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Captive Insurance EXPLAINED Guide

CAPTIVE INSURANCE EXPLAINED GUIDE

In association with:

Artex

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1. INTRODUCTION: THE EVOLVING CAPTIVE LANDSCAPE

The past four years have seen a revitalisation of captive utilisation. Captives are en vogue again but it has not always been the case this century.

In the UK and Europe, post Solvency II implementation in 2016 and in the midst of an extended 'soft' market, there was scrutiny on the relevance and need for captive strategies, outside of the largest companies.

The costs of running a captive had increased, investment returns were low, there was more scrutiny from tax authorities and bodies such as the OECD, and the commercial insurance market was an cost-effective place to transfer risk.

Captives were still relevant and well utilised, but new formations on this side of the pond were rare and there was consolidation and closures in some instances.

That all started to change in 2019 as the first signs of a hardening insurance market appeared.

Professional indemnity and D&O were first to bite hard, then other lines followed. Property and cyber remain particularly problematic, while insurers continue to tighten their belt and remain conservative across most lines.

Guernsey benefited from several captive and cell formations in 2019 and 2020 in response to the professional indemnity market hardening, while the D&O crisis prompted a new debate on whether this cover represents a suitable risk for captives to insure with Side A exposures starting to be underwritten into cell captives.

Today, property and cyber are front and centre of risk professional's minds and two lines that historically have been viewed as difficult for captives, given their low frequency, high severity profile, are finding their way into more captive programmes.

Some captives are following developments in loss and exclusion 'creep'. Looked at in isolation, changes in loss estimates or tweaks on cover wordings might seem immaterial, but viewed collectively these can have a material impact on a captive and are starting to make more appearances in captive risk assessments.

In Europe, we have seen the design and formation of MIRIS – an industry mutual established by a group of large corporate captive owners to provide additional cyber capacity. There are multiple efforts elsewhere in the market to mutualise risk, particularly in the case of cyber, using either captive or captive-type structures.

Broader risk retention implications

While new and specific lines of insurance being underwritten by captives often reflects the state of commercial market challenges, there has been a much broader increase in captive retentions across a number of lines.

This is most clearly demonstrated by the increase in annual captive premium. Not all domiciles release this information, or in a timely manner, but in the case of Vermont gross written premium increased from $30bn in 2021 to $42.5bn in 2022.

Such a jump is possible not just because there were 29 additional captives active in the state in 2022 (639 active captives at year-end) compared to 2021, but because existing captives had also increased their premium underwritten.

This growth in premium creates a number of both opportunities and challenges for captives as they increase in size. They must become more sophisticated re/insurers, utilising sound and analytical risk acceptance and pricing techniques, considering the extent of coverage, re-evaluating governance standards to ensure they are fit for purpose, re-assess banking and investment management arrangements and, most interestingly, take another look at their reinsurance or retro options.

Participate on more lines of coverage, help the parent target the optimum TCOR over the medium to long term, setting risk appetite and pricing based upon performance of the business underwritten.

For a turbulent reinsurance market, finding superior risk-managed portfolios is becoming more important than ever. Increasingly, commercial reinsurers are taking notice of captives, particularly larger, multi-line captives, and they want a piece of the action.

If captives are going to accept more high severity, low frequency risk, in addition to traditional captive lines, having a wide array of reinsurance options and relationships is going to be vital to ensure the long-term sustainability of the captive.

Structured reinsurance solutions and multi-year/multi-line programmes are not new innovations, but they are becoming more relevant to a wider group of sophisticated captives.

Specialist treaty and facultative reinsurers are also keen on engaging with captives, while there is a growing reinsurance broker community keen to build captive relationships.

On parametric covers, we have seen little captive involvement to date. There has been a handful of high-profile natural catastrophe bonds sponsored by North American captives over the past 10 years, but uptake has been limited.

The latest concept promoted in this area is for well-capitalised captives to buy a parametric policy in the reinsurance market, absorb the basis risk that exists in any parametric structure, and then issue a traditional indemnity policy to the group.

If deployed for the right risks using good modelling and analytics, this approach could be the enabler for more corporates to explore innovative parametric policies and further strengthen the captive/reinsurer relationship.

Technology

With any of the above approaches, exploring new and more innovative approaches to reinsurance and risk financing requires time, data, and analytics capabilities.

At present, risk professionals leading the strategy on insurance programmes for captive owners are time poor as they remain bogged down in an out-dated renewal process including endless calls for data, usually involving the exchange of schedules of assets and underwriting surveys over email and trapped in spreadsheets.

Not only does this present a very real cyber security risk to all parties involved in a transaction, it requires precious time which risk managers could be using to deploy their skills and seeking new solutions.

There is a growing number of platforms and insurtechs targeting captive owners specifically, understanding that a captive can be used to facilitate the adoption of new technology and use third party insurance partners to achieve a more efficient risk financing [administration?] process.

It is also true that if a captive wants to play a more central and higher profile role in the parent's insurance programmes, either by writing new lines, retaining more risk or engaging more directly with the reinsurance markets, then making use of greater data, analytics and modelling tools will be essential.

Home domiciles

Finally, while the scrutiny of captives by bodies such as the OECD continues, the likely introduction of a 15% minimum global tax rate for MNEs could shift the captive domicile dynamic further. This is another result of the hard market and refocus on national resilience in light of the pandemic, which has prompted a more nuanced interest in captives from national governments and regulators.

France successfully implemented its first bespoke captive regime at the end of 2022, with the argument that the ability of companies to build up reserves in a formalised internal reinsurance structure would improve resilience resonating with the French government.

Those efforts in France, pre-dating the hard market but undoubtedly boosted by it, have led to four new captives formed in the country this year, taking its tally to 12 with more expected.

Similar conversations are taking place in Italy, Spain and Germany meaning we could see a slow move towards more home domiciling as opposed to utilising the traditional European captive centres such as Luxembourg, Ireland, and Malta.

In the United Kingdom, the London Market Group has engaged government to consider the introduction of a new type of 'captive insurer' that would sit outside of Solvency II regulation with buy-in from the local market.

If secondary legislation is passed to implement this approach, it remains to be seen to what extent the regulator will embrace captives and whether it can deliver an appropriate regulatory environment for captives.

