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Bermuda’s Solvency II equivalence plans are on-track

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The Bermuda Monetary Authority (BMA) is confident that Bermuda will be successful in its bid to win equivalence with Europe’s Solvency II Directive while securing exemptions for its captive insurance companies following high-level talks with officials in Brussels.

Solvency II will introduce enhanced capital and corporate governance requirements for the insurance industry in Europe. Non-European domiciles can achieve an equivalency status.

BMA CEO Jeremy Cox has previously said that the BMA’s desire to meet regulation deadlines is not matched by other domiciles, such as Guernsey or the Cayman Islands, leaving Bermuda in a front-running position.

“We have some mischief makers out there—some competitor jurisdictions—that wish people to believe that Bermuda is following a path that will destroy its captive sector. The reasons are obvious why one would do that, but we’re certainly not planning on doing that.”

Of the talks in Brussels, Cox said that he was pleased. “I came away from the meetings with a renewed level of confidence. It is clear that we are on the right track, both in terms of achieving equivalence for our commercial insurers and reinsurers and in terms of securing the promised exemptions for Bermuda’s captive or limited purpose insurers.”

Cox added that the meetings, which were arranged in collaboration with the Bermuda government and the Association of Bermuda Insurers and Reinsurers, provided further proof that the strong relationships that have been developed with the European Commission, EIOPA and members of the European Parliament, have helped to pave the way for the current dialogue to take place.

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CIT IN BRIEF

Qatar finance centre signs insurance agreement with IAIS

The Qatar Financial Centre Regulatory Authority has signed an information exchange agreement with the International Association of Insurance Supervisors (IAIS).

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Willis licensed for Guernsey

Willis has been issued with a full commercial lines licence to conduct insurance intermediary services in Guernsey under the Insurance Managers and Insurance Intermediaries Bailiwick of Guernsey Law, 2002.

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Bermuda's Solvency II equivalence plans are on-track

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Shanna Lespere, the BMA's new director of international affairs, who also attended the talks, said that she was impressed with the way that officials in Brussels are treating Bermuda fairly.

Lespere added: "We are not yet over the finish line so I think our continuation of a strong advocacy programme remains a critical support element to achieving our goals in Europe."

Group supervision, the merits of full equivalence, transitional equivalence and delays in Solvency II implementation were also discussed in the meetings in Brussels.

Bermuda's equivalency news came before reports that the planned implementation deadline for Solvency II in 2014 could be delayed after talks between EU officials 'stalled' in mid-July.

Talks between officials representing the 'trilogue' of the European Commission, Parliament and Council on Solvency II were held on 12 July.

The trilogue met to thrash out the final text for Solvency II, but a reported breakdown in talks means that there would be no agreement until after the European Parliament returns from its summer recess.

A spokesperson for the European Council said that the European Commission submitted a proposal on 16 May to change the transposition dates for Solvency II, which has received European Parliament and Council approval.

"The last trilogue...was held on July 12. No further trilogues have yet been scheduled. But they are expected to continue after the summer recess. The main outstanding issue concerns long-term guarantees. The Parliament, the Council and the Commission have agreed that an impact assessment should be made, prior to developing implementing measures, to evaluate the impact of various provisions on long-term guarantee measures."

A spokesperson for the European Parliament added that it has penciled in its plenary session at the end of October as the point at which to adopt a negotiated deal between the European Council and the European Parliament.

"It is currently premature to speculate on the possibility of missing the 2014 deadline if only for the fact that negotiators will have the whole month of September and a part of October to work towards reaching a deal. With one pending issue—that of long term guarantees—this could be sufficient to reach an agreement."

In a telephone interview, Paul Clarke, a partner and the global Solvency II leader at PricewaterhouseCoopers, said: "Unless there is very rapid agreement, the prospect of having something that is voted on in October is pretty slim and therefore the rest of the timetable comes under extreme pressure. The outlook for January 2014 is not looking good."

"For most of the major players in the industry, and that probably includes some of the captives at least, delay is not welcome, as many of them have invested significantly in Solvency II programmes with a view to getting themselves into a position to start in January 2014," added Clarke.

In an emailed statement, a Bermuda Monetary Authority spokesperson said: "In common with other regulators with an interest in Solvency II developments, the Bermuda Monetary Authority is closely monitoring the situation in Brussels. Our ongoing regulatory enhancements for commercial insurers remain on track for completion in 2013, based on what the authority has deemed necessary for Bermuda's market. We also remain committed to maintaining Bermuda's practical, proportionate regime for captives as that work continues, and in the context of evolving international developments."

Qatar finance centre signs an insurance agreement with IAIS

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Michael Ryan, the CEO of the QFC Regulatory Authority, said: "We are very pleased to join with other insurance supervisors around the world in becoming a signatory to the MMoU [Multilateral Memorandum of Understanding]. With a growing number of international insurance firms continuing to establish in the Qatar Financial Centre, the MMoU will assist with their effective supervision through increased cooperation and exchange of supervisory information with our fellow MMoU signatories."

Peter Braumüller, the chair of the executive committee of the IAIS, said: "The MMoU is an essential regulatory tool—not only in crisis situations, but on a day-to-day basis —for supervisors to foster safer and more stable insurance markets, and the IAIS encourages each of its members to become a MMoU signatory."

The agreement will provide the QFC Regulatory Authority with a formal framework for the secure exchange of supervisory information with insurance supervisors around the world.

Willis licensed for Guernsey

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Willis is the only London-based insurance broker with both a Guernsey licence and a full-time local representative based in the Channel Islands dedicated to providing financial institution, professional indemnity and directors' and officers' liability (D&O) insurance solutions.

Willis is already licensed by the Guernsey Financial Services Commission (GFSC) to carry out captive insurance management services on the Bailiwick of Guernsey.

Roland Avery, chairman of Willis FINEX Global, said: "Guernsey is an important financial centre for many of our clients and therefore it is critical that

Willis is properly represented on the island. The fact that we are fully licensed by the GFSC and the presence of our full time local representative both demonstrate that Willis is committed to Guernsey and to supporting our clients wherever they are."

