



Understanding Captives

The How? The Where? The Why?

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UNDERSTANDING CAPTIVES AND THE BENEFITS OF TEAMING UP WITH RBC

EXECUTIVE SUMMARY

BACKGROUND

- Captive insurance companies (“captives”) continue to be an extremely important element of the general insurance industry.
- Alternate facilities (which include captives) account for approximately 50% of the North American insurance industry.
- There are over 5,000 captives in approximately 40 domiciles in the world.
- There are over 200 Canadian owned captives, with over 15 domiciled in British Columbia and most of the remainder in Barbados and Bermuda.
- Approximately 80% of the S&P 500 companies have their own captive subsidiary.

Reasons for Establishing a Captive

- Reduction in premiums;
- Insuring the uninsurable;
- Controlling your own insurance program (i.e. stability of premiums);
- Positive impact on risk retention, risk management and loss control;
- Cash flow benefits;
- Direct access to the reinsurance markets;
- Diversification to develop into a profit centre;
- Potential tax benefits; and
- Consolidation of deductibles.

Captive Financial Services from Royal Bank of Canada (“RBC”)

RBC offers captive insurance companies:

- A range of solutions from a dedicated captive team with over 15 years of experience;
- Comprehensive financial services including professional asset and investment management, the provision of letters of credit and reinsurance trust arrangements in favour of a fronting company, offshore funds including money market, safekeeping, banking and custodial services, cash management and securities lending;
- Assistance with construction of investment portfolios unique to captives to achieve various objectives including capital preservation, liquidity, asset-liability matching and capital growth; and
- Access to a wide range of investment solutions including deposit accounts with competitive rates, a variety of fixed income solutions and access to world class equity managers and hedge funds.

A GENERAL OVERVIEW

This document is intended to provide an overview of what a captive insurance company is, and how RBC can help its clients benefit from it.

BACKGROUND

The captive insurance industry is now generally recognized as a significant and integral part of the international insurance market. It has developed, essentially over the last 30 years, as an alternative risk funding vehicle; usually for lines of coverage which have a highly predictable loss profile involving low severity, but high frequency of claims. In recent years captives have increasingly been used for uninsurable, catastrophic risks like pollution, hazardous products warranty, etc. They continue to be used as a means for the insureds to directly access the reinsurance markets.

The early captives were incorporated in the 1920's, usually on a co-insurance or mutual basis in the United Kingdom and North America. Recently, several American states and the Province of British Columbia have introduced legislation to promote the growth of domestic (onshore) captives. However, many captives are incorporated in offshore financial centres, which offer a number of advantages, including:

- More appropriate insurance regulation;
- Lower capital investment requirements;
- Freedom from exchange control;
- Potential for the absence of, or decrease in the rates of, taxation (for some Canadian parent companies); and
- Greater flexibility in their insurance programs.

Both domestic and offshore captives fall into a number of categories, including:

- **Parent Only or Pure Captive**
A wholly owned or controlled company which only insures or reinsures the risks of its non-insurance parent or its affiliated companies.
- **Association, Group or Industry Captive**
An insurance company owned by a group of industrial or commercial companies or members of a professional association solely to insure or reinsure the risks of its shareholders. (This category includes industry pools where the risks of all shareholders are pooled and ceded back to participants of the pool on a shared basis).
- **Protected Cell or Segregated Portfolio Companies**
Legally separated underwriting accounts (structure formalized by legislation, similar to a rental captive that may keep separate members' accounts without legal separation).
- **Open Market or Sophisticated Captive**
A subsidiary which insures or reinsures the risk of its parent or affiliated companies, but which also insures the risks of unrelated parties or assumes open market reinsurance business.

Captives may be established as direct-writing companies issuing policies to, and receiving premiums from, their insureds directly; in other words, operating on much the same basis as the conventional insurance company.

The insurance industry is highly regulated and legislation requires that some or all lines of insurance be underwritten by only companies which have satisfied local regulations (then they become “admitted” insurers). Applicable regulations for admitted insurers include significant capital and surplus requirements, involve numerous filings and registrations, and require detailed annual reports.

Some captives are established offshore, whereby a domestic insurer (i.e. an admitted or registered insurer) issues the policy for the risks the captive intends to assume and then passes (cedes) all or part of the risk to the captive.

GROWTH OF THE CAPTIVE INSURANCE INDUSTRY

Recent surveys indicated that:

- There are in excess of 5,000 active captives throughout the world; and
- The principal reasons for growth in the captive industry have been the positive risk management benefits derived from offshore captives, as discussed in the following section, augmented by pricing and coverage stability not generally available in the domestic insurance industry.

