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EXPLAINED GUIDES

CAPTIVES AND UNDERSTANDING CAPTIVES

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AON

Acknowledgements

Airmic would like to thank Aon, who has prepared this paper on behalf of Airmic.

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Richard Cutcher
Captive Ambassador, Airmic
Richard is an experienced writer and commentator on the global captive insurance market, having spent five years as Editor of *Captive Review* from 2014 to 2018. He joined Airmic in 2019 as its Research & Development Manager and today runs its vibrant Captive Special Interest Group. Richard also runs the Global Captive Podcast, providing up-to-date commentary on the international captive market.

About Airmic
The leading UK association for everyone who has a responsibility for risk management and insurance for their organisation, Airmic has over 450 corporate members and more than 1,300 individual members. Individual members include company secretaries, finance directors, internal auditors, as well as risk and insurance professionals from all sectors. Airmic supports members through training and research; sharing information; a diverse programme of events; encouraging good practice; and lobbying on subjects that directly affect our members. Above all, we provide a platform for professionals to stay in touch, to communicate with each other and to share ideas and information.

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EY and Ince & Co
This is the second edition of the Captives EXPLAINED Guide. The first was published in 2016 with the support and input of EY and law firm Ince & Co. Much of the content from 2016 remains relevant today and we thank EY and Ince & Co for their insight and commentary

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01 Executive Summary

In an increasingly dynamic, constantly evolving and volatile marketplace and risk environment, the need to manage risk is critical.

The hardening global insurance market that began in 2019 has brought the topic of captives back to the forefront, and while their uses continue to evolve, the fundamentals of good captive practice remain much the same.

A captive insurance company is a risk financing mechanism in the form of an insurance or reinsurance vehicle, which is typically owned by a business. Through the provision of insurance products, the captive assists the business in the management of its risks. The captive insurance company has become an increasingly prominent risk control mechanism in the medium to long-term strategic planning of organisations ranging from large multinationals to medium-sized enterprises, spanning virtually every industry sector and international territory. Fuelled in part by an expanding number of jurisdictions authorising captives, there are now around 6,000 active captives globally.

This guide will take you through the life cycle of a captive from initial concept through to its benefits and uses, and finally to exit strategies. It is intended to be used by Airmic members starting out on their career in the profession, or by those who may wish to share knowledge with their business colleagues in areas such as procurement, finance, human resources and internal audit.

The following topics will be covered:

- What is a captive?
- What are the most popular locations and industry sectors for captive?
- What are the different types of captives?
- Why do organisations create captives?
- Setting up a captive
- Captive management and governance
- Developments in the use of captives and emerging trends

This is by no means a definitive guide; however, we hope it will go some way to answering these questions and to helping you understand the world of captives and how they may work for your organisation.

01 EXECUTIVE SUMMARY

02 What is a captive?

The how, what and why of captive insurance

2.1 What is the purpose of a captive?

A captive insurance company is a risk financing mechanism in the form of an insurance or reinsurance vehicle, which is typically owned by an organisation. Through the provision of insurance products, the captive assists the business in the management of its risks by doing any or all of the following:

1. Managing volatility through a dedicated vehicle

2. Making risk protection more efficient and effective

3. Providing more efficient and effective employee benefit programme support

4. Enhancing the organisation's ability to take advantage of the commercial (re)insurance market.

A captive belongs to a corporation or group and underwrites or reinsures primarily or exclusively the risks of companies belonging to that group.

The name 'captive' was coined in the 1950s, when the concept was being brought into practice for a mining company. A mine producing output that is kept solely for its own use is referred to as a 'captive' mine. When the mining company incorporated its own insurance company, it was referred to as 'captive' insurance as it wrote business exclusively for the captive mine.

Initially, the captive insurance company was viewed by the major insurers as a competitive threat. The UK insurance market was still controlled by the major tariff insurers and the new era of globalisation and competition was in its infancy. Most insurers now work co-operatively with captives, recognising that each has a different appetite for risk.

Captive insurance companies were very much a product of the volatile insurance markets of the 1970s and 1980s and were originally set up by companies looking to manage their rising primary insurance costs. Setting up one's own insurance captive as a subsidiary was seen as a cost-effective alternative to fully insuring risks with the commercial market, rather than retaining a proportion of the risk and only transferring the risk above the group's risk appetite or tolerance. Other advantages could include bespoke coverage, claims settlement certainty and potentially tax advantages.

Due to the location of many captives in domiciles that provided low tax rates, a perception can arise that captives are tax planning tools. This is generally not the case and captives are now viewed as a focus for risk management and to facilitate risk financing.

Captives are increasingly being used to address risks for which organisations find it difficult to obtain cover from traditional forms of insurance and that are above the organisation's risk appetite.

Common characteristics of a captive include:

- Licensed insurance entity subject to regulatory supervision
- Capitalisation requirements
- Underwriting and claims function
- Accounting function
- Investment function
- Statutory reporting
- Audit requirements
- The operational management activities and functions of a captive are often outsourced to a management company.

2.2 What are the various types of captives?

Multiple variations of captive insurance arrangements have emerged over several decades, including, but not limited to:

Single Parent Captives or 'Pure' Captives
These insure the risks of the owner or its subsidiaries. Some can also cover the risks of unrelated entities, although such risks are usually associated with the group in some way, for example, their customers or suppliers.

Group/Association Captives
These are owned by multiple unrelated entities and are designed to insure the risks of the different entities. An association captive usually insures the risks of entities in the same or similar industries. Some group captives can also insure organisations other than the owners.

Risk Retention Groups (RRGs)
These are a particular form of group captive and operate in accordance with the Liability Risk Retention Act (LRRA). RRGs are unique to the United States' insurance market and are limited to writing liability coverage for the owner(s)/insured(s).

Rent-a-Captive
This is a dedicated underwriting account formed within an insurance entity that allows other organisations to use the facility for a fee as a quasi-captive without the need to establish their own company.

Cellular Captive Companies
These can be used as rent-a-captives, fronting solutions or special purpose vehicles (SPVs). A sponsor will form the cellular company and provide licensing and operational services, with each (usually unrelated) participant having the rights to a cell that is legally segregated from the other cells. They allow a captive to segregate the accounts of each individual insured party so that each account is financed by the insured party and is protected from the liabilities of other accounts within the captive. They are typically located in international finance centres, such as Guernsey, Isle of Man, Bermuda, Cayman Islands, Gibraltar or Malta, although the principles are now adopted more broadly, most notably in the United States. Cell captives can be called slightly different names depending on the domicile, but the most common are Protected Cell Company (PCC), Incorporated Cell Company (ICC), Segregated Portfolio Company (SPC), Segregated Account Company (SAC) and Sponsored Captive.

