EXPLAINED
CAPTIVES AND UNDERSTANDING CAPTIVES
A short guide
2016
Acknowledgements

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Our specialist insurance and reinsurance expertise, coupled with our extensive regulatory knowledge and transactional experience, means that we are able to provide an exceptional service to captive insurers, their owners and managers.

Phil Clark and Matthew Mcewan acted as Executive Editors for this Guide and thanks for performing this role are extended to them both by Airmic.

Phil Clark
Director of Insurance at Vodafone Group.

Phil has been Director of Insurance at Vodafone since December 2008 and before that was Vodafone’s Deputy Group Treasurer, he is also a Vodafone Group Pension Trustee. Phil’s insurance team is responsible for ensuring all insurable risks are managed effectively often through the Group’s two insurance companies.

Matthew Mcewan
Director of Risk Management at Coca Cola Enterprises

Matthew won the Captive Professional of the Year Awards in 2016. The judges cited that his contribution to the industry, “goes far beyond his day job, offering his time and expertise to speak and lead discussions at Captive conferences around Europe.”

Chris Mcgloin

Thanks are also extended by Airmic to Chris Mcgloin, a past chairman of Airmic, for his contribution to the production of this Short Guide
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Executive summary

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

A Captive is a risk transfer mechanism in the form of an insurance or reinsurance vehicle, typically owned by a business, which, through insurance products, 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 by an expanding number of jurisdictions authorising captives, the number of domiciles actively competing for the right to regulate captives and favourable developments that clarify and broaden the rules for risk shifting, risk distribution and product qualification, the trend of market expansion in captives is likely to continue.

This guide will take you through the life-cycle of a captive from initial concept through to the benefit 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 for those who may be new to this subject to share 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? Which industry sectors?
- 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 answer these questions and to help in your understanding of the world of captives and how they may work for your organisation.
Executive summary


2 What is a captive?

2.1 What is the purpose of a captive?

A Captive is a risk transfer mechanism in the form of an insurance or reinsurance vehicle, typically owned by a business, which, through insurance products, assists the business in the management of its risks by doing any or all of the following:

1. removing balance sheet volatility
2. making risk protection more efficient and effective
3. providing a more efficient and effective employee benefit programme support
4. enhancing the organisation’s ability to take advantage of the commercial insurance market

A captive belongs to a corporation or group and underwrites\(^1\) or reinsures\(^2\) primarily or exclusively the risks of companies belonging to that group.

The name “Captive” was coined in the 1950’s when the concept was being brought into practice for a mining company. A mine producing output which was being kept solely for the corporation’s own use was 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.

In the 1970’s 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.

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1 to agree to pay for a certain kind of loss or damage by offering an insurance policy
2 to insure again, especially by transferring all or part of the risk in a contract to a new contract with another insurance company
Captive Insurance companies were very much a product of the volatile insurance markets of the seventies and eighties and were originally set up by companies looking for a lower cost method of addressing their rising primary insurance costs. Setting up one’s own insurance captive as a subsidiary was seen as a cost effective alternative to obtaining insurance from external providers and one which could bring with it bespoke coverage, claims settlement certainty and potentially tax advantages. Often they were established in domiciles providing tax efficiencies.

However, over the past decade the role of captives has changed dramatically and captives are now more generally viewed as dynamic vehicles to bring greater awareness to risk management and to facilitate risk financing, rather than just risk transfer/self-insurance tools. Captives are now increasingly being used to address risks for which companies would find it difficult to obtain cover from traditional forms of insurance and to facilitate bridging between operating companies and sources of alternative risk capital3.

Common characteristics of a captive include:

- Regulatory supervision
- Treasury management
- Investment philosophy
- Claims administration
- Capitalisation requirements
- Statutory reporting
- Audit requirements

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3 use of techniques other than traditional insurance and reinsurance to provide risk bearing entities with coverage or protection e.g. contingent capital, derivatives, insurance linked securities
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**
  They insure the risks of the owner or its subsidiaries. Some can also cover the risks of unrelated entities.

- **Group/Association Captives**
  They are owned by multiple unrelated entities and designed to insure the risks of the different entities. An Association Captive usually insures risks of entities in the same or similar industries. Some Group Captives can also insure organisations other than the owners.

