Use of Captives to Share Pension Annuity Risk



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Most Risk Managers use captives to manage property, casualty and hazard risks at the Enterprise level. Increasingly, there is significant interest among Risk Managers to use captives to insure employee benefits. The purpose of this article is to raise awareness of the use of captives among pension actuaries. This article addresses an emerging approach to using a captive to purchase annuities from an insurance company and ensure that the plan sponsor also participates in any potential investment and mortality experience gains.

Defining the Problem

In Canada, most mature Defined Benefit retirement plans have actuarial liabilities in respect of inactive members (i.e., retirees and beneficiaries in payment mode and terminated vested members), which are a significant proportion of the total plan (active and inactive members) liability. The inactive liabilities are projected to increase and likely to exceed the active liability, as the number of retirees increase with the aging of the "boomer" cohort and the closure of Defined Benefit plans continues. Plan sponsors are reluctant to purchase annuities to settle these inactive member liabilities, as the cost of purchasing annuities from insurance companies is deemed to be high, due to conservative profit margins in the pricing of these annuities. Even if the price for purchasing these annuities was "right," most plan sponsors view this as an opportunity lost on potential gains on investment and mortality.

Companies (that are not plan sponsors to multi-employer Defined Benefit plans) fulfill dual roles as plan sponsor and fiduciary/administrator of the Defined Benefit. As a plan sponsor and with the advent of the International Financial Reporting Standards (IFRS) accounting rules, companies are desirous of settling some of their inactive member liabilities, in order to reduce the interest rate volatility and mortality actuarial gains and losses from their comprehensive income statement and balance sheet. As a fiduciary/administrator, prudence would dictate that a portion or all of the pension payouts for individuals, should be diversified and insured by the purchase of annuities.

Over the next 10 to 15 years, Defined Contribution plan members will retire from these plans, which were established in the 1990s. In the absence of an option to purchase annuities from the plan, the current prevalent options are the use of Life Income Funds and Locked-In Retirement Accounts. Again, prudence would dictate that individuals retiring from Defined Contribution plans, insure and secure a portion of their retirement income by purchasing annuities.

The Captive Solution

Most recently, traditional annuity providers, mono-line insurers and other financial institutions in the UK, were clamouring to take the plan (active and inactive) liabilities off the plan sponsor's balance sheet – the "full buy-out" approach. As yet, there is no buy-out market for pension liabilities in Canada. Plan sponsors can manage pension annuity risks using liability-driven investments, longevity bonds, swaps, etc., or by transferring pension annuity risk using bulk annuity purchase; however, the transfer of

pension risk is regarded by many plan sponsors as expensive, and a loss of control and opportunity. The use of a captive provides a plausible approach to maintaining some control, and gain from future opportunities of good investment and mortality experience.

Captives At-A-Glance

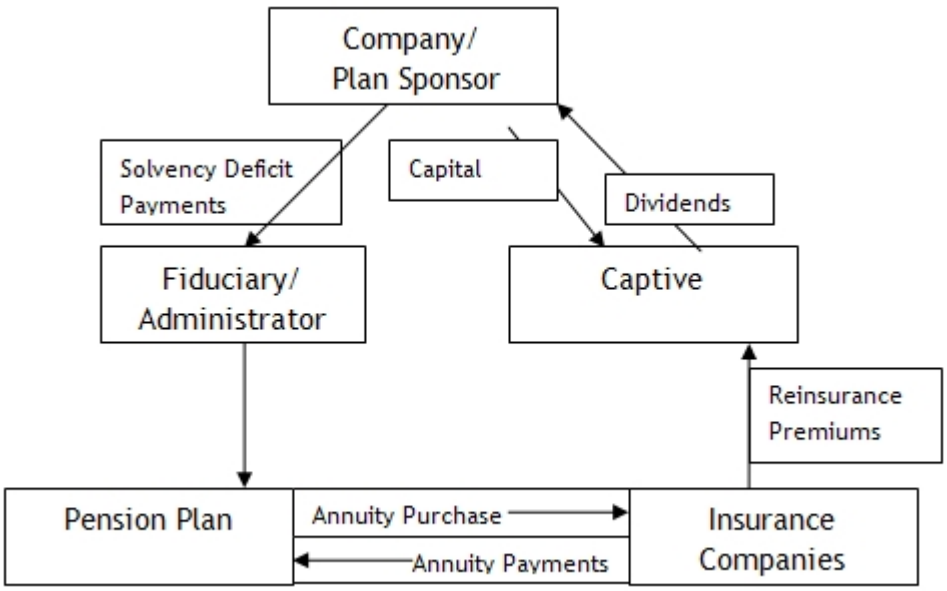
A captive is a bona fide Insurance or Reinsurance Company established by the company (the principal owner) to finance risks emanating from its operations, or insure risks from related parties. The word "captive" comes from the fact that the principal owner is the policyholder/company, that is, the insurer is "captive" to the policyholder/company.

