captive insurance times

The primary source of global captive insurance news and analysis

Reserve Mechanical

A learning opportunity

AHP Panel

Discussions around the new rules for association health plans

Emerging Talent

Diana Hardy, audit manager of Rives & Associates

BUTLER
UNIVERSITY

launches online Risk and Insurance MSc

The Butler University Lacy School of Business is launching an online Master of Science in Risk and Insurance (MSRI), among the first of its kind in the US.

The course, which begins in January 2019, will help address the insurance industries ‘talent crisis’—the gap between the risk and insurance industry’s personnel needs and the limited talent pool that exists in today’s job market.

The MSRI is targeted at students who aspire to advanced roles in corporate risk management and students with finance or legal experience seeking employment in the insurance field.

Additionally, it is intended to serve early-phase professionals already working for insurance firms in both property and casualty, and life and health, and students who have an undergraduate degree in risk and insurance and want to pursue advanced study in the industry.

The part-time programme will be exclusively online, apart from two required in-residence experiences–one on the Butler campus at the start of the programme and one at the end in Bermuda. The MSRI’s coursework will take approximately 24 months to complete.

Donald Ortegel, resident managing partner of Aon Global Risk Consulting, explained that the need for risk management experts in the professional services industry is well-documented.

Ortegel commented: “The good news is that the trend line is positive for professionals with a specific, applicable risk management four-year degree. Someone holding an advanced degree or additional education in this area would have an edge over other professionals competing for open and career-advancement opportunities.”

Associate professor of Risk Management and Insurance Victor Puleo, who will run the MSRI programme, said graduates of the programme will have access to some of the best jobs available for corporate risk managers.

Other candidates will be able to enter or accelerate their careers with insurance carriers and brokers, while high-calibre graduates from this programme will possess the capability to attain senior level positions in such firms.

He added: “As one insurance executive said in our focus group: ‘This degree is an automatic $10,000 raise for any employee who acquires it.’”

According to Zach Finn, clinical professor and director of Butler’s Davey Risk Management and Insurance programme, the goal of the programme is to prepare students for an industry that anticipates needing 400,000 new employees by 2020. Earlier this year at the CICA conference, Finn said education could play a huge part in counteracting the talent crisis. Applications opened on 1 August.

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Innovative ILS structure under development in Guernsey

An innovative new single structure to conduct both the fund and insurance element of insurance-linked securities (ILS) business is being developed in Guernsey.

Mark Helyar, a lawyer with insurance expertise, is leading the way with the evolution in the ILS space and is involved in the development of what he described as a "Fund of One".

The "Fund of One" would see an investor set themselves up with an unregulated investment fund and their own transformer cell, thereby running a private fund within a regulated structure.

The structure has received support from Guernsey's ILS industry, with the suggestion that it would present significant efficiencies for ILS fund managers.

Speaking at Guernsey Finance's ILS Insight event in Zurich, Heylar commented: "This is the way I think investors want to see the direction of travel–more control, reduced costs, both vehicles in the same jurisdiction, variable capital commitments brought in and out, and you can see exactly what you are doing."

According to Heylar, the model removed the challenges posed by regularly operating in different jurisdictions, regulation, time zones, accounting rules, audit and extra layers of administration costs.

He explained: "There is a big circle and everyone in that circle is taking a cut."

"Investors have difficulty understanding where the value is in the chain, it is difficult to understand the process, and particularly when you get a year of natural disasters like last year, people start to ask questions."

"It occurred to us and to clients that this kind of approach doesn't suit them. They want to clearly control the deals they are doing."

Heylar added that he expected the structure would be popular for large investors who did not want to be treated like a private investor, offering full transparency, a significant reduction in duplicated costs, and the chance to work with their choice of co-investors.

He said: "I am quite excited by this–in talking to regulators we are doing two things here which are usually done in silos–investment and insurance divisions often take a different approach to risks."

Blockchain can replace outmoded and insecure centralised networks

A 'revolutionary model' that replaces outmoded and insecure centralised networks is the true potential of blockchain technology in the insurance industry, according to a study by Aon.

The first article of Aon's 2018 Global Insurance Market Opportunities series, 'Blockchain: Mechanics and Magic', emphasises some of the 'surprising capabilities' of blockchain within the insurance industry and addresses common misunderstandings and inaccuracies.

The article's author, former Aon Benfield Analytics CEO Stephen Mildenhall, argued that commentators who suggest blockchain is a solution to the insurance industry's processing and back-office inefficiencies are missing its true potential.

According to Mildenhall, blockchain allows for the re-democratisation of data–providing access to data where and, when required, for the reassertion of the individual's control over their private data.

Because of this, insurers are well-positioned to provide a revolutionary infrastructure and alternative revenue model to replace outmoded and insecure centralised networks with distributed blockchain solutions.

Mildenhall suggested this 'revolutionary model' is the true potential of blockchain technology in the insurance industry.

Additionally, the article highlights that blockchain offers innovative solutions to the three concerns held by database users—data integrity, data validity, and data security.

CICA appeals for 2019 conference session suggestions

The Captive Insurance Companies Association (CICA) is appealing to the

industry for programme and session suggestions for its 2019 conference.

The conference, which will take place at the JW Marriott Starr Pass Resort and Spa in Tucson, Arizona, between 10 and 12 March next year, will be centred around the theme 'Captives: Shaping the Future'.

CICA is calling for programme suggestions based on the theme of "shaping the future" that deep dives into emerging issues and are creative solutions to move the captive industry into the future.

Additionally, the association is asking for programme suggestions for the Professional Development Track, which provides training on the skills captive and risk management professionals need to be successful in the captive market.

CICA's domicile neutral status gives the annual conference a unique environment in which over 500 captive industry professionals gather for education and networking opportunities.

Suggestions are open to both CICA members and non-members and the association has encouraged to not only consider fresh topics but also new methods of presenting the information.

In a statement, CICA suggested: "A talk show format, a TED talk, or an interactive case study would engage your audience and boost their learning."

The deadline for submissions, which will be reviewed by CICA's Programme Committee, is 5pm CST on Friday 17 August 2018.

Gulfstream structures unique reinsurance programme for RRG

Gulfstream Risk Advisors has successfully placed a uniquely structured reinsurance programme for a Vermont-domiciled risk retention group (RRG).

The programme, which is effective 1 July, covers the RRG's excess losses on medical professional liability policies.

Senior care PCC launched in Vermont

Assurance Agency and Michael Maglaras & Company have launched the 'AssureCap Advantage' programme, designed to meet the insurance and risk management challenges of the senior care industry.

The programme has been organised through the creation of AssureCap Indemnity, a protected cell captive domiciled in Vermont.

The aim of 'AssureCap Advantage' is to provide a unique and thoughtful approach to insuring the skilled nursing, assisted living, rehabilitation, and independent living business.

Michael Maglaras said the programme will turn that segment of the healthcare industry around in terms of performance and outcomes.

Maglaras added: "AssureCap Advantage is very much a curated programme."

"We've carefully assembled a collaborative team that includes Pinnacle Actuarial Resources, Paul Frank + Collins, AIG Captive Management Services, and Western Litigation, to make certain that senior care facility owners and their staffs can understand their exposures, manage their risks, and have access to the tools they need to improve quality and enhance the care they are pledged to provide."

Marty Butler, senior vice president and senior living and not-for-profit practice leader at Assurance Agency, said: "The AssureCap Advantage programme has been specifically designed to meet the challenges of insuring the exposures of the senior living business."

President and COO of Assurance Agency Dan Klaras said the combination of his company's approach to managing healthcare outcomes, a captive retained-risk platform and regulatory coverage from Lloyd's of London means the new programme "is the model for the future of senior living underwriting, claims management, and risk management".

The RRG, formed in Vermont over a decade ago to write medical professional liability coverage, mainly writes business in a single state, with some risks written in adjacent states where cross-border care is provided by the RRG's insured members.

The legislature in which the RRG operates has been systematically raising the Patient Compensation Fund (PCF) cap, which caps medical malpractice claims by providing claimants with indemnification from a state-run fund in lieu of the care provider's entire insurance limits.

The raise has meant reinsurance protection has become more necessary for the RRG's on-going operations.

The crafted reinsurance programme spreads the losses over a multi-year period to create a smoothing effect and protect the company with concrete backstop should the RRG incur losses in excess of the PCF.

The RRG pays a deposit premium to the reinsurer for the coverage and maintains control over which claims they cede and which they don't, and the amount of loss they cede determines their ultimate reinsurance costs.

According to William Hodson, Gulfstream's managing member, the multi-year spread coverage was placed with the advanced solutions team of one of the world's largest Europe-based reinsurers.

Hodson said: "The coverage provides a very creative and cost-effective way for the RRG to protect themselves with a solid reinsurance programme, despite the RRG being on the smaller end of the spectrum than most large treaty reinsurers are used to supporting."

"It really does pay to partner with professionals who know the unique needs and challenges of captives and RRGs, and can creatively solve those needs by focused advocacy and market-awareness to partner the right reinsurer with the right client."

Oklahoma seeks to expand captive department

The Oklahoma Insurance Department (OID) Captive Insurance Division (CID) is actively seeking a new deputy commissioner of captive insurance and a new senior captive analyst.

The CID's growth is a response to the growth in Oklahoma's captive market, which is due, in part, to the state's effort to modernise captive regulation.

The deputy commissioner of captive insurance will be responsible for managing, promoting and providing policy guidance for the CID.

The position, which will report directly to the chief of staff, will also attend industry events and meetings, help to ensure that the CID operates efficiently and effectively, and provide insight and innovation Oklahoma remain an attractive domicile.

The senior captive analyst will be responsible for providing the captive industry with prompt decisions on regulatory issues and that captive activities remain aligned with regulatory protections.

James Mills, CID director, said the state has seen incredible growth since passing legislation to modernise their captive market in 2013.

Mills commented: “As a regulator, we always want to be at the forefront of what the industry is doing.”

“Adding these senior positions to our CID helps us ensure that Oklahoma continues to provide the responsive regulation that our captive partners expect.”

Citadel Risk Group reports ‘return to a strong profit’ in 2017

Citadel Risk Group saw $24.52 million in earned premium last year, a 20 percent increase on 2016, according to the company’s full-year results for 2017.

The full year results also revealed a 114 percent increase in underwriting profit in 2017, up to $9.9 million from $4.6 million in 2016, and that net earnings for the year rose from $3.3 million to $6.7 million after tax over the same period.

Net assets for last year also rose on 2016, up 22 percent from $18.3 million to $22.5 million.

Citadel Risk Group’s combined loss ratio was 81 percent for 2017.

Tony Weller, group CEO, said the company was about stable, unadventurous underwriting and had seen a controlled upturn in deal numbers so far this year.

Weller commented: “I am delighted to report a return to a strong profit with a very much ‘steady as she goes’ course of trading.”

“A few other insurers have unexpectedly failed in 2018; our continued conservative methodology and actuarial reviews of every programme we write has meant we can continue to support our clients and brokers who deal with the management of mid to small sector risk.”

He added: “Citadel is very much a leader of ‘esoteric’ risk and we hope to continue this trend for the remainder of 2018.”

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 in 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 at 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.

"A solid set of results and a large thank you to all our clients."

OECD publishes discussion draft on financial transactions

The Organisation for Economic Co-operation Development (OECD) has published a discussion draft on financial transactions for public comment.

The document provides an interesting insight into OCED's view on dealing with financing transactions, the direction OECD countries may take on domestic legislation and guidance on the application of arm's length principle to a range of intragroup transactions where international guidelines have been mostly non-existent in the past.

One of the key features covered in the discussion is captive insurance, specifically the characteristics of captives and arm's length pricing approaches which can be applied to such transactions.

The guidance on captives outlines two attributes that are necessary for an insurance business, the assumption of risk by the insurer, and the distribution or pooling of a portfolio of risk.

Additionally, it states that in the event a captive doesn't demonstrate the latter, it may not be characterised as carrying out insurance business.

The discussion draft also focuses on arm's length pricing approaches in relation to captives, advising that when applying the principle to determine the remuneration of captive insurers the differences on account of capital adequacy between captives and arm's length insurers should be considered.

In a blog post discussing the draft, Rachit Agarwal, Randall Fox and Joel Cooper from DLA Piper note that "when highly profitable insurance contracts are sold by sales agents to customers, the ability to achieve a higher return is attributed to customer contacts at the point of sale".

"In this regard, the captive insurer should earn a benchmarked return based on returns of comparable insurers and the residual profit should be attributed to the sales agent for access to the customer at the point of sale."

Risk Stategies acquires Oxford Risk

US brokerage and risk management firm Risk Strategies has acquired Oxford Risk Management Group, a leading captive insurance consultancy.

Oxford Risk specialises in captive feasibility studies, coordination, and management of turn-key captive arrangements, both domestically and internationally.

Following the deal, the Oxford brand and team will operate as usual and its expertise and services will continue to be available to its referral channels even as it becomes a resource for Risk Strategies' clients.

Oxford has been led by its founding principals Michael DiMayo and Kevin Myers since it was established in 2010.

DiMayo commented: "Becoming part of Risk Strategies, an organisation that understands from its founding days the client benefit of a smartly structured captive, made sense as we looked for ways to extend the reach of our operations."

Mike Christian, founder and CEO of Risk Strategies, said creating and managing captive structures goes back to the earliest days of his company.

He explained: "Risk Strategies started primarily as a risk management consultancy to help organisations identify, understand and manage their business risks."

"Bringing on the team at Oxford will provide a valuable resource for alternative and enterprise risk management for existing and prospective clients across our specialised practices."

Terms of the deal have yet to be disclosed.

The gold standard

With sustainable growth so far this year, Vermont remains the leading US captive domicile. Christine Brown and Ian Davis discuss recent developments in the state

Ned Holmes reports

How has 2018 been for Vermont?

Christine Brown: We had a very strong start to the year, with 12 licenses issued in the first half of the year and three in review now. We've had a lot of really productive meetings, so we have a healthy pipeline of prospects too.