While there are benefits to domiciling a captive in the same country as the corporate group, risk managers should also consider the track record and commitment of a new domicile to captives, their understanding and flexibility, and the local infrastructure and captive expertise available.

In this regard, the traditional captive centres provide many advantages that will not be easily or quickly replicated by most new domiciles.

What this trend does reaffirm, however, is that captives are increasingly mainstream. Governments, rather than looking on them with suspicion, are more likely to embrace the concept and are interested in making it possible for companies to keep them at home.

Captives are long term vehicles, and their relevance should not be restricted to a hard or difficult insurance market. The steps taken and innovation achieved over the past four years should ensure they retain their place at the centre of a sophisticated insurance buyer's risk financing strategy.

WHAT IS A CAPTIVE?

- A captive is a special-purpose legal entity that is licensed as an insurer and is established primarily to insure a proportion of the risks of its sponsor—often a corporate parent, group or association.
- It is a risk-bearing vehicle.
- It can be either an insurance or a (re)insurance entity.
- In addition to being used for insuring or reinsuring the risks of its parent and affiliates, a captive can be used to insure or reinsure the risks of third parties, such as customers, suppliers or subcontractors.

2. TAKE CONTROL

In an increasingly dynamic, evolving and volatile global marketplace, the need to establish and maintain control over risk exposures is critical. To do so, successful businesses develop and implement risk management programs that support their strategic objectives, mitigate against new exposures and probe for emerging threats. Through effective levels of control, businesses achieve stability in turbulent markets, grasp opportunities when they arise and grow profitably throughout the market cycle

A central role

A central component of the risk control strategy for a growing number of organizations is the captive insurance company. The primary role of a captive is to insure the parent company, which usually owns or is a sister company to the captive vehicle, for all or a portion of its insurable risks. In practice, however, a captive creates much greater value.

The captive is an ideal mechanism for:

- Establishing a centralized risk framework
- Creating tailored, comprehensive and responsive coverage
- Enabling the development of tailored insurance policies
- Overcoming exclusions and other restrictions applied by the commercial market
- Delivering more responsive and broader coverage options
- Centralizing and improving risk retention strategies
- Increasing negotiating power with the commercial markets at renewal
- Improving claims handling and monitoring
- Potentially reducing the overall cost of risk
- Potentially increasing the cash flow of the combined business enterprise

A captive provides more than just a mechanism to control the risks of the parent company. It also offers entrepreneurial opportunities for joint venture partners, associations and insurance agencies. The majority of companies do not have the appetite nor the financial capacity to self-insure all their risks, and a captive allows the purchaser of insurance to optimize the balance between self-insurance and risk transfer with commercial insurers to suit their risks and resources. The process ultimately provides an excellent management and negotiation tool when trading risk in the market.

A responsive approach

One of the main strengths of the captive is its inherent flexibility. A well-structured captive can respond quickly and effectively to the changing demands of its parent company or fluctuations in the insurance market. A captive can adjust retention levels or amend insurance parameters when required, offering a rapid response tool that keeps pace with change.

In this guide, our goal is to make you aware of what a captive can offer your organization. We will discuss the many benefits of being a captive owner, summarize the processes involved in establishing a captive and provide a brief overview of the different types of captive structures available.

We hope once you have reviewed this guide it will help drive some of the decision-making process necessary to determine whether a captive could add value to your organization.

A well-structured captive can respond quickly and effectively to the changing demands of its parent company or fluctuations in the insurance market.

3. THE CAPTIVE MARKET

Modern captives provide a sophisticated risk transfer mechanism that plays a central role in the medium to long-term strategic planning of organizations ranging from Fortune 500 companies to medium-sized enterprises, and spanning virtually every industry sector.

On the rise

Global captive numbers have risen to beyond 6,181.[1] Increasingly, organizations acknowledge that risk managed through a captive is less costly and more efficient than traditional insurance placement. This is because the captive structure provides a premium rate that reflects the organization's unique exposures, as opposed to commercial insurance market rates that reflect industry averages, typical exposures and a margin for profit.

Control your risk

As the captive market has matured, the willingness of owners to place a broader array of risks into their captive and to raise their retention levels has also increased. The scope of the captive has moved beyond traditional risks such as property, marine cargo, workers' compensation and professional liability to encompass risks such as employee benefits, medical stop-loss, supply chain liability, trade credit, as well as emerging risks such as cyber liability.

Lower the barriers

Captives have continuously evolved in response to changing market needs. Today, there is a diverse range of captive structures available, including pure captives, group captives, agency captives, captive pools, and various cell structures and rent-a-captives. The most recent evolution includes segregated accounts/portfolio companies, protected cell companies, and risk retention and purchasing groups. These innovative structures have helped lower the financial and logistical barriers to the captive solution for many organizations, resulting in an expansion of their appeal to a much broader market.

A world of choice

At the end of 2023, 54.4% of captives globally were domiciled in the United States, with an additional 30.6% in North American offshore domiciles, and 10.9% in Europe.[2] While Bermuda and the Cayman Islands had previously been the largest domiciles globally, in 2023, Vermont overtook both locations to become the world's largest captive domicile with 659 captives. [3] European domiciles such as France, Italy, and the United Kingdom, and Canadian domicile Alberta, are also aiming to grow by developing captive insurance legislation and more robust and accommodating captive industry regulations. [4] As the global market shifts, companies can now locate their captive in more geographically desirable locations, both onshore and offshore, than was previously possible.

A growth market

The captive market is growing. New formations are on the rise, premium volumes are increasing, and overall market appeal is growing. Self-insurance, as part of a risk transfer strategy, is evolving to capture a greater number of risks, industries and territories. As the level of sophistication continues to increase, captives will become an even more effective and efficient structure for managing risk.

[1] According to *Business Insurance*, the number of captives at the end of 2023 had reached 6,181. This includes some estimates by Business Insurance and restated numbers that exclude microcaptives, series captives, and individual cells of cell members in protected cell companies.

