WORLD CAPTIVE FORUM 2015

Benefits:
Basics of Captives and Employee Benefits

Moderator:

Debbie Liebeskind, Towers Watson

Speakers:

Lance Henderson, Zurich Employee Benefits Network

Don Meyers, Caterpillar Financial Services

Ted Scallet, Groom Law Group

Lorraine Stack, Marsh Captive Solutions Group

WORLDCAPTIVEFORUM
FEBRUARY 1-4, 2015 | BOCA RATON, FLORIDA

WORLD CAPTIVE FORUM 2015

FEBRUARY 1-4, 2015, BOCA RATON RESORT & CLUB, BOCA RATON, FLORIDA

The Basics of Captives and Employee Benefits

February 2, 2015

The major topics we'll cover

The benefits of captives and benefits

Pertinent regulations

How to make it work for your company

Today's discussion leaders

Discussion Leaders by Topic Time 3:00 – 5:00 p.m.

The benefits of captives and benefits	**3:00 – 3:30 p.m.**

- Debbie Liebeskind, Towers Watson, Moderator
- Lance Henderson, Zurich

Pertinent regulations	**3:30 – 4:15 p.m.**

- Ted Scallet, Groom Law Group
- Lance Henderson, Zurich
- Lorraine Stack, Marsh

How to make it work for your company	**4:15 – 5:00 p.m.**

- Lorraine Stack, Marsh
- Don Meyers, Caterpillar

Our learning objectives for “The Benefits of Captives and Benefits”

- Understand what a captive is and how it’s used
- Gain insights into why and how companies use a captive for benefits

Captive Insurance Company Defined

A licensed insurance company that is controlled by a parent corporation, and whose primary purpose consists of insuring or reinsuring the risk exposures of the parent.

Licensed in a captive domicile

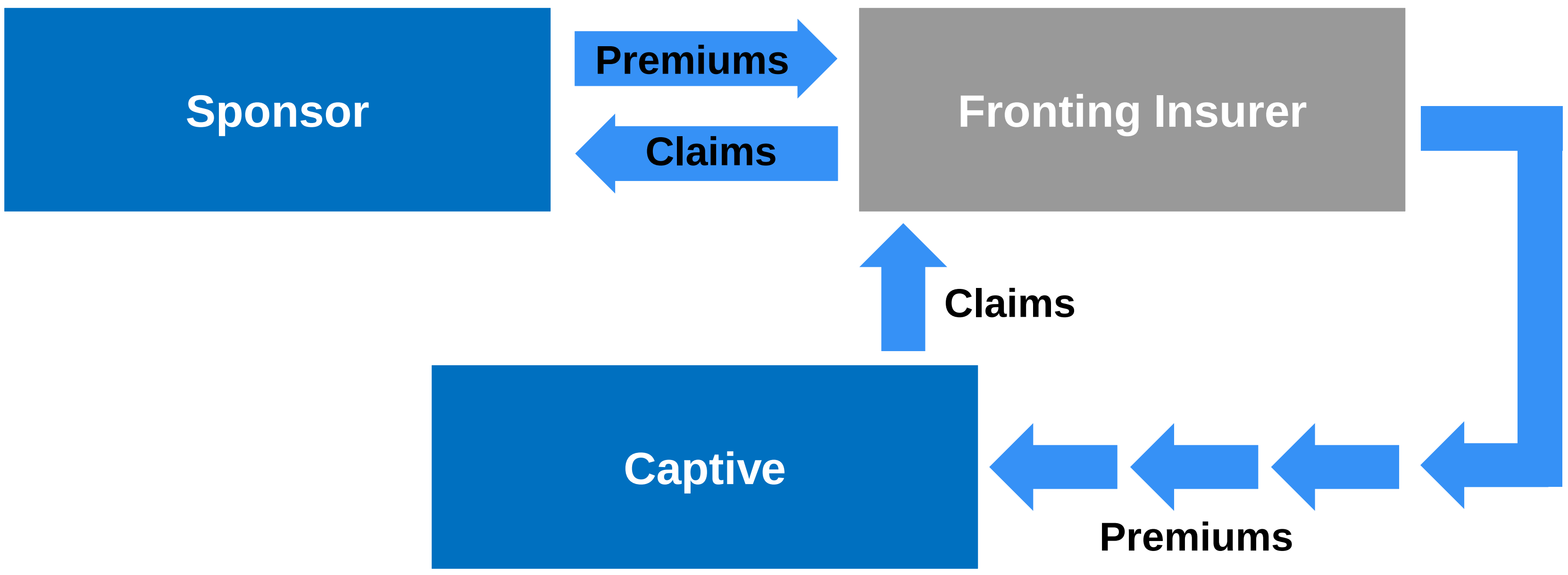
Regulated under special enabling legislation

"Admitted" only in its domicile

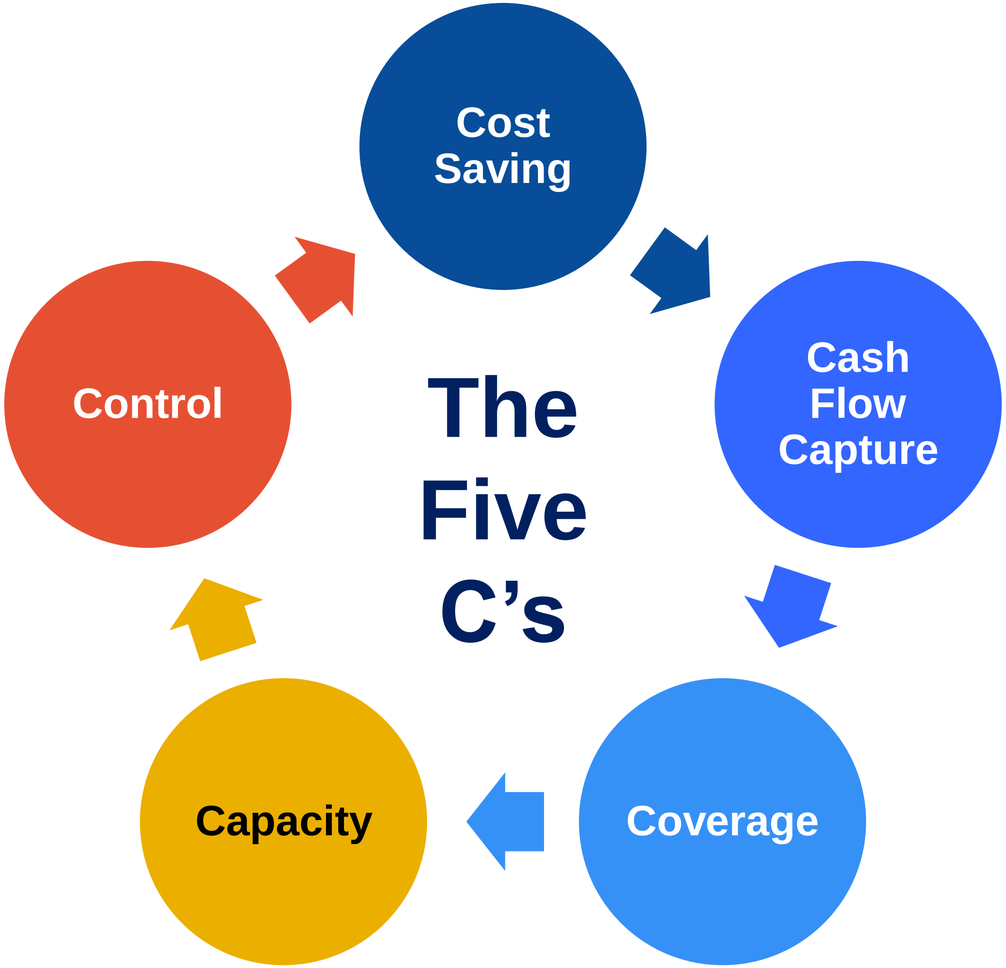
Non-admitted in all other jurisdictions
(unapproved status)