James Baird, a Willis executive director of FINEX National and the Channel Islands practice leader, said that a number of his clients are conduits for facilitating insurance for other regulated entities, adding: "They can say with confidence that by using Willis to facilitate their clients' insurance requirements they are engaging with an organisation which is fully licensed by the GFSC. We hope that this provides additional comfort to them, their clients and any other entity that interacts with Willis."

Nick Bachmann, Willis business development executive, FINEX National, commented: "We know it is important to have a local representative from a regulatory perspective, but it is equally important from a local relationship-building perspective. Most of our clients have mentioned how important it is for them to have someone on the island with whom they can meet regularly, and face-to-face as opposed to over the phone."

Guernsey attracts international insurance business

Guernsey licensed 52 international insurance entities in the first five months of 2012.

Figures from the Guernsey Financial Services Commission (GFSC) show that 739 international insurance entities had licences at the end of May 2012—there were 687 at the end of December 2011.

According to the figures, 63 new licences were issued and 11 were surrendered, representing net growth of 52 entities domiciled on the island.

As of 31 May 2012, there were 344 international insurers in Guernsey: 254 companies, 68 Protected Cell Companies (PCCs), 5 Incorporated Cell Companies (ICCs) and 17 ICC cells, as well as 395 PCC cells.

Fiona Le Poidevin, the chief executive of Guernsey Finance, said: "Figures from the GFSC showed that the number of new licences being issued really accelerated as we moved through last year and I am delighted to see that this trend has continued during the early months of 2012."

"We are seeing new licences issued across the different types of structures available but there has been especially strong growth in the number of cell companies being formed. A significant proportion of these relate to a PCC managed by JLT on behalf of the NewBuy scheme and where there are even more licence applications in the pipeline but we are also hearing from the industry that there are a number of other opportunities coming through as well."

JLT Insurance Management has reported that, as of 2 July 2012, 45 cells were licensed under a PCC that it has established as part of the UK's NewBuy scheme.

The UK government, in conjunction with the Home Builders Federation (HBF) and the Council of Mortgage Lenders (CML), launched the NewBuy scheme in March.

The aim of NewBuy is to offer prospective home owners newly built properties with 95 percent mortgages that are underwritten by house builders and the UK government.

The HBF PCC in Guernsey provides insurance to lenders under NewBuy. It also acts as the conduit for the UK government's guarantee.

Nick Wild, the managing director of JLT Insurance Management in Guernsey, said: "We are delighted that JLT Insurance Management in Guernsey has been able to play a key role in the launch of the NewBuy scheme."

"We have broken new ground with many aspects in the design of this insurance coverage and the PCC structure. Guernsey PCC legislation has once again proved its flexibility and the GFSC has done a great job processing the large number of cell applications."

A.M. Best rates Agrinational Insurance Company

A.M. Best has affirmed the financial strength (FSR) and issuer credit (ICR) ratings of Vermont-based Agrinational Insurance Company as "A- (Excellent)" and "a-" respectively. It added that the outlook for both ratings is stable.

The ratings agency has also assigned an FSR of "A- (Excellent)" and an ICR of "a-" to ADM Insurance Company, which is based in Arizona. The outlook for both ratings is stable.

The ratings for Agrinational are based on its "excellent capitalisation level, overall favourable operating performance and its strategic role as a captive insurer of Archer Daniels Midland Company", said A.M Best.

"Partially offsetting these favourable rating factors is the high net retention on Agrinational's property exposures, which has produced some variability in operating results. Also, as a single parent captive, Agrinational is exposed to concentration risk since its primary source of business is from one company. Additionally, Agrinational provides insurance for a limited amount of quasi third-party business sourced through an industry pooling arrangement."

In 2010, Agrinational purchased all of the stock of Advanta Corporation, a dormant insurance shell. In 2011, the newly acquired company's name was changed to ADM Insurance Company and it began writing multiple peril crop insurance and crop/hail named peril crop insurance.

Agrinational has invested in the leasing of railcars and barges that are production assets of ADM as a means of diversifying its investment portfolio.

A.M. Best said: "Management considers these investments as long term and a better alignment of the company's capital structure while providing stability in cash flows and investment returns."

As Agrinational's subsidiary, Archer Daniels Midland Company is "rated with Agrinational due to its role and strategic importance to its ultimate parent, as demonstrated by the inter-company reinsurance arrangement between the affiliated members".

Upcoming webinar from A.M. Best

A.M. Best will present its annual 'State of the Captive Insurance Market' webinar on Wednesday, 1 August.

Registration for the event is free online at www.ambest.com.

Members of A.M. Best's rating division who specialise in the captive insurance industry will review a forthcoming A.M. Best report examining developments in premium volume, loss reserves and admitted assets for rated captive insurance organisations.

Panelists for this webinar include Steven Chirico and John Andre of A.M. Best.

Attendees can submit questions in advance during registration or via during the live event, which will be streamed in video and audio.

EIOPA plays host to US/EU meeting

Increased cooperation was the name of the game at the European Insurance and Occupational Pensions Authority's (EIOPA's) fourth meeting for the EU/US insurance dialogue project.

The meeting was intended to increase mutual understanding and cooperation with a view to identifying the main commonalities and differences of the EU and US insurance regulatory and supervisory regimes.

Chairman of EIOPA, Gabriel Bernardino, who hosted the meeting, said: "Financial systems in the EU and the US still have significant differences and some of these are dictated by cultural differences and legitimate political options."

"However, we believe it is the responsibility of public authorities to create conditions to foster consumer protection, facilitate business relationships and enhance the efficiency of supervision. We are certainly committed to these objectives."

Michael McRaith, the director of the US Federal Insurance Office, underlined Bernardino's statements: "The insurance dialogue between the

EU and US is critical to the promotion of trans-atlantic understanding and cooperation, and to the promotion of greater consistency and alignment in insurance regulation."

"We look forward to continuing our work with our EU counterparts and US state regulators for the benefit of insurance consumer protection and business opportunity in both jurisdictions."

In addition to Bernardino and McRaith, the meeting was attended by Edward Forshaw, a manager in the prudential policy division for the UK FSA, Charlotte Paterson, the internal market and services directorate general of the European Commission, Susan Voss, the Iowa Insurance Division's commissioner and the immediate past president of the US National Association of Insurance Commissioners (NAIC), and Terri Vaughan, NAIC's executive director.