[2] *Business Insurance* captive survey Research & Rankings, April 1, 2024: https://www.businessinsurance.com/article/20240401/NEWS06/912363337/Research-&-Rankings-Captive-insurance

[3] Domicile landscape evolving fast for Canada's prospective captive owners," Captive Intelligence, 02 Nov. 2023. https://captiveintelligence.io/domicile-landscape-evolving-fast-for-canadas-prospective-captive-owners/

[4] Captive International, March 7, 2024, Onshore European domiciles aiming to grow: https://www.captiveinternational.com/onshore-european-domicilesaiming-to-grow; Captive International, October 31, 2023, Europe is leaning into captive domicile opportunities: https://www.captiveinternational.com/analysis/europe-isleaning-into-captive-domicile-opportunities.

FIGURE 1

TOP 10 CAPTIVE DOMICILES

Number of captive licenses
at year-end 2023

Source: *Business Insurance* captive survey

Rank	Domicile	2023	2022
1	Vermont	659	639
2	Cayman Islands	658[5]	642[5]
3	Bermuda	633[6]	633[5,7]
4	Utah	439	412[7]
5	North Carolina	311	294
6	Delaware	289	319[7]
7	Barbados	267	261[3]
8	Hawaii	263	255
9	South Carolina	221	209[7]
10	Guernsey	199[5]	203[5,7]

TOP 5 EUROPEAN DOMICILES

Number of captive licenses
at year-end 2023

Source: *Business Insurance* captive survey

Rank	Domicile	2023	2022
1	Guernsey	199[5]	203[5,7]
2	Luxembourg	195	195
3	Isle of Man	98	99[3]
4	Dublin	63	66
5	Sweden	28	29

TOP 10 US CAPTIVE DOMICILES

Number of captive licenses
at year-end 2023

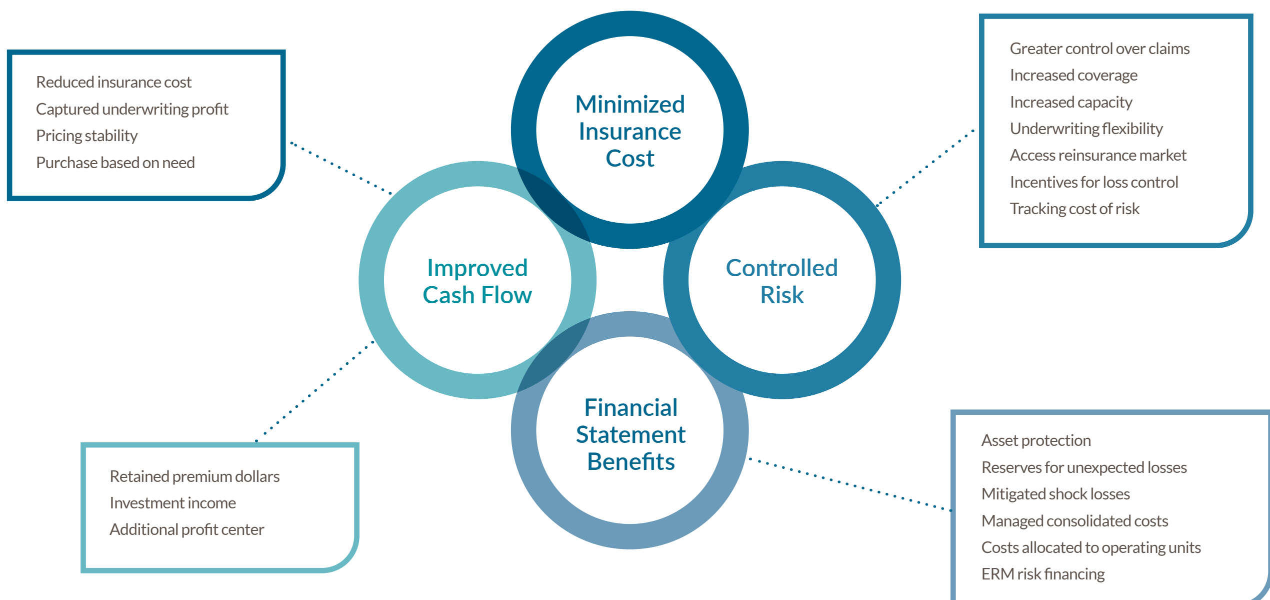
Source: *Business Insurance* captive survey

Rank	Domicile	2023	2022
1	Vermont	659	639
2	Utah	439	412[5]
3	North Carolina	311	294
4	Delaware	289	319[7]
5	Hawaii	263	255
6	South Carolina	221	209[7]
7	Arizona	176	162
8	Tennessee	162	150
9	District of Columbia	120	113
10	Nevada	100	155

[5] Business Insurance - From website
[6] Business Insurance estimate
[7] Business Insurance - Restated

FIGURE 2

What Factors Are Driving Captive Growth?



4. WHY FORM A CAPTIVE?

Making a decision to establish or join an existing captive is strategic. It requires a detailed assessment of your risk exposures, your attitude to and appetite for retaining risk, and a long-term commitment to optimize the balance between self-insurance and risk transfer to the commercial insurance market.

For most captive owners/members, the primary drivers for establishing or joining a captive revolve around cost, control and coverage, and include the ability to:

- Minimize and bring stability to the cost of insurance risk
- Provide custom, responsive insurance coverage
- Embed a proactive risk and claims management framework into the organization
- Access the reinsurance market directly
- Improve enterprise cash flow, cash flow timing and investment returns
- Generate a new revenue stream by covering third-party exposures

Multiple benefits

The range of benefits delivered by a well-structured captive has grown considerably in recent years due to a combination of increased sophistication, changing market dynamics and a more demanding captive client.

The principal advantages of a captive can be divided into three main categories: financial, risk management and claims control, and insurance coverage.

Who should consider forming a captive?

Any company with some of the following attributes should give serious consideration to making a captive part of their risk strategy:

- $500,000 or more in US dollars or equivalent annual insurance spend
- Proactive approach to risk management
- Long-term commitment to risk financing
- Strong financial balance sheet
- Appetite to finance retained risk

Long-term commitment:

Establishing a captive or joining an existing captive program requires a long-term commitment in order to fully capitalize on the many benefits. Depending on the type of captive structure selected, the capital required can vary from nominal to significant. In terms of risk capital expenditure, we normally recommend that only those companies with an annual insurance spend of over $200,000 in US dollars or equivalent consider a group captive or small captive program. Consideration for a larger pure captive should have an annual insurance spend of over $1 million or equivalent, and $500,000 or equivalent if considering a cell-type structure.

