Module C Unit 4A

FEASIBILITY

Purpose

At the end of this unit the participant should understand the purpose and key contents of a captive feasibility study.

Assumed knowledge

The reasons why captives are formed and the key benefits provided as set out in Unit 2

Summary of learning outcomes
1. Explain the key criteria for viability that should be considered in a feasibility study.
2. Explain which organisations are able to undertake such a study.
3. Describe what the expected contents of the study should be.
4. Explain how the amount of risk to be retained by the captive might be determined.
5. Explain why the feasibility study is so important in laying the foundations for a captive.

4.0 WHO SHOULD CONSIDER A CAPTIVE?

Captives are not only for the largest companies. Certainly, the large 'Fortune 500' companies ought to find a captive particularly financially attractive, as they would have a large capacity to retain risk against which their premium saving from the commercial market due to the need to purchase less insurance cover would be equally substantial. An annual total premium of, say, £50 million over all lines of business would not be unusual for these large companies and over a period of time, possibly ten years or so, they will, from an insurance point of view, become self-financing and pay to insurers more premium funds that they could possibly reclaim as reimbursement of losses suffered. All they are gaining from buying insurance is a risk spreading facility and if they can achieve that by other means, such as retaining it within their own captive subsidiary, it will be to their advantage.

Whilst the larger companies clearly meet the criteria, there might also be a variety of medium sized companies with the right spread of risk and superior loss experience. Furthermore, smaller companies with specialised insurance needs or opportunities, could well find a captive to be of advantage. Groups of professionals, for example, such as accountants or surveyors, may not be considered amongst the largest companies but they found considerable advantage in creating captives to write the primary layers of their professional indemnity risk when the market hardened in the mid-1980s. A smaller company with an opportunity for customer business could also find a captive viable for the writing of, for example, extended warranty insurance. Captives are also formed by companies which, despite possibly a limited obvious financial advantage, see strategic value in their own risk retention vehicle, as a financial reinsurance vehicle to write uninsured risk, to consolidate a multi-national programme, act as a focal point for risk management or respond to future business expansion.

Trade associations and other groups with common insurance problems are a further source of captive formations. One example of a successful group was an association of oil and petroleum distributors. This was an association of relatively small distributors with, in the main, from one to ten vehicles distributing oil products locally. Their premium rating for motor insurance was more geared by the market to that of the very large oil companies who drive high mileages in large vehicles travelling up and down motorways. By comparison this group was made up of vehicles being used on local roads, often driven by the vehicle owner or a member of his family, and hence incentivised to keep that vehicle on the road. Their claims experience was significantly better than the large oil companies but this was not being recognised by the insurance market. They got together and agreed to share risk in a group captive. Although this was originally an Australian group, it spread to the US and the UK and also wrote, ultimately, other lines of business outside motor insurance. There are, in fact, quite a number of very successful group captives of this nature, created by trade associations.

One can also take a three tier approach assessing frequency and security, as the following diagram illustrates:

(3)	CATASTROPHE REINSCE MARKETS	Low frequency	High severity
(2)	CAPTIVE	High frequency	Medium severity
(1)	OPERATIONAL DEDUCTIBLE	High frequency	Low severity

(1) relates to the high frequency low severity losses where the costs and frequency are predictable year on year. There is no point in insuring these even with the lower costs of a captive, especially with the premiums attracting insurance premium tax.

(2) relates to a frequency high enough that likely loss experience is less predictable year on year but can be modelled over time. Severity can be classed as medium such that a captive, with its capital, reserves, premium and possibly a financial reinsurance, can cope with the losses. These would be in the layer which can be accepted at group level over losses as per (1) acceptable at subsidiary level.

(3) is the low frequency, very high severity losses, not predictable and best transferred onto someone else's balance sheet to handle – i.e. a major reinsurer. These would be losses in excess of (2).

By limiting the insurance market element to (3) external premium spends are significantly reduced. Of course the acceptable level of frequency and security is a matter for each individual company and the actual numbers and classes of business in each category will vary widely by client.

4.1 CRITERIA FOR A CAPTIVE

- Premium Expenditure

A question is often asked as to the minimum amount of premium required to justify a captive. There is no definitive answer to this question as the optimum premium depends on a number of factors not least the type of insurance and the business of the client. As a rule of thumb, if one were looking at, say, property insurance alone, a premium of £500,000 could well be the trigger point of viability. The higher the premium is above £500,000 then the more likely justification for the captive, whereas below that trigger point, when the expenses of the captive are taken into account plus reinsurance purchased, the margin of saving might be such that additional pressure on the insurers for better terms may produce an equivalent net cost. Certainly, with premium below £250,000 a captive would almost certainly not make sense. However, it has to be recognised that here we are talking of property insurance and even that is subject to variables. If, for example, we have a company paying a premium of £1 million but the majority of this is taken up by the insurance of two huge petrochemical plants, it could well be that after the cost of reinsurance protection there would be insufficient funds in the captive to cover its own claims and expenses. If, on the other hand, we have a company with only a premium of £1,000,000 but this is for the insurance of a string of 200 small shops around the country, the risk profile is so low that the reinsurance cost would also likely to be a much lower percentage of the whole and, given the greater spread of risk, a captive might be viable. It might be that use of a cell within a Protected Cell Company (PCC) with its lower cost base is more appropriate when the premium levels are lower.