The meeting focused on the progress in the analysis of the EU and US regulatory and supervisory systems. This analysis is related to several key areas: professional secrecy, group supervision, solvency and capital requirements, reinsurance and collateral requirements, supervisory reporting, data collection and analysis and transparency to the market, supervisory peer reviews, independent third-party review, and supervisory on/site exams/inspections.

The next meeting is scheduled for October 2012 and will take place in Washington, DC.

Insurance market firming, says Marsh

Rates in the global insurance market generally firmed in Q2 2012.

According to the Marsh Risk Management Global Insurance Index, the global insurance market has shown a clear trend of firming since Q3 2011.

The multiyear slide in liability insurance rates showed signs of moderating as general liability and professional liability insurance rates were typically stable at renewal in most major geographies.

Property insurance rates rose in the Q2 2012, as they were driven by unexpected adverse loss developments from the major catastrophes of 2011, increased focus by insurers on the data provided by insureds, a rise in attritional losses, and changes to insurers' calculations of their risk-adjusted cost of capital.

Property insurance rates for insureds with moderate to heavy catastrophe exposures climbed significantly in loss-affected regions. Insureds without such exposures generally saw rates stabilise.

Marsh also found that some insurers are responding to increasing concerns about cyber risks with product innovations, such as new protection for cloud computing.

Overall, insurers in the Q2 increased their levels of scrutiny of new and renewing business, leading to longer underwriting times. They placed greater emphasis on the quality of data provided, including details around large losses and overall loss trends in programmes.

Cayman Islands proposes new ICC legislation

A new bill from the Cayman Islands could amend the islands' insurance law to allow the registration of portfolio insurance companies, and to provide for incidental and connected purposes.

This would in turn allow insurers that are formed as segregated portfolio companies (SPCs) to reap the same benefits as incorporated cell companies (ICCs) in other jurisdictions.

"Government, with advice from the Financial

Charles Taylor

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Services Legislative Committee, is proposing a legislative model that is more robust in comparison with other jurisdictions, because it operates squarely within fundamental and well-understood principles of corporate law," said a statement from Cayman Islands Financial Services.

A new or existing SPC insurance company would be able to incorporate one or more of its segregated portfolios, or cells, by establishing a portfolio insurance company (PIC) under the cell.

The PIC would then conduct the relevant insurance business, instead of the cell. But, while regulated by the Cayman Islands Monetary Authority, the PIC would not need to be separately licensed as an insurance company. "Unlike a traditional segregated portfolio, or cell, the PIC would be a separate legal entity—ie, an exempted company limited by shares," said the statement.

It went on to outline particular advantages of a PIC, as compared with a cell of an SPC, namely; the ability to contract with other cells or PICs within the same SPC facilitates reinsurance, quota sharing and pooling.

It is expected that this model would be more efficient and cost-effective than introducing standalone incorporated cell company legislation. "When finalised, the modifications should increase the Cayman Islands's competitiveness, help contain the costs of doing business, and generate revenues through fees collected from PIC registrations, incorporations and annual returns," concluded the statement.

RRGs hold strong despite underwriting losses, says Demotech

Risk retention groups (RRGs) continue to exhibit financial stability, in spite of underwriting losses that were recorded in Q1 2012, said Demotech.

Demotech provides a consultancy service that offers analysis and benchmarking used by self-insureds, captives, risk retention groups and insurance companies.

It said that assets and policyholders surplus have continued to increase at a quicker rate than total liabilities. Since Q1 2008, short-term assets have increased 36.8 percent and total admitted assets have increased 29.5 percent.

"More importantly, policyholders surplus has increased 64.3 percent during this time, while total liabilities have only increased 13.5 percent," said a statement from the Ohio-based financial analysis firm.

Liquidity, as measured by liabilities to cash and invested assets, for Q1 2012, was approximately 76.2 percent. "A value less than 100 percent is considered favourable as it indicates that there was more than $1 of net liquid assets for each $1 of total liabilities. This also indicates an improvement for RRGs collectively over for first quarter 2011 as liquidity was reported at nearly 80 percent."

Leverage, as measured by total liabilities to policyholders surplus, for Q1 2012, was approximately 150 percent. This indicates an improvement for RRGs collectively over Q1 2011 as leverage was reported to be more than 161 percent.

The combined ratio, as measured by loss ratio plus expense ratio, for Q1 2012 was 88.1 percent. This indicates an improvement for RRGs collectively over Q1 2011, as the combined ratio was reported at 90.6 percent.

A $10 million net underwriting loss was reported by RRGs collectively for Q1 2012. However, RRGs did collectively report a $49.8 million net income for Q1 2012.

VCIA preview

CIT talks to Richard Smith of the Vermont Captive Insurance Association about advocacy, the regulatory hurdles facing captive insurers and the association's upcoming conference

