



WHAT ARE CAPTIVES? AND HOW CAN TREASURERS MAKE THEM WORK IN THEIR FAVOUR IN THE CONTINUING BATTLE AGAINST RISK EXPOSURE? **MATTHEW LEE** OF IRMG EXPLORES THE ISSUES.

IN SEARCH OF A CAPTIVE AUDIENCE

Corporates' experiences with captives (insurance subsidiaries) vary enormously, and is often more to do with past experience and misconceptions than what a captive can and cannot achieve. A captive is a unique type of subsidiary (see Background Panel) which large corporations first began utilising in the late 1800s, either to manage a proportion of their insurance risks, or to provide an additional means of reserving for risks that were new and uncertain. Use of such entities was limited because few corporations had the internal spread of risks and exposures needed to utilise them. Most captives were initially formed as subsidiaries in the same locations as their parent because they were seen as insignificant in terms of taxation.

OFFSHORE VS ONSHORE

With increasing globalisation and continued growth in asset values, however, interest in captives re-emerged in the late 1970s and 1980s. Unlike earlier formations, the majority of new start-ups were formed offshore, where the ability to differentiate between captives and commercial insurers led to lower costs. This move also had interesting side-effects (soft benefits), which enhanced the financial performance of captive enterprises including:

- statutory and catastrophic reserves requirements;
- tax exemptions (0% taxation); and
- no dividend requirement.

It is estimated these days that 50% of all corporate premiums in the US – about \$35bn – are paid to captives. As a result, many tax authorities want to see captive profits reflected in parent companies' accounts and tax paid on these profits.

To achieve this, a number of anti-avoidance measures have been devised; the application of which varies from country to country (see Anti-avoidance measures on p56)

THE CURRENT CAPTIVE DEBATE

Given these restrictions, and the fact that most captive retentions are negligible in treasury value terms, why do companies persist with captives and why are there in excess of 4,500 in the world today? Answers vary, but the main issues include:

RISK FINANCING. Although insurance is only capable of indemnifying an estimated 10% of corporate exposures, the ability

to retain some element of risk at local level, and to contribute a further element of turnover for risk protection to a risk finance vehicle such as a captive, can benefit the sub-treasury level. The ability to access liquid capital quickly from this risk finance vehicle, instead of having to increase gearing or requesting liquid funds from treasury, may be more acceptable for some companies, especially when investment returns and asset values are depressed or performance is poor.

MARKET CYCLE. Insurance pricing has been unstable over the past three years. Although it is increasingly recognised that insurance rates have peaked for most classes of insurance, they are still generally higher than in the last decade and it is unlikely they will fall. The increase in rates is due to a variety of factors, including emerging exposures, such as terrorism and asbestos, deterioration in the investment return, and the damaging effect of the market

Background

Nearly all insurance companies started out as collective or pooled insurance entities formed by industrialists or as friendly societies, to insure new and emerging risks for which there were no other methods of protecting the individual or capital employed. The basic business model was to pool contributions, which became known as 'premiums', from which the losses were paid and expenses met. Given the fact that for many types of risk, such as marine risks (ships voyages) and liability exposures, it would not be possible for the results (profit) of the insurance business to be known within the normal annual accounting period, this gave rise to the creation of an additional page to the financial accounts – the technical account.

This page recognises the unknown element in the venture, which will not be known for a period of years and allows a proportion of turnover to sit in suspense, outside of the profit and loss (P&L) account, until the results of the insurance contracts underwritten are known.

At the moment, two methods of insurance accounting are recognised. The oldest method is fund accounting (essentially for marine, employers' liability and some longer-term exposures), where the total premium is set aside for a number of years (usually three) and from which claims are met.

downturn on insurers and reinsurers' liquidity and capital resources. As a result, insurers have had to rely on each account making a pure (underwriting) profit. Significant premium discounts (or lack of increases) have once again been available for clients with the ability and desire to retain greater elements of insurable risk on their balance sheets. In some cases, these retentions were not willingly elected, but forced on them by an insurance industry wishing to maximise the use of its capital and solvency reserves. When the insurance cycle is high (see Figure 1), the potential to reduce overheads by accepting larger retentions leads to debate as to how best to fund these exposures.