We are definitely keeping busy and expect our licensing numbers to be similar to the average we have had over the last few years, which is between 20 and 25–numbers we are happy with. This steady sustainable growth speaks to our fair but firm regulatory approach. We've never been about chasing numbers, but we are also very welcoming and want to hear about people's insurance and risk management needs and want to try to help provide solutions.

We don't include cell formations in our licensing numbers, but we're definitely seeing a growing interest, there have been six to date. Cells can be like their own little insurance company in a lot of cases, so they require the same amount of work on our end during the application process.

We want to make sure they can stand up on their own, from a solvency perspective, and incorporated protected cells have all the same governance documents that your typical pure captive would have. These formations have been keeping us busy, but it's not as transparent because they aren't included in our numbers.

Have there been any regulatory developments?

Brown: Apart from the affiliated reinsurance company (ARC) legislation things have been pretty quiet, which is a welcome change given the number of changes in the last few years with the adoption of governance standards, holding company regulations and credit for reinsurance. We did have some minor changes or enhancements that were included in our annual housekeeping bill passed this spring. Nothing major, the most notable would be our extension of the premium tax due date from 1 March to 15 March to coincide with the annual report filing due date. It made sense from a business perspective.

About six months ago, we hired Rebecca Aitchison, an in-house examiner, who came to us with over 25 years of experience as a captive manager. She has brought some excellent outside perspective for improvements in our processes and communication with the captives we regulate and the service providers.

Do you have any plans in the pipeline?

Brown: We typically meet with our industry partners in the fall to discuss legislative changes for the upcoming session.

There's nothing big on the horizon yet, but that's not to say something won't come up.

We are always looking for ways to make our processes more effective and efficient and have a few different projects going on to that end.

> At any conference these days blockchain and emerging technologies are always discussed. In Vermont, we are continuing to be as proactive as possible

We are developing a compliance manual, which is intended to provide supplemental information to our laws and regulations and consolidate the guidance we've put out there over the years via memos. We're also developing new application forms for different types of captives that will include specific guidance on our requirements with the goal of making the application process easier.

Cybersecurity is front of mind and touches all industries and companies, regardless of size.

The Vermont Captive Division is developing guidance for best practices as they relate to IT general controls and cybersecurity, including response plans and steps to take should you become a victim of a security breach. We're also in the process of updating our website, to be launched at the end of 2018, which will be more user-friendly and include downloadable checklists and other resources for users.

Vermont has been planning on working with the secretary of state on blockchain and captives, how is this going?

Brown: My understanding is that we are partnering with the Vermont Secretary of State to use the blockchain technology when we are issuing Certificates of Authority during our licensing process.

The thought behind it is that it would be a good test case for Vermont to get people to understand how it works given the low volume of transactions and little to no risk involved. The Department of Financial Regulation is working on a study on the potential applications of blockchain technology to the provision of insurance and banking. We have been conducting interviews with domestic insurance companies and interested parties to obtain input as to current uses and the future of insurtech and blockchain in the insurance industry.

The goal, I believe, is to prepare a report for our legislators to help them better understand the technology and its potential uses to make related legislative decisions.

This is a great example of Vermont's innovation and our ability to work with our lawmakers to stay on the cutting edge and respond to the latest developments impacting our industry.

Ian Davis: This is a very topical issue at the moment, at any conference these days blockchain and emerging technologies are always discussed. In Vermont, we are continuing to be as proactive as possible.

In addition to working with the Secretary of State's office, we are conducting working groups, holding educational forums and really doing our best to position ourselves well to help regulate these emerging technologies.

We certainly believe their collective impact on the insurance industry is going to be substantial in terms of managing data, identifying risks and managing exposures, but again we want to position ourselves to be at the forefront.

Technology is so pervasive today, if insurers aren't beginning to consider incorporating them into their business plan, then they will be behind the eight-ball.

> We've never been about chasing numbers, but we are also very welcoming and want to hear about people's insurance and risk management needs and want to try to help provide solutions

What motivations were behind the new ARC legislation?

Brown: We were approached back in March to help figure out a solution for US insurance companies that were using offshore ARCs and negatively impacted by the Base Erosion Anti-Abuse provision (BEAT) included in the recent US Tax Reform.

BEAT only applies to the payments made to offshore affiliates, so third-party reinsurance isn't impacted, but many US insurers may want to maintain their ARC, which provide effective capital management and operational control.

We were able to work with our legislature to pass a bill in May that allowed the licensing of this new type of captive.

This structure is one of several options for US insurance companies seeking to avoid the adverse tax implications.

The ARCs will be subject to the laws and regulations that are promulgated by the National Association of Insurance Commissioners (NAIC) under accreditation standards, so we will regulate them similarly to risk retention groups but the law allows some investment flexibility, which is one of the benefits of offshore reinsurance arrangements.

The companies will need to submit an investment policy to us for regulatory approval during the licensing process, and that policy needs to address diversity and provide for sufficient liquidity in line with the NAIC standards. Vermont wanted to help companies keep their underwriting profits in the US by allowing them to cede to a US affiliate instead of an offshore affiliate. The speed with which it passed showcases our relationship with our lawmakers and their support of the industry.

What impact do you expect the ARC legislation to have on the industry?

Brown: The ARC option is currently available, and we've had a couple of serious conversations. We hope to have a couple of licenses issued this year.

We're not anticipating a large volume of formations, or a growing trend, our intention was to respond to the need in the industry and create an on-shore solution.

We encourage US insurance companies to review their foreign reinsurance arrangements with tax professionals to understand BEAT better.

What state do you think the captive market is in at the moment?

Brown: Even though the market is soft, the alternative risk market and captive industry continue to grow.

As the risk environment changes, with things like cybersecurity threats, changing federal and state regulations, and emerging technology, people are very creative in figuring out what can fit within the captive framework.

One of the best things about being in this industry is the innovation we see. **CIT**

Reservation for micro captives

In June, the US Tax Court's ruling in the Reserve Mechanical case signified another win for the IRS in its campaign against micro captives. Find out how the industry reacted

Ned Holmes reports

The Internal Revenue Service (IRS) claimed another scalp in its campaign against micro captives in June with the US Tax Court opinion in the Reserve Mechanical v Commissioner of Internal Revenue case.

The court held that PoolRe, the risk pool used by Reserve and operated by Capstone Associated Services, was not a "bona fide insurance company" as it did not effectively provide risk distribution.

This absence of risk distribution meant that the transactions of Reserve Mechanical, for whom PoolRe was acting as a stop-loss insurer, in the tax years in issue (2008, 2009 and 2010) were not insurance transactions and, therefore, Reserve's deductions for premiums paid to the captive were denied. The court ruling was met with some surprise from the captive industry, with a number of factors drawing concern, including amongst others the stance on risk distribution pools, the criticism of 'cookie cutter policies', and the court's apparent view that if a business hadn't experienced actual losses in an area of coverage then no non-tax reason exists for acquiring insurance.

Capstone disputed the court's opinion, calling it "a disservice to the captive insurance industry and bona fide companies like Reserve" and asking if captive insurance still exists after the verdict.

Reliance on Avrahami

One of Capstone's criticisms of the court decision was its use of the verdict from the Avrahami case, in which the court ruled in favour of the IRS, who argued that Benyamin and Orna Avrahami's captive insurance company was organised to provide tax deductions under Section 831(b) of the Internal Revenue Code and lacked insurance risk or risk distribution. While there were some similarities between the cases—and it is understandable for the court to rely on a recent

"It would seem that this tax court case bears no resemblance to the Avrahami case, as Reserve Mechanical cites numerous reasons and transactions showing how its business was insurance-related"

Anne Marie Towle, captive practice manager, JLT Insurance Management

case between the IRS and captive insurance which concerned the issue of risk distribution—the two cases also differed greatly. The court's heavy reliance on Avrahami in its verdict drew some criticism from the industry.

Anne Marie Towle, captive practice manager at JLT Insurance Management, released a statement following the verdict in which she disagreed with the court's use of the Avrahami opinion.

She commented: "It would seem that this tax court case bears no resemblance to the Avrahami case, as Reserve Mechanical cites numerous reasons and transactions showing how its business was insurance-related."

"If the court gave no weight to more than three dozen previous rulings in favour of captives and similar arrangements, as it seems to have happened, I expect this will not be the last we hear of this case."

Ryan Work, vice president of government relations at the Self-Insurance Institute of America (SIIA), said he was also concerned about the use of the Avrahami verdict.

He explained: "Simply, looking at Reserve and Avrahami, they're very different captives in different areas of the country, looking at different risks."

"You can't compare terrorism cover in the greater Phoenix area to a captive covering various mining risks in Nevada."

"I was surprised that there were so many references to Avrahami, it is fresh in the court's mind, and I understand that, but there is also a number of case law and precedent before that, which was wholly set aside."

Alan Fine, partner in charge of insurance advisory services at Brown Smith Wallace, said that he had no issue in the court using the framework of previous cases to determine what is a 'bona fide' insurance arrangement but that the two cases in question were very different.

He said: "I hate to pile on Avrahami but it read like a list of what not to do when it comes to an insurance company, and I don't even come close to the same feeling here, I think there are one or two things that should've been done better."

Fallout

Moving forward, it appears that the IRS will continue to lean on previous victories for future cases, and Work suggested that the captive industry could use the Reserve case as a learning opportunity.

He said: "The IRS is going to learn more and more on cases like Reserve and Avrahami, and I think in the future as people tighten up their captives they need to ensure that they're following the highest standards they can."

"Every setback is also an opportunity, and I think, and there is no doubt that in different court cases, whether the industry wins or loses, people are dissecting them and figuring out what the IRS is looking at and what they can do better as a captive owner or manager."

"At the same time we all, including the IRS and the courts, have to realise that each captive is different and we can't treat a future captive case like it's the same structure as Avrahami or Reserve."

In its original response to the decision, Capstone stated it was "evaluating the full range of additional relief available to rectify the court's opinion". Fine suggested that the future impact of the case may depend on whether the case is successfully appealed.

He said: "I have thought about it long and hard, and I think it could go one of two ways. If the case is appealed then I think the impact, at least in the next year or so will probably be mitigated."

"I was surprised that there were so many references to Avrahami, it is fresh in the court's mind, and I understand that, but there is also a number of case law and precedent before that, which was wholly set aside"

Ryan Work, vice president of government relations, SIIA

"I think if the taxpayer decides not to appeal it will potentially have a chilling effect on new captive formations. I think it will also cause risk sharing facilities and their managers to take a step back and reevaluate their programme in light of this case."

Fine agreed with Work that the case could act as a learning experience for the industry, particularly influencing feasibility studies.

He said: "I think you'll see feasibilities studies looking a bit better. In this new world, I recommend to clients to make painstakingly sure that the risks and the need for this insurance is documented in the feasibility study."

"That is the biggest takeaway, whether the case is appealed or not, that as an industry we should all be looking to make sure the need for insurance is clear–because that is going to be questioned."

New IRS commissioner

According to Work, the Reserve case represents one step on a longer path toward a point where the IRS, the industry and the court all share an understanding about the captive market.

He commented: "My hope is eventually we are going to get to an endgame where the IRS and the court better understand the captive market and, in turn, the market matures in the way it needs to."

One of the things that may influence when this point is reached is the stance of the next IRS commissioner on the Service's campaign against captives.

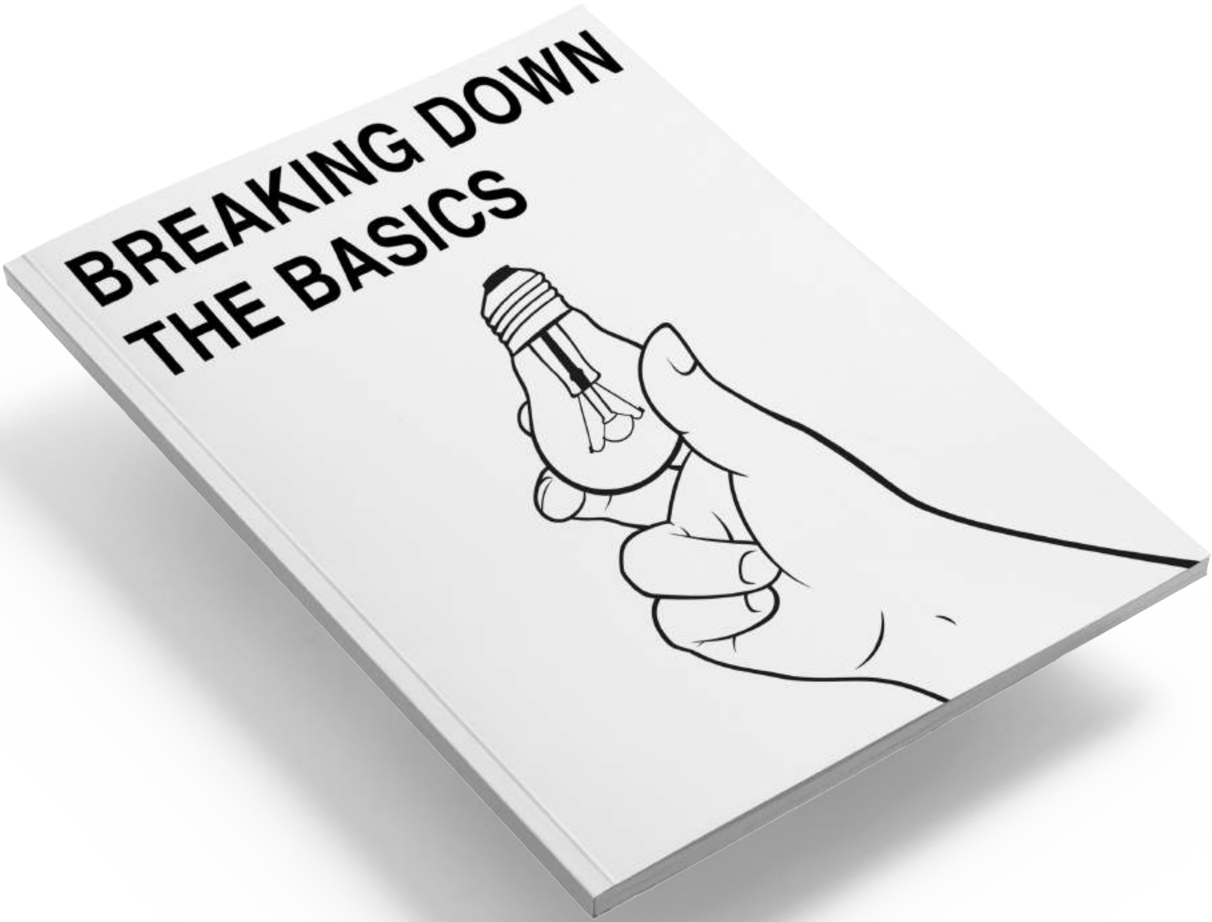
Charles Rettig has been nominated as the next IRS commissioner. Rettig has more than 35 years of experience as a tax attorney, much of it spent fighting the IRS, and as a strong supporter of the integrity of the US tax system has been appointed to numerous advisory boards for state and federal taxing authorities.