- **Risk Retention Groups (RRGs)**
  They are a special form of group captives limited to liability coverage for owner/insured.

- **Rent-a-Captive**
  Licensed offshore insurer formed by their owners to insure the risks of other organisations for a fee.

- **Protected or Segregated Cell Companies**
  Usually used as Rent-a-Captive, they cover the risks of unrelated third parties. 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: Guernsey, Isle of Man, Bermuda, Gibraltar or Malta, as most other countries do not have this corporate form.

- **Rent-a-Captive**
  Licensed offshore insurer formed by their owners to insure the risks of other organisations for a fee.

- **Agency Captives**
  They are usually owned by insurance brokers to insure client risks. Most established as “Rent-a-Captive”.
### 2.3 What types of risk does a captive typically cover?

Typically, 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 find 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.

<table>
<thead>
<tr>
<th>Traditional risk lines:</th>
<th>Non-traditional risk lines or newer coverages:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Deductibles(^4) and self-insured retention programs</td>
<td>• Employee Benefit programmes, including Life, Medical, Short Term Disability, Long Term Disability</td>
</tr>
<tr>
<td>• General and other professional liability</td>
<td>• Cyber-liability</td>
</tr>
<tr>
<td>• Product Liability</td>
<td>• Contingent Business Interruption</td>
</tr>
<tr>
<td>• Motor Vehicle insurance – property damage and third party liability</td>
<td>• Non-damage Business Interruption</td>
</tr>
<tr>
<td>• Property and Casualty risks, including UK Employers Liability and US Workers’ Compensation</td>
<td>• Reputation Risk</td>
</tr>
<tr>
<td></td>
<td>• Credit Risk</td>
</tr>
<tr>
<td></td>
<td>• Terrorism or acts of war</td>
</tr>
</tbody>
</table>

\(^4\) In an insurance policy, the deductible is the amount of expenses that must be paid out of pocket before an insurer will pay any expenses. It is normally quoted as a fixed quantity and is a part of most policies covering losses to the policy holder.
According to Aon, about 50% of the global top 47 risks are not insurable and only 25% are normally covered by commercial insurers. The other 25% may not currently be considered insurable risks (highlighted in red opposite - Figure 1) and may drive the need for self-insurance or captive insurance coverages in the future.
|   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |   |
|   | Economic slow down/recovery | Regulatory / legislative changes | Increasing competition | Damage to reputation / brand | Failure to attract or retain top talent | Failure to innovate / meet customer needs | Business interruption | Commodity price risk | Cash flow / liquidity risk | Political risk / uncertainties | Exchange rate fluctuation | Technology failure / system failure | Third party liability | Distribution or supply chain failure | Capital availability / credit risk | Weather / natural disasters | Property damage | Cyber / Computer crime / hacking / viruses / malicious code | Consequences of corporate governance / compliance | Counterparty credit risk | Lack of technology to support business needs | Inadequate succession planning | Failure of disaster recovery / BC plan | Crime / theft / fraud / employee dishonesty | Environmental risk | Loss of intellectual property / data | Failure to implement strategy | Interest rate fluctuation | Globalization / emerging markets | Directors & officers personal liability | Understaffing | Product recall | Corporate social responsibility / sustainability | Climate change | Absenteeism | Social media / Asset value volatility | Share price volatility | Unethical behaviour | Pandemic risk / health crisis | Outsourcing | Terrorism / Sabotage | Pension scheme funding | Sovereign debt | Harassment / Discrimination / Kidnap / extortion | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 | 21 | 22 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 | 31 | 32 | 33 | 34 | 35 | 36 | 37 | 38 | 39 | 40 | 41 | 42 | 43 | 44 | 45 | 46 | 47 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 | 21 | 22 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 | 31 | 32 | 33 | 34 | 35 | 36 | 37 | 38 | 39 | 40 | 41 | 42 | 43 | 44 | 45 | 46 | 47 | Figure 1 Captives and Insurability

- Uninsurable
- Insurable
- Partially insurable

**What is a captive?**

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. Globalization / 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
Figure 2  Comparison of the traditional lines of cover written by captives

