

The Willis logo is displayed in white serif font on a dark blue rectangular background. This background is part of a larger header bar that also includes a yellow section on the left and a dark blue section on the right. The entire cover features a background image of a highway at night with light trails from cars, overlaid with a semi-transparent white rectangle containing the title and subtitle.

Willis

# INTRODUCTION TO CAPTIVES

WILLIS GLOBAL CAPTIVE PRACTICE

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*We communicate with you to understand your business, providing the expertise and creativity to develop and deliver excellent captive solutions, and we do so with passion.*

Willis Group Holdings Limited is a leading global insurance broker, developing and delivering professional insurance, reinsurance, risk management, financial and human resource consulting and actuarial services to corporations, public entities and institutions around the world. Willis has more than 400 offices in some 119 countries, with a global team of approximately 20,000 Associates serving clients in some 190 countries. Additional information on Willis may be found at [www.willis.com](http://www.willis.com)



# INTRODUCTION TO CAPTIVES

Captive insurance companies have been used for many decades as one means of assisting organisations to manage their retained risk exposures. While definitions of captives vary, the following covers most of the key elements:

“A captive is a special purpose insurance company established to finance risks emanating from its parent group or groups.”

The captive movement began in the 1920's and there are now over 5000 captives worldwide and still growing. The value of captives and their increasing importance in the risk management derives from:

- Insurance rating structures reflecting market trends rather than individual loss experience
- Insufficient credit given by commercial underwriters for loss control efforts
- Differential coverage standards in various parts of the world
- Difficulties in insuring certain types of fortuitous risk
- The need for more formal structures to meet the increased transparency requirements of modern business.

Although the rate of captive formations increases in response to hard insurance markets, they are generally regarded as part of a longer-term risk management strategy, rather than short term cost saving vehicles.

The majority of multinational and global companies use a captive as a central focus for risk management, risk financing and the provision of insurance coverage.

# RISK RETENTION & RISK FINANCING PRINCIPLES

The feasibility of a captive insurance company will depend upon the risk financing objectives of the parent. These will generally include:

- Minimisation of the overall cost of risk
- Stabilisation of the cost of risk over time
- Maximisation of the protection of group and business unit resources, derived earnings and, ultimately, the balance sheet.
- Platform for the implementation of risk management strategy
- Flexibility and control over their insurance programme
- Leverage over the conventional market
- Provision of cover not conventionally available
- Profit centre, enabling diversification of the business
- Non-specific reserving
- Tax deductibility of premiums
- Improved cash-flow
- Investment returns from retained premiums
- Reduced administration costs

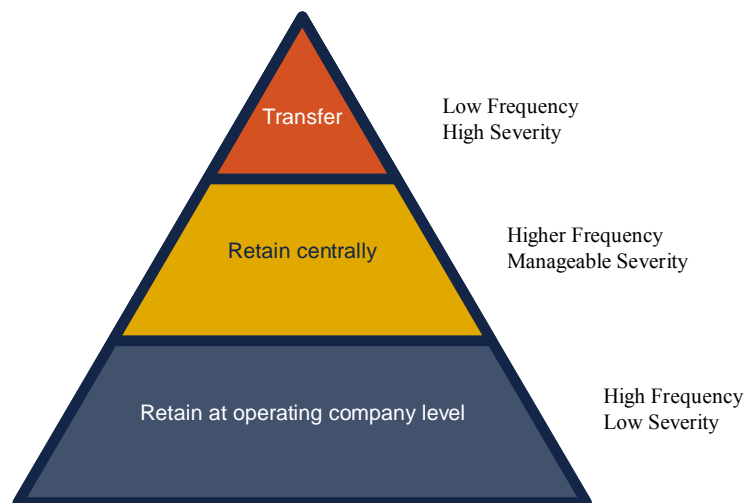
*Understanding  
your business is key  
to success.*

Every company has its own unique financial, cultural and risk profile and every risk financing strategy will be different because the design of the optimum risk financing programme must reflect the overall profile, psychology and mission of the company.

# RISK TRANSFER VERSUS RISK RETENTION

A risk financing programme should optimise the use of available funds by achieving the correct balance between risks that are transferred to the traditional insurance market and risks that are retained, either as an operating cost, or through other forms of risk funding, such as a captive insurance company.

In theory, the division of the risks to which a company is exposed can be illustrated as shown below. This demonstrates the interrelationship between loss frequency and loss severity, and summarises the usual risk financing methods for each combination of particular loss event. The actual divisions will depend upon the risk profile of the individual company.



*Communication is essential to a true partnership.*

Whilst this represents the ideal, in reality consideration must be given to:

- The availability and cost of insurance
- The financial strength of the parent and its ability to retain risk
- The degree to which the parent is willing to accept risk
- The amount of capital that the parent is able to, or prepared to, commit in order to support a captive subsidiary<sup>1</sup>
- The prioritisation of the parent's risk financing requirements.