REASONS FOR ESTABLISHING A CAPTIVE

The principal reasons for captive formation are listed in this section; it is usually necessary for more than one of these reasons to exist before the formation of a captive may be considered advantageous:

1. PREMIUM COST REDUCTIONS

Probably the most common reason for establishing a captive is to minimize overall costs of risk and risk management. Insurance purchased in the conventional market includes an allocation for the insurer’s overheads and profits, which is expected on average to be about 30% of the premium. Many insurers purchase coverage through the traditional distribution system, which often includes significant friction costs. For example, the premiums paid to the insurance broker can be subject to a commission of 10% before being passed to the insurer. The latter will assume some, often a small portion, of the risk, then purchase reinsurance coverage. The premium for this is paid to a reinsurance broker who takes a commission of 15%-20%. Many reinsurers will seek retrocession protection again through a broker. Establishing a captive often eliminates at least one layer of friction costs at material savings.

Other cost reduction opportunities include:

- Establishing the captive as the insurer or direct writer. This reduces the commission costs associated with commercial insurance companies.
- Incurring the costs of its affiliated risks without sharing the poor experience of other insurers. Commercial insurers have to factor their overall pool of risk into the premiums charged to any one insured.

2. INSURING THE UNINSURABLE

Some captives have been formed because coverage – for example for a new or potentially hazardous product – is either unavailable in the conventional market or is only available at an unacceptably high price. Other examples include inadequate conventional coverage availability for environmental pollution, medical malpractice and natural catastrophes.

3. INSURANCE PROGRAM STABILITY

The insurance industry is subject to considerable cyclical changes in which excess capacity leads to competition resulting in decreased premium rates and subsequently high loss ratios. This results in increased rates and reduced capacity, which may cause some types of coverage to be unavailable until increased capacity re-establishes a market. This sudden unavailability or excessive cost of the required coverage may cause insureds to contemplate the establishment of a captive.

A captive can create a stable base from which the insured can be confident in obtaining coverage, irrespective of the commercial market offerings, and pricing control.

4. RISK RETENTION, RISK MANAGEMENT AND LOSS CONTROL

The assumption or retention of its own risk within certain limits is attractive to a company with a better loss history than its industry's average. The existence of good risk management capabilities and the use of risk management tools, such as intensive claims analysis, related loss prevention and other control methods, can maintain and improve loss profiles and cost.

5. CASH FLOW BENEFITS

The insurance industry has traditionally relied upon investment income to supplement its often negative or modest underwriting results. Investment income is generated primarily from funds held as unearned premiums and reserved but unpaid losses. Premiums are usually paid in advance, often annually, while claims tend to be paid out over a period of time, the length of which depends on the type of business.

6. ACCESS TO THE REINSURANCE MARKET

Another benefit resulting from establishing a captive is its ability to gain access to the international reinsurance market – the wholesale market for insurance. As well as avoiding possibly one layer of friction costs and commercial insurance company costs, the insured is able to present its case face to face with the main risk taker. The reinsurance markets are generally financially stronger and more sophisticated than the primary market. These presentations allow the insurers to better understand the nature of the insured risks. This has proved to be one of the most significant benefits of captive insurance.

7. DIVERSIFICATION INTO PROFIT CENTRE

Another reason for establishing a captive is to diversify into open market insurance services and operate as a separate commercial profit centre. Although the primary reason for forming a parent-only captive is usually to reduce insurance costs, an ancillary benefit may be the generation of profits from unrelated business. However, the underwriting of such business also exposes the company to less controllable underwriting losses. Successful examples of such captives indicate that some underwriting control by the parent, including a professional selection of business underwritten, is desirable.

8. TAXATION

The subject of tax planning in connection with the use of captives is a complex one and anti-avoidance tax legislation now exists in many countries. Consequently, expert legal and tax advice must always be sought in advance of establishing a captive insurance subsidiary.

As indicated above, the establishment of a captive insurance company should always be determined by its viability as an insurance operation, independent of any tax consideration, which should be viewed as incidental.

U.S. Considerations

A subsidiary insurance company (i.e. a captive) should achieve advanced tax deductibility not available for an internal arrangement. Expenses can

be realized for only losses, claims and their directly related expenses when they become known. However, an insurance company can generally deduct for tax purposes the expense for losses incurred but not reported (IBNR). This is invariably a material expense for general insurance business. It is valued by actuaries and is attributable to (a) the occurrence of events that will give rise to a claim but have not become known and (b) the shortfall of the current valuation of known claims and actual settlements.

Canadian Considerations

Tax considerations apply to the controlled foreign corporation or affiliate (i.e. essentially as to whether or not its premiums paid to the captive are deductible for domestic purposes), to the captive itself and to the treatment of captive income and distribution of income from the parent company's perspective. These depend very much on the captive's location and its ability to defer the repatriation of earnings back to its parent (deferring any tax liability).

