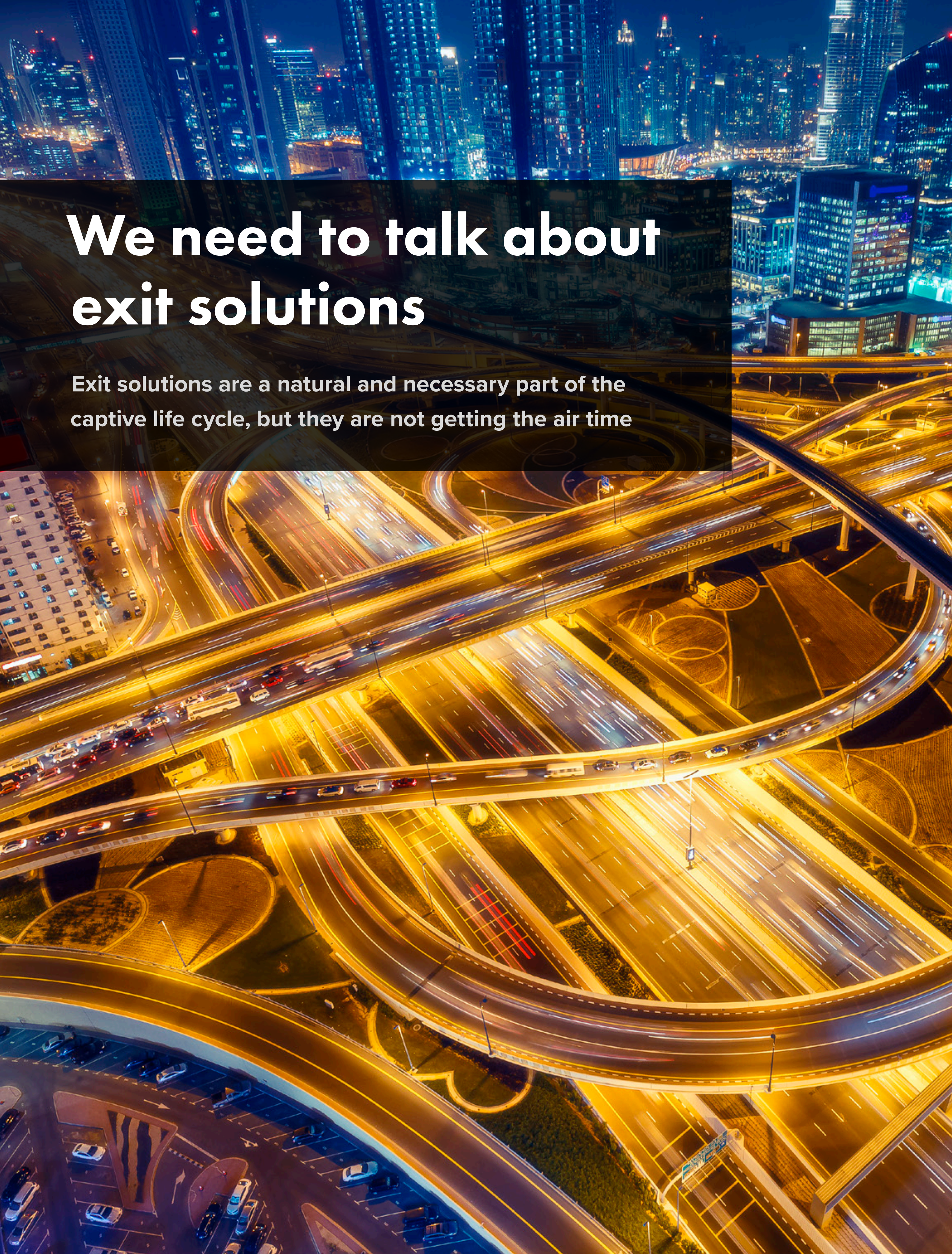
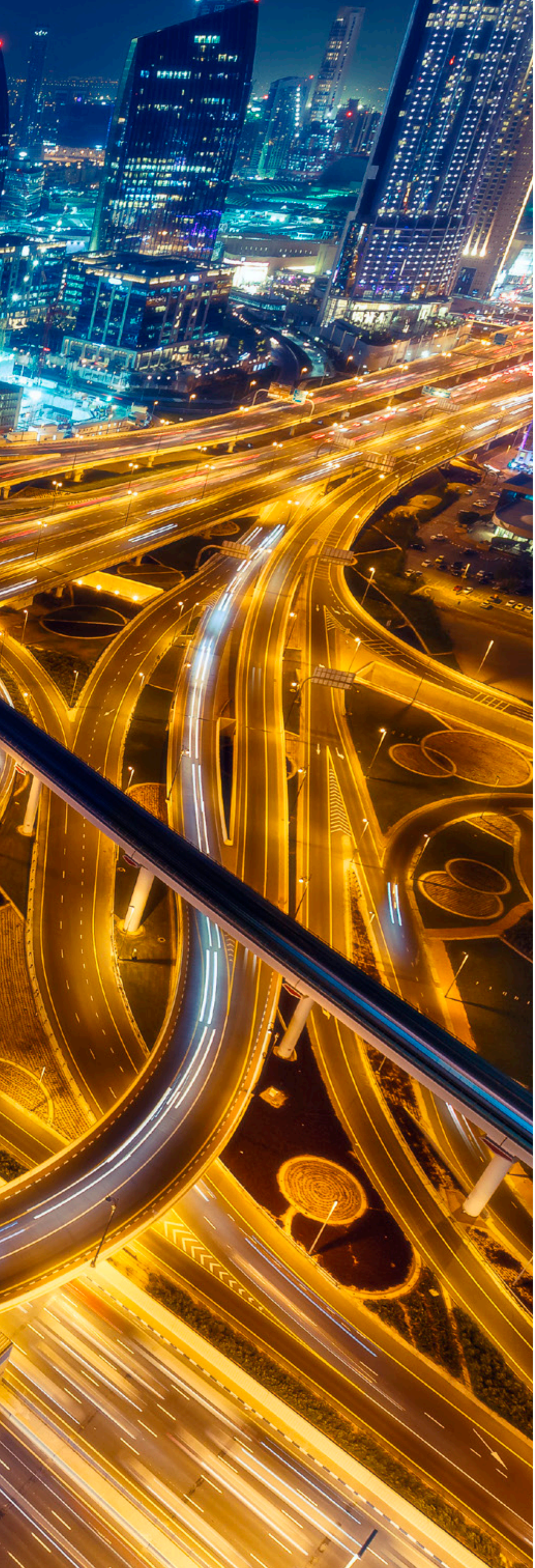
We need to talk about exit solutions

