

CAPTIVES

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SUMMARY

This paper looks at captives from a U.K. perspective.

It is now common for major companies to have a captive insurance subsidiary and further expansion of the captives' activities are anticipated in the next few years.

Section 2 considers "What Is a Captive" and concludes that a captive is part of the overall risk management process by being the special purpose financial vehicle to provide the funding and risk servicing mechanism for the risk management process.

In Section 3, the reasons for forming a captive are considered. Real cost benefits may accrue to a company as a result of having a captive through improved risk management, access to the reinsurance market, saving on the direct insurer's commission and expenses and investment income on the insurance funds. A further important aspect is that the captive can assist in providing coverage in problem areas that may otherwise be very difficult to place in the direct insurance market. Tax advantages are not considered to be a significant reason following recent U.K. legislation.

Section 4 considers the management of a captive. It is important to ensure that matters are so arranged as to avoid unnecessary tax penalties. A captive, either through its own staff or through a professional management services company, requires the same services as a conventional insurance company.

Tax matters are considered in more detail in Section 5. An essential factor is to ensure premiums are deductible for U.K. tax purposes. Many captives are established overseas and the Controlled Foreign Companies legislation is described together with brief notes on tax rules in the more popular locations for captives.

Section 6 looks at factors to consider in choosing a domicile. The first choice to be made is whether to establish the captive onshore or offshore. Factors to take account of when building a profile of a captive location are set out.

Involvement of a direct insurer as a fronting company is considered in Section 7. In some circumstances this is essential. The problem of security for the direct insurer is considered.

CAPTIVES

1. INTRODUCTION

- 1.1 The working party has looked at captives strictly from a UK perspective. A recent survey which sampled the UK's top 2,000 companies (1) showed that:-
- (a) 51% of the companies have one or more captives.
 - (b) 39% of all their insurance premiums are channelled by companies to/through their captives.
 - (c) 68% of the companies intended to further expand their captives over the next few years.

2. WHAT IS A CAPTIVE?

- 2.1 "I always thought the best method of risk management was never to tell the chairman" - Anon.
- 2.2 Risk Management is practiced in all Companies, whether determined in a corporate plan or in an ad hoc manner. Captive Insurance Companies are vehicles for part of the risk management process.
- 2.3 The Risk Process consists of three elements.
- 2.3.1 **The Risk Transfer element**

This is the transfer of real risk and is practiced primarily in the reinsurance market. Insurance companies operating in this market include ACE and XL. The insurance product generally has a large deductible before a claim is made, and is also limited in the aggregate both vertically (in amount) and horizontally (in total amount payable).

2.3.2 **The Risk Servicing element**

This is the basic business all Insurers are in. A substantial volume of premiums are collected, and these are used to service claims. General features of this market are a large number of policies, a large number of claims, with average size generally small. Examples include personal lines business and non-megabroker commercial lines business.

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2.3.3 The Risk Management element

Under this element risks are internally managed by a number of methods, and high exposures are managed either through risk transfer or risk servicing.

2.3.4 A few examples will help.

- (i) In assessing a manager's budget, he may be charged an insurance premium to cover theft losses. Since this premium is outside of the manager's control he does not have "ownership" of the problem. If, as an alternative, he is budgeted for all losses in his department - something he can control, then a different attitude may be taken. The theft of a typewriter will affect his costs. Risk Management is therefore introduced by budget controls.
- (ii) A brewery with a number of public houses may feel it is not being given full value for the risk control it undertakes in the premium it has to pay for the loss due to fire. As an alternative, it will retain a substantial part of the risk itself, and use risk transfer for the megalosses, i.e. it moves out of risk servicing into a combination of risk management and risk transfer.
- (iii) Because of inadequate risk management or moral hazard it may be impossible or difficult to place certain risks. Examples include professional indemnity, medical malpractice, product liability and product recall. An alternative is a risk management funding vehicle.

