captive insurance times
The primary source of global captive insurance news and analysis
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Risk Pools are not dead

Sean King, principal at CIC Services, discusses the Reserve Mechanical verdict

Emerging Talent:
Pam Sanchez from Utah Insurance Department

Gibraltar Update:
Brexit uncertainty hangs over existing insurance contracts

Capstone issues second response to Tax Court decision

Capstone has released a second response to the opinion of the US Tax Court in the Reserve Mechanical v Commissioner of Internal Revenue case.

The court's opinion was that PoolRe was not a "bona fide insurance company" and did not effectively provide risk distribution.

This absence of risk distribution meant that the transactions of Reserve Mechanical, for whom PoolRe was listed as the stop-loss insurer, in the tax years in issue (2008, 2009 and 2010) were not insurance transactions.

In the response, Capstone asked whether captive insurance can still exist after the decision, and offered a series of commentaries on the tax court's decision.

The first commentary focused on Capstone's dispute of the court's view that if a business had not experienced actual losses in an area of coverage, then no non-tax reason exists for acquiring insurance.

Capstone argued that this would "appear to be fundamentally inconsistent with longstanding practices" and had "no basis in the business community or the insurance industry".

Capstone stated: "What is being insured against is the fortuitous risk of future losses, not the fear of a reoccurrence."

According to Capstone, in the case of Reserve's insureds, which have facilities located within one of the country's largest Superfund sites, the court appears to have looked on the absence of prior pollution as negating the ability of the insureds to deduct prospective pollution coverage.

Capstone added: "Because there was no proof that any of the insurance policies covered losses previously experienced, the court concluded that no non-tax reason existed for the insurance."

"By extension, broad-based business interruption coverage and employment practices liability insurance–both provided through Reserve–would not in the court's view be insurance given that there was no history of prior losses."

The second commentary discussed the court's characterisation of coverages as 'excess insurance'.

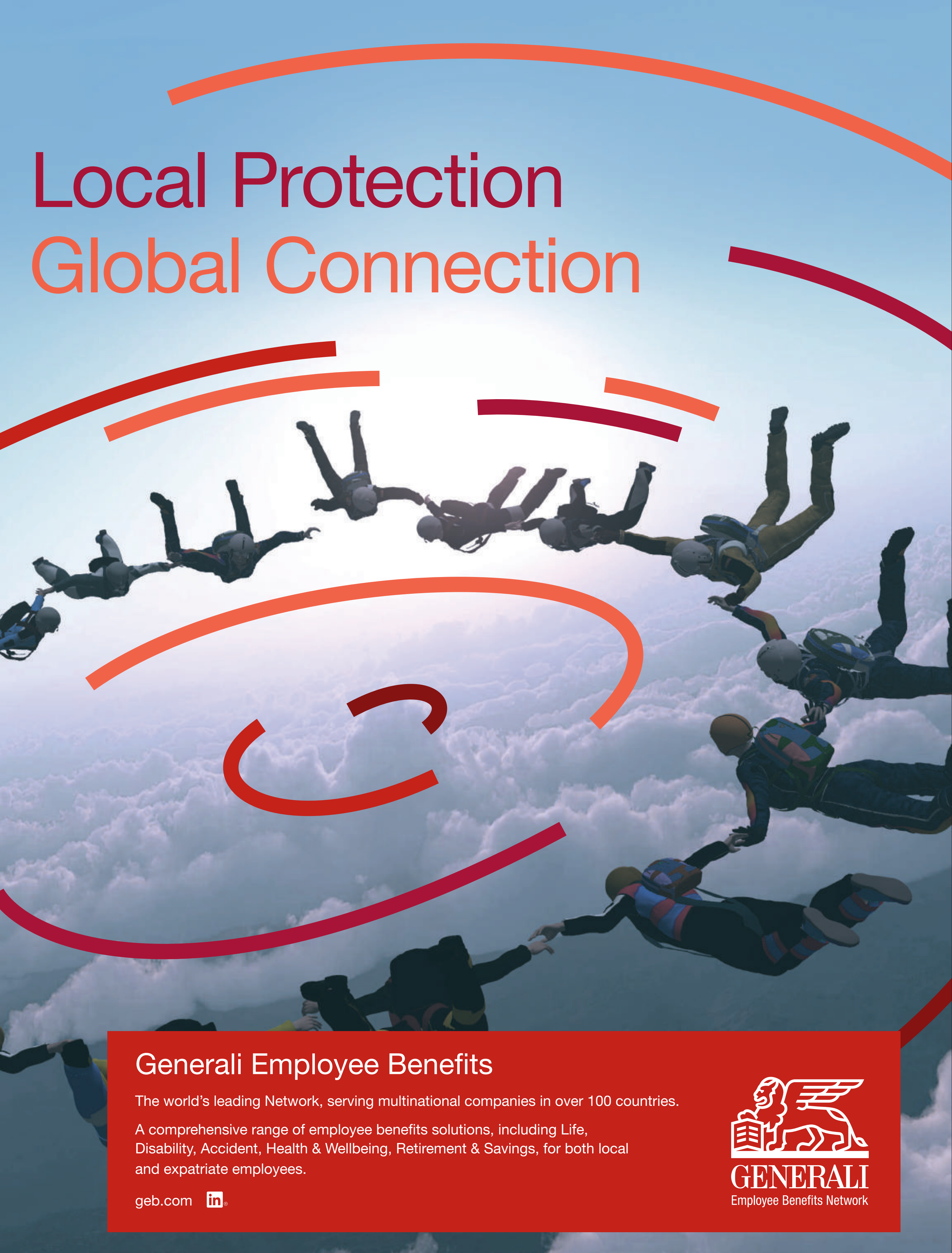
In the commentary, Capstone suggested that the court had erroneously concluded that the captive coverages, which were distinct from and didn't duplicate any commercial coverages, were not obtained for non-tax reasons because the insured had never exhausted the commercial policies in any year, despite the commercial policies covering distinct and separate risks from the policies issued by the captive.

