major developments in the captive insurance market. Twenty-five years ago, captive insurance companies were almost always domiciled outside of the U.S., affiliated with large employers, and focused on P&C risks only. Nowadays, most states have adopted legislation allowing captive formations in their jurisdictions, and captives have become more prevalent and are being used to fund employee benefits in addition to the employers' P&C risks. The market also extends to smaller employers that have relatively stable group-term life and/or LTD claims experience. A captive insurance company discussed in this article may be viewed as a wholly owned subsidiary of the employer with the benefits program to be funded.

Employee benefits reinsured by a captive

Group life and LTD insurance are among the most common U.S. employee benefit programs funded through captives. The way this

works is through an agreement between a "fronting" company—i.e., a licensed insurance company that underwrites the risks, issues the policies on its own paper, and administers the claims—and the captive that acts as the reinsurer. By having a reinsurer, the fronting company's exposure to losses associated with the insurance contracts is reduced because some of the risk is shared with the captive. Like most reinsurance agreements, the fronting company pays the captive premiums that correspond to the risk that the captive has assumed, net of any of the fronting company's retention charges (e.g., to cover underwriting expenses and claim adjudication fees), and then receives from the captive the portion of claims payments that are the captive's responsibility.

Employers also may choose to fund their employee benefits through their existing captive insurers to diversify their captive's risk profile.

LTD and group term life insurance in captive arrangements

In general, LTD claims are characterized by low-frequency and high-severity risks. The LTD insurance business typically accumulates very large claim reserves because benefits are paid over long periods of time. Claim management practices can significantly impact LTD claim termination rates (i.e., the percentage of claims that close due to a recovery from disablement or due to death), and ultimately the total cost of paying benefits. For example, an insurance company typically will adopt practices for claims reporting, reviews, assessments, and processing, along with return-to-work initiatives and rehabilitation support, but they will vary in the specific approaches used to manage each of these tasks and thus will have different results when paying benefits.

Group life claims are also low-frequency and high-severity risks. Unlike LTD, group life insurance claims are paid immediately in cash. However, claim reserves are required for group life waiver-of-premium benefits that provide life insurance coverage at no cost for employees who become disabled. Waiver-of-premium benefits (which typically represent around 10% of total group life costs) do share some of the same long-tailed risks as LTD, but not always to the same degree.

Key risk considerations

The Department of Labor requires captive arrangements that involve U.S. employee benefits to be structured as reinsurance agreements, as described above. This means that the risk management practices of the fronting company are still in place. However, there are still important risk considerations for employers that are considering reinsuring employee benefits through their captive arrangements. Some of the most significant of these risk considerations are:

- **Risk diversification**—Employers with existing captive arrangements for P&C coverages may see opportunities for improving their enterprise risk management practices by adding group life and disability programs to the mix. Because P&C risks are often uncorrelated with group life and LTD risks, combining the different coverages under one roof may provide a better spread of risk. The resulting diversification may help mitigate risk by reducing volatility of claims experience. Similarly, an employer that does not have an existing captive and wants to establish one for employee benefits programs may also consider funding its P&C insurance through the captive, in order to diversify the captive's risk attributes.
- **Counterparty risk**—Due to the nature of captive transactions that involve U.S. employee benefits, captives depend on the fronting companies to underwrite the risks and adjudicate the claims. The underwriting for group life and LTD insurance depends in large part on very company-specific perceptions of the underlying risks, such as LTD claim termination run-out patterns (i.e., whether benefits are paid for months or decades, depending on the cause of the disability) and group life mortality improvement. The adjudication of group life and LTD claims also tends to vary substantially from one company to another. The fronting company's ability to effectively underwrite the risks and administer claims is an important risk consideration for employers that use captives to reinsure group life and LTD programs.
- **Catastrophic risk**—All insurance companies that provide group life and disability coverages are exposed to catastrophic risk. One random event, such as a plane crash, can cause extraordinary losses. This is a particularly important issue for group insurance writers due to the concentrations of risk by employer group and location. Catastrophic risk is a big concern, even for group insurers that have many group customers. It is an even greater concern to captive insurers that insure only one group. The impact of a catastrophic event can be reduced by entering into reinsurance and stop-loss agreements.

- **Incidence risk**—Because group life and LTD claims are low-frequency/high-severity risks, the annual incidence rates for these coverages are typically less than 1%. Small changes in incidence experience can have large impacts on the liabilities of captive insurers. LTD and group life insurers effectively pool the experience from many groups to hedge incidence rate volatility. Captives may not have the same pooling ability due to the size of their blocks, and may therefore be exposed to greater incidence risk.