- Fiduciary
- Fidelity
- Marine Liability
- Aviation
- Umbrella Liability
- Errors and Omissions Liability
- Directors and Officers Liability
- Environmental Liability
- Medical Malpractice
- Marine
- Excess Liability
- Products Liability
- Professional Liability
- Auto Liability
- Other Financial Lines (Life Insurance, Extreme Mortality, Persistency, Longevity)
- Workers’ Compensation / Employers Liability
- Property
- General Public Third-Party Liability

- 2014
- 2013
The EY findings in Figure 2 opposite represent a 2013/2014 comparison of the traditional lines of coverage that captives have written during these two years. In terms of business written through captives, not surprisingly mainstream Third-Party Liability, Property and Casualty, Workers’ Compensation lines continue to dominate.

**Case study 1:**

**US Beverages Distribution business: Risk-funding platform**

**Challenge:** The company had many uninsured exposures for which it wanted to build a platform to fund for 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.
3 A brief overview of the captive insurance market

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

There are over 6000 captives established globally writing over $140 billion in gross premiums annually with $408 billion in assets under management (Source: Statista, 2015).

The global market shares by the top 20 competing jurisdictions as at September 30, 2015 are indicated in Figure 3.
Figure 3  Global market shares by the top 20 competing jurisdictions as at September 30, 2015
The US dominates the global captive market, which sources the volumes in Bermuda, Vermont and Cayman. However, Europe has seen a recent growth in captive domiciles and new entities. Guernsey is Europe’s leading captive insurance domicile and number four in the world, with more than 784 international insurance entities (captives/PCCs & ICCs/cells) and c$5bn GWP. Malta is one of the fastest growing European domiciles showing a 32% rise in entities between 2013-2014 (Source: Statista).

Eight major industry segments control 77% of global captives by entity (Figure 4).
Remarkably, for many years the same top eight industries have continued to hold the same top spots for captive use. However, the captives market has seen both growth and change when premium volume by industry is considered instead. Although financial institutions continue to come in first, industries such as Communications, Media and Technology (CMT) and life sciences organisations gain a much stronger footprint in the captive arena when looking at premium volume as opposed to number of captives. This is due to the risk factors and complex programs that CMT companies are required to manage.

Since these organisations tend to be very large, diverse and global, a captive serves as a central-processing 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 (e.g. claims from warranties), as opposed to transferring these to a third party as this would involve a fixed cost which is higher than what they may have had to assume via a captive setup. Retail firms may also prefer to use their captives to hedge the risks arising in their supply chain by writing the supplier’s program 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 optimise turn around times in addition to a desire to lower the cost of claims.

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\(^5\) 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 chose to act as a reinsurer for the layer in excess of the primary and retrocede\(^6\) a further layer into another reinsurer, the overall objective being to reduce costs and exposure to loss.

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5 Stop-loss insurance is insurance that protects insurers against large claims. Companies providing health insurance for their employees through a self-insured plan often subscribe to stop loss policies in order to protect themselves against catastrophic claims.

6 To cede (all or part of a reinsured risk) to another reinsurance company.
3.2 Why are captives formed?

There are a number of reasons that drive an organisation to consider setting up a captive:

- **Access to coverage**
  That would otherwise be too costly or not available elsewhere

- **Lower insurance costs**
  When the costs of insuring the risk in the external 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 pro-active inter-company cash management:
  - Intercompany financing
  - Cash / profit pooling
  - Interest rate arbitrage

- **Flexibility**
  When dealing with risk retention and risk management - by retaining the primary layer within the captive and reinsuring the excess layer, thus saving costs due to a risk transfer being effected at a higher attachment point

- **Deductible buy-down**
  Allows operating companies within the organisation to be fully insured with low deductibles

- **Writing unrelated risks for profit**
  Captives are looking to diversify their portfolio across classes of insurance in order to ensure that their profits are not adversely affected due to a single occurrence of high magnitude

- **Enables group to insure customers’ risks directly**
  A growing trend in a number of jurisdictions. Product lines might include:
  - Extended warranty
  - Insurance for theft, loss etc
  - Payment Protection Insurance
• **Stability of insurance costs, cover and service**
  To provide consistent and sustainable support to the business