MARK DUGDALE REPORTS

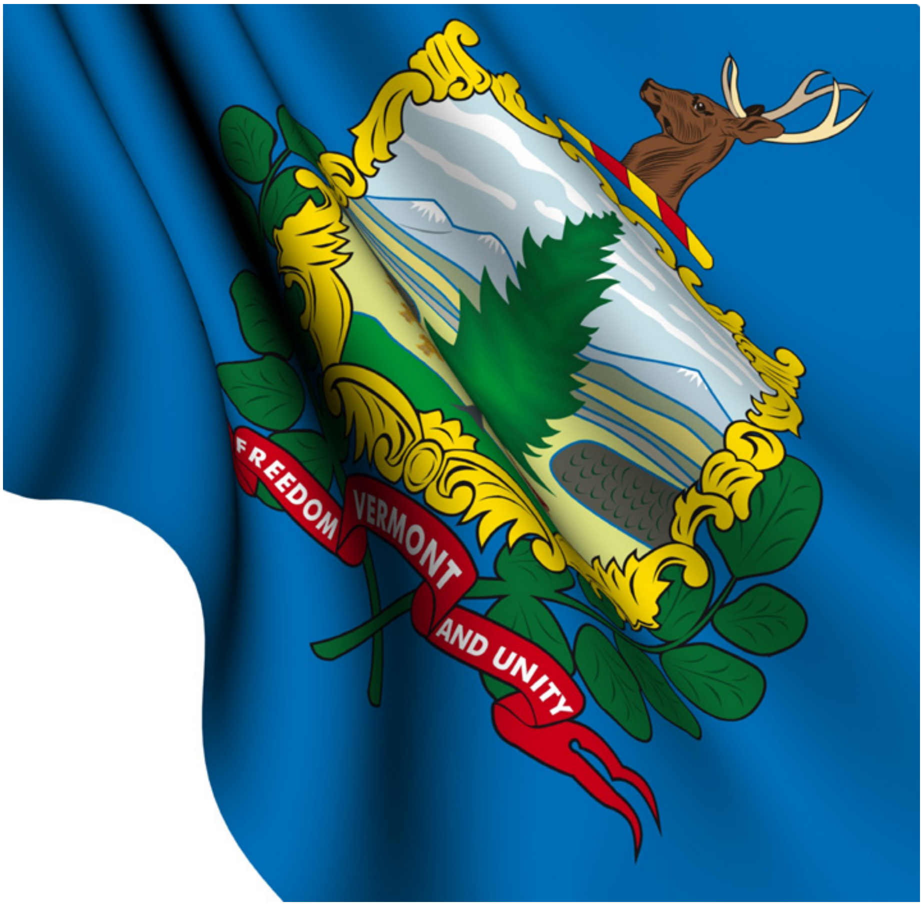
What has changed at VCIA since you took over as president in October 2009?

I think that the biggest change was the drastic turn in the world economy, which of course affected all manners of business. Somewhat surprisingly, the captive industry has remained robust, even during these difficult years, and I attribute this to forward thinking executives who see the long-term benefits of captives to their organisations. On the captive front, there has been an explosion of states passing captive laws, creating new domiciles in the US. I think that we are going to see some states do very well in this arena because they put resources into their regulatory frameworks, and we will also see others that lose interest and let their early inroads languish.

How has captive insurance in Vermont changed since you became president of VCIA?

The US State of Vermont continually builds on its past achievements in this ever changing industry. Just this year, Vermont expanded the criteria for eligibility for cell participants and added more options for minimum capital and surplus requirements by allowing the use of trusts.

One thing that has not changed in 30 years of captives being in Vermont is the state's commitment to the industry. From the governor, to the legislature, our congressional delegation, and our business leaders, Vermont's support of captives has never wavered. I think that the fact that there has been this stable, world-class policy and regulatory system for 30 years is a testament to Vermont's continued leadership in the industry.



What has VCIA been focusing on in 2012?

We continue to focus on bringing our members the services and advocacy that are needed to sustain and grow the captive industry. Much of our focus has shifted to Washington, DC, with the US Dodd-Frank Act and NAIC (the National Association of Insurance Commissioners) requiring more monitoring and leadership from VCIA. VCIA's advocacy efforts ensure that the voice and interests of its membership are accurately heard and represented to regulators, the judiciary, legislatures and the executive branch, at both state and federal levels. With more than 450 active member companies—many of which are well known and well respected industry leaders—VCIA is recognised and listened to during important regulatory and legislative discussions that affect our industry. Whether it is leading a coalition to prevent the IRS (the Inland Revenue Service) from promulgating injurious regulations, VCIA's support of the Risk Retention Modernization Act, successfully fighting the Neal Bill's taxation on reinsurance, or working to update Vermont's captive statutes, VCIA leads the way.

How is Vermont doing as a captive insurance domicile and how is VCIA contributing to this?

Vermont's legislature has passed new captive insurance legislation that has been signed into law by Vermont Governor Peter Shumlin. VCIA works very closely with the governor, the insurance commission and Vermont's general assembly in making sure that Vermont's captive law keeps pace with the needs of the industry. We survey our members before the legislative year to cull proposed changes to captive laws and then use our legislative committee to refine a package of changes to be introduced in the legislature. VCIA also contributes to the success of the domicile in other ways, including through our road shows, the annual conference and educational webinars. These things bring to light the benefits that our domicile has to offer potential captives.

First quarter licensure of new captive insurance companies is off to a strong start with eight new captive licences in 2012, according to data from the Vermont Department of Financial Regulation (formerly BISHCA). Twenty eleven was the 6th year in our history that Vermont surpassed 40 new captives and the first quarter of 2012 makes for the strongest start since 2005, and we are hoping for another robust year in 2012. Five of the newly licensed captives were pure, with one special purpose financial captive and two sponsored captives making up the balance. Some notable companies in the group of new licensees include Hormel Foods Corporation, ConocoPhillips Company and Deutsche Bank.

We like to say that there is a three-legged stool for captive insurance in Vermont: a great regulatory and policy team looking after the state, great captive service providers, and a great captive association. VCIA provides advocacy of behalf of our members at the state and national level, educational seminars, networking and marketing opportunities, and news and information. We coordinate with the state on our road shows where we continue to spread the word about captives in cities across the US. And, of course, we host the largest captive insurance conference in the US!

How do you see the regulatory landscape in the US at the moment?

The two areas of the regulatory landscape in the US that concern me the most at the moment are: the implementation of Dodd-Frank (specifically the Non-admitted and Reinsurance Reform Act, or NRRA), and NAIC's continued focus on the captive industry.

NRRA was intended to streamline the regulation and taxation of surplus lines insurance. However, some of the definitions in NRRA are so broad that questions have been raised about its effect on captive insurance. In a white paper that was sponsored by VCIA, Washington, DC, counsel Jim McIntyre of McIntyre & Lemon argues that NRRA was never intended to include captive insurance under the definition of "nonadmitted insurance". There have been many good minds in the captive legal community that have argued the relative legal complexities on whether NRRA applies or not, but the real question in my mind is what is NRRA's potential impact on the captive insurance industry.

There are two fundamental problems with captive insurance being included under NRRA. They are: (i) the disintegration of the robust regulation and expertise that strong domiciles provide; and (ii) the placement of non-admitted insurance will be subject to the statutory and regulatory requirements of the insured's home state only. With Florida becoming the newest state to pass a captive insurance law, there is greater competition and therefore greater choice for captive owners. This approach fails to appreciate the consequences of NRRA's application to any aspect of captive insurance, including the potential taxation of captive insurance premiums and regulation of captive insurance policies by a home state, and the potential sharing of independently procured insurance premium taxes. Moreover, the impact of the dissolution of longstanding expertise in captive domiciles' state regulatory departments and their established community of captive service providers will have serious consequences.