Work explained that Rettig had made some interesting comments in his confirmation hearing before the US Senate on 28 June.

Work said: "I can't say one way or another specific to captives, but in Charles Rettig's confirmation process in the Senate a couple of weeks ago he said that he would review whether the IRS's campaigns are appropriately designating limited IRS resources and whether they're focusing on things that, at the end of the day, aren't priorities for them." **CIT**

"In this new world, I recommend to clients to make painstakingly sure that the risks and the need for this insurance is documented in the feasibility study"

Alan Fine, partner in charge, Brown Smith Wallace



Deryl Bauman of First Tennessee Bank breaks down how to decide whether forming a captive insurance company is best for a business and how to get started

Who should create or use captives?

While the financial, tax and control advantages of forming a captive are clear, not all companies should invest time and resources in forming their own captive or participate in any of the variety of captive models available. The most common form of captive is the single-parent captive insurance company (a pure captive), which is owned and controlled by one company and only insures the risk of the parent company and any subsidiaries.

Perhaps the most important first consideration when deciding to form a captive is the ownership's tolerance to accept self-insured risk. The second factor to consider includes any current stressful issues that a business owner is experiencing with its commercial insurance programme. Finally, whether or not a business can afford to form their own single parent captive is determined by the start-up costs and annual levels of cash flow that the insured can dedicate to pay premiums into the captive.

Because of the trade-off between the commissions paid to commercial insurance brokers versus the annual, aggregate costs to administer a captive—which include captive manager fees, actuary costs, auditing costs, and state premium taxes paid—the break-even point for establishing a single parent captive is around $500,000 in annual premiums.

If that is not possible, smaller businesses have the opportunity to participate in the alternative captive models of association, group, or protected cell captives with annual premiums as little as $100,000, while still reaping most of the benefits of captives.

In Tennessee's statute, in addition to the pure captive, there are six other captive structures that companies can choose:

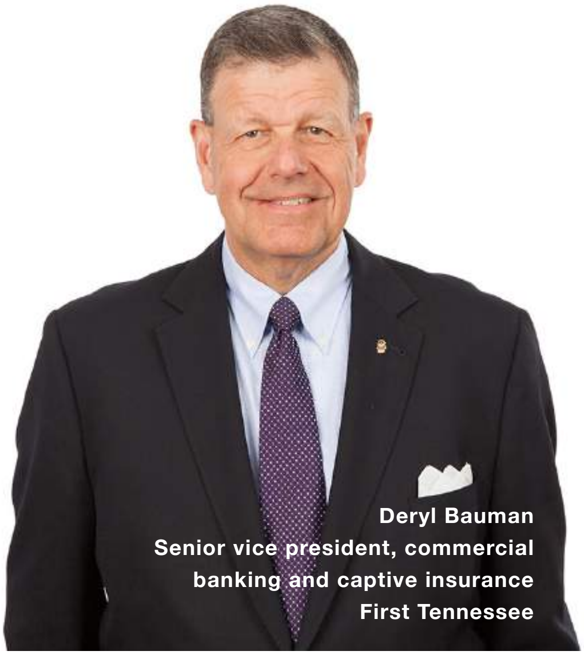
- Branch captive: a US-based arm of an existing offshore captive
- Special purpose financial captive: a reinsurance company that issues reinsurance contracts to its parent company and is owned and controlled by that parent company
- Association captive: has two or more owners and is generally owned by members of one industry or trade association, who are the only businesses qualified to participate
- Industrial insured captive: formed to insure the risks produced by a group of industrial ventures
- Protected cell captive: allow for assets and liabilities of one captive programme to be legally segregated from the assets and liabilities of another captive programme. Also known as a 'rent-a-captive', this type of captive permits multiple varied businesses to obtain insurance coverages from their own smaller cell that is a part of the larger protected cell captive
- Risk retention group: created under the Federal Liability Risk Retention Act and licensed in any one state to write liability insurance, potentially operating nationwide

Ultimately, the type and size of your company, the industry you are in, and the annual level of insurance claims you normally experience will help determine which type of captive makes the most sense for your business.

Getting started

If you think that establishing a captive insurance company could benefit your business, you can hire a domicile-approved captive management company to conduct an initial feasibility study to determine if a captive programme makes sense. Generally, this is either a no-cost or low-cost first step. You then may engage that captive manager to conduct a more in-depth feasibility study to determine the pros and cons of captive formation, which then becomes the business plan for your application for a captive license from the domicile of choice.

The captive manager will help you determine your domicile of choice based on key factors such as minimum capital requirements, types of captives available, ease of doing business with the domicile, and cost factors such as premium tax levels, travel for one annual board meeting in the domicile, and required actuary and auditing requirements of the domicile. Once the domicile approves a captive license, the captive manager will help to administratively form the captive in the state of the domicile, obtain a Federal Tax ID Number, and set up the banking arrangements necessary to fulfill the domicile's minimum capital requirement and to provide for checking and investment programmes for the treasury management of your premium deposits. **CIT**



Deryl Bauman
Senior vice president, commercial banking and captive insurance
First Tennessee

The return of the King

In his second commentary on the Reserve Mechanical case, Sean King, principal at CIC Services, discusses the IRS's much-needed victory and asks whether it was due to an ignorant court or a nuanced ruling

In part one, I discussed the impact of the Reserve Mechanical decision on risk distribution arrangements in general and on risk pools in particular. I distinguished my views on that subject from those of alarmist commentators, instead placing ourselves firmly among the majority of industry experts who believe that the decision only adversely impacts pools where the transfer of risk is not priced or is mispriced.

If anything, the logic used by the judge to invalidate Reserve Mechanical's risk pool reaffirms the legitimacy of many dissimilarly structured and properly priced pools.

The alternative basis for the judge's ruling

However, the Reserve Mechanical judge also ruled for the Internal Revenue Service (IRS) on an alternative basis. Effectively, the judge ruled that even if real risk distribution had been present (that is, if the risk pool had worked), the arrangement still didn't qualify as insurance "in its commonly accepted sense" and so the captive wasn't eligible for favourable tax treatment under Internal Revenue Code Section 501 (c)15 regardless. This second part of the opinion is, respectfully, poorly written in relation to the first. A good legal opinion will recite the facts, note the relevant laws, explain how the law applies to the specific facts, distinguish any seemingly contradictory prior precedent, and finally reach a legal conclusion. However, in this case, the judge recites the facts and the law without explaining exactly how the law applies to the facts and without distinguishing prior precedent. This leaves readers guessing as to exactly why the judge decided the way she did.

Some commentators have suggested that each fact mentioned by the judge as a basis for her conclusion is individually significant. In other words, if your captive has any identical fact, then you're sunk because the presence of any such fact is enough to taint the entire structure. But, that's not what the judge said, and interpreting the case that way both makes a fool of the judge and overturns years of prior precedent (recent cases where identical facts were specifically deemed by the court to be acceptable).

As a general rule of legal interpretation, it's improper just to infer that a newer case overturns an older one. Rather, overturning prior precedent generally must be done explicitly. Insightful readers of the Reserve Mechanical decision will, therefore, make every effort to harmonise the present ruling with prior precedent rather than reading them antagonistically. When that's done (as we do below), the decision is not quite as radical or controversial as some have suggested.

For the most part, all that's needed to harmonise the Reserve Mechanical case with precedent is to understand that the facts mentioned by the court as relevant to its conclusion are not individually significant but only cumulatively so.

The relevant factors

To determine whether the arrangement qualified as insurance in the ordinary sense, the judge weighed and balanced a number of factors (all taken from prior precedent):

"To determine whether an arrangement constitutes insurance in its commonly accepted sense we look at a number of factors, including whether the company was organised, operated, and regulated as an insurance company; whether it was adequately capitalised; whether the policies were valid and binding; whether the premiums were reasonable and the result of an arms-length transaction; and whether claims were paid. R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. at 231; Rent-A-Center, Inc. v. Commissioner, 142 T.C. at 24-25; Harper Grp. v. Commissioner, 96 T.C. at 60."

Below we briefly discuss the court's analysis of these factors and interpret it in light of prior precedent.

Organisation, operation and regulation

After finding that Reserve Mechanical, the captive insurance company in question, was organised and regulated like an insurance company, the court concluded that it nonetheless was not operated like one. In reaching this conclusion, the court cited a number of important facts, some that make perfect sense and others that–at least at first blush–seem to demonstrate either ignorance of, or complete disregard for the insurance industry, business norms and recent court precedent.

Among the latter, is the court's emphasis on the fact that the captive insurance company had no operational employees and outsourced its management to a third-party captive insurance manager.

However, rather than these things being evidence that the captive insurance company wasn't operated like a real insurance company, they are in fact completely consistent with insurance industry norms and have been for decades. For instance, a significant percentage of all licensed and regulated insurance companies in the world have no paid operational employees. And, the captive insurance companies in the precedent-setting Humana, Securitas and Rent-a-Center tax court cases (in which the taxpayers all won) likewise had zero paid operational employees. In Rent-a-Center, the court's majority specifically criticised a dissenting judge for clinging to the captive insurance company's lack of employees as evidencing something nefarious or unusual.

The Rent-a-Center court said: "In the real world of large corporations, these practices are commonplace. For ease of operations, including running payroll, companies create a staff leasing subsidiary and lease employees company wide. Or they hire outside consultants to handle the operations of a speciality business such as a captive insurer."

"[This captive insurance company], like Humana, hired an outside management company to handle its business operations. Compare op. Ct. note 6 ([this captive insurance company] engaged Aon to provide management services) with Humana Inc. & Subs. v. Commissioner, 88 T.C. at 205 (Humana engaged Marsh & McLennan to provide management services)."

So, did the court get that issue wrong? Or, is the court instead saying something more nuanced and fact-dependent? Clearly the latter. The court's real issue doesn't seem to be with the captive insurance company's lack of employees or use of a third party manager per se, but rather upon the fact that nobody seemed to be looking out for the interests of the captive insurance company, not even its owner, Zumbaum.

"Zumbaum, Reserve's 50 percent owner, president and CEO, knew virtually nothing about its operations. At trial, he showed very little knowledge of provisions in the policies that [the primary insured] and his other entities held with [the captive insurance company]. Zumbaum did not know how claims were made or handled, and he did not know where or how [the captive insurance company's] records were kept. [The captive insurance company's] operations were managed at [the third-party manager's] direction. It maintained an address in Anguilla, but there is no evidence that any activities were ever performed there."

According to the court, there was also a lack of due diligence around policy issuance: "Other than the feasibility study that [the third party manager] produced, there is no evidence that any due diligence was performed for the policies that [the captive insurance company] issued. The feasibility study gave an overview of [the primary insured's] operations, and some background documents relating to [its] operations were attached to the feasibility study. However, many of the background documents covered periods after [the captive insurance company's] incorporation."

"The feasibility study was not complete when [the captive insurance company] issued the direct written policies for 2008 or 2009. The feasibility study did not provide details about the other [two direct] insureds...and they were parties under every policy that [the captive insurance company] issued. These two entities were named as insureds on policies that did not seem to apply to their limited activities."

The opinion also noted: "There is no evidence that [the captive insurance company] performed any due diligence concerning the reinsurance agreements that it executed with [the risk distribution pool].

With respect to the quota share arrangement, it agreed to assume risks relating to a number of different businesses and a number of different lines of insurance. Nothing in the record indicates that [the captive insurance company] or anyone performing activities on [the captive insurance company's] behalf evaluated these risks before executing the quota share policies."

As I discussed in previous commentary, the risk distribution pool in the Reserve Mechanical case did not transfer a fixed percentage of the first-dollar-to-last-dollar risks on the underlying direct policies to the captive insurance company. So, actuarially speaking, the transfer of risk from the risk distribution pool required separate actuarial pricing, pricing that did not exist in this case. The result was that the captive insurance company assumed risks of the pool while (if the court is right) having done no diligence to ensure that it was adequately compensated for doing so. This is, of course, not something that an ordinary self-interested insurance company would do.

Another factor indicating that nobody was looking out for the interests of the captive insurance company was its claims procedures (or lack thereof): "Only one claim was filed under [the captive insurance company's] direct written policies. A claim notice was generated for the Stillwater loss, but no supporting documentation accompanied the claim notice."

"[The insured] did not submit and [the captive insurance company] did not insist on obtaining any documents to substantiate the occurrence or the amount of the claimed loss."

Any real self-interested insurance company would require evidence to support the legitimacy of any claims and would demand a complete release upon payment. That Reserve Mechanical didn't suggest to the court that it wasn't operated at 'arm's length' like a real insurance company.

Note the last sentence from two quotes above. The court states that it should generally be sufficient for independent parties "acting on [the captive insurance company's] behalf" (that is, an agent) to look after its interests. Phew! After all, wasn't that the third party captive manager's and attorney's job?

Usually, the answer would be 'yes'. But in this case the captive manager and captive attorney were related to each other and provided most all relevant services—captive formation, risk assessment, policy underwriting, direct policy pricing, reinsurance policy pricing, pool management, and so on—under one roof (or at least two related roofs), and for multiple similarly-situated clients.