Agency Captives
These are usually owned by insurance brokers to insure an element of their clients' risks, allowing brokers to participate in the profitability (or have accountability for losses) of the business they place, and are often established as a rent-a-captive or cellular captive structure.

2.3 What types of risk does a captive typically cover?

In principle, any risk can be covered through a captive structure. Popular types of risk covered within a captive structure include professional indemnity and other commercial insurance – property, casualty, business interruption, employer's liability and environmental liability.

However, captives are now starting to focus on new and emerging risks not covered by their conventional insurance policies, for which it may be difficult to fill primary coverage from carriers at acceptable rates. The spend so far has been relatively small, but levels of interest in cyber-crime liabilities and reputational/corporate crisis exposures are high and growing. The complex nature of both wordings and losses is the major current impediment.

Traditional risk lines:

- Deductibles and self-insured retention programmes
- General and other professional liability
- Product liability
- Motor vehicle insurance – property damage and third-party liability
- Property and casualty risks, including UK employers' liability and US workers' compensation.

Non-traditional risk lines or newer coverages:

- Employee benefit programmes, including life, medical, short-term disability, long-term disability
- Cyber-crime liability
- Contingent business interruption
- Non-damage business interruption
- Reputation risk
- Credit risk
- Terrorism or acts of war.

According to Aon (Figure 1), approximately 20% of the top 50 global risks are insurable, with 36% partially insurable. The remaining 44% of risks are not currently considered to be insurable, paving the way for strategic risk financing and captive insurance solutions.

Aon's findings in Figure 2, from the 2019 Aon Global Risk Management Survey, show the key types of risks underwritten by captives globally. Property and casualty continues to represent the main insurance class underwritten. An interesting observation would be the spread of risks being covered by captives, highlighting an important strategic benefit of captive utilisation in that they have the potential to cover risks not traditionally covered by the commercial insurance market.

> **As captives become more sophisticated, they are writing more non-traditional and emerging lines of insurance**

Figure 1 Captives and insurability

1 Economic slow down / recovery	2 Regulatory / legislative changes	3 Increasing competition	4 Damage to reputation / brand	5 Failure to attract or retain top talent	6 Failure to innovate / meet customer needs	7 Business interruption	8 Commodity price risk
9 Cash flow / liquidity risk	10 Political risk / uncertainties	11 Exchange rate fluctuation	12 Technology failure / system failure	13 Third-party liability	14 Distribution or supply chain failure	15 Capital availability / credit risk	16 Weather / natural disasters
17 Property damage	18 Cyber / Computer crime / hacking / viruses / malicious code	19 Consequences of corporate governance / compliance	20 Counterparty credit risk	21 Lack of technology to support business needs	22 Inadequate succession planning	23 Failure of disaster recovery / BC plan	24 Crime / theft / fraud / employee dishonesty
25 Injury to workers	26 Workforce shortage	27 Merger / acquisition / restructuring	28 Environmental risk	29 Loss of intellectual property / data	30 Failure to implement strategy	31 Interest rate fluctuation	32 Globalisation / emerging markets
33 Directors' & Officers' personal liability	34 Understaffing	35 Product recall	36 Corporate social responsibility / sustainability	37 Climate change	38 Absenteeism	39 Social media / asset value volatility	40 Share price volatility
41 Unethical behaviour	42 Pandemic risk / health crisis	43 Outsourcing	44 Terrorism / sabotage	45 Pension scheme funding	46 Sovereign debt	47 Harassment / discrimination / kidnap / extortion	

Uninsurable Insurable Partially insurable

Figure 2 Current risks underwritten in a captive or cell within a PCC by region

Industry	Yes (currently)	Yes (within the next three years)	No
Agribusiness	15%	7%	78%
Aviation	11%	7%	81%
Banking	26%	2%	72%
Beverages	11%	6%	83%
Chemicals	27%	0%	73%
Conglomerate	23%	2%	75%
Construction	20%	6%	75%
Consumer goods manufacturing	24%	1%	74%
Education	17%	0%	83%
Energy (oil, gas, mining, etc.)	26%	3%	71%
Food processing & distribution	10%	1%	88%
Government	0%	0%	100%
Healthcare	26%	0%	74%
Hotels & hospitality	4%	16%	80%
Insurance	13%	3%	84%
Investment & finance	10%	5%	86%
Lumber, furniture, paper & packaging	14%	5%	81%
Machinery & equipment manufacturers	16%	3%	81%
Metal milling & manufacturing	13%	2%	86%
Pharmaceuticals & biotechnology (life sciences)	31%	6%	64%
Power/utilities	21%	3%	76%
Printing & publishing	13%	13%	75%
Professional & personal services	12%	5%	82%
Real estate	16%	5%	79%
Restaurant	11%	11%	78%
Retail trade	24%	7%	69%
Rubber, plastics, stone & cement	5%	0%	95%
Technology	14%	5%	81%
Telecommunications & broadcasting	22%	0%	78%
Textiles	0%	0%	100%
Transportation manufacturing (non-aviation)	17%	7%	76%
Transportation services (non-aviation)	15%	3%	82%
Wholesale trade	6%	4%	90%

CASE STUDY 1

US beverages distribution business - Risk-funding platform

Challenge: The company had many uninsured exposures and wanted to build a platform to fund for these risks.

Solution: Nevada-domiciled small captive was created and adequately capitalised for uninsured environmental, product recall, accidental contamination and terrorism (NBCR), with significant economic savings.

03 A brief overview of the captive insurance market

Captive domiciles and the driver of new formations

3.1 Where are captives typically located and which industries do they cater to?

There are more than 6,000 captives established globally, writing over $140 billion in gross premiums annually and with $408 billion in assets under management (Source: Statista, 2015).

The majority of captives are located in the Americas, with the top 5 domiciles by number of captives (ranked by number of captive licences at year-end 2019) situated in the region. Bermuda, Cayman Islands and Vermont are the predominant captive domiciles, but an increasing number of states are promoting and welcoming new captive formations, ensuring a greater spread across the United States.

Guernsey, Luxembourg and the Isle of Man are the largest European captive domiciles, with Singapore the only representative from the Asia-Pacific region in the top 20. Labuan, a mid-shore jurisdiction connected to Malaysia, is the fastest-growing domicile in Asia.

Eight major industry segments control 77% of global captives by entity – financial institutions, healthcare, retail and consumer products, manufacturing, power and utilities, construction, transportation and tech & telecommunications.

Remarkably, for many years, the same top 8 industries have continued to hold the same top spots for captive use. However, the captive market has seen both growth and change when premium volume by industry is considered instead. Organisations working in the life sciences sector predominantly use captives for programme control and co-ordination along with the need to attain cover for difficult coverages, for example, clinical trials.