For other lines of business, the amount of administration, the risk and the range of traditional alternatives, all have to be taken into account. Premium paid for a risk where claims are likely only once or twice in a five year period, would be at a much lower level than premium where claims activity eroding premium is that much higher. The captive could be used in the first instance but the latter could possibly be better solved by use of a local deductible. It is also necessary to look at the potential development of a captive. There may be marginal business case for an original line of business but if there are other lines of business that can be brought in, with the fixed expenses already covered, the captive can become more viable. Remember that captive expenses do not grow commensurate with premium flow and, therefore, the premium volume required for an additional line of insurance can be very much less compared to the premium viability for a single line of business.

- Claims Record

Module C Unit 4A

FEASIBILITY

A first thought might be that a captive would not be viable unless the client had a very good claims record. Whilst a company with a good claims record, should it continue, would no doubt have a very financially successful captive and be able to buy reinsurance at economic cost, it is equally true that a captive can be of value to a company with a poor loss record. One of the reasons for the formation of a captive is the inefficiency of the commercial market such as the high percentage of premium retained by traditional insurers to meet their expenses. If a company has a poor loss record, its premium will be increased by the commercial market and therefore their monetary contribution to these expenses will tend to go up in proportion. Counterintuitively, the higher the premium then the more viable the captive may become and apart from the reduction in the expense factor, other features could come into play to make the captive very much worthwhile. With a deteriorating loss experience the premium increase imposed by insurers could, very likely, overcompensate in order to recoup losses in the past and even allow for a continuation of the deteriorated experience in the future. On the other hand, the insured may well have recognised the causes of the deteriorated experience and implemented improved risk management and loss control such that the loss experience going forward was much more likely to improve than deteriorate. In the traditional market the reflection of this improving experience in the premium charged would be a slow process whereas, with a captive, any improvement would have an immediate impact on the profitability of the captive.

So, captives can be viable where there is both good and bad loss experience but what really needs to be examined are the types of losses being suffered. For example, there might be a company with an excellent loss record running at, say, 40% of total premium, which would appear, on the face of it, to be ideal for a captive. They may be able to secure reinsurance in excess of the captive retention for, say, 60% of the gross premium but if it is that the claims experience relates entirely to losses within the captive retention, the captive would be sitting on a loss experience in excess of its retained income after expenses. Obviously other means would be needed to solve this problem. An examination of the causes of the claims would be a good starting point, followed by the introduction of risk management to reduce them in number and quantum. This could be coupled with the introduction of a deductible at the insuring company level; with or without a captive there is no point in insuring the inevitable regular attrition losses and it is better to bring a discipline on the insured to reduce those losses or to meet it as a regular business expense. The captive could then come in excess of the deductible. The above case, which would not be unusual, is an example of where, until the viability of a captive was examined, no problem was perceived but as a result of the examination of the loss record, thought to be good, it was found it could be further improved.

- Risk Profile

What sort of risks are being considered for the captive? What are the loss estimates and what is the loss frequency? As shown above, an apparent good experience overall may not necessarily work if there was a high frequency of low quantum claims. It could equally be that a calculation of loss estimates could show that the captive would have to hold an unacceptably large retention to make any premium saving worthwhile because of the high cost of reinsurance. Ideally for property insurance, it would make sense for a loss prevention surveyor to look at major and selected risks to produce a risk profile. This would ultimately be of value in the placing of the reinsurance.

Another aspect is to consider the premium to indemnity ratio. For liability insurance, the captive should be brought in at the burning cost level where there would be the highest volume of premium (and consequent saving of external premium if put through a captive) against which, of course, there would be the highest volume of claims. The purpose of the captive would be to remove this layer of burning cost from the market and insure the more unusual higher losses at the most economic cost. Bringing captives in at higher levels of liability insurance, where the premium is a much smaller percentage of indemnity, usually does not make sense as a captive does not have the spread of business available to the traditional market. For example, a premium of £1 million for an indemnity for £100 million would not work in a captive even if it were a 'once in a hundred year' risk as that loss could occur tomorrow. The traditional market, on the other hand, has thousands of clients and could meet the eventuality of one or two of them having claims each year.