Using a Captive to Finance Employee Benefits

ILLUSTRATION — U.S. LIFE AND LTD

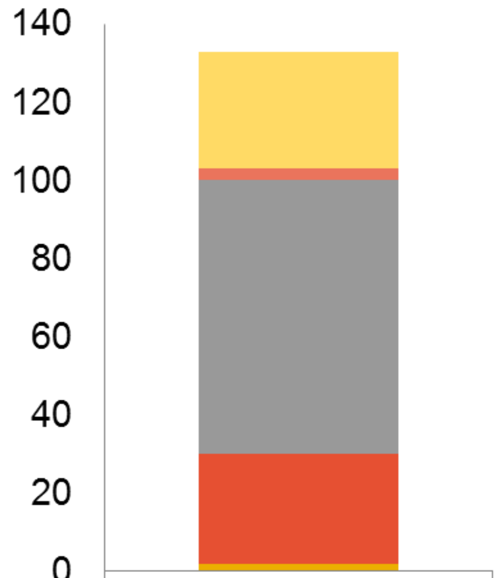


The value proposition for using a captive to finance benefits



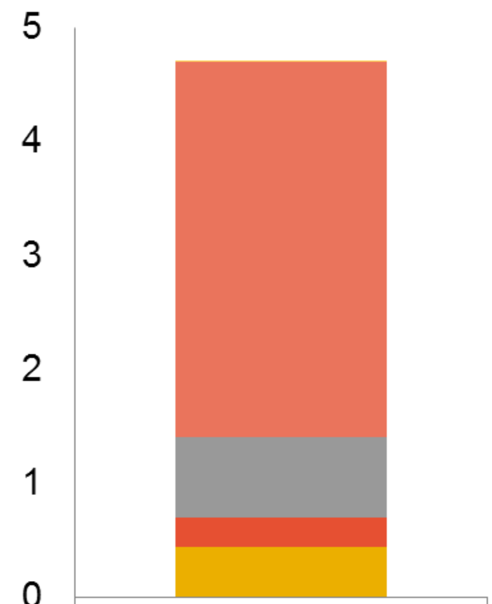
Employee Benefit Captives 2014

Estimated Number of Employee Benefit Captives in 2014



US Stop Loss Medical	30
Pensions	3
International Risk Benefits	70
US Life & LTD	28
Retiree Medical	2

Estimated Premiums Paid to Employee Benefit Captives in 2014 ($ billions)



US Stop Loss Medical	0.0036
Pensions	3.3
International Risk Benefits	0.7
US Life & LTD	0.26
Retiree Medical	0.44

Some important differences from P&C

- In the EB world, Umbrella/Master contracts or worldwide programs as well as DIC/DIL are not common
- Property/Casualty is Top-down – Employee Benefits is Bottom-up
- Employee Benefits are therefore set up locally
  - EB (second pillar insurance provided by the employer) differ substantially from country to country as they are always coordinated with the respective Social Security system (first pillar). For historical reasons, each country's Social Security system has developed completely differently
- EB are influenced by tax and working laws, interest groups such as syndicates, etc. and can therefore be political
- Liquidity is not as essential in reserves because of predictability of claims payments; hence longer duration and return seeking investments often used
- Reserves are established using the present value of the ultimate liability (versus P&C where the reserves are set at ultimate)
- Most reserves reflect a mortality component often with a loading for assumed longevity risk (that is, mortality improvements)
- IRS tax accounting for life and health insurers
  - Reserves fully deductible
  - Reserves established for tax by applying the IRS prescribed discount rate set each July

What are the savings?

Coverage	Savings Range*
Retiree medical	• 7% – 10%+ of the accumulated postretirement benefit obligation
Long-term disability	• 15% – 25% of commercial insurance • On self-insurance, accelerated deduction of claims cost and tax-effective investment accumulation on reserves
Term life insurance	• 10% – 15% of commercial insurance
Multinational pooling	• 10% – 15% of the pooled premium
Active medical	• First year only, incurred but not yet paid • After first year, medical trend
Multinational pooling	• 10% – 15% of the pooled premium
Active medical stop loss	• 10% – 12% of the cost of stop loss

*Actual client experience may differ from the savings ranges.

Reserve characteristics of key benefits

Key Benefits	Reserve Characteristics
Group term and voluntary life	Waiver of premium for disability, if included in the coverage; ~ 15% of premium for ~15 years
Long Term Disability (LTD)	Claim reserves ~12 – 15 years
Active medical and medical stop loss	All claims paid in 12 – 14 months; ~2 months of reported but not yet paid claims
Retiree medical	Net present value of expected ultimate cost of medical claims based on the most up-to-date mortality and current medical cost assumptions • Collectively bargained INcludes medical cost trend • Non-collectively bargained EXcludes medical cost trend and is amortized over working life; change in reserves includes trend
Pensions	Re-valued accrued benefits to date of retirement, including salary trend and most up-to-date mortality assumptions

Our learning objectives for “Pertinent regulations”

- Learn the basics, as they apply to benefits, of:
  - US ERISA regulations and captives
  - Pooling and non-U.S. regulations

U.S. regulations

- Internal Revenue Service
- Department of Labor
  - Prohibited Transaction Exemption

Captive Regulatory Considerations

Internal Revenue Service (IRS)	Department of Labor (ERISA)
• Parent company can take a tax deduction equal to all the premium paid to the captive if at least 30% is generated from unrelated business • EB plans are considered unrelated to the parent company	• EB plans are prohibited from being reinsured by a Captive (unless certain requirements are met) • DOL concerned with solvency and potential for self-dealing

The changing landscape

Prohibited Transaction Exemption (PTE)	
	• The use of employee benefit plan assets is subject to ERISA
	• Since ERISA prohibits transactions involving plan assets between "the plan" and a "party-in-interest" to the plan," employers could not insure employee benefits through a captive absent an exemption
	• Since 2000, the Department of Labor (DOL) has issued a number of PTEs allowing for captive insurance transactions with ERISA plans

Will a Prohibited Transaction Exemption ("PTE") be required?

- Yes, if the benefit plan is subject to "ERISA"
  - Covered: most life, health, disability and pension plans
  - Not covered: executive "carve-out," supplemental retirement plans, workers compensation, personal auto and homeowners
- And, if the transaction is "prohibited":
  - ERISA prohibits certain transactions with a "party in interest"
  - "Parties in interest" include the plan sponsor and any entity more than 50% owned by the plan sponsor, e.g., its captive
- And, if the transaction involves "plan assets":
  - Most ERISA plan transactions present a prohibited transaction issue and require a PTE, except certain medical stop loss contracts

Do you need an Exemption?

Three kinds of exemptions may apply to captive transactions:

1. Statutory Exemption (ERISA Section 408(b)(5)): automatic exemption, but benefit premiums must be less than 5% of all premiums written by the insurers affiliated with the plan sponsor
2. Class Exemption (PTE 79-41): automatic
   - Covers direct insurance transactions with affiliated insurers only
   - Transaction must also satisfy additional requirements, most significant of which is that benefits plus company-related premiums are less than 50% of all premiums written
3. Individual Exemptions (if above Exemptions do not apply)
   - DOL has granted more than two dozen and several are pending
   - Applicants can use an expedited ("ExPro") process if the transaction is substantially similar to at least two exemptions already granted within a specified time period
     - However, the DOL temporarily suspended such fast-track approvals in mid-2012 (more to come on this issue)

What are the individual exemption requirements?