Financial:

- Helps reduce total insurance costs over time by aligning premiums with actual loss experience
- Increases stability of premium rates during times of market volatility
- Provides direct access to the reinsurance market
- Eliminates high-expense ratios applied by commercial insurers
- Offers enhanced investment and cash flow benefits
- Can create new revenue-generating opportunities

Risk management and claims control:

- Delivers centralized information and risk control
- Facilitates improved risk capital allocations
- Consolidates and manages global programs
- Provides a vehicle to support enterprise risk management initiatives
- Allows for the ability to create more effective claims handling processes
- Improves claims monitoring capabilities
- Can expose any areas of higher-than-average loss activity through claims audits

Insurance coverage:

- Enables the development of tailored insurance policies
- Increases negotiating power with the commercial market at renewal when purchasing excess insurance
- Provides broader coverage options
- Can be adapted in response to changing market conditions
- Ability to overcome exclusions or other restrictions applied by the commercial market
- Delivers more responsive coverage
- Offers entrepreneurial opportunities for joint venture partners, associations and insurance agencies
- Centralized and improved risk retention strategies
- Stability of cover if commercial insurers withdraw from particular lines
- Can be used to underwrite third-party business
- Can be used to fund uninsured/uninsurable risk including contingent liabilities

The range of benefits delivered by a well-structured captive has grown considerably in recent years due to a combination of increased sophistication, changing market dynamics and a more demanding captive client.

5. IS A CAPTIVE OR CELL COMPANY RIGHT FOR YOU?

Making the right decision

With any important business decision, having relevant and accurate information is essential. When assessing the suitability of all captives, the following information is required:

- Description of business operations
- Historical loss and exposure data
- Financial information
- Details of the current insurance program, including any retained loss funding
- Details of additional risk capital expenditure
- Marketplace summary
- Business motivation for the establishment of a captive
- Review of any uninsured liabilities
- Details of the planned ownership structure
- Due diligence information on the captive sponsor and related parties

Consult the experts

To ensure that each component of the captive is effectively structured and aligned with risk and business objectives requires the appointment of a team of experts.

A comprehensive captive team can include:

- Insurance/captive manager
- Insurance broker/consultant
- Legal advisor with captive experience
- Tax advisor with captive experience
- Claims administrator
- Actuary
- Auditor
- Bank/investment advisor
- Regulator

The feasibility study

A feasibility study is a collaborative study of a company's risk profile that often includes actuarial reports; financial models; a review of the insurance market conditions; and an assessment of regulatory, legal and tax issues. This report recommends risk management options, and establishes whether a captive is feasible and, if so, how this should be structured. Components of this review often become part of the insurance license application in the captive domicile selected. A feasibility study is generally based on the following framework.

Introduction and executive summary:

- Terms of reference
- Report objectives

Organization overview:

- Current insurance program
- Premium expenditure
- Details of any current self-insurance funding and nonconventional risk transfer
- Loss history information
- Actuarial report (if applicable)

Captive requirements:

- Cost/benefit analysis
- Minimum requirements
- Solvency
- Capitalization
- Premiums
- Captive entity or structure options
- Fronting arrangements (if required)
- Reinsurance (if required)
- Retention levels
- Claims management
- Domicile review
- Regulatory and compliance
- Timelines for establishment and ownership
- Directors

Financial analysis:

- Stress testing, including loss scenarios and net captive retention
- Premium funding estimates
- Prospective pro forma
- Expected loss calculations
- Comparison of a captive to the existing risk financing program
- Estimate of likely expenses
- Surplus and capital contributions
- Investment strategy
- Tax position

Other considerations:

- Future development opportunities of the captive
- Tax and accounting
- Ownership structure
- Class of license
- Exit strategy
- Recommendations:
- Final recommended strategy

Registration and licensing

It is essential to work with an experienced captive manager when registering and licensing a captive with a regulatory authority. They should be conversant in all regulatory requirements of the chosen captive domicile. It is also advantageous if they have a strong working relationship with the regulator.

It is essential that you work with an experienced captive manager when registering and licensing a captive with a regulatory authority.

The captive manager will work closely with you and the regulatory authority in the chosen domicile to complete all necessary documentation and submit all information required for the license submission. This will include a detailed business plan incorporating the following information:

- Full details of proposed ownership and supporting due diligence
- Description of the insurance program to be underwritten by the captive
- Strategic and underwriting objectives
- Reinsurance, fronting and any security requirements
- Three-to five-year financial projections
- Capital adequacy calculations
- Risk management framework
- Compliance and corporate governance procedures
- Appointment of service providers
- Board of directors
- Investment strategy
- Dividend policy

Ongoing captive management

Once the captive is operational, the captive manager's role becomes focused on ensuring that the new captive delivers the full extent of the benefits possible, and evolves over time to meet the owner's strategic and risk objectives. These services will include:

- Company and secretarial administration
- Regulatory liaison and compliance
- Corporate governance
- Accounting and financial reporting
- Coordination of any third-party service providers
- Strategic advice on the evolution of the captive

The captive manager's role is wider than the operational maintenance of the captive. It is critical that the manager also ensures that the captive continuously evolves to meet the parent organization's needs throughout its life cycle. This involves working in partnership with senior management so that any changes in the risk profile, requirements of the parent or variations in the commercial insurance market are reflected in operation of the captive.

The manager also ensures that the captive continuously evolves to meet the organization's needs throughout its life cycle.

Captive fees and costs
The costs associated with administering a captive vary depending on captive type, complexity, domicile and levels of administration required.

