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## AN INTRODUCTION TO CAPTIVE INSURANCE



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redmond  
limited**

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OF A CAPTIVE:

A CAPTIVE IS A LIMITED PURPOSE, LICENSED INSURANCE COMPANY. IT IS A RISK BEARING VEHICLE WHOSE MAIN FUNCTION IS TO INSURE THE RISKS OF THE CAPTIVE'S PARENT COMPANY AND AFFILIATES.

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# The Captive Market

- ▶ WELL-STRUCTURED CAPTIVES ARE ABLE TO RESPOND QUICKLY AND EFFECTIVELY TO FLUCTUATIONS IN THE INSURANCE MARKET AND TO ANY CHANGE IN DIRECTION FROM CORPORATE PARENTS.

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A strong risk management profile is important in the dynamic and sometimes volatile insurance market place. Maintaining control in a changing risk environment is essential to the successful operation of a business. Organizations that develop and implement proactive, risk programs that support strategic objectives, mitigate rising exposures and monitor continuously for emerging threats, are more likely to succeed. Effective risk management allows businesses to achieve stability in turbulent markets, take advantage of opportunities and grow profitably.

## Prominent Role

For a growing number of organizations, a central component of their risk control strategies is a CAPTIVE insurance company. The main role of a CAPTIVE is to insure the parent company and its subsidiaries against selected exposures. It should be noted that in practice, a CAPTIVE can create much greater value than just this.

A CAPTIVE is an ideal mechanism for:

- Establishing a centralized risk retention vehicle
- Creating bespoke, broad and responsive coverage
- Improving claims handling and monitoring
- Potentially reducing the overall cost of risk.

A CAPTIVE is more than just a mechanism to control the risks of the parent company. It allows the purchaser of insurance to optimize the balance between self-insurance and third party insurance to suit their risk retention appetite. The CAPTIVE should be viewed by the broker and risk management team as a new market where they can strategically purchase coverage.

## Responsive Approach

CAPTIVES have the ability to adjust retention levels or amend insurance coverage whenever required. Flexibility is one of the inherent advantages of owning this vehicle. A well-structured CAPTIVE is a rapid response tool that allows quick decisions and tweaks and edits to be made in response to the changing demands of its parent company or to fluctuations in the insurance market.

This introduction brochure explains what a CAPTIVE insurance company can offer your organization. It will walk through the many benefits of being a CAPTIVE owner, summarize the processes involved in setting up a CAPTIVE, and provide a brief overview of some of the different types of CAPTIVES available.

▶ CAPTIVE INSURANCE COMPANIES TODAY ARE SOPHISTICATED RISK RETENTION MECHANISMS THAT PLAY A PROMINENT ROLE IN THE STRATEGIC RISK MANAGEMENT OF ORGANIZATIONS IN VIRTUALLY EVERY INDUSTRY SECTOR.



### On the Rise

Global CAPTIVEs now number over 7,500\*. Organizations are coming to understand that risk managed through a CAPTIVE is often less costly and more efficient than traditional means. This is because the CAPTIVE structure bases its premium rate on the organization's unique loss history, whereas commercial insurance market rates rarely differentiate one company from another.



