Revisiting the Captive Concept

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Contents

Why should you read this guide?

Market conditions are prompting more discussions around alternative risk financing. The trend towards increased retentions will almost certainly lead to more extensive utilization of captives, even by businesses that may have previously discounted this approach due to a lack of scale.

A captive can provide several advantages to organizations in all industry groups and geographies, and close to 6,500 captives[1] worldwide have proved over the last 30 years to be a very effective tool to control and manage risk. However, before deciding to establish a captive, you need to carefully consider the capital commitment, the risks of adverse results, operating costs and the commitment of the management team.

Aon's 2019 Global Risk Management Survey highlights that over 20 percent of companies surveyed currently have, or are planning to set up, a captive or active cell in a protected cell company (PCC).

Captives can provide several advantages to organizations in all industry groups and geographies and are an effective way to take financial control of insurance allocations and manage risks.

This guide aims to help you understand how the formation of a captive can benefit your business and specifically:

- Find out if a captive is right for you
- Who uses a captive
- What the common types of captive structures are
- Where to establish your captive
- How to set up your captive

We hope this guide will be a useful resource, whether you are forming a captive insurance company for the first time, or re-evaluating your current practices as part of your risk retention program.

1 Source – Business Insurance 2019 Captive Managers & Domiciles Rankings & Directory.

What is a captive?

A captive is a bona fide insurance or reinsurance company owned by a non-insurance company parent which primarily insures or reinsures the risks of its parent and/ or affiliated companies, usually formed in a specialized regulatory environment - a domicile.

At a very basic level a captive is a form of risk retention mechanism (like a deductible) that is used to aggregate premium and loss information for its parent.

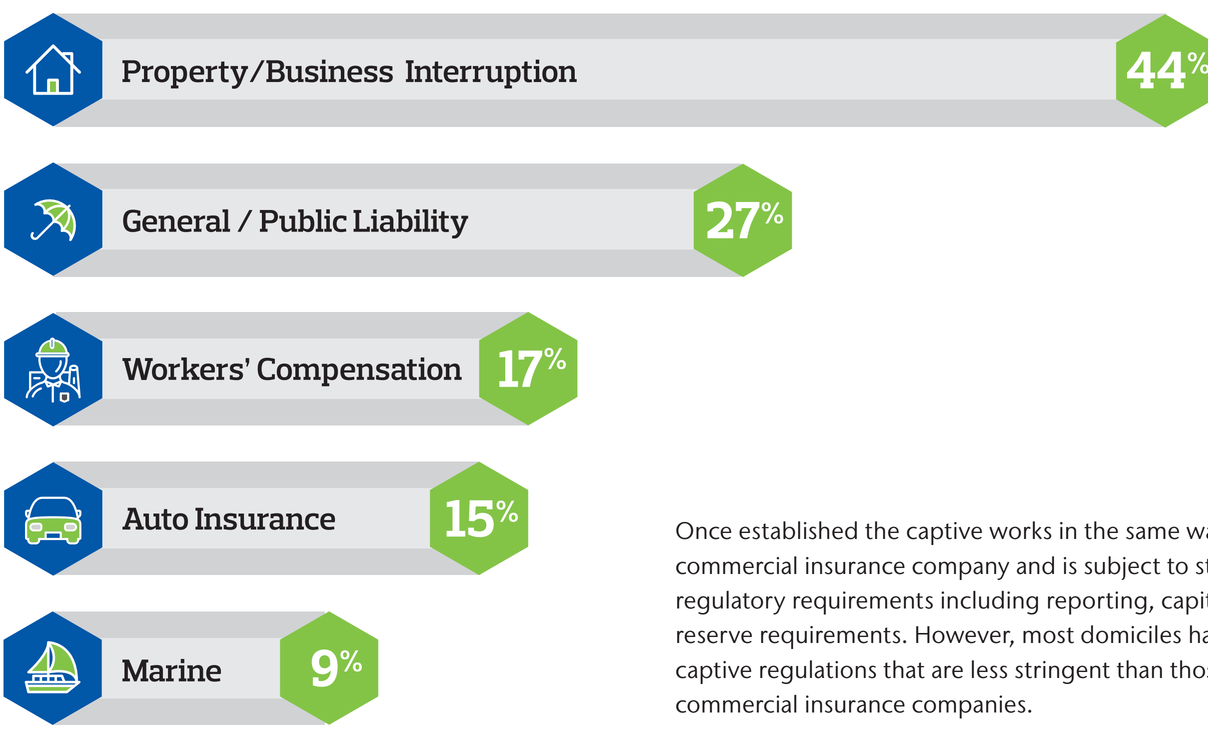
Furthermore, a captive can make risk financing more cost effective and ultimately reduce the total cost of risk. A captive will control the budget that is allocated to risk management and will pay for the company's losses.

Captives are formed to cover practically every risk.

The term 'Captive' was first coined in 1950s by Frederic M. Reiss, better known as the fatherof captive insurance, when he helped a mining company form a captive. Since then, close to 6,500 captives have been established worldwide.

