Captive Solutions: The Art of Optimization

With the emergence of new risks along with capacity restrictions across industry sectors, it has never been more important for risk managers to strike the right balance between risk retention and risk transfer. For many, this has led to increased interest in alternative risk solutions with self-retention vehicles, such as captives, emerging as the cornerstone of a consolidated and long-term risk management approach. In Canada, and indeed across North America, the industry is seeing a considerable uptick in the utilization of alternative risk solutions and new captive formations, along with the expanded use of existing captives. This is reinforced through the Marsh Captive Landscape 2020 report which indicated a 200% increase in the formation of new captives compared to prior year, with a similar number of formations expected by the end of 2021.

During this time of heightened uncertainty, navigating this challenging insurance landscape emphasizes the importance of implementing a flexible, dynamic, and long-term risk management strategy within an organization. With companies focused on the strategic deployment of capital, and with captives being a long-term solution rather than a short-term fix, optimal program design and engagement with the relevant experts are crucial. This engagement comes with the need to fully understand the options available, assessing whether a captive is the right fit and aligns with long-term strategic goals.

Categorizing your options: It's a question of choice

Categorizing the types of captives available is a crucial step in determining the appropriate structure for an organization. There are three main types of captive to consider:

- **Single-parent, wholly owned captive:** an insurance or reinsurance company formed primarily to insure its owner (parent company) and its affiliated companies. Premium spend in excess of USD $1M is the typical benchmark that would make this an economically viable option given the upfront capital and resourcing requirements.
- **Rent-a-Captive:** a client "rents" a portion, or segregated "cell", within a sponsored captive facility. This arrangement may also be referred to as a Protected Cell Company (PCC) or Segregated Accounts Company (SAC). Premium spend in excess of USD $500k is an acceptable level for considering a cell captive.
- **Group captive:** an insurance company formed and owned by an industry, trade or service group, or a group of companies strictly for the benefit of its members to meet a shared insurance need.

Historically, single parent captives have been the predominant structure utilized within the market; however, we are now seeing growing interest in the cell captive option with Marsh reporting a 53% increase in cell captives across their facilities in 2020 with a focus on the U.S. and Bermuda. For those insureds who have not considered risk retention vehicles in the past, a cell captive is a comparatively simple way to gain experience in the captive space while requiring limited investment from a resourcing and capital perspective.

Why location matters

For those Canadian clients considering a wholly owned captive, choosing the right domicile is crucial to ensuring the successful positioning of a broader risk management strategy. Insureds, alongside their captive management partners, should assess not only the regulatory environment, including capitalization and taxation requirements, but also the local captive market, in order to accurately establish start-up costs.

Barbados has long been a domicile chosen by many Canadian companies, with over 279 existing captives, the majority of which are owned by Canadian or U.S. organizations. With an established regulatory environment, strong infrastructure, and tax treaties in place, Barbados is a viable captive domicile option for Canadian insureds.

Bermuda, the longest-standing and largest captive domicile worldwide, is a common choice for sophisticated insurance buyers. With a robust regulatory environment (including Solvency II equivalency), a deep pool of industry experts and a flexible approach to technology and innovation, this domicile provides a number of benefits to the insured. The Canadian Tax Information Exchange Agreement, signed in 2010, introduces additional potential benefits for Canadian insureds.

With over 60 captive domicile options globally, including at least 25 in the U.S., insureds should work with their service providers to clearly articulate their risk management strategy and select a domicile which will best position them for success.

A world of opportunity

For many, recent hard market conditions have prompted a change in risk management approach, which is driving the considerable growth we are seeing in this sector. It should be remembered that a captive solution is not a short-term fix but rather a long-term risk management approach, going beyond a simple need to smooth the peaks and troughs of the traditional insurance market. In a hardened market, such as the one currently being experienced, there is significant opportunity to utilize captives in creative and innovative ways, from deductible buy-downs to filling gaps in excess layers due to capacity constraints, or the need to maintain consistent pricing, and even the funding for exclusions or non-competitive terms not covered by the traditional insurance market.

Structurally, captive solutions offer a significant opportunity for insureds, but there are also longer-term benefits. By retaining risk within a captive, insureds can potentially benefit from investment earnings, balance sheet protection and general promotion of loss control through effective risk management, alongside access to the commercial reinsurance market. Captives represent a long-term risk management tool that should form part of a wider enterprise risk management approach; creativity and innovation within your captive structure are key to long-term success and insureds should look to their service provider for that depth of expertise when designing a compliant global program.

Positioned for success

With an ever-changing risk landscape, it is crucial that insureds take the time to put in place a solution that best meets the long-term objectives of their enterprise risk management strategy. For organizations with a strong balance sheet, appetite to retain risk and a favourable loss record, a captive can be a key strategic asset in helping to navigate the complexities of the traditional insurance market. But choosing the captive structure that best meets an organization's business needs and selecting a domicile that adds the most value are crucial to ensuring long-term success.

When it comes to the structuring of your global program there is, in reality, no one size fits all solution. It is imperative that service providers fully explain all of the available options, including the benefits and considerations of each. Service providers must review the entire insurance program, evaluating an insured's global structure and regulatory/contractual requirements, to make sure that a captive approach makes sense and provides the appropriate ROI (Return on Investment) — while simultaneously helping clients navigate the process, from design to implementation, with domicile selection being a key element of this. Whether dipping their toes in the water with a cell captive or diving straight in with a wholly owned captive subsidiary, it is important for insureds to have a multi-tiered approach to structuring their global programs. Striking the right balance between risk retention vehicles and risk transfer will help position the overall risk management strategy for success in the long term.

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