Module C Unit 4B

INITIAL DECISIONS IN SETTING UP A CAPTIVE

Purpose

At the end of this unit the participant should be able to demonstrate an understanding of the main decisions that should be made with regard to establishing a captive, why they are important and the factors associated with them.

Assumed knowledge

Options available and reasons for choosing a particular captive domicile. See Unit 3

Summary of learning outcomes
1. Explain why most captives' owners appoint a, professional third party management company to administer their captive
2. Explain the importance of the composition of the captive board.
3. Describe the typical contents and purpose of the captive's business plan.
4. Describe the key matters that should be considered at the first board meeting.

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4.0 MANAGEMENT

4.0.1. Own Staff v Management Company

The main choice is whether to engage direct employees or to employ the services of an outsourced management company. This should be an early decision in that whoever is appointed will need to be involved in the other initial resolutions and decisions. A management company will be very helpful, particularly in an offshore domicile, in guiding the parent regarding the choices to be made.

It would be most unusual today for any new captive owner to start operations using their own staff. The very early onshore captives did employ their own people but at that time, there was little alternative. An arm's length management attitude has to be maintained, especially if the parent does not wish to be seen as controlling the captive for tax reconciliation purposes and allowance of premiums for tax deductibility, regardless of location. Apart from the fiscal considerations, the specific skills required in the operation of a captive insurance company can be comprehensively and economically purchased from captive management companies, which have been specifically set up and highly skilled in captive operation. The services required are fully explained in Unit 7 but essentially, the management company's advantages over using one's own staff can be summarised:

- Cost

The management company will have staff available to it who are skilled in all of the disciplines required by a captive insurance operation. Very often some of the skills are needed only on isolated occasions throughout a year but they can be called upon as required and the individuals merely log their hours against the captive. It would not be unusual for five or ten people of the management company to be involved at some time over the year with a particular captive, yet the total of their work may add up only to one or two full time equivalents (FTE) which is all that the captive would be paying for. There are, indeed, many captives operating, where the total of hours spent are less than one FTE but it might still involve several individuals and their particular skills.

- Wider expertise

The management company will have wide experience of managing captives for many different trades and industries. The particular skills of accounting, secretarial, reinsurance, complying with regulatory procedures, can be delivered much faster and expertly by people who are carrying out these functions on a daily basis. Any problems that might arise for the captive in its business or management have probably been faced by the management company before; indeed, problems that might arise if employing one's own staff may well not arise through the use of a management company.

- Reinsurance facilities

Reinsurance is a very important part of any captive operation. Some captives aim to arrange their own reinsurance on a direct basis and whilst this can be done successfully, it is probably a far better idea to use the skills of a reinsurance broker. These people will know the market and are more likely to secure the best terms. A management company may have a reinsurance broker as part of its own organisation but independent managers will very often have an association with a skilled reinsurance broker.

Additionally, some captive managers may have particular reinsurance treaties or facilities of some description available to them, access to which can be made available to their captive clients.

Apart from the placement aspect, there still has to be someone involved in the management of the captive who is well versed in reinsurance terms and procedures, to evaluate reinsurance quotations, check documentation and generally deal with day-to-day administration.

- Local knowledge

Most captives are domiciled offshore and the locally resident management companies will know their way around the location. More specifically they will be able to recommend suitable candidates to act as directors of the company, the bankers, auditors and investment houses, the lawyers for formation, accountants for external audits and, not least, will have a professional relationship with the insurance regulator in the domicile. In short, they will have a rapid route to the key influencers, gather market intelligence and have an intimate knowledge of market practice. They will be skilled in the production of statutory returns and will be replicating the same function for different clients' dozens of times a year. They will know the particular laws and regulations and, as managers of many companies, are more likely to be involved in discussions or consultations considering any changes to these regulations.

- Number of staff

The advantage of having large numbers of staff available means that a management company can cope with staff absences such as holidays and sickness that much easier. If the captive employs its own staff, it is likely to have only one person in each discipline and if that person is absent, problems can arise. By comparison a management company will have a number of skilled staff on hand so that, if one is missing, there is always someone else to call on or to provide any corporate information that may be wanted, the delivery of which is time critical.