Since these organisations tend to be very large, diverse and global, a captive serves as a central risk financing vehicle for their usage. Similarly, life sciences companies have significant volumes of premiums and capital within their captives, resulting from the need for product liability, product recall and other lines of coverage.

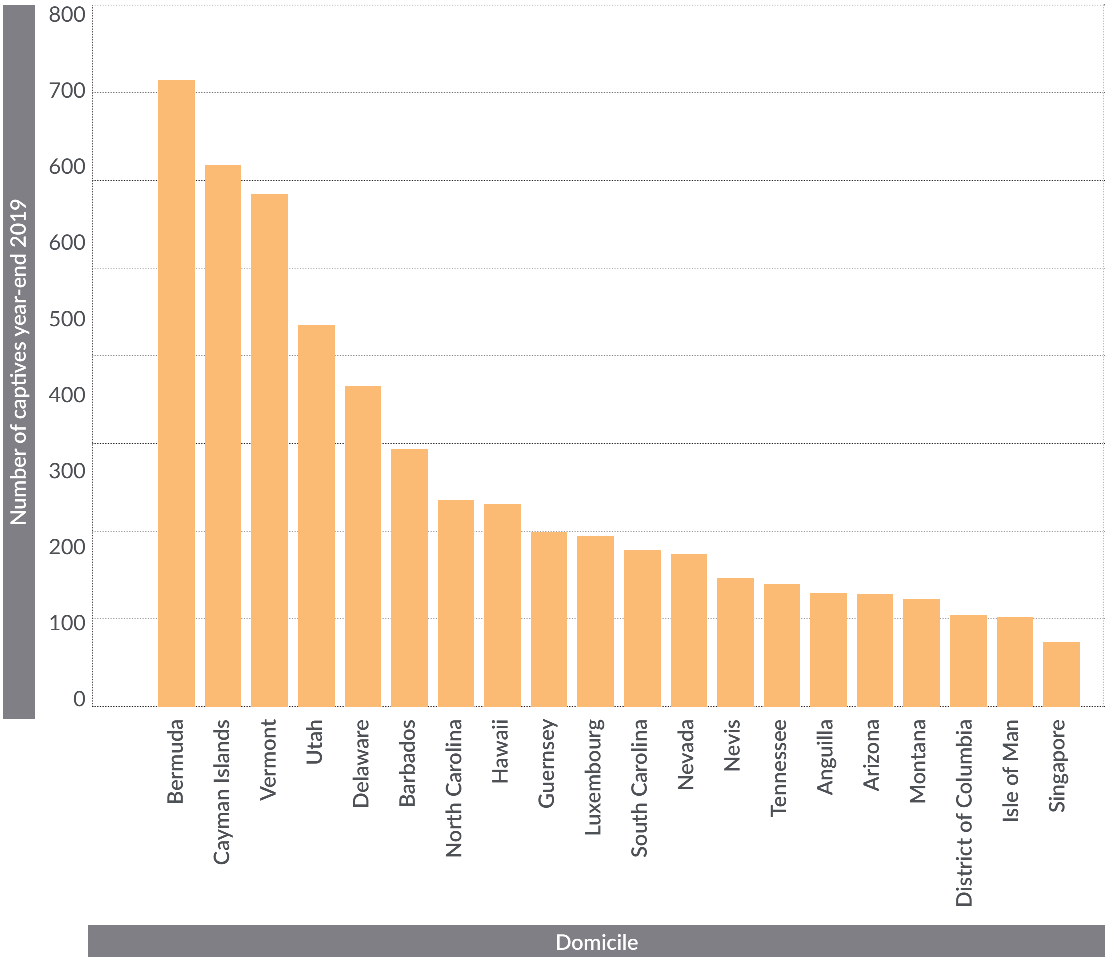
Retail companies prefer to capitalise by leveraging their captives to fund certain costs (claims from warranties, for example), as opposed to transferring these to a third party, as this would involve a fixed cost that is higher than what they may have had to assume via a captive set-up. Retail firms may also prefer to use their captives to hedge the risks arising in their supply chain by writing supplier programmes via their captive.

As opposed to the cost-focused approach that retailers adopt, manufacturers prefer to place reliance on their captives to assist with the day-to-day operational requirements such as administration and processing of claims, with a view to optimising turnaround times in addition to a desire to lower the cost of claims.

The use of captives in the healthcare sector is gaining popularity because companies can leverage their captives to provide cover on a layered basis – with the captive insuring the primary stop loss layer, which could be tapped into before using the external insurance cover. Here, since the attachment point of the external stop loss cover is relatively high, it would help the company save on costs, while also still providing protection from claims of high value.

A similar trait is observed in the energy and construction segment wherein the captive assumes a primary layer and reinsures via excess layer/s. In some cases, the captive may also choose to act as a reinsurer for the layer in excess of the primary and

Figure 3 **Busines Insurance Captive Directory 2020**



retrocede a further layer into another reinsurer, the overall objective being to reduce costs and exposure to loss.

With the acceleration of technological advancements, including emerging digital risks, a new tranche of industries has entered the market seeking insurance coverage for new types of risks. This has been made more relevant due to the current hard market, which has accelerated since 2019.

Procuring PI and custodian insurances for blockchain companies is one example. The limited history of this industry presents the commercial insurance market with many challenges from pricing risks to developing policy wordings. As such, risk financing vehicles such as captive (re)insurance companies provide alternatives to purchasing insurance.

3.2 Why are captives formed?

An organisation may consider utilising a captive insurance company for various reasons including:

Access to capacity and coverage
That would otherwise be too costly or not available elsewhere.

Lower insurance costs
When the costs of insuring the risk in the commercial insurance market are considerably higher than the expected cost of claims.

Cash flow
As premiums are paid to an affiliate, money remains available to the group until a claim becomes payable (i.e. it is not paid to a third party). This enables better/more proactive inter-company cash management, including:

- Intercompany financing
- Cash/profit pooling
- Interest rate arbitrage.

Flexibility
By retaining the primary layer within the captive and reinsuring the excess layer, premium savings could be made due to a risk transfer being effected at a higher attachment point where claims are less likely to occur. Albeit, assuming risk at the primary layer also means accepting more risk.

Deductible buy-down
This allows operating companies within the organisation to be fully insured and benefit from insurance with low deductibles, which might be required for contractual or regulatory reasons.

Enables a group to insure customers' risks
This can turn the captive into a source of revenue and also strengthen customer relationships. Product lines might include:

- Extended warranty
- Insurance for accidental damage, theft, loss, etc. for goods sold
- Payment Protection Insurance.

