

A point of view
on captives
through the eyes
of the beholder



Building a better
working world



It is all too common to hear discussions, particularly around the proverbial water cooler, about whether a company should set up a captive or enhance an existing one. Maybe you have been asked about this by the CFO or CEO directly. For companies that are looking to set up a captive, questions arise: what to do? whom to ask? how to start a review? who will lead the project? who is the sponsor? Questions also arise for companies that want to enhance a captive: do we have the capital? what programs to add? does this make business sense? if so, this year or next? All these questions, and many others, need quick answers. For most of the mature participants in the captive insurance market, some of these answers may come naturally. But easy answers may not be the case for companies that are looking to enter the captive market for the first time or have a captive that has been on “autopilot” for many years.

So, what points of view (POVs) can you expect to encounter when you find yourself in a situation where leadership is asking for answers, teammates are ready to hit the ground running, but no definitive plan exists to get this project off the ground? More importantly, how should decisions be made, what departments need to be involved and who are the key stakeholders? What follows is a snapshot of various POVs that are generally observed in corporate discussions and sidebar commentary to make sense of it all. Happy trails!

The C-suite

As with most corporate initiatives, an executive from the C-suite will inevitably be involved and render a final “go/no-go” decision. The executive may start to push for a captive project because they heard about it from their counterpart in the industry, or they may simply need to sign off on funding for the project (and eventually the captive). Bottom line: C-suite executives will not be involved in the day-to-day project details, intricacies of the feasibility studies or specifics of the domicile rules around a particular policy. They just want bottom-line answers to key questions:

- ▶ Does it make sense?
- ▶ What is the return on investment?
- ▶ What is the impact on the available “cash on hand”?
- ▶ Should we tie up capital or borrowing capacity if not able to use it for other projects?
- ▶ Do we obtain real cost savings from the new (or enhanced) structure?
- ▶ Will our company’s name end up on the front page of the news in a negative light?

The answers to the above, and other similar questions, may be: “it depends,” “maybe,” “not really” or “yes/no.” But beware! The C-suite does not want “maybe” and “I hope so.” They want you, as the risk professional, to back an analysis and make a concrete decision recommendation. The goal of the C-suite is to get the right information at the right time to make a decision, while having comfort that the details and analysis have been thoroughly conducted and vetted.



The finance (treasury) and accounting teams

While finance (treasury) and accounting are often two separate teams within a corporation, they often speak with one voice, and they are almost always involved in the analysis of new or expanded captive structures. In certain cases, these teams may even drive the process or project. From the finance and accounting perspective, the key concern is process disruption, but there are a few other key questions and concerns:

- ▶ What changes are needed to our processes and to how we currently conduct business?
- ▶ How much cash do we need to generate premiums and capital payments?
- ▶ Do we need to set up another entity in the system?
- ▶ Do we need another bank account? Will this impact cash pooling?
- ▶ How do we keep the ledger, since we've never had an insurance company?
- ▶ Can we take cash out of the captive? How? How do we get cash out of the entity if we need it, say, for a business interruption due to a pandemic?
- ▶ Do we need to prepare and file any additional financial statements, and, if so, do we need to get them externally audited?

These questions and many others are inevitable and need to be asked by the finance and accounting teams, especially those in organizations that have never dealt with a captive or that do not have the internal expertise across various functions. In general, most finance and accounting teams have a neutral POV on captives, and their biggest concern is about changes to internal processes, additional administrative burden and potential added deadlines.

The risk team

Of course, one group that will be intimately involved with a captive is the corporate risk management team. The risk team's POV will be one of the key drivers in analyzing the benefits and costs of establishing or enhancing a captive program. After all, it directly impacts their domain – the insurance and risk management function of the company – and they will most likely be the ones conducting most of the administration of the captive, even if all day-to-day operations are outsourced to a third-party captive manager. Risk managers will have a hands-on interest in developing a program that (1) fits well within the overall risk management strategy of the organization, (2) contributes to risk management cost reduction and (3) provides a reliable platform to fall back on when an insurable event related to a captive program occurs. Key questions to be answered include:

- ▶ Can a captive reduce our total cost of risk? (This question is especially relevant in a hard market.)
- ▶ How much administration will this add to an already small, overworked department?
- ▶ What are the downside risks if the captive does not perform as expected?
- ▶ How can we use this tool now, and in the future, to enhance our risk management programs?

Recently, given the hard insurance market, further impacted by the "social inflation" phenomena, setting up or enhancing a captive structure has risen to the top of the agenda for most risk managers. The renewal rates are at all-time highs, and C-suites that are looking at cutting costs, keeping expenses flat and reassessing capital management are demanding more from all internal departments. For companies that are cash-strapped due to the COVID-19 pandemic, such planning has become even more relevant. A captive is that "worst best-kept secret" that forward-looking risk managers should consider keeping up their sleeves for the next executive update session.

The tax team

Yes, we are all used to hearing the phrase, “two certainties in life – death and taxes,” coined by Mark Twain. While it is important to reiterate that captives are set up for business purposes, the POV that tax is a benefit in a captive structure is correct (at least outside of the tax-exempt organization structures). Tax also happens to be one of the benefits that is easier to calculate, whether you’re setting up a new captive program or enhancing an existing one. In essence, if you know the premium, expected loss, and corporate state and federal tax rate, you can calculate the tax efficiency before the new captive programs are put in place. From the POV of a tax director, a potential tax benefit can help pay for the cost of establishing or enhancing the captive and provide a tax-efficient capital management function in an area that has been historically (and to some extent continues to be) viewed as corporate expense.

Most tax directors are concerned with these items:

- ▶ What is the tax impact of the new or enhanced program?
- ▶ Is the benefit permanent or temporary?
- ▶ What is the impact of any new deferred taxes on our overall surplus?
- ▶ How do I compute all appropriate adjustments, and what forms do we need to file?
- ▶ What are other tax implications on our structure and dividend/capital management?

In short, tax team POVs should, and in most cases do, help drive the captive establishment or enhancement process and rightfully so. Establishing a captive for an organization is a team sport among the departments, not a “one-man” show.

Other groups?

From time to time, and depending on a particular policy being written, other internal departments may be involved (e.g., employee benefits, HR, general counsel, foreign operations, operational business unit managers, internal audit, procurement). Each group will have its own concerns and POVs similar to the ones we’ve mentioned above. It is important that each team involved (or impacted) provides input at the start of the project, as last-minute changes or revisions can be costly or result in missed deadlines (and potential loss of certain benefits).



So, in the end:

While we’ve covered some of the key POVs, it is important to note that the list is not all-inclusive. Whether a benefits department, HR or any other function is involved in the creation or administration of a captive, the decision to move forward should benefit the overall organization as a whole. With that said, as with any other multidimensional projects, there should not be too many cooks in the kitchen, and each organization should make a sound decision as to who will drive the actual project and process while asking for input from all POVs. To take a leading approach, the process should always start with a detailed step plan, a dedicated project leadership team, and a focus on the POVs and stakeholder questions that need to be addressed.

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