Capstone claimed that the court's focus on this excess issue was misplaced as each and every one of the direct policies Reserve issued covered insurance risks for which the insured had no underlying coverage.

In the statement, Capstone added: "Each of the direct policies issued by Reserve represented the primary (first layer) coverage and did not provide coverage that was 'excess' over any other commercial or captive insurance."

"The court concluded that this excess' language, even in the absence of a duplicative underlying commercial policy, was fatal to a finding of insurance for federal income tax purposes."

Read more on p6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Capstone issues second response to Tax Court decision

Continued from p3

Capstone also felt that despite the court taking testimony from seven experts and three witnesses from Reserve's side and only one expert witness from the government's side, the court's decision appeared to be taken on "its own understanding of the insurance industry without discussing the evidence presented".

Additionally, it argued that the decision "appears to have rejected established norms, introducing newly articulated concepts that formed the basis for what the court considers insurance for federal income tax purposes".

The third and final commentary in the statement emphasised Capstone's surprise in the court's apparent requirement that to be valid insurance the policies should be individually drafted and not be based on forms.

Capstone explained: "The court appeared to call for an unrealistic approach in requiring that policies be individually manuscripted and negotiated for each insured."

"In these regards, the court has a wholly different understanding of how a business should conduct itself regarding insurance issues."

Capstone argued that the court had apparently viewed policy contracts being based on forms as another "fatal factor", while they suggested this was ubiquitous in the insurance industry.

It also referenced the court's issue that the policies were copyrighted, and stated: "The court did not address how it is possible to pool or share risk among unaffiliated insureds using a hodgepodge of individually negotiated contractual coverages."

It added: "The court appeared to call for an unrealistic approach in requiring that policies be individually manuscripted and negotiated for each insured."

"In these regards, the court has a wholly different understanding of how a business should conduct itself regarding insurance issues."

ICCIE changes up ACI CE guidelines

The International Center for Captive Insurance Education (ICCIE) has made changes to its continuing education (CE) guidelines for graduates of its Associate in Captive Insurance (ACI) designation.

According to ICCIE, the changes should make it "more convenient and easier" for ACIs attending approved sessions at captive conferences to earn more credits.

One of the changes was to remove the limit to CE credits that can be earned from approved conference sessions, which previously was four of the 12 credits per renewal window.

There were a number of financial alterations to the guidelines, including a new payment option offering a one-time discounted payment on all the CE credits required per three-year renewal window.

This prepay subscription will allow ACIs to pay for their 12 credits in webinars and webcasts for $1,100. The subscription can be purchased at any time and the credits can be used over multiple windows.

ACI Alumni Network (AAN) members who purchased the prepay subscription will have their annual dues halved to $50 per year.

AAN members will also now receive a 50 percent discount off one course per year and see the cost of all online webinars and live-at-conference CE sessions reduced to $75, down from $90.

Seminars at conferences will now have an administrative fee of $100 per webinar.

ICCIE recently announced a partnership with Captive Insurance Companies Association (CICA) on a new programme to support the career development and educational needs of captive professionals.

The partnership gives recent ACI graduates a complimentary one-year CICA membership, access to is mentorship programme and attendance to the annual CICA conference.

North Carolina foreign captive tax exemption gets final approval

The North Carolina General Assembly has given final approval to legislation that will exempt 'foreign' captive insurance companies from all state taxes.

'Foreign' captive insurance companies are those domiciled outside of North Carolina but within the US.

North Carolina does not currently tax captives that do business or write coverage in the state but are chartered in other states, in contrast to some US states that impose a 'procurement tax' on captives chartered outside their domicile but that insure risks for companies doing business in the state.

The legislation is contained in SB 99 and would offer specific tax exemptions for premium taxes, corporate income taxes, franchise taxes, privilege taxes and insurance regulatory charges imposed by the North Carolina Department of Insurance (NCDOI).

In May, it was announced that the North Carolina Captive Insurance Association was considering the 'foreign' captive exemption, along with a 'premium tax holiday' in 2019, as an incentive to attract both on and offshore captives into the state.

Additionally, the General Assembly has approved three technical changes to the state's captive insurance act, codified as SL 2018-120.

The word "investigation" was removed from GS 58-10-345(g) and GS 58-10-355 as the word "audit" sufficiently addresses the type of work that could be conducted by consultants retained to assist NCDOI with its responsibilities under the statute.

GS 58-10-385(a) has been amended so that when captives update changes in officers or directors, the bio changes will be deemed approved unless disapproved within 30 days from the Commissioner's review of the bio affidavit.

Positive ratings for National Independent Truckers RRG

A.M. Best has revised the outlook to "positive" from "stable" for the long-term issuer credit rating and affirmed the financial strength rating of "BBB+ (Good)" and the long-term issuer credit rating of "bbb" of National Independent Truckers Insurance Company (NITIC), a risk retention group (RRG).