Stability of insurance costs, cover and service
To provide consistent and sustainable support to the business.

Access to the reinsurance market
Directly rather than through the commercial insurance market.

Centralising data can be particularly important on employee benefit programmes but has relevance across all lines.

Facilitating the **incubation of unusual risks** (e.g. patent insurance) internally within the organisation, enabling a claims history to be developed with the aim eventually to obtain external insurance.

Driving risk management strategy. This might include:

- Research on new and emerging risks
- Feasibility studies for new risk programmes for the captive
- Funding loss control within the business.

Use of a captive may provide **efficiency in pricing** through access to the wholesale market.

Some domiciles offer significant **investment flexibility** to pure captives.

CASE STUDY 2

US car rental business – Pricing improvement

Challenge: The company hoped to gain greater control of its collision damage waiver product and capture a greater share of its economic value where it sold a third-party insurer's product and received a basic commission.

Solution: A captive was established that used the company's in-house call centre and IT systems to gain greater control of product design and pricing, and to capture profit previously leaked to commercial insurers. The business was able to reduce its programme expenses, with an increase in its revenue of over 50%.

3.3 How do you know a captive is right for your organisation?

The need for a captive stems from the nature of the business risks, the business strategy, the products under consideration, the magnitude of risk, as well as its frequency and severity, and the ability of the business to retain/absorb its insurable risks.

Here are some key questions that a business needs to ask itself when considering whether a captive would be an appropriate risk transfer mechanism:

- Is your insurance spend greater than £1 million per annum?
- Do you have a risk management strategy and philosophy as well as an appetite for self-insurance?
- Does your organisation believe it is paying a premium for insurance coverage that does not accurately reflect the risks it presents?
- Does your organisation have the balance sheet and capital strength to support material retention of risk?
- Does your organisation have good loss ratios and / or predictable claims profile?

The use of a captive should be considered for entities that meet the following criteria:

- Businesses with international exposures and/or complex corporate structures (multiple operating entities)
- Businesses with insurance premium spend of £1 million or more per existing insurance coverage
- Businesses with requisite risk currently uninsured or underinsured

It is important to note that setting up a captive requires a long-term commitment in order to fully capitalise on the many benefits. Going forward, captives will be required to have much more significant capital, resource and cost bases than previously, and they will therefore tend towards having more relevance for organisations with larger and more complex risk portfolios, especially those with large external and internal liability exposures.

The captive will be an important part of the overall risk management structure of the business and the business plan for the captive should recognise the overall risk approach of the business. It is usual for the role of the captive to have visibility at the highest levels within the organisation so that risk management actions and activities are aligned. Also investment, audit and financial reporting for the captive should be part of the business as usual structure.

3.4 What are the potential advantages and drawbacks of a captive?

Figure 4 The pros and cons of captive insurance

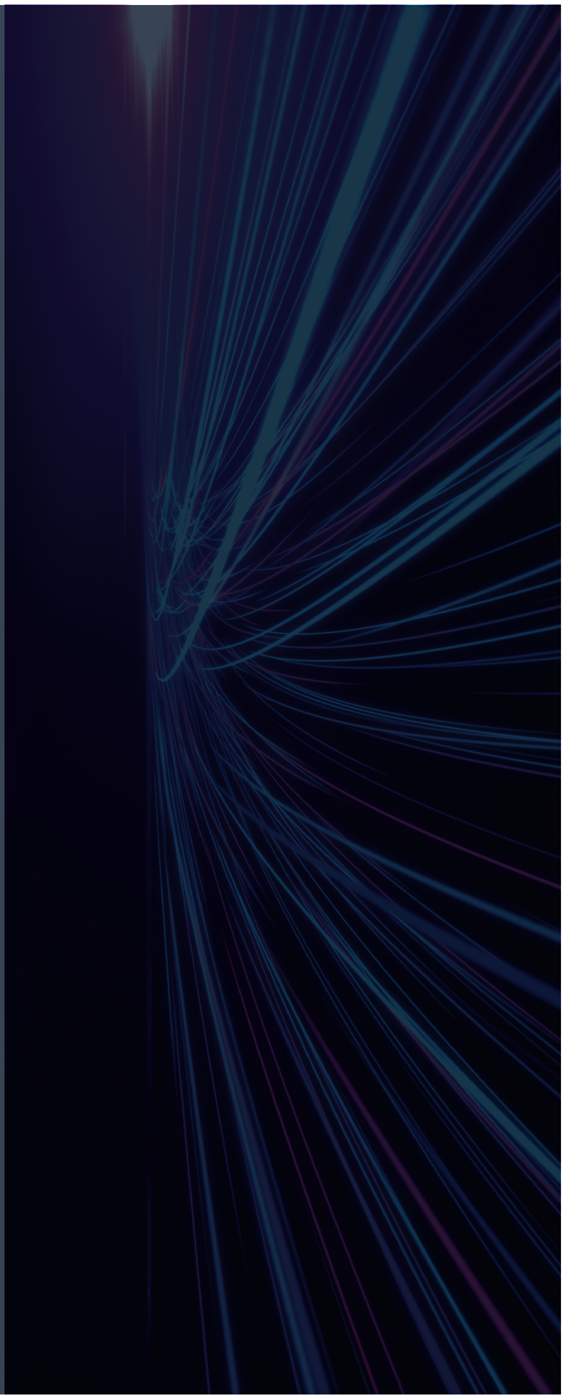
Advantages	Drawbacks
Cover for risks that are unavailable or expensive in the commercial market.	Capitalisation required.
Enhanced organisational view of costs and benefits of risk management, including visibility and standardisation of benefits globally.	Once a captive is established and operational, it can be difficult to completely close down.
Accumulation and segregation of risk funding.	Inadequate loss reserves and potential losses will erode group capital rather than external capital.
Incentives for loss control and immediate benefits for controlling losses.	Administrative costs and ongoing management time associated with setting-up, managing and running the captive.
Investment income and underwriting profit retained within the group.	
Additional profits from insurance products for customers.	
Equitable pricing of premium based on own risks and capture of profitable underwriting.	Exposure to volatile risk and underwriting loss.
Improved service through unbundling providers.	Insurance premium tax when covering a previously uninsured risk.
Access to reinsurance and assists negotiation position when engaging with commercial insurers, i.e. to access more wholesale insurers for group risk.	Regulator in domicile unable to respond to changing business requirements of captive and parent.
Additional focus on risk management and control as group is now responsible for risks. Also allows for increased control of claims.	Choice of domicile is important as some domiciles may attract more attention from tax or other authorities.

CASE STUDY 3

Global energy business – Insurance spend reduction

Challenge: The company had grown substantially over time and had diversified geographically. Management felt that the historical risk appetite was too conservative and wanted to take advantage of its strong risk management ability.