Over the past few decades, captive domiciles such as Vermont have methodically developed a level of expertise and sophistication to serve the captive insurance industry well, much in the same way that New York, London and Switzerland have developed as banking and financial services centers. Vermont and other captive domiciles—both onshore and offshore—grew and attracted individuals with a high level of experience and professionalism with respect to both service providers, and probably more importantly, the regulators of the industry. And domiciles have benefited greatly from the continued growth of the captive industry.

What NRRA does is create a false sense of more competition among domiciles. In fact, I believe that NRRA will have the opposite effect and is a false choice for captive owners. It may be easier for brokers to deal with self-procurement taxes under NRRA, but the potential disintegration of the expertise and resources for the captive industry to thrive hurts both the industry as a whole and the organisations that it serves. And if NRRA makes the placement of non-admitted insurance, including captives, subject to the statutory and regulatory requirements solely of the insured's home state, the whole framework of a strong captive insurance industry could be put at risk.

As for NAIC, it is more of a mixed bag. Over the past few years, NAIC has focused on the governance and capital adequacy of Risk Retention Groups (RRGs). The way that an RRG is different to a 'traditional' insurance company is that its policy holders are also the stockholders. In addition, most insurance companies are formed under state laws but RRGs are formed under federal laws, specifically the Liability Risk Retention Act of 1986. VCIA and the state of Vermont worked with other parties to make sure that NAIC's recommendations regarding RRGs were rational and not overly burdensome. I think that we were successful for the most part in this area.

More recently, NAIC formed the captive and SPV user subgroup to discuss the use of Special Purpose Vehicles (SPVs) by insurers. There was discussion among committee members to the effect that the subgroup provides an opportunity to have a more inclusive dialogue about captive insurers. One member stated that it was time for captives "to come out of the shadows and be examined thoroughly". There were other comments that indicated that some of the subgroup members would like to broaden the discussion from captives and SPVs that are established by insurers to include captives generally. However, Dave Provost of the Vermont Insurance Department, among others, weighed in and reminded the subgroup that its charge is to study the use of captives and SPVs that are established by insurance companies, not to look at all captives.

The subgroup is still in the fact finding stage and discussion has not yet advanced to what recommendations might be appropriate for its white paper. However, the comments above are an indication that captives are still not well understood by many in the traditional insurance regulatory world.

What about globally?

The economic downturn, especially the connection with the banking and financial services industries, has led more scrutiny of the insurance industry as a whole, even though it has remained very solid throughout the crisis. Solvency II, whenever it comes, is certainly an issue that many of our members will have to deal with, especially if they have offshore business. How the US insurance market and regulators manage Solvency II remains to be seen. My hope is that there will be recognition of the strength of our insurance regulatory regime ,and with that the EU and US will come to some agreement that will have as little disruption on captives as possible.

What do you expect to be the hot topic at the VCIA conference?

I think there will be a number of areas that will get the attention of attendees. One of the highlights of the afternoon sessions deals with a growing interest in how to include employee benefits in captive insurance companies. The session will include a discussion by both the risk manager and human resource director for YKK Zipper Company, which recently received approval for including employee benefits within its captive insurance company. Participants in this session will be provided with valuable how-to information from people who were able to break down the barriers between HR and risk management that existed within the corporation and successfully implement a captive strategy.

What NRRA does is create a false sense of more competition among domiciles. In fact, I believe that NRRA will have the opposite effect and is a false choice for captive owners

I also believe that the session on NRRA will get a great deal of attention, as well as a session on the top 10 risks and opportunities that are faced by captives and how they can be resolved. Another morning session will explore trends in investments and the all-important investment income that is derived from captive insurance companies. Additionally, there is a forum on healthcare reform that will be of interest to healthcare captive insurance companies. **CIT**

Richard Smith
President
Vermont Captive Insurance Association

No place like Oklahoma: developing a domicile

CIT talks to John Doak and Owen Laughlin of the Oklahoma Insurance Department after the state recently amended its captive insurance legislation

MARK DUGDALE REPORTS

The US State of Oklahoma has been a captive insurance domicile since 2004, and has worked to develop its offering so that the state can reap the benefits of a local captive insurance industry. It is the Oklahoma Insurance Department's job to enforce Oklahoma's insurance-related laws and provide consumers with accurate, timely and informative insurance information. It is also tasked with promoting a competitive marketplace in Oklahoma—a trying task considering states such as Vermont's investment in the industry.

The Oklahoma Insurance Department's commissioner and deputy commissioner have a mixture of insurance and legal experience that makes them well suited to contributing to the development of Oklahoma as an attractive destination for captives. The insurance department's head is commissioner John Doak. He took up the role at the beginning of 2011, having previously worked in the executive level of the insurance industry at firms such as Marsh, Aon Risk Services, HNI Risk Services and Ascension Insurance. The insurance department's deputy commissioner, Owen Laughlin, has practised law, worked in the banking business for 20 years and worked as an assistant district attorney. CIT talks to them about what Oklahoma is doing to attract more captives to the state.

How has captive insurance grown in importance to US and international companies over the last few years?

John Doak: Captives have grown rapidly worldwide, and especially in the US, because they have provided an alternative risk management tool for especially hard-to-insure or expensive risks. Many businesses have managed to stay viable by availing themselves of captives when other alternatives were unworkable.

Why did Oklahoma decide to allow captives in 2004?

Doak: It was thought that Oklahoma companies needed alternatives to manage their insurance needs, and that captives provide another option. In the last 10 years, Oklahoma has enhanced its efforts to become business friendly, reduce the cost of doing business and encourage expansion and new investment. The passage of the right-to-work law in 2001 is another example of a continuing effort by the Oklahoma legislature to build a great place to do business.

How has Oklahoma's insurance department worked to develop Oklahoma as a viable US captive domicile?