9. CONSOLIDATION OF DEDUCTIBLES

A captive may be used to centrally retain risk at a level that a group as a whole can afford, while allowing operating units to retain only those levels which they can individually afford.

CAUTIONS IN ESTABLISHING A CAPTIVE

No matter what its type, a captive must relate its underwriting to its financial capacity to sustain loss. Generally speaking, a conservative approach is recommended. A captive must have the financial resources to meet at least its largest single exposure at any given point in time.

1. CAPITALIZATION/ADMINISTRATION

Initiating a financial venture such as a captive insurance company requires significant commitment by its owners. It must always be remembered that at least the original capital and any surplus is fully at risk – that is the essence of the insurance business.

Allocation in a group program, claims and loss control are usually manageable, especially when a professional captive manager is used. However, determination of capital contributions, calls and/or distribution of funds for a captive with a large number of members (particularly if the group’s composition changes regularly) may present problems.

The financial resources of a captive are derived from paid-in capital (for shares), its policyholders’ surplus (from retained profits), standby loan arrangements with a commercial bank or with its parent corporation, commercial reinsurance, its policy premiums and, in some cases, the assessments on assessable premium policies. Available capital and surplus can be more highly leveraged offshore; although, recently the captive industry as a whole has become more conservative and now maintains a much lower overall operating ratio.

2. MARKET FLUCTUATIONS

As previously mentioned, insurance program stability is considered an advantage of using a captive. While this means that a captive’s pricing and coverage may be more predictable and/or attractive than those of the traditional insurance market during a “hard market”, the opposite could be the case during a “soft market”.

Conclusion

A detailed feasibility study should always be conducted and should include proper consideration of all risk funding alternatives. Such studies are typically completed by an insurance company that specializes in this area.

CAPTIVE DOMICILES

The following attributes should be sought in selecting a domicile for a captive insurer:

1. Flexible insurance regulation affecting coverages underwritten, limits of liability, amounts of reserves, investment, policy forms or rates.
2. Jurisdictions with lower capitalization requirements. Jurisdictions generally have different cost requirements as determined by their internal regulations, and capitalization requirements may therefore be lower in some jurisdictions.
3. Abundance of captive management, banking and auditing services.
4. Relatively simple procedures for organizing and activating the captive.
5. Little or no domicile taxation of the captive's premiums, income or capital gains.
6. Economic, political and social stability of the country.
7. Convenience of travel and communication between the captive's business office and the parent organization's headquarters.
8. Compatibility of local language, currency and customs with the operation of a North American owned company.
9. From the tax perspective of the captive's parent company, where possible, reasonable or attractive tax treatment of the captive's income under the tax rules of the parent company's home country, optimally from the point of view of both the shareholder taxpayer (parent corporation) and premium paying taxpayers. As noted, the captive itself will invariably be established in a jurisdiction where little or no taxation is applicable to the income of the captive locally.
10. In addition, a tax treaty between the home country and the captive domicile, which may provide some unique opportunities to extend the tax planning benefits.

CAPTIVE MANAGEMENT

As noted previously, it is extremely important that a captive be managed and operated in its place of domicile. If an offshore captive does not actually function offshore, it is likely that any tax advantages otherwise available may be nullified, and that possibly even some penalties may be imposed.

The parent corporation must therefore generally keep the management of its captive “at arm’s length”. The captive should not be directly operated or controlled by those responsible for the corporate insurance program in their capacity as employees of the parent corporation.

The parent corporation’s control of a captive as majority stockholder is through the Board of Directors and Officers of the captive. Any communications between Directors or Officers of the captive residing in Canada or the U.S. and the captive’s management should take the form of an “internal memorandum”. Communications on insurance purchases should not be combined with communication on management matters, and should be no different than communications with a commercial insurance company.

Management services reasonably independent of the parent corporation are usually required for a captive; whether it is domiciled in Barbados, Cayman or elsewhere. These services can be provided either by a separate employed staff or by purchasing the necessary services from an independent captive management firm on a fee basis. Due to the considerable expense involved in staffing and managing a remote subsidiary insurance company, it is usual and recommended that management services for a captive be purchased from a professional captive management firm.

CAPTIVE FEASIBILITY STUDIES

It is extremely important to perform feasibility studies for potential captive insurance companies. These studies are usually detailed and can include:

- Review of coverages and whether they are appropriate for captive inclusion;
- Analysis of deductibles and loss trends, and preparation of loss projections;
- Preparation of estimated pro forma financial statements for the proposed captive; and
- Review of possible captive domiciles, a general commentary on the “fit” of a captive in the parent’s risk management strategy/philosophy.