Source: Business Insurance 2019 Captive Managers & Domiciles Rankings & Directory, March 2019

The top five risks written in captives according to Aon's 2019 Captive Benchmarking survey



Once established the captive works in the same way as a commercial insurance company and is subject to statutory regulatory requirements including reporting, capital and reserve requirements. However, most domiciles have specific captive regulations that are less stringent than those applied to commercial insurance companies.

Determine if a captive is right for you

Simply answer the following questions to find out.

	Yes	No
1. Are you spending more than USD 1m in premium and/or retaining a large deductible for any particular insurance policy?	☐	☐
2. Do you have risks that the insurance market is unwilling to accept or are too expensive to insure?	☐	☐
3. Do you want to have more control over your claims?	☐	☐
4. Are you looking to stabilize your total cost of risk regardless of insurance market volatility?	☐	☐
5. Do you have multiple business units that operate independently from a cost and capital perspective?	☐	☐
6. Do you want your insurance fund to remain accessible even after premium is paid to generate investment income and/or be available for certain collateral needs?	☐	☐
7. Are you in a competitive industry in which your peers utilize captives?	☐	☐
8. Is your company exposed to high frequency, low severity losses?	☐	☐
9. Do you have five years of claims history and a well-established risk management framework in place?	☐	☐
10. Do you have the willingness and financial ability to invest up-front costs in order to meet meaningful longer term objectives, pay a captive premium and provide initial capitalization?	☐	☐

The results

The majority of your answers were a yes

A captive could be beneficial to your organization and help to finance risk in a more cost effective and efficient way. You should seriously consider a captive feasibility study as a first step. **Our team is happy to assist.**

The majority of your answers were a no

It sounds like a captive is probably not for your organization and the way you finance risk is possibly the best approach for your organization currently. **Our team is happy to assist.**

Why are organizations forming captives?

The insurance market is in transition. Unprecedented loss levels, coupled with other factors such as evolving buyer demands, changing exposures, reinsurance pressures and an increase in the cost of doing business, are pushing insurers into a reassessment of their business models.

For commercial insurance buyers, this is leading to rate increases, capacity constraints, tightening terms and conditions, and growing insuer scruity on risk management practices.

We asked respondents to **Aon's 2019 Global Risk Management Survey** what their reasons for setting up a captive were. With this challenging insurance market as a backdrop, it is not surprising that cost efficiencies (63%) and a reduction in insurance premiums (51%) were the first and second reasons respectively.

Top five reasons for setting up a captive

Source — Aon's 2019 Global Risk Management Survey

How can a captive help you?

Captives provide three key advantages to companies and are formed for a variety of reasons, which are highlighted below:

Financial Benefits

- Cash flow considerations
- Cost of capital reduction
- Speed of claims payment/settlement
- Stabilizing risk financing cost over time
- Portfolio effect

Risk Management Benefits

- Direct access to the reinsurance market
- Improving insurer purchasing power
- Cycle management and independence
- Funding of non-insurable risks
- Control over claims settlement
- Setting of claims reserve

Organizational Benefits

- Formal mechanism of risk retention
- Appropriate funding of risk retention
- Corporate governance considerations
- Creation of an additional revenue stream

1. Financial benefits

Cash flow considerations

When a company pays premiums to commercial insurers, cash leaves the organization and claims payments are often made long after the premiums are paid. However, if premiums are paid to a captive, the cash remains inside the organization and generates investment income. This substantially improves the organization's cash flow flexibility and contributes towards reducing the total cost of risk.

Cost of capital reduction

While an organization can retain risks without utilizing a captive, it creates inefficiency due to the high degree of uncertainty at the business unit level. It is conceivable that each business unit would set aside capital up to its self-retained worst case scenario. Since a captive bundles the business unit's risks collectively, the retained risks are shared amongst the business units and financed only once. This will free up capital for the organization's core business.

Speed of claims payment/settlement

Commercial insurers can be relatively slow in claims payment and settlement depending on the complexity and the nature of the claim. Under a self-insured program, a company can manage the claims process much more efficiently, which can mitigate financial problems for its subsidiary if faced with a major cash outflow issue due to an insured loss, proactively helping the business get back to normal trading conditions quicker.

Stabilizing risk financing cost over time

Market premium and capacity vary substantially over the long term. Optimizing an organizations risk retention through a captive shields the parent from insurance market volatility. While the market has been soft over the last few years, it would be prudent to plan ahead by taking measures against this exposure.

Portfolio effect

Risk retention programs can often involve making retention decisions by line of coverage, business unit, year or geography. Combining retentions in a captive creates a 'portfolio' of retentions that collectively are more predictable and allows you to make more informed decisions about risk retention generally.

How can a captive help you?

2. Risk management benefits

Direct access to the reinsurance market

The captive is a legitimate insurance company with access to the reinsurance market. This provides clients with additional choices. Reinsurance carriers may offer better rates, coverage and/or services. Additionally this can help should a specific type of risk become uninsurable or overtly expensive.

Improving insurer purchasing power

In addition to reducing cost of capital, bundling the organization's risk through one entity may improve its purchasing power. The organization can retain more risk than the sum of its individual subsidiaries without endangering its overall financial position. Increased retention positively impacts the organization's attitude to claims prevention and shows the market that management is committed to and confident of its risk management practice. It also avoids the expense of taking too much risk as is possible in a decentralized approach.

