BRYAN CAVE
A Broader Perspective

Bulletin

Captive Insurance Team

To: Our Clients and Friends September 2013

Captive Insurance Companies in Europe – The Benefits of Internal Risk Coverage

Captive Insurance Companies (or in short "Captives") are intra-group insurance companies. They insure risks of their affiliates resulting from their business operations instead of transferring them to the insurance market.[1]

Today there are over 5,000 Captives worldwide with US headquartered enterprises in the lead. Over 60% of the Fortune 500 have established Captives. But Captives are not only for the large conglomerates. A Captive can also be suitable for a smaller or medium sized company, depending on the specific risk profile.

A big advantage of Captives is that they can insure risks that cannot be insured in the direct insurance market (e.g. deductibles), or not at a reasonable price. Captives can also capture underwriting profit and investment income typically retained by commercial insurers. Further, through their access to the reinsurance market, Captives can potentially obtain more favorable premium rates and other terms and conditions compared to commercial insurance coverage. Thus, Captives can help save premiums which over time may considerably exceed their administration costs. They can not only be used for the classic property & casualty risk coverage, but also for losses resulting from product liability, extended warranty, environmental contamination, credit default, un(der)funded pension schemes, and compliance. In parallel, Captives can improve internal risk management by centralizing profit and loss information relating to a company's risk management programs and reinforcing the benefits of loss prevention and similar risk management tools.

In this Client Alert we will summarize the main drivers for, and key considerations to be made prior to, setting up a Captive.

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[1] Note: Captives can, in theory, also insure third party risks. In this Client Alert we only talk about so-called "Pure Captives", which exclusively insure group internal risks, since a discussion of the use of Captives to insure third party risks is beyond the scope of this Client Alert.

Types of Captives

Captives can be structured to directly write insurance for company group members or as a reinsurance company. Captives set up as reinsurance companies typically use a commercial fronting insurer to issue the respective policy to the group members and then reinsure the risk with the Captive; the premiums paid by the group members will be passed through as ceded reinsurance premium less a certain fronting fee. The Captive itself can further reinsure the risk in the reinsurance market (so-called "retrocession"), potentially at more favorable premium rates.

International groups further have the choice of domicile. Captives incorporated in the same jurisdiction as the parent company are so-called "Domestic Captives"; in turn, if the seat is abroad, they are called "Offshore Captives". The best jurisdiction for a Captive depends on various considerations: the regulatory framework, accounting requirements, tax benefits, political aspects and legal stability, capital requirements and currency exchange risks.

Advantages of Captives

Captives can help reduce insurance costs significantly over time. But monetary benefits are, by far, not the only driver for setting up a Captive. Captives can help to materially improve internal risk management and compliance. Besides, Captives can insure risks for which coverage may not be available in the commercial market (at all or at a reasonable price). In more detail:

- <u>Flexibility; Improved Risk Management and Compliance</u>: The Captive's insurance policies can be adapted to the specific risk profile of the group and the group's individual objectives and business strategy. The awareness about the interplay of risk management, a low claims rate and low insurance premiums usually results in a positive risk selection. In addition, the internal handling of the claim, but by a different entity, can help avoid moral hazard and improve group wide compliance.
- <u>Improved insurance costs</u>: If properly designed and when used within the context of a risk management strategy that emphasizes risk retention, a Captive can provide significant savings to the group's overall insurance program costs.
- <u>Accrual ability, Tax advantage, Cash Management</u>: If properly structured, the Captive can build tax deductible reserves for the insured risks and the operating companies can deduct the insurance premiums paid – unlike Captives, operating entities cannot accrue reserves for uninsured risks. Depending on the respective tax situation of the individual group members and applicable tax treaties, this can result in tax benefits. In addition, depending on the regulatory requirements, the Captive can use the excess funds for optimizing the group's cash management.
- <u>Balance sheet protection</u>: If a risk materializes, the balance sheets of the operating entities are protected since the loss is borne by the Captive. For that purposes it is imperative that the Captive is properly capitalized and/or reinsured.
- <u>Coverage of uninsured risks</u>: For many risks which are business specific or new or have a particularly bad risk profile (high potential losses or high probability) there is often no coverage available in the open market or at least not for a reasonable premium. Since a Captive underwrites

only the risks of its corporate group, it can calculate the underlying risks based on its own experience and provide insurance coverage for premiums appropriate to the group.