Exit solutions are a natural and necessary part of the captive life cycle, but they are not getting the air time





Exit strategies, a critical yet often under-discussed aspect of the captive insurance lifecycle, are essential for captive owners planning their future transitions. Although these strategies can be complex and sensitive, which might not suit early conversations with prospective captive owners, more transparent discussions about the strategies involved, and when they are appropriate, can only be beneficial.

More sophisticated approaches exist beyond the basic options, such as loss portfolio transfers and company liquidation. These include transferring additional risks with a different profile into the captive in order to make use of the underwriting capacity. Some domiciles, such as Luxembourg, also offer specific solutions — Luxembourg having an active market for captive sales, for example. By integrating the captive within a group of financial vehicles, structured finance solutions can optimise the exit strategy. As the industry evolves, a transparent conversation about exit strategies for captives is vital for maintaining financial stability and compliance.

Why and how?

Just as with setting up a captive, the motivations for seeking an exit solution can vary significantly. Strategic changes, regulatory considerations, financial underperformance, and shifts in risk profiles, are all common drivers. According to Carolyn Fahey, executive director at AIRROC, the common theme is that they are "all circumstances where there are liabilities and owner capital trapped in the captive."

Fahey elaborates: "The reason for the creation of the captive may no longer be core to business, or it may have become redundant after a merger. Run-off liability can be the result of age, inheritance, cessation of writing certain lines of business, or just liability capitation after a certain period. The owner might want to invest in a completely new business.

"Captive owners should constantly evaluate their captives' current operational needs and look at best practices in light of market conditions. Considering a legacy transaction is a part of this process."

Explaining the options for captive owners that seek exit solutions, Paul Corver, founder and director of Revroc Consultancy, notes: "One is to liquidate the captive. However, if the captive has the potential for future claims, liquidation may not be a viable option, particularly if the captive operates under a front company.

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Founder and director
Revroc Consultancy

In that scenario, the captive could potentially commute with the front company, paying them a premium to assume the risk and eliminate the associated liabilities within the captive."

According to Corver, an alternative solution would be to sell the captive. "It may be attractive to a party that wishes to establish a captive in that jurisdiction, but it is likely just as simple to start one afresh. However, there is a large legacy market that acquires captives, as well as regular insurance or reinsurance companies. While a sale process would entail administration, it provides a full and final exit. The courts could unwind a voluntary liquidation in certain situations," he says.

In the right circumstances, dissolving a captive insurance company presents numerous benefits. This move can significantly cut operational costs, lessen administrative burdens, simplify regulatory compliance, and improve strategic alignment. Most notably, it can also free up capital for other uses.