Captives can be Canadian or offshore. British Columbia (www.bccia.com) has captive-friendly legislation, which would be suitable for use of captives for managing pension risk in Canada.

Most captives that extend outside of British Columbia are "fronted." This means that a licensed insurance company is used to issue the policy to the insured, and a reinsurance agreement is entered into between the licensed insurance company and the captive.

The fiduciary/administrator purchases bulk annuities or single premium annuities for inactive plan members or retiring defined contribution members, from highly rated and licensed insurance companies. It is important that pension annuities are purchased from two or more insurance companies, and the pension annuity from each insurance company is limited to no greater than $2,000 per month; this ensures that pension annuities for each plan member are 100% guaranteed, since pension annuities up to $2,000 are fully insured by Assuris (www.assuris.ca). Each of these insurance companies reinsures all, or a portion (as agreed to by the plan sponsor and insurance companies), of the bulk annuities with the captive.

Structure of Captive



The captive approach provides several key advantages:

- desired level of pension annuity risk remains with the plan sponsor; however, this risk is transformed into a corporate risk within the captive;
- distributable profit may emerge from the captive, which can eventually be paid out as dividends;
- the plan sponsor settles the pension liabilities for inactive members and removes these liabilities from the balance sheet, thereby reducing the volatility due to interest rate and mortality;
- the plan sponsor reports and consolidates the financial information for the captive, using corporate accounting rules;
- pension accounting rules would not be applicable to the captive;
- the plan sponsor continues to have some control on the investments since all, or the bulk, of the annuities are reinsured with the captive;
- the inactive plan members receive a 100% guarantee on their pension payouts. In fact, the inactive members get a "triple" guarantee from the highly rated insurance companies backed up by Assuris and the plan sponsor via the captive;
- if the captive is used to manage risks other than pensions, that is property, casualty and hazard risks;
  - the incremental set-up and ongoing costs of including pension risks into the captive would not be as onerous as the original set-up and ongoing costs,
  - the long-term structure of pension liabilities contributes to the diversification profile of the captive;
- there may be tax advantages for an offshore captive structure. Offshore captives are usually exempted from income taxes in the offshore jurisdiction; however, it is important to ensure that the captive is not subject to Canadian income tax based on residency –"mind and management" test. That is to say, if management exercises decision-making from Canada, then the captive could be deemed to be a Canadian company for tax purposes.

Unfortunately, the above advantages come with some significant disadvantages. The plan sponsor has to establish the captive with seed capital, ensure that there are sufficient solvency reserves to secure the reinsurance annuity risk and clearly understand its risk tolerance appetite. Also, if the pension plan is in deficit, solvency deficit payments would be required for the initial bulk annuity purchase. Since the annuities are purchased from an insurance company, it is unlikely that there will be any regulatory issues; however, it is prudent that the plan sponsor seek the necessary approval from the pension regulators.

Pension actuaries should increase their awareness of the use of captives and other alternate risk transfer approaches for managing pension risks. Employee benefit actuaries may also wish to consider the use of captives for insuring post-retirement benefits, long-term disability and other company-sponsored benefits in Canada. Actuaries should be working closely with the company's Risk Manager and Legal Counsel to determine the feasibility of establishing and using captives for managing pension and benefit risks.

The opinions expressed in this article are the author's personal views and should not be attributed to his colleagues, employer or the CIA Enterprise Risk Management Applications Committee.

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