### Risk Dispersement

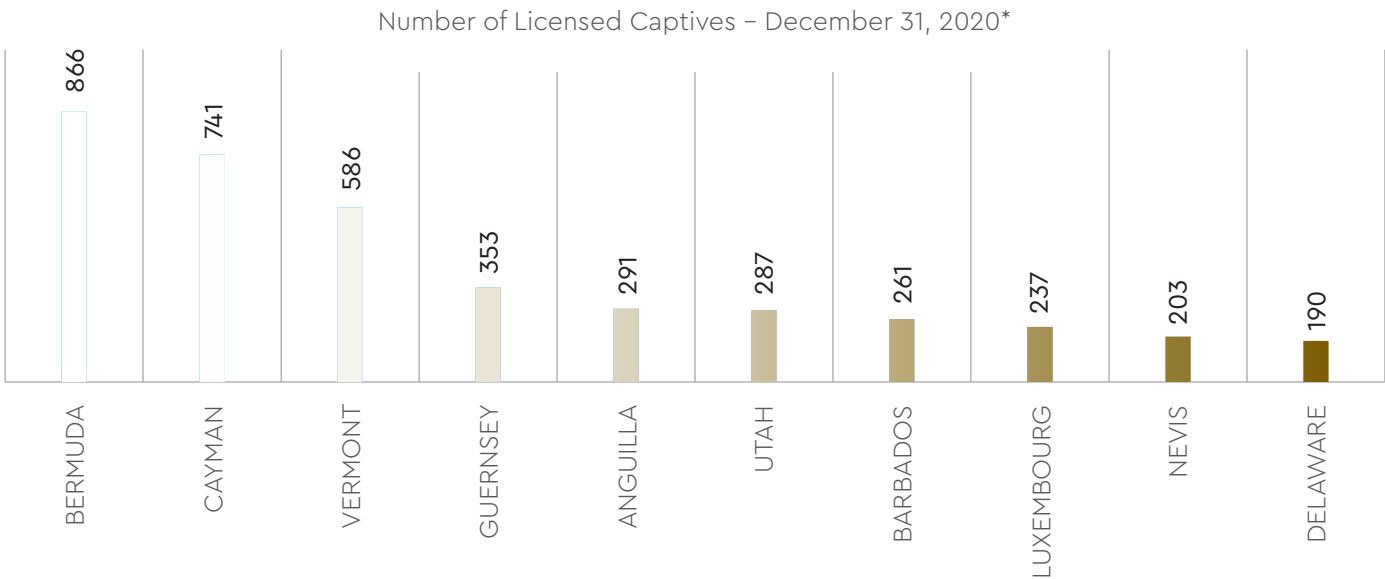
As CAPTIVEs continue to evolve, owners are discovering a willingness to include a broader array of coverages in their CAPTIVEs, and to increase retention levels. CAPTIVEs have moved beyond the more traditional risks (e.g., property, general and professional liability) to also include exposures such as directors & officers insurance, supply chain liability, employers' liability, and even emerging risks such as cyber liability and political risk.



### Removing Roadblocks

Today, the diverse range of CAPTIVEs includes: single parent CAPTIVEs, group CAPTIVEs, and various cell structures. An important and recent evolution has come in the form of Protected Cell Companies. These entities have helped lower the financial and operational barriers that have prevented entry in the past to the CAPTIVE space for many organizations.

## TOP 10 CAPTIVE DOMICILES



\*Source: Business Insurance Captive Survey

# Why Own a Captive?

- ▶ THE CAPTIVE STRUCTURE OFFERS PREMIUM RATES THAT REFLECT AN ORGANIZATION'S UNIQUE LOSS HISTORY AS OPPOSED TO THE GENERAL MARKET RATE OF A COMMERCIAL INSURANCE PROVIDER

The decision to own a CAPTIVE needs to be part of an organization's strategic risk management plan as it requires detailed assessment of the company's overall risk profile and financial well being.

For most owners, the primary reasons for setting up a CAPTIVE include the ability to:

- Stabilize and potentially reduce the cost of risk financing
- Provide customized, responsive insurance coverage
- Embed a proactive risk and claims management framework
- Access the reinsurance market directly
- Improve cash-flow timing and investment returns
- Generate a new revenue stream by covering third-party risk

## Long-standing Commitment

Setting up an effective CAPTIVE requires a long-term view. CAPTIVES are not short-term solutions to a hardening rate environment in the commercial insurance market. To fully realize its benefits, a CAPTIVE demands a long-term commitment to properly optimize the balance between self-insurance and third party insurance.

Depending on the type of CAPTIVE structure, the capital requirement can be significant. In terms of capital investment, it is normally recommended that only companies with an annual insurance spend of over C\$1,000,000 consider setting up or participating in a single parent CAPTIVE. For those considering a cell-type structure, the minimum is a C\$500,000 insurance spend. Note that every company is different and each case should be considered separately. Changing risk environment factors including forecast exposure and premium growth may encourage companies with smaller premium spends to consider a CAPTIVE.