Cycle management and independence

The ability to retain more risk provides the organization with greater independence from capacity available in the insurance market. Through the captive, the organization can choose to retain more or less risk depending on market cycles. With a good program in place, the captive can accumulate substantial shareholder equity, which further increases the organization's capacity to retain risk.

Funding of non-insurable risks

The parent can protect its subsidiaries for risks that the insurance market is not willing to accept or that are too expensive to buy by incubating the risk in the captive as premium and loss information is developed over time in the captive, the parent is better positioned to approach the insurance or reinsurance market place for protection.

Control over claims settlement

Brand and reputation is highly crucial for many companies, especially those in the consumer goods and services sectors. Through a captive, the organization may exert significantly more influence over how a claim is handled.

Setting of claims reserve

The risk management team is in a position to set reserves for the captive's insurance liabilities. This involves substantial professional judgment as the reserves can be more or less conservative, reflecting the organization's attitude to risk.

How can a captive help you?

3. Organizational benefits

Formal mechanism of risk retention
The captive's premium and loss data are centralized. This provides a formal measure of the organization's overall risk management performance. Where appropriate and desirable, the organization can turn its risk management department into a profit centre.

Appropriate funding of risk retention
The captive also provides feedback on the effectiveness of the organization's risk financing strategy. As the organization acquires more experience, it can adjust the captive's retention limits and use of available capital.

Corporate governance considerations
The captive structure creates a strong governance environment to manage risk across the organization by centralizing the collection of risk data in a regulated environment and promoting better risk management behaviors.

Creation of an additional revenue stream
Captives primarily insure the risk of its parent, however, there are many examples of captives that have expanded beyond their parent's risk to provide insurance solutions to other parties. These strategies can be extremely successful when an insurance product is linked to the company's overall marketing strategy to benefit core revenue lines (by creating differentiation in the marketplace) as well as earning profits from insurance products.

What additional considerations should you keep in mind?

Here are four key considerations to bear in mind when looking to establish a captive:

Capital Commitment

The parent company must contribute the capital required to support the captive's business plan, which must be agreed by the insurance regulator in the captive's chosen domicile. Whilst these funds remain within the parent group, they may not realise the same return as they would have if invested in the parent's operations. Many captive domiciles allow surplus cash including capital to be loaned back to the parent group.

Risk of Adverse Results

The captive's capital could be eroded by adverse operating results, particularly in the early years of the captive's development. Although it is normal to build into any captive program a degree of protection against adverse underwriting results, it is only possible to minimize the risk to the captive, never eliminate it.

Operating Cost

In creating and managing a captive, you will incur various expenses including but not limited to:

- Implementation costs
- Management fees
- Legal and auditing fees
- Local taxes
- Regulatory/licensing fees

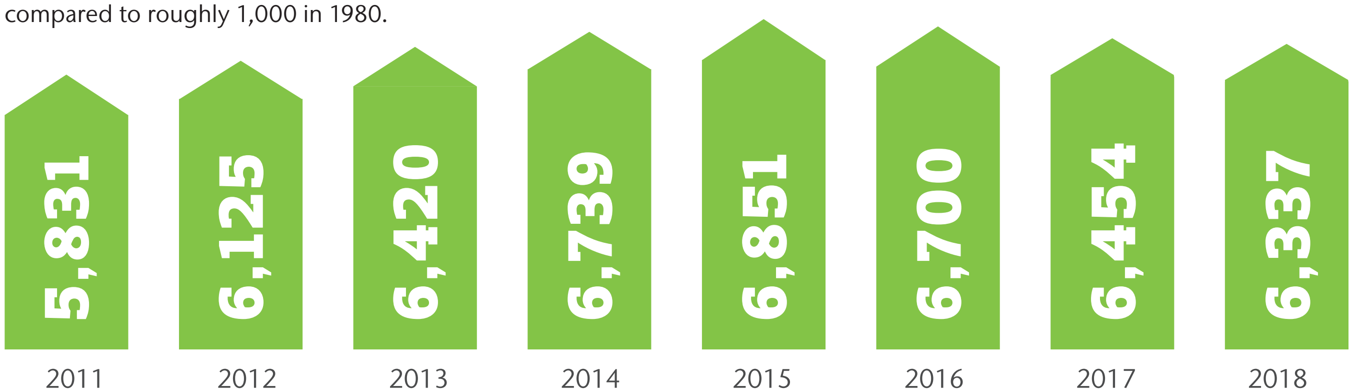
Commitment of Management

A captive will require a commitment of the parent company's management time and some travel costs.

Who uses a captive?

