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Captives and Protected Cell Companies for Employee Benefits: a European View

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This article explores the use of captives in employee benefit coverages. For any reader for whom the concept of captive insurance brings to mind thoughts of kidnap and ransom coverage (which is not the subject of this article), it may be helpful to start with a definition.

WHAT IS A CAPTIVE INSURANCE COMPANY?

A captive insurance company is an insurance or reinsurance company owned by a non-insurance company, which insures or reinsures the risk of its parent or affiliated companies. The main objective of a captive is cost saving. Cost saving should be measured as the difference between the existing practice, e.g. a fully insured arrangement, and the cost of the captive option.

Captives might be thought of in terms of an evolution in employee benefit insured arrangements. The significant stages of this evolution could be considered as three generations, as follows:

- contracts of insurance direct from an insurer (first generation);
- multinational pooling, which is the linking of insurance contracts with a network of insurers, in order to benefit from shared claims experience for a company's employees over a range of countries (second generation); and
- captives (third generation).

Historically, the cover written by captives has been non-life, e.g. motor, fire, employer's liability and product liability. However, recent activities in Europe and the USA have increased the interest in using a captive as a vehicle for insuring employee benefits. To date, these transactions have covered such benefits as life, disability and health care.

Bringing employee benefits into a captive insurance company requires the involvement of the human resources and finance departments. These two areas of an organization may seldom be involved in joint projects, and clearly have different objectives. Bringing them together will be crucial in achieving success. Given many companies' lack of familiarity with the use of captives generally, or for employee benefits in particular, it may be that independent consultants are engaged to provide objective analysis as an aid to decision-making.

CAPTIVE USE FOR EMPLOYEE BENEFITS

The current use of captives is principally the preserve of the larger multinational. However, with the advent of Protected Cell Companies (PCCs), we expect the captive approach to employee benefits to broaden the market.

The country in which growth has been most apparent is the USA, where demand must be particularly strong, given the compliance requirements of the Employee Retirement Income Security Act 1974*. For the European captive centres, the regulatory conditions appear

The Cadbury Schweppes Challenge

Cadbury Schweppes, in the UK, established a captive for employee benefits coverage in 2003 in the Dublin International Financial Services Centre. The rate of tax applicable in this jurisdiction was 10% as compared with 33% in the UK. Her Majesty's Revenue & Customs (HMRC) in the UK challenged Cadbury Schweppes's right to the lower tax rate under Controlled Foreign Company (CFC^{*}) legislation. Cadbury Schweppes took the case to the European Court of Justice and received a ruling in September 2006. The ruling stated that:

- freedom of establishment, *even for tax purposes*, in another member state is allowed; and
- CFC legislation should not be applied except for “wholly artificial” arrangements.

The HMRC interpretation of this ruling allowed lower taxation to apply only in those cases where a parent had employees working in the captive. The reduction in UK chargeable profits was limited to the “net economic value” created by those employees. Draft guidance was issued in December 2006, with the result that the tax treatment of captives was largely unaffected.

* A Controlled Foreign Company is one that is resident outside the UK, in a jurisdiction that applies a lower tax rate than the UK but remains controlled by persons resident in the UK.

less daunting and there is increasing activity. Cadbury Schweppes is a name that has come to wider attention, given its challenge to the UK tax authority's ruling in the European Court of Justice (see BOX 1 above). It is a particularly relevant case, exploring the tax issues for an employee benefits captive. The outcome was that captives remained Controlled Foreign Companies for a UK parent and could therefore add only limited tax benefits to their other advantages. However, the situation is different for PCCs and these potential tax advantages relative to captives are discussed below.

Cost/Benefit Assessment

In determining the appropriateness of a captive arrangement, the first step would normally be in the form of a cost/benefit analysis. This compares projected outcomes for ‘with captive’ and ‘without captive’, for the company's income and expenditure and for its balance sheets.