- Risk Management

Utilising a captive the insuring group is, in effect, carrying its own risk to the extent that the captive is involved. This concentrates the mind of the owner/insured on risk management and encourages the development of intensive risk management programmes to reduce losses. The success of such programmes has a direct effect on the results of the captive and generates cash savings for the organisation. The captive removes the “why worry, it’s insured” syndrome and this change of behaviour is reinforced when a senior director of the parent group sits on the captive board. In theory the thought would be that a company should not form a captive until they have a viable and successful risk management programme in place. In fact, what often happens is that captives are formed for financial reasons and this subsequently has the effect of triggering an enhanced risk management programme thus securing additional future advantage.

- Operational Feasibility

It might be thought obvious that the creation of the captive has to be operationally feasible within the group. Nevertheless, it is well worth the time spent in examining the philosophy and makeup of a potential captive owner to overcome any potential operational problems before they arise. For example, what is the relationship of the risk manager with the subsidiary companies and how decentralised are the subsidiaries in their insurance arrangements? What relationships do the subsidiaries have with local insurers? Could a new global insurer, fronting the risk on behalf of the captive, be introduced? Does the group operate in territories where it would be possible to export the premium? In this regard a company operating in such countries as Brazil or India would find it difficult to get the premium out of the territory and into a captive. There could be circumstances in Africa or the Far East where, although particular countries may not have laws to prevent outward reinsurance, in practice it might be difficult, if not impossible, to cede out hard currency to pay the captive.

- Internal Understanding

It is most important that, before a captive is created, the board and other senior members of the parent group are fully cognisant as to what they are doing and how a captive works. The reasons for the creation of the captive, for their group particularly, need to be explained with the potential advantages and potential results of good and bad experience understood and accepted. This is not to say that captives are going into the ‘risk’ business. A properly constituted captive, with a solid reinsurance programme, ought to be able to protect its capital from loss just as the traditional market does. But the variability of profit has to be explained in that the average insured derives profit as a consequence of turnover whereas the captive has a variability factor according to loss experience. Directors have been heard to ask questions like “does the creation of the captive mean that we can now insure those risks that the market won’t accept?” Well, this may be so in the right circumstances but where this is said in the context of the insurance of high risk property, the fact that the captive is the self-insurance vehicle of the group has to be reinforced. It might seem obvious to state that the parent group has to understand what they are doing but there are many misconceptions as to how captives operate. It should be borne in mind that the officers and directors from the parent group, apart possibly from the risk manager, are not insurance experts and the principles and practice of the market and how the captive is going to operate, need to be well explained.

4.2 WHO SHOULD DO THE STUDY?

There are a variety of organisations willing, able and competent to perform captive feasibility studies but selection of a provider may depend upon the particular connections of the client, their own views and the type of problem giving rise to the consideration of a captive solution. However, the best advice is going to come from those organisations with practical experience of captives with knowledgeable consultants.

A common choice would be to select one of the captive managers. There are excellent captive management facilities in all main captive domiciles, some of which are owned by the major brokers and some by firms whose sole business is the management of captive insurance companies. As they manage a wide variety of captives themselves they would be the ideal firms to approach for a feasibility study. The primary insurance broker would be well aware of the client's portfolio of insurances and may well be aware of the reason for captive consideration; indeed, may well have recommended it to the client to solve a particular problem. Some people might consider there to be a conflict of interest in that, by recommending a captive, the broker would be reducing his potential to earn brokerage commission but two facts militate against this. The majority of brokers are now paid by fee anyway and it would be very short-sighted of a broker not to give best advice to their client as this could so easily be discovered to the ultimate detriment of the whole account. Secondly, it would likely be the captive management personnel rather than the broking side, would complete the study. Conversely, it has been argued that captive managers have a conflict and will always tend to recommend a captive. If this is so, it is they who have to make it work and their professionalism is unlikely to allow them to recommend an unviable operation. At the end of the day it is a matter of personal choice. Those managers who concentrate solely on captive management, usually known as the 'independent' managers, can work very happily with brokers – indeed, they will usually need to use brokers for reinsurance placement. They could be an ideal choice if anybody was looking for captive management entirely independent of insurance broking or whose existing broker did not have captive management facilities.

The third potential for the provision of a feasibility study would be to obtain it from a pure consultant. These are individuals or firms who have a wide knowledge of the problems and the reasons for captives and how they operate but are not actually captive managers themselves. A potential drawback could be that the consultant will not have to implement the recommendations to which the chosen manager may offer alternative solutions. On the other hand, it can be argued that the consultant is the most independent with no conflict of interest. The consultant would certainly be the ideal person to choose if a second opinion was required on an original feasibility study and deliver an unbiased evaluation of the proposals.