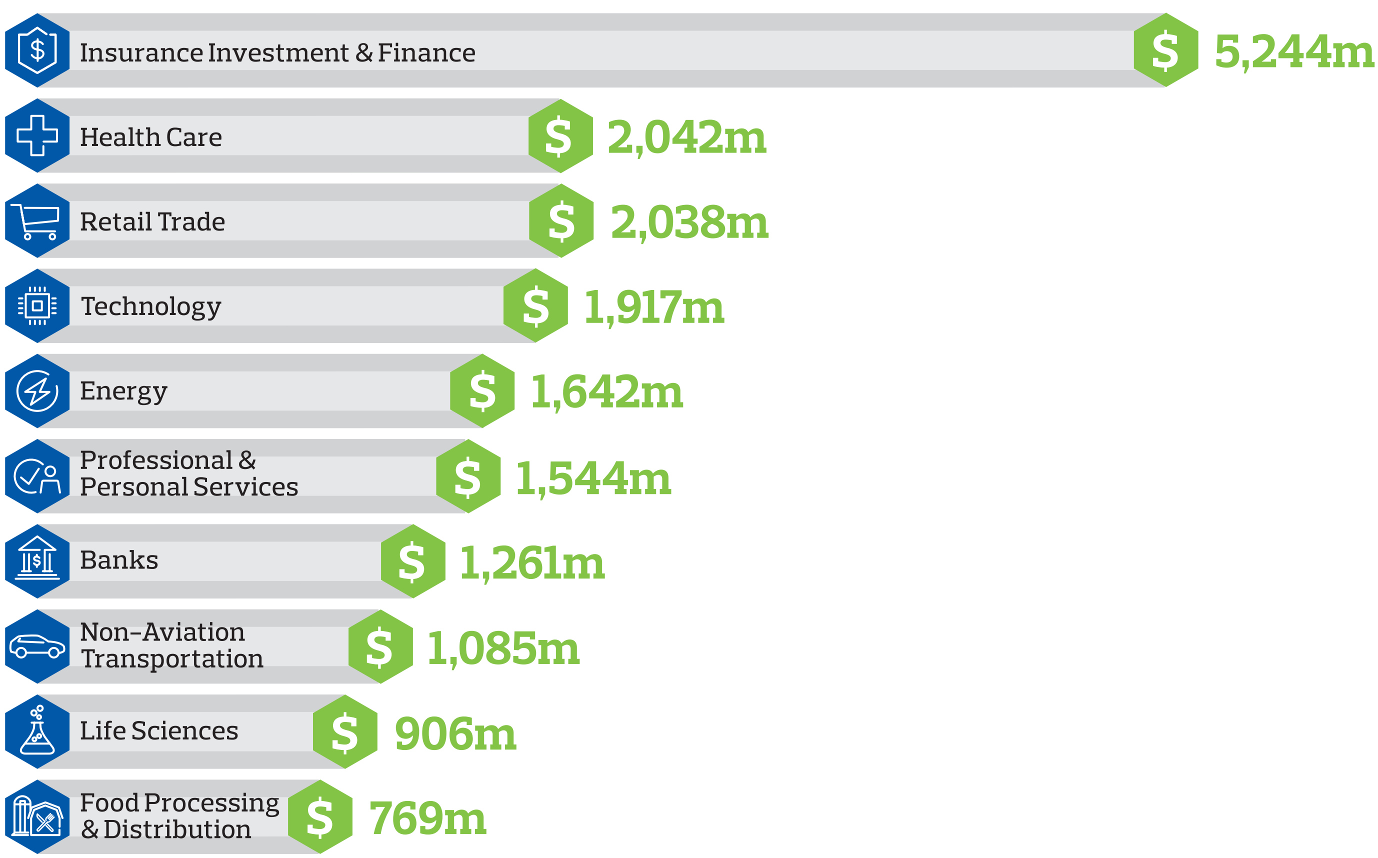
Although captives have been around for more than 60 years, there has been significant and sustained growth in the last 30 years.

According to Business Insurance, today there are close to 6,500 captives globally compared to roughly 1,000 in 1980.



Source: Business Insurance 2019 Captive Managers & Domiciles Rankings & Directory, March 2019

According to Aon's 2019 Captive Benchmarking Survey, seen as a good proxy for the captive sector at large, the top 10 industries using captives based on premium volume are:



What are the common criteria found in organizations establishing a captive?

From Aon's experience of assisting organizations to create and manage captives, the common factors seen in the companies looking to establish a captive are both quantitative and qualitative.

Quantitative Criteria

Premium Volume	There needs to be a critical mass in annual premiums to justify the frictional costs in forming a captive. While situations and objectives vary, annual gross premiums of at least USD 1 million per line of coverage can be used as a benchmark.
Risk Retention Level	There needs to be sufficient capital should the organization choose to retain risks substantially higher than its current level. It would be prudent to perform a risk retention analysis to determine the organization's risk bearing capabilities. Aon undertakes this assessment using the organization's annual report and other available data.
Positive Loss Ratio	A strong recent loss history speaks well for the organization's positive risk management results. In addition, loss ratios are a quick test of whether the organization could have taken advantage of increased self-retention. A loss ratio of 80 percent or lower is normally sufficient to generate a meaningful return in the captive for short-tailed risks, i.e. Property Damage / Business Interruption (PD/BI).
Time Lag between Loss Occurrence and Payment(s)	The time lag between loss occurrence and payment(s) is often significant. Even claims for short-tailed risks like PD/BI can take more than a year to settle. The captive allows the organization to retain use of its cash while claims adjustments are in progress. For longer-tailed risks, i.e. liability risks, the cash can remain accessible for years.