According to A.M. Best, the revised ratings reflect NITIC's "strong" balance sheet strength and its "adequate" operating performance, in addition to its "limited" business profile and "appropriate" enterprise risk management.

A.M. Best said it expects the company to continue to improve its risk-adjusted capital position and operating performance.

It was also noted that surplus has benefitted from NITIC's extensive risk management programme to produce underwriting profits in the difficult line of commercial automobile liability, supplemented by capital contribution requirements for policyholders in their first five years of RRG membership.

A.M. Best explained: "The rating affirmations reflect the company's consistently strong operating performance demonstrated by comparison of its past five calendar years and five-year average combined ratios to A.M. Best's commercial auto composite average."

Guernsey ILS market outperforming 2017

Guernsey's insurance-linked securities (ILS) market has seen a positive start to the year and is outperforming 2017.

Statistics for protected cell company (PCC) cells, the main method of writing new ILS business, are, to date, well ahead of those for 2017.

Industry figures show business flows, from both established and new clients, have been good so far in 2018, with the industry seeing an overall net growth, including ILS, of 2.2 percent last year, with a top line growth of 10 percent.

As of year-end 2017, PCC cells represented 57 percent of the 853 international insurers in Guernsey.

Derek Maddison, chairman of the Guernsey International Insurance Association, said one of the industry drivers was the increasing number of natural catastrophes for which people are seeking cover.

Maddison said: "Some of these risks can be difficult to place in conventional insurance markets."

"There may not be enough capacity or the insureds may want a particular trigger to be used instead of proving an event in the conventional insurance sense."

"There is also a growing appetite among the institutional investors to diversify into such risks."

Guernsey Finance chief executive Dominic Wheatley commented: "These are exciting times for ILS."

"With international fragility and uncertainty on the rise, and innovation in the market, the ILS sector is rapidly developing."

The Guernsey insurance industry has been considering establishing entities combining insurance and investment activity in one vehicle. Guernsey lawyer Christopher Anderson, partner at Carey Olsen, said: "Although this is at an early stage, this could present significant efficiencies for ILS fund managers."

IUA publishes Brexit clause

The International Underwriting Association (IUA) has published a Brexit clause to help companies manage insurance contracts once the UK exits the European Union.

The intent of the Brexit Contract Continuation Clause is to clarify how companies will continue to pay claims despite any business disruption caused by a situation in which adequate transitional arrangements aren't agreed.

Currently, insurance companies that rely on the EU financial services passport to conduct cross-border business between the UK and continental Europe may not be licensed to continue providing cover, or pay claims, on existing contacts after the Brexit in March 2019. The new clause, which was drafted by the IUA's Clauses Committee at the request of its

Brexit Working Group, allows a risk to be placed with a 'contingent' EU-based insurer alongside a UK domiciled insurer.

If there are Brexit issues, the contingent insurer will step in and fulfill any policy obligations that the original carrier is no longer able to cover.

According to the IUA's director of market and legal services, Chris Jones, Brexit continues to be uncertain in both the nature of its final outcome and the UK and the EU's future trading relationship.

Jones commented: "A number of other market clauses have already attempted to address the issue of contract continuity, but it has proved difficult drafting a solution that covers all political eventualities."

"Another problem has been catering for the many different corporate structures, both currently present in the London Market and planned by firms as part of their Brexit contingency responses."

"Consequently, a key concern of the IUA's new clause has been to ensure that the legal principles underpinning the contingent insurer approach are sound and that the terminology and intent of the wording is as clear as possible."

Rhode Island PCC changes will make run-off transactions easier

Rhode Island made new amendments to its Protected Cell Company Act and Voluntary Restructuring of Solvent Insurers Law that will make the execution of run-off transactions easier.

HB 8163, which was introduced to the House on 4 May 2018, was passed unanimously and will come into immediate effect following the Governor's signature.

The amendments will open the door to the $100 billion market in US transactions via books of legacy business. The Voluntary Restructuring of Solvent Insurers Law will authorise both insurers and reinsurers to

CIC Services continue effort to block IRS Notice 2016-66 implementation

US captive manager CIC Services is continuing in its efforts to block implementation of Internal Revenue Service (IRS) Notice 2016-66.

On 2 November 2017, a memorandum opinion and order by a Federal Judge in Tennessee denied CIC Services injunctive relief and granted the IRS's motion to dismiss.

Judge Travis McDonough explained that a ruling in CIC Services' favour would "restrain the IRS's assessment or collection of taxes".

CIC Services had accused the IRS of unfairly labeling captives as tax avoiders in Notice 2016-66 and requested an injunction to delay Notice 2016-66 for micro captives.

The IRS's notice expressed concern that micro captive transactions had the potential for tax avoidance or evasion and the injunction was denied.

CIC Services subsequently gave Notice of Appeal to the US Court of Appeals for the 6th Circuit. The brief was completed on 21 June with CIC Services filing its reply brief.

According to the IRS, the Anti-Injunction Act bars this suit, despite its acknowledgment that it failed to comply with the Administrative Procedures Act, which occured when the IRS declared certain types of captive transactions to be "reportable transactions" by unilateral fiat.

In April 2017, NCCIA filed an Amicus brief in support of CIC Services.

The appellate process continues in Cincinnati, Ohio, with Falke and Dunphy representing CIC Services.

Holmes Murphy partners with CSDZ

Holmes Murphy has partnered with Minneapolis-based construction insurance specialists Cobb Strecker Dunphy and Zimmermann (CSDZ).