## SHOULD YOU CONSIDER FORMING A CAPTIVE?

Certain companies will benefit greatly from owning a CAPTIVE. If your organization has the following attributes, you should seriously consider a CAPTIVE as part of your overall risk management strategy:

- Proactive approach to robust risk management
- Good understanding of their overall risk profile
- Long-term commitment to risk financing
- Strong financial balance sheet
- Reasonably predictable insurance risks
- Risk approach which is aligned with their overall business objectives
- Real interest in financing assumed risk positions

## Expanding Range of Benefits

In recent years, the range of benefits derived from a well-structured CAPTIVE has expanded considerably. This is due to a combination of increased sophistication, changing market dynamics and a more demanding CAPTIVE client.

The main advantages of a CAPTIVE can be divided into four categories: Financial, Risk Management, Insurance Coverage and Other Advantages:



### Financial

- Helps reduce overall insurance costs by aligning with actual loss experience
- Provides stability of premium rates during times of volatility
- Provides direct access to the reinsurance market
- Eliminates any additional loading charges applied by the insurer
- Offers enhanced investment and cash flow opportunities
- Creates new revenue generating opportunities
- May provide a more efficient tax structure and may also provide a mechanism for accelerated tax deductions for loss reserves



### Risk Management

- Delivers centralized risk control
- Facilitates improved risk capital allocations
- Consolidates and manages global programs in one area
- Provides a vehicle to support other enterprise risk management initiatives
- Provides more effective claims handling processes
- Improves claims monitoring capabilities
- Facilitates regular claims audits exposing any areas of higher than average loss activity



### Insurance Coverage

- Enables the development of tailored insurance policies
- Provides broader coverage options
- Overcomes any exclusions or other restrictions applied by the commercial market
- Delivers more responsive coverage
- Provides improved risk retention strategies
- Provides stability of cover if commercial insurers withdraw from particular lines
- Increases negotiating power when purchasing excess insurance



### Other Advantages

- Policies can be amended when required rather than only upon renewal
- Can be changed in response to changing market conditions
- Enables third-party business

# Setting up a Captive

THE KEY TO A SUCCESSFUL CAPTIVE STRUCTURE IS TO ADDRESS PRACTICAL CONSIDERATIONS RIGHT FROM THE START.

Determining if your organization is a viable candidate for a CAPTIVE vehicle is an important first step in the set-up process. Below are some practical questions that should be addressed from the very beginning:

What is your primary motivation for setting up a CAPTIVE?

What lines of business do you want to include?

Can you source coverage, premium and loss history information for the last 5–10 years for these lines?

Have you received any indication of your next renewal terms?

What are your growth projections or acquisitions and how do they affect your risk profile?

Are there any regulatory restrictions on from whom you can purchase your insurance?

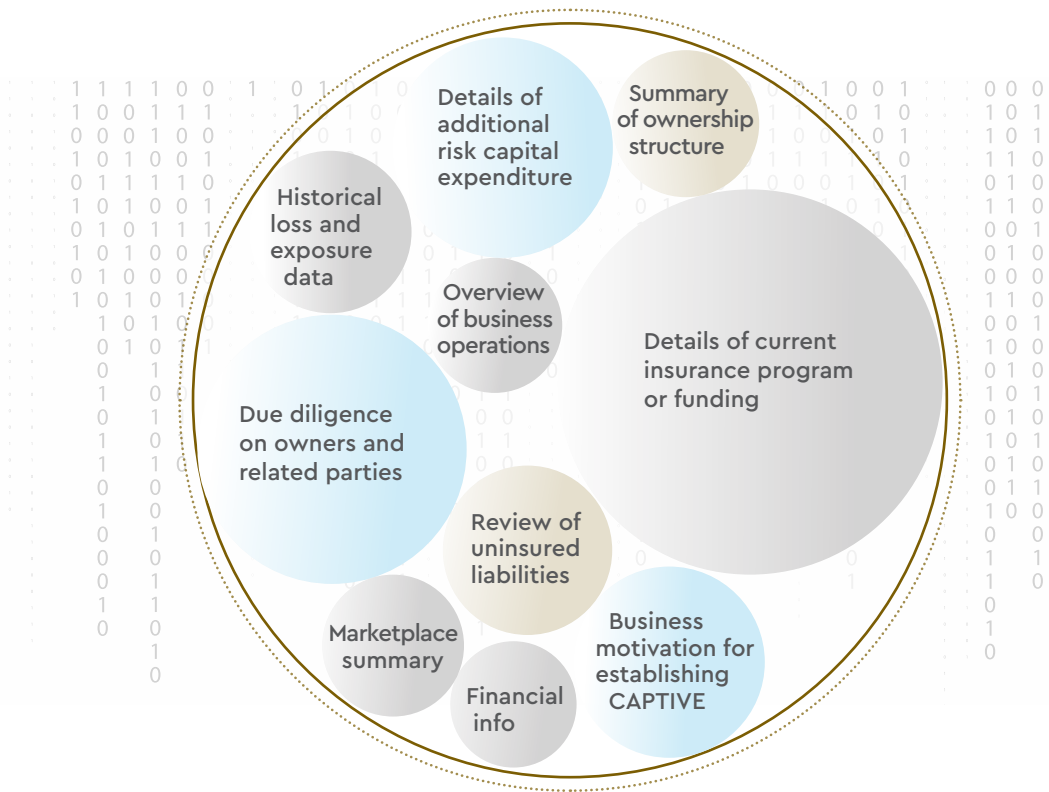
What ownership structure would you use for the CAPTIVE?