While the method chosen varies from company to company, it is usually a mixture of business units absorbing some exposures through operating expenses, with the balance insured by the risk finance vehicle. Such an approach is usually the best for European multinationals that tend to be more decentralised.

At the end of the period, specific reserves are established for outstanding claims and those claims that are as of yet unreported. This second reserve is based on the statistical records for the class of business and is known as an incurred but not reported (IBNR) reserve. Any surplus or deficit is then recognised through the (P&L) section of the annual accounts.

Clearly, such an accounting methodology, with profits held for a number of years untaxed, is out of favour with the taxation authorities and is being replaced (International Accounting Standards) by the revenue accounting methodology.

Revenue accounting simply disposes of the funding approach and requires that, at the end of the first financial year, the insurer declares an estimated profit, based on the 'earned premium', less claims paid, losses reported (specific reserves), claims costs and the IBNR. This was always unpopular with insurers in some countries where the increased volatility of results was not recognised by the creation of non-specific reserves, such as catastrophic and contingency. The fear has always been that this leads to increased capital requirements and concerns over insurer bankruptcies, which heightened the price cycle.

It should be noted that insurance subsidiaries, known commonly as 'captives', generally follow the accounting rules for insurance entities in their parents' locations for consolidation purposes.

FRONTING FEES. With insurers increasingly examining their staffing levels and support costs, inevitably, they have come to the conclusion that the contribution larger companies make to their income is insufficient. This has led to increases in fronting and claims management costs, and the introduction of capital charges for those clients that require insurers to act for them in several countries and expect the majority of premium to be ceded back to their own captives. Rather than accepting these charges, many companies have attempted to minimise overheads by forming firms in jurisdictions such as Ireland, Gibraltar and Switzerland, where insurance companies can write policies across Europe.

ACCOUNTING AND REGULATORY CHANGES. Over the past five years, the number of new accounting standards has multiplied, coinciding with the general drive by governments worldwide towards lower taxation rates. This requires the tax net to be widened, resulting in a greater need for transparency in accounting, particularly for cross-border groups. The result has been a general reduction in the level of provisions a company is allowed to hold and more stringent measurement of such provisions. There are two ways in which companies are affected. First, the challenge to existing provisions and arrangements includes areas such as:

- accounting for liabilities on leases;
- Financial Reporting Standard 12 (FRS 12) – general accounting for provisions;
- acceptable debt provisions and the measurement of such debt; and
- net present value reserving on liability provisions.

Secondly, companies are being impacted by new exposures and new issues that are being introduced, generally for socio-economic reasons, such as:

- Waste Electrical Equipment Recycling (WEEE) – EU-wide (from?) 13 August 2005;
- CAR – recycling liability for manufacturers;
- valuation of and meeting pension liabilities; and
- Basel II requirements on the use and measurement of capital for banks.

In each instance, the challenge to an existing provision, or creation of a new liability affecting corporate returns (thereby creating volatility), can be met by using a captive. While the captive cannot achieve any long-term benefits on its own, because of consolidation,

it is often an important access tool to reinsurance protection which needed to provide catastrophic protection. Generally, such methods, often described generically as alternative risk transfer (ART), assist the company by easing volatility (cash calls) and allowing risks to be replaced by a known and therefore budgetable expenses.

ASSESSMENT OF EXPOSURES. One of the most difficult issues for companies is measuring the value offered by the transfer of insurable risks against the group's overall performance. For most treasury exposures, the treasury team will know the effect of a loss – for example, a change in exchange rates – and can then work out the most appropriate financial instrument and the cost of such a transaction. However, there is no such ready measurement for insurance transactions. Consequently, some consultants have developed tools that not only measure a company's ability to absorb risk (corporate risk tolerance), but also assess the impact of a loss and set the value of premiums that would be acceptable to hedge such exposures (optimisation).