Solution: Establish a Barbados captive that allowed the parent to increase its risk retention according to its risk appetite and substantially reduce external insurance premium spend. The company was able to reduce external insurance premium spend by 25%, tie the captive strategy into the organisational goal of continuous improvement of risk management, and align corporate and divisional appetites for key insurable risks.



3.5 What are some typical examples of captive structures?

Captives have traditionally been used as retention and cession vehicles for their parents' property and casualty programmes, where the captive retains a portion of the primary layer (above any business unit retention) and any exposure above this would be transferred into the (re)insurance market in the form of excess layers. The captive might also participate further up the tower in some capacity, particularly if there are any gaps in the excess layer placement.

The various **entities** in a captive insurance programme include the following:

Insured party/company
The ultimate end user seeking insurance cover.

Captive insurance company
The self-insurance vehicle created by the insured party to retain, manage and mitigate its insurance risk. This company may either assume the role of a primary insurer or a reinsurer, depending on the structure of the insurance programme.

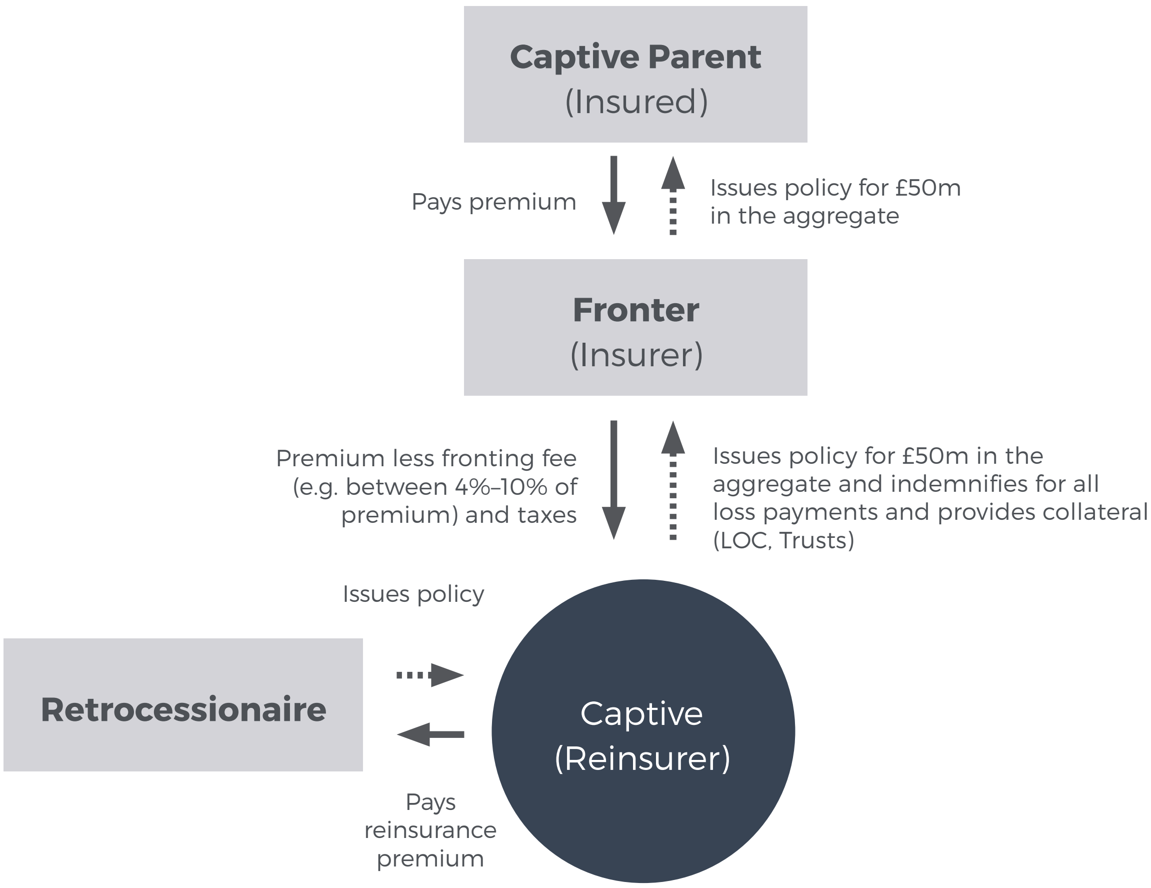
Fronting company
Refers to the insurance company, which may be involved in a facilitator role to help with the logistics of the placement. The fronting company is an entity licensed to operate in the region under consideration and would play a key role in issuing paperwork in respect of the insurance contract. It may or may not retain a portion of the risk. A fronting fee would be charged, representing a percentage of the total premium placement it facilitates.

Insurer/reinsurer
The external entities that underwrite the risk to be insured. Their role would depend upon the attachment point at which they assume the risk. For example, the fronter may reinsure into the captive, which may seek further reinsurance (retrocession). Alternatively, the captive may only write a net retention with the insured accessing excess capacity directly.

Here we illustrate some examples of captive structures:

The captive may decide that it will retain only part of this risk and therefore it will cede the 'excess' to a reinsurer – this is known as 'gross line'. The benefit of a gross line programme is that the captive has more flexibility in its insurance programme and it controls the primary rates and reinsurance rates it pays.