Captives will generally begin by participating in the high frequency / low severity layer of their programmes. As the captive becomes more experienced and ideally has a stronger balance sheet to support the retention of risks, it will look to progressively move towards the medium frequency / manageable severity layer of the programme. Over time, the transfer of risk to the external insurance markets may be limited to those risks falling within the low frequency / high severity layer.

<sup>1</sup> A captive is an insurance company, and it therefore requires capital to enable it to meet the required solvency margin in the country in which it is located. It should be noted that, subject to eventual choice of captive domicile, capitalisation is normally based on a percentage of premium received each year, though some captive domiciles impose a more stringent test, which relates to aggregate risk exposures. The higher the premium income, the higher the capitalisation requirement will be. It is possible to structure or locate a captive programme in such a way that initial capital requirements are kept as low as possible, and most captives are established with that in mind.

# CAPTIVE ADVANTAGES AND DISADVANTAGES

## ADVANTAGES

Captive-based financing offers the following benefits:

- Ability to ring fence retained risk exposures
- Development of increased risk retention capability to support the overall insurance programme
- Improved management focus on the profitability of the insurance programme, thus giving an opportunity to change the programme as opportunities are identified to reduce external expenditure
- Opportunity to establish, at low cost, a subsidiary dedicated to internal risk financing, which is likely to deliver (reasonable) profits over the medium term
- Financial efficiency, to a lesser extent, provided by the use of insurance company reserving techniques

A captive is extremely flexible, and the likelihood is that parents will wish to develop the programme as the captive's ability to accept risk is realised through the retention of operating profits. Once established, a captive can grow its risk retention capability and form an ever-greater part of its parent company's overall arrangements.

*We develop  
solutions for your  
business*

## POTENTIAL DISADVANTAGES

A captive is not always the correct solution for a company's risk financing strategy. Disadvantages include:

- Possibility of a loss
- Limited spread of risk
- Capital requirement
- Management Time

# SUITABLE CLASSES OF BUSINESS

Preconditions for successful captive participation in a given class may include some or all of the following:

*Our creativity produces better solutions.*

- An adequate spread of risk to minimise the possibility of large fluctuations in annual losses resulting from a single event
- Low severity, high frequency losses allowing predictability of future losses
- The parent's continued commitment to good risk management procedures
- Historic loss ratios which hold reasonable probability of underwriting profits
- Dependable, accurate historic loss statistics
- An adequate captive premium in relation to the risks accepted allowing a reasonable level of underwriting profit and/or investment income.
- The availability of good quality reinsurance at reasonable cost

In its initial stage, a captive will often underwrite property damage and business interruption, motor and primary liability risk. Captives can, and do, however, underwrite virtually any class of insurance, including machinery breakdown, professional liabilities and credit insurances. It is also becoming more common for captives to underwrite employee benefits such as private medical insurance and some life assurance products.

# TYPES OF CAPTIVES – THE MAIN OPTIONS

There are a number of options regarding the captive's structure and business plan that will be determined by the aims and needs of its Parent. The key objectives for the formation of a captive are:

- Control of risk
- Control over the financing of risk
- Stability of premium costs within the uninsured areas of risk
- Long term strategy to support and strengthen the negotiating position of a Company when purchasing insurance from the conventional market

Willis are not tax advisers, and we are therefore unable to give specific tax advice regarding the establishment, structure and operation of captives. Nonetheless, we do recognise that tax planning is frequently a factor in captive establishment, and we would recommend that prospective captive parents consult its own tax advisers in order to ascertain whether there are any overriding considerations.

## NON-ADMITTED INSURANCE COMPANY

This is a licensed insurance subsidiary in an off-shore location insuring either parental corporate or customer risks, either directly or as a reinsurer of an admitted “fronting” insurer.

## DIRECT WRITING CAPTIVE INSURANCE COMPANY

An insurance company approved and regulated within the European Economic Area and permitted to underwrite insurance policies issued directly to the public in the EEA.

## PROTECTED CELL COMPANIES/RENT-A-CAPTIVE

A Protected Cell Company (PCC) is a corporate structure that allows some of the assets and liabilities of the company to be segregated in separate cells. The key features of a PCC are as follows:

- A PCC operates in two parts, with a core and an unlimited number of cells. There are many possible structures, and the eventual structure adopted is tailored to the needs of the sponsor and users in each case. Establishment costs and administration are minimal for a new cell owner.
- Creditors of a PCC cell only have access to cellular assets of that particular cell plus the company's non-cellular assets (though, under certain circumstances, access may be able to be limited to cellular assets only). In most cases, the cell owners are expected to collateralise any underwriting risk within their cell.
- To meet the needs and demands of clients, Willis Group has its own EU (Malta) domiciled PCC facility, Lime Street Insurance PCC, and an offshore facility located in Guernsey.