What are the common criteria found in organizations establishing a captive?

Qualitative criteria

Premium/Risk Distribution	A company with only one exposure in one location, is not likely to be a captive candidate. However, many companies have diversified by owning insurable assets in different parts of the world and in different divisions or subsidiaries. The risk exposure is different across locations and hence a captive is a good way to capitalize on the organization's lowered volatility in its risk profile.
Commitment of Senior Management	The Chief Financial Officer and Risk Manager should have an initial interest in both quantitative and qualitative advantages of captive formation. It is noteworthy that they are often influenced by others in the same industry. Once the exploratory stage is under way, it is crucial for a captive management provider to walk through the process with management when they have to present the concept to board and committee members.
Loss Control Capability and Attitude Towards Risks	The organization should focus to keep losses to a minimum. Management should have the ability to influence the operating business units to make loss control a priority.

What are the main types of risk underwritten by a captive?

Aon's 2019 Global Risk Management Survey shows that general third party liability and property are the most frequently underwritten lines of coverage within a captive, at 50 percent and 48 percent respectively; but captives are writing a whole range of risks and this is set to continue. It is interesting to note that cyber liability/network liability is now predicted to be the number one risk to be underwritten in five years' time.

1. General / Third Party Liability — 50%
2. Property (Property Damage / Busness Interuption) — 48%
3. Auto Liability — 34%
4. Employers Liability / Workers' Compensation — 30%
5. Catastrophe — 28%
6. Professional Indemnity / Errors & Omissions Liability — 24%
7. Directors & Officers Liability — 24%
8. Product Liability & Completed Operations — 21%
9. Terrorism — 18%
10. Marine — 18%

IN THE NEXT 5 YEARS:

1. Cyber Liability / Network Liability — 34%
2. General / Third-Party Liability — 28%
3. Property (Property Damage / Business Interruption) — 25%
4. Health / Medical — 24%
5. Credit / Trade Credit — 23%
6. Auto Liability — 18%
7. Crime / Fidelity — 16%
8. Directors & Officers Liability — 16%
9. Employee Benefits (Excluding Health / Medical and Life) — 16%
10. Financial Products — 16%

Are there different ways to structure a captive?

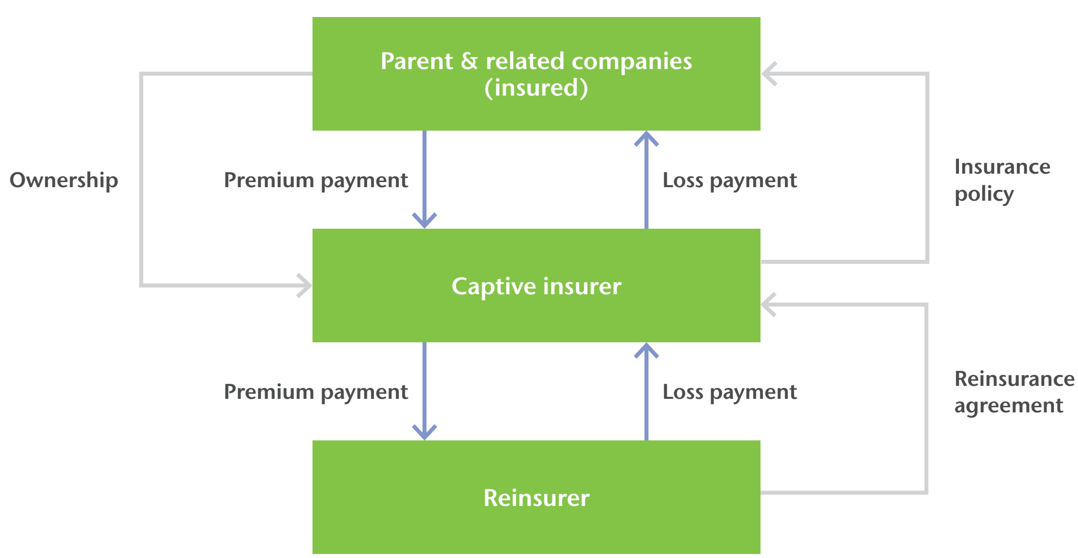
There are several ways to structure a captive and finance risk. Each option will result in varying levels of risk retention and risk transfer to the commercial (re)insurance market. A number of key factors will influence the way you structure your captive and these include:

- Industry classification
- Asset values
- Number of employees
- Revenue
- Locations, risk management and risk profile

The illustrations below show the typical relationship between the parent company group, the captive subsidiary and the various insurers/ reinsurers involved in a captive insurance program.

This is the basic captive structure whereby the captive is a 100 percent owned subsidiary. In countries where non-admitted policies are allowed, the captive could underwrite on a direct basis.

