CLOSING THE CAPTIVES

Nigel Montgomery and Ian Clark look at the issues facing captives in run-off

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Companies and groups often own captives which are no longer actively used and which wrote business not only within their group, but also for companies which are now outside it and for external third parties. Typically, following various mergers and acquisitions, a group may have a small collection of captives where at most only one is required. These will probably be managed in offshore jurisdictions by third parties whose ultimate line of reporting leads to the finance function at board level. It is fair to suggest that in many cases captives are not the highest priority in a busy CFO's life. But there are significant reasons why these insurance subsidiaries should receive serious attention because they represent both a prospective asset from which to extract value and also a potential threat when corporate governance is all-important.

Changing the *status quo*?

The initial establishment of a captive is a big decision for any corporate entity. It is one that is generally taken in conjunction with advice received from the in-house risk manager, the external insurance broker and, in some circumstances, the auditor as well. However, once established, the question is rarely asked whether the original reasons for setting up the captive remain valid. Frequently, the external captive managers employed are part and parcel of the same group as the insurance brokers and it may not be in their best interests to question the continuing rationale for a captive's existence.

Many of the captives now operating in offshore jurisdictions were set up at a time when offshore tax legislation was far more beneficial for the parent organisation. In recent years, however, the majority of the major industrial countries have passed their own controlled foreign companies legislation which has seriously restricted the taxation benefits available on the establishment and operation of captive insurance companies. In many cases, the original rationale for the establishment of the captive no longer exists.

Other recent developments which have increased the costs of maintaining a captive have also had a detrimental effect. In particular, the introduction of insurance premium taxes has added additional cost to the equation, particularly where the decision has simply been between self-retention of risk on the corporate balance sheet or self-retention in a captive subsidiary. Many existing captives merely exist to retain deductible risk in what was a tax-efficient manner.

Perhaps the final nail in the coffin has been the weakening of insurer balance sheets following the World Trade Center loss. By frequently fronting, insurers are now requesting collateral guarantees in some form from the parent organisation over the performance of their captive subsidiaries. The cost of providing letters of credit (LOCs), performance bonds or, in some cases, parental guarantees has not only highlighted the existence of the captive subsidiaries but also the exposures which have been retained within the group.

Post-WTC and the significant increase in insurance costs faced by all businesses, insurance has become a major item on the boardroom agenda and captive insurance subsidiaries in offshore jurisdictions have come under the spotlight of a developing corporate governance programme.

These issues have in many cases led to consideration being given to the closure of captive subsidiaries and the ongoing financing of property and liability exposures through the corporate balance sheet. Quite often the clincher has been the further savings in management time and the greater flexibility arising from the repatriation and use of the funds which currently support the captive's claims liabilities.

Strategic options

Historically, the options for closing a captive were limited. Generally, it involved the novation of existing portfolios of business and also the cancellation of in-force policies, if these continued to exist. A novation of the portfolios of business would either have been back to the parent company or, alternatively, to a third party insurer, albeit the latter would have included a risk premium over and above the established reserves. For this reason, in many cases the preferred route was to transfer the liabilities back to the parent company, having satisfied the regulators that the transfer was above board and that all residual liabilities had been removed from the captive.

One of the biggest drawbacks to this approach was whether the parent organisation was able or willing to accept a transfer of liabilities from its captive subsidiary, particularly if some of the exposures were related to companies which were no longer part of the group or if any third party exposures were involved. In many cases, this was an unattractive option, but the alternative of a transfer to a third-party company was considered too costly. As a result, captives were maintained even if the rationale for their original establishment no longer existed.

One of the other problems often faced when closing down a captive is how to deal with any fronting insurers that may have been in place around the globe or for certain compulsory lines of business.

Frequently, fronting insurers have sought some form of guarantee from the parent company such that it would stand in place of its captive subsidiary should any claims arise. These guarantees may have been in the form of LOCs, performance bonds or, in some cases (depending on the parent company's balance sheet strength), parental guarantees. Each of these options will have incurred an additional cost which the parent company may not have been willing to bear.

However, with recent developments in the use of schemes of arrangement for insurance companies and the procedures for portfolio transfers, a new set of tools has emerged which can be used to terminate a parent company's involvement with its captive insurance subsidiary. These include:

- active commutation strategy aiming for an early closure;
- accelerated closure using a scheme of arrangement;
- change of jurisdiction/repatriation; or
- sale.

Of these, the first is likely to prove unsatisfactory once a decision to close the captive has been taken. Most likely, the parent company of a captive will want to unlock the embedded value in the captive while also actively addressing the issue of its potential liabilities. In many jurisdictions this can be done by way of a solvent scheme of arrangement. It is frequently possible to bring the captive business into another jurisdiction before closing it out.

Schemes of arrangement under the English *Companies Act* and equivalent legislation in other jurisdictions have been used for more than a decade to close insurance companies. They take the form of a binding agreement with all, or a selected group of, policyholders under which their claims are crystallised and paid in full with an appropriate net present value discount.

One important feature of these schemes is that they bind all policyholders even though it may not be possible to make contact with them because they have changed address or simply disappeared. The schemes become binding if a court approves them and they attract the support of a majority in number representing 75% by value of those policyholder-creditors which vote on the scheme proposition.

Other than a sale, there is no alternative mechanism available for achieving finality in insurance companies. Even running off to 'exhaustion' may be a misnomer as it is very difficult to prove that no further claims will come in even after a period during which none have been received.

Another favoured option is to sell the captive inclusive of its claim reserves to a buyer experienced in the management of closure of insurance companies. Whilst there has been a market for such transactions in Bermuda for many years, it is only in recent times that a fully-fledged trading market for insurance companies in run-off has developed in the UK and, indeed, elsewhere.

Whatever route is chosen, regulatory permission will be needed, both in the country of the captive's domicile and, potentially, the country into which it may be transferred. In order to satisfy the regulator that any scheme of arrangement, transfer of the portfolio or sale is appropriate, it is likely that a detailed claims review accompanied by an actuarial report from an independent actuarial firm will be required. In any event, it would be advantageous for such a transfer to take place if at any stage it was contemplated that the claims exposures would revert to the parent group balance sheet.

In addition, advice on the tax status of a proposed transaction will be required. To some extent, the scope of this advice will be dependent on the strategic and regulatory considerations that are likely to emerge as the various options are considered. It is, however, likely to encompass:

- advice on the tax implications of terminating/novating the captive's insurance policies and in particular the effect this would have on the specific tax legislation relating to controlled foreign companies;

- advice on the tax-efficient method of liquidating the captive company and returning its capital to the parent organisation; and

- obtaining appropriate clearance from the relevant tax authorities.

Conclusion

In an era when corporate governance is a topic of enormous importance, the risks inherent in captives are surely too great to ignore. How many senior executives are happy to sign off accounts which may not reflect the true extent of their subsidiaries' obligations? Given that third-party insurance and potential claims from former group companies insured by a captive may be very significant, a captive's balance sheet should be a matter of concern at a senior level, especially when reinsurance security is under threat. Add to this the impending soft market for many forms of traditional insurance and the temptation for companies to stick to their core activities (which often do not include insurance) and there is at least a compelling case for a strategic review of dormant captives. Any review will, of course, also provide guidance and a detailed foundation for future action.

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