Owen Laughlin: The Oklahoma Insurance Department has only recently begun to develop the captive market in Oklahoma. Revising the statute was the first step. We are in the process of developing the in-house expertise to effectively handle captive applications. Commissioner John Doak has made the timely and business-friendly processing of captive applications a priority.

What are the advantages and disadvantages of Oklahoma's captive legislation, and what was the effect of the legislation's implementation?

Laughlin: The Oklahoma captive legislation specifically tracks the language that is found in other US states that have successfully attracted captives, most notably South Carolina.

The major difference was corrected by reducing the cap on the premium tax to $100,000. This brings Oklahoma law into compliance with other captive states.

What is the aim of the $100,000 premium tax cap?

Doak: The $100,000 premium tax cap is designed to place Oklahoma onto a level playing field with other captive-friendly states. Since Oklahoma is now receiving very little premium tax from captives, any increase will be an improvement and a benefit to state revenue.

What are your projections for how the tax cap will affect new captive formations in Oklahoma?

Doak: We have had numerous inquires since the passage of the new legislation. One significant new captive has been formed in Oklahoma and we have been informed that others are in the works. It is too early to gauge the long-term outlook, but we are optimistic that others will follow.

What sort of legislative environment is Oklahoma hoping to create for captives?

Doak: The Oklahoma legislature has worked very hard to build a business-friendly state in which to do business, and is committed to doing more. The captive legislation, and especially the amendments that were passed this year, is an effort to give businesses viable options when doing business here.

What about the service providers in Oklahoma?

Laughlin: There are some very experienced service providers located in Oklahoma that have routinely formed captives in other states, primarily because Oklahoma did not have a cap on premium tax, and because the Oklahoma Insurance Department was not a particularly friendly place to do business. Commissioner John Doak and his leadership team have many years experience in the private sector, and they are serious about making the department astute in captive formation and business friendly in general.

How will the Non-admitted and Reinsurance Reform Act (NRRA) affect new captive formations in states such as Oklahoma?

Laughlin: We believe that the jury is still out on NRRA and its application across the board. We are very opposed to the ceding of regulatory authority to the federal government.

What about other regulatory initiatives?

Doak: We are very opposed to federal intervention into the insurance market. State regulation of insurance has served the public and the insurance industry very well for decades, and there is no compelling need to change the regulatory framework now. The obvious result would be more cost to consumers and fewer insurance products from which to choose. CIT

John Doak
Commissioner
Oklahoma Insurance Department

Owen Laughlin
Deputy commissioner
Oklahoma Insurance Department

When the taxman comes around

If the end is nigh, what does 'Taxmageddon' mean for US captive owners? Gary Osborne of USA Risk Group explores the possibilities

A combination of mandatory spending cuts and tax increases could bring the US economy to its knees at the end of 2012. If US Congress and the president fail to act before then, significant fiscal events will automatically be triggered under current law. Together, these events create a 'perfect storm' that could push the already struggling American economy back into recession. Federal Reserve Chair Ben Bernanke dubbed it a "fiscal cliff". The popular name is 'Taxmageddon', referring to the expiration of the Bush tax cuts and the mandatory spending cuts caused by the failure of US Congress to agree on discretionary spending reductions.

In our niche world of alternative risk and captive insurance companies, the consequences will certainly, at least, be a restrainer on formations. Secondly, it will create more consideration of strategies to avoid the double tax impact of corporate tax and dividends and force consideration of ways to turn tax treatment towards capital gains or even the single level of a controlled foreign corporation.

The tax changes that will most effect the captive world would be the dividend rate reverting to the same rate as individual tax rates, and the possible increase in the long-term capital gains tax to 20 percent, from the current 15 percent. When you also consider the additional taxes on the wealthy from the Affordable Care Act, the top individual rate could jump from 35 percent to 43.4 percent and dividends could jump from the current 15 percent to 43.4 percent. Add on state taxes, and the overall tax rate nears 50 percent! Let's try to examine some strategies to minimise these possible changes:

(1) Premium holiday

The concept of premium holidays has been around for a while, mostly in the group captive and risk retention group space, and it was considered to be more effective as a 'handcuff' on members. The premium holiday was given to members who were part of a profitable mature year as a reduction to their renewal premium. If you were no longer buying your coverage, any and all premium holiday benefits would be lost. How would this work under the contemplated higher taxes? Assume the policyholder pays a premium of $1 million and receives a stock dividend of $300,000 (let's further assume a dividend tax rate of 39.6 percent). We compare that to a $1 million premium payment and a 30 percent premium holiday:

Cash outlay: $1,000,000 premium

Less dividend received: $181,200
($300,000 *0.604)
= $818,800

Cash outlay—premium holiday: $700,000

Difference: $118,800

(2) Capital gains

As is often the case with federal tax policy, the possible tripling of the dividend rate will make capital gains at 20 percent far more appealing, and some transactions will be structured to shift from dividends to capital gains.

In the captive world, this may mean a greater utilisation of cells, as converting net income into a capital gain will probably require the actual sale of a captive to a willing party (the dividend received deduction will make this unnecessary for corporately owned captives but for LLCs and individuals this will be an important consideration).

Cells can be formed quickly and with less cost than standalone captives and, if owners would like to receive funds on a reasonably frequent basis (say every two years), the 19.6 percent to 23.6 percent difference between dividends and capital gains will mean that the cell company sponsors could 'buy' the cell and release funds to the owners as a capital gain. Assuming there is a fairly minor transactional expense (risk fee plus new cell formation expense), there would probably be at least a 15 percent tax reduction. This can also be done with a standalone captive, but the formation expense for this is probably $20,000 to $30,000, while a cell will likely be less than $5,000.

(3) Controlled foreign corporation

A US shareholder of a controlled foreign corporation (CFC) has to include its share of subpart F income of a CFC in its income. Subpart F income includes insurance and investment income that are related to risks that are outside of the CFC's country of incorporation.

There has been interest in the use of CFCs even before the possible tax changes event. All insurance companies in the US (with the exception of non-profit captives and, to some extent, reciprocals) are taxed as "C" corporations and so pay corporate tax and have the double taxation of dividends on distribution. The dividend rate change could create a substantial shift in captive formation for smaller non-corporate entities offshore, leaving shareholders facing only one level of taxation.