The omnipresence of a single obviously conflicted captive manager/attorney combined with its lack of a financial interest in the profits of the captive suggested to the court that it wasn't sufficiently looking after the interests of the captive. Though the court does not explicitly say so, a captive insurance arrangement where legal services, risk assessment services, policy underwriting, actuarial pricing, captive management services, and other services are provided by separate, unrelated professionals, each contracting directly with the captive insurance company and each owing it a separate and independent duty of loyalty, shouldn't be subject to the same criticism.

No need to be alarmist

There's no need or reason to read the court's alternative finding in the Reserve Mechanical case as some alarmist commentators have.

The finding is not the end of the captive insurance industry (or the end of small captives), nor does it demonstrate the court's ignorance of the industry. Rather, when read as a whole, and when we consider that the factors noted by the court are cumulative evidence of the subjective intent of the captive insurance company and its insureds and not individually significant, this case stands for the simple proposition that all captive insurance companies should be operated for their own self-interest (and not merely to advance the interests of its owners, primary insureds or third party advisors), and that each insured must have well-documented and legitimate non-tax reasons for purchasing the insurance in question. **CIT**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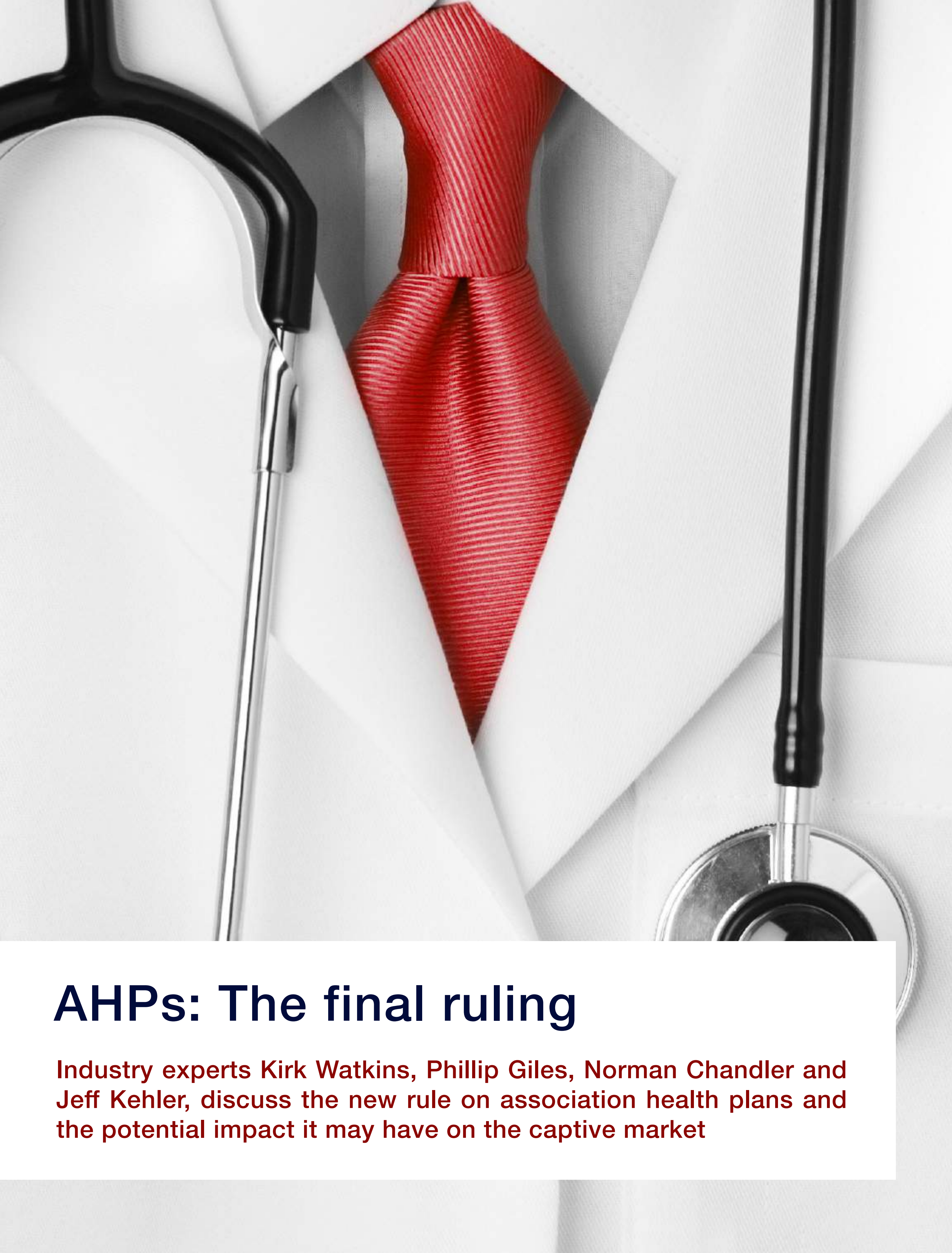

AHPs: The final ruling

Industry experts Kirk Watkins, Phillip Giles, Norman Chandler and Jeff Kehler, discuss the new rule on association health plans and the potential impact it may have on the captive market

Ned Holmes reports

The White House and the Department of Labor (DoL) issued a final rule on association health plans (AHPs) in June. The reform allows AHPs to be treated as a large group health plan for the purposes of the Affordable Care Act, which it is hoped will allow them to obtain health coverage at a lower cost.

There is a suggestion that in the future a large number of AHPs may convert to a self-insured structure as this will allow them to capitalise on such a plan's ability to preempt state insurance regulation and benefit mandates.

I spoke to a number of industry professionals; Kirk Watkins, practice leader of captive insurance programmes at Trion Group; Philip Giles, vice president of sales and marketing at QBE North America; Norman Chandler of the Alabama Captive Insurance Association and Jeff Kehler, captive programme administrator at the South Carolina Department of Insurance; about the AHP ruling and the future impact it may have on the captive market.

What are your thoughts and predictions on the association health plan rules by the US DoL?

Phillip Giles: I'm really underwhelmed by the final ruling. The rules, as originally proposed, represented some promise for expanding the structural options available for smaller to mid-sized employers for providing healthcare insurance to employees. What was delivered in the end was just a slightly more defined version of the status quo.

The final rules help define what entities are eligible to form and participate in an AHP, however, they also allow each state to continue regulating AHPs under their existing multiple employer welfare arrangement (MEWA) legislation. Instead of having a uniform set of regulations nationally, we are left with the same inconsistent patchwork from one state to the next.

There is also no mandate requiring any state to permit an AHP; and currently, only about half of the states permit MEWAs. The lack of sufficient continuity will create regulatory conflicts and inhibit the formation of multijurisdictional AHPs.

Jeff Kehler: The new legislation may be helpful to smaller, main street type employers who could not otherwise offer health coverage to their employees. However, this is not without concerns and risks. Some may argue the reduction in standards and more liberal rules afforded AHPs may destabilise existing insurance markets and offer an AHP an unfair advantage.

The AHP may not offer the essential benefits required by other plans and therefore may leave some employees without the benefits they need to treat certain diseases or conditions.

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Vice president of sales and marketing
QBE North America

Kirk Watkins
Practice leader for captive insurance programmes
Trion Group, a Marsh & McLennan Agency, LLC Company

Norman Chandler
President
Arsenal Insurance Management

Jeff Kehler
Captive programme manager
South Carolina Department of Insurance

A safe prediction is many will begin to jump on this as an opportunity to be a first-in marketer. However, once it is determined how difficult it will be to construct an AHP, the enthusiasm will wane. It will be quite a long time before all the questions and issues are resolved.

A good analogy is between AHPs and employee benefits in captives. It seemed a great idea at the time, but it took forever to gain any momentum in the marketplace.

Norman Chandler: The new rule has created a lot of renewed interest in AHPs. We expect that there will be continued interest in AHPs by associations looking to provide new member services. The new rule is helpful for grouping independent contractors and grouping by geography.

However, I'm not sure that this rule goes far enough to allow for significant new AHP formations since the state-by-state regulatory system for MEWAs isn't changed by the new rule.

If a state preemption comes about new year by DoL, then we'll see tremendous growth in AHPs.

Kirk Watkins: Many individuals in the US benefited from the Patient Protection and Affordable Care Act, which was signed into law on 23 March 2010. More commonly known as the Affordable Care Act (ACA) and referred to as, Obamacare. The legislation for AHP will allow the formation of one large group from smaller groups of employers, associations, organisations, etc. These new groups would be permitted to be recognised, as one 'employer' for the purposes of underwriting, servicing and administration of medical coverage, much like an individual large employer group.

Previously, these smaller groups had no choice but to be fully insured. However, with the ability to be recognised as one large organisation, the group has several options to choose from, including, self-funded, self-insured or continue to be fully insured with a larger, potentially healthier pool. Choosing to be self-funded may lead to greater oversight by the members, which could potentially alter plan design to be less beneficial to the employees, which may impact the employees of these smaller organisations. The other point of view may be, those organisations which think highly of their employees, or face challenges in recruiting and retaining employees, may use the ability to customise plan designs as a way to enhance their plans and pass the benefits onto the employee.

Adversely, AHP's may challenge the marketplace, through adverse selection. The ability of small employers and potentially self-employed individuals, to form a single healthcare group, may lead to the 'survival of the fittest'. Signifying that the healthiest populations may band together, form an association and benefit by the lower risk associated with that group. However, this will directly affect the marketplace, as healthy individuals leave the fully insured pool, for a newly created, 'healthiest and lower cost' pool.

Certain challenges remain inherent in the medical marketplace. Even with these new larger groups, some claims like hepatitis, preemie babies, heart attack and serious accidents, could happen at any time. Being fully insured, these small groups currently do not retain any of the risk associated with those events. As they move forward and self-fund plans with other members, participants may experience catastrophic economic loss that is associated with unforeseen medical events. A series of these events may create significant negative loss, plan years. These significant losses may lead new members to reconsider their choice and potentially re-migrate to a fully insured scenario.

How will AHPs have a future impact on the captive market?

Giles: I don't believe the final version of the rules will materially impact the captive market. However, the publicity surrounding the

AHP's may challenge the marketplace, through adverse selection. The ability of small employers and potentially self-employed individuals, to form a single healthcare group, may lead to the 'survival of the fittest'

Kirk Watkins of Trion Group

AHPs will give most state regulators serious pause for concern. First, it is a MEWA-like arrangement. This means states will have to figure out how to regulate them reasonably while still protecting the employee from the effects of a financial insolvency

Jeff Kehler of the South Carolina Department of Insurance

originally proposed rules have increased market awareness, and maybe curiosity, of MEWAs which may in turn generate some level of exploratory activity. I believe that some existing self-funded MEWAs may explore the possibility–through the formal feasibility process–of conversion to a single-parent captive. I don't, however, expect widespread market impact resulting from the final rules.

Kehler: AHPs will give most state regulators serious pause for concern. First, it is a MEWA-like arrangement. This means states will have to figure out how to regulate them reasonably while still protecting the employee from the effects of a financial insolvency.

It is likely to be a long time before AHPs are prevalent in the insurance marketplace.

Watkins: Core medical coverage is not typically self-insured in the US, it is either self-funded or fully insured. This is primarily due to the economic benefits of not having to pay a premium tax when self-funding core medical coverage.

When core medical coverage is placed in a captive, the employer must add a premium tax to the cost of the programme. In the self-funded model, Carriers like Blue Cross or Aetna, act solely as a TPA and provide their network and services for an administrative services fee.

However, medical stop-loss for companies with a captive may be placed in the company's captive. These groups can choose to retain all or a portion of the stop-loss risk and potentially insure only the catastrophic events. It is feasible to think, that AHP's could increase the desire for new captives in the market which would serve as medical stop-loss captives for the AHP's.

Chandler: Since the new rule leaves in place state regulation of AHPs, we think that domiciles have a tremendous opportunity to encourage new AHP formation. State laws vary significantly from state to state. This allows the captive domiciles to be creative in addressing the legacy MEWA issues.

Specifically, we think that Alabama offers an outstanding opportunity for innovation. The state laws on MEWAs aren't overly burdensome and that allows even more flexibility in captive programme creation. We expect Alabama to be an exception, in that, we expect several new AHP formations there.

What challenges will AHPs cause for the captive market?

Giles: In terms of captive market implications, it's important to understand that the typical AHP, will be comprised of a grouping of very small entities (and possibly even individuals) that are much too small to self-insure on their own.

Unless an AHP can attain a sufficient collective size and achieve the consistent track record of underwriting credibility and claims profitability required for self-funding, conversion to a captive structure would not be a viable consideration. Assuming an AHP can achieve a sustainable self-funded structure, it would still take about three to five years of experience credibility before conversion to a captive would be prudent.

Other significant challenges for a prospective AHP will be to first achieve 'bona fide' status as defined by the DoL final rules. To qualify, the group of employers must have a 'commonality of interest' such as being engaged in the same trade, industry, line of business or profession. The association must also

> I fully support the decision not to include that in the final rules as it helps prevent AHP formation by non-affiliated third-party programme managers not appropriately vested in long-term performance

Phillip Giles of QBE North America

demonstrate at least one substantial business purpose unrelated to the provision of health insurance coverage. According to the final rule, a commonality of interest standard is met if the association would be a viable entity in the absence of sponsoring an employee benefit plan.

There are a few options for self-funded AHP formation. New and existing employer groups that meet the qualifying 'bona fide' group standard, can establish an AHP under the DoL existing rules if they are in the same industry (for example, homogeneous) and within the same geographic location. Under the new rules, newly formed homogeneous industry groups can be formed and are not subject to geographic restriction. 'Unrelated' (for example, heterogeneous) AHPs can be considered for approval if membership is confined to within the same state or metropolitan area. Both types of groups must meet the 'bona fide' group standard.

In short, it will be easier for homogeneous groups, having a legitimate trade connectivity, to demonstrate the requisite 'commonality of interest' than for heterogeneous groups. The guidelines for demonstrating the 'substantial business purpose' needed to achieve the commonality of interest standard by the association seem ambiguous but could potentially be reached through the offering of association member services such as advertising, educational sessions, business conferences, and the like.