4.3 PRE-FEASIBILITY – IDENTIFYING THE PROBLEM

Before any detailed feasibility study is embarked upon, it is necessary to establish the factors which have given rise to consideration of an alternative to traditional insurance. Consider the following:

- Cost

Is the overall cost of the insurance programme considered to be too expensive? If there is a heavy burning cost of attrition losses, is a sufficient discount offered for accepting a deductible from the traditional primary market? Has the renewal pricing increased because of market hardening generally or due to the individual poor experience of the insured? Despite poor loss experience, have risk management procedures been implemented which ought to correct the situation and have these been reflected in the insurance premiums charged?

All of these are different aspects of cost, an examination of which will dictate, to some extent, the approach to be taken and the method and type of reinsurance of any captive recommended.

- Capacity

It is sometimes impossible to divorce problems of capacity from that of cost because a shortage of market capacity invariably leads to an increase in premium pricing. Often, despite increases in premium, one can still find a shortage of placement capacity of sufficient security to satisfy the buyer. At the 'right' rate there is usually sufficient capacity around but it can often be with companies of unacceptable security. Very often a shortage of capacity leads to an administratively expensive placement of quite small lines with a multitude of carriers. Using a captive and cutting through to the reinsurance market may access additional capacity. Furthermore, some captive managers have specific facilities or reinsurance treaties available for use by their clients.

- Inadequate Coverage

The preceding paragraph refers to the shortage of what might be called traditional capacity i.e. that which would normally be available were it not for a hardening of the market. This heading refers to a long-term shortage of capacity for the client's particular risks. This could arise from a professional firm seeking higher limits of professional indemnity cover or a bank wanting to secure higher bankers' blanket bond limits. Possibly the problem is the long-term protection against potential pollution risks on sites bought with an unknown past or sites sold with potential, albeit unknown, future problems. Perhaps the problem is a product recall risk; there might be some market available in some circumstances but it is likely to be inadequate for the majority of large clients and comes with a very high premium cost. The problem may relate to uninsurable risk, where possibly the client is looking for the long-term funding of product trials, protection against product failure or financial risks arising from interest rate and foreign exchange variations. Often there are bank facilities available for protection against some of the financial risks but these are expensive and the larger group can often find, with its geographical spread, that it can offset these risks internally. It might thus want to develop a captive for the protection of subsidiaries against individual risks which, when aggregated, will be acceptable to the group as a result of contra effects from other parts of the world. Credit risk, particularly associated with political and governmental risk, is expensive and largely uninsurable in emerging territories which may be just the locations where the group see the greatest opportunities for future expansion.

The choice of consultant or organisation to prepare the feasibility study could well be dictated by particular problems under this heading in that some will have particular expertise in advising and finding ultimate solutions to satisfy the particular client group needs.

- Strategy

Maybe a reason to undertake a feasibility study is a combination of all of the above and stems from a decision by the buyer to create a long-term alternative to the traditional market, which they can arbitrage as a purchasing tactic. A traditional view is to use the captive to a greater or lesser extent, according to hard and soft market cycles, whereas in the difficult to place or uninsurable risk category they may want to have a vehicle in place for long-term financial protection. Sometimes the study could arise from a risk review by the client. A real example of this was an insured with a fairly traditional insurance placement, with low deductibles circa £5,000 for the traditional lines. A captive was already operating, writing cover with a moderate retention and a traditional reinsurance placement. Following a review by internal auditors and external consultants the decision was ratified at main board level that, in future, the company would accept £20 million for any single loss, wherever it arose. At this level of risk retention, captive retention was a challenge given the risk/reward equation. The upshot was the whole programme being stood on its head and, in effect, a whole new feasibility study commissioned. These overall strategy feasibility studies are certainly interesting and can be quite exciting but they usually arise out of the development of a captive already created to solve problems of cost and capacity. This develops over the years to inclusion of uninsurable risk and then becomes part of the integrated risk financing strategy of the group although not always with the same dramatic strategic change as in the quoted example.

4.4 PRE-FEASIBILITY – THE INDICATOR STUDY

Before embarking on a full feasibility study, which is going to take time and create expense for both parties, most consultants will prepare what they would term an indicator study, the purpose of which is to provide a quick overview of the issues and the likely viability of a captive. The result is usually a concise report and should the conclusions appear to be positive, it would make proposals on how to proceed. The indicator study may be provided free of charge whether the consultant be an existing broker or insurer, an independent manager or pure consultant. In some cases a fee is charged but can be offset against the cost of a full feasibility study if a decision is taken to proceed with same. No reinsurance quotations would be obtained, neither would there be any detailed examination of the risks or, indeed, the insurance programme itself although these, no doubt, will have formed the basis of initial discussions with the client and will be summarised. The end result and object of the indicator study is to confirm that the problems as outlined by the client can be solved and value generated by the establishment of a captive such as savings could be made or the uninsured problem could be solved in certain ways. A fee is then quoted to provide the full review and study.