- Risk management services

Other risk management facilities are usually available also. If the parent and/or captive wants to consider a total review of their programme or move into certain financial reinsurance structures, management companies might well offer available people, divorced from the day-to-day management of the captive, who can provide such consultancy advice. It is true that such expertise can be bought from outside, but such people would not have available to them the background knowledge of the captive and using outside consultants on an ad hoc basis is invariably less efficient and more expensive, albeit they may well be considered more objective (not having any conflict of interest).

- Sharing knowledge

Clients of captive managers find they rapidly become, in effect, part of a family. Some captive managers have annual meetings of their clients. Obviously, the purpose is to make presentations of new products or to discuss matters of general import but probably the most important feature of these gatherings is the ability of clients to talk to each other and exchange their own experiences. This can be extremely valuable such that it is not unknown for clients of a single captive manager, in a common business segment, say, banking, to arrange their own meetings. They discuss matters of general interest affecting their own business and these might be chaired or even organised by the captive manager. It is much more difficult for such opportunities to be created from a self-managed captive. It is comparable to a risk manager who refuses to join the Institute of Risk Management, be a member of the local insurance managers' association or be a member of the Chartered Insurance Institute (or a local equivalent in the country of residence). Over years this generates an isolation and a lack of market awareness and people who join and really get involved in their professional organisations, will readily admit that they probably get more out than they put in: similar thinking applies in the use of a captive management company community.

There are a number of captives which are self-managed but these tend to be mature companies whereas the above comments relate to new operations. Self-management tends to be only for the largest groups and even then, often associated with ancillary decisions such as wanting to develop further into the commercial insurance business, as a reinsurer or insurer of customer business e.g., a bank writing accident, sickness and unemployment insurance on loans or a retailer writing its own extended warranty cover. It could be that the staff employed to self-manage a captive forms critical mass and they then expand into providing management services to other companies and there have been examples of this over the years – even when the original captive no longer exists but the management operation does.

4.1 CHOOSING A MANAGER

By this stage the choice of manager may already be self-evident in that the parent may well have gone through this process at an earlier stage when considering who was going to perform the feasibility study. Even so, that decision was made for the production of the feasibility study and a separate decision has to be made and, ultimately, a contract agreed and signed, for the captive management services. The choice of manager falls under three main categories i.e. insurance company owned, broker owned or independent managers. As to the pure captive management expertise it is probably true that any are more than adequate to fulfil all of the duties described in the next chapter. Whoever is the owner of the captive management company, they will be employing local staff skilled in captive management.

The organisation may have had a very happy relationship with an insurance broker who may have delivered the feasibility study and with whom they will be perfectly happy to purchase captive management services. On the other hand, there are captive owners who feel that these are duties that should be segregated such that they will have an insurance broker for their primary insurance broking, an entirely separate manager, either owned by another broker or independent, to manage their captive and then a separate broker used for reinsurance, so that there is independent management thinking for all three roles. Certainly, where one organisation is used, great care has to be taken in splitting the duties in order not to run afoul of the Revenue needs of keeping the offshore work offshore. Using three organisations helps in this area but that is not to say that using a single organisation for all functions will not work. It just has to be governed properly and there should be efficiencies and improved accountability in using one organisation to fulfil all three roles. A large number of managed captives use a management company that also fulfils both primary insurance broking and reinsurance functions within the same organisation. The apparent conflicts of interest that might arise are not so apparent in practice in that there are usually very clear dividing lines and quite separate organisations for each function and often far stronger divisions than the usual Chinese walls. If a conflict of interest does arise then, of course, this has to be addressed but they tend not to be regular occurrences.

The independent captive manager will stress, of course, the need for keeping captive management separate from insurance broking and if that is the thinking of the parent organisation then they are an obvious choice in that one is not bringing in another broker who, it may be assumed, would be a competitor for the broking business as well as the captive management.

Depending on the type of captive being formed and the reasons and who has done the feasibility study, the choice of a management company may become fairly obvious, but one should be looking for experience in fulfilling the required functions of the captive without any conflicts of interest. Such conflicts of interest do not necessarily apply just because the captive manager may be the broker but obviously this is an aspect that needs to be declared and addressed to ensure proper governance.