As I mentioned earlier, the lack of regulatory uniformity from one state to another will be a challenge to multijurisdictional AHP formation. The AHP rules, via the Employee Retirement Income Security Act (ERISA), preserve state regulation of MEWAs from regulatory preemption which extend to self-insured AHPs. Therefore, AHPs having employer-members in multiple states, such as those sponsored by national trade associations, could be subject to competing sets of state-level MEWA compliance regulations. The most likely option would be to form AHPs on a state by state basis within states permitting MEWA formation.

It's also worth noting that the originally proposed rules would have allowed AHP formation solely for health plan sponsorship. I fully support the decision not to include that in the final rules as it helps prevent AHP formation by non-affiliated third-party programme managers not appropriately vested in long-term performance. Non-vested third-party sponsorship (and profiteering) was fairly prevalent in the early MEWA days of the late 1980's and early 1990s and resulted in widespread insolvencies and tightened regulation.

Kehler: The major challenge is how to protect the employee from being harmed by a financial insolvency of the captive. A state may require a front company and lots of reinsurance before considering this arrangement. This structure may negate some of the benefits of using a captive because of cost and reduced efficiency.

Some states may have to change their captive legislation to enable the formation of AHPs using a captive insurer.

Watkins: Smaller groups may enter the AHP market and exit quickly, due to much higher than anticipated claims and/or the misconception that they could consistently experience lower claims cost, year over year. That, of course, may be true in some of the plan years, but not all. This may result in the those participants preferring the security and forecast ability a fully insured plan provides.

Chandler: The challenges are great. AHPs must comply with DoL, ERISA, and state laws in addition to captive laws in the domicile. There is an extensive knowledge base needed to put together an AHP programme that utilises a captive. In most domiciles, an

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> The new rule greatly helps existing associations to more easily form health plans. Associations of mostly independent contractors, such as realtors, are now allowed to group together to form an AHP

Norman Chandler of Arsenal Insurance Management

AHP programme will require approvals of the MEWA programme and the captive programme. In most domiciles, these approvals will have to be obtained from different divisions within the Department of Insurance.

Make no mistake, running an AHP requires experience with administering health plans. If you don't have that experience, you should go out and get it if you want to create an AHP.

Another challenge includes the traditional skepticism of MEWAs by state regulators.

What opportunities will the rules provide?

Giles: I was cautiously optimistic that the originally proposed rules would lead to increased opportunities for groupings of smaller employers to participate in structural options typically available only to larger entities.

As I mentioned earlier, the final version of the rules is quite diluted and only seem to preserve the existing, fragmented, state-based MEWA structure that has been in place for many years; maybe with a bit more definition in terms of qualifying standards.

We have been working with several established self-funded MEWAs that have expressed an interest in converting to a single-parent captive, and I expect more existing MEWAs will consider the same option. If nothing else, the new rule process has increased market awareness of AHPs and MEWAs, which may lead to some new formations, however; I believe that this will only deliver moderate–much less than originally anticipated–impact within the self-funded market and will have even less impact in the captive world.

Kehler: It is difficult at this stage to predict what opportunities will arise from the legislation. At first blush, it seems a captive arrangement would make sense and offer additional benefits through reduced cost and greater efficiency.

However, there are so many unanswered questions that are fundamental to how an AHP will work, it is impossible to say if a captive insurer could be involved either as a direct insurer or a reinsurer. Only time will tell.

Watkins: The proposed rule changes may allow organisation like the Chamber of Commerce and trade organisations to band together and offer plans that may provide more robust coverage at a substantial savings, to the employees of smaller organisations.

In those geographic areas where the group can negotiate with a very limited number of providers, they may be able to create a plan that significantly reduces overhead and administrative cost, from the typical fully-insured level.

Chandler: The new rule greatly helps existing associations to more easily form health plans. Associations of mostly independent contractors, such as realtors, are now allowed to group together to form an AHP.

The new rule also allows grouping by geography. So the requirement to be of similar industry is no longer applicable. We expect that associations that promote causes in specific geographic regions to now form AHPs for their members.

In the past this members would have to be of similar industry to group together.

The new rule changes the status of AHPs to large employers which is a great help, too.

Innovative captive domiciles will also benefit from this rule. The more experienced domiciles will do better than others. **CIT**

Innovation and flexibility

Debbie Walker analyses North Carolina's captive insurance market

There are a lot of reasons why North Carolina has become a leading destination for captive insurers. A team of highly qualified, customer service-oriented accounting and actuarial professionals at the North Carolina Department of Insurance (NCDOI) are responsible for the regulation of captive insurers. The North Carolina Captive Insurance Association provides leadership, education and support to the industry. Experienced and knowledgeable captive managers and other professionals provide services to captive insurers licensed in the state.

But perhaps one of the biggest factors is the state's captive insurance law, which eschews a one-size-fits-all regulatory approach and provides an innovative, flexible approach to the regulation of captive insurers who call North Carolina home.

The North Carolina General Assembly unanimously passed the North Carolina Captive Insurance Act in 2013. The statutory framework provides a solid foundation for the formation and operation of captive insurers. Additionally, the law provides the commissioner of insurance with discretion and flexibility to regulate each captive insurer based upon each insurer's risk profile. The law has been modified annually to provide clarity and improve existing provisions.

The captive law contains provisions that result in efficient regulation of licensed captive insurers and provides for regulatory cost savings for the formation and operation of captive insurers.

For instance, the law enables the operation of all types and structures of captive insurers including pure, protected cell, special purpose, industrial insured, branch, association, and special purpose financial captive insurers as well as risk retention groups.

Group and agency captive insurers, along with other types of captive insurers not specifically defined in the law, may be licensed as special purpose captive insurers, if the commissioner deems the applicants' plans appropriate. This means that most any type of captive insurer may be formed and operated in the state.

The flexibility and discretion built into the law is demonstrated through the capital requirements contained in the laws.

For pure, protected cell, and special purpose captive insurers, the commissioner is granted discretion to establish the minimum capital requirement based upon each insurer's proposed business plan. Therefore, the required capital will be that amount determined by the commissioner to be necessary to support all obligations of the captive insurer.

The law allows for the NCDOI's unique examination approach. Under this approach, the NCDOI does not schedule mandatory routine examinations. Instead, examinations are performed as necessary on a target basis, focusing NCDOI resources on the important issues and providing a cost savings to well-run, financially sound captives.

The law does not require captive insurers to pay any fees to the NCDOI (except for a special purpose financial captive application fee). This means no application fees, business plan amendment fees, renewal fee—no NCDOI fees whatsoever, reducing the regulatory costs of formation and operation of captive insurers.

Exemptions from certain annual reporting requirements (such as an exemption from the annual report, if an annual independent CPA audit report will be filed) may be granted by the commissioner upon request. Each exemption

> North Carolina's innovative captive insurance law provides for sensible yet appropriate regulation as well as regulatory cost savings to the captive insurers licensed in the state

request is considered by the commissioner on a case-by-case basis to determine if the granting of an exemption is appropriate. This results in a more efficient regulatory process and another cost savings to the captive insurers.

One of the more recent changes in the law allows the NCDOI to grant provisional licensing approval to a captive insurer applicant that has filed its license application and the NCDOI has made a preliminary finding that the expertise, experience, and character of the owners and managers of the applicant are acceptable.

This provisional approval may be limited by the NCDOI in any way deemed necessary, and the NCDOI may rescind the approval at any time, if the commissioner determines that the interests of the insureds or the public are at risk.

The law provides for the ability of a captive insurer to request an inactive captive insurer status, resulting in a waiver of the state taxes and a possible waiver of financial filing requirements. Insurers requesting this status must have ceased transacting insurance business and have no remaining insurance liabilities.

An insurer with this status is not subject to state tax and may obtain an exemption from one or more of the filing and reporting requirements.

As stated earlier, North Carolina's captive insurance laws provide for the formation and operation of protected cell captive insurers.

These insurers may establish one or more cells, and those cells may be incorporated (incorporated protected cell) or unincorporated (protected cell).

The law also provides for the transfer of a cell from one protected cell captive insurer to another or for the conversion of a cell to a standalone captive insurer.

In addition to the law that enables the formation of cells by protected cell captive insurers, the North Carolina captive insurance law enables the establishment by any type of captive insurer, with the commissioner's approval, of one or more separate accounts to which risks may be allocated so that they are separate and apart from the other risks of the insurer.

By enacting the captive law, the General Assembly sought to generate a positive impact on the state's economy through the receipt of premium taxes, the growth of jobs, and the generation of business revenues by captive service providers.

Like similar laws in other jurisdictions, each captive insurer is required to hold at least one annual meeting in North Carolina.

However, a captive insurer that utilises the services of two or more North Carolina-based service providers may be exempted from this requirement.

North Carolina's innovative captive insurance law provides for sensible yet appropriate regulation as well as regulatory cost savings to the captive insurers licensed in the state.

The benefits afforded by the law are just some of the reasons that captive owners are making the decision to form and operate their captive insurers in North Carolina. **CIT**

Emerging Talent

Showcasing the new generation of captive professionals

Diana Hardy, audit manager, Rives & Associates

Personal bio

I was born and raised on a farm in a small town in Eastern North Carolina. Growing up the youngest and only girl of three, I enjoy being the aunt to my eight beautiful nieces and nephews. I enjoy being active either through running, dancing or hot yoga. Most importantly, I love giving back to my community and being surrounded by friends and family.

Professional profile

As a graduate of North Carolina State University, I currently work in the Greensboro office of Rives and Associates. I practice in the areas of auditing and attestation and have nine years of experience in public accounting. My experience has allowed me to provide value to a broad spectrum of entities within the insurance industry including reinsurance considerations, complex and unconventional investments, complicated accounting topics, and mergers and acquisitions. I manage multiple captive and traditional insurance teams within Rives and Associates. Additionally, I serve as a board member of the Goodwill Industries of Central North Carolina and is the assistant treasurer to the board and a member of the Greensboro Rotary Club. I was recently awarded the IASA's 'Top 30 Under 30' 2018 award.

What has been your highlight in the captive industry so far?

Meeting new people. I meet someone new who is smart and captivating almost weekly. Meeting these people makes me excited to be in an industry which recruits individuals who are abstract thinkers. Our industry is centered on the basic premise of minimising risk while maximising returns. Every risk profile is different and finding creative ways to accomplish this is stimulating. There is so much to gain from just talking with others in this industry.

What/who have been your influences in the captive industry?

I'd have to say my biggest influence is the driving force behind the industry: correlating risk taking with anticipated profit. Being a numbers person, putting numbers to identified risk really excites me. Three particular women in the industry immediately come to mind: Debbie Walker, North Carolina Department of Insurance (NCDOI); Leane Refalko, NCDOI; and Anne Marie Towle, JLT. Having the honour to listen to presentations from them and getting to know them has influenced me to want to become a female leader in the industry and follow in their footsteps to be on the forefront of the industry.

What are your aspirations for your career in the captive industry?

I hope to be a 'go to' industry leader and on the forefront of understanding and communicating complex accounting standard updates affecting both financial reporting and tax reform. Our industry is full of very smart people, but even with that being the case, complex topics arise and therefore the proper treatment is in a grey area. I love figuring out the best way forward.

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

Dive in! It is an ever changing, diverse, and sometimes challenging industry that can only make you a better professional. CIT

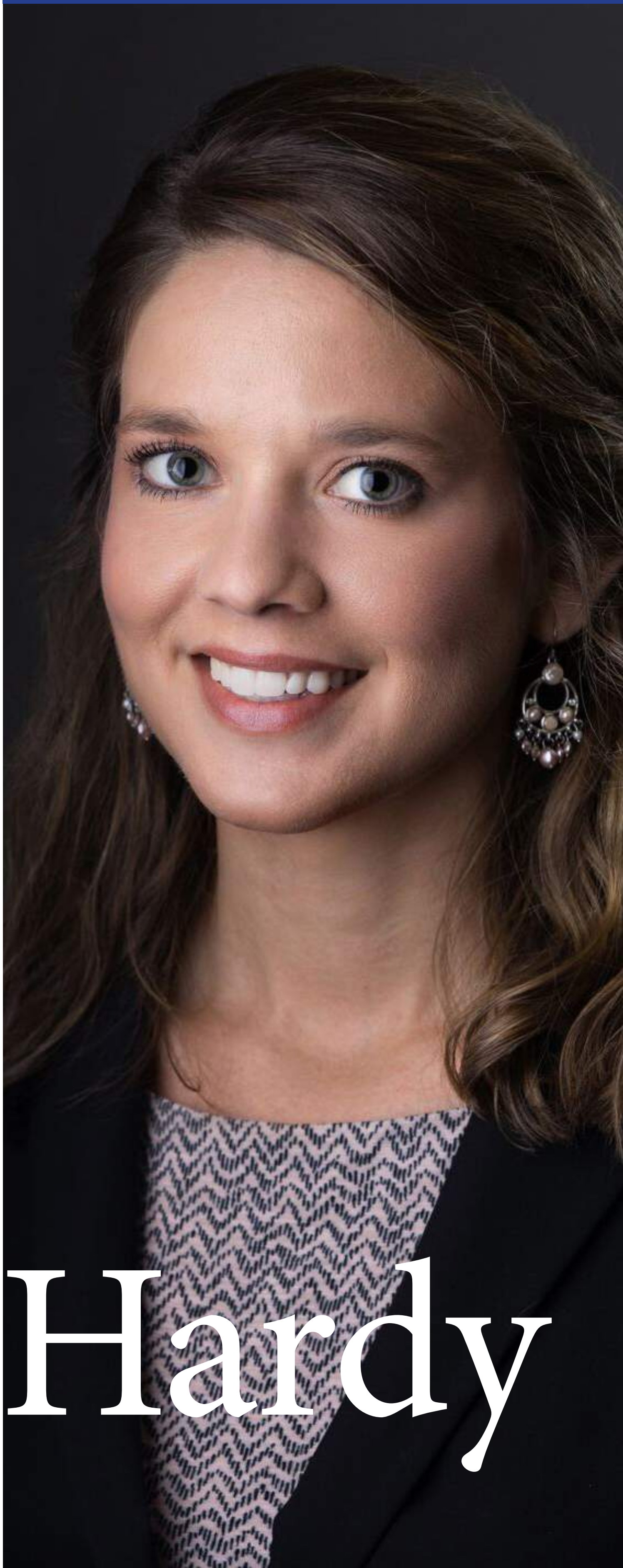
"Diana Hardy is very collegial, well spoken, and highly knowledgeable about the ever-changing regulatory landscape, and GAAP financial reporting requirements.