4.5 CHOOSING THE RETENTION LEVELS

Much is written about risk appetite and the levels of risk that should be retained by particular organisations. This is very often actuarially reviewed and the end result is a recommendation as to the percentage of turnover, cash flow or gross or net profit that can be accepted. It can even be related to a percentage of asset value. These reviews certainly have their value and can be extremely useful in suggesting to a client the level of risk they can retain compared, possibly, with the levels of risk which the study is suggesting they are already accepting, knowingly or unknowingly.

Different advisors will recommend different levels of retention but as a general rule of thumb most companies are uncomfortable introducing a variability to their net profit exceeding 5% when it is possible to transfer such variability to an insurer, at what they consider an acceptable cost.

This rule of thumb also has a bearing on whether a company is large enough to consider establishing a captive.

Consider if a company has an expected net profit of £100m the maximum aggregate level of insurable risk it would want to retain would be £5m. This may be a sum large enough to attract a premium reduction from the insurance market sufficient to warrant establishing a captive.

If the company’s net profit were only £10m then the maximum aggregate level of insurable risk it would want to retain would be £500k. That is not a sum large enough to attract a significant premium reduction from the insurance market and makes the viability of a captive unlikely.

When it comes to choosing the optimal retention level of the captive, the choice can rest on the cost effectiveness of the reinsurance programme. Even though a detailed review shows that, for one reason or another, a client could accept a retention of, say, £1 million each loss, the reinsurance programme may indicate that the best terms are available for a retention of, say, £500,000. The reasons for this are fairly practical. If, for example, we are placing a risk of £100 million and all past losses are well within £500,000 the reinsurer is writing, in effect, £99.5 million. If the retention is raised so they are writing £99 million, the risk change to the reinsurer is insignificant – in this example 0.5%. Accordingly, it is most unlikely that they are going to offer any significant extra discount over a retention of £500,000. From the captive’s point of view any higher retention will need capital to support it without the offset of any consequent premium saving. Also, initially, the client board will be looking at the cost/reward ratio and will see little advantage in a higher retention if there is no material saving on the premium. Looking long-term it can be argued that a captive should take as high a retention as possible regardless of the discount offered by reinsurers on the basis that risk retention encourages better risk management. This is fine in theory but in practice, for most organisations, a higher risk retention has to save sufficient money to make it worthwhile. Sometimes it is better to pay a premium for use of reinsurers’ capital, than to provide one’s own.

4.6 CONTENTS OF THE STUDY

FEASIBILITY

In effect, the study will cover four main issues. The existing insurance programme and risk review will be fully analysed, the general history and background of captives and their uses will be reviewed, operational issues will be explored in some detail, including choice of domicile and all of the financial elements will be examined including financial projections under a number of loss scenarios. Breaking down these four overall elements in detail, the feasibility study should almost certainly contain the following sections:

- Background to Captives

The feasibility study is addressed largely to people with a limited knowledge of the intricacies of the insurance process. The risk manager himself may have limited experience of captive insurance companies but certainly his fellow executives and the main board of the client company, who will need to give the final approval, will have little or no knowledge of the subject. It is therefore extremely useful that the history of captives be included with an outline as to why they are formed and how they operate. The advantages in general terms, slanted towards the operational needs of the recipient of the study, would be useful and a good background to the following sections.

- Digest of Data

To avoid any subsequent dispute as to the basis of the study and so that true comparisons can be made, the data upon which the study is based should be included. At this stage, if only certain insurances are to be considered suitable for captive treatment, the study would include only details of those insurances. If part of the terms of reference was to review and comment on the whole insurance programme, it would often be better that this be done as a separate report with the feasibility study picking out only those covers chosen for captive treatment.

- Review of Risks and Past Losses

Any uninsured risks could be examined.

There should be a review of the claims profile and detail of past loss experience, where appropriate 'banded' into various loss tiers. This is going to be important in the evaluation of the captive insurance programme in that many claims eroding the retention would have an adverse effect on the captive whereas if the same amount of loss experience was made up by one or two large claims, the impact could be quite different. This claims profile will dictate, to quite a large extent, changes in the levels of underlying deductibles, the captive retention and the type and cost of the reinsurance programme.