The downside to the CFC is that it is deemed as a distribution and so, income must be reported on the individual's tax return even if the individual does not receive a distribution from the CFC. However, for an individual owner of a captive, the difference could now be substantial. As a simplified example, assume a 39.6 percent tax bracket and a share of income of $1 million. If this was a domestic captive, the $1 million would be reduced to $650,000 by corporate tax and the dividend of $650,000 would be netted by 39.6 percent to result in a receipt to the individual of $392,600. If the CFC is utilised, the $1 million is taxed as a deemed distribution at ordinary income (39.6 percent), resulting in a receipt to the individual of $604,000.

(4) Reciprocal

Captives have been formed as reciprocals in recent times, primarily for non-profit entities, especially non-profit group programmes. However, the basic idea is that it is an exchange of contracts and an attorney manages the unincorporated entity, and that income at year-end is 'distributed' to participants who pay tax at their own level. So, it largely achieves the benefit of a single level of taxation, albeit at the expense of some administrative complexity and, as with a CFC, the possibility that the actual distribution of cash may be different than the attributed distribution of income. It may become a more attractive option, even with the convoluted structure, to avoid double taxation at 35 percent plus rates to both levels.

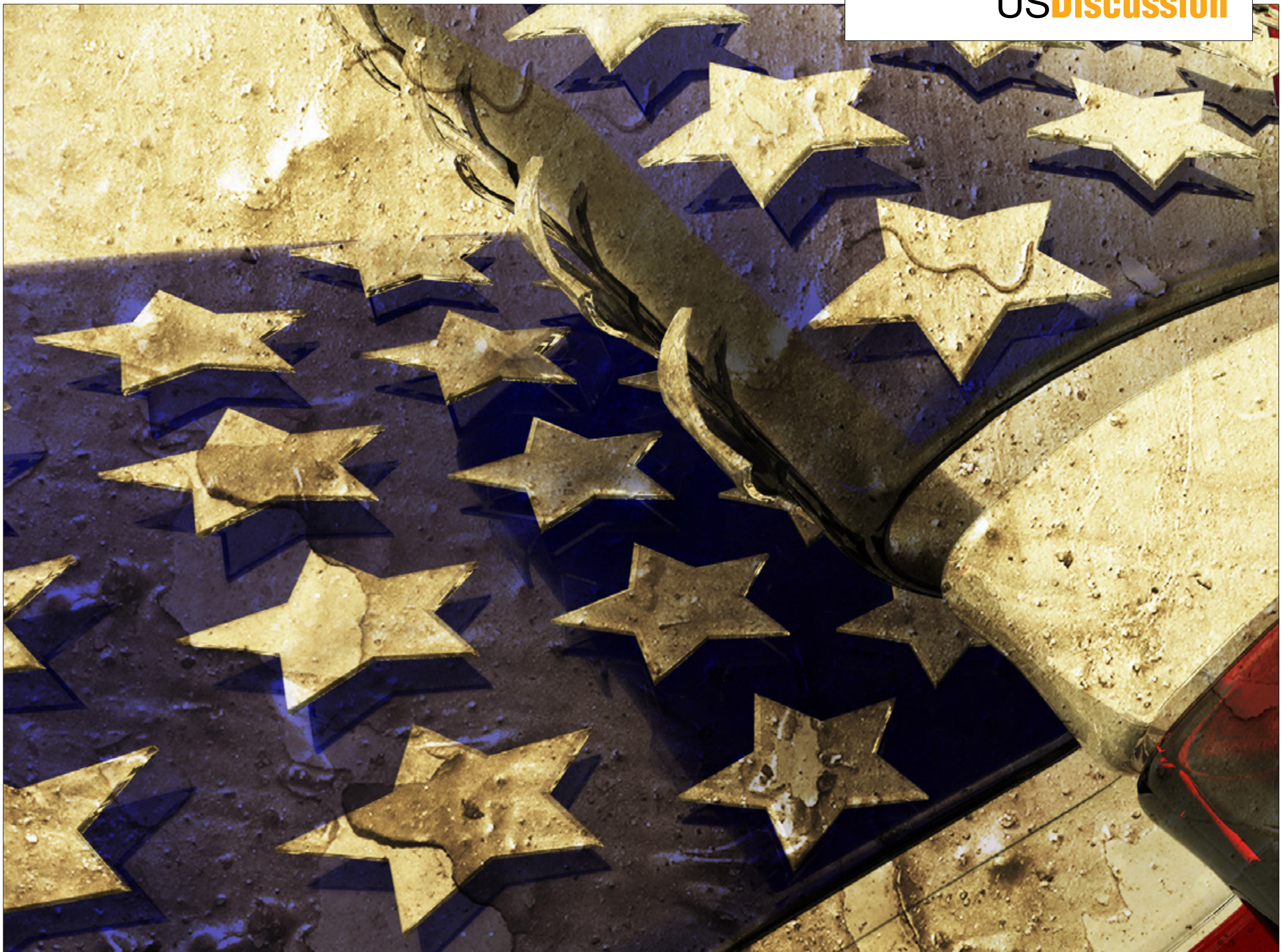
(5) 831(b)s

The 831(b) small insurance company election has been a popular feature of many recent captive formations. However, a 39 percent to 43 percent dividend rate would negate much of the potential tax benefit that is achieved under many of the more popular structures. Would this mean the end of the boom in 831bs? In my opinion, no, as it would merely mean that the strategy with an 831(b) would move away from dividends and become capital gain-based, with the use of cells probably being the most obvious change to reduce frictional costs.

The discussion above is, of course, hypothetical, and while the tax strategies that are outlined may work in many cases, it is imperative that you discuss any tax strategies with your own tax advisors and ensure that the facts of your own situation are given full consideration. It appears that the powers in Washington, DC, are coming up with tax policy that is designed to drive business offshore, while constantly claiming that they are driven to encourage business in the US. Oh, to enact tax policy that would actually reward captive owners for doing business in the US! CIT

The strategy with an 831(b) would move away from dividends and become capital gain-based, with the use of cells probably being the most obvious change to reduce frictional costs

Gary Osborne
President
USA Risk Group



An eye on the US

The US captive insurance market is expanding, but how long will it last? CIT opens the floor to two industry experts to find out more

MARK DUGDALE REPORTS

The US boasts more than 30 captive insurance domiciles—a figure that industry commentators predict will rise. Some US states, such as Vermont, are captive powerhouses, with approximately 1000 licensed companies, while others, such as Florida, are new to the captive game, and so are more famous for their theme parks than they are for their captive offerings.