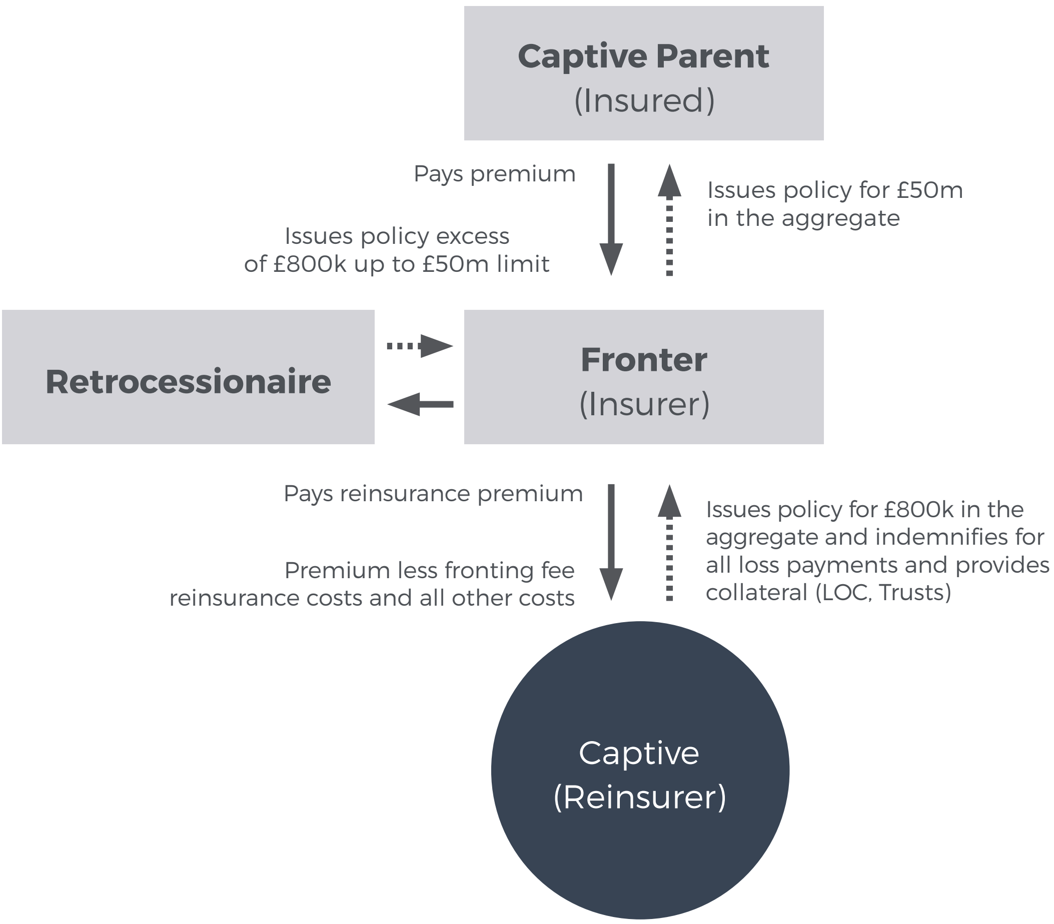
Figure 5 Gross line programme



An alternative to the gross line programme is a 'net line' programme, which is simpler to administer. In this case, the captive only insures that portion of the risk it wishes to keep. The fronter will determine with the captive the level of risk the fronter itself will retain, if any, and what is to be insured in the commercial market. Cessions to the captive are net of all costs and expenses to the fronting company, i.e. fronting fees, taxes, any other overrides and cost of cover above the captive layer.

It has the benefit of being much less labour-intensive than the gross line programme, with fewer insurer security issues. However, not all the premium flows through the captive, and its control of the programme is reduced as the captive, in this scenario, does not have the option to approach the market itself.

Figure 6 Net line programme



04 Setting up a captive

The necessary steps and questions for captive formation

Whilst the actual formation of a captive insurance company need not be a lengthy process, sufficient time should be allowed for feasibility studies, financial projections, determining domicile and, finally, preparing and submitting the application for an insurance licence. Figure 7 reveals some key questions a business may ask itself when deciding to set up a captive.

4.1 Which domicile should a business choose?

One important consideration in establishing a captive is determining where it will be domiciled. The decision largely depends upon an organisation's analysis of a given domicile's benefits and drawbacks relative to its reasons for forming a captive. Key considerations for choice of domicile include: operational costs and fee levels, permitted classes of insurance, quality of local infrastructure, political stability, experience, approval process, regulatory restrictions and applicable taxes.

Restrictions on permissible investments and capital requirements are also key considerations. While choice is welcome, the range and diversity of potential locations for a captive make the task of selecting the right domicile challenging.

The parent company's industry can influence the choice of domicile and some captives are domiciled in jurisdictions that specialise in specific types of risk. Conversely, some jurisdictions have sought to tailor their captive legislation around certain types of coverage. For example, the Cayman Islands is the leading domicile for healthcare captives and Vermont is a leader in captives for medical malpractice coverage and risk retention groups.

The engagement with the regulator in the domicile may also be important, including the speed of decision-making to support commercial opportunities for the captive.

International Financial Centres (such as Bermuda, Cayman, Guernsey and Isle of Man) have offered an attractive home for captives due to a combination of proportionate regulation and flexible operation.

However, there has an been increasing challenge of captives in low tax jurisdictions due to perceived harmful tax practices or lack of economic substance and this has led to renewed interest in onshore captives. This is an established trend in the US and is now becoming more common globally, impacting captive numbers in some of the more established domiciles.

4.2 Financial reporting considerations

The most common financial reporting standards applicable to captives are US GAAP and IFRS. US GAAP has a specific chapter within the AICPA Audit and Accounting Guide for Property and Liability Insurance Entities that deals with captive insurers.

Many domiciles allow captives to chose the accounting standards applied, although owners should be mindful of their needs on consolidation.

In general, for both US GAAP and IFRS, captive insurers are subject to the same insurance accounting considerations as other (re)insurers. Some jurisdictions have reduced disclosure requirements for captive (re)insurers. IFRS 17 represents a major overhaul of insurance accounting requirements and may impact captives, particularly if writing long-term or multi-year policies.

Key financial reporting considerations include whether the contracts written satisfy the risk transfer criteria and the appropriate valuations of insurance liability obligations accepted and retained by the captive.

Each jurisdiction will also typically have its own capital and tax reporting requirements, which vary from place to place. Captive administrators will be able to provide accounting services covering off these reporting requirements.

Figure 7 Key questions a business may ask itself when deciding to set up a captive

Key questions	Is a captive the most appropriate risk financing tool for your company?	What is the most appropriate domicile and ownership structure for the Captive?	What is the most appropriate captive structure and what are the options?	Are the intended programme structures and retention levels appropriate?	Are the captive's overall risk management and claims reserving frameworks appropriate and aligned with the group's overall approach?
Subsections answering the questions	1 How do the proposed Captive arrangements align to the overall strategy?	4 What are the strengths and weaknesses of alternative domiciles?	7 What would be the appropriate levels of capital within the Captive?	9 What would be an appropriate Captive programme	11 Are the overall group and captive risk management processes appropriate and consistency defined?
	2 Are there more suitable options for the management of Group insurance risks either as a whole or for specific risks?	5 What is the most appropriate ownership structure for the Captive?	8 What would be the appropriate organisation and governance structure of the Captive?	10 What would be the appropriate retention levels and lines of business insured through the Captive?	12 What would be a robust and appropriate approach to claims reserving?
	3 How can the captive drive improvement in the value proposition of the group's business overall?	6 What tax options are potentially available?			
Outcomes	• Clarity over the appropriateness of a Captive overall and for specific risks	• Identified strengths and weaknesses of alternative domiciles • Clarity on most appropriate ownership structure and tax efficiencies	• Clarity over optimal capital levels within the Captive • Clarity over optimal governance structure for the Captive	• Clarity of the intended programmes' appropriateness based on lines of business written and retention levels	• Understanding of overall risk appetite • Understanding of the current reserving approach and potential improvements

4.3 Regulatory considerations

A number of jurisdictions have made themselves into well-known captive domiciles, typically with a regime for captives that is carved out of the main insurance regulatory regime.