- Financial Projections

It is unlikely that all of the insurance business of the client is going to be transferred to the captive, certainly in the first instance and therefore this section will include details of those lines of business that it is proposed be included from inception together with how it is proposed they be written and the amount that should be retained. Of particular importance in this section would be actuarial or 'as if' projections. These tables would be based on the existing premium and loss experience and would show how these would be split between the captive and reinsurers, based on differing loss scenarios, to produce projected underwriting results. Management expenses would then be included plus the investment income to produce the final annual result. Rather than produce a single year projection with the average of claims, it makes sense to produce these figures for, say, five years showing the individual losses for each of five years. Some may be good and some may be bad and apart from showing the dampening of potential variability of results over time, this will also show the advantages of the compounding of investment income. Against "the expected" projections based on actual past results there should be included "best" and "worst" case scenarios. Without this being explained, most clients would assume that the worst case scenario would have a more detrimental effect than usually turns out to be the case. The effect of the reinsurance with, possibly, aggregate stop loss cover, will show how a really serious claim is met by reinsurers and how the reinsurance programme can limit the captive exposure when there is an accumulation of claims. The question “what is our maximum financial loss” is likely to be asked so the answer should be included within the report.

In addition to considering the financial aspects of the insurance programmes the captive is going to write, consideration must also be given to the level of capital that the captive will require to meet statutory solvency margins as well as to ensure that the captive is able to meet its liabilities as they arise. More about this can be found in Unit 6

- Reinsurance Review

The prior section will show the levels at which reinsurance protects the captive and the financial impact of this. This section should give more detail on the reinsurance and will be of more value to the risk manager. The type of reinsurance, be it excess of loss or quota share, and the reasons for the programme being structured in that fashion, should be outlined. This is the feasibility study rather than the indicator study, so the reinsurance programme included should be very close to final quotations. Availability of reinsurance protection in the future, according to any market variability that might be a feature of the particular business, should be commented upon. Finally and of paramount importance, is the security of the reinsurers themselves. It is often said that captive insurance companies trade by virtue of their reinsurers’ creditworthiness and this is correct is many cases. The use of the capital of the captive has to be optimised and the reinsurance programme should be designed to achieve this. There is nothing unusual in this and, indeed, the reinsurance programme of any traditional insurer would be designed to protect its shareholders’ funds in just the same way and to limit the potential downside in any single financial year.

- Operational Proposals

Where a major group of companies is concerned with operations in various countries, it is essential to include a review of the proposed operational procedures. There is no point in getting acceptance on a financial basis and then having to explain to the insured that they are going to have to change their insurance carrier in order to secure appropriate fronting services throughout the world. How the new insurance programme is to be implemented is essential detail for the client who can then assess, in the light of any discussions that may have taken place with subsidiaries during the course of the study and in the light of general relationships with other parts of the group, how acceptable the proposals will be and the likelihood of the programme being effectively implemented. In a sense this turns financial figures behind any recommendations into the practical evaluation of how they can be put into effect.

- Management Services

Assuming that the organisation being used to write the feasibility study is an entity that can also provide captive management services, one would expect a full review of those services to be included somewhere in the report. Regardless, the role and responsibilities of management of the captive should be discussed. It would be expected that this would cover most, if not all, of the management duties discussed in Unit 7.

- Location Review

  Even though the client may be predisposed to a particular location for the domicile of the captive and may well have approached a management company in that particular domicile for the provision of the feasibility study, it is still important to review other potential locations.. It is therefore beneficial to review the main attributes of the principal domiciles that might be appropriate for that particular client and prepare a comparison matrix. The advantages of one particular domicile then should become apparent. However, the choice of domicile is entirely that of the client. Obviously they will be guided in this decision by the advice given to them and the review of other locations but the reasons for choosing captive domiciles are many and varied and may go beyond pure risk financing factors.

- Development Potential

The initial recommendations will likely be that a limited number of insurances form the business plan of the new captive. Logistics, change management and acceptability throughout the client group usually make it inappropriate to attempt to go too far too fast. However, there will almost certainly be a number of other insurances or the development of existing insurances, that could well be incorporated with advantage in the captive in the future and these should be highlighted.

- Executive Summary

Although we mention this last, this section often comes at the front of the report. It is probably the most important section in that it should, in a matter of two or three pages, summarise the basis of the study, the conclusions and recommendations and the costs and savings so that any executive of the client company can read this and quickly come to a conclusion as to the viability of the proposals. Obviously, the additional detail on any point is included in the relevant sections but that is often left to the risk manager to evaluate and it would be expected of any risk manager to go through the executive study to satisfy himself that the summarised conclusions, which is probably all his senior executives are going to read, are valid and are backed up by acceptable analysis in the more detailed sections.