We were very impressed with the level of professionalism and the timeliness in responding to our inquiries.

Diana will take the necessary time to understand the processes, procedures, and transactions that occur to provide a high quality audited financial report, consistent with the requirements of and domicile.

I would highly recommend Rives & Associates and more specifically, ask for Diana."

Frederick Marcks, consultant, Synergy Insurance



Diana Hardy

Twin peaks

Ernie van der Vyver, partner at Clyde & Co, explains what new legislation will mean for cell captive insurance companies in South Africa

Ned Holmes reports

What is current cell captive insurance company legislation in South Africa?

Unlike other jurisdictions, South Africa does not have protected cell company (PCC) legislation.

Until as recent as 1 July 2018 there was no specific definition of a cell captive insurer and thus no dedicated cell captive insurance licence. A cell captive insurer was an insurer registered in terms of the Long-term Insurance Act, 53 of 1998 and/or Short-term Insurance Act, 52 of 1998, respectively with specific conditions of registration (for example, policy benefits may not be limited to the funds available in the cell).

Unlike traditional insurers in South Africa, who were prohibited from issuing different classes of shares without prior approval from the relevant authority at the time, over time cell captive insurers were permitted to issue different classes of shares.

The creation of different classes of shares allows cell captive insurers to distribute profits in the forms of dividends to the various cell owners, based on the profitability of the insurance business generated through the particular cell owner.

However, on 1 July 2018, the Insurance Act, 2018 took effect, which seeks (among others) to provide a consolidated legal framework for the prudential supervision of insurers and repeals substantial portions of the Long-term and Short-term Insurance Acts dealing with prudential supervision.

The Insurance Act also introduces the definition of a cell captive insurer and now provides that only cell captive insurers licensed under the Insurance Act may conduct insurance business through cell structures. We note that the full detail regarding cell captive insurance business will be dealt with in terms of subordinate legislation issued pursuant to the provisions of the Insurance Act.

It is important to note that the Insurance Act is one of several changes in the insurance industry of South Africa.

The Financial Sector Regulation Act was recently enacted in South Africa and certain sections of the Act commenced with effect from 1 April 2018. The said legislation establishes the so-called Twin Peaks model of regulation in South Africa, which entails establishing two regulators being the Prudential Authority within the South African Reserve Bank, and the Financial Services Board transformed into the new Financial Sector Conduct Authority.

Similar to regulation in the UK, the Prudential Authority will supervise the safety and soundness of financial institutions while the Financial Sector Conduct Authority will supervise how financial services firms conduct their business and treat customers.

On 3 July 2018, the Financial Sector Conduct Authority and the Prudential Authority published a joint communication which inter alia, confirms that the Prudential Authority intends to consult on proposed subordinate legislation to deal with adequate governance and risk management, including provisions to be provided for in cell agreements and the Financial Sector Conduct Authority intends to consult on subordinate legislation which constitutes primarily conduct of business matters which includes, amongst others, who may be a cell owners. On 20 July 2018, the draft conduct of business subordinate legislation was published for consultation.

Of import, the Insurance Act has not changed the position that there is no PCC legislation in South Africa. Given that there is no PCC legislation in South Africa cells are not regarded as distinct legal entities and there is no legal ring-fencing of funds in the case of liquidation of a cell. Therefore, all the assets and liabilities of each cell forms part of the assets and liabilities of the cell captive insurer.

However, cell captive arrangements between cell captive insurers and cell owners in South Africa are primarily governed by contractual arrangements, most notably by way of shareholder agreements and the cell captive insurer's memorandum of incorporation. The cell captive insurer utilises the shareholder agreements with each cell-owner to notionally ring-fence cells.

Have these legislative/regulatory changes been in the pipeline for a while?

As early as June 2013, the Financial Services Board (as it was then known) published a discussion paper titled 'Review of Third Party Cell Captive Insurance and Similar Arrangements'. The said paper provided the initial regulatory policy proposals of the Financial Services Board with respect to third-party cell captive insurance and this concept of "similar arrangements".

Notably, the discussion paper, as the name suggests, was merely a discussion paper in which the authorities set out its views on how it intended to deal with third party cell captives in future.

It was postulated that a final position paper on cell captives would be released as early as the end of 2015, which would contain the final regulatory proposals. However it took until 3 July 2018 for the joint communication by the Financial Sector Conduct Authority and the Prudential Authority to be published which provided an update on the regulatory policy proposals mooted in the discussion paper.

While we are still waiting the publication of the proposed subordinate legislation, which will deal with adequate governance and risk management in cell agreements, the draft conduct of business subordinate legislation was published on 20 July 2018 for consultation.

What are the key points of the update provided by the joint communication

The joint communication provides inter alia, an update on the extent to which the regulatory policy proposals mooted in the discussion paper have been accommodated in the Insurance Act and provides clarity regarding the supervisory oversight of the two authorities in regulating cell captive insurers.

In this regard, the Prudential Authority will regulate matters pertaining to adequate governance and risk management, including provisions to be provided for in cell agreements, whereas the Financial Sector Conduct Authority will regulate who may be a cell owner.

The regulatory concerns, which the Insurance Act, together with the aforesaid subordinate legislation seeks to address were summarised in the discussion paper. By no means exhaustive, the primary concerns related to the lack of uniformity of license conditions for active cell captive insurers; and the ownership structures inherent in cell captive arrangements could give rise to significant conflicts of interest, depending on who the cell owner is.

Regarding the latter issue, conflicts and the impact thereof on policyholders has been a primary consideration of the respective authorities. Of particular concern was the situation where a cell owner was an intermediary or an associate of an intermediary. The intermediary's ability to earn profits (through the shareholder arrangement with the cell captive) creates the potential for conflicts of interest (for example, intermediaries market and sell policies and earn prescribed commission, but also have a vested interest in the profitability of the insurers, which is directly influenced by policy volumes and loss ratios).

To mitigate such risks, the Financial Sector Conduct Authority has in its draft subordinate legislation provided certain limitations on the ownership of cell structures by intermediaries (or an associate of intermediaries).

Firstly, it is proposed that the cell owner must only render intermediary services in respect of policies underwritten by that cell owner. The intermediary must thus act as a tied agent. Secondly, the intermediary must not own cells in more than one cell captive insurer (for example, acting clearly on behalf of one insurer only). Thirdly, an 'affinity relationship' must exist between the main business of the cell owner and the insurance business conducted through the cell structure. Lastly, the primary business of the cell owner is not the rendering of services as an intermediary.

A relationship will, based on current proposals, constitute an 'affinity relationship', if the primary business of the cell owner is not insurance business and the broader business relationship between the cell owner and the policyholder results in the offering of suitable insurance products and consistently offers fair value to the policyholder.

Is the new legislation bringing regulation to a space in which it was previously lacking?

Specific cell captive legislation did not exist prior to the enactment of the Insurance Act and cell captive insurers were regulated in terms of the general insurance regulatory framework. Only

Ernie van der Vyver, partner at Clyde & Co

specific regulation was achieved by including cell captive specific conditions in the cell captive insurer's licensing conditions.

Several material risks (to both financial soundness and fair conduct of business) for insurers, policyholders and effective supervision that may arise from such structures and business models were identified in the discussion document and measures to mitigate these risks are now in the process of being introduced through the Insurance Act and its subordinate legislation.

What is the timeline moving forward?

In terms of the transitional arrangements contained in Schedule 3 to the Insurance Act, the Prudential Authority must by 30 June 2020, convert the registration of all previously registered insurers to a licence in accordance with the Insurance Act.

Until such time, insurers registered in accordance with the Long-term and Short-term Insurance Acts continue to exist as an insurer and may continue to do insurance business until a licence is granted in accordance with the Insurance Act.

The Prudential Authority has published a communication which details the envisaged conversion process and notes therein that a progressive implementation of conversion will take place such that from 1 January 2019 to 1 October 2019 existing cell captive insurers will be converted.

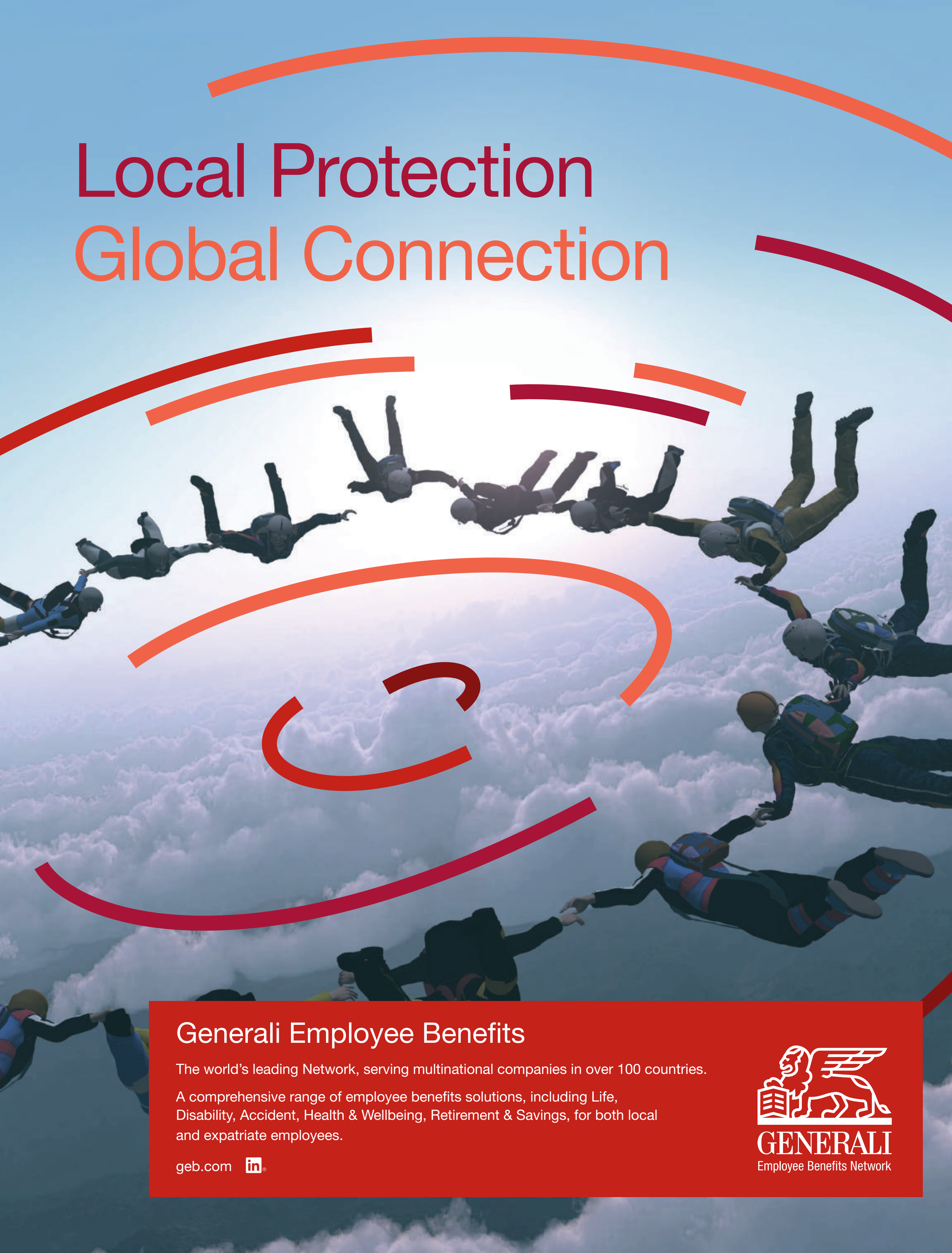
Notably, said conversion is largely dependent on the finalisation of the subordinate legislation applicable to cell captive insurers, which is yet to be completed. In the joint communication it is noted that the envisaged effective date of the proposed subordinate legislation dealing with prudential matters is 1 January 2019.

What effect do you predict this will have on the South African market?

Given the current proposals regarding the limitations pertaining to cell owners, it is possible that exiting cell owners will no longer be permitted to own cells. This concern is becoming a critical concern from the relevant industry, as we have been asked to advise several clients of this risk and whether their current business conducted through a cell will survive this regulatory change, as currently proposed.

It is difficult to advise on the true impact the regulatory changes will have on the cell captive market in South Africa given that the advice is limited to regulatory proposals. However, we anticipate that based on the current proposals there will be a reduction in existing cell owners, partly as a result of non-compliance with the limitations of cell ownership and partly due to increased regulatory supervisory requirements.

The impact is not only limited to cell owners. Cell captive insurers will also be impacted by the advent of the Insurance Act and related subordinate legislation. Cell captive insurers are accountable for the financial soundness and regulatory compliance of each cell structure that it puts in place. The financial soundness obligations are similar to those stated under Solvency II and will undoubtedly place new pressures on existing cell captive insurers. Cell captive insurers will also not be allowed to underwrite any traditional insurance business (for example, non-cell insurance business). **CIT**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Tax court conclusions

Alan Fine of Brown Smith Wallace discusses the questions he feels are raised by the Reserve Mechanical case and the takeaways for captive insurers

In June 2018, the US Tax Court issued another decision in a micro captive insurance case, 'Reserve Mechanical v. Commissioner of Internal Revenue'. In this case, the court determined that the risk sharing pool being used, PoolRe Insurance, did not qualify as a 'bona fide' insurance company. Therefore, the arrangements involving the pool lacked the requisite risk shifting, resulting in the taxpayer's deductions for premiums paid to the captive being denied.