Against a global trend of increasing rigour in insurance regulation, jurisdictions that adopt a benign approach to captives are of interest to groups considering this form of structured risk management. In some jurisdictions, however, regulators generally apply similar rules to captive as to other insurers and only limited concession is made to the fact that exposure to captives is confined to the groups of which they are members. The United Kingdom, for example, is not widely considered a benign regulatory environment for captives.

Choice of location may however be constrained by other requirements, for example, the tendency in some countries to require insurance to be placed with local insurers or to retain risks onshore. In such circumstances, even with judicious use of fronting, groups inevitably experience some leakage of risk and additional frictional cost.

As they are usually companies, captives are subject to whatever local statutory reporting is required, and concessional reporting may apply for insurance regulatory purposes. This is justified by the lower threat (compared to third-party insurers) that captives pose to the financial system, the lower public interest need for disclosure and the ability of legitimately interested parties to obtain the information that they need.

4.4 How is a captive managed?

When setting up a captive, the need for a qualified insurance manager on the planning team is very important, particularly in the formative stages. The manager also relieves the captive owner of having to employ their own specialist staff to run an insurance company.

The requirement for adequate initial capitalisation of the captive is dependent in part on the level of risk projected to be assumed by the captive and the requirements of the particular domicile chosen. In some cases the capital can be provided in a contingent form e.g. partly paid share capital, subordinated loans or letters of credit. Such principles are also included in the tiering of capital under Solvency II.

One critical function to be performed during the formative stages is the identification of the risks to be insured by the captive. The operating company will be paying premiums to one or more commercial insurance companies to protect it from specific risks, some of which could be catastrophic if they were to occur without such insurance. The goal of smaller captives would be to maintain the transfer of the catastrophic risks to the commercial carriers, but to assume the underwriting associated with the more 'manageable' risks.

As a result of the OECD Base Erosion & Profits Shifting (BEPS) project, which was commissioned by the G20 to bring transparency, coherence and substance to the international tax affairs of multinational groups, it is vital that captives are managed with an operating model in line with these principles. Namely, it is important that the captive employs an appropriately skilled person to manage the affairs of the captive, including managing, controlling and monitoring outsourced providers in the captive location.

Additionally, underwriting decisions should be made in underwriting committees and forums, separate from board meetings. The group's insurance arrangements should be at arm's length and on comparable terms with those that would be observed between independent parties. This refers to both the insured and the captives' respective pricing.

The need for annual actuarial reviews, annual financial statement audits, continuing tax compliance oversight, claims management and other regulatory compliance puts the day-to-day management of a captive insurance company beyond the skills of most general business people.

Likewise, the involvement of the management company in the investment activities of the captive is essential from a planning perspective to assure that the captive's liquidity needs are met.

4.5 The role of the captive board

A captive's board, when composed of a combination of appropriate individuals from the insured and expert independents, plays an essential role by holding the captive's operation to account, providing independent oversight and expert insight. Independent directors are key to demonstrating and delivering the substance, good governance and independence increasingly demanded from regulators and tax authorities around the world.

Captive boards commonly contain representatives from the parent organisation. Captive non-executive directors provided by the parent's treasury, legal or company secretariat function may provide an independent view from the risk and insurance management function, but their employment by the captive's key (or only) policyholder means that true independence must be sought further afield.

The topic of captive boards, and in particular the role of independent non-executive directors (iNEDs), is discussed at length in the 2019 Airmic Guide: Captive Governance.[1]

[1] Captive Governance: A Practical Guide for Independent Non-Executive Directors and Captive Boards. https://www.airmic.com/technical/library/captive-governance

Ensure a regular captive healthcheck is undertaken

Captives are a dynamic risk financing mechanism and, as such, the need for them can increase or decrease over time. Organisations should review their captive arrangement on a regular basis to ensure it is delivering against its objectives as part of the overall risk management strategy.

If it is decided that the captive is no longer the appropriate vehicle, the organisation may decide to exit the captive. In the event that the captive owners decide to cease writing business through their captive, there are several options available to the owners to bring finality to the run-off and release capital back to the group.

Run off
Managing the run-off to expiry enables insurance contracts to respond to future claims as they arise. It will be important to manage down the administration costs as these will become relatively more expensive as claims mature. The longer the duration of the run-off, the longer capital will be trapped in the captive.

Reinsurance
The purchase of whole account reinsurance would transfer the financial risk and could be combined with the outsourcing of claims-handling to the reinsurer. This should allow early release of some capital, although the captive will need to be retained and managed until the expiry of all risks.

Commutation
Acceleration of the settlement of claims by returning the risk to fronting insurers or insureds can enable a relatively quick exit of the captive's exposures. This allows the captive to release any excess capital earlier and it may be a more cost-effective option than run-off to expiry. Any policyholders, fronting insurers and reinsurers must be commercially motivated to accelerate claims through commutation in order to complete an early exit.

Scheme of arrangement
This is a Companies Act mechanism typically available in British Commonwealth jurisdictions, which subject to Court approval, binds all policyholders. A scheme provides for a mass commutation of the captive's insurance policies on a fair and transparent basis, providing early finality to the captive.

Portfolio transfer
Transferring a captive's insurance liabilities and associated assets to another insurance carrier brings early finality to the portfolio. The captive owner can benefit from a relatively speedy transaction process enabling the early release of capital, as well as a competitive buyer market, which can drive value for the vendor. It often requires regulatory and sometimes Court approval.

Disposal
Through a share sale, a captive owner can dispose of the captive to a suitable specialist acquirer. This option has similar benefits to that of a portfolio transfer: a relatively speedy process, early value release and a competitive buyer market to drive value.

05

IS YOUR CAPTIVE FIT FOR PURPOSE?

06 Emerging trends – what's next?

6.1 Shift to strategic use of captives

Captives are increasingly connected to the active management of their parent's operational risks. As cyber has fully emerged as a risk and the insurance market for it has developed, the captive's role has also increased. Aon's cyber benchmarking study saw cyber premiums in captives rise over 250% between 2018 and 2019, albeit from a low base.

The hardening insurance market, accelerated by the global Covid-19 pandemic, has resulted in the commercial insurance market increasing premium rates and restricting insurance coverage. This has led to renewed interest from organisations looking at the feasibility of utilising a captive. As well as layered retentions, quota share participation has become more relevant to replace shrinking line sizes and get a fair price for the risk accepted.