How would you fund the capital required to start the CAPTIVE?

How would you fund security/collateral requirements?

## Compiling Information

Having the right information/data is essential for any business decision. When assessing the suitability of any CAPTIVE, the following information is required:





## Feasibility Studies

Feasibility studies are conducted to assess a company's risk level. Utilizing actuarial reports, investment models, insurance market conditions and an assessment of regulatory, legal and tax issues, the report provides recommended options for your company and establishes whether or not a CAPTIVE is suitable for your organization. The study drills down into the core components of your company and will likely become a part of the insurance application for your selected CAPTIVE domicile. Feasibility studies are generally based on the following guidelines:

- Introduction and executive summary
  - Assignment overview
  - Feasibility analysis objectives
- Organization overview
  - Current insurance program
  - Premium expenditure
  - Details of other risk transfer arrangements
  - Loss history information
  - Actuarial report (if available)
- CAPTIVE requirements
  - Cost/benefit analysis
  - Minimum requirements:
    - Solvency
    - Capital
    - Premiums
  - Structuring requirements:
    - Fronting arrangements
    - Reinsurance, if required
    - Retention levels
    - Claims management
  - Domicile selection
  - Regulatory and compliance requirements
  - Anti-money laundering requirements
  - Timelines and ownership
  - Directors
- Financial analysis
  - Various loss scenarios and attachment points
  - Premium funding estimates
  - Pro forma financials
  - Expected loss calculations
  - Comparison of CAPTIVE to existing risk financing program
  - Operating expenses
  - Surplus and capital contributions
  - Investment strategy and returns
  - Tax treatment
- Other considerations
  - Continuing development of the CAPTIVE
  - Tax overview
  - Ownership structure
  - Corporate structure
  - Class of license
- Final Report and recommendations