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2.3.5 The risk management element is itself split into two elements. The first is the physical elimination or control of risk - good working practice. The second is the method of budgetary control and financing of the risk losses. Under this second element there are a number of options:-

- * Direct use of the insurance market - risk servicing.
- * Risk retention and paying losses as they arise straight from the balance sheet.
- * Funding of losses, either directly in the company or by some special purpose vehicle.

2.3.6 The special purpose funding vehicle is a captive insurance company.

2.3.7 Captive insurance companies have the following features:-

- * They are wholly owned subsidiaries of a trading company, or of a partnership group of identifiable individuals.
- * They deal almost exclusively with the risks of the owners or specified group.
- * They are established under insurance principles, requiring proper premiums, adequate claims and access to the reinsurance market.
- * They are established in an fiscally efficient manner.

2.3.8 Under this definition, captives therefore include the various professional indemnity mutuals, captives owned by Groups, P&I clubs, but exclude ordinary mutuals such as Factory Mutual, although these were established under Captive principles.

2.3.9 A feature of Captives is that certain captives do take on more outside business as their external expertise grows, and eventually they cease to be captives and become bona fide insurers. The best U.K. example of this is Chandos, the Bass Captive, which started off as a Gibraltar Captive and now is a fully fledged insurer.

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} now
in UK
and no
longer
covered by
Bass.

2.3.10 To summarise:-

Captives are the special purpose financial vehicle established by a company, or a group of similar individuals, to provide the funding and risk servicing mechanism for the risk management process. A further type of captive is used for offering insurance on customer risks usually in the areas of extended warranty and creditor insurance.

3. REASONS FOR FORMING CAPTIVES

3.1 **Focus on risk retention strategy**

- 3.1.1 This is one of the most important advantages of forming a captive. Effective risk management can play an important part in the overall profitability and efficiency of any company.
- 3.1.2 Companies which have instituted safety and other loss prevention programmes have seen claims steadily reduce in size and frequency, with the result of either a build up of surplus, and therefore increased capacity in the captive, or a reduction in insurance premiums.
- 3.1.3 Companies have also been able to motivate managers to recognise that each loss is actually retained within the group and have built up a strong team spirit emphasising the loss prevention aspects of their operation.
- 3.1.4 Such companies have developed technical loss control expertise and in many cases significantly reduced the legal costs associated with several types of loss.
- 3.1.5 The effects of a self insurance programme are more evident if contained within a separate entity such as a captive. The captive thus provides opportunities to design allocation systems to distribute loss costs more equitably among profit centres, to implement uniform accounting procedures, to accumulate actuarial information, to design more effective claims handling, loss control and engineering programmes, and to unify their application throughout all divisions or subsidiaries of the company.

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3.2 Formalised funding vehicle.

- 3.2.1 A captive is a long term funding vehicle for which financial statements are prepared. The captive will collect data and set up loss reserves, both of which may well not properly happen in the absence of a captive. Thus, the parent company's risk management programme can more easily be monitored and evaluated on a financial basis.

3.3 Access to reinsurance market.

- 3.3.1 Reinsurers like to accept retrocessions from captives because they can take comfort from the fact that the insured is itself financially involved, through the captive, with its own risk. Also, most captives are managed by experts who themselves have ready access to both the traditional reinsurance market and also to captive retrocessionnaires, who provide an excess coverage which is some times difficult to achieve commercially.

3.4 Improved cashflow and investment income.

- 3.4.1 The insurance premiums paid by a company to a commercial insurer are usually paid at the commencement of the year of risk and attract, for the commercial insurer, a considerable amount of investment income.
- 3.4.2 Captives can achieve an improved cashflow for the parent by:-
- (i) offering more flexible premium payment plans;
 - (ii) paying insured losses substantially quicker;
 - (iii) charging a lower premium.
- 3.4.3 Premiums paid to reinsurers are usually paid in arrears and thus there may be an immediate cashflow benefit in switching from the primary commercial market to the reinsurance market.
- 3.4.4 In addition, captives sometimes earn commission on their reinsurance premiums and may also be able to negotiate specific profit commission arrangements.