- Captive or branch is licensed by a U.S. state or territory
- Captive has one year of audited financials, and reserves are reviewed and reported annually
- No more than adequate consideration is paid for insurance contracts
- No insurance commissions are paid by the ERISA plan
- Charges are consistent with market rates and calculated using the same methodology as typically used by insurers
- Plan participants must receive benefit enhancements, the cost of which must be borne at least in part by the plan sponsor (more to come on this)
- Fronting carrier must be “A” rated
- Reinsurance arrangement must be indemnity only
- Independent fiduciary initial and ongoing review and approval
- Disclosure to plan participants

Examples and costs of life benefit improvements

Benefit Improvement	Estimated Cost
Survivor education benefit	0.004% of premium
Increase the percentage of insurance coverage for Acceleration Benefit Option to over 50%	3% of premium
Increase the maximum amount paid for the Acceleration Benefit Option	3% of premium
Expand the number/type of illnesses covered by the ABO	3% of premium
Increase the length of coverage continuity for disability	TBD
Provide independent financial counseling to survivors	Estimate $0.35 per employee per month

Examples and costs of AD&D benefit improvements

Benefit Improvement	Estimated Cost
Survivor education benefit (LTD as well)	0.004% of premium
Extra benefit for critical burns, coma, criminal assault, and/or surgical reattachment	3% of premium
Extra payment to death benefit if deceased had used safety equipment such as seat belts or helmets	0.004% of premium
Child care benefit — 5,000 per year for four years, up to an overall maximum of the AD&D amount on the schedule for child(ren) up to the age of 12	0.004% of premium
Cobra continuation benefit — maximum benefit period of three years, maximum amount of $6,000, up to an overall maximum of the AD&D amount on the schedule	0.004% of premium
Repatriation — if death occurs at least 100 miles from principal residence, cost of transporting the deceased, up to $5,000	0.004% of premium

Examples of disability benefit improvements

Benefit Improvement	Estimated Cost
Employee education benefit (LTD)	To Be determined (TBD), based on claims history
Rehabilitation benefit (LTD)	TBD
Coordinated education benefit • During waiver of life premium, up to two years • During LTD, with two-year waiting period, up to two years	TBD
Extended STD period Increase in coverage	TBD based on salary levels TBD

U.S. DOL Exemptions Through January 2015

Indicates Towers Watson involvement

Companies	Benefit Plan	Fronting Company	DOL Date
1. Columbia Energy (now NiSource Inc.)	LTD	Wausau	11-Oct-00
2. ADM	Life	MN Life	5-May-03
3. International Paper	Life, AD&D	MetLife	7-Nov-03
4. SCA	Life, AD&D, LTD	Aetna	7-Jul-04
5. Alcon Labs	Life, LTD	Aetna	19-Aug-04
6. Alcoa	Life	MetLife	8-Jan-05
7. Sun Microsystems	Life	AIG	29-Sep-05
8. Astra Zeneca	Life, LTD	Prudential (Life); MetLife (LTD)	5-Jan-06
9. AGL Resources Inc.	Life, AD&D, LTD	Hartford	1-May-06
10. H.J. Heinz Co.	Life	MN Life	17-Sep-06
11. Wells Fargo	Life and LTD	MetLife (LTD); MN Life (Life)	31-Jan-07
NiSource Inc. (2)	Life	Prudential	17-Mar-07
12. Cephalon	Life, AD&D, LTD	Prudential	14-May-08
H.J. Heinz Co. (2)	Life, AD&D, LTD	Liberty (LTD); CIGNA & MN Life (Life)	25-May-08
13. YKK Corporation	Basic Life, AD&D	AIG	20-Jun-08
14. ConAgra	Life, AD&D	Prudential	4-Oct-08
Astra Zeneca (2)	Business Travel Accident	Zurich	20-Dec-08
15. Deutsche Post/DHL	LTD	Prudential	22-Dec-08
16. United Technologies Corp. (UTC)	Life, LTD	CIGNA (Life); Liberty Mutual (LTD)	26-Dec-08

U.S. DOL Exemptions Through January 2015 (continued)

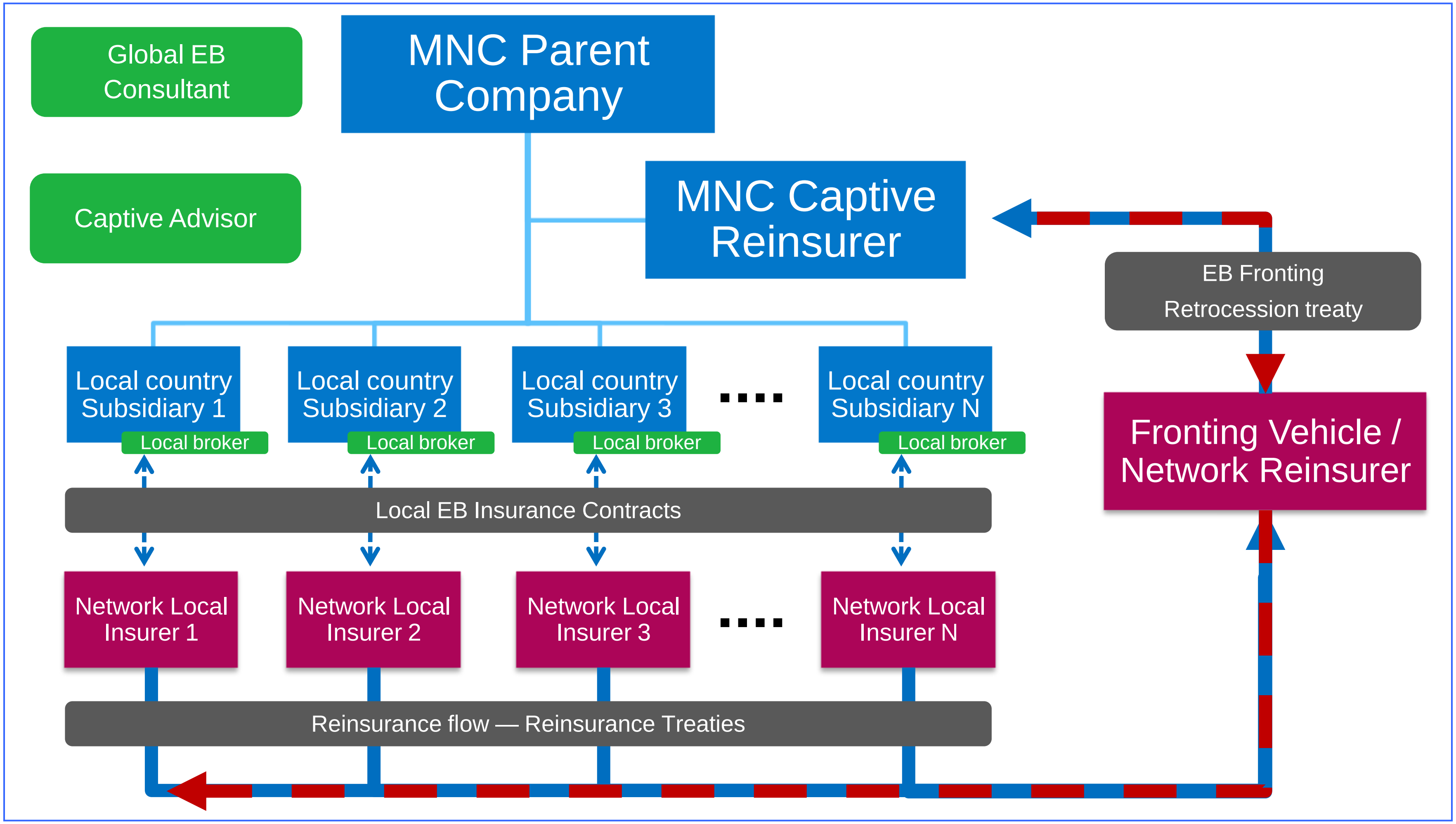
Indicates Towers Watson involvement

Companies	Benefit Plan	Fronting Company	DOL Date
17. Memorial Sloan – Kettering Cancer Center	Life, LTD	Prudential (Life); Unum (LTD)	31-Dec-08
ADM (2)	LTD	Aetna	25-Jan-09
18. Banner Health	Life	MN Life	29-Jun-09
YKK (2)	Supplemental Life, AD&D	MN Life (Life); Liberty Mutual (LTD)	16-Oct-09
19. Microsoft	LTD	Prudential	19-Nov-09
20. Dow Corning	Life, AD&D, LTD	MN Life (Life); Aetna (LTD)	28-Nov-09
21. The Coca-Cola Company	Retiree Medical	Prudential	2-Apr-10
22. BB&T	Life, AD&D, LTD	Hartford	13-Oct-10
23. Verizon	Life	Prudential	10-Aug-11
24. Deutsche Bank	LTD	Unum	20-Aug-11
Dow Corning (2)	Basic Life	MN Life	25-Nov-11
Microsoft (2)	Life, AD&D	Prudential	18-Jan-12
25. R&L Carriers	Life, AD&D, STD, LTD	Unum	19-Jan-12
26. Google	Life, AD&D, LTD	Prudential	22-Mar-12
27. Via Christi Health	Life	MN Life	7-June-12
The Coca Cola Company (2)	Life (actives), AD&D (retirees)	MetLife	28-Mar-13
28. Intel	Life, AD&D	MN Life	6-Nov-13

