WINDING UP A CAPTIVE

WILLIS GLOBAL CAPTIVE PRACTICE

CAPTIVE EXIT STRATEGIES

However compelling the original case for a captive insurance Company may have been and however successful it has been in delivering value, there can come a time when it has outlived its usefulness. The problem then arises: how do you extricate yourself from it?

There are two major areas of interest:

- Lower, and more stable, cost of risk than risk transfer alone
- The company will have accumulated insurance liabilities during its active life that will need to be efficiently and effectively disposed of before the shareholders' funds can be returned to the shareholder

  Care must be taken in deciding the right means of returning accumulated shareholders' funds without incurring unnecessary costs and tax charges.

This paper sets out a process of analysis in relation to the disposal of insurance liabilities and summarizes the options available to facilitate the return of shareholders' funds.

GENERIC EXIT OPTIONS

There are two means of disposing of a captive insurance company: liquidation and sale. However, regardless of which of these ultimate disposal options might be adopted, it is likely that some cleaning up of the balance sheet through the resolution of some or all of the insurance liabilities will be required. There are 4 ways in which this can be achieved:

- Commutation of reserves
- Portfolio transfer (novation) of liabilities
- Reinsurance to close
- Restructuring of liabilities

Clearly the choice of preferred ultimate company disposal will dictate this selection to some extent; for instance a reinsurance to close will clean up the balance sheet but will not facilitate the liquidation of the company. Whatever other considerations are accommodated, all disposals of liabilities must be under taken with the approval of both the appropriate regulatory authorities and the directors of the captive.

COMMUTATION OF DIRECT POLICIES

Commutation is the simplest option where policies have been issued directly exclusively to the parent organization. In relation to current policies, especially on short tail classes, it is often a good option to cancel ab initio with a full refund of any claims and all premiums. This has the added attraction of enabling the recovery of all insurance premium taxes. Particular care must be taken where third-party risks are insured within a Group insurance policy, for instance where a disposed Group business remains covered by the program.

COMMUTATION OF FRONTED POLICIES

On fronted policies, fronting insurers are often happy to commute captive reinsurance reserves for a reasonable margin that should compare favourably with the full costs of runoff to expiry of all liabilities where the captive is to close down completely. Costs can be kept down further by simultaneously commuting the corresponding risks under the direct policy, leaving the policyholder in the same position as they would have been had they had a higher deductible on the original policy.

PORTFOLIO TRANSFER (NOVATION)

This involves replacing the captive with another organization as party to the insurance contracts.

Typically this would be another insurance company. The main drawback to such arrangements is the

However, where risk transfer is required, or the fronting insurer is unwilling or unable to commute, this can be an effective solution. Of course, as a risk transfer option costs are likely to be relatively high and market capacity may be hard to find. Typically reserves of at least $10 million would need to be involved for this option to be worth considering.

REINSURANCE TO CLOSE

This involves purchasing reinsurance of the existing captive to take on or cap existing liabilities. This has the effect of limiting the downside of the liabilities, but does not mitigate future costs as the captive will need to remain active during the run off of liabilities. However, it may be useful where other options are not available and returning risks to the ultimate policy holder is not feasible or desirable (for instance where a captive is included in the disposal of a subsidiary or insurance must be maintained to meet bankers' warranties etc.). The implications of running off to expiry should be carefully considered before committing to options that involve this as it can take many years before the captive may close, if indeed it ever does, and management costs will need to be met throughout that period.

RESTRUCTURING OF LIABILITIES

Typically this involves the novation of liabilities into a PCC cell, financed through a combination of reinsurance and non-cash capital. This has five potential advantages over conventional run-off:

- Opportunity for earlier release of captive capital
- Reduced operational costs and management commitment
- Increased capital efficiency
- Segregation and capping of liabilities
- Improved fiscal efficiency

As with all novation options, the agreement of fronting insurers will be required to implement such a restructuring.