• **Access to the reinsurance market**
  And ability to allow risks to be reinsured more efficiently as a portfolio

• **Centralising data on Employee Benefit and other programmes**
  To enable analysis and informed decision making to reduce the overall cost of this risk to the business

• **Facilitates 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

"It is well understood today that captives provide significant benefits in reducing the price of risk transfer and by providing access to the reinsurance market. But they also provide risk managers with a data base of knowledge of risk exposures, which permits an overview of all the major areas of the business that is unparalleled in other management systems. This is critical because risk management is about no surprises, not no risk. Of even greater importance is the way captives mitigate the volatility associated with self-insurance by smoothing the financial effect of surprises for smaller profit centres."

*Alan Fleming Chair of the Airmic Captives Special Interest Group*
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 receives a basic commission.

Solution: A captive was established that used their in-house call centre and IT systems to gain greater control of product design and pricing and capture profit previously leaked to commercial insurers. The business was able to reduce programme expenses, with an increase in its revenue by over 50%, well over its “commission only” arrangement.

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

The need for captives stems from the nature of business risks, the business strategy, the products under consideration, the magnitude of risk – its frequency and severity and the ability of the business to retain/absorb their 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:

- Does your organisation have risks that can be insured?
- Is your insurance spend greater than £1 million per annum?
- Do you have a risk management strategy and philosophy as well as appetite for self-insurance?
- Does your organisation believe it is paying premium that does not accurately reflect the risks it presents?
- Does your organisation have the balance sheet and capital strength to support a captive organisation?

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

- Businesses with multiple entities or those that can create multiple operating subsidiaries or affiliates.
- Businesses with £1 million or more in sustainable operating profits.
- Businesses with requisite risk currently uninsured or underinsured.
- Business owner(s) interested in personal wealth accumulation and/or family wealth transfer strategies.
- Businesses where owner(s) are looking for asset protection.

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 will therefore tend towards 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.
### Figure 5  The potential advantages and disadvantages of a captive

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cover for risks that are unavailable or expensive in the commercial market</td>
<td>Capitalisation required</td>
</tr>
<tr>
<td>Enhanced organisational view of costs and benefits of risk management, including visibility and standardisation of benefits globally</td>
<td>Once a captive is established and operational it can be very difficult to completely close down.</td>
</tr>
<tr>
<td>Accumulation of risk funds in a tax efficient way</td>
<td>Inadequate loss reserves and potential losses will erode Group capital rather than external capital</td>
</tr>
<tr>
<td>Incentives for loss control and immediate benefits for controlling losses</td>
<td>Significant internal administrative costs and ongoing management time associated with setting-up, managing and running the captive</td>
</tr>
<tr>
<td>Investment income and underwriting profit retained within the group</td>
<td>Increased cost of other insurance not included in the captive.</td>
</tr>
<tr>
<td></td>
<td>The captive may insure the less risky aspects for the group. Therefore, a third party insurer may charge extra for perceived extra risk</td>
</tr>
</tbody>
</table>
### Additional profits from insurance products for customers
- Risk of misselling\(^7\) if involved with consumer products

### Equitable pricing of premium based on own risks
- 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 your group risk
- Regulator in domicile unable to respond to changing business requirements of captive and parent

### Allows for increased control of claims and claim processes for faster, better settlement
- Choice of domicile is important as some domiciles may attract more attention from tax or other authorities

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\(^7\) The deliberate, reckless, or negligent sale of products or services in circumstances where the contract is either misrepresented, or the product or service is unsuitable for the customer’s needs. For example, selling life insurance to someone who has no dependents is regarded as misselling.
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 their strong risk management ability.

Solution: Establish a Barbados captive that allowed 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 & Casualty programmes, where the captive retained a portion of the primary layer (over and above a base layer of retention in operating companies) and any exposure above this was transferred into the insurance or reinsurance market in the form of excess layers. The captive might also participate further up the chain in some capacity, usually in a high excess layer.
The various entities in a Captive insurance programme include the following:

- **Insured party/company**  
  Is the ultimate end user seeking insurance cover.