# CAPTIVE DOMICILES

The world's largest captive domiciles are Bermuda (885), Cayman (780) and Vermont (560). These locations are primarily focussed on US corporations and attract a limited amount of captive business from outside the US. The same applies to the British Virgin Islands (285) and Barbados (225). European parented captives have tended to look closer to home for their captive domiciles, with Guernsey (355), Luxembourg (251), Ireland (114), Isle of Man (145), Gibraltar (17) and Malta (9) the larger domiciles.<sup>2</sup>

Willis believes it is in the interest of captive owners that the domicile of their captives should be well regulated and respected. Reinsurers and other service providers are more comfortable dealing with captives located in domiciles where they consider a well-regulated approach is maintained.

Key selection criteria for domicile choice include:

- Location and communications
- Familiarity of parent with domicile
- Costs
- Infrastructure
- Fiscal considerations
- Regulatory regime
- Political stability and international reputation
- Legal framework
- Market access

<sup>2</sup> As at 31.12.2009.

# CAPTIVE OPERATION AND MANAGEMENT

The captive management functions must all be carried out in the domicile itself by qualified and experienced professionals in each of the relevant disciplines, which include:

- Insurance Management
- Accountancy & Audit
- Company Secretarial & Legal
- Banking and Investments

*Without delivery  
there is no value.*

As a separately constituted subsidiary company, the captive will be controlled by its shareholders (minimum of two), but operated by a board of directors. The board will usually be required under regulation to include at least one local, independent, non-executive director. However, for practical and governance reasons it is usually advisable to have more, and sometimes to have a majority of independent directors.

The establishment and execution of an appropriate investment policy is therefore very important to the financial success of a captive. The criteria by which the investment policy should be judged are:

- Security
- Liquidity
- Yield

The majority of captive insurance companies use professional investment managers, who follow formal guidelines laid down by the company's board of directors. Any reputable domicile will be able to offer many potential investment managers experienced in the particular demands of captive insurance fund management.

# CAPTIVE FORMATION

*Expertise is at the core of everything we do.*

Once the captive location has been chosen our management team can deal with the company formation and administrative matters. In order to obtain the necessary insurance business licence and tax exemption certificates, the managers would present a business plan that would typically include:

- Details of the risks to be covered
- Capital available to the company
- Company incorporation documents e.g. Memorandum and Articles of Association
- Names, professions, domiciles and nationalities of proposed directors and managers
- Details of fronting and reinsurance arrangements and financial data relating to the programme
- Ownership information.

The establishment and licensing process for an off-shore captive would typically take less than 2 months, whilst an on-shore direct writing captive will take up to 6 months to set up.

# WILLIS GLOBAL CAPTIVE PRACTICE

**Willis Global Captive Practice** (“Willis GCP”) is a leading insurance management and consultancy practice, we manage well over 330 captive insurance vehicles, mutual insurers, risk retention groups and commercial insurance companies. Our clients write total premium of \$4.4 billion and have assets of \$27.1 billion. They range across all industry types and sectors.

The GCP employs 138 captive professionals across all significant captive domiciles including Bermuda, Guernsey, Isle of Man, Ireland, Gibraltar, Cayman Islands, Luxembourg, Malta, Barbados, Vermont, Hawaii, New York, Singapore and Hong Kong, as well as in key financial centres such as London and New York. Other captive professionals are employed in Willis’s broking teams throughout the world.

The services provided break down into 3 categories:

## ■ Captive Management

The Willis captive management services are tailored to our clients’ needs. Willis can take complete responsibility for managing the captive, provide expertise in specific areas, or act as management consultants, reviewing and overhauling underperforming areas.

## ■ Captive Reinsurance

Global presence, an extensive and diverse client base, and a reputation in the business give Willis unparalleled access to the international reinsurance markets, uniquely positioning us to provide creative solutions and cost savings.

## ■ Captive Consultancy

Willis understands that companies do not stand still. Changing conditions in the external environment as well as internal developments may call for a fresh approach to risk financing. The Captive Consultancy team are on hand to help clients establish or evolve their captive and, where it is no longer viable or applicable, to look for alternative solutions.

Expertise for undertaking the captive feasibility study is achieved through the pooling of the Willis Group’s resources and knowledge, which is well regarded for its breadth of experience in captive consultancy, risk management and design of risk transfer and finance solutions. This expertise is further consolidated through Willis’ long standing position as a leading captive manager and consultant world-wide.

## CONTACTS

### **Nigel Goodlad**

New Business Director  
Direct: +44 1446 773 675  
Mobile: +44 7715 759 451  
goodladnb@willis.com

### **Brendan Duggan**

Director of Consulting  
Direct: +353 166 94 462  
Mobile: +353 8678 01473  
dugganb@willis.com

### **Michelle Gwynn**

Director of Sales  
Direct: +44 20 3124 6938  
Mobile: +44 7985 554 979  
gwynnm@willis.com

*We are passionate  
about working with  
you.*





Kreuz  
München-Nord  
2500 m  
Sarching-Süd  
1000 m

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