### CONSULT CAPTIVE EXPERTS

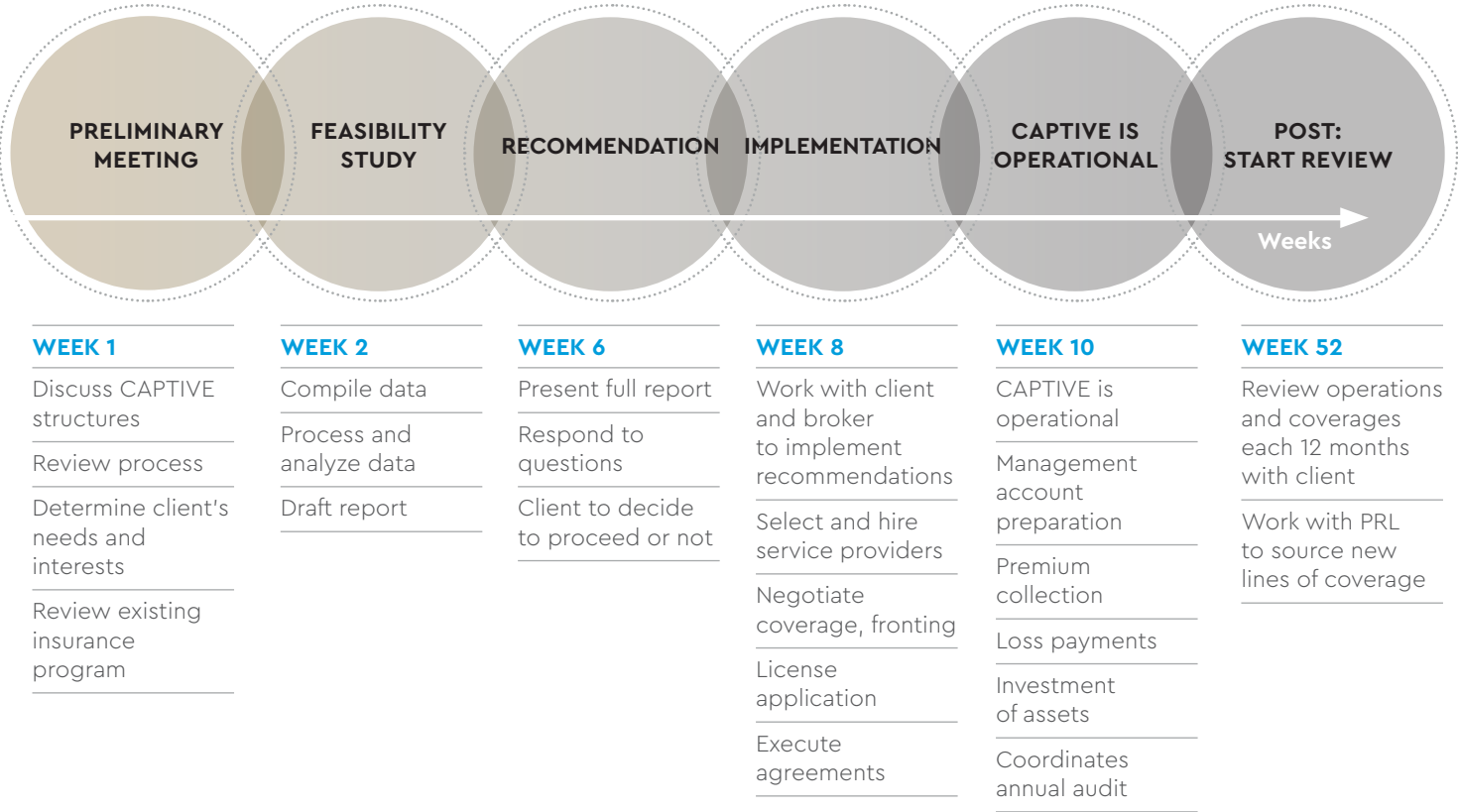
To ensure that the CAPTIVE is effectively structured and aligned with your risk and overall business objectives, it is important that you have the right CAPTIVE experts working for you. A comprehensive team might include:

- |                                 |                                    |                 |
|---------------------------------|------------------------------------|-----------------|
| ■ Captive Manager               | ■ Insurance Broker                 | ■ Legal Advisor |
| ■ Captive Advisor               | ■ Third Party Claims Administrator | ■ Tax Advisor   |
| ■ Internal Risk Manager and CFO | ■ Actuary                          | ■ Auditors      |
|                                 |                                    | ■ Bankers       |

# Setting up a Captive (continued)

- ▶ IT IS ESSENTIAL THAT YOU WORK WITH AN EXPERIENCED CAPTIVE MANAGER WHEN REGISTERING AND LICENSING A CAPTIVE WITH A REGULATORY AUTHORITY.

## CAPTIVE TIMELINE



## Registration and Licensing

When registering and licensing a CAPTIVE with a regulatory authority, it is **imperative that you choose an experienced CAPTIVE manager**, one that is fully conversant in all regulatory requirements of the chosen CAPTIVE domicile. If possible choose one that has strong working relationship with the regulator and local legal counsel in that domicile.

Your CAPTIVE manager will work closely with you, PRL, legal counsel and the regulatory authority to complete all necessary documentation and submit all required information. This will normally include a detailed business plan incorporating:

- Ownership structure and supporting due diligence
- Description of CAPTIVE insurance program
- Reinsurance
- Collateral requirements
- 3–5 year financial projections
- Capital adequacy calculations
- Compliance and Corporate Governance procedures
- Fronting agreements
- Board of Directors
- Investment Strategy
- Dividend Policy

- ▶ THE MANAGER ENSURES THAT THE CAPTIVE CONTINUOUSLY EVOLVES TO MEET THE ORGANIZATION'S NEEDS THROUGHOUT ITS LIFE CYCLE.

