Captive Marketplace Perspective
July 2003

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Current (re) insurance market conditions continue to provide motivation for companies to actively examine alternative ways to finance risk. The year 2002 and 2003 to date, saw significant levels of activity in evaluating, expanding and establishing alternative risk financing vehicles and markets – captives, special purpose vehicles, structured transactions, cell captives and others. It is the view of Willis that this activity will continue for the rest of 2003 and beyond.

Additionally, more and more organisations are looking to play an active role in the sale and distribution of insurance products to their customers. In many cases, these organisations are looking to take controlling positions within these marketplaces, and have found captives to be strategically important in this regard.

The intention of this paper is to review the current captive marketplace, providing relevant supporting case studies.
Captive Participation Opportunities

Captives have many uses and, with over 4,500 in existence, many organisations, both large and small, have found these to be important strategic tools in their overall business plans. Whether to support the risk financing requirements of their owners, or playing an intrinsic part in the capture of revenue arising from the sale of insurance products to the owner's customers/members, captives continue to prove themselves as important and valuable resources.

Before looking in detail at some of the ways that captives have benefited their owners, it is probably worth mentioning some of what may be termed as the "first principles" of captives:

- A captive may be defined as a (re)insurance vehicle operated by an organisation whose primary business is not insurance. There are many forms of captive, including rent-a-captive, protected cell company, reinsurance captive and direct writer. A captive can play an important role in the risk financing of various types of risk, including both life and non-life covers.
- A captive should be viewed as a long-term strategy, in that the greater benefits are likely to be achieved over time.
- Operating a captive does not necessarily require increased risk retention on the part of the owner. In many cases, captives are used primarily to achieve direct contractual access to reinsurance markets and/or nature and terrorism pools.
- Taxation benefits are rarely the only, and usually not the primary, motivation for operating a captive.

Case Study A
A Solution For Costly Fronting Insurance

A large European based energy company, has had a successfully trading captive insurance company located in the Isle of Man for a number of years. It has always been necessary to arrange fronting insurance in order to ensure that a fully admitted policy is provided to group subsidiaries located within Europe. Historically, this has not been a difficult or costly matter. The hardening marketplace, combined with the increased security requirements and fronting fees being demanded by potential fronting insurers, meant that our client had to examine alternative fronting options.

The solution for this client was the incorporation of a direct writing subsidiary of the existing Isle of Man captive in Gibraltar. The client chose Gibraltar over Ireland primarily because it needed the company up and running within three months from the decision to form the captive.
In the current (re)insurance market, captives are typically being used to mitigate against the impact of premium increases and cover restrictions imposed by (re)insurers.

Facing such conditions as:
- Increased deductibles imposed by (re)insurers,
- Reduced capacity and coverage gaps in upper limits,
- Reduced sub-limits for specific exposures,
- Lack of (affordable) coverage for certain risks,
- Concerns regarding the security of certain (re)insurers;

many organisations are seeking alternatives to what they perceive as an "unreasonable marketplace". While it is no doubt stating the obvious, simply because a risk cannot be insured doesn't mean it ceases to exist!

Captives have proved themselves to be a viable option in the prevailing market conditions through a combination of the following:

- Direct contractual access to reinsurance markets providing necessary capacity, and in some cases increased competition for the risks. The downgrading of many insurers makes direct contractual access to the ultimate risk carrier more important from a security perspective.
- A financially attractive method for maintaining reserves for retained risks, be they deductibles on existing policies or even uninsured / uninsurable risks. While many of the historical tax advantages associated with captives have been eroded, and the current investment performance of captives mirrors the general gilt and bond marketplace, a correctly applied captive strategy can assist in reducing the overall cost of risk to the organisation.

Captives are by no means a commoditised offering. While some advisors have attempted to apply them in this way, the Willis approach, based primarily on our experience, is that to gain the optimum value from a captive, the solution employed needs to be customised to the individual needs of the organisation. Any analysis undertaken by an organisation in respect of determining the feasibility of, and value-added by their employing, a captive will need to address the following questions.

Case Study B
Cost Effective Way Of Funding Uninsurable Risks

The issue facing this French based pharmaceutical organisation was that there were certain risks that the organisation was forced to carry on its own balance sheet, as insurance cover was not available within the marketplace. The organisation asked Willis to determine whether there were alternatives available that could reduce the cost of risk to the organisation.

Following a detailed study of the organisation and the likely frequency and quantum of losses relating to the uninsurable risks, Willis proposed that the client form a captive in Ireland due to a combination of flexible regulation of captive reinsurers and the tax regime available to the client.
Captives From A Risk Financing Perspective (continued)

Case Study D
Increased Revenue Through Captive Participation

This major banking organisation, operating in both the United Kingdom and Republic of Ireland, has had an Isle of Man based captive insurance company in existence for a number of years. Historically, the bank has derived its income from these programmes in the form of sales commission. An established profitable underwriting track record, imposing increased deductibles, the client decided to take the opportunity to look at risk retention within the organisation on a wider basis, to determine the strategic options available to them from both an operational and financial perspective.

Willis undertook the preparation of a captive feasibility study, whereby a detailed examination of the main risks facing the organisation was conducted, with particular emphasis on those risks retained by the organisation in terms of how these risks were managed and financed.

The client has subsequently formed a Guernsey based captive insurance company, charged with providing a cost effective financial solution to risks retained within the organisation, but also expected to take a proactive position on the day-to-day management of these risks.

Case Study C
Better Management Of Retained Risks

This client, a largely African based energy company involved in both upstream and downstream activities, had grown significantly over the last ten years. Facing a hardening insurance market, the client decided to take the opportunity to look at risk retention within the organisation on a wider basis, to determine the strategic options available to them from both an operational and financial perspective.