The merger, which is the company's largest to date, adds more than 100 employees, making Holmes Murphy one of the largest employee-owned brokerages in the US.

The move reflects Holmes Murphy's business strategy, strengthening the company's depth in the property and casualty, and construction and surety industries.

The company is planning to expand further and bring its employee benefits, captive, and personal lines expertise into the mix of exceptional property and casualty services that both companies offer.

CSDZ will continue to operate on a standalone basis from its three US locations, Minneapolis, Salt Lake City and Madison, Wisconsin.

CSDZ chairman and CEO Scott Egginton, who will also take on the role of chairman emeritus at CSDZ, said he couldn't imagine entering into this kind of partnership with any other company.

He explained: "At CSDZ, relationships are what matter … The future is bright for all our employees, and I look forward to seeing how we can grow with Holmes Murphy."

According to Daniel Keough, Holmes Murphy chairman and CEO, the opportunity for growth that this merger offered will enhance their clients' service experience.

Keough continued: "Holmes Murphy has long been known for providing the best insurance solutions to lower our clients' cost."

He concluded: "By adding CSDZ's expertise, we're able to take our knowledge and capabilities to the next level."

cede run-off commercial books with court-sanctioned finality in a similar fashion to a Part VII of the UK's Financial Services and Markets Act in the UK.

Last year, ProTucket Insurance became the first Rhode Island domestic insurer created to provide run-off portfolio transfer solutions under the Voluntary Restructuring of Solvent Insurers Law.

The bill was supported by Pro Global, the Department of Business Regulation, the Property Casualty Insurers Association, Locke Lord, the Governor's Chief of Staff Brett Smiley and Governor Raimondo.

Mory Katz, managing director of US at Pro Global, thanked "everyone who worked so diligently to get these amendments passed".

Katz added: "This bill has the potential to ignite economic development and bring hundreds of millions in capital to Rhode Island."

"The changes that have been passed will now strengthen the existing regulation by reducing potential ambiguities in how the law is applied."

According to Katz, the legislative changes allow Rhode Island to be a leader in the market and will mean increased occupational opportunities in the state.

He explained: "The amendments to the Voluntary Restructuring of Solvent Insurers Law and Protected Cell Companies Act show there is a real willingness in government, not just business, to make the law work. There is a consensus that it's good for the industry and good for the state."

Stuck between a rock and a hard Brexit

Amidst the uncertainty surrounding Brexit's impact on Gibraltar's insurance industry, Ned Holmes gets an update from Nigel Feetham, partner at Hassans International Law Firm

Ned Holmes reports

Uncertainty looms large as the UK stumbles towards the 29 March 2019 date set for Brexit. The sobering possibility of a 'hard-Brexit', the UK leaving the EU with no-deal, is being felt by the UK and Gibraltar insurance markets who remain unsure what that eventuality would mean, especially for existing insurance contracts.

According to Nigel Feetham, partner at Hassans International Law Firm, existing insurance contracts in Gibraltar should be protected in the event of a hard Brexit.

In Feetham's view, in the event of a hard-Brexit, in which a loss of EU passporting rights led to Gibraltar insurers being prohibited from paying claims under existing validly issued insurance contracts prior to Brexit, the Gibraltar Government would leave no "stone unturned in support of the financial services industry, especially as far as Gibraltar's EU and legal rights are concerned".

He added: "The same should also be true of the UK Government in the event of a no-deal."

Gibraltar insurers are currently preparing contingency plans for the consequences of Brexit, which include runoff, portfolio transfers via contractual novation of European books of business, Gibraltar 'Part VII transfer' equivalents and redomiciling to a European territory.

One of the issues insurers have had to consider is whether policyholders under existing policies could lose their right to claim in the event of a hard Brexit, which would see the UK and Gibraltar leave the EU following the 29 March 2019 date. No deal would result in a loss of passporting rights.

Feetham stated that there has been much speculation that following a hard Brexit "UK and Gibraltar insurance companies writing EU business would be prohibited from continuing to pay claims under existing [issued prior to Brexit] insurance contracts".

He explained: "The argument is that insurance authorisation under the EU passporting arrangements permits not just writing insurance business but also performing existing insurance contracts and that without such passporting rights insurance companies may not be able to pay claims (as absent EU authorisation this would be prohibited post-Brexit and insurance contracts could therefore be rendered void)."

This issue may become particularly relevant if the UK were to negotiate an agreement that extends the transitional period beyond 1 April 2019 but excluded Gibraltar from such an arrangement, which according to Feetham the EU has threatened to do.

Feetham stated that in addition to European and human rights legal arguments against this eventuality which could see the matter also being considered by host state (national) courts, it is open to the Gibraltar authorities to challenge it on the basis of "the Gibraltar Constitution as a deprivation of the right to property under section 6, namely, a policyholder with a contractual entitlement (property) under an existing validly issued Gibraltar insurance policy should not be deprived of such right".

Additionally, he argued that "for the EU to say (if they did) that existing UK/Gibraltar passported insurers cannot 'continue' to pay claims in the event of a hard Brexit would hardly be consistent with the EU-wide regulatory objective of treating customers fairly or fair customer outcomes".

Feetham continued: "If that [the potential breach of the Gibraltar Constitution] is right, arguably, a Gibraltar Court would uphold a customer's rights, and correspondingly an insurer's obligation, to pay claims under an existing validly issued insurance contract, notwithstanding the withdrawal of passporting rights by the EU."

He asked: "Where an insurance policy is sold in good faith under the EU passport regime with authorisation at the time of sale, how can you sever the ability/right to sell from the ability/right to then pay a claim under it and service that contract?"