## Continuous Captive Management

The CAPTIVE manager's role refocuses once the CAPTIVE is operational. The aim now is to ensure the company realizes the full extent of the advantages offered. These may include:

- Company administration services
- Regulatory liaison and ongoing compliance corporate governance services
- Accounting and financial reporting
- Coordination of third-party service providers
- Monitoring and tracking of investment activity

The CAPTIVE manager works in partnership with your Senior Management Team and PRL to ensure that the CAPTIVE continuously adapts to meet the organization's current risk management needs.

For example, any changes in the operational or risk profile of your firm, or fluctuations in rates in the commercial insurance market are reflected in the evolving structure.

## Captive Fees and Costs

Management fees vary depending on CAPTIVE type, complexity and the domicile selected.

### These items may impact the costs of a typical CAPTIVE:

- Number of lines of coverage
- Number and nature of insured parties
- Number of policies
- Reinsurance
- Fronting arrangements
- Amount and type of investments expected investment activity
- Number and variety of different service providers monthly vs. quarterly financial statements Reports specific to your organization
- Flow of funds or information
- Number of board meetings per year and their locations

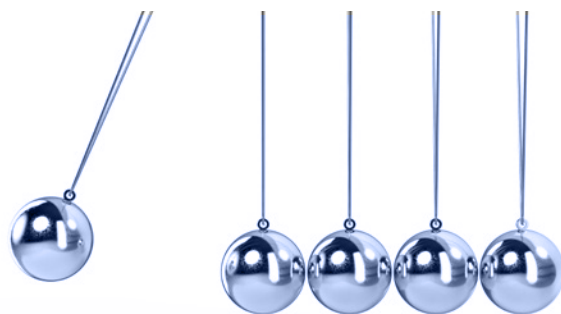
### The typical costs and fees of a CAPTIVE may include:

- Feasibility study
  - Actuarial fees
  - Legal/tax advice fees
  - Fee for the study preparation
- Implementation
  - Capital investment
  - Government application fee
  - Initial license fee
  - CAPTIVE manager fees
  - Lawyer fees
- Ongoing costs
  - License renewal fees
  - CAPTIVE management fees
  - Lawyer fees
  - Auditor fees
  - Actuarial fees
  - Meeting expenses

## THINGS TO CONSIDER

Key considerations when establishing a CAPTIVE include:

- Fronting vs. Direct Issuance
- Reinsurance
- Program administration
- Claims administration
- Actuarial analysis
- Pro forma financials
- Domicile requirements
- CAPTIVE structure





# Captive Coverage and Types

- ▶ CAPTIVES ARE EXCEEDINGLY FLEXIBLE STRUCTURES WHICH CAN PROVIDE A WIDE RANGE OF INSURANCE COVERAGES. IT IS OFTEN USED BY THE PARENT TO ENSURE AN OPTIMIZED MIX OF SELF-FUNDED AND COMMERCIALY INSURED RISKS.

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A company generally self-funds the more predictable lines and limits in a CAPTIVE. The less predictable and more intense risks are often placed into the commercial insurance market because it has greater capacity and capital for such risks. The more catastrophic the risk, the larger the insurer base needs to be to ensure adequate risk pooling.

Insurance coverages that are best suited for a CAPTIVE generally pay a significant amount of premium, offer the potential for profit (supported by historical data), and have investment earnings on cash flow. To ensure the feasibility of establishing and administering a CAPTIVE, the total premium generated, net of administrative and reinsurance costs, should be sufficient to cover all financial commitments.

## Extending Reach

CAPTIVE insurance coverages have expanded in recent years to include an increased and diverse array. This propagation has been fueled by the greater awareness of risk profiles, better understanding of the costs associated with effective risk management, and an increased understanding of the overall benefits offered by a CAPTIVE.

The flexibility of a CAPTIVE allows it to offer its parent swift and efficient means to respond to shifts in market dynamics, regulatory changes or other emerging risks.