Once competence is assessed, an important criterion in the choice of a captive manager is one of personal chemistry. The captive owner is going to strike up a long-term relationship with a team managing one of their subsidiaries. They will be visiting the domicile regularly and dealing with such people on a daily basis. It is important that they get on and if there is any clash of personality or difference in values and behaviour found in the early stages then it may be wise to avoid that manager if the issues cannot be quickly resolved.

There is certainly nothing wrong in conducting a tender for services involving more than one manager. It is not unusual for at least two managers to be competing for a single captive. Even existing captives often put out their future management to tender and, indeed, some organisations are required to do this as a matter of course every three or five years. It would be true to say that relatively few captives change managers following these periodic ‘beauty parades’, which is credit to the managers in situ. There are, occasionally, some parent groups who have a full beauty parade of maybe up to five managers. Even here, however, most will agree that, in the final analysis, there is often very little to choose between managers from the point of view of expertise and/or, for that matter, on the question of cost, particularly when one is comparing the same level of services.

4.2 MANAGEMENT COMPANY CRITERIA

Having said that the majority of captive management organisations are very similar and can fulfil all of the functions required of the captive, it is nevertheless worth undertaking due diligence on the facilities of the chosen manager if only for the risk manager to have an audit trail of his recommended manager when reporting back to his own management and evidencing why and on what basis he recommended that particular service provider. It is recognised that in virtually all domiciles, captive managers have to be approved and licensed by the regulator and their work is, in effect, overseen by the local insurance regulator and would face regulatory scrutiny following complaints of inadequate service, to preserve the reputation of that particular domicile.

The duties of the management company are covered in Unit 7. These should be reviewed, with the captive client deciding those points most relevant to them and whether their potential manager can provide them. One aspect to be checked would be the local standing and expertise of the manager. This can be done by asking questions locally but the best way is to speak to other clients of the manager. A list of clients should be obtained and references obtained. There is no better recommendation than a satisfied client and no manager should be afraid to introduce other clients.

4.3 CHOOSING THE DOMICILE

Unit 3 goes into domicile choices in some detail and there is no point in repeating that here. The basic decision that needs to be made is whether the captive is to be domiciled:

- onshore, i.e. in the country of the parent;
- in another country;
- offshore.

Having made this basic decision the actual location then needs to be decided. It is likely that the client will be well along the road in choice of domicile in that it would almost certainly be a material part of the feasibility study and apart from discussions that might have been held, it is to be anticipated that there would already be a recommendation. Whilst the choice is many and varied, there are all sorts of reasons why people choose particular domiciles, with most clients having a predisposition or a reason such that the final choice is usually between three or less possibilities. There is nothing unusual in a client spending a few days visiting two or more locations and talking to potential managers, lawyers and regulators as well as generally looking into the infrastructure of the domicile.

4.4 CHOOSING THE BOARD OF DIRECTORS

The captive typically does not commence underwriting until after its first board meeting when the business plan and other statutory matters are approved. A specimen agenda for the first meeting is included at the end of this chapter, which in effect lists all those initial decisions that need to be made before the company can commence business. Obviously, therefore, a board of directors needs to be appointed, to attend that first meeting.

Whilst most domiciles do not dictate the number of directors on the board, typically the board consists of a minimum of three directors, with a majority of those resident in the captive domicile. A representative from the parent could be the risk manager or the person to whom he reports (often the company secretary or finance director). If it is a larger board then both could be appointed. The managers will make recommendations as to local directors but all this is discussed in some detail in Unit 16.

Occasionally a permanent chairman is appointed. Otherwise it is left to appoint a chairman on an ad hoc basis at each meeting but market practice tends towards this being a resident director from the domicile. The reason for this is that the chairman often has a casting vote in the event of a split decision by the board. Thus the local majority on the board is preserved.

It is also normal practice that each director appoints an alternate director, to attend meetings and vote in his stead when he cannot attend personally. These alternates are representatives of the appointed director who is responsible for them. These alternates need to be approved by the regulator on a similar basis as the original directors. This is particularly important for the local directors so that regardless of holidays, sickness or business pressures, a majority of local directors can be maintained.