By creating a sophisticated financial model, it is possible to examine a range of scenarios exploring the impact of the captive on the company's profits, expenses and capitalization. Key assumptions can be varied to test sensitivity. Typical cash flows for a captive are shown in FIGURE 1 opposite. Reserving regulations and the period for which projections are made are important for the model, particularly for long-tail business.

Assumptions

Key assumptions for the model would be expected to include the following:

- the capital requirements,
- reinsurance pricing,
- the reinsurance strategy,
- dividend policy,
- taxes on the captive and on the parent (as a result of the captive),
- the cost of running the captive,

- the inflation rate,
- expenses,
- projected claims experience, including settlement delays,
- reserving policy, and
- the captive investment strategy.

Once the captive has been created, it is important that the results are still monitored to ensure that the expected benefits are obtained and to review the assumptions which formed the basis for its approval.

Case Study

A substantial European company established an employee benefits captive with a view to realizing increased cost savings. It started reinsuring its employee benefits cover into a captive in 1993. These risk benefits amounted to total cover of around US\$20 million[†] and included the following types of cover:

- life,
- short-term disability,
- long-term disability,
- medical and medical stop loss,
- accidental death and dismemberment, and
- personal accident.

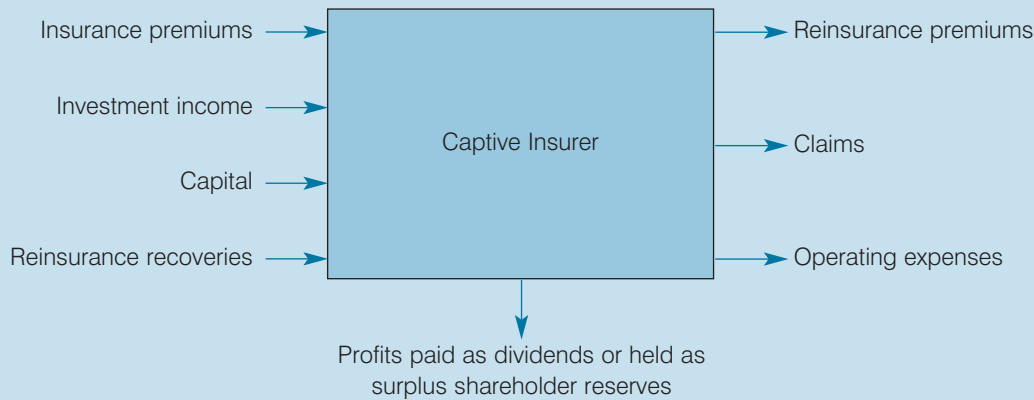
The parent company reviewed the cost savings over the period 1997-2004 to assess the effectiveness of the captive arrangement. During this time it received profits from the captive of US\$8.8 million and expense savings

* For further information, please see ‘Pursuing a Captive Solution’; in the ‘Report on Multinational Pooling and Captives’ by Nigel Goodlad and Chris Burns, *B&C International*, July/August 2007.

† £1 = US\$0.51 €1 = US\$0.65 as at 9 May 2008

FIGURE 1

Typical Cash Flows for a Captive



of US\$5 million on a US\$50 million premium. The savings on the premium are analysed in FIGURE 2 below. Overall, 20% savings on premium were realized, equivalent to US\$10 million. However, some of this was returned as an incentive to local business units in the form of a premium discount. In addition to the achievement of the primary goal of cost savings, other positive outcomes were noted, including:

- the ability to pay 'difficult' claims (for example, not having to accept the rigid definitions of disability used by the fronting insurer); and
- greater tailoring of benefit structure (for example, setting different pre-existing condition requirements).

Although the ride to these favourable objectives was not entirely smooth, most of the difficulties experienced by the parent related to making the change from the existing structure to the captive, and not to ongoing problems. For example, local brokers and insurers applied pressure on local business units to resist use of the captive. Other problems that were encountered (but resolved) included human resources getting to grips with the captive and inefficient re-routing of the captive business from the local units of the fronting insurer.