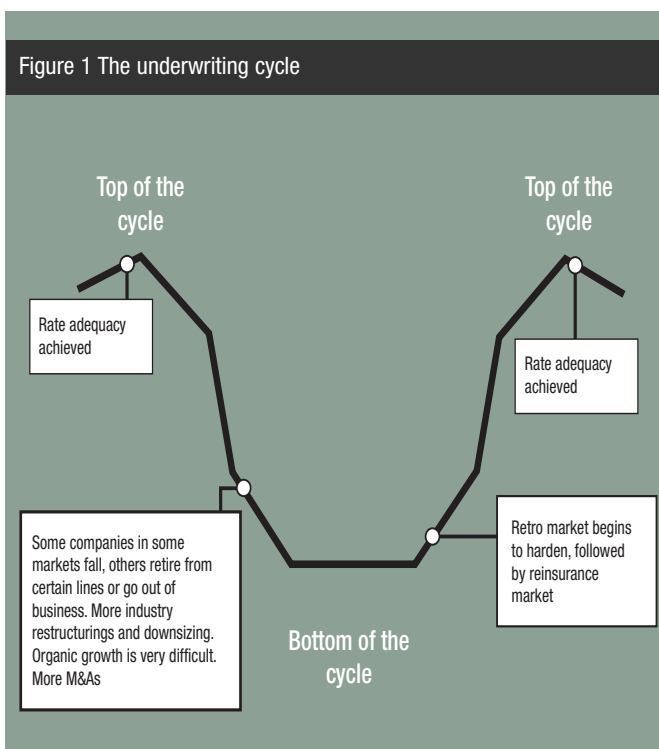
ALTERNATIVE STRUCTURE OF CAPTIVES. Given the cost of establishing and closing captives, and the size of some of retentions, use of captives is limited by timing and capital issues. This has resulted in the development of new insurance products and the re-emergence of cell companies and mutuals. Cell firms are insurance companies, through which corporations may establish insurance protection in return for a capital injection of shares or other acceptable security. However, as the company is owned by third parties and the corporation's shareholding is one of many, the corporation does not have to concern itself with the management of the enterprise or, indeed, with the closure of this entity. It should be noted, however, that if the risk is long term in nature, the insurance company might require some concession or commercial trade-off from the corporation before the assets invested are released.

Mutuals are again in vogue, as the premium savings on offer and lack of insurance cover available to single corporations make the complications of investing in such groups worthwhile. The ability to partition a major part of each investor's risk into a separate cell is often utilised in such groups to avoid problems with risk-sharing.

WEALTH CREATION: EMPLOYEE BENEFITS AND CUSTOMER INSURANCE. A number of insurers have identified personal rather than commercial insurance as the area in which they wish to concentrate because of the lower levels of churning and higher profit margins. Similarly, corporations with large workforces or customer bases have become interested in arranging insurance for these so-called affinity groups. These can range from employee benefits cover, where the premium is paid by the corporation, to household, medical, travel and motor insurance. If managed well these schemes can create a genuine profit for the business.

DIRECTORS AND OFFICERS. One area many companies will not scrimp on is the purchase of directors' and officers' insurance. However, the premium cost and cover limitations have increased interest in utilising captives to provide such insurance, despite issues concerning the ability of a company to indemnify the directors. Further increases in such premiums has led to companies to examine the possibilities for self-insurance.

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Anti-avoidance measures

- **Consolidation of Accounts**
 Accounts of all defined subsidiaries and joint ventures to be consolidated into those of the head office.
- **Central taxation**
 Tax charged on an overall entity basis rather than on where the profits were sourced.
- **Wider definition of subsidiary**
 Extended to include the concept of entities 'controlled', which removes the requirements for a physical ownership in terms of voting rights.
- **Transfer Pricing Rules**
 In this instance, an insurance entity cannot charge premiums that are higher than those of external insurer (comparable price test). If the premiums are higher, then the excess premium will not be treated as a business expense and will not qualify for tax relief.
- **Source-base income taxation**
 Corporation tax must be based on central accounting rather than solely where income is sourced.
- **Valuation of Reserves**
 Reserves must be based on an agreed valuation criteria.
- **Controlled Foreign Company Rules**
 Reserves based on parents' accounting rules, and corporation tax to be paid on profits at a rate equivalent to 75% of the parents' corporate tax rate.