The globalisation of manufacturing businesses has been one of the dominant trends of the past two decades, as groups for both developed and developing economies combine their capabilities to manufacture, package and supply consumer goods with a far lower cost base than was previously achievable.

The challenge for insurers has been how to assess the exposures inherent in such virtual supply chains, especially when the hazards may be exacerbated by single-source supply and Just-in-Time manufacturing techniques.

The whole production and distribution chain is exposed to the risk management capabilities of the weakest link. Insurers have struggled to give anything other than a sublimit on property covers for Contingent Business Interruption exposures (where damage suffered by a third party impacts the assured's business).

For many multinationals, these sublimits are not sufficient for their needs, nor is there likely to be a timely recourse at law from their growth market suppliers. Using their captives strategically to provide a financial allocation against such third-party business interruption exposures makes sound commercial sense and can also accrue tax benefits.

6.2 Cyber risk

The onset of a number of new major risks (e.g. cyber and fiduciary liabilities) and the need to address these risks via captives is being recognised in the market. However, there still persists some reluctance in underwriting these risks on a standalone basis. This can be attributed, in part, to challenges in ascertaining the magnitude of the risk and thereby in designing a comprehensive cover.

Cyber risks continue to be partially insured within the property, liability or other existing insurance programmes, as opposed to being addressed separately by captives.

According to Aon's 2019 Global Risk Management Survey, organisations are increasingly using their captives to retain cyber risks, with the number of captives doing so increasing to 16%, Aon envisages.

6.3 Employee benefits

A number of organisations are already using captives to fund the costs of employee benefits such as medical and life insurance, accidental death, long-term disability and retiree benefits. Development of these programmes within the captive is increasingly popular and is likely to continue to expand.

The costs of providing insurable employee benefits is increasing, with the 2019 Global Medical Inflation reports from Aon, Mercer Marsh Benefits and Willis Towers Watson all showing medical insurance escalating at a compound average rate of almost 10% per annum globally. These rising costs attract the attention of CFOs and senior management, who are keen to see them brought under control. With some employers spending more than £1k per person per year on insurable employee benefits, global budgets for employers with larger populations can be very substantial, although captive programmes can be viable from premium volumes starting at £5m.

Despite the challenge of achieving buy-in from across the organisation, discussed above, and the transition from employee benefits being controlled territory by territory to being managed centrally, more multinational corporations are beginning to implement an international employee benefit (IEB) programme. One of the increasingly popular options among multinationals is to use their captive as part of a global underwriting programme.

The fronting network(s) issue local paper to the subsidiaries, as with a traditional global property and casualty programme, and the programme is reinsured by the group's captive.

The growth in popularity of the captive-backed approach has been supported by more global fronting networks offering more sophisticated captive administration support, administration and reinsurance protection options. There are now six global employee benefit networks for captive owners to choose from and multinationals will often use up to three different networks, depending on the size and geography of their programme, to ensure the best coverage. This employee benefits and captives topic is discussed in more detail in the Airmic 2019 Guide: Managing Risk – The Human Factor.[2]

6.4 Directors' & Officers' insurance

D&O insurance protects and reimburses the company when it is obligated to indemnify its directors and officers in the event they are exposed to claims arising from the decisions and actions taken within the scope of their regular duties. Traditionally, this insurance has largely remained outside the realm of captive insurers, but with the D&O market in a high state of distress, organisations are looking for alternative options. Some Airmic members have reported renewal rate increases of more than 400%, while 100% increases have become common in 2019 and 2020. When considering D&O insurance, it is important to remember coverage is split into three separate agreements:

- **Side A** covers claims against directors and officers not indemnified by the corporation. The liabilities of D&O insurance are personal liabilities, meaning that if someone else won't pay their legal bills, the directors and officers are personally on the hook.
- **Side B** is for the benefit of the corporation. When a corporation does indemnify directors and officers, Side B provides for reimbursement of the corporation.
- **Side C** is entity coverage. For a publicly traded company, this is for securities claims only. Privately held and not-for-profit companies enjoy more entity coverage—all risk unless specifically excluded.[3]

A growing number of captives are now considering or already writing Side B and Side C cover as rates are becoming increasingly prohibitive. Because of the nature of Side A, single parent captives will not write this coverage. There is, however, a handful of examples of corporates making use of a cell or sponsored captive to provide this coverage, and this approach is gaining traction. Others are using alternatives to the commercial market such as Indemnification Trusts.

6.5 Conclusion

Captives, naturally, become a hot topic when insurance rates harden and corporates look to explore alternative risk financing strategies. That is true for both existing and prospective captive owners. Those organisations that already own a captive are considering placing higher retentions and adding new lines to their captive.

As a result, large existing captives are growing their premium and assets under management and becoming increasingly sophisticated. The addition of employee benefits and other third-party lines of insurance makes the largest captives look more like commercial insurers and brings greater responsibilities with regards to governance and management.

For those considering forming a captive for the first time, perhaps driven by rising insurance costs, it is important to remember that a captive should be viewed as a long-term risk financing strategy. When conducting a feasibility study, prospective captive owners should ask themselves if a captive will still make commercial sense in a soft insurance market.

[2] Managing Risk: The Human Factor. https://www.airmic.com/technical/library/managing-risk-human-factor
[3] Sides A, B, C as easy as 1, 2, 3: D&O Insurance Made Clear. https://abovethelaw.com/lawline-cle/2016/09/01/sides-a-b-c-as-easy-as-1-2-3-do-insurance-made-clear/

07 Where to look for further information

- Airmic: Captive Governance – A practical guide for Independent Non-Executive Directors on captive boards, 2019 - https://www.airmic.com/technical/library/captive-governance
- Airmic: Managing Risk – The Human Factor, 2019 - https://www.airmic.com/technical/library/managing-risk-human-factor
- Airmic white paper: Why Brexit will have a big impact on the captive insurance market, 2018 https:/www.airmic.com/technical/library/white-paper-why-brexit-will-have-big-impact-captive-insurance-market
- Aon Global Risk Management Survey, 2019 https://www.aon.com/2019-top-global-risks-management-economics-geopolitics-brand-damage-insights
- Aon Captive Insights https://www.aon.com/captives/insights/an-introduction-to-captives.jsp
- Captive Review magazine https://captivereview.com/
- Captive.com website https://www.captive.com/
- Global Captive Podcast https://www.globalcaptivepodcast.com/

07 WHERE TO LOOK FOR FURTHER INFORMATION

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EXPLAINED GUIDES

Marlow House
1a Lloyd's Avenue
London
EC3N 3AA

Tel: +44 207 680 3088
Fax: +44 207 702 3752
Email: enquiries@airmic.com
Web: www.airmic.com

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