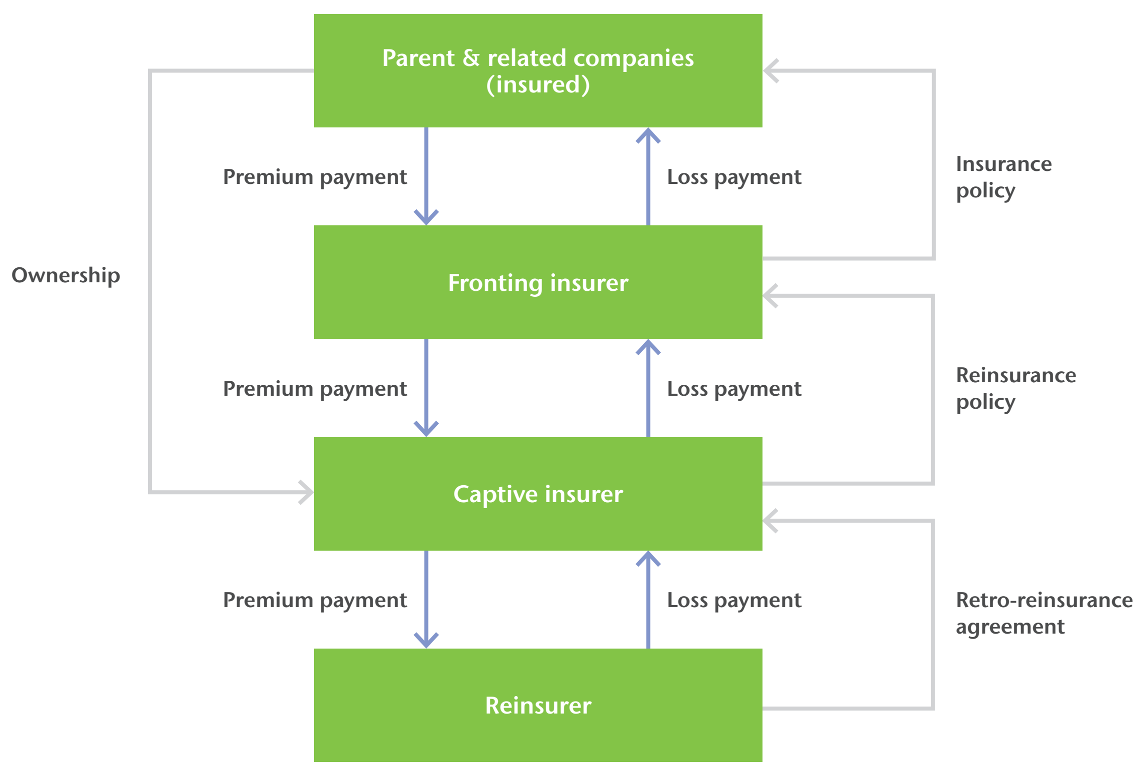
Sample Captive Structure – Captive Insurer



Are there different ways to structure a captive?

If non-admitted policies are not allowed in the jurisdictions where the companies risks are located, the captive would require locally admitted policies to be issued by locally licensed insurers to 'front' the policy on behalf of the captive. The captive would then act as a captive reinsurer.

Sample Captive Structure – Captive Reinsurer



Are there different ways to structure a captive?

Provided below is a list of the most common types of captive:

Single Parent Captive	This is a wholly owned insurance or reinsurance subsidiary that is owned by a single parent company to insure the risks of the parent and related companies in the group.
Group Captives	Group captives are owned by, and insure, a group of entities or individuals. These organizations are often members of a common industry or trade association that pool their risks in a group captive.
Sponsored Captives	Sponsored captives are captives that are established by a third party sponsor. Instead of setting up its own captive insurance subsidiary, the insured can 'rent' the captive facility from a sponsored captive, which provides the benefits of a captive at a lower operating cost. **The White Rock Group** is one such sponsor with operations in key domiciles, including Bermuda, District of Columbia, Gibraltar, Guernsey, Isle of Man, Malta and Vermont. Owned by Aon plc, the White Rock Group offers clients a diverse suite of captive insurance solutions through utilization of Protected Cell and Incorporated Cell structures.
Risk Retention Groups	A risk retention group (RRG) is an alternative risk transfer entity. RRGs must form as liability insurance companies under the laws of at least one state or domicile. The policyholders of the RRG are also its owners and membership must be limited to organizations or persons engaged in similar businesses or activities, thus being exposed to the same types of liability. Most RRGs are regulated as captive insurance companies. However, RRGs domiciled in states without captive law are regulated as traditional insurance companies. RRGs are mainly used by companies in the following industries - healthcare, professional and financial services, government and institutions, transportation, and property development.

Is a captive right for your organization?

If you answered yes to the majority of questions in the worksheet on page 5, then the next step would be to conduct a captive feasibility study.

The study is a vital component in determining if you would benefit from a captive and provides a framework to establishing a captive that will meet your specific risk and insurance needs.

The following information shows the elements that Aon could include in a feasibility study with clients.

Captive Feasibility Study

- Review current program
- Review alternative risk financing options
- Optimizing the program structure
  - Develop an enhanced understanding of specific risks through risk simulation modeling
  - Co-ordinate with market availability and pricing through Risk Transfer Pricing Analysis to evaluate the sensitivity of insurance premiums to increased / decreased retention levels
  - Develop an in-depth understanding of the organization's ability to retain risk through a Risk Bearing Capacity Evaluation
  - Provide alternative optimum risk financing strategy options through optimization processes that will determine the program with the lowest cost of risk for a given level of volatility
- Domicile options and type of vehicle
- Captive financial projections and business plan comparing to current state
- Timeline and key tasks for the establishment of the captive
- Management of the captive
- Status review after initial phase of operation

Where should you domicile your captive?

