BENEFITS UPDATE: THE EVER-CHANGING FRONTIER

NEW FRONTIERS
THE 11TH ANNUAL EXECUTIVE EDUCATIONAL CONFERENCE
USA RISK GROUP

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ACA Update

- Six years later, still controversial
- Pace of regulations is slowing
  - Transition from rule-making to rule-enforcing
- First serious audits are about to begin
- Many issues still unresolved
  - “MEC” Plans
  - Cadillac Tax
  - Fully Insured Nondiscrimination
  - “Substantial coverage”
  - Cost Containment and “medical inflation”

Agency Update

- IRS
  - Overwhelmed by Form 1094/95 Reporting
  - Understaffed division in charge of this effort
  - Focus will be limited to reporting only for at least the next year
- DOL
  - Tasked by the White House with conducting ACA audits
  - Focus on failure to provide coverage, “easy targets”
  - Effort planned for Fall 2016

Anti-Self Insurance State Initiatives

- NY Ins. Law §§ 3231(a), 4317(e)
  - Bars sale of stop loss by New York carriers to groups between 1 and 100
- CA SB-161
  - Raised attachment points for small employers ($40,000 spec as of January 1)
  - Definition of small employers expanded to the 51-100 market on January 1
- Are these provisions going too far? Who can fight them?
- The captive workaround

ACA and the Election

- The fight to repeal ACA has weakened every day since its passage
- “Repeal and replace”
  - Implies a replacement will exist prior to repeal
  - Implies legislative action, not executive action
- Clinton – Continuation
- Trump – ???
- Senate races may matter more than the Presidency

Captive markets today

- Good news: still the best means of mitigating health and ACA costs
- Good news: verticalization is slowly catching on
- Good news: major carriers are more commoditized than ever
- Bad news: difficulty in persuading mid-size companies to spend now and grow endowment for savings later
  - Employers are suffering from increasing costs now and are often impatient to see results. Innovations in quicker savings will drive greater adoption
  - Example: technology is evolving to better predict claims experience based on demographics alone, which may assist mid-size groups in lowering rates without prior claims history

Captive possibilities tomorrow

- The insurance industry is being upgraded by several technology firms
  - Disruption is here in the form of better benefits administration and private exchanges
- Employers will expect upgrades and seamless integration of all health and welfare plans for all segments of employees
  - Holistic view of the benefits program opens the door to captive discussions
- Integrate or lose market share

Questions?

Employee Benefits: Applications of Captive Insurance Companies

MERLINOS actuaries consultants

Background

- A significant number of employer groups self insure some of their employee benefits that are offered to their employees and their dependents:
  - Per the Employee Benefit Research Institute (EBRI), approximately 55% to 58% of employees with group medical coverage are enrolled in self insured plans.
  - Approximately 85% of employees who are employed by organizations with at least 1,000 employees are enrolled in self insured group medical plans.
- Short-term disability is frequently self insured by mid to large size employers. Group life and long-term is much less frequently self insured; however, some very large employer groups do self insure some of this risk.
- The prevalence of self insurance of employee benefit plans creates a large opportunity for captive insurance companies to help manage this risk.

Background - Continued

- Employers who self insure their group medical plans typically purchase two types of medical stop loss insurance to help manage the volatility of the risk:
  - Individual stop loss (ISL) insurance attaches on a member level and reimburses the employer plan sponsor if member level claims exceed the ISL attachment point. The typical ISL attachment points are from $50,000 to $500,000 depending on the number of employees covered by the plan.
  - Aggregate stop loss (ASL) insurance limits the employer's liability for member level claims that are below the ISL attachment point. ASL coverage typically attaches at 120% or 125% of expected claims below the ISL attachment point.
- The stop loss insurance is typically placed by either the broker of record or the plan's third party administrator.
- ***A key distinction that will be made is whether the captive is issuing insurance to cover the employer or the employees.***

Why Insure Employee Benefit Coverages in Captive?

- ***Risk Diversification*** – Employee benefit risks will typically be statistically uncorrelated with the other risks covered by the captive. As a result, the year to year volatility of the entire captive insurance entity can be lower.

- ***Premiums Based on Experience*** – The employer may be able to reduce their costs if they are currently insuring certain coverages in a market that is driven by manual rating. The employer can thus benefit from their own good claim experience.

- ***Risk Charge Reductions*** – Insurance companies add risk and profit loads for the coverages that they issue. Insuring some coverages in a captive will reduce the dollar value of these loads that are paid by the employer to commercial insurance carriers.