Elements that impact these costs are:

- Number and type of insurance policies
- Number and territories included in the captive program
- Service requirements for insurance and claims administration
- Number of currencies, frequency of premium receipts and claims payments
- Any reinsurance-related work
- Liaison with fronting carrier(s)
- Need for administration of security arrangements
- Volume and type of investments
- Expected treasury and investment activity
- Liaison with professional and service providers
- Frequency and format of financial reporting
- Custom reports
- Number of board meetings or other necessary meetings per year
- Volume of certificates of insurance required

The typical costs and fees associated with a captive can include the following:

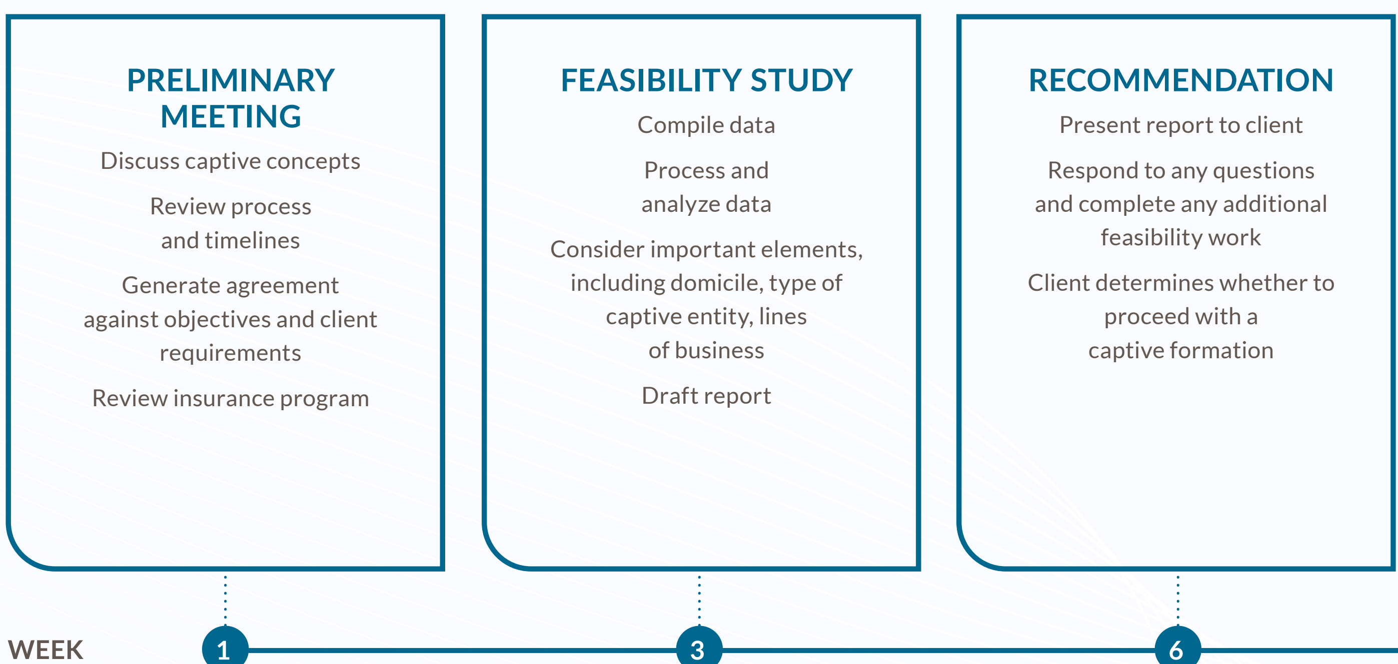
Feasibility study

- Actuarial fees
- Legal, tax and accounting advice
- Completion of report

Captive establishment

- Capitalization
- Application fee (an independent application review fee may also apply in some domiciles)
- Year one license fee
- Incorporation costs
- Captive manager fee
- Legal fees

FIGURE 3



(Typically 12 to 16 weeks; however, certain domiciles and types of programs may take six to 12 months)

Ongoing costs

- License renewal fee
- Other domicile fees
- Captive management fee
- Any necessary ongoing legal advice
- Director's fees
- D&O insurance
- Auditor fees
- Actuarial fees
- Sundry expenses, including meeting costs, travel and accommodation

Key Captive Considerations

When establishing a captive, you will need to consider the following:

- Fronting vs. direct policy issuance
- Reinsurance
- Program administration
- Claims administration
- Actuarial analysis
- Financial reporting
- Choice of domicile to meet requirements
- Captive ownership and type of entity

IMPLEMENTATION

Work with client and other professional advisors to implement the agreed-upon strategy

Appoint any required service providers

Negotiate coverage, fronting, reinsurance and security requirements

Submit license application

Execute agreements

10

CAPTIVE IS OPERATIONAL

Management account preparation

Policy issue and premium collection

Administer loss payments

Investment of assets

Annual audit

Schedule board meetings

16

FIRST ANNUAL REVIEW

Review captive participation, operations and coverages against ongoing objectives

Continue working with client's professional advisors to evolve and add new lines of coverage where appropriate

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6. WHAT CAN A CAPTIVE INSURE?

The captive is a versatile instrument that can be used to provide cover across a broad range of insurance lines. It allows the parent to efficiently optimize its mix of risk transfer to the commercial market and self-funding.

Some captives focus on traditional limits, while other captives write less predictable lines. The majority of captives tend to underwrite aggregate loss limits to ensure the captive's long-term viability. Larger risk layers are generally placed into the commercial insurance market, which has greater capital, appetite and capacity for such risks.

The types of insurance coverage that are suitable for a captive, particularly one newly formed, tend to be those that pay a reasonable level of premium and offer the potential for profit supported by historical data, plus projected investment earnings on cash flow. The total premium generated in aggregate across all lines being underwritten by the captive, net of administrative and reinsurance costs, should be sufficient to make establishing and administering the captive worthwhile.

It is important to note that companies that lack sufficient premium volume, resources or appetite for establishing their own captive can still access many of the benefits by participating in a cell-type structure, such as a protected cell company or a segregated portfolio company, or by joining an existing group captive program.

Extending its reach

In recent years, many captives have expanded their risk appetite to include an increasingly diverse range of insurance coverages. This is mainly due to greater awareness of the parent's risk profile and better understanding of the costs associated with managing those risks effectively, as well as a greater understanding of the overall benefits offered by a captive.

Given its inherent flexibility, a captive also offers the parent company an efficient means of responding quickly to changing market dynamics, whether attributable to regulatory changes, volatility in the commercial insurance market or emerging risks. Examples have included interest in using captives to provide medical stop-loss cover following the Affordable Care Act in the US; trade credit following the financial crisis; accessing UK and US terrorism pools; and more recently, exploring the potential for covering cyber liability.