"Arguably, policyholders have a legitimate expectation that the insurer would remain authorised to pay claims."

"Understandably, however, Gibraltar insurers will still need to prepare for all Brexit eventualities and take professional advice as appropriate."

According to Feetham, one of the views currently taken in the UK insurance industry appears to be that grandfathering of existing contracts will be agreed in the end.

He said: "This may explain anecdotally why not all UK insurers are rushing Part VII transfers through the UK courts to get their European books transferred into an EU entity; but even if they all did, perhaps it is doubtful it could be done in time or indeed if they could secure enough Court time to do it."

"We should find out soon if this view holds true but it is difficult to see how the contrary [no agreement on grandfathering] is in the interest of anyone."

Since Captive Insurance Times spoke to Feetham, the EIOPA released a supervisory opinion that failed to provide any assurance with regards to grandfathering of existing insurance contracts and contract continuity. **CIT**

Emerging Talent

Showcasing the new generation of captive professionals

Pam Sanchez, financial examiner, Utah Insurance Department, captive division

Personal bio

I am originally from San Diego, California, but have lived in Utah most of my life and call it home. I enjoy spending time with my husband and two kids, ages four and 10 months old. We like to travel as much as we can and experience new places and food!

Professional profile

I double majored in Accounting and International Business at Westminster College in Salt Lake City and went back to complete a master's degree in Accountancy a year later. While in college I was keeping the books for my dad's restaurant businesses and then worked as a payroll clerk. It was in graduate school that the door into the captive arena opened for me when I interned at a local CPA firm, Larson & Co, which specialises in insurance accounting.

How did you end up in the captive industry?

After my internship at Larson & Co I was hired by Ross Elliott who was director at the time for the Captive Division with the Utah Department of Insurance. At the department I worked as an analyst reviewing annual statements and audits.

Three years later I had the opportunity to transition away from audit and regulation and was hired as the assistant controller for Kornerstone Administrative Services, a company that sells and manages finance and insurance protection products for vehicles and has a Utah domiciled captive. At Kornerstone I assisted with preparing financials and reconciling accounts for both the parent company and their self-managed captive.

Do you see yourself as representing groups that are underrepresented in the captive industry?

I am the daughter of first generation Mexican immigrants and the only person in my family with a graduate degree.

I feel honoured to not only represent an emerging generation of captive talent but also represent women and Latinos who are normally underrepresented in the finance and captive Insurance industry. At the beginning of my career it was intimidating to walk into a conference and not only be among the youngest, but also a woman, and furthermore, possibly the only Latina person in the room. As I've grown into this industry I feel confident in my knowledge and experience and feel proud of what I represent.

Most importantly, my academic and professional successes fulfill the 'american dream' and the 'better life' my parents came here for: a life filled with the luxury of working in an industry I know and enjoy while still having time to be a mum and spend time with those who matter most, my young family.

What is your impression of the industry and what are your aspirations for your career in the captive insurance industry?

I foresee proactive growth for captives as companies continue to see the value in self-insurance and alternative risk financing mechanisms. I hope to grow alongside this industry while contributing my knowledge and expertise within the regulatory environment or eventually back into private sector.

For now, I love having the opportunity to work with a diversity of companies involved with captives domiciled in Utah but located across the nation while having a good work-life balance.

What advice do you have for anyone considering a role in the industry?

Talk to people and ask questions! One of the most important lessons I have learned in my career is to overcome self-inflicted intimidation and ask the question.

A significant portion of what I know about captives and accounting I can attribute to the fact that I started asking the right questions at the right time.

On the other hand, there were times when I added unnecessary stress to myself by not asking for help or clarification. Networking is also important, the captive community is small and tight knit and the chances of working with the same people are high so, get to know your peers!

“Pam Sanchez's professional experience and resourcefulness are an asset to Utah's captive division and to the industry as a whole.

Her understanding of both the industry and regulatory perspectives makes her a trusted member of our team and a fair, effective regulator.

I appreciate her ability to share her experience with her teammates and to lead by example.”

Todd Kiser
Utah Insurance commissioner

Pam Sanchez

A taxing result?

Sean King, principal at CIC Services, breaks down some of the factors of the Reserve Mechanical case and explains why, contrary to some beliefs, risk pools are not dead

After a decades long streak of losing almost every US Tax Court case of consequence involving captive insurance companies, the Internal Revenue Service (IRS) has managed over the last year to win two, though they are both of questionable relevance to most of the captive insurance industry.

The most recent case was Reserve Mechanical v Commissioner of Internal Revenue. Like Avrahami, it involved facts that are atypical to those of most of our clients, facts that made the court's job in ruling for the IRS easier.

Rather than recite those facts at length, it's more efficient to discuss the court's conclusions and then mention any relevant details as we go along.

In a nutshell, the court concluded that the captive insurance company in question was not entitled to the tax benefits of Code Section 831(b) for two reasons:

(1) There was insufficient risk distribution due to deficient risk pooling

(2) The insurance company was not operating in such a way that it could be viewed as offering insurance "in the commonly accepted sense"

Today I will discuss the first basis for the court's ruling.

Risk distribution pools

Risk distribution, which is the ability of the insurance company to spread its risks among multiple insureds and risk exposures, is an inherent part of any true insurance arrangement. Many captive insurance companies attempt to achieve risk distribution via participation in risk distribution pools, or simply 'risk pools'. In this context, risk pools are arrangements where one captive insurance company assumes some of the risks of multiple other (usually unrelated) captive insurance companies.