- ***Investment Return on Reserves*** – The captive insurer gets to hold the claim reserves for the coverages they issue as opposed to a traditional insurance carrier. As a result, the captive retains investment returns. This could be meaningful for longer tailed coverages like long-term disability.

Captive Applications – Group Medical
Single Parent Captives

- The most common coverages group medical coverages issued by a captive are the following:
  - ***Captive issues a coverage for a "layer" of ISL coverage***. For example – The employer historically purchased ISL with a $250,000 attachment point. The captive could issue a layer of coverage that covers member claims from $150,000 to $250,000. The employer would then be responsible for claims under $150,000.
  - ***Captive issues a coverage for a "layer" of ASL coverage***. For example – The employer historically purchased ASL @ 125% of expected claims below the ISL attachment point. The captive could issue a layer of coverage that covers aggregate claims from 115% to 125% of expected claims. The employer would then be responsible for claims up to 115% of expected claims.

Captive Applications – Group Medical
Single Parent Captives - Continued

- ***Captive issues a coverage to reimburse the employer for Health Reimbursement Account (HRA) claims***. Some employers with high deductible health plans offer a HRA plan to help employees meet the deductible. There is some uncertainty each year about the level of HRA claims, so the captive could issue a coverage for HRA claims that would lock in the employer's cost for HRA claims.

- ***Captive issues a guaranteed renewable A&H policy to cover future medical inflation for a fixed cohort of employees***. For a fixed cohort of employees, there is a large degree of uncertainty about their future level of medical claims. Captives have issued coverages that indemnify the employer against future medical inflation in exchange for a fixed premium paid to their captive insurance company.

- ***In all of these examples, the captive is issuing an insurance coverage to the employer. As a result, Department of Labor approval is not required to finalize the transaction.***

Captive Applications – Group Medical Group Captives

- Groups of employers commonly utilize captive insurance companies to pool a portion of their large claim risk. This allows smaller employers (typically 100 to 250 employees) to collectively purchase less commercial stop loss insurance coverage. This should result in lower long term costs for these employers due to the frictional costs of commercial stop loss insurance.
- Group medical stop loss captives typically have a fronting company who issues the ISL coverage at a certain attachment point and then cedes a layer of this risk back to the group captive insurance company.
- ***Group captives can make sense for employers; however, they must use caution to make sure that the captive is pooling risk from employers with reasonably similar claim morbidity and approaches to loss mitigation (wellness, disease management, etc.)***

Captive Applications – Group Medical
Group Captives - Example

- The following 5 companies decide to start a group stop loss captive:
  - Company A
  - Company B
  - Company C
  - Company D
  - Company E
- Companies A, C, and E buy ISL stop loss insurance with an attachment point of $100,000. Companies B and D buy ISL with an attachment point of $125,000.
- USA Risk Group is the captive manager. StoplossFront, Inc. was selected as the fronting insurance carrier.
- BestTPA is selected as the TPA for all 5 companies.

Captive Applications – Group Medical
Group Captives – Example - Continued

- StoplossFront, Inc. issues stop loss insurance to all 5 companies at their selected attachment points.
- StoplossFront. Inc cedes a $100,000 layer of the risk to the group captive. Thus for companies A, C, and E the group captive will cover large claims from $100,000 to $200,000. For companies B and D, the group captive will cover large claims from $125,000 to $225,000.
- StoplossFront, Inc. will cover large claims that exceed $200,000 for companies A, C, and E. The company will cover large claims that exceed $225,000 for companies B and D.
- ***The impact of the captive is that insured a $100,000 layer of large claims for all five companies. The covered layer is different for some companies, but the size of the layer is $100,000 for all five companies.***
- ***The employers are now pooling this $100,000 layer of risk amongst themselves and can share in the profits and losses.***

Captive Applications – Group Medical
Group Captives – Example - Continued

- There are a number of issues to be considered in setting up a stop loss group captive:
  - It's best to group companies who have some similarities in size, industry, and approach to loss control.
  - The captive manager should consider whether it makes sense for all companies in the captive to use the same plan designs and network.
  - Program expenses need to make sense in order for the captive to work. Captive manager needs to make sure that the front is ceding a reasonable amount of premium to the group captive.
  - ***In this group captive example, the captive is issuing an insurance coverage to the employer. No DOL approval is required.***

Affordable Care Act
Considerations for Plan Sponsors

- Plan sponsors of self insured group medical plans need to be aware of the specific requirements of the Patient Protection and Affordable Care Act (PPACA) with respect to self insured plans:

- The PPACA "Play or Pay" requirements effectively require all employers with at least 50 full time equivalent (FTE) employees to provide qualifying insurance coverage or be subject to penalties. The key provisions are as follows:

  - Employers must offer at least one plan that provides "minimum value", which is defined to be a plan that has an actuarial value of at least 60%.