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

- **Fronting company**  
  It is 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. They may or may not retain a portion of the risk. The charge a fee called the fronting fee, which is small percentage of the total premium placement which they facilitate.

- **Insurer / Reinsurer**  
  They are the external entities who 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 who may seek further reinsurance (retrocession). Alternatively, the captive may write the primary layer and reinsure the excess layers with various players in the market.

A brief overview of the captive insurance market
Some examples of captive structures seen below:

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.

However, the disadvantage is that it is more labour intensive. Also the fronting fees and security requirements may increase as the Fronter has no control over the reinsurance bought by the captive and therefore may view this as an additional risk. This would be more suitable for a captive that has been running for many years and has built up the expertise to take more control over the captive programme.

**Figure 6** Gross Line Programme

<table>
<thead>
<tr>
<th>Captive Parent (Insured)</th>
<th>Captive (Reinsurer)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pays premium</td>
<td>Pays reinsurance premium</td>
</tr>
<tr>
<td>Issues policy for £50m in the aggregate</td>
<td>Issues policy for £50m in the aggregate and indemnifies for all loss payments and provides collateral (LOC, Trusts)</td>
</tr>
</tbody>
</table>

Premium less fronting fee (e.g. between 4%-10% of premium) and taxes

Retrocessionaire
An alternative to the Gross Line programme is a “Net Line” programme which is more suitable for a company in a start up situation. 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 reinsured 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 then the Gross line programme with fewer insurer security issues. However, not all the premium flows through the captive, it’s control of the programme is reduced and the cost of reinsurance is often higher as the captive, in this scenario, does not have the option to approach the market itself.
4 Setting up a captive

The formation of a captive insurance company is usually a lengthy process including feasibility studies, financial projections, determining domicile, and, finally, preparing and submitting the application for an insurance license.

The table opposite reveals some key questions a business may ask itself when deciding to set up a captive.

4.1 Which location should a business choose?

An important factor 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. Key considerations for choice of domicile include: operation costs and fee levels, permitted lines of business, quality of local infrastructure, political stability, experience, approval process, regulatory restrictions and applicable taxes. In addition, restrictions on permissible investments and capital requirements are key considerations, as well. Competition within the captive space has never been greater, as emerging domiciles compete for market share with the leading domiciles. While competition is always essential, the range and diversity of potential locations for a captive make the task of selecting the right one challenging.

The parent company’s industry also impacts the choice of domicile. Many 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 are the leading domicile for health care 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.

Amongst the most popular locations for setting up a captive, Bermuda, Guernsey, Isle of Man and Gibraltar are particularly attractive, most of them being established captive markets. However, except for Gibraltar which has a special status, these locations are not part of the EEA (European Economic Area) which means they carry an increased CFC (Controlled Foreign Corporation) risk than locations in the EEA space. Other locations such as Malta or Luxembourg, despite being established captive markets and part of EEA, they perceive a higher personal tax (15%), compared to a zero personal tax regime in the aforementioned regions.
### Key questions a business may ask itself when deciding to set up a captive

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<th>Key Questions</th>
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<td>Is a captive the most appropriate risk financing tool for your company?</td>
<td>1. How do the proposed Captive arrangements align to the overall strategy?</td>
<td>• Clarity over the appropriateness of a Captive overall and for specific risks</td>
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<td>2. Are there more suitable options for the management of Group insurance risks either as a whole or for specific risks?</td>
<td>• Identified strengths and weaknesses of alternative domiciles • Clarity over optimal capital levels within the Captive • Clarity on most appropriate ownership structure and tax efficiencies • Clarity over optimal governance structure for the Captive</td>
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<td>3. How can the captive drive improvement in the value proposition of the group’s business overall?</td>
<td>• Clarity over 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</td>
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<tr>
<td>1. How do the proposed Captive arrangements align to the overall strategy?</td>
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<tr>
<td>4. What are the strengths and weaknesses of alternative domiciles</td>
<td>7. What would be the appropriate levels of capital within the Captive?</td>
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<td>7. What would be the appropriate levels of capital within the Captive?</td>
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<td>8. What would be the appropriate organisation and governance structure of the Captive?</td>
<td>11. Are the overall Group and Captive risk management processes appropriate and consistency defined</td>
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<tr>
<td>9. What would be an appropriate Captive programme</td>
<td>12. What would be a robust and appropriate approach to claims reserving?</td>
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</table>
### 4.2 Financial reporting considerations