In Guernsey the directors and alternates must complete a Personal Questionnaire (PQ) for the regulator to consider before they can be authorised to be appointed to the board. It is worth bearing in mind that approval of the original directors by the regulator can be a source of delay in obtaining approval for the captive to be formed, so the completion of PQs be prospective directors should be undertaken as early in the license application process as possible. The directors from outside the domicile may not be familiar with the forms or the process and should be led through this by the insurance manager to avoid any problems.

Also at their first meeting, directors should declare any interests which could affect their decisions. Thus, the parent directors would record their position with the parent, any director from the manager would record that fact, and the lawyer may record his position as partner in the practice forming the company and so on. This register of interest needs to be kept up to date and should be formally re-visited and checked at every board meeting.

4.5 NAME OF COMPANY

Views differ widely as to the basis of choosing a name for the captive company. Some people feel that the name should not directly indicate its parentage and others have an opposing view. Unless the company was considering expanding into unrelated business or proposed to write customer business and did not wish those who insured or reinsured with it to know its parentage, it really doesn't matter.

It is sometimes a necessary part of local law that one of the words “insurance”, “reinsurance”, “assurance” or “indemnity” has to appear in the title so as to differentiate from other local companies formed there. Insurance companies will usually require separate and specific authorisation from the insurance regulator to use that word in its title. It is usually worth coming up with two or three initial suggestions for captive names and checking these out with the manager the regulator and the local Company Registry to see that they are acceptable. A.M. Best and other organisations produce an annual list of captives and these can be checked to ensure that the name has not been used before. All domiciles should be checked because even though the name may not have been used in the domicile chosen, it could be cause confusion if the same name was being used elsewhere.

4.6 OTHER DECISIONS

Other decisions and appointments that need to be made are:

4.6.1 Lawyers

An appropriate firm might be recommended by the parent company's own lawyers but offshore recommendations would be forthcoming from the proposed captive manager. There have been thoughts expressed that it can be useful to use a smaller firm for formation in that legal personnel might be more available than from the larger firms but, in practice, there is really no difference and with the larger firm, one may have access to greater experience and potential alternate directors to the board.

4.6.2 Bankers/investment managers

The clearing bankers appointed by the captive board will commonly be a subsidiary of the bankers used by the parent group. But this is not always the case in that some banks are not represented in all domiciles. Using a different bank to the parent company is not a problem, as the captive operates entirely independently and money transmissions between banks tend to be just as efficient as those within the same bank. What is important is that the local bank chosen has the facilities and the experience in money transfer, foreign exchange, issuing letters of credit and other facilities that will be required by the captive.

The opening of bank accounts is now rather a laborious process due to the considerable KYC requirements necessary to fulfil due diligence on the captive, its ultimate beneficial owners and the board of directors. Do not underestimate the information, documentation time and patience required to complete this process.

Only the larger captives will appoint investment managers from inception as most will keep funds liquid in the early stages with cash deposits at the bank on relatively short-term a popular tactic. It is certainly useful to have access to wider facilities for such deposits than just using the clearing bankers, who will not always provide the best interest rate on any particular day. It might be advisable to agree a group of banks or deposit houses that can be used (usually those with high credit ratings) or possibly use the services of a money broker to secure the best investment rates.

Later on, discretionary investment management advice might be required, usually when funds available for investing are of the order of £5 million or more. Whilst the parent group might have some predisposition in the choice of investment manager, again it would be usual for two or three to make presentations to the board of the captive in the domicile, and for the board to make their decision. Even where the parent may feel that there should be a short list of one, the final decision and appointment to be made in the domicile by the captive's board.

4.6.3 Auditors

Most of the leading international accounting firms are represented in all of the leading captive domiciles and it does make sense for the local firm of the parent group auditors to carry out the audit of the captive. Certainly it is essential that audits of the captive are carried out by local personnel experienced in the particular requirements, not only of insurance companies but also to comply with local regulations. Thus, in the occasional situation where the parent company auditors may not be represented in the domicile, typically it would be more expensive and less efficient for an auditor to come in from outside of the domicile in order to carry out the audit. Not only would there be travel and accommodation expenses but they would have to learn about the insurance operation and the domicile requirements. In such circumstances, use of a local firm, reporting through to the principal auditors, would be advisable.

