

# Think twice before shutting your captive

Companies struggling with liquidity may be tempted to shut their captive insurance operations during these difficult times. There are less drastic ways of getting money out. **By Stacy Shapiro**

**C**losing down an insurance subsidiary because the parent company needs extra cash is a dramatic step. It is better to review the funds held by the captive to see if there is surplus that can be either sent or loaned back to the parent without threatening the viability of the captive. This course of action will ensure the owner still has the captive available when insurance or reinsurance markets harden – which some experts predict will happen quite soon.

“Owners should in any event regularly review how their captives are funded and structured and see whether there are funds that can be released back to the parent company. All businesses should seek to optimise their return on assets, and a captive is no different in that regard. If there are surplus funds in a captive they can be redeployed,” says Nick Wild, Executive Chairman (ex Americas) of JLT Insurance Management. “This should be done in an orderly and cautious way rather than as a

knee-jerk reaction to the current economic crisis, because funds that you take out of a captive today might be needed to deal with claims that arise in the future.”

“There is pressure now to get cash out of captives,” says Paul Bailie, Executive Chairman (Americas) for JLT Insurance

## HAVE YOUR CAKE...

Potential sources of free funds in a captive can include:

- 1 **Retained earnings** = dividend.
- 2 **Surplus capital** = capital reduction or loan to parent.
- 3 **Claims reserves** = dividend or loan to parent.
- 4 **Access to all of the above through sale of the captive** – remember that there is a real cost to the business embedded in this option.

Management. “People are looking for liquidity wherever they can find it. But against this we’re seeing some hardening in insurance and reinsurance markets and there is greater focus on insurer and reinsurer security, hence owners are more likely to increase the use of captives by retaining more risk.”

Taking a more sophisticated approach and reviewing the requirement for the cash within the captive will allow the company to see if there are funds that may be repatriated back to the parent while maintaining the viability of the subsidiary.

### Review earnings and capital

If the captive has increased its retained earnings over the years, it may be able to return some surplus in the form of a dividend to the parent company. These funds are historical profits that have been retained to increase the captive’s balance sheet allowing it to take on more risk. They are freely distributable by the captive’s board to the extent that they have not already been >>>

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utilised to support retained risk on the current portfolio of business written or long-tail liabilities.

Another source of cash may be the paid-up capital of the captive. Over the last four years when insurance rates have been quite soft with few major claims, owners may have reduced the amount of risk going into their insurance subsidiary. As a result, it might now need less capital, especially if it was originally set up during a hard market with a sizeable capital base.

“We are seeing greater scrutiny of captive

balance sheets and the need to ensure that capital is being used appropriately and efficiently,” says Bailie. “Indeed, this is something that a captive, like any business, should be constantly considering.” Having too little capital is certainly a bad thing, but conversely a company that is over-capitalised will not realise the maximum value for its parent. Financial modelling can assist in determining adequate capital and/or alternative forms of funding for the captive’s business. “We are now looking at dynamic financial analysis (DFA), a tool already used

in the commercial insurance and reinsurance markets, as a means to better allocate capital,” says Bailie.

If it is found that there is more capital in the captive than is required to support the business, the amount of capital could be reduced and sent back to the parent company. However, this may be short-term thinking if the market is hardening through 2009/2010. “You may find you want to take more risk again and need to recapitalise the company,” Bailie adds, “and it will be difficult to do that if the parent company has low liquidity. On the other hand, it may be that a parent company’s survival is predicated on pulling in money from numerous subsidiaries and not just the captive. It could really be make or break time for them.”

#### Claims reserves

A third area for possible release of funds is claims reserves, but caution is most critical here. Claims reserves often include not only the known losses but also estimates of losses that have not yet been notified, known as incurred but not reported (IBNR) claims. “If you’re going to consider accessing that pool of funds, you have to exercise significant caution, and we would suggest that you don’t

do it without having an actuarial review if you haven’t had one in recent times,” says Wild.

