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With employee benefits posing some significant costs, **Walter Ralph** and **Brian Quinn** of **Granite Management** examine the use of a captive reinsurance solution to cover this increasingly important issue

WALTER RALPH, director of Granite Management, specialises in assisting companies with implementation and management of a captive reinsurance arrangement for financing their global employee benefit programmes. Formerly, he worked for General Motors with responsibility for non-US employee benefits.

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Implementing a captive reinsurance arrangement for the financing of a multinational company's international employee benefit programmes takes time and effort, but it is time and effort well spent. Savings can easily be in the range of 15% to 20% and one of our clients has been saving in the neighbourhood of 35% off the former cost of the programmes for several years now.

The cost of employee benefit programmes is not obvious at the outset. Cost drivers are generally not well understood and if not managed properly employee benefits can become very costly indeed. The true cost of a benefit programme begins with the benefit promise itself. Compensation and benefit professionals need to promise what they must in order to attract and retain appropriate staff for their organisation. To do less is a disservice to their employer. But be mindful of the adage 'be careful what you promise, you will have to pay for it'.

In the area of risk benefits (life, health, disability and so forth), it is easy to deceive yourself that by buying insurance you have transferred the benefit obligation to the insurance company. Nothing can be farther from the truth. The insurance company is providing you with a service and that service is annual budget certainty. You pay for this service through the risk charge and profit element that they include in the annual premium calculation. But don't expect the insurance company to subsidise the benefit promises you make to your employees. Over time, the sum total of annual premiums paid will exceed the cost of employee claims. This isn't a criticism of insurance companies; they must make a profit in order to stay in business and they do this by providing companies with annual budget certainty.

When you think about it, the benefit promise to employees is simply that their claims will be paid – nothing more and nothing less. This is all that employees value, so why would a company pay for more if they didn't have to? But in addition to paying for claims, premiums paid to insurers include frictional costs such as insurance company profit, broker fees, and risk charges, to name a few. These are appropriate if a company needs to buy annual budget certainty in addition to paying for employee claims, but are unnecessary expenses if a company can achieve budget certainty in some other fashion.

Therefore, the goal is to find a way to provide annual budget certainty without having to pay for it. Companies with large concentrations of employees can achieve this through self insurance in many cases. However, companies for which self insurance is inappropriate, either due to lack of size in any one location or legal restrictions, can still dramatically reduce the cost of their risk benefit promises by reinsuring the risk into a captive reinsurance arrangement. Through the captive arrangement, companies achieve economies of scale and smoothing of risk volatility by aggregating the risk associated with the various benefit promises made to employees in many different countries around the world into one risk profile, much as an insurance company does. Importantly for compensation and benefit professionals, the terms and conditions of the various programmes do not need to be the same. In fact, from the employees' perspective, there does not need to be any change in the value of the locally competitive benefit promise. This point bears emphasising to human resource professionals who have only experienced cost reductions through deterioration of benefit terms and conditions (such as lowering the value proposition for the employee).

Captive reinsurance arrangements for employee benefits have many advantages:

- Reduced cost of employment through:
  - Elimination of insurance company risk and profit charges
  - Elimination of broker fees where these are not legally required or value added
  - Reduction or elimination of other frictional costs

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"THE BEST CAPTIVE REINSURANCE ARRANGEMENTS START WITH A PARTNERSHIP BETWEEN THE MULTINATIONAL COMPANY'S HR AND RISK MANAGEMENT DEPARTMENTS"

- Improved corporate governance due to centralised control of employee benefit promises

– Detailed reports/claims data
– Better understanding of any latent liabilities

- Ability to actively manage premium cashflow

– Investment income further reduces the cost of providing the employee benefit

The best captive reinsurance arrangements start with a partnership between the multinational company's human resource and risk management departments. Once all parties are on board, setting up a captive programme requires first that you select a global fronting insurer or insurers. Your fronting insurer should have a global footprint that matches or nearly matches your own. In addition, you need to assess the competitiveness of the global network charges and local fronting insurer administrative charges. Importantly, you will want a network insurer who is willing and able to transfer 100% of the risk into your captive arrangement in order to give you maximum ability to reduce the premium charge to a level that covers claims, plus administration costs and nothing more. Next, you must negotiate an appropriate reinsurance agreement with your chosen fronting insurer covering such things as:

- Ceding commission
- Quarterly and annual accounting preparation and timing
- Audit rights – management reporting on claims

Next, you should assess whether or not any other charges such as brokers, consultants and third-party administrators are value-added. In a captive arrangement, all you need is a fronting insurer and someone who can provide the local administration. Usually the administrator will be the local arm of your fronting insurer, but in some cases it may be another party.

Once the global structure has been developed, each individual employee benefit contract needs to be included in the programme. In theory, this is rather straightforward. However, in practice there are differences from country to country. Some of these differences are cultural while others are legally required. It is also a good idea to engage local leadership (local human resource and finance, union leaders, works council members, trustees and so forth), especially if you need to change local benefit administrators.

As the reinsurer, your captive arrangement will have final say over the annual premium to be charged to each local unit in cases where you are retaining 100% of the risk. You can either establish a rate designed to reduce local unit costs as much as possible or a rate which allows a small profit in your captive arrangement. Either way, the savings are accruing to your company. In those situations where less than 100% of the risk is ceded to the captive, your ability to dictate the amount of premium to be charged is somewhat marginalised, but where you have at least 80% of the risk the captive's underwriting philosophy should still be controlling.

While this all seems like a lot of work – and it is – the benefit to your company should be well worth it. Some captive reinsurance arrangements are saving up to 35% of the annual premium formerly paid. Conservatively, a company should be able to save at least 20% of former premium paid, representing an annual savings of $2m for every $10m of annual premium. And, again, we want to stress that the saving is achieved without making any changes to the benefit terms and conditions. It is all money you are leaving on the table.