FIGURE 4

What risks can be placed into a captive?

TRADITIONAL CAPTIVE LINES

- General liability
- Property and business interruption
- Terrorism
- Professional indemnity and errors & omissions
- Auto liability
- Marine
- Aviation and associated covers
- Healthcare liability
- Employment practices liability
- Environmental liability
- Workers' compensation and employers liability
- Product or service extended warranty

EXPANDED CAPTIVE LINES

- Employee benefits including erisa
- Terrorism including tria/tripra
- Fiduciary and surety bonds
- Product recall
- Title and private mortgage
- Equipment maintenance
- Construction exposures
- Trade credit
- Pension longevity
- Errors & omissions
- Creditor life
- Legal expenses

EMERGING CAPTIVE LINES

- Self-insured medical stop-loss
- Reputational
- Intellectual property
- Medicare fraud and abuse
- Expert witness testimony
- Tax audit insurance
- Lease residual value
- Punitive damages
- International kidnapping protection
- Supply chain
- Cyber
- Environmental
- Contingent liabilities

7. TYPES OF CAPTIVES

Captives come in a variety and ever-evolving range of formats designed to meet the requirements of a diverse spectrum of clients. While the single-parent or pure captive remains the most common, group captives, association captives and agency captives have served to enhance the overall appeal. The phenomenal growth in the formation of segregated/ protected or sponsored facilities and cell-type structures has also opened up the benefits to much smaller organizations.

Single-parent (pure) captive:

- Owned and controlled by one owner
- Formed to insure the risks of the parent only
- Most popular structure
- Certain captives can expand into third-party business

Segregated/protected/incorporated cell company:

- Owned by a third-party sponsor (often an insurance manager)
- Insures the risks of multiple insureds
- Individual cells are beneficially owned by the insureds
- Cells are legally segregated from each other
- Offers the benefits of a captive without the same level of financial commitment and associated costs
- Some domiciles permit the formation of incorporated cells

Group captive:

- Owned by a group of companies
- Can be related (i.e., trade groups) or unrelated (i.e., same size)
- Insures the risks of the group
- Can be subject to joint and several liability

Agency/producer-owned captive:

- Owned by a producing retail or wholesale insurance agency/broker
- Can be homogeneous or heterogeneous books of business
- Assumes underwriting risk on the portfolio as a new revenue stream

Employee benefit captive:

- Can insure medical stop-loss, retiree benefits, group term life and long-term disability
- US-based medical stop-loss group captives designed for employers with 50 to 1,000 employees

Producer-owned captive:

- Owned by organization(s) in the insurance distribution channel
- Can be homogeneous or heterogeneous book of business
- Assumes underwriting risk on a portfolio as a new revenue stream

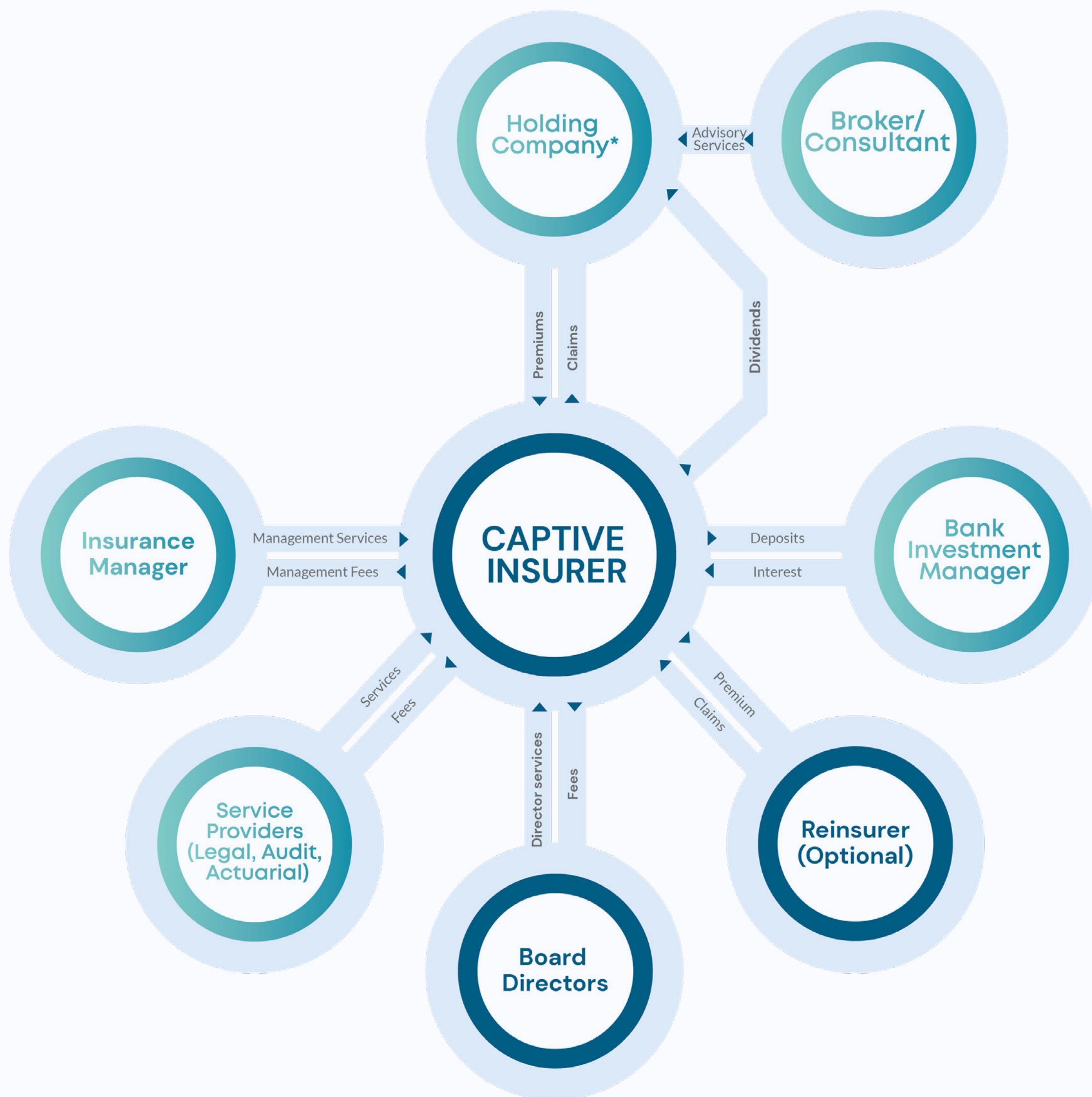
Risk retention group:

- Every insured must be an owner
- Writes only liability lines of insurance for policy holders engaged in similar business activities
- Authorized by the Federal Risk Retention Act of 1986; only available to customers in the United States

FIGURE 5

The Captive Structure

The following diagram provides an outline of the structure of a single-parent captive, indicating the key parties in the structure and showing how capital, services and fees flow.

