Getting it right: Captive formation and management

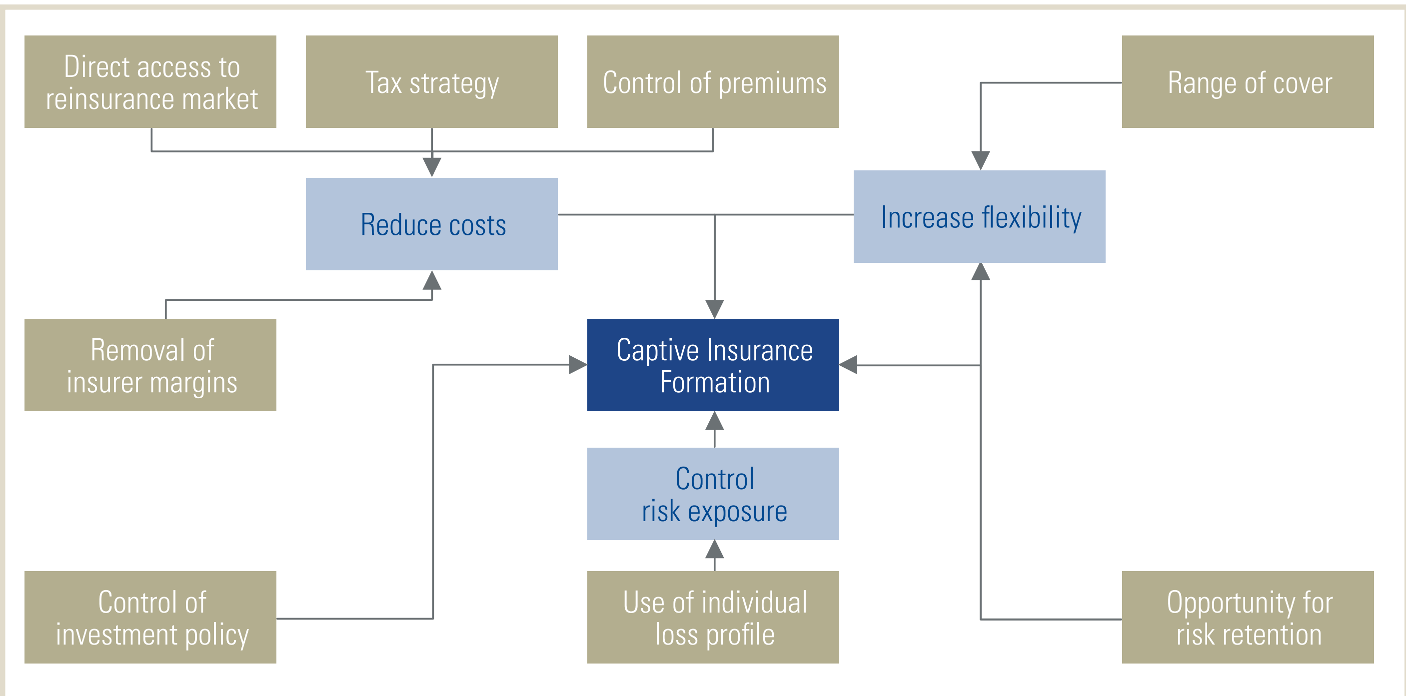
Regulatory and legislative changes occurring across Europe are fundamentally altering the way corporate groups manage their risk management processes.

Some of the most significant drivers of change include the planned introduction of Solvency II across the EU by 2016 and the introduction of new Controlled Foreign Company (CFC) rules in the UK at the beginning of 2013. The changing tax and regulatory landscape means that many large corporate groups are undertaking a complete review of their risk management structures, including their use of group captives. In addition, groups that had previously not established a captive are now revisiting the concept in light of the new regulatory and fiscal landscapes.

Potential benefits of a captive

There are a number of benefits for companies looking to establish a formal risk retention structure such as a captive, including:

- Aligning tax with commercial strategies
- Reduced insurance costs and smooth market cycles
- Greater control over risk exposure
- Increased flexibility over risk management
- Access reinsurance markets



Key issues in the captive formation

Whilst there are many potential benefits in establishing a captive, a clear understanding of the key issues is essential. What then, are the key issues when deciding on the optimum structure and domicile for a potential captive?

Differing reporting requirements in each domicile that may add or reduce complexity and cost to the risk management process.

Corporates need to therefore review the reporting obligations and what that might entail in terms of management time as well as cost.

Typically a captive will use a licensed insurance company (the 'fronter') to write business in certain jurisdictions and the captive will then reinsure the fronter.

In general, there are no statutory requirements in any of the domiciles that govern the amount and type of collateral that must be provided to a fronting insurance company – the collateral demands will be driven by the fronter's requirements and will be a matter of commercial negotiation between the parties.

Captives therefore need to assess which structures can reduce the amount of collateral that becomes trapped and the likely costs of fronting arrangements.