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- What levels of risk can/should the organisation support financially? Is the balance sheet sufficiently strong to support proposed risk retention levels? What level of volatility can be accepted in the P&L account? Does the organisation have a risk adverse culture?
- What are the appropriate levels of risk that should be retained within the organisation for each of its major programs? What is the availability and cost of transferring the risk? What are the exposures and how predictable are the loss levels? Is there sufficient financial incentive for retaining these risks?
- What is the most appropriate mechanism to employ in the funding of these risks? Does the organisation see this as a long-term or short-term strategy? Are the funds required to support retained risks sufficient to make a captive financially attractive?
- What are the fiscal and regulatory issues to consider in order to ensure that the solution employed matches the needs of the organisation?

A process that methodically deals with the above issues will determine whether, and to what extent, a captive may be an efficient tool in achieving added value to the organisation in question.
In many cases, 2002 and 2003 to date, saw a return to basics, with many captives taking a greater role in supporting increased deductibles on the organisation’s Property and Casualty programmes. Many captives, hibernating since the peak of the soft market, reemerged to again prove their value to their parent organisations. In addition, there have been a significant number of new formations.

It has certainly not been plain sailing for both new and existing captives. Those seeking fronting insurance, where a licensed insurer stands in front of the captive to ensure that a legally admitted cover is provided, will continue to see increased security requirements. The increased cost of fronting arrangements has impelled many companies with European based operations to consider forming direct writing captives. The domiciles of Gibraltar and Ireland offer these facilities.

Structures
The last 18 months have seen significant interest in assessing the rent-a-captive (RAC) facility vis-à-vis the protected cell company (PCC) concept. Perhaps unsurprisingly, however, Willis is finding that the increased control and flexibility offered to organisations through incorporation of their own captive will in many cases outweigh the RAC / PCC benefits. Lack of PCC Legislation in Ireland and Luxembourg has tended to preclude the use of PCCs by organisations that would otherwise favor these domiciles.

Group, Association and Affinity type programs are receiving heightened attention as smaller businesses are getting pinched severely, even in cases of solid loss history. These mutual-type arrangements create capacity where the traditional market has failed to do so.

Case Study E
Directly Accessing Nature Pool

A Scandinavian based chemicals manufacturer with significant operations in Europe, including Norway, has traditionally insured directly with the marketplace, retaining varying levels of deductibles, depending on the state of the marketplace.

Prompted by the prevailing hard market, the company requested in 2002 that Willis undertake a captive feasibility study to examine to what extent the use of a captive could assist them in their risk financing requirements.

Willis recommended that a direct writing captive was likely to be the most suitable for this organisation for the following reasons:

– direct contractual access to the international reinsurance markets
– removal of the need for costly fronting insurance
– membership of Norwegian Nature Pool, and other similar arrangements.

Case Study F
New And Alternative Market Capacity

A large motor manufacturer, whose finance division play an active role in the financing of the export of vehicles to developing markets, has traditionally purchased Political Risks insurance within the established market. The company, however, found that individual country capacity restrictions limited their ability to trade with acceptable counter parties.

By restructuring the program whereby a significant level of risks were retained within a captive and excess cover was purchased from an alternative reinsurer, Willis were able to provide the client with AA rated protection yet also give them greater control and flexibility over how they were able to run their business.

The form of captive used in this arrangement was a direct writing captive, as the risk transfer market was on pure reinsurance basis and fronting insurance would probably have been impossible to arrange.
Case Study G
Effective Centralising Of Retained Risks

A Southern-European based security firm with significant level of operations in Latin America was looking for a way in which the sizeable level of deductibles carried by the various Latin American subsidiaries could be centralised in the most cost-effective way.

Willis proposed the establishment of a reinsurance captive to carry the major part of these deductibles on a centralised basis, leaving a nominal level within the local operations to continue to promote risk management diligence.

As well as centralising the retained deductibles, the client also benefited from a reduced cost of risk relating to these operations through leverage of the available tax arbitrage.

Case Study H
Accessing Reinsurance Market

A rail operator experienced a difficult renewal as the main insurance market utilised withdrew from the renewal negotiations. Due to capacity constraints in the direct market and the market perception of the rail sector, it was not possible to place the risk with an alternative direct insurance market.

Due to time constraints (renewal date was fast approaching) it was not possible to establish a dedicated captive, so as an immediate solution a Willis managed rent-a-captive facility was used to front the risk and then fully reinsure to the external market.

Subsequent to this the client has seen the value of operating a captive and has transferred the policy and reinsurance protection from the rent-a-captive to its own wholly owned insurer.

In addition, the rent-a-captive and captive also provided cost effective access to Pool Reinsurance Company Limited (the UK terrorism pool).

“Willis has only one aim – the success of our clients...”
Willis Captive Practice

Willis operates a Global Captive Practice with over 100 people dedicated full time to the management of our clients’ captives as well as providing advice to both existing and prospective clients.

We work closely with the Willis network to provide risk financing expertise to complement risk transfer solutions. We take a strategic view of risk which gives us (and our network colleagues) access to the most senior management within client organisations. We add value by designing innovative insurance programmes, achieving optimal utilisation of the clients’ capital, and advising on related accounting and fiscal issues.

As well as providing captive management services, Willis specialises in the provision of captive consulting services encompassing the following:

- Captive Feasibility Studies,
- Strategic Captive Reviews,
- Captive Domicile Reviews,
- Captive Operational Health Checks,
- Risk Retention Analyses

We are available to support new business bids, defensive reviews, and renewal planning. We can quickly advise on a case by case basis whether a captive or other risk financing options merits consideration. We can provide support remotely or meet with the client or prospect.

Further information on our services is available from:

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“How can the Willis Captive Practice help you?”

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