Other European companies that have taken advantage of captive use for employee benefits include Svenska Cellulosa Aktiebolaget (SCA), the Swedish consumer goods and paper giant, and DHL, the subsidiary of Deutsche Post World Net, and arguably the world's leading postal, courier and logistics company. Although this provides good evidence of interest in captives being translated into action, why hasn't there been more activity? Undoubtedly, the joint involvement of the finance and HR departments causes friction in the process of evaluation and initiation of a captive. It may be that scale plays a part, too. Larger companies are likely to be the ones that are already familiar with captives via the non-life insurance side of the business (motor, employer's liability, product liability, etc.). Those jurisdictions specializing in captives may also have rules limiting the mix of business within a captive with the result that some of the employee benefits business may be excluded from the vehicle used for the non-life business, meaning that a new captive would be

necessary. The cost and effort required to set up a captive could therefore be a deterrent, as might the loss of economies of scale in having to have a separate captive for employee benefits business.

Any vehicle that was able to offer the advantages of captives without the disadvantages would be very attractive. In particular, it would open the door to a wider range of companies, including those that had previously ruled themselves out on the basis of economies of scale. There is at least one vehicle that lays claim to this description: the Protected Cell Company.

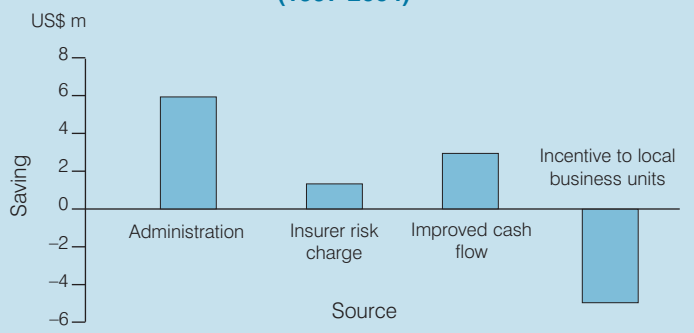
WHAT IS A PROTECTED CELL COMPANY?

A PCC is a single legal entity with the capability of creating separate cells. It provides for the statutory segregation of the assets of different cells. This avoids any risk of contagion between cells by protecting the assets of each cell from the liabilities of any of the other cells. The law, in effect, prevents creditors of one cell from having recourse to the assets of another or the core. However, access to core assets can be specifically provided for by means of a recourse agreement.

The PCC concept originated in Guernsey but has since been copied in various jurisdictions globally. It has turned out to be the fastest-growing vehicle in the captive insurance industry. While many companies are attracted to the captive concept, they cannot financially justify forming their own captive subsidiary and having to bear the full brunt of the capitalization, licensing and

FIGURE 2

Premium Saving by Source (1997-2004)



administration costs. The first PCC did not make its appearance until 1997, but by 2007 European centres had 80 PCCs (a full breakdown by jurisdiction is provided in FIGURE 3 below). However, it is the number of cells that may give a better indication of volume and there were 262 of these in Guernsey alone. To put this number in perspective, it represents more than 25% of the number of captives from all European jurisdictions (1,038) recorded in the same year.

Advantages of a PCC Cell Structure

The employee benefits cell can offer employers similar services and benefits to those available through traditional captives. These include:

- cost savings,
- retention of risk profit,
- greater benefit customization, and
- ability to pay 'difficult' claims.

A cell can be provided as a captive to, for example, a parent employer. The advantage of this approach is that the captive management skills in the core are immediately available but, in contrast to a traditional captive:

- start-up is quicker;
- running costs are lower; and
- less capital should be required.