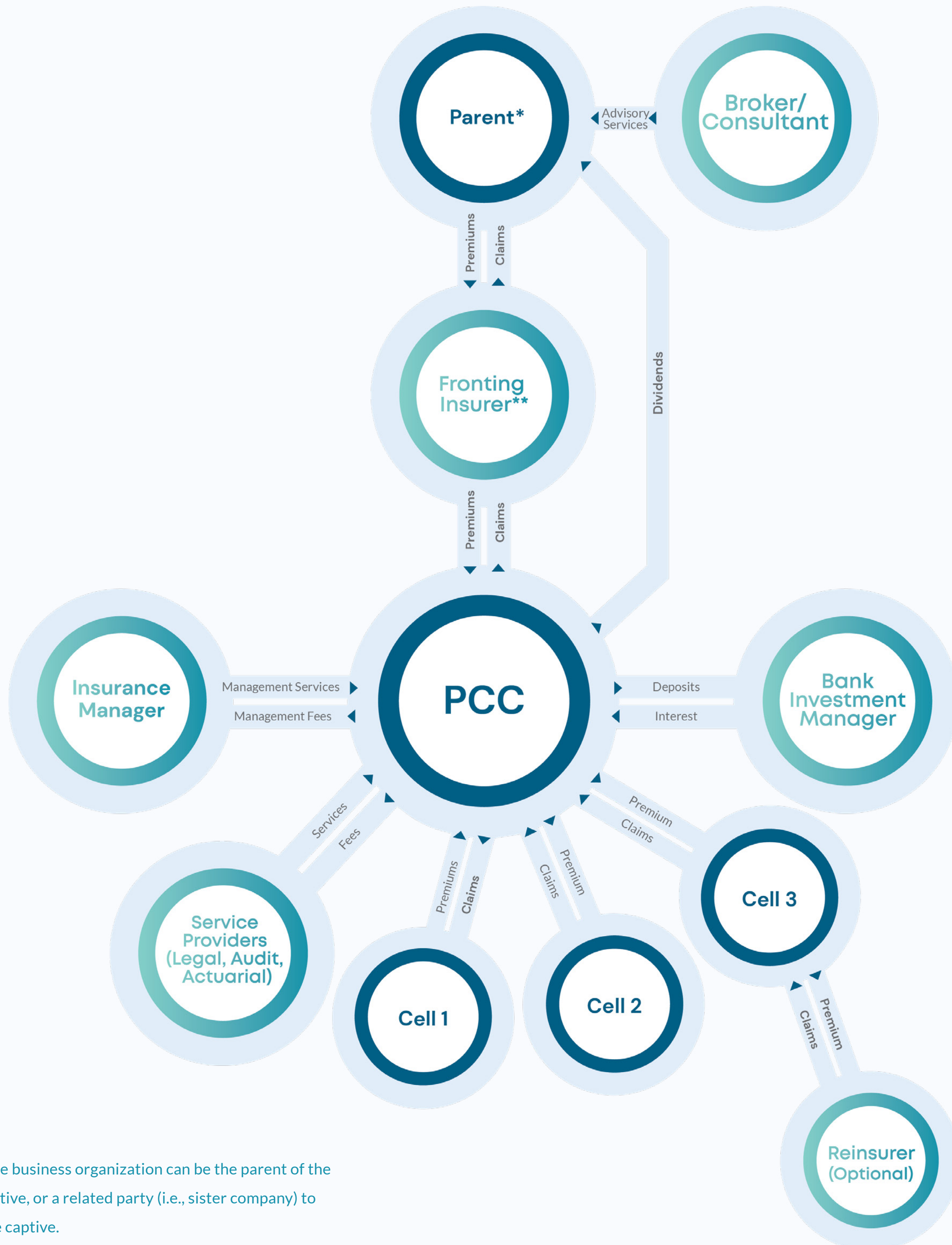


*The business organization can be the parent of the captive, or a related party (i.e., sister company) to the captive.

FIGURE 6

The Protected Cell Structure

The following diagram provides an outline of the structure of a protected/segregated/incorporated cell captive, indicating the key parties in the structure and showing how capital, services and fees flow.



*The business organization can be the parent of the captive, or a related party (i.e., sister company) to the captive.

**Many captives do not require a fronting insurer.

8. CHOOSING THE RIGHT DOMICILE

One of the most important decisions to make when establishing a captive is choice of domicile. Competition within the captive sector has never been greater, as emerging domiciles compete for market share with the leading domiciles. While competition is healthy, the range and diversity of potential locations for a captive make this challenging for the customer.

Domicile factors

For most organizations, geographic proximity and ease of travel has made the decision of where to domicile their captive more straightforward.

However, there is a range of factors that should also be given careful consideration when selecting the most appropriate domicile, including:

- Solvency, capitalization and surplus requirements
- Approach, responsiveness and efficiency of the regulator
- Stability of regulatory and business environment
- Legislation: company and insurance law and the availability of cell legislation
- Maturity and quality of local financial services infrastructure
- Availability of high-quality expertise
- Convenience of travel to and from domicile
- Operational costs
- Taxation and accounting requirements
- Compatibility of language, currency and culture
- Convenience of time zone
- Political stability
- Redomiciliation agreements

If your organization conducts the majority of its business in a territory other than the one in which
the business is headquartered, it may be beneficial to establish the captive in a domicile close to that business.