Risk pooling can be accomplished in a few different ways. One common way is for the captive insurance company in question to sell insurance policies directly to its primary insured. That captive then 'cedes' (that is, transfers) a portion of that risk (usually at least 30 percent but often as much as 50 percent or more) to an unrelated reinsurance company. Many other unrelated captives do the same thing with the same unrelated reinsurance company, so the unrelated reinsurance company therefore serves as the 'risk pool'—it assumes various risks from multiple unrelated captives who in turn insure unrelated insureds of their primary insureds. The unrelated reinsurance company, or the 'risk pool', then 'retrocedes' a blended portion of all of the risks that it has assumed back to each of the ceding captives. By blended risk, we mean that each captive participating in the arrangements assumes a proportionate share (commonly called a 'quota-share') of all the risks assumed by the pool—that is, risks of completely unrelated companies.

The risk pooling mechanism employed in the Reserve Mechanical case was a little different than that described above, but the distinction is irrelevant. The important thing to note is that there are generally multiple separate transfers of risk in any risk pooling arrangement. For instance, in the one described in the last paragraph above, there were three separate risk transfers—the transfer from the primary insured to its related captive (via the directly written policies), the ceding of some portion of that same risk from the related captive to the unrelated reinsurance company, and then the retrocession of the reinsurance company's now 'blended' risks back to the captive.

Each transfer of risk must be accurately priced

For any captive insurance arrangement to be honoured as a real insurance arrangement, it's critical that each transfer of risk be accurately priced using sound actuarial principles. Without sound actuarial pricing, we don't have a valid 'insurance' arrangement.

However, in many risk pool arrangements, including the one employed by Reserve Mechanical, only the directly written policies (those issued by the related captive directly to its primary insured) were actuarially priced. The other or subsequent transfers (such as between the risk pool reinsurance company and the Reserve Mechanical captive), had no actuarial pricing support and seemingly no other objective justification. Quite simply, they were not 'arm's length' transfers of risk and associated premiums.

Furthermore, in the Reserve Mechanical case, the premium paid to the risk pool exactly equalled (in dollar terms) the amount of premium subsequently paid by the pool to the captive in exchange for the latter's assumption of the blended risk of the pool. This resulted in a 'circular flow of funds'—dollars in equalled dollars out, and essentially to the penny. This circular flow of funds combined with a lack of actuarial support for the transfer of risk to the pool and its subsequent transfer of blended risk back to the captive was enough to draw the suspicion of the court. In the absence of an economic justification for the circular flow of funds, the arrangement looked to the court to be deficient so as to not qualify as insurance. Since premiums paid were seemingly unrelated to the amount of risk transferred, there was no true risk distribution, at least not as that term is understood in a traditional insurance context.

When premium equals risk and risk equals premium

Despite the (misguided, or perhaps malicious) comments by some industry pundits to the contrary there are, in fact, instances in which an underlying economic justification for a circular flow of funds may exist. Likewise there are instances in which separate actuarial pricing for subsequent risk transfers may be actuarially unnecessary or, more properly, actuarially redundant.

For instance, when a captive cedes a fixed percentage of its total risks (from first to last dollar risk) under each direct written policy to the risk pool, then almost any actuary will confirm that no separate pricing study is required for that subsequent risk transfer, at least if we assume that the policies originally issued by the captive were underwritten and priced correctly. In such cases the actuarial pricing of the directly written policies is sufficient and controls subsequent transfers of that risk because a fixed portion of that exact same risk is subsequently transferred. Since there has been no change to the nature of the risks and the underlying policies were priced accurately, risk equals premium and premium equals risk in such arrangements. Transferring some fixed percentage of the overall risk means also transferring that same percentage of the overall premium.

For instance (and subject to exceptions that are irrelevant to today's discussion), if the captive's directly-written policies are accurately underwritten and priced by an actuary and the captive subsequently cedes 50 percent of all of its risks on each policy (from first dollar to last dollar) to the pool reinsurance company–then–actuarially speaking and assuming the pool reinsurer has confidence in the initial pricing, the reinsurance company is simply due half of the premium received by the captive.

By definition, ceding half the risk of loss on each policy means ceding half the premium if the policies are correctly priced. This is not a controversial statement. Almost any actuary would readily confirm it once given sufficient context, however, in light of the Reserve Mechanical decision, having written actuarial acknowledgment of this logical fact is strongly advised.

Reserve Mechanical's problem

But notice that the logic above does not work unless firstly the risk transferred remains unchanged so that the original actuarial pricing still holds, and secondly a fixed portion of each and every risk is transferred. In the case of Reserve Mechanical, the structure didn't transfer a fixed portion of each and every risk and the risks that were subsequently transferred changed.

In the Reserve Mechanical risk pool, the individual captives retained all of the risk of loss up to a certain dollar amount for each claim under each policy and then transferred only the risk of loss above that dollar amount to the risk pool reinsurer. Said another way, only the 'stop-loss' portion of the risk was actually assumed by the pool and only a blended portion of that stop-loss risk was then ceded to each individual captive. All losses below the stop-loss amount were retained by the individual captive, and each captive bore its quota-share of any losses in excess of the stop-loss amount.

Because only stop-loss coverage was pooled, and because claims below the stop-loss amount are almost certainly likely to be more frequent in occurrence, separate actuarial pricing was certainly necessary to establish how much of the actuarial risk of loss was retained by each captive and how much was transferred to the stop-loss carrier.