Also, disability incidence rates may be correlated with the state of the regional and/or national economies in certain industry sectors. Past experience has shown that incidence rates spike during recessions in industries that are susceptible to layoffs and reorganizations. For this reason, captive insurers whose parent company's operations are sensitive to the economy may be at even greater risk.

- **Interest rate risk**—LTD and group life waiver-of-premium benefits can be payable for very long periods of time, sometimes measured in decades. Captives that hold the assets supporting the reserves should invest the premiums in assets with long-term yields to fund the long-tailed claim liabilities. If these assets do not earn at least as much as the interest assumed in the pricing, there could be asset-liability mismatches and possible solvency issues down the road. On the other hand, if a captive earns more on invested income than the interest assumed in the pricing, then profits can be reimbursed to the parent company. An in-depth understanding of LTD and group life cash flow patterns and a solid investment strategy are essential for mitigating the interest rate risk.

Also, most LTD and group life insurers offer their customers rate guarantees that last several years. During the guarantee period, premium rates are fixed regardless of any changes in interest rates. Coverages that are funded through a captive arrangement may be structured without a guaranteed lock-in period, in which case changes in the interest rates could have an immediate impact on the premiums that the parent company—the employer, in this case—must pay. A small shift in interest rates can have a large impact on premiums, because of the long duration of disability claims.

- **Asset default/reinvestment risk**—LTD and group life insurers own assets backing the reserves that are held to fund future benefit payments. Because disability claims can be payable for very long periods of time, the assets are usually invested long and exposed to varying degrees of risk, depending on the quality of these assets. Changes in market values can affect earnings and may exacerbate default and/or reinvestment risks. During the recent recession, many group life and disability insurers' profits diminished due, in part, to changes in market values and deficiencies in their asset portfolios. For these reasons, cash-flow testing exercises that include asset-liability duration matching and sensitivity testing around interest rates are key analyses for managing the asset default and reinvestment risks.

- **Social Security risk**—Most LTD plans are integrated with Social Security Disability Income (SSDI) and benefits from other sources (e.g., workers' compensation insurance). This means that the plans will reduce the LTD monthly benefit amount by benefits from other sources awarded to the disabled employee. SSDI benefits are by far the most common LTD benefit offset, and they typically cancel out about 40% of the gross LTD benefit amount. LTD premiums take into account both the likelihood of receiving offsetting benefits and the estimated offset amount.

There have been growing concerns that the SSDI trust fund will be depleted in the not-too-distant future. If this were to happen, SSDI benefits would be reduced to match Social Security contributions designated to fund the SSDI program. In other words, SSDI benefit amounts would be reduced and would cause many LTD claims to be significantly underfunded, because earned premiums would be insufficient to cover future claims. This is a very important risk consideration for all insurance companies (including captives) that provide LTD coverage. Even if the SSDI trust fund is not depleted, any future changes in SSDI benefit administration will likely impact a captive's earnings stream.

- **HIPAA risk**—Captives that reinsure group life and LTD risks typically do not get involved in the claims process and, therefore, generally do not handle sensitive personal health information (PHI) on a regular basis. However, to the extent that captives do handle PHI, infrastructures must be developed to protect PHI according to the health privacy law's ("HIPAA") regulatory standards. This could include additional investments in systems development, employee training programs, and legal staff. These captives would also be required to adopt and maintain HIPAA policies and procedures and documentation of security activities. In the event of a PHI security breach, the captives would have to disclose the concerned parties and would have to produce documentation about the PHI involved and the risk mitigation levels that were in place prior to the breach.

Conclusion

The practice of funding group life and LTD insurance programs through captives has become more widespread, as companies search for new ways to reduce the costs of providing employee benefits. In a fall 2014 Milliman survey, seven out of nine major group life and/or disability insurance writers indicated that they are active in captive markets for either group life or LTD insurance, or both. Because captives retain a portion of the insurance risks, they wrestle with many of the same risk issues as other group life and disability insurance writers, such as mortality, morbidity, interest rates, and the economy, among others. However, captives may be exposed to greater volatility and greater concentrations of risk because of the size of their blocks of business and because the blocks typically represent just one employer group. Therefore, employers choosing to use captives to fund group life and/or LTD programs require a disciplined risk management approach.



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