- Access to reinsurance market: Captives can directly access the reinsurance market and, thus, potentially achieve better insurance terms than operating entities in the commercial market. The group can become less dependent on the commercial insurance market and achieve additional flexibility as a result.
- Transparency: Providing insurance through a Captive often leads to a better understanding and focus on risk management and the claims history of the group, potentially leading to a significant reduction of the company's overall cost of risk. At the same time the calculation of the premiums becomes more transparent.
- Low running costs: Captives can save on overall insurance costs by capturing underwriting profit that is built into the premiums of commercial insurers. There are different options available, including Rent-a-Captive models. Virtually all administrative and management functions of the Captive can be efficiently outsourced to third party service providers.
- Insurance technical profits are retained: If the Captive has underwriting profits (in particular in years with no/low claims or through successful investments) they remain within the group and not with the third party insurer. They can either be carried forward, or, subject to regulatory approvals, can be advanced as inter-company loans, or be distributed to the parent company.
- No price fluctuations or risk of extra-ordinary termination after claim: While insurance premiums are often subject to material up- and down turns, Captives can help to stabilize premiums (subject to the Captive being properly capitalized and meeting applicable regulatory requirements). Further, there is no need for annual renegotiations or the threat of termination when risks materialize or a certain accumulation of claims occur.

So in general, there are many reasons which support the formation of a Captive. However, one must not forget that the Captive is an insurance company and must be solvent enough to bear the insured risks if and when they materialize, or have sufficient reinsurance coverage. Further, if only the "good" risks are covered internally this may result in higher third party premiums for the "bad" risks. Also, Captives have to comply with applicable insurance laws, including capitalization and reserve requirements. The regulatory requirements are subject to change, as are the applicable tax laws, so that envisaged future profits may be smaller when collected than anticipated originally.[2] But the existing Captives show that the pros often outweigh the cons if structured and managed properly.

[2] For example, the Solvency II regulation (2009/138) may result in substantial changes for insurance companies, including potentially capital requirements for Captives.

Addressable Risks

Captives can insure most of the known risks and group specific risks.[3] Typical risks covered include:

- Deductibles
- P&C Risks
- Contractors All Risk
- Credit Default
- Fidelity
- Product Liability
- Extended Warranty
- Business Interruption
- Employee Benefits and Pensions Schemes
- Punitive Damages (where permitted)
- M&A Liabilities
- Surety (Performance or Warranty Bonds)
- Litigation or investigation expense, including compliance penalties (to the extend permitted)

Suitable candidates for Captives

The range of businesses that are suitable for Captive structures is as broad as the spread of insurable risks and the strategies pursued with self-insurance concepts. In general, the use of a Captive should be considered for entities that have the required liquidity to capitalize the Captive (depending on the type, structure, domicile, and risk profile, but based on the EU regulation 2005/68/EG a minimum of EUR 1 million for reinsurance Captives) and meet one or more of the following criteria:

- <u>Minimum annual premium</u>: If the goal is to reduce general insurance premiums through access to the reinsurance market and exercise of available tax benefits, the business should have a certain minimum annual premium (approx. EUR 1 million) and a positive claims history. Proper deductibles will help support a sustainable calculation.
- <u>Functioning risk management</u>: Companies that have or are willing to adopt good risk management practices or that want to have more control over claims handling and other aspects critical to their risk management programs.
- <u>Restricted insurance market access</u>: Companies that are unable to obtain adequate insurance in the commercial market or Companies that have better-than-average loss experience but are hindered

[3] Limitations may come from other directions, like the compliance department. It is questionable if good corporate governance allows a Captive to insure certain D&O risks like willful wrongdoing of the board members or employees.

by other factors (e.g. structural complexity) that inhibit efficient access to commercial insurance markets or the ability to obtain stabilized insurance pricing.

Forming or participating in any type of captive insurance company involves significant legal, tax and risk management issues and requires consideration of each company's unique situation and objectives. Bryan Cave's Captive Insurance Team regularly assists clients with the design, formation and licensing of captive insurance companies, and advises on corporate, regulatory and tax aspects of captive insurance companies. Clients of Bryan Cave's Captive Insurance Team include Fortune 500 companies, national associations and privately held businesses.

For questions or further information, please speak to your regular Bryan Cave contact, a member of our Captive Insurance Team, or the authors of this client alert:

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