Depending on the selected captive domicile, each regulatory regime will have differing requirements on solvency, liquidity and statutory capital, not just in absolute terms but in what form the capital and assets may take. Risk managers need to assess the capital requirements and the flexibility of the asset admissibility rules for each domicile, and match those against the financial resources and strategy of the parent.

Corporates may wish to insure third parties and therefore need to review the benefits of having a direct or 3rd party license compared to the increased regulatory and capital burden that such licenses may entail, including a review of the cost benefit of obtaining an independent security rating for the captive.

The current focus on efficiency and cost reduction has invariably led to companies looking at their overall spend on insurance and seeking ways to reduce their overall insurance spend. As part of the review an assessment will be made of the retention 'sweet spot' that will maximise risk transfer and minimise premium leakage.

Changing CFC rules in the UK and the EU mean that for some companies there are now significant tax advantages to locating a captive in the EU. As such, captive owners should undertake a cost benefit analysis of the tax savings that could be generated under the new CFC rules.

The pace of change in new legislation and case law, and the introduction of new types of product coupled with changes in tax authorities behaviour mean insurance premium tax (IPT) operating structures need to be continually reviewed to ensure compliance with the law and continued alignment with commercial objectives.

Our approach to captive feasibility studies

In undertaking a captive feasibility study, KPMG typically adopts a two phase approach. The first step, Phase I, will involve conducting interviews and meetings with key stakeholders to better understand the current state of your risk management program and your wider business objectives for the future. This collaborative approach will include working not only with your management but also your current broker, and other advisers such as actuarial consultants. We believe that this approach enhances the quality and robustness of the review and its recommendations.

We consider that the purpose of Phase I of the project will be to:

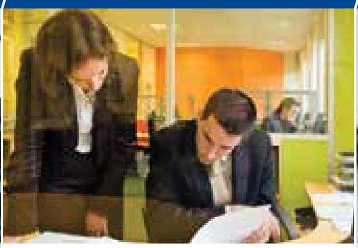
1. Obtain a clear understanding of your financial, operational and strategic goals over the short and medium terms and your existing risk management arrangements
2. Agree with management the 'key design principles' for the risk retention structure
3. Set out a list of potential risk management structures and evaluate these structures against the agreed 'key design principles' including a high level cost benefit analysis of each
4. Provide an overview of the main captive domiciles from a regulatory capital, tax, legal (including exit/redomestication tools) and operational efficiency perspective
5. Agree a short list of options that will go forward for further review in Phase II of the project

Why KPMG?

Independence

- As a 'Big Four' accounting firm, we provide no management or brokerage services and we have no bias or unstated agenda in terms of any given risk transfer option (or domicile)
- We are able to offer an integrated review that considers the risk modelling, tax, regulatory, accounting and business planning issues

Relationships and Experience



- We have a well-established record in delivering risk management reviews to small organisations through to large multinational groups
- KPMG member firms have a network of specialist insurance teams in major captive domiciles around the world

Market Knowledge

- We have a team with strong industry relationships with brokers, regulators, insurance groups and captive managers
- We offer robust and creative ideas to help ensure that the many risk management options are properly assessed

Flexible Remuneration Structure

- We are able to structure flexible remuneration arrangements some of which can be contingent on the costs savings realised from the feasibility review

Suggested scope of Phase II of the captive feasibility review

Overview of risk management options	• Provide background on and current thinking on advantages/disadvantages of: – Commercial (re)insurance – Captives – Protected and incorporated cells – Lloyd's of London syndicate – Self-insured deductibles
Capital efficiency and risk retention	• Actuarial review of past claims experience to ascertain optimum deductible
Cost benefit analysis	• Comparison of financial and non-financial projected outcomes for each option compared to 'as is' scenario
Capital and solvency requirements	• Scale and timing of funding and regulatory capital requirements for each risk management option • Base case regulatory capital requirements under Solvency II and non-Solvency II scenarios
Analysis of fronting requirements and costs	• Provide an analysis of the likely fronting collateral requirements and assess impact of the option on the client's cash-flow and funding requirements
Regulatory requirements	• Provide an overview of Solvency II (and SII equivalence) and its application to captives • Comparison between Solvency II and non-Solvency II regulatory regimes • Regulatory outlook
Tax issues	• Strategies that underpin the wider commercial objectives
Accounting issues	• Review of appropriate accounting treatment of each option
Other issues	• Writing direct business – expansion of product lines • Impact of the risk management strategy on the client's lending covenants • Exit strategies available for the captive in the short listed captive domiciles • Obtaining a rating for the captive • Captive manager and NED selection
Recommendations	• Evaluation and comparison of each option against the agreed design principles

Contacts

Should you wish to discuss whether a captive insurance company could benefit your organisation, please contact one of our professionals from KPMG's global network of independent firms:

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