Pooling and non-U.S. regulations

- Risk management tools
- Financial Guarantees
- Solvency II

MNCs, Captives and Fronting Networks: An operational diagram



Financing employee benefits from multinational pooling to captives

Financial Improvement Scale

No savings | Modest | Significant | Maximum

Degree of insurance/reinsurance

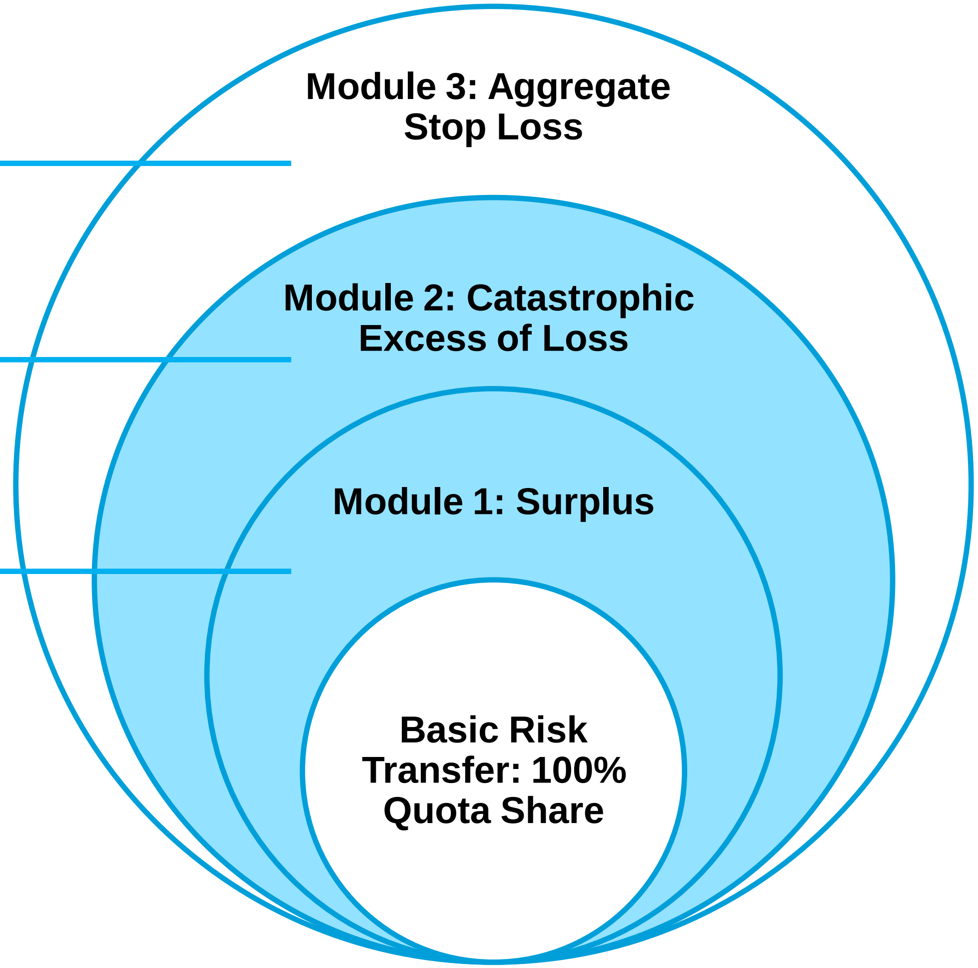
1	2	3	4	5	6
No multinational pools	Traditional multinational pooling	Client pool(s) (negotiated improvements)	Pool(s) reinsured to captive	Pools reinsured to captive plans • Captive issuing direct cover • Deposits held by captive	Independent Administrative Services Only (IASO), no local reserve

Risk Management tools for captives: A modular approach

Protection against aggregate losses (often due to high frequency / low severity claims)

Protection against catastrophic claims

Protection against high severity / low frequency individual claims ("peaks")

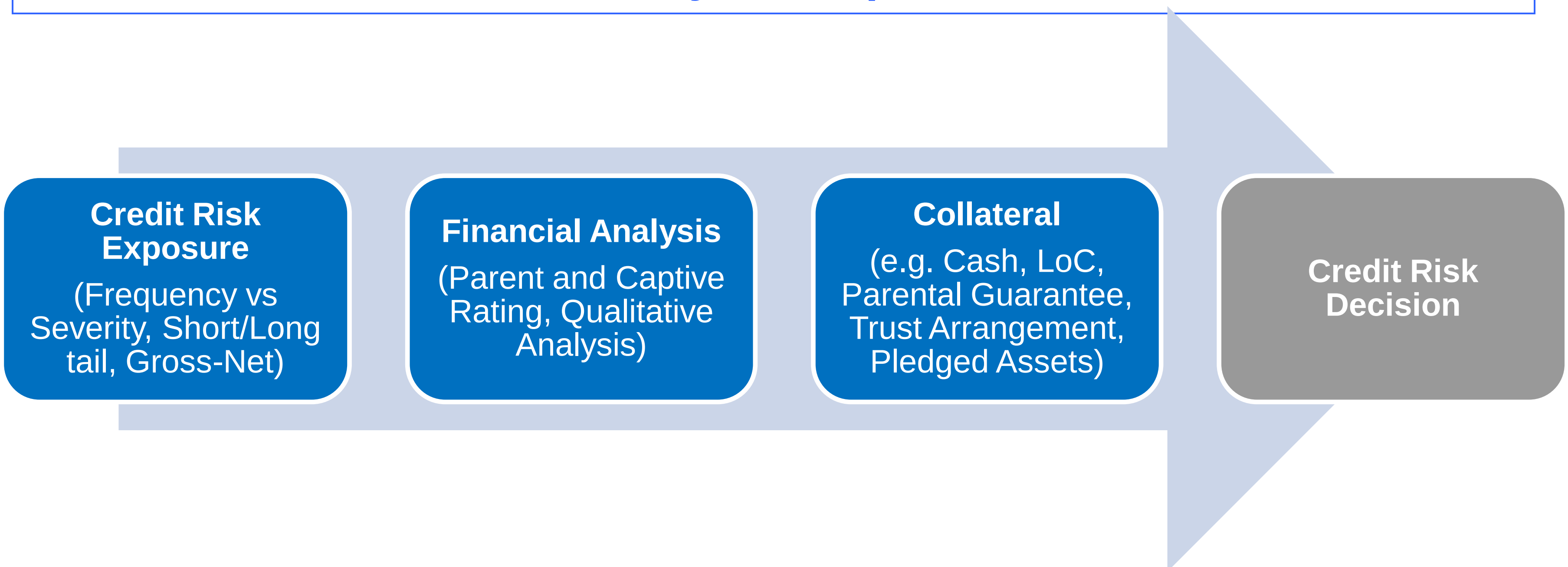


Captive considerations

Financing	Fronting Fees / Risk Charges	Administration Fees	Operational Fees

• Securitization
  • Reinsurance trust
  • Letters of credit
• Exposure
  • Risks retained by fronting carrier
  • Amount of additional protection required (beyond expected costs)
	• Cost to “rent paper”
	• Risk charges for retained risks
	• Stop Loss
	• Other expenses
		• Same services and costs as traditional funding arrangements
		• Premium taxes
		• Captive management fees
			• Feasibility study
			• Legal fees
			• Independent Fiduciary fees

Credit Risk Assessment
Summary of the process



The **credit risk decision** is based on the financial strength of the counterparty considering the following:

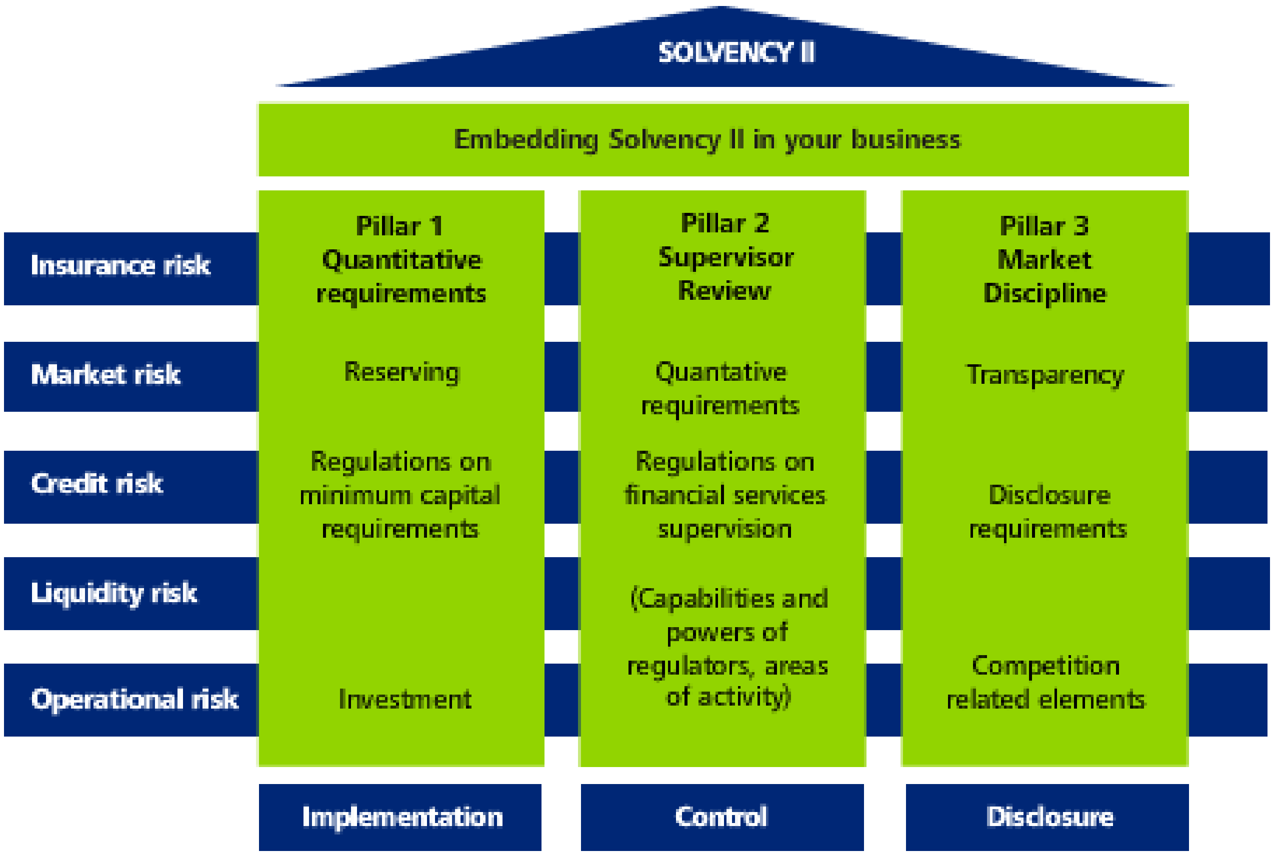
➔Total Credit Risk Exposure (individual and whole account view assessment of current and potential exposure)
➔Adequacy of retrocession panel
➔Collateral
➔Local law or regulatory requirements

Collateral Options
An overview of common options

Cash/Pledged Assets	•Cash/Assets transferred to a lender to secure a debt. The ownership is not transferred and remains with the borrower, unless default occurs. •Low/no creation and maintenance costs
Letter of Credit	•Bank undertakes an obligation on behalf of the buyer to pay the seller. To this end the buyer must have sufficient assets/credit with the issuing bank •Commissions and charges depending on the issuing bank
Trust Arrangement	•Excess cash from the captive's balance sheet deposited in a trust account, the cash could remain on the balance sheet, but it would be noted that it has been ring-fenced for the insurance company (beneficiary) to pay for claims •Low/no creation and maintenance costs
Funds Withheld	•Reinsurance cession in which the ceding company does not actually remit premium to the reinsurer, but retains the premium in a separate account from which claims will be paid •Low/no creation and maintenance costs
Surety Bond	•Bond provider should be 3rd party and insurance company should be stated as beneficiary, claimant should be captive •Rather unusual, therefore might be complicated and lengthy process •Need to find an suitable provider, Terms & Conditions to be defined
Parental Guarantee	•Guarantee of parent company to subsidiary company (captive) •Irrevocable and unconditional guarantee to pay to the insurance company (beneficiary) a predefined max. amount

Comments:
- Different accounting frameworks, laws and regulations require different disclosure requirements.
- Collaterals offered in one region may differ from those in other regions due to availability, local or regional laws and other considerations.

Solvency II — The 3 Pillars



Capital Requirements | **Governance & Risk Management** | **Disclosure & Transparency**

Risk Correlation Matrix

	Market	Default	Life	Health	Non-Life
Market	1	0.25	0.25	0.25	0.25
Default	0.25	1	0.25	0.25	0.5
Life	0.25	0.25	1	0.25	0
Health	0.25	0.25	0.25	1	0
Non-Life	0.25	0.5	0	0	1

Source: EIOPA, Technical Specification for Solvency II

Default and non-life risks are seen to have some correlation
-> small diversification effect…

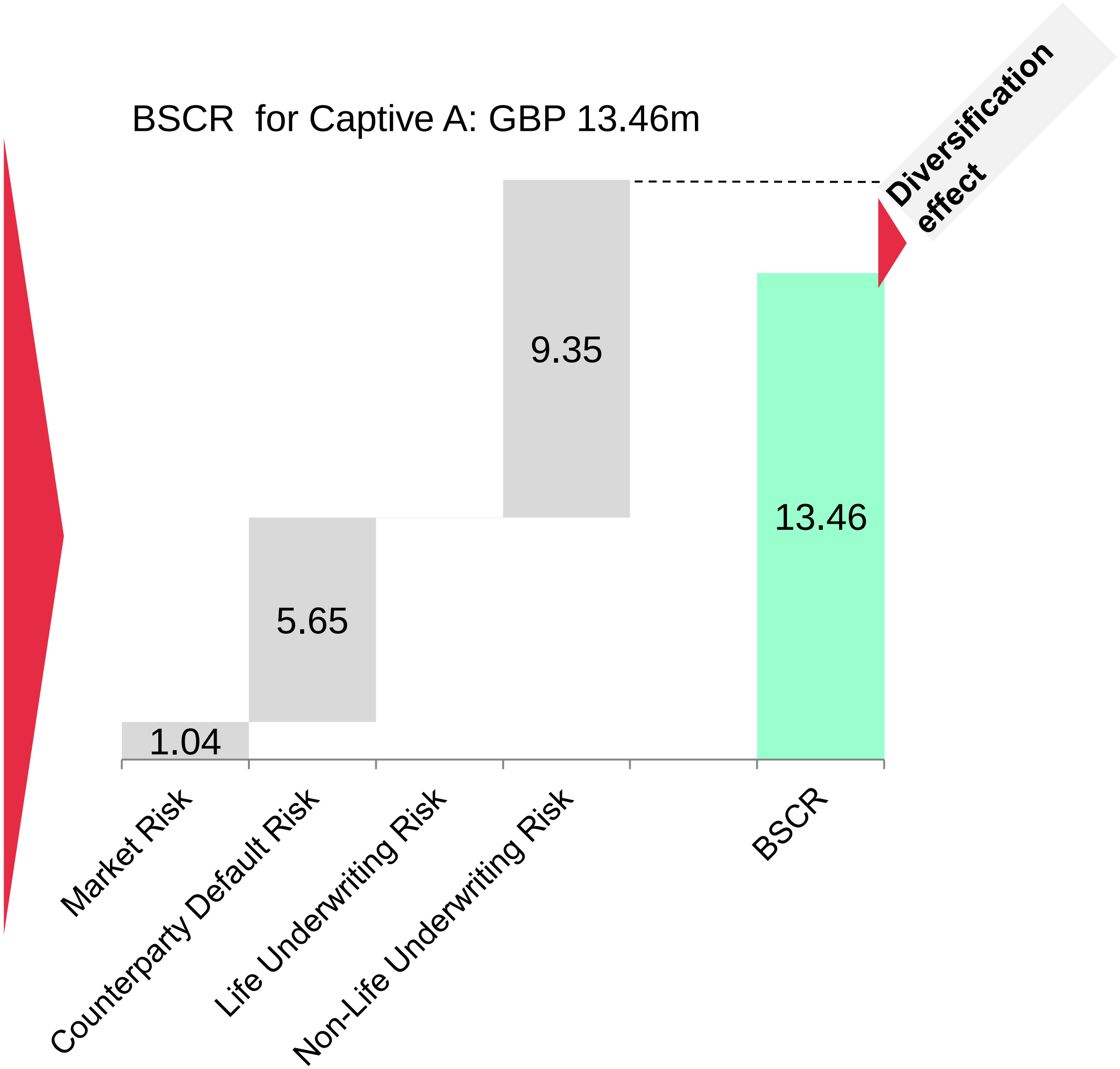
…whereas life and non-life risks are seen as uncorrelated
-> large diversification effect

Example A

Captive A

Captive A only writes property and liability.