"The key advantage is that you get your investment back," says Gabrielle Morella, managing partner at Morella & Associates. "If you have accumulated assets within your captive, this was not only an insurance decision but also an investment decision. When you liquidate, you eventually get that investment back."

Morella notes: "There will be tax implications, but once the investment is out, you can do whatever you want with it — reinvest in various other business opportunities, take distributions out to the owners, whatever the applicable parties would like to do."

Despite the limited options available to owners in the past, the ever-evolving captive landscape and run-off market, estimated by PwC's 2024 Global Insurance Run-Off Survey to have grown beyond US$1 trillion, now offer a broader array of solutions, increased expertise, and greater flexibility and sophistication in navigating the exit process.

With more options and better resources than ever before, it is important to ensure that captive owners find the solution that is best suited to their specific situation. Fahey explains: "The primary run-off transactions are loss portfolio transfers, adverse development covers, commutations, novations, and sales."

She continues: "Legacy providers often specialise in certain types of transactions. The legacy space has experts in all sizes and types of transactions. No transaction is too small to bring to market.

"Legacy experts recognise that these transactions can often be a new concept for captive owners and managers. Use their expertise to explain and outline the transaction's relative merits and related mechanics."

More and more (re)insurers and reinsurers are transacting with the legacy market to protect against volatility, release capital, and improve operating efficiencies. Corver observes that reinsurance can provide financial finality for discontinued lines, aged liabilities, or expired policies, or it can novate the policies for full finality, subject to relevant parties' approvals.

"This removes collateral obligations and can free up capital for distribution to parents, support next year's renewals, or even write new perils into the captive," he says.

The approach for participants in a group captive is a little different for the owners of single-parent vehicles, but added flexibility comes at a cost — and one that is not always considered. Phillip J. Holowka, chief operating officer at Complete Captive Management, observes: "When an insured is a participant in a group captive, they have much more flexibility to exit that group captive simply by way of notice. You inform the captive that you intend to leave, and then the captive will respond."

Holowka notes: "Your golden handcuffs involve relinquishing a portion of your unearned underwriting profits, or losing access to your capitalisation or a portion of the collateral. Those golden handcuffs are a vital and often overlooked factor to consider.

“Often, clients enter these groups as captives, and they don’t know the cost of exit. There is a cost that is often being ignored.”

Referring to single-parent captive owners, he rationalises: “they have a lot more latitude to unwind the captive solution at their pace rather than making a decision that will impact others.”

All too often, however, heading for the exit door is not the course of action that owners will take, with dormancy seen as a more attractive alternative.

Morella says: “Others will just do nothing, which is maybe the easiest option because it is just ignoring the situation. They’ll do nothing, but we try to caution against that for anything beyond the short term because you still have governance requirements, meaning tax returns to file. You are still a business entity, and your funds are still sitting there. There are investment opportunities for accumulated assets within the captive, so as long as the owner understands what dormancy means, they are fine to stay there for a period of time.”

Dormant captives: A missed opportunity?

An estimated 20 per cent of the nearly 7,000 single-parent captives globally are dormant, meaning they have established themselves but are not actively underwriting any insurance policies or participating in insurance-related activities.

Indeed, a significant number of captive domiciles, including many of the biggest and best respected, have introduced dormancy legislation to reflect the evolving need and desire within captive owners for flexibility and adaptability. The legislation differs from jurisdiction to jurisdiction, but regulatory relief and cost-saving benefits are common themes across the board.

Talking about the benefits of keeping a captive dormant, Corver remarks: “If the owner envisages at some point reinvigorating the captive to underwrite new risk, then leaving it dormant could be advantageous. For instance, if the owner initially established the captive in a hard pricing market and it became dormant during a subsequent soft market, it could prove beneficial to retain it during another hard market cycle.

“The benefit of keeping it dormant would depend on local regulatory requirements and associated costs. Regulators may still require annual returns and licence fees, especially if the captive still has liabilities.”

Many captive owners use dormancy as a strategic decision to reactivate when market conditions or their risk management needs change, but it has disadvantages, especially when used as a longer-term alternative to exiting.

“It’s a safe investment,” says Morella. “It’s sitting there, it’s safe. Since it does not actively participate in an insurance treaty, there is no risk associated with the use of the accumulated assets, making it easy to let it sit there until they are ready to make a decision.”

She further explains: “You are not going to be writing any premiums — the insurance activity has ended, but you are still a participant in an insurance arrangement. You will be part of the insurance program audit, you will be filing a tax return, and a lot of programmes have yearly maintenance fees.

