RATIONALISING YOUR CAPTIVE

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INTRODUCTION

In these days of changing markets and limited capital it is important to keep your captive programme relevant both to the risks you face and the market conditions that prevail in key risk areas. From time to time this will lead to significant changes in captive strategy, placing previously significant lines of business in the captive into run-off. This paper seeks to identify the options available in dealing with run-off lines and how to go about assessing which option will provide the best option for you. The start point assumptions are:

- The captive has an on-going strategic role and will continue to trade; and
- The captive has accumulated insurance liabilities during its active participation in the discontinued line(s) that must be satisfactorily discharged.

This paper sets out a process of analysis in relation to the disposal of insurance liabilities and highlights other areas for review following a significant change in captive business plan to maintain and/or enhance efficiency and, therefore, captive value generation.

GENERIC EXIT OPTIONS

There are six means of discharging liabilities under a discontinued line of business in a captive insurance company:

- Run-off to expiry
- Commutation of reserves
- Portfolio transfer of liabilities
- Reinsurance to close
- Restructuring of liabilities
- Cancellation of policies

Clearly the choice may be restricted to some extent by the circumstances of the insurance involved and will ultimately be determined by the objectives of the captive owner. Each of these generic options carries with it specific benefits and features, involves certain costs, and will be appropriate in varying circumstances. The choice between them must be made through a five step process:

- Identify feasible generic options;
- Determine the primary objectives of the parent and other interested parties;
- Select options that address these objectives;
- Fully cost these options on a net current value basis and select cost effective solution; and
- Implementation.

RUN-OFF TO EXPIRY

This is the default option and involves least action to implement. However, this does not mean it is without cost as the administration of claims, premium adjustments etc, and their accounting and reporting involves management costs, and the release of reserves may enable the release of cash and even profits, as well as reducing associated security commitments to fronting insurers.

COMMUTATION

This is the simplest option as regards options to bring an early closure to policy commitments. It is particularly useful where policies have been issued directly exclusively to the parent organisation. In relation to current policies, especially on short tail classes, it can be combined with the cancellation ab initio in relation to current policies with a full refund of any claims and all premiums. This has the added attraction of enabling the recovery of all insurance premium taxes and produces a very quick and straightforward exit from the lines involved.

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On fronted policies, fronting insurers are often happy to commute captive reinsurance reserves for a reasonable margin. Costs can be kept down 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. There is some potential here for hidden costs such as the costs to the parent organisation of administering and settling claims within the new higher deductibles.

PORTFOLIO TRANSFER

This involves replacing the captive with another organisation as party to the insurance contracts. Typically this would be another insurance company. The main drawback to such arrangements lies in their legal complexity and the need to obtain the full agreement of any fronting insurers. However, where risk transfer is required, and/or the fronting insurer is unwilling or unable to commute, this can be an effective solution. Of course, risk transfer costs are likely to be relatively high, and market capacity may be hard to find. Also given the difficulty in marketing and the complexity of these arrangements, transactional charges are relatively high, making portfolio transfers financially feasible usually only where substantial reserves are being released.

REINSURANCE TO CLOSE

This involves purchasing reinsurance of the captive to set a cap on 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 a corporate disposal, or insurance must be maintained to meet bankers' warranties etc.). It is also useful where the risks involved are no longer core to the parent company's business, perhaps involving discontinued or disposed business lines, or where the risks involved have the potential for significant deterioration in the future.

RESTRUCTURING OF LIABILITIES

Typically this involves a portfolio transfer of liabilities into a cell of a Protected Cell Company, 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

CANCELLATION OF POLICIES

This is an extremely efficient way of extracting a captive from current policies. It can be actioned ab initio with a full return of all premiums (and IPT), or with immediate effect with a pro rated premium refund. In the latter case some further measures will have to be taken regarding the liabilities incurred to date. For this reason cancellations are often undertaken in combination with a commutation of liabilities.

RATIONALISATION PROCESS

Willis' process towards release of shareholders funds comprises 5 steps.

STEP 1: ANALYSE THE BUSINESS AND IDENTIFY FEASIBLE OPTIONS

The nature of the business will determine the options available. Key in defining the feasible options available are these four questions:

- What are the risks insured into the captive?
- What programme structures were involved?
- What insurance liabilities remain?
- What feasible options exist to dispose of the remaining liabilities?

In our experience common sources of error in this process include:

- Lack of appreciation of the options available for different lines of business
- Lack of understanding of regulatory effect of different options
- Exaggeration of the difficulty/costs involved in certain options
- Misguided belief that captives are "stuck" in certain situations
- Misunderstanding of the nature of certain lines and attaching liabilities

STEP 2: ANALYSE 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 from amongst feasible options. This involves answering the following questions:

- What programme 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?

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 organisation. Relevant questions here would be:

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

In our experience common sources of error in this process include:

- Failure to identify interested/influencing parties
- Failure to identify and prioritise key objectives
- Failure to identify potential "roadblocks"
- Failure to identify potential objectives as achievable

STEP 3: IDENTIFY OPTIONS THAT ADDRESS KEY OBJECTIVES AND OUTCOME PRIORITIES

This is simply the consideration of each of the feasible options identified in step 1 against the selection criteria identified in option 2. It is likely that some of the options will not meet key objectives and will be eliminated leaving just one or two remaining options to consider. In our experience a common source of error in this process is:

- Difficulties in the prioritising of competing objectives

STEP 4: PLANNING AND COSTING OF REMAINING OPTIONS

This involves the identification and assessment of all costs involved in the implementation of the remaining options and their discounting to present net values. In order to undertake this, a detailed implementation plan must be created covering the identification and scheduling of all aspects to the full discharging of remaining liabilities, and their discounting at reasonable rates to produce a sound basis for decision making. In our experience common sources of error in this process include:

- Failure to identify all aspects of implementation
- Failure to include "hidden" costs involved in implementation (especially the incidental financial benefits of some options that serve to mitigate costs)
- Failure to take proper account of the length of tail involved in the run-off of certain classes and unrealistic discounting bases

STEP 5: IMPLEMENTATION

The exercising of the implementation plan should involve the allocation of tasks and the monitoring and control of the project to an agreed timescale with regular reporting to the board of the captive. In our experience common sources of error in this process include:

- Incomplete and/or ineffectual planning
- Imprecise allocation of tasks, objectives and reporting lines
- Lack of senior support and necessary expertise
- Inadequate communication with stakeholders

WILLIS' CREDIBILITY

Willis' Global Captive Practice is our centre of excellence for captive matters and consists of a team of insurance and accounting professionals with a wide range of professional backgrounds and business experience. We are experienced in the challenges associated with the management of change processes within 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 bring together the expertise and experience from across the Captive Practice and the Willis Group to design and implement strategies that meet your objectives and required timescales, and deliver maximum value to stakeholders.

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