If an actuarial review demonstrates, with a high degree of certainty, that the loss reserves exceed the expected losses, then reserves can be released to profit and the profit returned to the parent as a dividend.

If there is an element of uncertainty, as there often will be with long-tail risks, it would be more prudent to maintain the loss reserves but perhaps consider lending some of those reserves back to the parent company. This is especially the case where the contract between the captive and the parent is a direct relationship and there are no third parties with rights to the proceeds of the insurance policy.

Many captive owners are considering lending funds back to the parent company at a commercial rate of interest. This practice is more common in onshore US and Bermudian captives than in European captive domiciles, as the loans require regulatory approval and are not automatically treated as admissible assets for solvency reasons. However, in Europe increasing numbers of captive owners are enquiring whether they can make such loans.

“In Bermuda, clients are looking a little harder at getting funds back from the captive insurance company by way of inter-company

## CASE STUDIES

### Eli Lilly holds onto risk

Pharmaceutical company Eli Lilly has decided to retain more risk in its two captives domiciled in Bermuda as part of an overall plan that happens to coincide with the current economic situation.

Eli Lilly’s two mature captives – one for US risks and one for European risks – will retain more of the company’s transit risks, benefit programmes, clinical trials liability and general liability this year. Also, the company’s captive for European risks is writing trade credit insurance for the first time.

“I believe that we have very good risk management practices that the market may not be giving us credit for, and they are not pricing our risk appropriately for some of the programmes we have in place,” argues Mark Saltgaver, Director of Corporate Risk Management at Eli Lilly in Indianapolis.

“So, I’ve looked to utilise the captives to retain more of our risks rather than offloading to a third party insurance market. Now, with the financial crisis upon us and the insurance market hardening, it may further substantiate this position,” says Saltgaver.

### Interserve keeps a close watch

“If we think that the insurance market isn’t pricing our risk fairly, it gives us the ability to price it ourselves through the captive,” says Tim Jones, Financial Director at Interserve, whose captive is in Guernsey. “That takes us closer to the consequences of that risk and gives us an incentive to manage what we’re doing and to put in place processes to reduce its occurrences. We can then participate in the rewards by not having to spend it all on a premium.”

In times when the insurance market is pricing risk very hard – as was the case with employer’s liability when Interserve set up its captive in 2002 – or now, when companies are worried whether the insurer will be there when a claim needs to be paid, “then it’s very attractive to have a captive that can keep part of that risk in-house,” says Jones. Today, Interserve’s captive writes the first elements of its employer’s liability and professional indemnity programmes.

loans,” Bailie explains. “That does require approval from the regulators here, but they’re generally quite reasonable about it. The approval process takes about a week.”

A Bermudian captive lending funds to its parent was a typical transaction even before today’s economic turmoil, but more companies are examining the possibility now.

#### Selling the captive

Finally, if the parent company is in real trouble, it has the choice of selling the captive or its portfolio to one of the companies that buy captives – which may include the fronting company. In the current climate, sales are certainly occurring and the number of enquiries regarding this option have increased. However, this is a one-time-only solution. The sale of the captive will have a cost for its shareholder at the

time of sale as the acquiring company expects to make a profit from the purchase.

The subsequent lack of a captive to assist with risk financing needs in the future may also prove to be an expensive mistake for the shareholder. “This is why we see this as an option only to be pursued if the disposal of the captive is mission critical for the parent,” says Wild. “If the captive has come to the end of its usefulness for the parent that is a different scenario to what we are considering here, which is effectively a forced sale.” **RS**

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## REVIEW CLAIMS RESERVES

A UK-based captive owner suspected that a third party administrator had historically over-reserved and, therefore, some surplus existed, says Patrick Harrington, Claims Consultant at Echelon Claims Consultants Limited.

“We found in this instance that the claims weren’t managed well,” he says. “There was a reasonable amount of over-reserving, but also concern that there was under-reserving for some claims, too.”

In such cases, there may be money available for release from claims that are over-reserved – but Harrington says that each claim should first be reviewed to make sure there isn’t any significant under-reserving.