SALE OF THE CAPTIVE

Although offering a number of possible benefits, the sale process itself can be complex and expensive and buyers are not always easy to find. The key potential advantages include:

- Involves realization of a capital gain rather than the realization of taxable profits
- Can provide complete and unambiguous finality

Disadvantages include a number of factors that impact one or more of the costs, difficulty and timescales to complete a sale. However, there are additional potential disadvantages arising out of the inevitable divergence of the interests of the new captive owners and the policyholders. Disadvantages include:

- Loss of control over claims process.
- Loss of security following reduction of capitalization to minimum levels
- Possibility of the compromising of commercial interests by the new owners of the captive acting to bring about the early resolution of the insurance business
- Need to persuade counter-parties and other interests to agree to the change in ownership (i.e. fronting insurers, reinsurers, regulators, policyholders etc.).
- Significant management time commitment
- Given the need to offer potential buyers the prospect of profits, it is unlikely that full value will be obtained by the captive owner

Given all of the above, it is no surprise that captive sales are rare and generally feature in circumstances of parental distress or where the captive is a substantial business in its own right.

WINDING UP PROCESS

Willis's process towards release of shareholders' funds comprises 4 steps.

STEP 1: ANALYZE THE BUSINESS

The nature of the business of the captive will determine the options available in winding it up. Key in defining the exit strategy options available are these four questions:

- What are the risks insured or reinsured into the captive?
- What program structures were involved? I.e. was it written on a direct or fronted basis, was the aggregate exposure limited within inward policies or by way of reinsurance purchased etc.
- What insurance liabilities remain?
- What is the best estimate of the quantum and timing of the remaining liabilities, and associated management costs?
- What feasible options exist to dispose of the remaining liabilities?

STEP 2: ANALYZE LEGITIMATE INTERESTS AND DETERMINE OUTCOME PRIORITIES

The priorities of interested parties and their level of influence over planning and implementation of the strategy will determine the selection of strategies from amongst available options. This involves answering the following questions:

- What are the priorities of the parent in terms of time scales, costs and desired outcomes?
- What program delivery structures were used?
- What third party policy holders exist?
- What regulatory bodies need to be appeased?
- What other legitimate interested parties can be identified?

For each party involved:

- What are their priorities?
- How can they influence planning/implementation to enforce their priorities?

STEP 3: ANALYZE OTHER RELEVANT ENVIRONMENTAL/ BUSINESS ISSUES

In the course of business the captive will have established relationships and infrastructure necessary for the execution of its business plan. These need to be carefully and sensitively dismantled with minimum cost and without adversely affecting continuing business relationships of the parent organization. Relevant questions here would be:

- What security is in place in support of fronted programs?
- Does the captive have any directly employed staff?
- What continuing relationship does the parent organization have with the service providers and other counterparties of the captive?
- What are the financial and fiscal objectives of the winding up?

STEP 4: DETERMINE A DETAILED IMPLEMENTATION PLAN

For most mature captives the legacy liabilities will be complex, requiring more than one disposal strategy to be adopted. As a general rule people tend to focus on the "low lying fruit" at first and leave more difficult liabilities until later. This has the effect of extending the time line for completion of the winding up, as well as potentially limiting options available in relation to the more challenging liabilities. The construction of a detailed plan at the outset helps clarify objectives and control activity to ensure the quickest and most efficient exit is achieved.

WILLIS' CREDIBILITY

Willis' Global Captive Practice is a team of captive insurance professionals with a wide range of professional backgrounds and business experience. We are experienced in the challenges involved in winding up captive insurance companies and have access to important complementary expertise elsewhere within the Group, including Structured Solutions, Loss Portfolio Transfer technology, specialist reinsurance markets etc. We aim to bring together the expertise and experience from across the Captive Practice and the Group to design and implement effective exit strategies that meet your strategic objectives and required timescales and deliver maximum value to stakeholders.

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