Furthermore, if the stop-loss amounts were set at different levels for different risks for policies issued by different captives, then every single policy would essentially need to be repriced to determine the correct premium associated with the actuarial risk transferred.

In Reserve Mechanical, such pricing did not exist. Rather, the amount transferred between each captive and the risk pool reinsurers was simply calculated as the amount of money required to ensure a circular flow of funds—that is, the amount needed to insure that each captive got back exactly what was paid to the risk pool.

This was enough for the court to question the legitimacy of the arrangement:

"The evidence shows that the stop-loss pool was divided among the captives so that reinsurance premiums equalled the portion of direct premiums paid by each captive's affiliated insureds. We conclude that the amounts that [the pool] was to pay [the captive] under the quota-share arrangement were not determined at arm's length or using objective criteria."

What the courts didn't say

Some commentators contend that the court effectively ruled that any circular flows of funds between a captive and a pool "does not provide risk distribution" and therefore that "quota-share risk pools simply don't work". This is not in fact what the court ruled at all, nor is such a conclusion even a remotely reasonable inference from the ruling.

The circular flow of funds was only an issue in this case because, as the quote from the court above implies, a fixed percentage of all the overall risk wasn't transferred from the pool to the captive, the risk transferred was different from the original risk assumed by each captive due to stop-loss layering, no arm's length actuarial analysis determined or priced the portion of the risk that was transferred from the pool to the captive, and the amount that was transferred from the pool to the captive was calculated specifically to ensure a circular flow of funds—that is, to ensure that everyone ended up with the same amount of money they began with.

The court makes quite clear that these factors were the source of its concern:

"The perfect matching of payments under the corresponding stop-loss endorsements and quota-share policies (from insureds to [the pool], and from [the pool] to captives) indicates that the quota-share arrangement was not the product of arm's-length considerations."

And why is that so? The court tells us why in the very next sentence:

"[The primary insured's] risks that were insured through [the pool] were different from the risks that [the pool] ceded to [the captive] under the quota-share policies."

And why were they different? Because only the stop-loss layer was pooled, and there was no actuarial delineation of the portion of the risk of loss retained by each captive versus the portion absorbed by the pool.

The payment of funds from one party to the other was simply designed to ensure a circular flow and not to account for the underlying risk transfer economics of the transaction.

Again, the court makes the nature of its concern crystal clear:

"The same amount that [the primary insured] and the other insureds were obligated to pay [the pool] for the stop-loss coverage was to be paid to [the captive related to the primary insured] pursuant to the quota-share arrangement. [The captive] has not explained why these amounts were the same. It has not explained how all [pool] clients in the quota-share arrangement would be able to transfer a particular set of risks (i.e., those associated with their affiliated insureds) and assume in exchange a blended portion of completely different risks for exactly the same premium price. [emphasis added]."

Note that if the taxpayer had been able to explain why these amounts were the same, which actuarially speaking is easily done when a fixed percentage of fixed risks (from first dollar to last) is transferred on a quota-share basis, and if the risks subsequently transferred had been the same, then the court would have reached a very different conclusion. Regrettably for Reserve Mechanical, that was not the case.

Zero pooled claims ensured perfect circularity of cash flow

It's important to note (because the court emphasised it) that no claims were paid by the pool in Reserve Mechanical's case because none of the underlying policies experienced claims sufficient to trigger the stop-loss protection offered by the pool. Because the pool paid no claims, the circular flow of funds was perfect. Dollars paid in to the pool exactly equaled dollars returned to the original payers (or their captive).

As the court said:

"[The captive] never recorded and it does not contend that it had any losses or expenses in connection with its purported quota-share liabilities. Accordingly, the end result for each tax year under the quota-share arrangement was that [the captive] would receive payments from [the pool] in exactly the same amount as the payments that [the pool] was entitled to receive from [the primary insured of the captive] and the other insureds for the stop-loss coverage."

And again, all without any actuarial justification!

Is this the end for risk pools?

The court's decision simply does not address pools in which a fixed percentage of the total risk (from first dollar to last dollar) is transferred, the risk transferred is unchanged from the originally-priced risk, the percentage of premium transferred exactly corresponds to the percentage of risk transferred, the pool regularly and consistently pays claims, and payments from the pool to the captive are reduced by these pool claims, thereby interrupting the near-perfect circular flow. Neither I nor any other lawyer or CPA that I know (and I've spoken with many) interpret this case to mean that all quota-share risk pools are dead. Quota-share arrangements are not something invented by the captive insurance industry for some nefarious tax purpose but rather are common risk distribution structures employed in innumerable commercial insurance contexts.

The obvious issue in the Reserve Mechanical case wasn't the existence of a quota-share arrangement or even the circular flow of funds, it was simply that the circular flow of funds had no underlying actuarial or economic justification. When the flow of money is simply designed from the outset to ensure circularity with disregard to the amount of underlying risk transferred, it's just not real insurance. Fortunately, that's simply not the case with many other risk pools, and the court's ruling therefore has little to no bearing on them. If anything, the court's rationale in Reserve Mechanical explicitly supports the legitimacy of these latter types of pooling arrangements. **CIT**

Captive industry dates for your diary

VCIA Annual Conference

Vermont

August

07-09

vcia.com

NCCIA Annual Conference

North Carolina

August

20-22

NCCIA.org

SCCIA Annual Conference

South Carolina

September

11-13

SCCIA.org

NRRA National Conference

Chicago, Illinois

October

03-05

riskretention.org

Comings and goings of DARAG, Lloyd's and more

Legacy acquirer DARAG has appointed Tom Booth as group CEO, effective 23 July.