Case background

Reserve Mechanical was created by the owners of Peak Mechanical and Components. Peak's business operations involved the distribution, servicing, repairing and manufacturing of equipment used for underground mining and construction. Reserve issued policies to Peak and two affiliated entities with little activities, covering a variety of enterprise risks such as loss of major customer, excess pollution liability, excess cyber risk, weather-related business interruption and regulatory changes. The policies in question were excess policies that took effect only after the insureds' commercial coverages were exhausted. Premium amounts were calculated only for the three insureds together without any breakout of the premiums per insured. Seven of the 13 policies issued in the captive's first year contained retroactive dates.

During the years in question, there was a single claim under the direct policies, for loss of a major customer. Reserve paid a total of $175,000 in connection with the covered loss.

Peak then entered into a stop-loss arrangement where PoolRe agreed to pay claims paid by Reserve if certain claims thresholds were exceeded. Between 51 and 56 other parties entered into similar arrangements with PoolRe. PoolRe also entered into quota-share policies to redistribute risks among the other PoolRe participants. Reserve also assumed risks from PoolRe related to vehicle service contracts.

Reserve, which had been formed and domiciled in Anguilla, elected to be treated as a domestic insurance company for all purposes of the Internal Revenue Code. It filed as a tax-exempt insurance company under Section 501(c) (15), as its premiums were less than $600,000 per year, and more than half of its income came from insurance operations.

The court's decision

The court determined that Reserve did not insure sufficient related parties nor statistically independent risks from these parties to satisfy the requirement of risk distribution. The court then turned its analysis to the pooled reinsurance arrangements with PoolRe.

The US Tax Court took exception to the circular course of cash flows between Reserve and PoolRe; for example, Reserve would receive payments from PoolRe exactly equal to that paid by Reserve to PoolRe. There were also concerns that the underlying risks assumed by Reserve were not comparable in scale to those risks ceded by Reserve, and that PoolRe did not enter into the arrangements with Reserve for the purpose of distributing risks. For these reasons, the court determined that PoolRe was not a 'bona fide' insurance company.

The US Tax Court then turned its attention to whether the policies issued by Reserve constituted insurance in the commonly accepted sense. In particular, the court seemed to focus most on the lack of a non-tax business purpose for creating the captive and paying premiums. The court pointed to the fact that there were no changes to the coverages purchased in the commercial marketplace nor was the taxpayer able to demonstrate the need for these additional coverages. The feasibility study did not document the need for the

> Captive owners need to do appropriate due diligence on their captive service providers and the programmes they offer, as well as the workings of the mechanics of the captive arrangements

Alan Fine, partner, Brown Smith Wallace

additional coverages, the probability of a loss event that would be covered by the new policies or how the new policies would supplement the existing commercial policies.

It is worth noting, however, that the court did acknowledge that these items were discussed at various points leading up to the feasibility study, including during the visit of the Peak facilities and operational sites.

The court also took exception to the pricing of the policies issued by the captive, noting in one instance where more premium dollars were spent for one month of coverage from the captive than was spent for an entire year's coverage in the commercial marketplace.

Court's decision sparks questions about future conclusions

There are a few areas of the court's rationale that are unsettling. First, the court had a problem with the fact that the taxpayer and its owners failed to conduct an independent due diligence of the risk pool. The court did not explain whether this standard applies to all insurance arrangements or just to captive insurance, and appears to impose the requirement that anyone involved in a captive insurance arrangement become an expert in reinsurance. How far would this rationale extend? For example, do investors in an oil and gas partnership need to become experts in the various aspects of drilling?

Second, the court also found the 'cookie cutter policies' issued by Reserve (created by the captive manager and affiliated law firm) problematic. This issue seems to be a 'heads we win, tails you lose' argument for the IRS, and ignores the fact that there tend to be incredible similarity in policies issued by commercial carriers for the same lines of coverage. Does this mean that a person's homeowners policy isn't a valid insurance arrangement because it has exactly the same language as the policy received by a neighbour?

Third, as previously discussed, the court had issues with the lack of support in the feasibility study demonstrating the need for the additional insurance coverages. It focused heavily on lack of evidence that Peak ever had costs resulting from excess pollution liability, determining that there was a lack of a non-tax business purpose for the purchases from Reserve. Is a prior claim now required to justify the purchase of a new line of coverage? If a doctor has never had a malpractice claim or event, does that mean the physician has no non-tax business purpose behind the purchase of malpractice insurance? The opinion could certainly be read that way.

Finally, in determining whether an insurance arrangement constitutes insurance, opinion requires the consideration of more than 'whether the premiums chosen can be arrived at by actuarial means'. This is particularly confusing. Wouldn't the certification of premiums by a licensed actuary be demonstration of the arm's length nature of the premium determinations?

Takeaways for captive insurance companies

Here are two key points captives should take away from the Reserve Mechanical decision:

- It is imperative that feasibility studies appropriately document the actual need for additional coverages being purchased
- Captive owners need to do appropriate due diligence on their captive service providers and the programmes they offer, as well as the workings of the mechanics of the captive arrangements

Captive insurance companies remain a viable, valuable tool to help manage risk. However, it is crucial now more than ever to make sure they are being created and managed properly. **CIT**

Kerr on the side of caution

Eric Lark of Kerr Russell discusses group captives, what they offer and their best practices, emphasising the importance of members educating themselves on all aspects of captives

Ned Holmes reports

Can you outline your role and responsibilities Kerr Russell?

I am a senior partner here at Kerr Russell, having joined the firm out of law school in 1991. I work in the captive insurance and corporate law practice areas. I have been working with captives and other alternative risk structures for the last 20 years.

In my role, I work directly with captive clients, which encompass all types of captives across a number of different operational industries. I am also supported by an outstanding team of captive attorneys, with the collective aim of providing exceptional and cost-effective legal advice and service to our captive clients.

How has 2018 been for Kerr Russell in the captive market?

This year has been exceptionally robust in the captive market, and our practice is stronger than ever. To mention just a few examples, I'm working on a new heterogeneous group captive that will be domiciled out of the Cayman Islands; I am also working on a Hawaii-domiciled captive for a large healthcare system. As a result, I will be attending the Hawaii Captive Insurance Association Conference for the first time in October. We have several other captives which we recently assisted in structuring and forming and still others that are in the planning stages.

Our mature captive clients continue to face issues as the industry constantly evolves. We are keen to help them successfully navigate industry-wide issues as well as the challenges unique to their particular situation. This year has thus far been very busy for us and we are grateful.

What do you think of the current state of the captive market?

I think overall the market remains strong. It is an interesting time, I must admit. Captives increasingly find themselves in the news for various reasons, most good, some bad. micro captives remain the subject of intense Internal Revenue Service (IRS) scrutiny, which has negatively impacted that area. However, 831(b) captives that are set up for legitimate insurance reasons remain a very compelling option, especially given the increase in the qualifying premium threshold. With the recent 'Avrahami and Reserve Mechanical' Tax Court decisions, the IRS is on a bit of a roll and, among other issues, pooling arrangements have come under attack.

However, in both of these cases, some disadvantageous facts proved easy targets for the IRS. What I take from the decisions is that properly structured captive arrangements, including those that incorporate proper pooling arrangements, are readily distinguishable and should continue to withstand scrutiny.

On the whole, I believe the captive space remains strong for a number of reasons, some of which include: overall increased awareness of captives; the rising number of companies becoming frustrated with volatile pricing in their industry; the growth in the number of legitimate domiciles—especially in the US; the advent of innovative coverages in an increasingly complicated world; and the continued availability of traditional reinsurance which allows fronted programmes to remain competitive.

The captive industry is ever-evolving, which makes it exciting. It continues to flourish because intelligent organisations will always seek to better control their risks and insurance dollars through alternatives to the traditional insurance market.

There is a new generation of professionals entering the industry, energised and bringing new ideas. While the captive industry continues to face a myriad of challenges, it remains very rewarding for a great deal of companies.

What do group captives offer?

Group captives come in many shapes, structures and sizes, but essentially they allow companies that may not be large enough (from an insurance dollar standpoint) to form their own (single-parent) captive to nevertheless participate in a captive programme and enjoy its benefits. If they have a positive loss profile, they should be able to lower and stabilise their overall insurance costs as opposed to being priced with their industry in a volatile market.

Another, perhaps less obvious, benefit for companies participating in group captives is that such companies typically become much better from a safety, risk control and claims handling standpoint.

What I have seen from my 20 years working with group captives is a heightened focus on safety, risk management and claims. There are a few reasons for this. First, the group captive members are working with their own dollars rather than insurance company dollars. Second, they're accountable to the other group captive members, with whom they are sharing risk. If you're causing a lot of risk sharing, the semi-annual meetings might be a bit uncomfortable.

> Group captives are ideally suited for companies that operate in industries with inherently difficult risk profiles, leading to volatile and high pricing in the traditional insurance market. The best candidates are the companies in those industries that are best-in-class from a safety standpoint, but are nevertheless still priced with the industry

Additionally, companies see the direct impact of their risk and claims management efforts on their bottom line and benefit from an increased awareness of risk management and loss control best practices. Participants are able to learn what other quality, best-in-class companies are doing. There is an exchange of risk mitigation ideas, especially in the homogenous group captive setting, which benefits the collective membership.

Finally, group captive participants are able to share operational best practices as well.

Who are group captives best suited for?

Group captives are ideally suited for companies that operate in industries with inherently difficult risk profiles, leading to volatile and high pricing in the traditional insurance market. The best candidates are the companies in those industries that are best-in-class from a safety standpoint, but are nevertheless still priced with the industry.

Some industry examples include trucking, construction and manufacturing. Homogenous group captives have responded to the need for these types of companies to look at alternative insurance structures.

Additionally, any company that spends significant insurance dollars and that has made risk reduction, safety, and aggressive claims handling a priority will benefit from the group captive model. Likewise, companies that haven't acted yet but have a desire to take control of their risk management costs and make themselves safer will always be good candidates. Indeed, companies looking to leverage safety as a market differentiator will always benefit from the group captive structure.

What are some of the best practices for group captives?

Oh, where do I start? A successful group captive should be completely transparent and able to withstand the most intense scrutiny. The members need to fully understand the captive structure and its risks, the money flow, the costs and coverages, the service provider roles and compensation dynamics, and exit strategy.

All of this and more needs to be fully transparent and explained to the members up front and in writing. Members need to feel free to challenge things that don't make sense and not just drink the 'Kool-Aid.' While complete unbundling of the captive services provided by third parties would appear optimal, this is not always practical and there are certain economies to be enjoyed with some bundling of services, so long as there remains complete transparency and member awareness of the potential conflicts and disadvantages to bundling.

Additionally, the group captive needs to be run properly, with regular meetings, appropriate checks and balances, proper corporate governance and internal controls, a detailed risk management framework, vigorous committees, written protocols and procedures and significant member involvement, all in an effort to avoid problems and surprises from a financial or risk management perspective. Members need to educate themselves concerning all aspects of the captive. **CIT**


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Staying true to form

Bermuda has always been at the forefront of innovation in the insurance industry, Stephanie Sanderson of Beesmont explains how the Island is continuing that tradition with its latest developments in insurtech

Bermuda's insurance history is an extremely rich one. The captive insurance sector, which was once thought radical, was developed in Bermuda in the 1960s and 1970s and established Bermuda's bourgeoning international insurance industry. The 1980s saw Bermuda develop excess liability insurance and the 1990s saw increasing catastrophe reinsurance being established. More recently we have seen the insurance-linked securities (ILS) sector develop and prosper in the jurisdiction, making Bermuda a global leader in the market. Today, Bermuda has both the largest ILS and captive sectors in the world and has one of the world's largest reinsurance sectors.

Behind the history of Bermuda's insurance industry are innovation—a willingness to lead and develop new products—and a sophisticated and well-respected regulatory framework. Bermuda's latest innovative move is its development of an insurtech regulatory regime.

The use of technology to create greater efficiency in the current insurance industry models is being monitored by insurance leaders the world over. Just as the fintech industry is shaking up the traditional banking and financial services industry, insurtech is challenging incumbents in the insurance industry. Innovation by its very nature flies in the face of convention and demands forward thinking, and we see insurtech develop more rapidly than before. According to online statistics, market research and business intelligence portal, Statista, the value of capital invested in insurtech companies has been substantially rising for the past five years.

The Bermuda Monetary Authority (BMA) recently stated that it recognises the growing importance of disruptive innovation in the insurance and wider financial industry, and the critical role that innovation plays in promoting efficiency and enhancing competitiveness in the market. In recognition of this, the BMA announced that it would be launching two parallel innovation tracks: an insurance regulatory sandbox and an innovation hub, both targeted at insurtech.

Insurance sandbox

The insurance regulatory sandbox is aimed at companies that are looking to be subsequently licensed as insurance entities under Section 4 (Regular Insurers) or Section 10 (Insurance Intermediaries) of the Insurance Act of 1978. The sandbox will allow companies to test new technologies and offer innovative products, services, and delivery mechanisms to a limited number of policyholders or other clients in a controlled environment and for a limited period.

A company interested in taking advantage of the sandbox will need to apply to the BMA. Start-ups are ideal candidates, although existing insurance companies can also apply. Examples of the types of insurtech solutions that the sandbox can benefit include providing parametric insurance coverage to clients using a smart contract platform or another form of self-executing technology, making use of blockchain solutions to provide insurance products, or development of smart contract platforms to manage multiple policies.

To qualify for the sandbox, the proposed product, service, or business model should be new or use existing technology differently. Further, the company should have conducted research and due diligence on the proposed product or service, understand the applicable regulations and have the appropriate risk mitigation plans in place. A business plan will need to be provided to the BMA.

Once the BMA has assessed a company's proposal, it will determine the legislative and regulatory requirements that would be modified for the duration of the sandbox testing period. It is important to note that the sandbox will have appropriate safeguards to protect the policyholders and counterparties of companies that participate in sandbox testing. Once approved by the BMA, a company will be assigned a temporary sandbox license in accordance with its business model and a list of companies approved to operate in the sandbox will be published on the BMA's website for transparency.