4.7 CAPITALISATION

Two aspects override all in the question of capitalisation of a captive: it has to be sufficient and it is important to get it right first time. One does not want to have to go back to the parent company to request additional capital unless it is due to future unanticipated expansion of the business of the captive which should be seen as a positive development. Unit 6B will look in detail how the Statutory

Solvency Margins, Minimum Capital Requirement (MCR) and Prescribed Capital Requirement (PCR) are calculated as well as discussing the Own Solvency Capital Assessment (OSCA). The capital must be sufficient to meet these solvency margins so here we will just consider the more practical issues relating to capitalisation.

Based upon the captive's business plan, the potential aggregate net (after reinsurance) risk of the captive has to be calculated, other risk factors are considered and then the funds necessary to support this risk profile assessed. Occasionally it may be fully protected by reinsurance such that there will be no exposure to the capital but this is not always the case, so it is recommended that the capital be sufficient to meet the possible maximum loss scenario of the captive and for the captive to remain in business and offer renewal of the business plan without having to call for additional capital from the parent. Typically, the captive board will seek a margin on top of the minimum capital permitted to allow for deviations in the captive's performance. The Inland Revenue at the parent company end cannot be ignored in this consideration. The parent is arguing that the captive is a bona fide insurance company but they cannot do this if it is insufficiently (or overly!) capitalised or if the capital is not paid up and the captive is relying on further callable capital or loans from the parent.

Some advisers do not consider it good practice to have partly paid shares although it could well be acceptable for there to be an authorised capital higher than the paid up capital. There is an important distinction between the two. Where a share, say, of £1, is partly paid with 10% paid up, legally the balance of 90p can be looked upon as a guaranteed loan facility to the captive in that, when it is called, the shareholder is required to pay it or risk losing the existing share. It may not be a good idea for a captive to have such a loan facility; the board may feel more comfortable with fully paid up capital and any credit risk attaching to future calls on partly paid shares removed. Alternately, the parent company may seek to divest its limited capital elsewhere within the group and prefer the contingent nature of the callable shares.

By comparison, it is perfectly normal for an organisation to have a much higher authorised capital than it has paid up. This is merely looking to the future and provided the paid up capital is sufficient for the current operations, then all is well. The subtle difference is that if the captive offers additional shares over the paid up capital and within the authorised capital, it is open to existing shareholders to buy these shares or not without any effect on their existing shareholding, i.e. there is no legal compulsion for them to pay up the additional capital and, in effect, if such be the case, bail out the captive from any financial difficulty. Equally it may not be a good idea to have redeemable shares and, indeed, these may not be allowed in the particular domicile chosen. If they are allowed, typically they will be bound by certain limitations as a regulator would not be comfortable with a company being able to redeem shares and, in effect, reduce its capital, without the regulator's approval.

For Protected Cell Companies or Association Captives, redeemable shares may well be a more appropriate capital structure to use (because of the increased flexibility) without the same potential Revenue implications.

It should be reiterated that it is important for the initial capital to be sufficient for the planned operation of the captive, both for solvency and working capital purposes. Capital sufficient to fund the initial business plan should be paid in and made available. Any staggering of raising capital to reduce the initial commitment and 'drip feed' the captive as it needs funds, is generally not a good idea and may be regarded as demonstration of a lack of commitment to the captive concept. Worse, it shows that, without the parents help, the captive cannot survive independently, and so could be challenged that it is not a bona-fide independent company. Having arrived at an appropriate capitalisation, it is then important that the reinsurance programme is appropriate such that that capital is adequately protected. Whilst there are organisations which are prepared to put capital at risk in the formative years of a new project, in the main most do not expect capital bases to be eroded and so structure reinsurance protection to limit any downside.