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3.4.5 Outstanding claims and unearned premium reserves, which otherwise would be kept by a commercial insurer, are held for investment by the captive until they are required for loss settlement. With some types of coverages, particularly liability lines, such funds may be retained for a number of years.

3.6 Programme consolidation and rationalisation.

3.6.1 The captive provides opportunities to more easily structure alternative retention or deductible plans since it may not be subject to the same regulatory constraints applicable to commercial insurers.

3.6.2 Captives are usually domiciled where there is little, if any, regulation concerning policy form, thereby allowing extension of coverage by both amount and type that would not be normally available. Fronting policies may be amended by endorsement to reflect the broader terms of the reinsurance.

3.7 Coverage in problem areas.

3.7.1 Certain types of risks (e.g. sensitive product liability risks, chemical liability and selected professional indemnity) are either impossible to place or demand high premiums, even though the insured may have a good claims history. This has led to groups of firms to establish captives for particular industries, e.g. architects, P&I Clubs.

3.7.2 A properly structured captive not only covers the required risks, but will also have more favourable access to the reinsurance market by ensuring that a sound programme is in place.

3.7.3 The captive facilitates the provision of small covers to satisfy legal and contractual obligations which could not be offered by a self insurance fund or are too small to warrant obtaining cover in the commercial market.

3.7.4 The captive can provide a great degree of flexibility in unusual situations.

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3.8 Potential tax advantages.

- 3.8.1 Recent legislation has meant that tax is unlikely to be a significant factor in captive formation. This aspect of captive formation is discussed further in Section 5.
- 3.8.2 What is important, is that the captive is set up in such a way that tax does not give rise to problems for the parent company and the jurisdiction of origin, and that the reserves may be accumulated in the jurisdiction where the captive is incorporated and managed.

3.9 Potential cost savings/reduced insurance cost.

- 3.9.1 Most companies do not retain as much risk as they are financially able. Commercial insurance companies have fixed and variable administrative costs which are passed on to the buyer. A captive can reduce the overall cost of an insurance programme by taking advantage of a parent company's financial ability to retain some level of risk. Captives may reduce insurance costs to the parent company in two ways:-
- (a) by realising underwriting and investment profits from the parent company's premium flow;
 - (b) through access to reinsurance markets that operate on a lower cost structure than direct insurers.
- 3.9.2 Inherent in all commercial/traditional insurance market operations is the payment of commission by insurers to those who introduce business to them. It may be agency commission to an agent who acts as the go between, it may be brokerage to a broker or it may be reinsurance commission with a reinsurer. All insurance premiums include an element for commission and this can be anything from 0% to 50% of the premium. It follows that if an organisation can go direct to an insurer, it may be able to negotiate with the insurer a premium reduction equal to the commission being saved (net premium basis) because no intermediary is involved. Furthermore the running of a commercial insurer also includes the costs associated with wages, rents, rates, printing, computing and other administrative expenses.

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- 3.9.3 The potential for making cost savings is thus a very important aspect of forming a captive.
- 3.9.4 When a captive is set up, it saves the parent paying a commercial insurer's business expenses and profit, and also commissions and brokerage. However this is only a true saving if the captive's own operation costs are less than that part of the premium which is saved.
- 3.9.5 When a company pays a premium or employs a broker, it buys insurance services; for example, legal costs, fire surveying, recovery of uninsured losses, negotiations with third parties etc. Therefore, the savings argument becomes specious if the total cost of going it alone is more than the portion of premium paid previously or if captive claims settlers pay claims less capably than commercial insurers. The service purchased by a company from a commercial insurer includes the professional skills, knowledge and expertise of the insurer's staff and advisers and their skills also affect other elements of premiums, i.e. the amount necessary to meet claims and create reserves.
- 3.9.6 It must be borne in mind that the formation and operation of a captive entails various expenses including organisational costs, management fees, legal and auditing fees and in some cases local taxes. Generally, these additional costs will be offset provided the captive earns sufficient investment income primarily from the paid in capital but the cost of the capital has to be serviced. In addition, a captive will require a commitment of the parent company's management time, and some travel costs.