The most common financial reporting standards applicable to captives are US GAAP and IFRS. In US GAAP there is a specific chapter within the AICPA Audit and Accounting Guide for Property and Liability Insurance Entities (http://www.aicpa.org/Publications/AccountingAuditing/KeyTopics/Pages/PropertyLiabilityInsuranceEntities.aspx) that deals with captive insurers.

In general, for both US GAAP and IFRS, captive insurers are subject to the same insurance accounting considerations as other insurers. Some jurisdictions have reduced disclosure requirements for captive insurers. It is worth noting that with the upcoming changes in IFRS accounting for insurance contracts, US GAAP may be considered a more stable accounting framework for Property & Casualty insurers, including captives.

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

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

### 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 for captives are of interest to groups considering this form of structured risk management. In some jurisdictions, however, regulators generally apply to captives similar rules 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 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, 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 captive, the need for a qualified insurance manager on the planning team is very important, particularly in the formative stages. 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, this initial capitalisation can be accomplished through the use of irrevocable letters of credit. The irrevocable letter of credit would be obtained by the sponsor applying to the bank for this letter of credit. This will involve a fee for the issuance of such a credit facility and may restrict the sponsor’s other borrowing capability.

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 is 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 more “manageable” risks.

The attractive tax benefits associated with the smaller captives can sometimes cause business owners to forget that the captive must operate as a true insurance company. The use of an experienced and capable captive management company is an essential element of the normal operations of such an entity.
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 forums, separate from board meetings. The group’s insurance arrangements should be arm’s length, being on comparable terms with those which 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 needs 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.

A consideration in selecting domicile for some groups is whether the location offers expertise in captive management. Certain jurisdictions have made a specialism of captive management, enabling groups to outsource the management of their captive to a local operator, often the local arm of a global risk services organisation. Some jurisdictions permit the formation of protected cell companies or similar, enabling a streamlined authorisation process and ring-fenced risk management mechanism for groups prepared to ‘rent a cell’ in a company that already has an insurance licence, and have the company’s management run the cell along with others.
Is your captive fit for purpose?
5 Is your captive fit for purpose?

Captives are a dynamic risk transfer mechanism and as such the need for them can increase or decrease over time.

Therefore the organisation should review its 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 captive owners decide to cease writing business through their captive, there are several options available to 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 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**
  Purchase of whole account reinsurance would transfer the financial risk and could be combined with 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 expiry of all risks.

- **Commutation**
  Acceleration of the settlement of claims 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**
  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 early release of capital and 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.

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**Case study 4:**

**Global Consumer Products business - Exit solution**

**Challenge:** Two of the group’s insurance captives were surplus to requirements and were placed in run-off.

**Solution:** The owners chose to dispose of the entities to enable early release of capital back to the group. Both captives were over capitalised so the sale process involved a capital extraction through a pre-completion dividend.
6 Developments in the captive market

6.1 Global outlook

- It is estimated (EY Research, 2015) that the global captives industry will grow 5% to 7% annually (by premium level) over the next five years. Driving this growth will be the US Affordable Care Act and non-traditional and uninsurable risks, such as cyber liability, surety, crime, terrorism and fiduciary, that may be passed over by or be too expensive to cover in the commercial markets.

- Economic expansion in Latin America and Asia (Japan, China and India) has stimulated increased demands for insurance products and services. Rating agency Fitch views the growth potential of the reinsurance market in these regions as enormous given the relatively low insurance penetration there compared with the more established US and UK markets. The growing economies and increasing spending power of the population in these regions have fueled greater demands for insurance protection.

- Globalisation will also play a key role in the increased demand for captives and reinsurance companies. As companies that are operating within the US, Europe and emerging markets expand their global reach, their risk managers will explore structures and solutions that will address some of their growing multinational exposures. It is estimated that by 2025, nearly 50% of the world’s largest companies will come from emerging markets, which will use captives to write cross-border risks (EY Research).
6.2 Emerging trends - what’s next?