## ALTERNATIVE OPTIONS TO OWNING A CAPTIVE

Not all organizations are in a position to create their own CAPTIVE. This could be due to the lack of sufficient premium volume or resources, or simply the lack of desire to take on the effort of establishing an insurance company. For these organizations, a viable alternative that will allow them access to many of the benefits of a CAPTIVE, could be to join a cell-type structure, such as a protected cell company or segregated portfolio company.

# Captive Lines

What risks can be placed into a CAPTIVE?



## Traditional Lines

General Liability
Professional & Product Liability
Auto Liability
Health Care Liability
Employment Practices Liability
Environmental Liability
USA Workers' Compensation
Product or Service Extended Warranty
Property Business Interruption
Business Interruption



## Expanded Lines

Employee Benefits
Political Risk
Surety Bonds and Fiduciary Risk
Marine Coverage
Title and Mortgage Insurance
Equipment Break Down
Construction Exposures
Trade Credit Risk
Cyber Risk
Errors & Omissions
Creditor Life



## Emerging Lines

Reputational Risks
Intellectual Property
Product Recall
Product Tampering
Expert Witness Testimony Coverage
Tax audit Insurance
Lease Residual Value Risk
Punitive Damages Coverage
International Kidnapping Protection
Supply Chain Risk

# Types of Captives

CAPTIVES come in a wide and evolving range of formats designed to meet the requirements of many clients. While the single parent CAPTIVE remains the most used structure, the emergence of group CAPTIVES, and cell-type structures has also opened up the benefits to smaller organizations.



## Single Parent (Pure) Captive

- Owned by one owner
- Insures the risks of the parent and subsidiaries only
- Most common structure
- Certain CAPTIVES may write some unrelated business or risks



## Group Captive

- Owned by a group of companies
- Can be related (i.e. trade groups) or unrelated (i.e., same size or risk)
- Insures the select risks and limits of the group



## Segregated/ Sponsored Cell Company

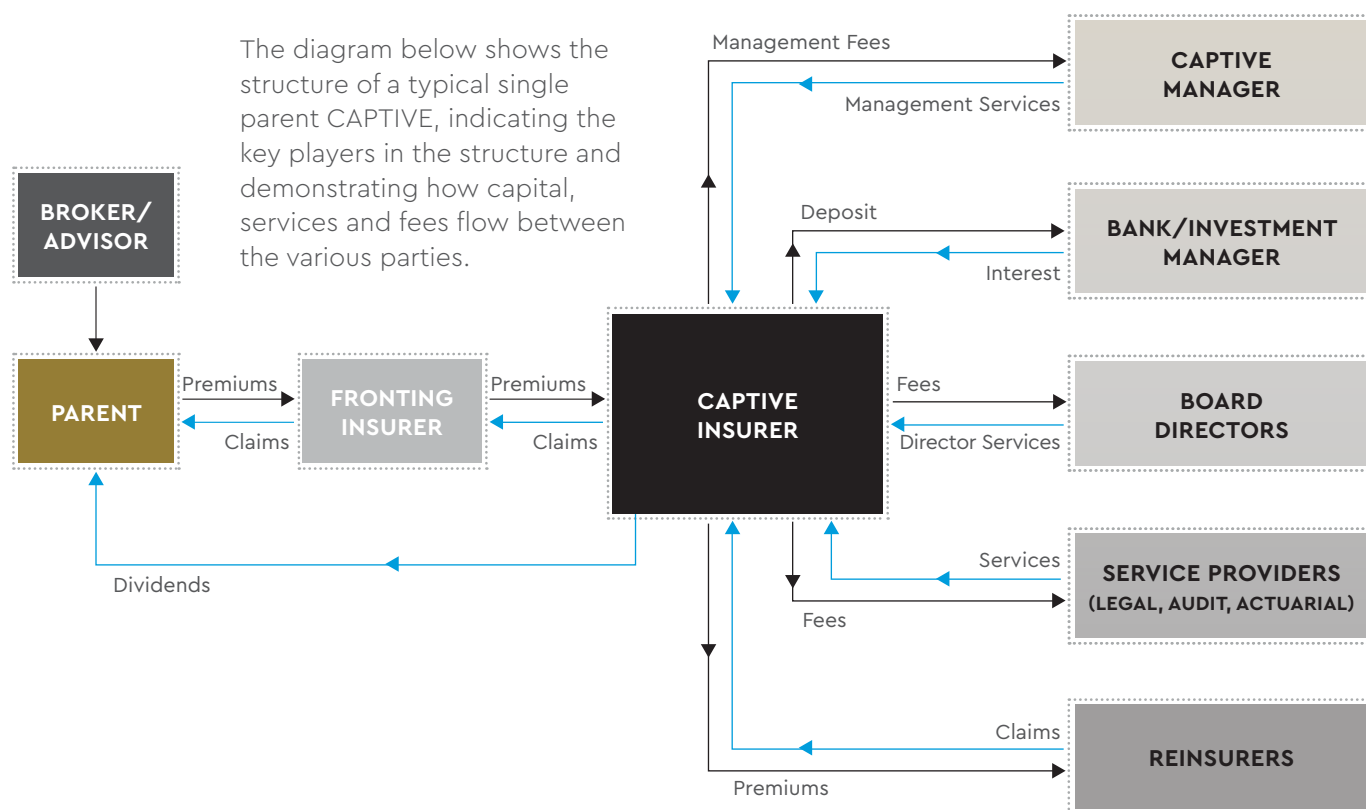
- Owned by a third-party sponsor
- Insures the risks of multiple insureds
- Individual 'cells' or companies are owned by the insureds
- Cells are legally segregated from each other
- Affords the benefits of a pure CAPTIVE without the same level of financial commitment