4. MANAGEMENT OF A CAPTIVE

4.1 Management Structure

- 4.1.1 The management of captive insurance companies is effected by a board of directors who determine policy by board resolution. The day-to-day implementation of policy is delegated to the captive's management team. Although some of the larger captives have their own management teams the majority of captives employ professional captive management companies for this purpose. Companies offering management services fall into the following categories:-

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- (a) independent captive management companies
- (b) broker owned captive management companies
- (c) underwriting agents, insurers and reinsurers
- (d) other companies and advisers such as banks, lawyers and accountants

4.1.2 The board of directors is chosen having regard to need for the captive to demonstrate a sufficient degree of independence from its parent, the representation requirements of the parent and local legislation which usually requires that one of the local directors should have insurance expertise. The majority of the directors would also usually be domiciled in the captive location. Compliance with these conditions avoids tax penalties and establishes the domicile of the captive because usually the location of a company's management determines its domicile for tax purposes. Also, it is necessary for the captive to demonstrate that it is at arm's length from the parent in order for premiums paid by the parent to the captive to be tax deductible.

4.1.3 In cases where the day-to-day management of the captive is delegated to professional management companies there is a management agreement which documents the contractual responsibilities and obligations of both parties. For offshore captives the management company would usually be resident in the location of the captive because the day-to-day management must also be seen to take place in the captive domicile for the captive to be treated as an overseas company for tax purposes. Management services would be paid for by the captive's parent.

4.1.4 Where the management of the captive is in-house then the parent should ensure that arm's length and domicile requirements are satisfied particularly if the parent uses one of its existing organisations for this purpose.

4.2 Management Functions

4.2.1 The main functions performed by the management of a captive insurer are listed below. Captive management companies provide services in some or all of these areas; management agreements usually provide for services to be sub-contracted where appropriate.

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- (a) underwriting
- (b) investment management
- (c) reinsurance
- (d) claim analyses
- (e) claim handling
- (f) loss reserving
- (g) accounting services and financial control
- (h) management reports
- (i) policy documentation
- (j) legal advice
- (k) feasibility study and initial business plan
- (l) tax management

5. TAX

5.1 **Introduction**

- 5.1.1 Most captive insurance companies are set up offshore. This is partly to obtain the benefits of lower tax regimes but also because of lower capital requirements in offshore locations and because DTI requirements in the UK are complex and onerous when only related party risks are being insured.
- 5.1.2 An offshore location can, however, result in reduced flexibility as regards the utilisation of tax losses within a group, as UK losses cannot be offset against offshore profits of a captive or vice versa.
- 5.1.3 The UK tax issues which may affect a UK group, including an insurance group, setting up an offshore captive are threefold:-
 - (a) residence of captive
 - (b) premium deductibility for UK companies
 - (c) CFC issues

5.2 **Residence**

- 5.2.1 Where an offshore captive is formed it is important to ensure that it is not resident in the UK for tax purposes or any potential tax savings through the use of an offshore location will be lost.

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5.2.2 Accordingly the majority of the directors of the captive should be resident in the country in which it is located and central management and control of the captive should be and be seen to be exercised in that country.

5.3 Premium deductibility for UK companies

5.3.1 From a tax perspective the advantage of a captive operation is that it is easier in principle to obtain a current tax deduction for a premium to an insurer, than for a provision set up to cover an anticipated risk. However, the Inland Revenue may seek to disallow premiums paid by a UK group to its offshore captive. The principal argument, which is based on similar arguments developed by the US Revenue authorities, and confirmed by US case law such as the *Carnation* case is that the premiums are not payments for insurance at all, as there has been no transfer of risk out of the group. They represent, in effect, no more than the setting up of an internal provision for the risk concerned, which would not itself be tax deductible.