4.7 COST OF A FEASIBILITY STUDY

Although obviously variable according to the extent of the study, the cost differential is probably less so than for management fees. A basic cost, covering all the aspects reviewed above section and thus providing a blue-print to form and operate a captive, could be expected to be in the range of £30,000 to £50,000. To this would be added the cost of and any extensive actuarial work if required.

4.8 EVALUATING THE STUDY

Upon receipt of the feasibility study the client will need to evaluate this in detail. This would primarily be the group risk manager’s task in advance of the study was passed on further within the organisation as it is for him to decide whether the proposals being made are practical. These can be considered under the two main headings of operability and financial security viz:

- Operability
    - How will this be received by operating companies?

To a large extent this is going to be dependent upon how the group is structured and how much the principal subsidiaries have been involved in the study so far. In large groups there may be a number of risk managers around the world and without them supporting the project, no group captive programme is going to be successful. It is important that they join any group arrangement freely and secure advantage from it. In many groups there can be subsidiaries large enough to run their own captives and this may need to be recognised such that a protected cell arrangement might be the answer. However, Protected Cell Companies are addressed in Unit 2 and at this stage we will assume that a single captive for the use of the whole group is to be the solution. Acceptability is something which needs to be addressed at a very early stage and it would have made sense that the responsible people at the subsidiaries were included in the initial thinking and the production of the feasibility study itself rather than meet the problem after the study has been completed.

- Relationships with existing insurance providers

To what extent does the study bring in new insurers? Could existing insurers be used and has their potential involvement been fully examined during the production of the study? If new local insurers are to be involved in order to create a global programme, will these be acceptable to the local subsidiaries? What is the relationship with existing local insurers and would the subsidiaries be prepared to break that relationship and adopt the new proposals involving the captive? The proposals may ultimately be for the good of the group but are they for the good of the subsidiary which will probably hold its own profit & loss account and developed and maintained its own relationships with local brokers and insurers?

- Would a reduction in market premiums effect the viability of the proposals?

It is to be expected that when a group carries out a feasibility study with the object of forming a captive, existing insurers may respond by offering to reduce their premium rates at the next renewal when it might be proposed that the captive participates. Again this is a subject that should have been addressed at an early stage, but the effect of these potential premium reductions on the viability of the captive proposals need to be worked through. For example, it may be that the feasibility study indicates an overall advantage of, say, a 25% saving of premium. However, if a subsidiary secures a 25% premium reduction from its existing insurer, it does not necessarily mean that that eliminates the captive advantage. All it means is that the initial premium into the captive is reduced by 25% but then that may in turn, depending how it is placed, reduce the cost of reinsurance premium. In any case there will be the earnings derived from investment income on premium and loss reserves and such earnings escalate over time, so there may still be significant group advantage even if the captive wrote the business at the reduced premium rate. This can only be established by producing revised financial projections based on new premium levels. Having said that, the captive is not in the business of writing business at the lowest possible rate but at a price which is fair and commensurate with modest profitability. There are opportunist insurers who will reduce premiums in order to obtain or retain business in particular circumstances and then seek to increase pricing when they feel the time is right. Captives tend to maintain consistent rates over the longer term which means that whilst they may not be the cheapest in soft markets they should not be the most expensive in hard markets. Nevertheless, there can be circumstances where an aggressive insurer, intent on retaining a subsidiary’s business, will reduce the premium rates sufficiently that the captive’s participation is not financially sensible. In the evaluation, the risk manager has to decide how the possibility of this in any one subsidiary would affect the viability of the whole captive programme.

In discussing this case with the subsidiary it is always worth pointing out the long-term nature of the captive compared with the cyclicality of the insurance market. Most subsidiaries will be coming into the captive at their existing market rates or at an agreed discount from existing market rates. If a subsidiary obtains a dramatic reduction and stays out of the captive arrangement it will have to bear the risk of those rates increasing in the future, should their local market harden or if it is being under-rated merely for retention of business. If it then seeks to enter the captive arrangement, it may be at the current market rate. So, in any evaluation, the subsidiary itself has to consider this long-term risk and the potential group advantages, against its possible short-term gain.

- Local service issues

Do the proposals suggest a single global insurance broker or can existing local brokers continue to be used? Of course, where there is already a global broker who may well have been the broker producing the feasibility study, this is not a problem but there are many groups where there are long-standing local arrangements with a variety of insurance brokers or service providers. How will they be affected by the captive proposals and how acceptable will any changes be to the subsidiary? If a global arrangement is being introduced, what level of local service can be provided to the subsidiaries and how will it compare to what is being replaced?