- Current premium for property: **GBP 3.7m**
- Current premium for liability: **GBP 3.0m**
- Captive Assets of GBP 50m



Example B

Captive B

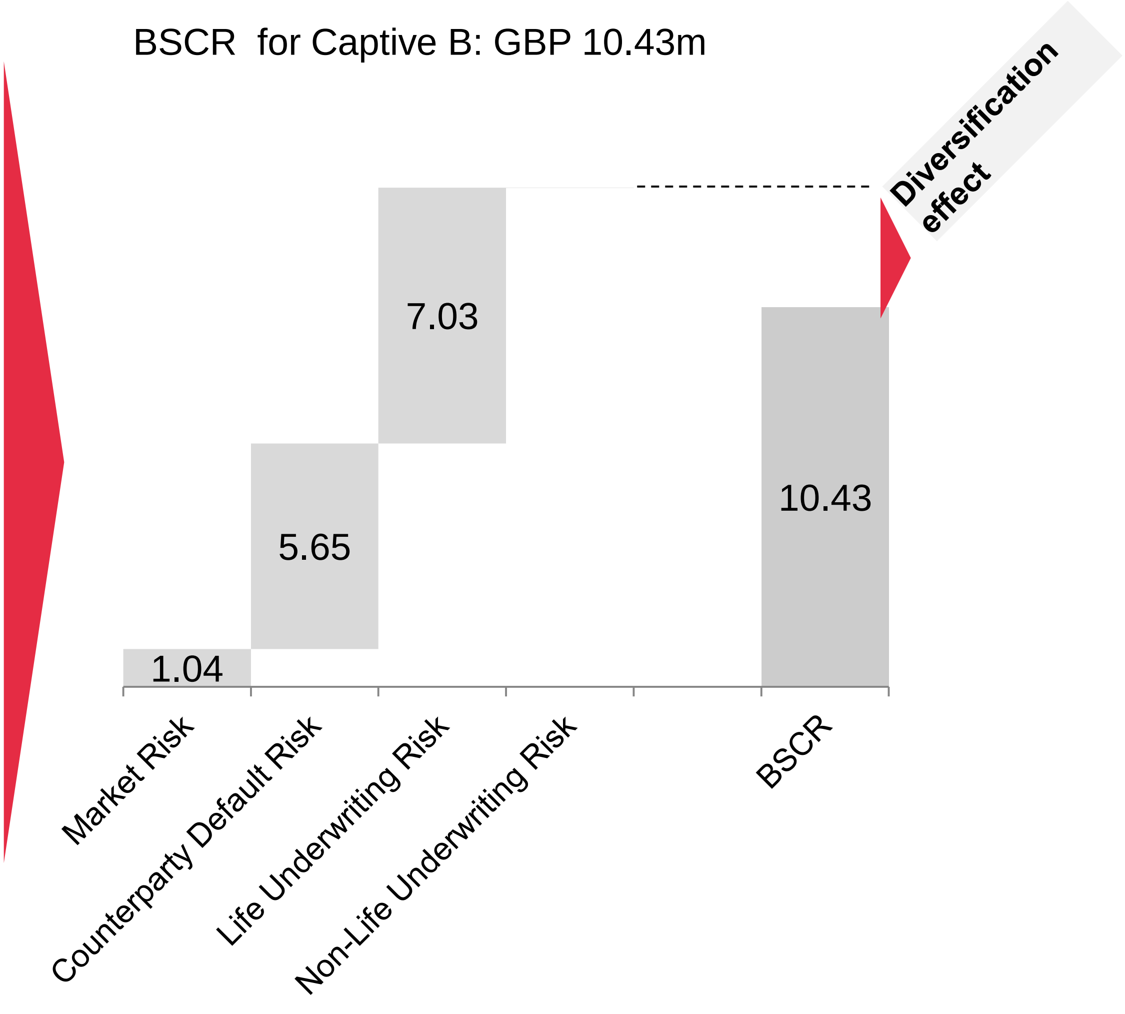
Captive B writes mortality risk for 14’000 lives.

Current premium: GBP 8m

Average lump sum: GBP 310k

Average age of insured people: 40y

Captive Assets of GBP 50m



Example combined

Captive A

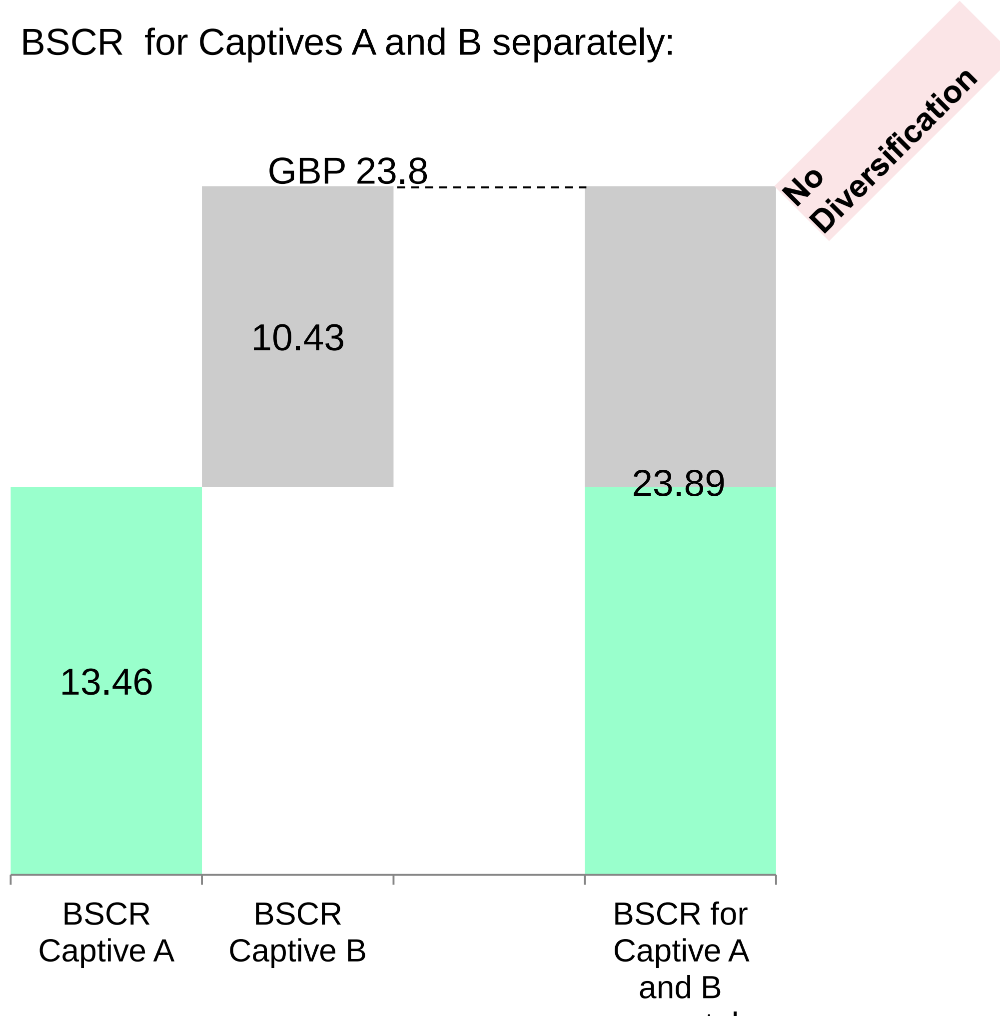
Captive B

Captive A needs to cover the BSCR of GBP 13.46m

Captive B needs to cover the BSCR of GBP 10.43m

The BSCR for the two captives together amounts to GBP 23.89m

BSCR for Captives A and B separately:

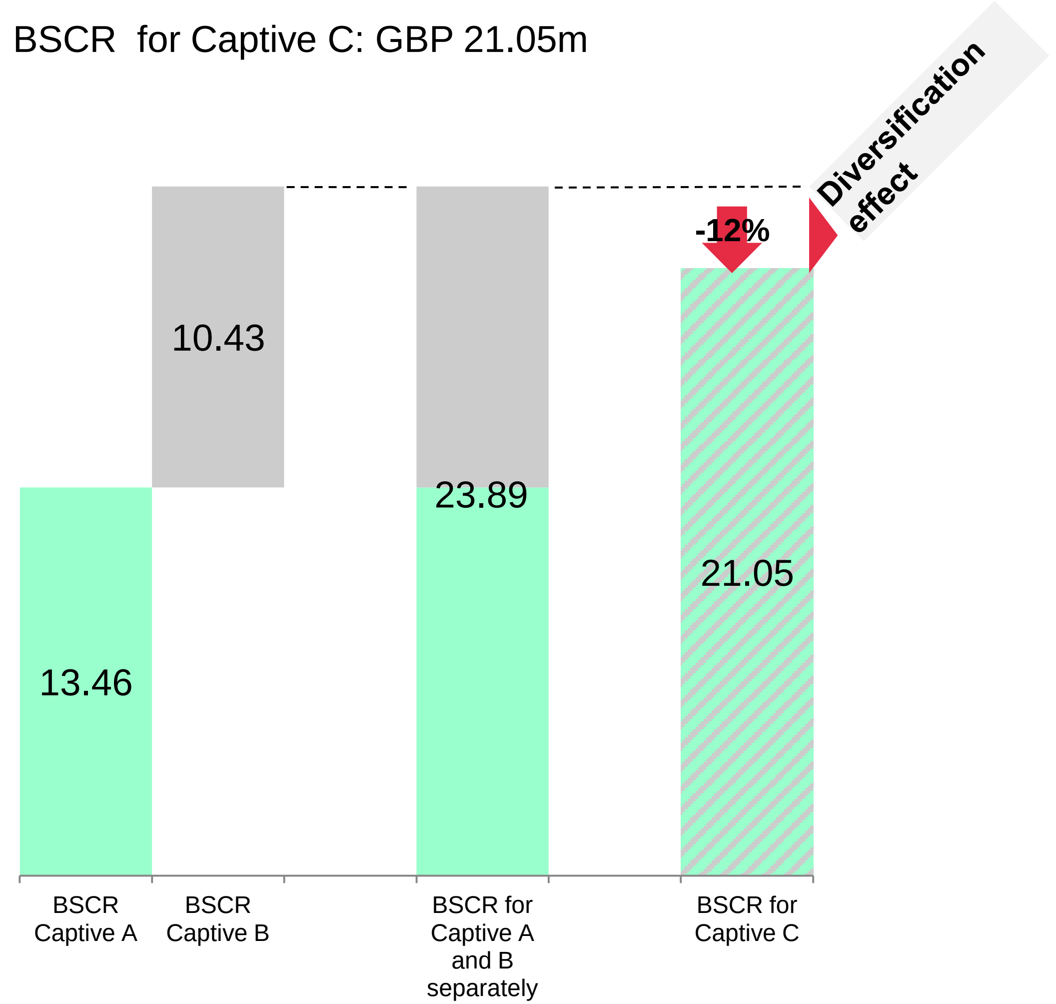


Example C

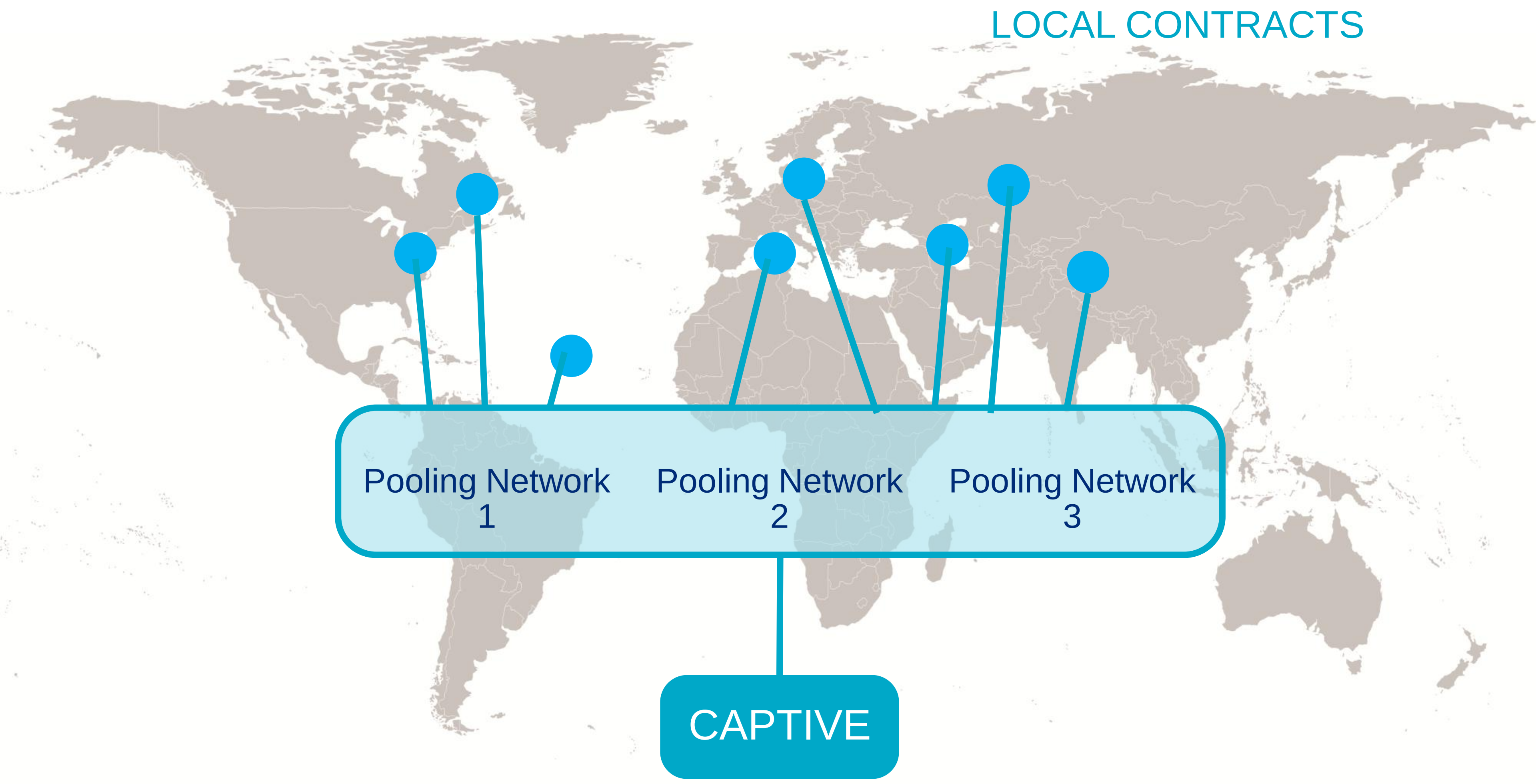
Captive C

Captive C writes both underwriting risks as one entity

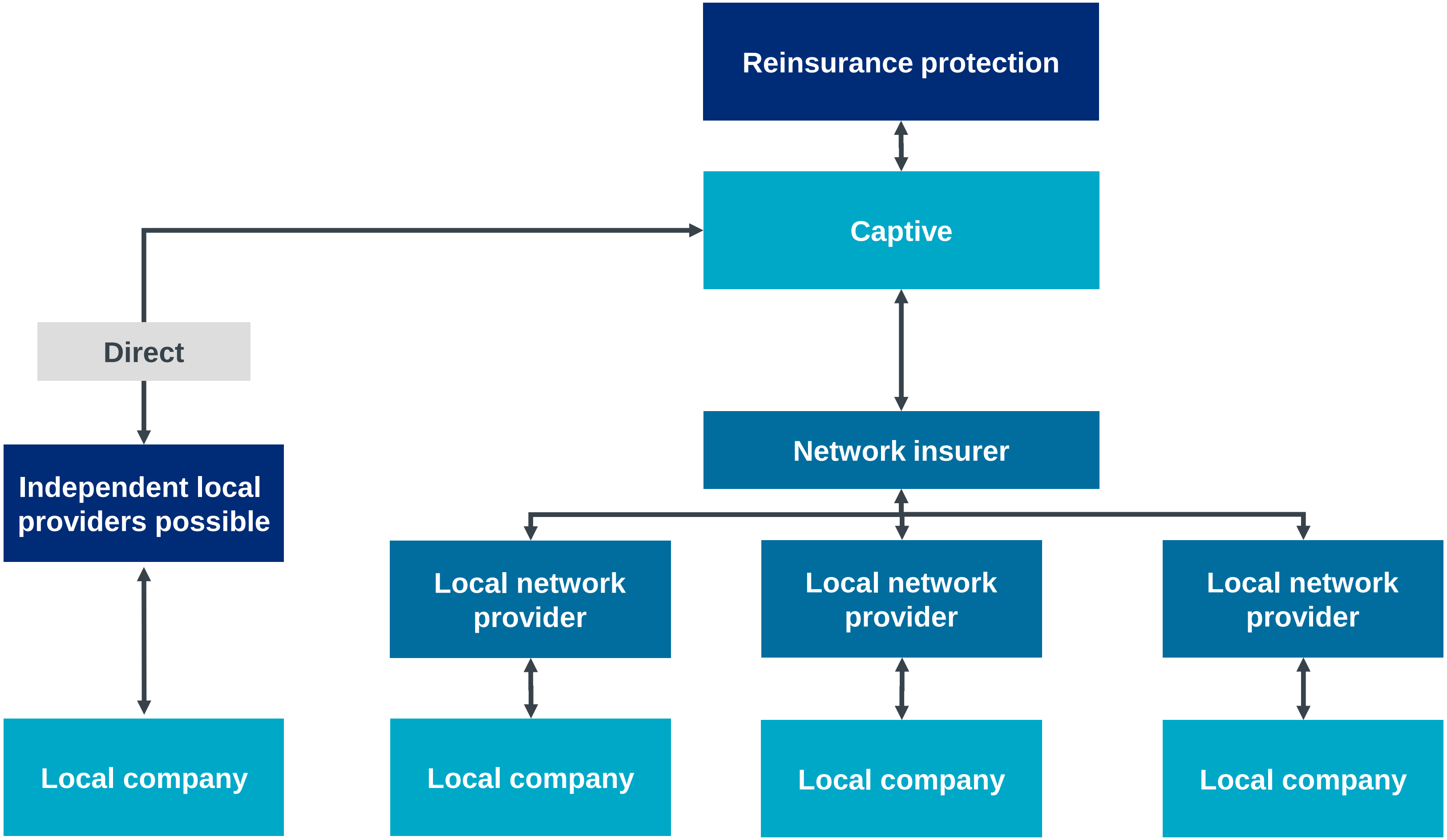
- Predefined **diversification reduces** the **BSCR** from GBP 23.89m to GBP 21.05m, down **12%**



International Benefits
The Path to Captives



International Benefits Captive Structures



Our learning objectives for "How to make it work for your company"

- Learn implementation process steps
- Forging the partnership between Finance and HR
  - Review Caterpillar case study

Implementation process

Evaluation

- Obtain Risk Management and HR buy-in
- Data mine your global EB spending
  - Pooling Networks
  - Internal Databases
- Feasibility study
  - Savings
  - Goals
  - Costs & bench-marking
  - Captive structure/domicile

Selection

- Identify your preferred providers
- Select contracts to transition
  - Years 1,2,3
- Determine underwriting philosophy
- Commence DOL application (US only)
- Obtain internal approvals/buy in
  - Legal, Treasury, Tax, Purchasing

Implementation

- Communications
  - Regional
  - Business Units
- Governance
  - Reinsurance Agreements
  - Collateral
  - Accounting treatments
  - SLA's

Monitoring

- Quarterly Accounting
- Claim Management/ Monitoring
- Exposure Analysis and reporting
- Plan Design Control

2015 Project Outline and Example Timing

WORKSTREAM	Q1 2014	Q2 2014	Q3 2014	Q4 2014	2015 onwards
1. Evaluation & captive feasibility	Data collection.	Feasibility analysis. Implement captive strategy if appropriate (e.g. setup, licensing).			
2. Network selection/ negotiation		Negotiate with networks.	Agree/sign agreements and treaties.		
3. Governance framework		Governance framework created/adjusted and agreed to reflect strategy and responsibilities.			
4. Communication			Communications drafted and rolled out internally and through broking network.		
5. Local Implementation.			Implement in line with strategy (timing depends on local renewals).		

Implementation considerations from the captive perspective

General Licensing and Capital Requirements

- Authorization for life and non life risks
- Application process 3/5 year business plan including;
  - Forecast premiums/claims and costs
  - Detailed description of risks /exposures
  - Financial projections
  - Actuarial Analysis
  - Solvency Projections (EU Solvency II)

Governance and Organisation

- Legal, tax & regulatory advice
- Determine achievable implementation timeline
- Fronting Insurer; single/multiple
- Reinsurance Agreements/Collateral
- Captive protection; stop loss, excess of loss/cross class reinsurance
- Additions to captive board?

Operational Management

- Additional time and attention required from corporate
- Frequency of premium/claims payments
- Data Management. Managing the flow of information to satisfy management and regulatory reporting requirements:
- Actuarial support (Possibly life & Non life actuary)

Forging the Partnership between Finance and HR — Basic questions to address