When selecting the location or domicile for your captive, the key factors that you should consider include:

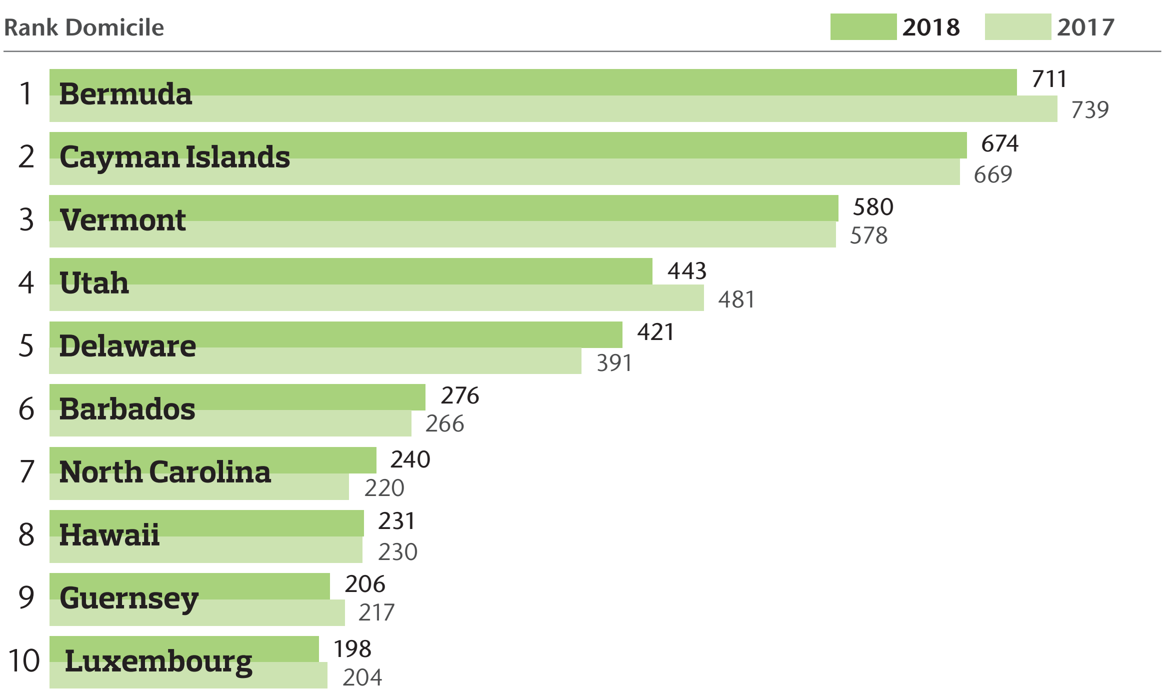
- Ease of formation
- Regulatory environment
- Flexibility of regulations
- Service support infrastructure
- Geography/ time zone consideration
- Experience in your specific industry and the type of risk being underwritten
- Accountability, communication and convenience
- Taxation
- Exit considerations

A feasibility study (see page 19) will help you to decide on the most suitable option(s) for your business.

The graph below shows the top 10 domiciles across the world.

Main captive domiciles

Counting - Ranked by number of captive licenses at year-end 2018



Source: Business Insurance 2019 Captive Managers & Domiciles Rankings & Directory.

What's involved in setting up a captive?

Once the feasibility study is completed and the domicile selected, the key requirement is obtaining an insurance license from the local regulator.

Timelines may differ depending on the domicile selected, however the process typically takes two to three months, and involves the following steps.

Tasks

- Captive feasibility study/business plan finished
- Selection of auditors, company secretary, directors and captive manager
- Preparation of application form to be submitted to insurance regulator
- Regulator reviews application
- Meeting with the regulator
- Establishment of legal entity
- First board meeting
- Opening of bank accounts
- Payment of share capital and allotment of shares
- Confirmation by auditors
- Submission of audit confirmation and other documents to the regulator
- Regulator issues license
- Captive operational

What outsourced services will you require?

As the captive owners’ core business is not insurance, the vast majority of captive owners worldwide outsource portions of the required services to specialist service providers.

As captive insurance managers we act as an extension of our clients’ team. We work with each client to identify and select appropriate services to meet the specific needs of the captive entity. Our dedication to our clients and our exposure to 1,360 insurance entities allows us to provide market leading service.