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4.8 INITIAL BUSINESS PLAN

Finally, and presumably in consultation with the chosen manager, there will be the need to agree and document the business plan. This will form an essential part of the initial insurance licence application to the regulator in the chosen domicile and is something that will be looked upon very carefully by that regulator. In effect, it forms the basis of the capitalisation issue. A lot of this will, of course, be lifted from the feasibility study but not necessarily so. The feasibility study may have covered other classes of business beyond those initially going into the captive or it may be that, following further discussions with the chosen manager and the reactions of the reinsurance market, that variations are considered appropriate. It will be on the basis of this first business plan that the licence to operate will be granted. Generally, therefore, the business plan should include the following information:

- Classes to be written and source of the business.
- Details of any fronting arrangements.
- Local deductibles, captive retention and aggregate limits.
- Premiums.
- Reinsurance programme, names of reinsurers, limits and premiums.
- Aggregate stop loss or other excess protections.
- Variations from standard policies, whether claims made or occurrence.
- Three years financial projection.
- Details of all intermediaries involved.
- Progression from gross premium to earned premiums and commission structure.
- Claims reserving policy.
- Details of investment programme, including related party loans.
- Dividend policy.

There is an example of a Business Plan for a simple captive structure provided in the Appendices

4.9 THE FIRST BOARD MEETING

Below is a sample agenda for the first board meeting of a captive which effectively lists the items to be agreed and considered before the company can truly start business. This is a draft which will doubtless vary between managers but most aspects will apply to most captives. Many items are confirmation or ratification of what has already occurred, bearing in mind this may be the non-executive directors' first introduction to the company and its proposed objectives. Other points, however, do require decisions by the new board.

First Board Meeting of Captive Insurance Company: Agenda

1. Election of Chairman (sometimes there is a standing Chairman determined at the first meeting of the company otherwise appointed at each meeting)

2. Apologies for Absence

3. Confirmation of Appointment of Directors
    - Appointment of Alternate Director
    - Noting of Director's Interests (i.e. potential conflicts)
    - Directors service contract (if required), tenure, fees quantum and frequency
    - Directors and Officers insurance

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4. Appointment of Company Secretary (normally the Insurance Manager or a subsidiary of theirs)

5. Confirmation of Incorporation
   - Certificate of incorporation
   - Memorandum and Articles. Consideration of Quorum for the board
   - Issue of share capital and certificates (if applicable)
   - Authority to sign on behalf of the company
   - AGM waiver if applicable

6. Adoption of Company Seal (if any)
7. Approval of Company Register and Statutory Books
8. Registered Office (usually the manager's office)
9. Finance and Accounting
   - Appointment of auditors
   - Financial Year end
   - Accounting standard
   - Frequency of reporting
   - Tax status and application for exempt status if required

10. Appointment of Bankers and mandates
11. Appointment of Investment Managers (if any)
12. Investment Strategy
13. Appointment of Insurance Company Manager
    - Appointment of General Representative
    - Approval of Management Agreement
    - Agreement to Management Fees

14. Review of the application for the Insurance Licence
    - Copy of Insurance licence and accompanying correspondence from the regulator
    - Category of licence and consideration of all relevant requirements of same
    - Own Solvency Capital Assessment (OSCA) or Own Risk and Solvency Assessment (ORSA) if required

15. Compliance
    - Appointment of Compliance Officer
    - Appointment of MLRO & MLCO if required
    - Compliance manual
    - Compliance monitoring programme
    - Corporate Governance Code
    - Business Risk Assessment and Risk Register
    - Data Protection registration
    - Tax substance, board procedures and CIGA

16. Approval of Business Plan and report from the Managers on the readiness to write business
    - Consideration and approval of policy wordings
    - Consideration and approval of any fronting or reinsurance agreements

- Appointment of reinsurance broker (if required) and consideration and approval of Terms of Business Agreement (TOBA)

17. Corporate data sheet and Meeting and Action check list
18. Dates of Next Meetings
19. Any Other Business

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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. Is it necessary to appoint a standing Chair of the board?
2. State three reasons for appointing an insurance management company?
3. Name one other service provider that must be appointed at the first board meeting?
4. Why must the captive hold its first board meeting before commencing business?

Summary of learning outcomes
1. Explain why most captives' owners appoint a, professional third party management company to administer their captive
2. Explain the importance of the composition of the captive board.
3. Describe the typical contents and purpose of the captive's business plan.
4. Describe the key matters that should be considered at the first board meeting.