“Others are probably just waiting for a time period where they want to reinvest the funds, where they need the funds, or where they have plans for business expansion. It just depends on what the business owner is thinking.”

Holowka asserts that captive owners should typically not view dormancy as a long term option. “If a captive is not within the 18-month plan, then there is no real duty to maintain it,” he says.

“A regulator is not going to be too keen on a captive that has no duty, no obligation, and no purpose. You may even get outside pressure from the regulator to liquidate, shut down, or write policies again.”

Holowka continues: “The insured incurred a sunk cost to maintain the operations of a dormant captive that has no purpose or duty. If a business can have an internal rate of return of X, and now there is free and clear capital coming into that business, that’s the return that any business wants to look for.”

Given this perspective, the question persists: why do more captive owners not utilise exit solutions to wind up their captives, reduce operating costs, and free up capital for other business ventures?

“It is so business-dependent and dictated by what their long term plan is,” says Morella. “I think probably half of that 20 per cent just do not want to deal with it at the moment. I would love to say people have a long term plan for decisions, but sometimes it’s just easier to wait until something becomes more pressing. Others are probably just waiting for a time period where they want to reinvest, where they need the funds, or where they have plans for business expansion.”

Fahey remarks: "With the options that are prevalent in the legacy space, I see few advantages to keeping a dormant captive unless the owner has reason to believe that it might need to be reactivated at some point. Also remember that an owner can consider exiting an entire captive or carving out just specific liabilities. The flexibility gives the owner a way to truly remove any part of a captive that benefits their strategy.

"The strategic, financial, and operational benefits of sustaining a captive can surpass the challenges and expenses involved in its exit. This leads many captive owners to maintain their captives despite changing business conditions or potential disadvantages. Each situation is unique."

Given the flexibility of the available solutions, the fact that such a large chunk of captives are dormant represents a missed opportunity for many owners and the industry in general. Adding further to this point, Fahey emphasises: "As a business owner, if you no longer 'need' a part of that business, isn't it just smart to stop putting any resources into it?"

She argues: "Maintaining a dormant captive drains staff resources. Captives may find themselves in any range of situations where considering an exit solution is a smart and strategic portfolio management tool.

"One of the key features of any exit strategy is that the options are flexible, and the parties involved find a solution that makes sense for all involved and for the scenario they are working with."

She continues: "Educating captive owners and managers about the benefits of a legacy transaction still requires a significant amount of work. This is partly why AIRROC continues to prioritise this goal. We have seen a marked increase in captive transactions over the last ten years, and we expect that to continue to grow."

Incorporating exit solutions into business strategy

Captive owners should regularly review their structure to ensure its viability, but exit strategies should be established from the start. Rome was not built in a day, and similarly, unwinding a captive entity is not an overnight task.

This complex process can span months, sometimes even years. Therefore, it is crucial to integrate exit strategies into the conversation and planning stages right from the beginning.

Corver explains: "Captive owners are specialists in their industry fields, whether pharma, energy, transport, or the very many other industries that benefit from captive usage. They are unlikely to be insurance experts, and they are certainly unaware of the legacy sector. I have been actively engaged in the captive sector for over a decade, educating captive managers and owners on their options regarding legacy solutions.

"This is not just disposals but also loss portfolio transfers, novations, or adverse development covers that provide economic or complete finality to their obligations. It has also been commented that captive managers are not necessarily incentivised to highlight the possible exit solutions, as it could eliminate or reduce fee income from that captive. When I was actively acquiring captives, we would merge them together into a single company in each jurisdiction, thereby reducing overhead and costs."

Meanwhile, Holowka remarks: "When we do our consultations with new captive owners, we also talk about the exit strategy and the succession plan. What should be your captive liquidation endpoint triggers? The word 'investment' holds significant importance. The employer is investing in the captive. When you invest in equity, you should go in with a point and a limit to sell it. Why is the captive so different?"

Unfortunately, whether it is exit plans for single-parent structures or the 'golden handcuffs' issue facing group captive participants, the appropriate messaging is not always there. "It is dependent on the captive management team that you work with," says Morella. "We have a complete solution for our clients, so if they come to us and say we need to prepare for liquidation, we know what we need to tell them to advise them so they understand all the consequences and what steps need to be taken.

"It can not be included in the captive sales pitch as it is impossible to sell both the product and its liquidation simultaneously. You can connect them, but it is ultimately an educational subject and sometimes it might get overlooked."

Holowka agrees: "It should be part of the conversation. The compelling story often goes unnoticed, primarily because the captive's life story receives insufficient coverage.

"Everyone is bullish on forming captives, but then there is no discussion about exit strategies. There should be equal importance placed on why you form a captive and why you close one up." ■