- Identifying roadblocks
  - **HR:** Who is their current provider and what are the terms and conditions of their current plan?
  - **Finance:** What kind of savings will the project give them?
  - **Captive Insurance Company:** Are they willing to work within plan parameters?
  - **Purchasing:** Does purchasing have to be involved? If yes, when?
  - What is the role of each of the partners (HR, Finance, Captive, Purchasing)?
  - **Tax**: Will tax support project (Retiree Medical, Workers' Comp., LTD, Group Life)?
  - Treasury: Will Treasury support funding?

Forging the Partnership between Finance and HR — How to proceed

- Presentation of the project
  - Detailed discussion on how the captive project works
  - Detail what value they will have as part of this project — savings, economies of scale, no loss of control, funding, claims
    - Show how a typical premium is built — components and costs to the company
  - Roles and responsibilities — what is expected of the unit HR and unit Finance person, the Captive and the International Employee Benefits department
  - Make sure they understand this is a global project and that eventually every unit will participate (based on legal ability to do so)
- Do not have a presentation without both HR and Finance in the room together
- After the presentation — give the unit HR and Finance time to walk away and think about questions and concerns

Forging the Partnership between Finance and HR — How to proceed (continued)

- Approximately two weeks after the initial presentation, call a second meeting; talking about this process takes more than one time to fully understand
  - Answer all of their questions
  - Give them more time to think about the project
- Approximately two weeks after the follow-up meeting, set up a call to work on next steps together
  - Timeline
  - Implementation plan
    - Meeting with provider
    - Communication plan
    - Roles and responsibilities

Forging the Partnership between Finance and HR — Case study from Caterpillar

- Identify why there are roadblocks, if any, and the key drivers for Finance and HR
  - M&E vs. FPD (separate divisions and financial reporting). Debt/capital impact.
  - Stakeholder Management — sensitive and difficult (EO/Tax/Treasury/HSD/Benefit Funds Committee/Legal/FPD
  - Program Management — perceived threat, fear of embarrassment, turf wars, protect head count, lack of trust
  - Profit vs. Cost Mentality — who gets accountable profit
    - VEBA Wars — disputes over funding approaches and program structures
- Learn how companies have overcome roadblocks
  - Acquired M&E life and health insurer managed by FPD
  - Strong Blackbelt with effective communications
  - Top level support: FPD personnel now in key positions (Director of HSD/Treasurer/ U.S. Tax Manager)
  - Enterprise (holistic) approach where savings drive decisions. Build on successes
- Create a plan for forging the partnership
  - Key Sponsorships from leaders of Treasury/Tax/HSD

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