CAPTIVE INTERNATIONAL

When a captive founders

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Certain captives fail, but what goes wrong? And what can be done about it? Stephanie Mocatta, chief executive officer of SOBC DARAG, has some suggestions.

No-one sets up a captive thinking it will fail, but sometimes they do. This article looks at the ways a captive can get into trouble—and provides some suggestions as to how this can be avoided, if caught early enough.

There are two main ways a captive can fail:

- More general causes of failure from the wider insurance market; and
- A specific reason relating only to that captive, or captives in general.

There is often a view that a captive is somehow a different type of beast from a normal P&C insurance company. Indeed, this is true of its ownership, structure and the underlying business. However, fundamentally it is an insurance company, and the causes of failure in insurance companies can, and sometimes are, replicated in captives.

Causes of failure

Why do insurance companies and captives fail? There are many ways for an insurance company to go wrong, either related to how it was originally set up, or to changes in the market.

Some of the more obvious and major causes are:

- Why was the company in existence in the first place and does that reason still exist? This is particularly relevant to captives that may have been established during a hard market if softening commercial rates mean it has little relevance going forward.
- Is the management team up to the task? This can be particularly true as a captive or insurance company grows, meaning operation issues and costs can become increasingly burdensome, changing an otherwise profitable book of business into a loss-making one.

The management team has to take a new look at operations, put in place the correct structures, streamline processes and drive down costs—without affecting the quality of the work. Many 'early stage' management teams, that were great to get everything off the ground, are not suited to the pressures of growing operational management.

- What's happening in the wider market, and changes in legislation and regulation can affect the viability of a captive or insurance company. For instance, the Obama-years changes to the Federal Black Lung programme, that put the onus on insurers to prove that the COPD/cancer, etc, was *not* caused by coal dust, rather than the other way around, has changed the whole aspect of these policies and claims. President Trump does not appear to be repealing this, and therefore it is possible that companies with this exposure will fail going forward.

Some of the other pitfalls we have seen that can lead specifically to captive failures include:

- The 'D' word— It is less common now, but an inherent fact of some states' risk-based capital calculations is that diversification gives credit and leads to a smaller surplus requirement. This is all very well and good *unless* the captive diversifies into unknown territories or classes, where it has less expertise and less experience. This is often a recipe for disaster.

- Merger of parent companies. When two (or more) companies merge—and we have seen some mega-mergers in the last few years, particularly in manufacturing, hospital groups and the pharmaceutical industry—there is often more than one captive under the new parent company. On occasions more than one captive can be useful—if there is a need for both onshore and offshore coverage, or if there are distinct classes of business to be covered. However, generally, and through no fault of their own, a number of these captives become redundant.

- Collateral and front companies. We have seen a number of what would otherwise have been successful captives fail, because of either or both of the charges from the front companies and the collateral requirements. If the charges from the front are excessive, this can make a profitable book flip to a loss-maker; if the collateral requirements are unreasonable, and/or not adjusted regularly on an agreed basis, then the captive can be technically solvent but have no free cash and become unable to operate itself. We have seen some that could not even free enough cash to pay the audit fee.

- The last reason—and one we would urge you to think about very carefully before starting a captive—is the underlying business simply rubbish? Prospective captive owners should ask themselves "why is my premium so high?", and "why can't I get coverage for that risk in the open market?".

If the answer is that the inherent risk is too high or too volatile, perhaps the business should be restructured. In that case putting the risks into one's own captive will never make it better.

Steps to take

What can be done to avoid failure? This starts with the initial setup of the captive—perhaps we could call it "the engagement". Everyone thinks this is a great idea, no-one is thinking about pitfalls or the future—but think of your feasibility study as a pre-nup. What could go wrong? And what will happen if it does?

Act quickly, if premium is dropping and costs are escalating. If you can act decisively and with speed you may save the captive.

Look at the commissions being charged—the setup fees, the brokerage, the reinsurance wording (does it actually provide cover?), the captive management fees and the TPA fees for claims handling—how much premium does this actually leave the captive?

Are there minimum charges, so that if the premium drops, the captive gets worse and worse? Think of your broker as the wedding planner—he doesn't get paid unless he gets you to the altar—so you know where the motivation is!

In all those contracts that are signed in the heady days of first love—study the divorce clauses carefully. What rights to information and documentation do you have? Do you have the ability to adapt and change as your business changes? What happens when it all goes wrong?

Finally, no-one ever sets out to get into a mess, but if you find your captive in one, here are three key take-aways:

- Talk to your regulators, engage with them. They have seen it before and may be able to help.
- Act quickly, if premium is dropping and costs are escalating. If you can act decisively and with speed you may save the captive.
- “Do not let the sweet smell of the premium overcome the stench of the claims”—writing your way out of trouble rarely works!

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