5.3.2 For this argument to succeed in the context of UK law and practice, it is necessary for the Revenue to demonstrate that the captive is not carrying on true insurance business because, for example, there is no adequate spread of risk, and that the captive would be unable to meet a maximum probable loss claim, without recourse to its parent for further funding.

5.3.3 There is no decided case law specifically on captive operations. It is clear, however, both from general principles and from Revenue practice that there must be some diversity of risk insured by the captive, that the captive must be adequately capitalised, that it should have in place a satisfactory reinsurance programme and should generally be operating in a commercial manner. The Revenue may also look at the premiums from a transfer pricing angle. In that case it may be possible for the company to obtain third party evidence to support the pricing. More generally, actuarial input both for setting of premiums and the determination of technical reserves could be helpful in demonstrating the commerciality of the operation and the justification for premium levels. Also, claims handling procedures must be seen to be exercised by the captive and not the parent company.

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5.4 Outline of Controlled Foreign Companies (CFC) legislation

5.4.1 A CFC is a company which is:-

- (a) not resident in the UK for tax purposes,
- (b) controlled by UK residents,
- (c) subject to a "lower level of taxation" (i.e. less than one-half the UK rate) in its country of residence

5.4.2 The effect of the legislation is broadly to tax a UK resident company which owns an interest (widely defined) in a CFC on its share of the apportioned profits of the CFC, whether distributed or not. Profits for this purpose are calculated on the basis that would have applied had the CFC been resident in the UK.

5.4.3 A number of exemptions from the legislation are provided, of which the two most important in practice are:-

- (a) the acceptable distribution test,
- (b) the exempt activity test.

5.4.4 The acceptable distribution test requires, broadly, that for a trading company, 50% of available profits should be distributed. Available profits means, broadly, commercial profits shown by the company's accounts. In practice, therefore, this test may not be particularly onerous, if the CFC is able to use a particularly strong reserving basis. The regulatory requirements in a number of offshore locations are helpful in this respect.

5.4.5 The most important requirement of the exempt activities test is that over 50% of premiums should be received from third parties. This exemption is most likely to be of use in the case of a captive owned by an insurance group, which is in a position to direct a proportion of its third party business to the captive.

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5.5 Popular locations

5.5.1 Brief notes on the favourable taxation rules which apply in a number of the more popular jurisdictions for captive insurance companies are provided below. Most territories, with the notable exception of Ireland and Luxembourg, do not benefit from a well developed network of double taxation treaties, and to some extent that will inhibit investment strategy since, in many instances, investment income will remain fully taxed in its country of origin.

5.5.2 Bahamas

There are no taxes on corporate income. A business licence fee is levied on businesses operating in the Bahamas. Depending upon the level of gross profits the rate varies between 0.25% and 1% of sales, with a maximum of B\$280,000 per annum.

5.5.3 Bermuda

During the 1970's Bermuda emerged as a major captive insurance company location and there are now more captives in Bermuda than in any other location. A captive located in Bermuda is normally an 'exempted' company, so called because it is exempted from the laws restricting the percentage of share capital that may be held by non-Bermudians.

For corporations there are no taxes on income or profits, dividends or capital gains. Additionally 'exempted' companies can obtain exemption up to the year 2016 from any future legislation imposing taxes computed on profits, income or capital gains.

However, an exempted insurance company must pay a Government registration fee of Bd\$2,000 on incorporation and Bd\$1,000 annually thereafter. In addition a payroll tax known as the 'hospital levy' must be paid by all business. This is currently paid at a rate of 2% of gross remuneration.

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5.5.4 Cayman Islands

There are no taxes on income or capital gains in the Cayman Islands. A licence fee of up to CI\$5,000 is however, payable on the formation of an insurance company and annually thereafter.