- Effect on other insurance covers

With a particular line of business being taken away from existing insurers and placed through the captive, will this affect other insurance placements? For example, the insured group may have an excellent property programme but a very difficult to place liability risk and it may well be that they have one insurer writing both risks. The threat could be made that, if the profitable property insurance is taken away and put with the captive, this will have an adverse effect on the liability insurance. It has been known that, when a bank was forming a captive, there were threats from the insurance market to close their bank accounts at that bank if they went ahead. It has to be said that in most instances these are threats that are rarely implemented. Most insurers look at the profitability of each line of business separately. They also look at overall premium income such that, having lost a property account they would not also want to lose the premium flow from liability covers. Except in a very hard market, there is usually a competing insurer prepared to take on the risk. Nevertheless this is an issue which is sometimes raised at an executive level. It therefore has to be considered and addressed with answers and potential alternative solutions ready.

- Tax

The feasibility study should flag tax issues related to the operation of a captive that should be considered by the parent's tax department and its professional advisors. These are considered in more depth in Unit 14 but suffice to say that no company should embark on establishing a captive without having first considered the matter of taxation.

- Security issues

It is assumed that the client has had the protection of a fairly full insurance programme in the past so that the new proposals have to be reviewed to compare with what has been perceived as complete security. Of course, there will no doubt be much included in the feasibility study showing what the true cost of that comfort has been and it may well be suggested that the proposals add further security using very high quality reinsurers, rather than detract from the existing arrangement.

- Protection of captive's solvency and capital

It is absolutely essential that the reinsurance programme protects the capital of the captive and thereby preserves its solvency. Main board personnel of the client will recognise that the captive proposal means they are getting into the risk business. It has to be explained to them that traditional primary insurers themselves do not retain all the risk underwritten but by scientific rating and evaluation of risks and proper reinsurance, they limit their exposure to, generally, a percentage of annual premium income. The captive is doing exactly the same thing and reference would be made to the financial projections in the study which should show, not only the most likely result based on past experience but also the 'worst case' results showing the effectiveness of any recommended reinsurance programme to limit the downside.

4.9 SELLING THE CONCEPT INTERNALLY

The need to involve subsidiaries in the proposals at a very early stage has been stressed and it is clear that if this is done the wheels have been well oiled for selling the concept internally. The next most important body of people to be convinced is the board members of the parent group, as it is they who are going to give the final approval for the creation of another subsidiary company and the provision of capital. Thus it would be helpful if the proposals had been discussed, again at an early stage, with key personnel involved in this decision process such as the group finance director. It may well be that the finance director or company secretary will have already approved the expenditure on the feasibility study and so are already in tune with what is going on and, presumably, are sympathetic to it. There may also be an executive committee reporting to the main board and it would make sense that the final proposals be approved by them before going to the main board.

There can be circumstances where it is essential to involve key shareholders, particularly where such a shareholder may be one of the principal insurers. Third party relationships need to be considered and the effect of increased self-insurance via the captive on debentures, loan agreements and banking covenants. These may well dictate that assets which act as security for any loan or debenture has to be insured with insurance companies acceptable to the trustees: as the trustees are often insurance companies themselves, it is unlikely that they will agree to the security provided by an unrated captive and a fronting arrangement with a rated carrier may be needed.

4.10 ACCESS TO THE FEASIBILITY STUDY

It is often the case that the feasibility is put on a back shelf and forgotten once the captive is formed. This is a mistake. The feasibility study is a significant piece of work with much embedded knowledge and value. It forms the foundation of the captive as it contains the information and audit trail upon which the decision to create the captive have been based. Any staff working at an Insurance Manager would be well advised to seek out the studies of the captives they work on and read them. They provide an excellent understanding of the reasons for the captive’s existence and the expectations set for those who have approved their formation.

Clearly most captives develop over time and original reasons for their feasibilities may gradually become redundant, however, the client will likely want to monitor the performance of the captive against its original objectives and keep exploring ways to enhance the value and performance of the captive. They can therefore be used as a benchmark and provided the captive has not been in existence for more than say five years, much of the information and ideas contained in the study will still be relevant.

Module C Unit 4A

FEASIBILITY

Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. What is the purpose of a captive feasibility study?
2. Does a company have to be very large for a captive to be viable?
3. Is it important that a company exercises sound risk management if it is to consider a captive?
4. How large does the premium spend of a company need to be for a captive to be viable?
5. Who might be best placed to undertake a feasibility study?
6. Try to obtain access to a feasibility study in order to scrutinize it.

Summary of learning outcomes
1. Explain the key criteria for viability that should be considered in a feasibility study.
2. Explain which organisations are able to undertake such a study.
3. Describe what the expected contents of the study should be.
4. Explain how the amount of risk to be retained by the captive might be determined.
5. Explain why the feasibility study is so important in laying the foundations for a captive.