The onshore/offshore decision

A key consideration when choosing the most appropriate domicile for a captive will be whether to locate the entity in an onshore or offshore jurisdiction. In recent times, there has been an increase in organizations establishing their captive onshore in the US and EU.

There are a number of factors that can influence this decision: regulatory developments, tax and accounting considerations, travel cost savings, and the surge in the availability of new onshore domiciles with captive legislation. However, despite this development, mature offshore domiciles like Bermuda, Cayman and Guernsey continue to dominate the captive marketplace, benefiting from their established and constantly evolving captive legislation, well-reputed and proportional regulatory environments, extensive captive-focused infrastructure, and ease of conducting business.

Selecting the right domicile is a process that must be closely aligned to the organization's objectives for establishing the captive. While it is possible to redomicile the captive, this is generally not straightforward and the goal should always be to select the appropriate domicile at the start.

For most organizations, geographic proximity and ease of travel has made the decision of where to domicile their captive more straightforward.

9. A CAPTIVE CASE STUDY

A community hospital was considering setting up a captive. Despite relatively sophisticated risk management procedures and better-than-average claims experience, the hospital was weighing a significant reduction in its OB-GYN practice given its inability to secure continuous insurance coverage at stable rates. The impact of this on their community would be devastating, as access to local OB-GYN practitioners would be severely restricted. Sense prevailed when a board member called this the tail wagging the dog: "We're letting insurers dictate our mission. Show me Plan B."

That pivotal meeting triggered the hospital's risk manager and CFO to review the hospital's history of premiums paid, claims reimbursed and exposures growth.

That pivotal meeting triggered the hospital's risk manager and CFO to review the hospital's history of premiums paid, claims reimbursed and exposures growth. They discovered that over the 10 prior years, the hospital had paid in premiums five times the amount of claims reimbursed. The excess carrier experienced only one payout of $250,000 on an OB-GYN case that they insisted be settled out of court, regardless of what the hospital's risk manager and legal team considered a very defendable claim. The hospital's loss experience had improved significantly during the 10-year period, despite significant growth in exposures (i.e., occupied beds, outpatient visits, employed practitioners, etc.).

Presented with the facts and the board's instruction to take control of risk financing, the hospital's broker agreed to explore the idea of using a captive with the assistance of an independent consultant.

A feasibility study was completed to further analyze the loss history, develop actuarial estimates of current claims liabilities and future liabilities, explore regulatory and tax parameters, evaluate ownership structures, compare alternative attachment points for commercial coverage, determine capital and solvency requirements, and compare domiciles. The outcome was a recommendation to establish a captive prior to the next insurance renewal date.

The captive's capital requirement was minimized by adding the following program features:

- Premiums for the limits retained by the captive were actuarially determined using a 75% confidence level.
- Premiums were set sufficiently higher than this to cover the captive's annual operational costs.
- The primary insurance policy contained a mechanism for retrospectively adjusting premiums to partly counter any significant under-/overfunding of a given policy year.
- The excess limits insured by the captive were fully reinsured in the commercial market.

As shown in the case study, conservative funding at the 75% confidence level meant that the captive had built up surplus of $7.4 million after five years ($3.5 million difference between insurance liabilities estimated at the expected and 75% confidence level, and $3.9 million of funding in excess of liabilities estimated at the 75% confidence level). The retrospective rating plan allowed for some but not all of this surplus to be utilized by setting premiums for the sixth policy year at the actuary's estimate of expected losses, without adding a margin for the 75% confidence level. Delaying release of all the surplus recognizes the long-tail nature of hospital and physician professional liability insurance, and the possibility of still seeing the loss experience for any prior period deteriorate. This long tail also has its benefits, because premiums can be invested in the meantime, with investment returns supplementing any surplus from the insurance transactions.

Fifteen years after the captive's establishment, it was in a position to negotiate better excess premiums in the market by increasing the excess attachment point and also taking a vertical slice of the excess layer. It also was in a position to release surplus to the hospital to fund ongoing healthcare initiatives, and had sufficient capacity to start considering other lines of coverage in the captive.

The captive afforded the hospital control of its destiny, and its mission was intact.

This case study highlights the importance of certain features in ensuring the success of a captive program:

- Good risk management
- Favorable loss experience
- Accurate exposure data
- Disciplined application of retrospective premium mechanism
- Prudent release of surplus reserves
- Long-term commitment to this strategic initiative on the hospital's part

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At Artex, we believe there is more to alternative risk management. As a trusted leader and provider of diverse reinsurance and ILS solutions, our global team operates at the intersection of art and science—where creative thinking meets expertise and superior outcomes are made. That's how we're able to fully understand our clients' needs and deliver the most comprehensive solutions available.

Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital. At Artex, we believe in finding you a better way.

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As one of the world's largest insurance managers, we combine our international experience and local market expertise in every captive solution we deliver. Our global reach means we can offer a domicile-neutral approach, which delivers the most appropriate captive location based on your needs. As a wholly owned subsidiary of one of the world's largest insurance brokerage firms, we have an entrepreneurial and independent culture backed by a Fortune 500 company.

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Our range of specialist services, delivered by insurance industry experts, spans the full life cycle of the captive structure and covers all permutations of captive arrangements. We also offer access to the largest independent network of cell companies, as well as a variety of risk pooling services. The hallmarks of our success lie in our attention to detail and personalized approach with every customer we serve to truly understand the DNA of each business. We also believe that by understanding where we are today, we can better help our brokers and their clients move ahead with true control over what the future may bring. We view today's challenges as tomorrow's opportunities, and leverage this mindset to create alternative risk management solutions that change the way clients conduct business and plan for the future.

Where art meets science
By expertly combining the benefits of a tailored captive vehicle with insurance and reinsurance products, our risk transfer structures are designed to flex with changing organizational and market dynamics. That way we guarantee a solution that is always fit for purpose. In today's volatile environment, that makes a compelling option for any insurance buyer.

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Airmic
Marlow House
1a Lloyd's Avenue
London
EC3N 3AA

Tel: +44 207 680 3088
Fax: +44 207 702 3752
Email: enquiries@airmic.com
Web: www.airmic.com