Generally, the information required to prepare a captive study is:

- A listing of policies (and any formal self-insured programs) with respective premiums and deductibles;
- A complete traditional insurance program submission;
- Group-up claims data (10 years if available, five years minimum); and
- Client/prospect’s guidelines, objectives and risk management philosophy.

The final output is a business plan which is used for approval by the Supervisor of Insurance in the jurisdiction selected.

SETTING UP A CAPTIVE

Follow these steps to set up a captive insurance company:

1. Complete a feasibility study. This is not a legal requirement, but will typically be necessary to select domicile, project losses and provide support for the business plan. Feasibility studies are conducted by an insurance specialist.
2. Select a licensed captive manager in the appropriate jurisdiction.
3. File an application with a business plan to the Supervisor of Insurance (Regulator).
4. Select the directors. Usually a combination of senior captive manager personnel and external directors.
5. Incorporate the company with the assistance of legal counsel.
6. Open a bank account.
7. Select an auditor.
8. Resubmit the application with the incorporation documents and auditor’s certificate of paid-in capital.
9. Obtain a licence.
10. At the same time, select an investment manager and custodian and start the process of setting up credit facilities if appropriate.

RBC – A PREMIER CAPTIVE SERVICES PROVIDER

RBC® has a highly developed international banking network with a strong reputation in servicing the financial needs of the captive insurance market. RBC is a premier provider of financial services to captive insurance companies around the world. With an in-depth knowledge of the industry's dynamics, specialist capabilities and outstanding financial backing and resources, we deliver innovative solutions to captive insurance markets worldwide.

The comprehensive range of services that RBC offers is designed to satisfy the wide-ranging needs of a diverse captive client base from a relatively straightforward requirement to a sophisticated solution that includes banking, custody, credit and investment management – all supported by a relationship manager that knows the business.

BANKING

RBC offers captives an extremely high degree of management flexibility, control and liquidity via a range of tailored banking services. Like all of our financial solutions for captives, our banking services are completely tailored and never “off the shelf”.

With the expert assistance of a relationship manager, you can choose from a complete range of global banking solutions, including:

- Call and term accounts, available in all major currencies;
- International payments to most points of the world through our global interbank network;
- Treasury management services; and
- Online account access for clients to manage their positions throughout the working day.

CUSTODY

RBC provides timely, efficient and cost-effective custody administration of your captive's portfolio assets.

The international division of RBC Wealth Management has been providing domestic and global custody services to captive insurance companies for over 15 years.

LETTERS OF CREDIT

RBC can help secure the stable financial backing your captive needs. Letters of credit can be key in helping your captive insurance company to capitalize or meet the security requirements of ceding or fronting companies and regulators. Our letters of credit service meets all the standards established by the National Association of Insurance Commissions (NAIC) and other regulatory bodies and is one of our core strengths in the captive insurance market.

RBC CAPTIVE INSURANCE TRUST

RBC Captive Insurance Trust is an innovative and economical alternative to standby letters of credit. Our trust is tailored to meet the needs of captive insurance programs and fulfill the regulatory requirements placed on them. Similar to a standby to a letter of credit, our trust can be set up with ease, often within 24-48 hours. As Regulation 114 trusts gain in popularity, RBC and our team of administrators can provide you with the knowledge and customized attention these trusts require.

INVESTMENT MANAGEMENT

RBC can tailor an investment management program to suit the assets and risk profile of your captive. When choosing an investment management partner for your captive, it's important to consider the company's experience with managing portfolios around the distinctive needs of captive insurance companies.

Our captive investment management team has been managing captive portfolios since 1991 and has US\$4 billion in assets under management. In helping to design your captive's investment program, we look at requirements for credit, liquidity, capital preservation, asset-liability matching and capital growth.

RBC provides captives with access to a wide range of investment solutions including cash, money market and term deposits, a variety of fixed income solutions and access to world-class external equity managers and hedge funds. The captive investment portfolio is then efficiently structured to maximize return and minimize risk, typically using a combination of asset classes and managers.

ABOUT RBC

RBC is Canada's leading financial institution as measured by market value and assets, and is one of North America's and the world's leading diversified financial services companies. As at September 2008, RBC ranked fifth among the largest North American financial institutions and in the top 15 of global financial institutions as measured by market capitalization.

RBC enjoys one of the highest credit ratings of any financial institution – Moody's Aaa, Standard & Poors AA- and Fitch AA. RBC consistently has a high quality balance sheet, proactive risk management and a strong liquidity position.

This underlying strength and stability, taken together with RBC's effective and cost-efficient delivery network, brings our captive insurance clients a combination of financial stability, strength and flexibility.

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