Module C Unit 4D

EXIT STRATEGIES

Purpose

At the end of this unit the participant should be able to demonstrate an understanding as to how to exit a captive strategy if the need to do so arises

Assumed knowledge

Differences between long tail and short tail insurance business. Refer to Unit 11

Summary of learning outcomes
1. Explain the reasons for wanting to exit from owning a captive.
2. Explain matters that can influence the method of exit.
3. Describe methods to dispose of any remaining liabilities.
4. Describe the available options for closure of the company.

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4.0   REASONS FOR EXIT

4.0.1. Changes in the insurance market

A common reason for establishing a captive is in response to a hard market where premiums are considered too high, terms and conditions too stringent and/or capacity for coverage is limited or dries up completely.

Market cycles mean that these hard market conditions can reverse to an extent that the financial benefit of utilising a captive to carry risk of the parent organisation is no longer apparent as the insurance market is offering competitive terms for cover on all the risks that the organisation wishes to insure.

Such changes may lead to a captive becoming redundant either permanently or temporarily.

4.0.2. Changes in the business strategy of parent organisation

Business objectives and drivers are continually changing to respond to the changing demands of their customers and to remain competitive or reposition to become more competitive. As result significant changes in the risk profile of a business are not uncommon.

Such changes may lead to a captive becoming redundant either permanently or temporarily.

4.0.3. Mergers, acquisitions and disposals

Mergers can sometime lead to an organisation with an existing captive acquiring a second captive and determining that only one is required going forward. It might be that the organisation did not have a captive pre-merger and do not wish to retain one post-merger for some of the reasons discussed in 4.1.4. The same scenarios can play out as a result of acquisitions.

Disposals could lead to a loss of the critical mass of premiums to maintain a captive's viability and thus lead to a desire for an exit strategy.

4.0.4. Changes in senior management at the parent company

Some senior executives consider the captive solution differently, with some strong advocates of captive participation. Should there be a change of personnel at the parent company it may well be that those executives who formulated and implemented the formation of a captive depart and are replaced by executives who do not consider the vehicle to be an appropriate way to address the organisation's exposures.

4.0.5. Changes in regulations relating to the captive

The regulations relating to the operation and governance of captives are continually evolving and in nearly every case that evolution adds additional complexity and cost to the operation of the captive. This could reach a point where the viability of the captive is called into question, either due to rising operational costs, more onerous capital/solvency requirements or increased governance demands.

Such changes could lead to a wish to exit the captive strategy or alternatively a desire to move the captive to another domicile where the regulation and/or capital requirements are less onerous.

4.0.6. Changes in taxation legislation in country of parent company or captive domicile

Whilst captives should not be formed solely for tax reasons, should the relevant tax regimes in either the parent company's location or in the captive domicile change such that there is an adverse tax outcome by maintaining the captive then it may be a trigger for exit. The tax changes could be in relation to corporate tax or premium taxes.

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4.0.7. Adverse performance of the captive and/or insolvency

There may be reasons why the captive has not performed as expected such as adverse claims experience, poor investment performance or a combination of the two. In extreme cases this may lead to the captive becoming insolvent and/or not being able to meet statutory solvency margins. If the shareholder is unwilling to recapitalise the captive there will be a need to implement an exit strategy.

4.1 METHODS FOR EXIT

The method of exit can be influenced by the reason for wishing to exit as well as the nature of the business written by the captive and the costs of a run off of the business in an orderly fashion.

4.1.1. Long tail verses short tail business

Where the business written is short tail in nature and the captive ceases writing new business, it can be reasonably anticipated that within a reasonably short period (say a maximum of three years) the majority of claims will be reported (or anticipated will be settled) or capable of settlement. In this scenario the cost of maintaining the captive in order to run off any outstanding liabilities may not be prohibitive.

Conversely when a captive has written long tail business such as Employers, Public or Products liability it can take many years after the captive has ceased to write such polices for losses to develop, be reported and then settled. Maintaining the captive during an extended period of run off can be expensive and time consuming and it is therefore useful to explore other options which can facilitate an earlier exit from the captive.