Current executive chairman, Stuart Davies, will work with Booth to coordinate the planned significant expansion of DARAG, remaining in his role until the transition is complete. He will become non-executive chairman thereafter.

In January, Randall and Quilter announced Booth would be leaving his roles as director and group CFO this year.

Prior to his roles at R&Q, Booth was corporate finance director where he headed the corporate finance team for the non-life insurance sector.

Davies said DARAG is set on global growth, with a number of key transactions in the core and new markets in recent months.

He added: "Tom Booth is the ideal candidate to lead this continued expansion."

"DARAG has an unparalleled level of expertise and is able to provide capital efficient, tailored legacy solutions, no matter the size or complexity of the portfolio."

Booth commented: "DARAG has an outstanding reputation as one of the market-leading providers of legacy solutions."

"Legacy is a fast-growing market, with excellent revenue potential and a track record of delivering market-beating returns."

"DARAG's expert team has deep knowledge and understanding of the global market, and I am honoured to be joining this exciting business as CEO."

Lloyd's of London CEO Inga Beale will step down in 2019, having led the global insurance and reinsurance market for five years.

Beale joined Lloyd's in January 2014 and has played a vital role in the cultural change and adoption of new technology that has accelerated the market's modernisation and digitalisation.

In 2013, Beale founded the Inclusion@Lloyd's initiative, which has embedded diversity and inclusion as a business imperative across the global insurance sector.

Prior to joining Lloyd's, Beale served as group CEO at Canopius Group and as global chief underwriting officer at Zurich.

The exact date for Beale's departure will be confirmed in due course.

Bruce Carnegie-Brown, chairman at Lloyd's said Beale's boldness and persistence have been key in bringing about real change.

Carnegie-Brown explained: "In her five years at Lloyd's, Inga Beale has set in motion a series of changes aimed at modernising the market and making it more efficient and inclusive."

"I have very much enjoyed working with Beale, and I am grateful for the support she has given me in my first year as chairman."


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Beale said that leaving Lloyd's had been a tough decision.

She added: "When the time comes I will miss the energy, innovative spirit and expertise that I come across every working day."

"Leading Lloyd's is an honour and I am proud to have played a part in ensuring that it remains relevant and fit for purpose for the future."

"The world trusts Lloyd's to be there when it matters the most and I believe it is well placed for the next 330 years."

James Bulkowski is relocating to the Cayman Island from New York to take on an expanded role at Ernst & Young, effective 9 July.

Bulkowski said that while continuing his current role of senior manager at EY, he will "also help to further expand EY's strategic captive insurance network expansion and commitment from EY to the Bahamas, Bermuda, British Virgin Islands and Cayman Islands market".

He has served as senior manager in the insurance and actuarial advisory services practice EY since 2004, specialising in property and casualty consulting, with a focus on captive insurance companies.

Previously, Bulkowski held a senior vice president position at an insurance brokerage firm specialising in large account relationship management, brokerage, and alternative risk transfer vehicles.

Holmes Murphy has promoted John Hurley to president of property casualty brokerage services, effective 1 July.

An industry veteran with nearly 30 years of experience, Hurley was previously the senior vice president of property casualty.

Hurley has been with Holmes Murphy, a US independent risk management and insurance brokerage firm, since he joined as an intern in 1990.

Hurley began leading the entire property casual line of the company's business in July 2017, and according to Dan Keough, chairman, and CEO of Holmes Murphy, his approach has helped it grow.

Keough said: "We could not be more thrilled to see his innovation bring forth more positive outcomes."

"John Hurley has embraced his role and has been instrumental in not only developing and implementing a property casualty sales process enterprise-wide but also aligning our deep commitment to understanding client cultures to help determine risk effects on financial outcomes to provide the best service."

He added: "He's also expanded the property casualty leadership team, among many other noteworthy achievements."

Risk consulting services provider Hanover Stone Solutions has appointed three executives who will have prominent roles in the firm's recently formed Strategic Planning Consulting practice.

Joanne Morrissey, Edward Loughridge, and Gary Dubois all join Hanover Stone as senior advisors.

Morrissey is co-leader of the Strategic Planning practice alongside Donna Galer and has more than two decades experience advising corporations on strategic and financial matters, including roles at The Hartford Insurance Group, as well as Crum and Forster.

Concurrently president of Caledonia Marketing, Loughridge has held numerous management and senior leadership positions with Zurich and Kemper.

Dubois has worked with leading property and casualty insurers on their business development through a consultancy he established in 2016, GND Resources.

Dubois has previously held roles at Pioneer Special Risk Insurance, Crum and Forster, Seneca Insurance, Valiant Insurance Group, Liberty Underwriters, Reliance National, and CNA.

The Strategic Planning Consulting practice helps insurance executives identify, evaluate and capitalise on their company's key opportunities for growth and sustainability.

Hanover Stone CEO Timothy Morris commented: "As more US property/casualty and life insurers seek our assistance with their strategic planning, we are expanding our team of senior insurance leaders who have been directly involved in leading these critical initiatives."

"During their careers, Edward Loughridge, Joanne Morrissey and Gary Dubois have guided many insurers through major strategic planning and change initiatives."

He added: "They are strong additions to our team and we look forward to their contributions to our insurance company clients and to our firm." **CIT**