Multinational pooling is the method with which most global companies will be familiar, where the coverage of employee risk benefits is concerned. To some extent the advantages listed here apply to pooling. However, they generally apply with greater effect to a captive or cell. For example, the profit retained by the insurer can be greatly reduced. There may be other advantages in using a captive or cell, such as the following:

- greater availability of coverage, especially in 'hard' markets;
- retention of control of the cash flows and investment income;
- more immediate rewards from controlling risk;

- a rating structure that may more closely reflect the experience of the parent;
- direct access to reinsurance markets;
- diversification of risks (adding life business to a non-life captive);
- lower risk charges and capital charges;
- possible additional tax advantages (especially in the USA);
- flexibility;
- capacity for uninsured and/or uninsurable risks, e.g. AIDS/HIV; and
- enhanced opportunities for risk retention and premium savings.

For UK-registered companies there is one key technical difference between a PCC cell and a captive. Currently a captive would be considered a Controlled Foreign Company, whereas, under certain circumstances, a PCC cell would not. Central to this is the status of the owner of the PCC.

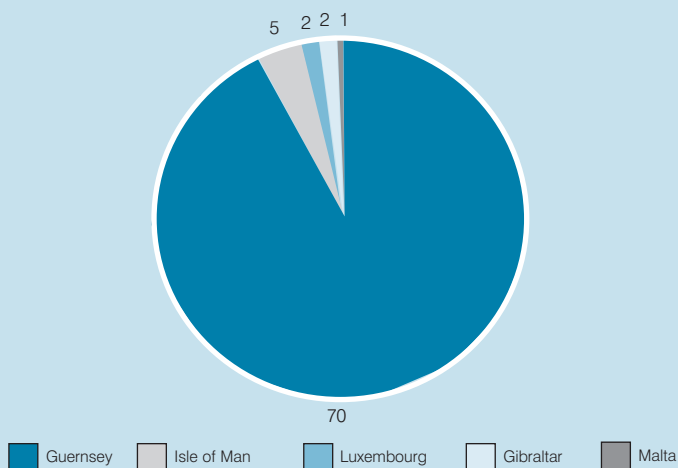
PCC Legislation

Each jurisdiction is responsible for its own legislation as regards PCCs. However, it is worth considering at least one jurisdiction's law for a fuller understanding of how the regulators approach supervision. Guernsey's law is used as an example here, since it was the originating jurisdiction and is the largest European centre of PCCs by some margin.

The Protected Cell Companies Ordinance, 1997 (with subsequent amendment) is the defining legislation. There is no restriction on the placing of employee benefits business in a PCC cell (which mirrors the treatment of captives). However, there is a restriction on the mixing of long- and short-term business within a cell (again, mirroring captives' treatment). In this regard, long-term business includes disability and pensions but, for example, life, medical and accidental death and disability are considered to be short term. For a captive this is of greater relevance, since short-term business could be included within an existing non-life Guernsey captive. Although this would save on time and expense, it may not be the ideal outcome, since the sponsoring company may have preferred to keep these business lines separate, other things being equal. For a PCC structure, setting up a new cell is comparatively cheap and straightforward, so the company could keep employee benefits and non-life business separate with relatively little inconvenience.

The amendment to the original legislation contained useful clarity on the cell's rights – or otherwise – to the core's assets. On the passing of The Protected Cell Companies (Amendment) Ordinance, 2006, the default position was established as there being no automatic right of access of a cell to the core's assets. The PCC's owners could choose, however, to put a recourse agreement in place, allowing a cell right of access to the core. This could be a useful feature for a group company owner of a PCC (for example, one with different business lines in separate cells).

FIGURE 3 Number of PCCs by Jurisdiction (2007)



SUMMARY

The use of captives and PCCs for employee benefits business is comparatively new but there is considerable interest and activity, in both Europe and the USA. There are examples of multinational pooling insurers integrating captives into their pooling structures to improve client service. The key points in summary are as follows:

- A growing number of companies are using captives for employee benefits.
- Most activity relates to the largest companies.
- Both European and US jurisdictions are involved.

- There is considerable scope for growth.
- PCCs may be economically viable where a captive would not be.
- PCC cells should be more cost effective in implementing requirements to segregate long-term from short-term business.
- PCCs offer most of a captive's advantages and reduce the number of disadvantages.

The scale of growth in the next few years could be dramatic. Ω