The proof-of-concept phase typically lasts between six and 12 months and the company must carry out proof-of-concept based on agreed-upon parameters and conditions that were set during the BMA's review stage. Once the proof-of-concept phase has been completed, a final report must be submitted to the BMA outlining the outcome of the testing.

Upon the successful end of the sandbox testing period the company will exit the sandbox, be re-licensed to an existing class—Class 1, 2, 3, 3A, 3B or 4 if a general business insurer, Class A, B, C, D or E if a long-term insurer, special purpose insurer, insurance manager, broker, agent, or salesman—and be fully subject to the applicable legal and regulatory requirements.

The sandbox increases efficiency by reducing the amount of time and expense it takes for innovative products, services, and delivery mechanisms to reach the market as well as eliminating or reducing the cost of regulatory uncertainty for start-ups.

The innovation hub

Apart from insurtech companies that would qualify for use of the sandbox, the BMA has also indicated that it is keen to promote broader dialogue on innovative insurance solutions with all market participants, including those conducting activities that are not directly regulated by the BMA. To that extent, the BMA has proposed the implementation of an 'innovation hub'.

The BMA has created a working group–the BMA insurance innovation working group (IWG)—that acts as a platform for exchanging ideas and information.

The innovation hub can be used by companies that will eventually apply for entry into the sandbox when the concept is sufficiently developed.

For example, a company may engage with the innovation hub where it is still developing its thoughts and ideas and is not yet prepared for proof of concept which is required under the sandbox.

It is expected that the sandbox and innovation hub will in future, be expanded to include fintech start-ups more broadly and, specifically, digital asset business, which is also being developed in Bermuda.

The BMA expects to use experiences through the sandbox and the innovation hub to ensure Bermuda's regulatory regimes continue to be modernised and keep up with the pace of innovative technologies.

Although insurtech is a disruption of the market, it is also a natural progression of the insurance industry in today's digital world. Kathleen Reardon, CEO of Hamilton Re, put it well when she said: "In a decade, our venerable, well-established carriers with legacy systems and cultures—if they manage to survive—will be anachronistic."

Bermuda is yet again demonstrating it is a world leader in innovative insurance products and services with the implementation of its insurtech framework. **CIT**

" It is expected that the sandbox and innovation hub will in future, be expanded to include fintech start-ups more broadly and, specifically, digital asset business "

Stephanie Sanderson, partner, Beesmont Law

An all-star cast

The fifth edition of the ICRMC takes place in Bermuda in December, Nancy Miller of MSA Research, explains that the calibre of the agenda and seniority of the speakers is what sets it apart

Ned Holmes reports

After four years in Canada, the International Cyber Risk Management Conference (ICRMC) is launching a Bermuda-based event in December.

The event, which is partnered with the Bermuda Development Authority (BDA), will be centred around the theme of 'insurance approaches to cyber risk management' and includes an all-star cast of cyber risk professionals.

Captive Insurance Times spoke to Nancy Miller, executive vice president and COO of MSA Research, about the reasoning behind the new event and why the industry should be excited for it.

Who are MSA research and what do you do?

MSA Research is a Canadian-owned, independent and impartial analytical research firm that is focused on the Canadian insurance industry. MSA is the dominant provider of financial information relating to Canadian insurers, with 90 percent of Canadian industry using our reports and software.

MSA's mission is to provide Canada's insurance professionals with comprehensive financial information, unparalleled analytical tools and rigorous research on a consistent basis.

Given its central role in the insurance industry, MSA also produces several world class events including, the National Insurance Conference of Canada (NICC) and the ICRMC.

Why did you decide to hold the conference in Bermuda this year?

The fifth edition of the ICRMC will take place at the Hamilton Princess in Bermuda on the 6 and 7 of December this year. We were invited to bring this premier event to the island at the request of the Bermuda government via the BDA. We have been consistently impressed with the engagement of the industry leaders of Bermuda and we are looking forward to showcasing an international set cyber security and insurance experts from Bermuda and around the world.

How is the conference unique?

What sets the ICRMC apart is the calibre of the agenda, the seniority of the speakers, and opportunity for rich networking and learning. As producers of the event, we are not selling cyber products or services. Our product is the event itself and we pride ourselves on delivering a rewarding experience.

How much focus will there be on risk management and captive insurance?

With Bermuda being the 'world's risk capital' and a centre of excellence for captives, the ICRMC in December tilts heavily towards insurance and risk transfer but it goes far beyond that. Captive owners and risk managers are more than mere insurance buyers.

They are risk experts managing complex organisational needs and cyber risk is an unparalleled challenge. The ICRMC has risk management at its core and is designed to address the breadth of the threat landscape.

What are you most excited about ahead of the conference?

Thanks to the reputation of the ICRMC and an exceptional steering committee, we have an embarrassment of riches with respect to the speakers. We are thrilled with the rock-star talent of our CISO session, global cyber leaders from Deloitte, XL Catlin, AIG, Chubb, Aon, Willis, Marsh, FS-ISAC, and FireEye. The perspectives of senior government speakers from the US and Bermuda will add a richness to the conversation given the current international environment of sophisticated state-sponsored cyber-attacks.

Do you think staying on the cutting edge of Cyber is important for the captive industry?

Yes of course, in its latest Global Risks Report, the World Economic Forum ranked cyber-attacks second only to natural catastrophes to the global business community and government. The captive industry is on the front lines of risk management and deals with cyber 24/7. It is no coincidence that the ICRMC's tagline is 'because cyber risk is everyone's business'. **CIT**

> "The perspectives of senior government speakers from the US and Bermuda will add a richness to the conversation given the current international environment of sophisticated state-sponsored cyber-attacks"

Nancy Miller, executive vice president and COO, MSA Research

Comings and goings at CFSIC, Beecher Carlson, Global Captive Management and more

The board of Connecticut Foundation Solutions Indemnity Company (CFSIC) has been chosen by the captive's incorporators.

CFSIC is a non-profit captive set up to distribute remediation funds to assist homeowners impacted by the 'crumbling foundations' issue.

The nine-person all-volunteer board was selected in accordance with the enabling legislation.

The board will include Lyle Wray, executive director of the Capitol Region Council of Governments; Donald Poulin, an affected homeowner from Manchester; Mark McDonnell, an investment manager from Stamford; John Filchak, executive director of the Northeast Connecticut Council of Governments; and Bruce Kellogg, an affected homeowner from Vernon.

Additionally, it will include a number of industry representatives, including John Rachek, an insurance industry executive; Kevin Smith, representing the banking industry; Dan Keune, representing the real estate industry, and Steven Werbner representing the municipal government.

The board will also comprise of four non-voting members, Connecticut representatives Jeff Currey and Kurt Vail, and senators Cathy Osten and Tony Guglielmo.

Michael Maglaras, principal of Michael Maglaras & Company, whose firm is acting as CFSIC's superintendent, said he was delighted about the group of citizens that the incorporators had chosen to lead the captive.

He explained: "Each person on this board brings knowledge, perspective, and fiduciary ability to the crumbling foundations natural disaster with the naming of this board, great progress will now be made in serving affected Connecticut homeowners."

Michael Maglaras & Company will be meeting with the Connecticut Insurance Department soon to update regulators on the captive's business plan and the rollout of its operations.

Maglaras added: "Once this captive is launched and is operational, it appears clear to me and many that, regarding ultimate claim liabilities, this will become the largest captive formation in the history of the captive movement."

"The insurance company will be launched and operational in November. We're on target and on schedule."

Beecher Carlson Insurance has added Clayton Price as general manager of its captive practice.

Price, who has more than 37 years in the industry, will be responsible for the development and leadership of the captive practice in Cayman Islands.

Additionally, he will direct sales strategy and guide the company's clients in effectively using their captives and captive assets. Price leaves his previous role in the captive management operations at a large broker firm in Cayman. The addition of Price, who will report to captive practice leader Jason Flaxbeard, is part of the expansion of Beecher Carlson's captive practice.


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Flaxbeard commented: “We are thrilled to welcome Clayton Price to the captive practice.”

“His expertise make him an invaluable asset to our organisation and to our clients.”

Global Captive Management (GCM) has made three new additions to its senior management team: Ian Bridges, Jennifer Reid and Alanna Trundle.

Bridges and Reid have been promoted to senior vice president, while Trundle has been made vice president.

A driving force in group captives, Reid is one of GCM’s longest standing employees having been at the company for 15 years.

Prior to GCM, Reid, who concurrently serves as the secretary of the Insurance Managers Association of Cayman (IMAC), spent eight years at KPMG. Bridges is responsible for the company’s operations in South Carolina and New Jersey and is also heavily involved in business development.

In addition to his 16 years of experience in the captive industry, Bridges US tax expertise has been vital to helping GCM successfully navigate the ever-evolving tax landscape for clients.

Trundle is adept in multiple aspects of the captive management industry, such as managing large segregated portfolio companies and groups, public companies, and not-for-profit owned captives.

In addition to managing some of GCM’s most important clients, Trundle sits on IMAC’s Forum Committee.

Peter MacKay, GCM CEO and chairman, said all three additions were talented and keenly dedicated and represented a combined 40 years of captive experience.

MacKay commented: “The promotion of both Jennifer Reid and Ian Bridges to senior vice president is merited on their personal accomplishments.”

“Together with Monique MacDonald, senior vice president, they are key to the ongoing and future management of the company as we prepare to head into yet another new decade in the industry.”

He added: “GCM is also excited to add Alanna Trundle to its management group. She has spent her entire captive career with GCM, joining the company in 2010.”

“GCM was quick to recognise her outstanding ability and her promotions throughout her time at GCM are a testament to her value to our clients and GCM.”

“It is without question our management team continues to have all the key elements to grow and adapt in the evolving captive insurance industry.”

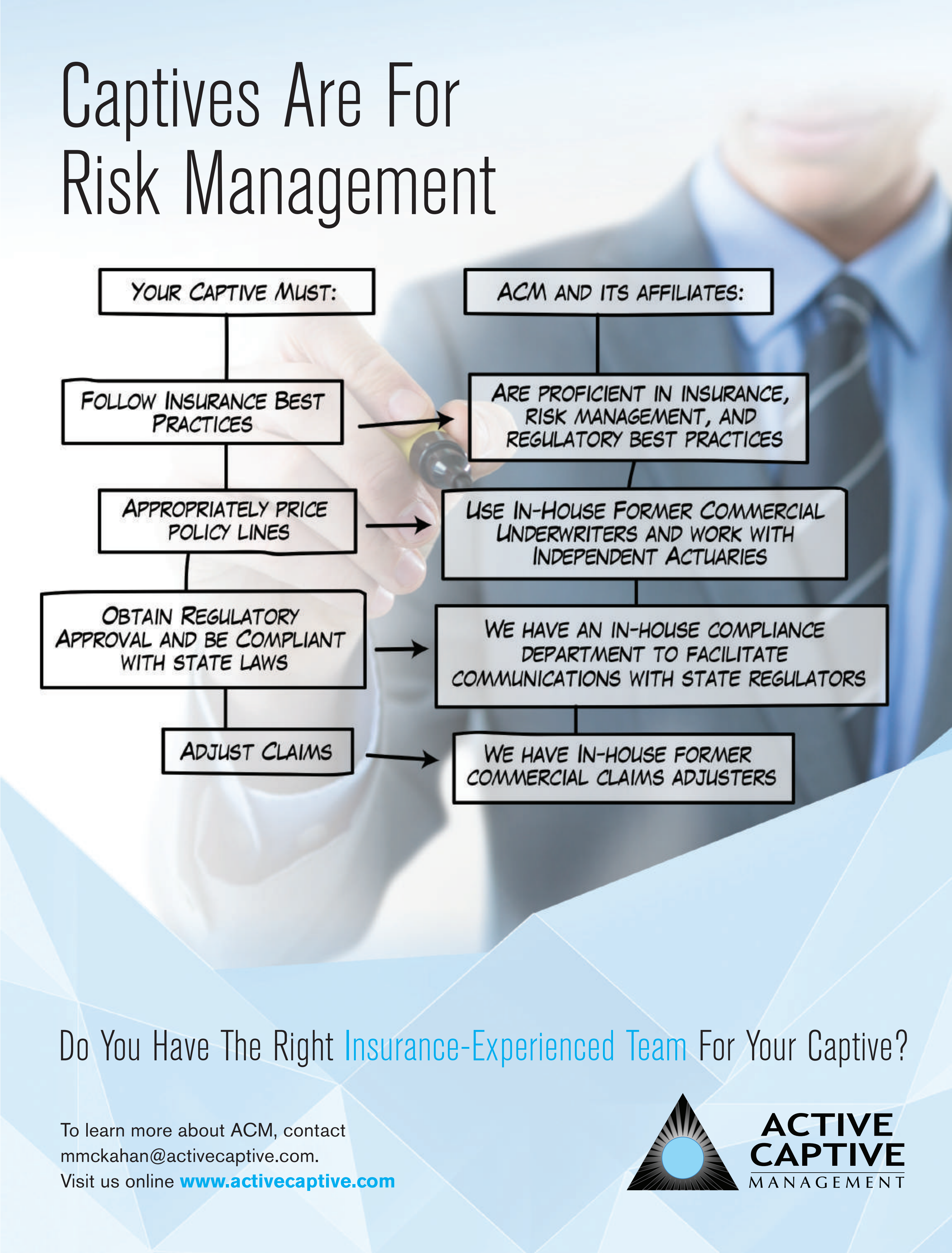
Willis Towers Watson has appointed Ian Podmore as its US head of captive underwriting.

Podmore, who joined Willis on 25 June, most recently held the role of senior vice president at Atlas Insurance Management.

Based in Charlotte, North Carolina, Podmore concurrently serves as president of consulting, captive insurance, reinsurance and alternative insurance markets.

A global insurance veteran with more than 30 years experience, Podmore began his career at Ecclesiastical Insurance Group.

He has since worked for Marsh in both Bermuda and Vermont and was senior vice president and chief underwriter for both Bank of America and AmTrust Specialty Programme Group. **CIT**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