5.5.5 Gibraltar

A company resident in Gibraltar, whether incorporated in Gibraltar or elsewhere, may make a claim to be exempt from Gibraltar taxation if no Gibraltar resident individual has an interest in the company. Such an exempt company is liable to a fixed levy of £225 per annum, if incorporated in Gibraltar and £300 per year if incorporated elsewhere.

5.5.6 Guernsey

A company resident in Guernsey, whether incorporated in Guernsey or elsewhere, may make a claim to be exempt from Guernsey taxation, if no Guernsey resident individual has an interest in the company. The company would then pay only an annual fee of £500.

5.5.7 Ireland

A company set up in the International Financial Services Centre in Dublin Docks, enjoys a special 10% rate of tax. Prior approval by the authorities is required and approval is only given if the intention is to set up something more substantial than a brass plate operation. So far as insurance is concerned, Ireland has the advantage that it is in the EC and IFSC companies can benefit from the EC single market directives. This is particularly relevant for a captive seeking to write some third party business. At present the special 10% tax rate is only scheduled to last until 2005 and approval of any new enterprise must be given before the end of 1994.

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5.5.5 Isle of Man

In general, a company, resident in the Isle of Man, whether incorporated in the Isle of Man or elsewhere, may claim exemption from Isle of Man tax provided it derives its income from business activities outside of the Island, except for income from money invested with the Isle of Man Government and licensed banks. Specifically, insurance companies may apply for exemption from Manx tax, provided the underwriting relates to risks situated outside the Island, or insurance business carried on with other exempt insurance companies. Application for exemption costs £2,000 plus a further £500 for a licence fee.

5.5.9 Luxembourg

Corporations pay tax at between 20% and 50% depending on level of taxable profits.

Whilst it is not possible to apply for exemption from tax as for some of the territories noted, a number of tax incentives are available. Insurance and reinsurance companies benefit from preferential regulations for the determination of the taxable income for corporate income tax. These regulations allow considerable flexibility in the calculation of insurance reserves generally and, in the case of reinsurance operations, catastrophe reserves can be set up, such that taxable income can effectively be reduced to nil for the first ten years of operations.

6. CHOOSING A DOMICILE

6.1 There are basically two choices to be made:-

6.1.1 **Should the captive be in the country of parent's domicile?**

This might be an attractive option if:-

- there are restrictions on going offshore by the parent's government (for political reasons maybe)
- there are no tax advantages in going offshore

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it will be more convenient in terms of communication, management and control.

6.1.2 Should the captive be offshore?

This is usually the most attractive option, although:-

- it must be seen to be at arms length from parent
- there will be increased cost and lack of convenience compared to domestic captives
- there will be travel, additional management time, language difficulties.

6.2 The factors that need to be taken into account can be summarised as follows:-

6.2.1 Operating convenience of the location in relation to the parent company

- geographical location
- cost of travelling expenses
- cost of management time
- cost in relation to time changes
- level and sophistication of communications (travel, telephone, telex, fax etc.)

6.2.2 Legislation for the formation of Insurance Companies

- is it easy to form a company
- what are the reporting requirements (these should be fairly undemanding)
- what are the procedures for application
- how long does it take for authorisation to be granted.

6.2.3 Taxation

Two main considerations:-

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- (a) *premiums paid from parent to captive must be tax deductible*

the choice of location could influence the tax authorities of the parent country in this respect

- (b) *tax rates in domicile*

low tax rates will enable captive to build-up reserves and expand capital base. (However, this might only be a deferral since dividends will eventually be paid to the parent which may be subject to tax.)

6.2.4 Cost and Capability of Management Services in Location

The capability is generally considered to be more important than cost.

6.2.5 The Political Stability of the Location

- There are political question marks over Bermuda, the Bahamas, Cayman Islands, Gibraltar, Hong Kong, the Channel Islands and Vanuatu. *misprint!*
- Some form of contingency plan should be considered if a politically risky location is established.