# Captive Structure and Domicile Selection

- ▶ THE MOST COMMON TYPE OF CAPTIVE IS THE SINGLE PARENT CAPTIVE. THEY ARE OWNED AND CONTROLLED BY ONE PARENT, AND INSURES ONLY THE RISK OF THE PARENT ORGANIZATION OR ITS SUBSIDIARIES.

## Structure of a Single Parent Captive



## Domicile Factors to Consider

As location is one of the key decisions in establishing a CAPTIVE, the task of selecting the right domicile can be challenging. Competition is significant as emerging domiciles compete for market share with the leading domiciles. There are a broad range of factors which should also be given careful consideration when selecting the most appropriate CAPTIVE site. These may include:

- Capitalization and surplus requirements
- Receptiveness and efficiency of regulatory environment
- Stability of regulatory and business environment
- Availability of cell legislation
- Quality of local infrastructure
- Availability of high quality service providers
- Convenience of travel to and from domicile
- Reasonable operational costs
- Taxation treatment
- Compatibility of language, currency and customs
- Convenience of time zone
- Political stability
- Redomiciliation agreements

# About Purves Redmond Limited

► IF IT'S A BUSINESS, WE CAN INSURE IT.

## PRL is one of Canada's top independent insurance advisory and brokerage firms.

Purves Redmond is committed to providing clients with the highest level of service, connecting them with the very best industry experts, insurers and solutions available, while conducting business in a genuine, honest and transparent manner. We provide expert guidance and insurance coverage to our clients across a spectrum of Canadian businesses.

From professional service providers to mining and energy projects, transportation and waste management programs, or complex infrastructure builds in major cities, we've helped clients, large and small, navigate the risks and opportunities that come with doing business in Canada.



### Mining, Energy & Power

The mining industry faces a number of complex challenges that stretch across the globe.



### Construction & Infrastructure

Our dedicated construction team has expertise in every facet of the industry including insurance and bonding solutions.



### Waste Management, Transportation & Logistics

The safe and secure handling of complex waste continues to be a growing industry, and one that faces new challenges, risks.



### Professional & Financial Institutions

Lawyers, patent agents, brokers, private and public investors, educators and consultants all face risks specific to their industry.



### Retail, Hospitality & Real Estate

With more employees than any other industry in Canada, retail has become a fundamental part of our country's economy.



### Manufacturing

The manufacturing sector continues to make advancements in the way it fabricates, processes and transforms products.



### Technology

Technology companies are on the cutting edge of today's economy, and are expected to make up an even bigger share in the future.



### Healthcare & Life Sciences

Society holds healthcare professionals, drug developers and manufacturers to very high standards.



### Non-Profit

Clients face challenges every day in managing its organization's fundraisers, programs, services, staff.



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