  - The plan must be covered to "substantially all" of its full time employees. An employer can meet this requirement if it offers the coverage to at least 95% of full time employees.

  - ***If "minimum value" coverage is not offered to substantially all of the employees, there is a $2,000 penalty assessed for all full time employees (less the first 30) if at least one employee obtains a subsidy at the state or federal exchange..***

Affordable Care Act
Considerations for Plan Sponsors - Continued

- The coverage must be affordable. PPACA offers employers some safe harbors to use to ensure compliance with the affordability requirements. The most commonly used safe harbor is the "9.5% rule". As long as the single employee contribution for at least one plan design does not exceed 9.5% of the employees W-2 income, the employer is in compliance.

- If an employer does not offer affordable coverage, they will be assessed a penalty of $3,000 ***for each*** employee who receives subsidized health insurance at a state or federal exchange. Total penalties cannot exceed the penalty the employer would pay if he did not offer coverage at all ($2,000 per EE penalty).

- ***If the employer plan sponsor offers minimum value coverage to substantially all of the employees AND the coverage meets the affordability requirements, no PPACA "pay or play" penalties can be assessed against the employer.***

Captive Applications – Life & Disability
Single Parent Captives

- There have been a very limited number of employers who have utilize their captive insurance company to cover the group life or disability coverage that is offered to their employees.
- The structure of the transaction is as follows:
  - Fronting company issues the group life and long term disability coverage to the employees.
  - Fronting company cedes some or all of the risk to the employer's captive insurance company.
  - The reinsurance contract between the fronting company and the captive is a "indemnity insurance arrangement", which means that fronting company is responsible to pay claims regardless of the ultimate solvency of the captive.
  - Fronting company will require collateral to be posted by the captive.
  - Fronting company will pay and manage all claims. In exchange for these administrative services, the front will get a fronting fee.

Captive Applications – Life & Disability Single Parent Captives - Continued

- This type of transaction will require Department of Labor (DOL) approval. There are several requirements that will be met to get DOL approval:
  - Captive must be US domiciled.
  - Fronting insurance carrier must have a minimum AM Best rating of “A”.
  - Participants must be notified.
  - An independent fiduciary will be required to analyze the transaction and opine on the financial viability of the proposed transaction. The premiums charged by the captive must be “reasonable”.
  - A nominal increase in benefit value will be required.

Captive Applications – Life & Disability Single Parent Captives - Continued

- ***When is DOL Approval Required?***
- DOL approval is required whenever a proposed captive coverage constitutes a "Prohibited Transaction" as defined by ERISA. The general elements that are required are the following three items:
  - ***Fiduciary*** – Needs to be a "welfare" plan that has a fiduciary, which is essentially all employee benefit plans.
  - ***Assets of the Plan*** – Applies if the captive policy is purchased with assets of the plan.
  - ***Party In Interest*** – The employer plan sponsor is a "party in interest"

Captive Applications – Life & Disability Single Parent Captives - Continued

- DOL approval will be required for a captive transaction related to nearly any employee benefit plan. This would include the following: (1) Group Medical; (2) Group Life; (3) Group Disability; (4) Group Dental or Vision.

- ***Medical stop loss insurance does not require DOL approval because the coverage is not considered an "employee benefit program" under ERISA. Stop loss insurance indemnifies the employer from volatility associated with the underlying self insured group medical program.***

Captive Applications – Tax Issues

- In nearly all cases, the employer who utilizes a captive to cover employee benefit risks must consider the tax consequences of these transactions.

- Under the Internal Revenue Code (Code), employers are not permitted to deduct a reserve that has been established with respect to a future contingency. The tax deduction is not allowed until the claim has actually been paid by the employer.

- If a captive retains the risk, it ***may be*** possible for the captive to immediately deduct the reserve for the future contingency. The result is an acceleration of tax deductions for the employer's consolidated tax entity.

- Historically, the Internal Revenue Service (IRS) has not been supportive of the concept that an employer's consolidated tax group can deduct captive claim reserves. However, the courts have consistently held that these tax deductions are allowed if the captive covers a sufficient amount of "unrelated risk". ***This is a very complex topic***.