Our core services fall into five distinct categories:

1. Financial Accounting/Management

- Provision of management accounts
- A comparison against budget and other specifically requested schedules such as investment details, and underwriting and claims information
- Management commentary highlighting any significant items in the financial statements, budget variances, statutory compliance issues, etc.
- Oversight and management of a timely and successful annual audit in conjunction with the captive’s auditors
- Effective management of operations and assets
- Handling all correspondence in relation to the captive’s continuing business

2. Insurance Services

- Preparation and issuance of policies and endorsements to ensure suitability within the overall risk financing objectives
- Preparation and issuance of certificates of insurance where required by the captive
- Assist with credentialing and claims history requests
- Liaison with the captive’s insurance brokers to ensure its efficient use as a core part of the risk management program
- Collaboration with the captive’s brokers to structure and place any required reinsurance program behind the captive
- Coordination with the appointed actuaries for the captive
- Maintenance, reporting and analysis of underwriting and claims statistical records
- Underwriting functions such as captive premium recommendation and allocation

What outsourced services will you require?

3. Compliance Services

Aon is responsible for ensuring regulatory compliance. We will act as the principal representative for the captive as set out under the provisions of the laws of the various domiciles in which we do business and fulfill the following duties:

- Maintain principal place of business in the domicile, if required;
- Monitor the captive's compliance with insurance regulations and requirements contained in the applicable laws and, if necessary, make recommendations as to corrective action
- Prepare, coordinate and submit the annual filings as required by the Law
- Arrange for the payment of appropriate local government fees
- Prepare and submit business plan amendments for regulatory approval, including the addition of new covers, changes in limits, rotation of directors, etc.
- Liaise with the captive's appointed attorneys and auditors.

Cash Management

We undertake the management of cash, including:

- Coordination of the selected investment advisors to ensure timely reporting
- Monitoring cash balances held in the captive's bank accounts and investing surplus funds on a timely basis in accordance with the company's investment policy
- Execute checks and set up wire instructions within agreed limits of authority conferred by the captive's Board

Board Meeting Services

We provide services for the annual Board Meeting, including:

- Preparation of a comprehensive Board book of agenda items and supporting material, such as past minutes for ratification, financial and underwriting reports, claims reviews, auditor, actuarial and investment reports and special items for consideration by the Board, such as strategy reviews
- Act as the captive's Company Secretary and prepare necessary resolutions and actions of the shareholder and the Board of Directors

Fronting and Partner Insurer(s)

A fronting insurer may be required to issue a local policy where legislation necessitates a locally issued policy. There are a number of well-known international insurers that provide these services.

Claims Management

The captive retains a proportion of the parent's insurable risk. As a result the captive is required to manage claims that occur within its share of the risk. This is usually outsourced to a third party administration.

The cost of managing claims is largely dependent on the number of claims and the complexity (generally related to costs) of the claims.

What outsourced services will you require?

Auditor

All large multinational accounting firms have a significant presence in all major captive domiciles, equipped with sizable audit practices with experience in insurance accounting and financial reporting.

Investment Manager

Typically, captive insurance companies invest funds in the most appropriate way and to create a profitable portfolio without jeopardizing the captive's ability to meet its obligations.

Whilst management of short term investments can be provided by the captive manager, long term and more aggressive investment strategies should be developed by a professional investment manager.

Cash Management

Your captive manager will assist in the process of setting up the required bank accounts and bank mandates, and will coordinate with investment advisors in accordance with the company's investment policy.

Your captive manager can also assist in the process of securing letters of credit when necessary.

Company Secretary

A company secretary is required to assist in the submission for incorporation as well as providing company secretarial work after incorporation.

The role of the company secretary is to keep the Article and Memoranda of the company, the share certificates and the records of board meetings, to pay the government fees, and to handle certain compliance matters.

Loss Reserve Specialist

The engagement of a loss reserve specialist in respect of the captive's loss and loss expense provisions is mandatory in some jurisdictions.

However, it is deemed best practice and is sometimes required by the audit firms.

Underwriting Support

In addition to loss reserve specialist, actuaries also assist in the future pricing of general insurance risks based on historic losses, reinsurance costs, premium allocation, premium tax assessment and settlement.

Why Aon?

Aon's Captive and Insurance Management delivers value to clients by focusing on the management, control and reduction of clients' total cost of risk. As an integral part of Aon's Global Risk Consulting, we do this by helping our clients identify and quantify the risks they face; by assisting them with the selection and implementation of the appropriate risk transfer, risk retention, and risk mitigation solutions.

As a risk retention mechanism, a captive insurance company is often at the heart of a comprehensive risk program.

Aon's Captive and Insurance Management team is one of the world's leading captive and insurance management service providers. We manage 1,360 insurance vehicles worldwide and our clients generate total premiums of over USD 32 billion per annum through managed insurance vehicles.

Conclusion

We hope you have enjoyed this guide. We would be delighted to assist and discuss further as you look to invest in a captive.

Although establishing and managing a captive insurance company can seem like a challenge, especially when you also have your daily tasks to complete, we think that with the right captive management partner, it will prove a sound investment and form a critical part of your risk management strategy. After all, a captive insurance company can help:

- Reduce the cost of capital and stabilize risk financing costs
- Improve insurance/reinsurance and enhanced coverage purchasing power
- Provide greater independence from the conventional insurance market
- Improved claims payment/settlement times
- Provide a formal way to measure and evaluate risk management performance

Next steps

Ready to take a captive feasibility study?

Contact our captive insurance specialists for an informal chat and to better understand how a captive can help your organization.

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About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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