- **Shift to strategic use of captives**
  Captives are increasingly connected to the active management of their parent’s operational risks. Trade credit, supply chain and Contingent Business Interruption (CBI) covers are the emerging areas of insurable risk that captives have started including in their programmes.

  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 that 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 insufficient 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.
• **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 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.

• **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. See also the AIRMIC publication “Captives and Managing Captives – Explained. A Short Guide”.

• **Regulatory and Tax Authorities pressures**
Are making the captive management landscape increasingly complex to operate within and is driving the need for increased professional expertise outside of the mainstream insurance industry.

The regulatory pressure reflects an increased drive to standardise the current patchwork of national and regional approaches to insurance regulation. Whilst this has started with the major groups with cross-border operations, that could be damaging to the financial system were they to fail, it is inevitable that global standards will result in being reflected in more rigorous domestic requirements. There is a risk that captives will be swept up in these enhanced requirements.
Solvency, governance and reporting requirements suitable for large institutions may be imposed by default on captives, with limited opportunity for exemption. These pressures on what might be called the mainstream insurance industry increase the need for resources and personnel to enable companies to adhere to requirements, and threaten the viability of companies such as captives typically run on a lean basis. Those jurisdictions that continue to maintain a benign environment for captives may revisit the boundaries of the captive definition, challenging third-party business and potentially the liability risks of group companies where injured parties could suffer loss were the captive to fail.

The path to consistent international prudential regulation depends upon engagement by major jurisdictions, and has proven slow but has accelerated in recent years under G20 pressure. At a more local contract level, the ability of captives of multinational groups to write group business cross-border depends on regulatory acceptance of business ceded to captives. Here, the issue of non-admitted insurance remains real, and there are few signs of liberalisation as more markets open their insurance industries. Local operations of such groups, rather than the captives, are the ones at risk of regulatory action where insurance is placed with captives in preference to local companies.

- **OECD BEPS and EU Anti-Tax Avoidance Directive:** Over the last five years global tax authorities have increasingly scrutinised captive insurance arrangements, focusing on questions relating to substance, commercial purpose and pricing. In what is likely to further reinforce this trend, the main workstreams of the two-year Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project concluded in October 2015 with a series of measures that bring fundamental changes to the international tax landscape and could significantly impact captive insurers.
While some of the OECD changes have yet to be fully concluded or implemented in European Union (EU) Member States, others may have immediate effect in some jurisdictions through existing domestic legislation. The OECD will be undertaking further work during 2016 and 2017 to establish specific guidance on the transfer pricing of financial transactions, which includes captive insurance arrangements.

In addition, on 28 January 2016 the European Commission released an anti-tax avoidance package including a proposed EU Anti-Tax Avoidance Directive (ATA Directive) with a view to future implementation by EU Member States.

With this in mind, groups with captive insurers are starting to consider the following key actions to prepare for the changing tax landscape:

- **Commercial rationale**
  Assess the capital or other commercial benefits arising from the arrangements for the insured, captive and the group as a whole.

- **Substance**
  Review and, where necessary, remediate operating models to ensure new substance requirements are met and that the risk of creating a deemed taxable presence outside the captive location is mitigated.

- **Transfer pricing**
  Review the transfer pricing position of captive arrangements and document, update or revise where appropriate.

- **Engage**
  Given the OECD’s further work during 2016/2017 on financial transactions will include captive insurance, it will be important that groups with captive insurers spend time sharing information and insights with the OECD about the industry.
Developments in the captive market
7 Where to look for further information

- **www.captive.com**  
  Captive insurance news, information and resources

- **www.captiveglobal.com**  
  In-depth captive articles and analysis

- **www.bit.ly**  
  About EY Captive Insurance services

- **www.bit.ly**  
  Publication of final OECD BEPS reports - Implications for captive insurers, EY 2015

- **www.statista.com**  
  Statistics portal, market research, specialist publications

- **www.airmic.com**  
  EXPLAINED Employee Risk Management and Managing Employee Benefits Insurance - an Airmic short guide
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