6.3 Building a Profile of a Location

The following provides a useful list of the factors which should be taken into consideration when building a profile of a location.

6.3.1 What type of Company can be formed?

- Direct writing
- Reinsurance
- Resident and fully licensed locally
- Non-resident exempt corporations.

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6.3.2 Procedure for obtaining authorisation

- who decides
- who influences them
- what are the chances of success
- what are the timescales
- what are the detailed formalities.

6.3.3 Criteria for official considerations

- will the authorities be concerned with who owns the captive
- will the authorities be concerned with the nature of business required by captive (pure or external)
- what are the minimum capital requirements
- do the authorities take into account the captive managers
- do the managers need to be local
- do the directors have to have insurance expertise
- do the directors need to be locals.

6.3.4 Local Legislation

- what are the minimum solvency requirements
- are any assets inadmissible
- what is the degree of supervision of a captive
- what is the nature of the statutory returns
- what is the position of confidentiality
- are there limits on premium growth
- are there any restrictions on risk acceptance in relation to size of exposure and type of risk
- are there restrictions on policy wordings
- are guarantees from the parent required.

6.3.5 What is the tax position?

- is tax payable within the location
- what reserves are allowable for tax purposes
- does the tax treatment depend on the type of captive
- is there a registration fee or other ongoing fees.

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6.3.6 Other financial matters

- are there any restrictions on the form of assets backing paid-up capital
- are there any exchange control problems attesting ability to receive premiums or pay claims
- what is the position regarding loans by captive to parent.

6.3.7 Services

- does an international financial services system exist within the location (accountants, bankers, lawyers etc.)
- what management services are available
- are there restrictions on company title
- what is the access and quality of local staff.

7. FRONTING

- 7.1 Fronting is used to describe the process whereby the direct insurance for a parent organisation is written by an insurance company with a substantial part of the risk reinsured to the captive insurance company of the organisation.
- 7.2 The main reason for the use of fronting is that the insurance company will be licensed to write business in local territories and will have local representation whereas the captive will be established in a single location, the choice of which will have been determined by the factors described in earlier sections. Where compulsory insurance is involved, third party motor and employers liability in the UK, then, if business is to be routed to an offshore captive, a local fronting insurer is required, who is authorised to write these classes of business. There will be a reinsurance arrangement between the captive and the fronting insurer, but a financial guarantee would not be provided by the parent as that would remove the risk transfer element from the transaction and endanger the tax situation of the captive.

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7.3 The fronting company could provide some or all of the following services:-

- issue local policies and ensure that they are written at market rates. This would provide an indication to the regulatory authorities that the relationship between the captive and the parent organisation is on 'arms length'
- deal with the payment of local premium taxes
- carry out risk surveys
- administer and pay claims
- produce loss statistics.

These services could attract a fee of 5% of the gross premium.

7.4 The amount retained by the fronting insurer can either be a proportion of the original insurance (say 10%) or have an aggregate limit (say £1M) for Property. For Liability business the fronting insurer would wish to retain a higher proportion.

Although any class may be included within the arrangements, they are most commonly applied to Property, Business Interruption and General Liability.

Fronting does have its disadvantages - the captive loses direct control and can incur additional costs as a result of duplication of services.

7.5 Most captives would fail fronting insurers' reinsurance security requirements on account of low solvency ratios, narrow spread of business, less supervision and so on. A fronting insurer will need to put in place special arrangements to protect itself against failure of the captive. As already mentioned above, a financial guarantee from the captive's parent is usually not feasible. The measures that may be taken include:-

- (a) Letters of Credit
- (b) Establishing trust funds
- (c) Regular review of accounts (captive and parent)
- (d) Reinsurance arrangements subject to fronting insurer's approval
- (e) Agreement limiting captive's investment policy, requiring a certain level of solvency etc.

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