Let's talk closure

Mike Palmer and **Tony Weller** of **Citadel Risk Group** highlight the importance of having a comprehensive captive exit strategy for when the going gets tough

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The growth of captive insurance over the last 30 years has been staggering and jurisdictions all over the world, both onshore and offshore, have established themselves as captive havens, often with a number of entities springing up in quite a short space of time.

While many companies go on to see steady growth and tidy returns from their captive insurers, an increasing number do not. The reasons for this vary; not all captives reach the economies of scale required to make them profitable and owners may enthusiastically overestimate premiums which then don't materialise.

The actuarial, audit, legal and management fees of a captive may simply outweigh the benefits, particularly if the captive is part of a large group and treated as somewhat of an afterthought.

Additionally, where significant mergers and acquisitions (M&A) activity has taken place, a company may acquire one captive more than they really need, especially if they already have their own through which they intend to write their newly acquired business.

In such instances, it is quite clear to many in the industry, from regulators and auditors to lawyers and accountants, that it is in the interest of shareholders and owners alike to close or run-off the captive, and yet, more often than not, this doesn't happen.

Few if any captives have an exit strategy written into their business plans and companies rarely factor finality options into the equation, even when there is a pressing need to do so.

Failed departure

Despite the fact that closing a captive may represent a sound financial decision which saves money in the long run, many companies are under the impression that the regulatory and administrative requirements as well as the financial costs of finality are too high to justify the benefits of closure.

In cases where a captive owner relies heavily on a designated manager, the opportunity to close a captive may never arise. Although managers have a duty to act in the best interest of the captive and its owner, many will fail to raise the possibility of closure even if this is the most appropriate step for a captive which isn't fulfilling its *raison d'etre*, which among other things, is to make a profit for shareholders.

For a captive to close or run-off, their owners must find someone else to take on the captive or its risks, paying them a premium for doing so. The preparation costs and time which go into providing a risk services company with the most accurate and up-to-date information, including claims and reserves information along with actuarial reports, can seem quite substantial.

Reinsurance arrangements, where in place, can also be a hurdle to closure. Many reinsurers do not want to continue taking on the captive's risks if ownership changes and negotiating with reinsurers can be complicated and time-consuming.

Captives that are very small or have very high claims can also face difficulties when trying to close, more often than not because service providers are less willing to offer them suitable finality solutions.

Exit solutions

In spite of the difficulties that can come with trying to close a captive and the initial costs associated with the process, captive owners should not shirk away from finality.

There are a number of solutions and strategies available to companies which allow for a smooth and successful transition. With Citadel Risk Group, the closure of a captive can go one of three ways: purchase, novation or loss portfolio transfer (LPT).

One option is to purchase the captive outright. We are active in many offshore jurisdictions and in some, such as Vermont, this is not feasible as regulations stipulate that policyholders and shareholders must be the same.

In this case, we can write a reinsurance assumption and novation policy and assume all the risks of a captive, allowing the owners to liquidate it and distribute their funds accordingly. Additionally, we can assume the losses incurred for a certain year or period of time through an LPT, enabling a client to focus on the live aspects of their portfolio.

Each captive is different and we assess every situation individually, based on the number of outstanding claims, the actuarial data provided, the reinsurance arrangements if applicable and of course, the type of risks written. The volatility and maturity of a portfolio are also key factors impacting our considerations and our ultimate decision on whether to take on a captive's closure.

Some captives would do well to broach the

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subject of finality with a service provider at an early stage, as this can reduce the administrative costs involved in preparing for run-off. It is worth remembering that there is always a certain amount of volatility in the first 12 months after the decision to go into run-off has been made.

The time it takes to implement a finality solution will also be impacted by these factors, but it is crucial for captive owners to remember that the process will always be quicker than the lifetime it can take for a general liability or workers' compensation claim to be settled.

With all of our finality and exit solutions, we will manage the risks that we have acquired. We, and other firms in the run-off arena, are paid a premium in order to manage claims responsibly, whether through settlement or commutation.

Looking for closure

Captive ownership can be quite personal and it is understandable that not everyone can instantly embrace finality and what it entails. Nonetheless, in an insurance climate which is increasingly competitive, it is important for owners to be realistic and to acknowledge when an exit is needed.

Finality does not equate to failure but it can be the difference between making big losses or saving time, energy and resources in the long term, which can be put to better use within a company. Owners need to take a long, hard look at their insurance books and business arrangements and assess whether their captive is best meeting their needs, which may have changed since the captive was first established.

If the answer is no then finality – in whatever form – should be the natural choice. Citadel Risk can help you through this process step by step, ensuring a smooth handover and providing you with peace of mind and ultimately, closure.

THREE REASONS WHY CAPTIVES DON'T CLOSE:

1) Economic: the administrative costs of shutting down, including paying a premium to a finality broker even when claims fall under the Incurred but not reported (IBNR) category, can often seem off-putting to owners.

2) Regulatory: jurisdictions have varying regulations governing captive closure, some of which are more favourable than others.

3) Reinsurance arrangements: if a captive has reinsurance arrangements, these can impede or slow-down closure, particularly if the reinsurer wishes to cede their risk in the event of run-off.