4.1.2. Direct writing

If the insurance policies have been written by the captive directly with the parent organisation it is possible to reach a mutual agreement as between the insured and the insurer to transfer any known and unknown liabilities from the captive back to the parent. This process is known as commutation

When doing so it is important that an arm's length price is paid by the captive to the parent to transfer those liabilities and in such circumstances it might be best to have an actuary assist in determining that pricing.

Once the risk has been transferred back to the parent the captive can be closed down. See section 4.2 for further details.

4.1.3. Fronted business

Where the business written by the captive is fronted it is not possible to simply pass the risk back to the parent company. There are three option available to the captive in these circumstances:-

- Commutation – this is the process of unwinding the reinsurance contract with the fronting company such that the liability for all outstanding and future claims is passed back the fronting company. This can only happen with the agreement of the fronting company and this will require a negotiation as to what price the fronter will accept that risk. Again actuarial input will assist with the pricing of the risk. It is not uncommon to discuss possible future commutation terms with a fronting insurer when the fronting arrangement is first established. This provides the captive with some comfort in knowing that the fronting company is at least minded to assist with a commutation if approached and in some cases the fronter may even be willing to agree in advance a methodology for determining the price of such a commutation (although that is less common in practice).

  Once the commutation is complete the captive will be ready for closure.

- Novation - if the fronting company is unwilling or perhaps unable to agree to a commutation the captive must then look to other parties to assume the risk from the captive. There are quite a number of companies that specialise in taking on books of (re)insurance business that are in run off. They are commonly known as Run-Off or Legacy companies. In arranging a Novation one needs to first check if the fronting agreement allows this to take place. Sometimes the agreement will be silent, alternatively it may contain an Assignment Clause which might prevent any assignment of the risk by the captive to another party or it may state that an assignment may only take place with the fronting company's consent.

Assuming the Novation is permitted, the captive is relieved of its liability under the reinsurance contract with the fronting company and the Run Off company effectively steps into the shoes of the captive and become liable to the fronting company. Any security (such as a LOC) acting as collateral to the reinsurance agreement can be unwound once the Novation is completed.

Once the Novation is completed the captive will be ready for closure.

Sale of the captive – in some circumstances a Run-Off company may agree to buy the captive from its owner. There are a number of benefits, as well as some hurdles, in such an arrangement as follows:

- It is unusual for the fronting agreement to prevent a change in ownership of the captive. So, if the fronting company is not interested in entering into a commutation and will also not allow a Novation to proceed, then a sale can be the final solution

- Sale of the captive means that there is no need for the current owner to go through the closure procedures discussed in section 4.3

- The sale of the captive will require regulatory approval for a Change of Control which is not required for a Commutation or Novation.

4.2 METHODS OF CLOSURE

Once the business written by the captive has either run off to natural expiry or has been disposed of by either commutation or Novation, then the insurance license can be surrendered to the regulator. At this point the regulator will typically permit the company to remain dormant for a maximum of one year with "Insurance" still in the company name. If one wanted to retain the company for longer than that it would be a requirement that the name be changed to remove any reference to insurance.

Typically, owners do not wish to retain the shell company. Should this be the case the owner can either appoint a liquidator to settle any remaining non-insurance liabilities, then distribute any remaining assets and close the company down or the insurance manager can deal with these matters and then the board can make an application to the domicile Companies House for their captive to be removed from its registrar (in Guernsey, this would be the Guernsey Registry for a Voluntary Strike Off (VSO)).

If you wish to know more about VSO there is information available at the link below

http://www.guernseyregistry.com/article/158354/Striking-off-or-winding-up-a-company

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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. Why might a merger or acquisition by the captive's shareholder lead to the need for its closure? 2. Why might a different approach be required when exiting long tail business as opposed to short tail covers? 3. What services does a legacy company offer? 4. What's the advantage of Voluntary Strike Off compared to Voluntary Liquidation?

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