While each domicile has its own state legislation and regulator for captive insurance companies to deal with, federal and international law is slowly encroaching on the state system. Some argue that legislation such as the US Dodd-Frank Act is eroding the state system and removing any benefits that it offers to captive insurance companies. Others disagree, arguing that—in the wake of global financial difficulties—financial industries need this type of regulation.

The issues facing US domiciles great and small are complex, but new captives are forming, which suggests that companies that are prepared to enter the US market consider the positives of captive insurance in the US to outweigh the negatives—at least at the moment.

CIT talks to two industry experts to get their views on the state of the US captive insurance market. Ellen Charnley, who is the captive solutions growth leader in the US for Marsh's captive solutions group, provides the captive manager's point of view, and Jeff Kehler, programme manager of alternative risk transfer services at the South Carolina Department of Insurance, provides the state's point of view.

How have US domiciles positioned their offerings in recent years?

Ellen Charnley: The growth in the number of US domiciles in recent years has been rapid. More than 30 US states now have captive legislation. However, the majority of states follow the legislation that was adopted by the first US domicile, Vermont, so there is little difference between the specific captive laws. Capitalisation levels and expenses are largely the same in most domiciles, so what sets one domicile apart from another is the level of experience and dedicated resources that are available to support the captive industry. Unless emerging domiciles can invest in a solid infrastructure, the more established domiciles will continue to prosper.

Jeff Kehler: The market branding of today's mature domiciles evolved over time as the captive market itself was developing at the same time. With the recent proliferation of new captive domiciles, there is a greater effort by the mature domiciles to build greater differentiation and separate identities from the emerging domiciles.

Many of the newer domiciles struggle to establish an identity. The exceptions are Utah and Kentucky, which have done a great job of branding themselves as domiciles specialising in mini-captives.

The market branding of the newer domiciles and positioning in this increasingly crowded field may be determined by the marketplace, the state's domestic industry, the regulators, or, more likely, by a combination of all of three.

What are captive managers and other service providers doing differently?

Charnley: Captive managers have long been perceived as administrators and accountants, yet the captive parent requires more innovative advice and consultation in the current market in order to respond to changes in the insurance market and use its captive effectively. As a consequence, larger captive managers have more captive consultative services available to assist captive parents as they navigate through regulatory challenges such as Dodd-Frank and Solvency II. At Marsh, the captive solutions division is now aligned with Marsh Risk Consulting, providing yet further consultative services and capabilities.

Kehler: The role of the captive manager continues to change in incremental steps. Some of this is driven by changes in the National Association of Insurance Commissioners (NAIC) accreditation standards, which require managers to submit additional filings as new standards become effective. Some managers are being more proactive with company boards and are spending time educating them on what it means to run an insurance company. Lastly, I think regulatory scrutiny has driven some change as well. Because of economic fluctuations, regulators have had to heighten their scrutiny of investment programmes, business plan changes and related party transactions.

Where are you seeing new line growth?

Charnley: A captive can provide coverage for just about any risk. The factors that drive the decision to place risks in a captive are: firstly, whether the risk can be priced; and secondly, is there is a benefit to placing the risk through the captive. As organisations become more sophisticated and focus on enterprise risk initiatives, many companies are looking to place larger, less predictable risk into their captive, such as supply chain risk, cyber risk, and other catastrophic risks. Developing statistical models is sometimes the solution to determining an appropriate price and therefore a captive premium for such risk, but ensuring that the captive is adequately capitalised is another critical factor.

Kehler: In South Carolina, changes in lines of coverage are subtle as we've always been a very diverse domicile and we've always been known as an innovator. Utilisation of captives for employee benefits, medical stop loss and healthcare will continue to grow along with the more traditional lines of coverage.

> Hospitals are looking more to develop their physician alignment strategies because of the ACO creation as a means to control costs and increase patient care
>
> **Ellen Charnley**
> **Captive solutions growth leader—US**
> **Marsh's captive solutions group**

The more creative lines of coverage appear to be associated with mini captives as opposed to traditional single parent captives. The minis are more focused on wealth transfer and less on risk management. So, they tend to focus on insurable risk that is less likely to have frequency or severity of loss.

How is Dodd-Frank's Non-admitted and Reinsurance Reform Act (NRRA) affecting new captive formations?

Charnley: The impact of NRRA on captives is still a grey area. Parent organisations of large captives (writing direct policies) are starting to investigate possible mitigating strategies to lessen the potential premium taxes that could be imposed, including establishing or redomiciling a captive to the company's 'home state'. With more than 30 US domiciles, the possibility that a company can form a captive in its home state is greater today. We have provided several companies with consultative services on this subject resulting in the establishment of multiple captives in different states, in some instances.

Kehler: There was a huge brouhaha over NRRA when some domiciles decided that it was an opportunity to collect self-procurement taxes on insureds that were domiciled in their state but were securing coverage from a non-admitted, foreign captive. In a few cases, captive owners changed their minds about the state of domicile and selected their home state in order to avoid this tax. Now, it seems to be less of an issue in domicile selection.

Solvency II has probably had a more significant impact on re-domestications than NRRA. Even though Solvency II has not been enacted yet, there is enough concern over the uncertainty of the impact on captive insurance companies, that many have made the decision to abandon a domicile subject to Solvency II or seeking equivalency to Solvency II. Despite assurances from regulators of these domiciles, a significant number of companies have decided to leave rather than wait around to see what will happen. The story may be very different once Solvency II is finally enacted, but right now, it has motivated some captive owners to take action.

What impact do you expect ObamaCare to have on captives writing healthcare business?

Charnley: For many hospital systems, plans are underway to recruit new physicians into employment. This means that the number of employed physicians will grow. Many hospital systems have captives already, so it is likely that we will see premiums grow in these captives as the hospitals recruit more physicians. More premiums will likely mean that capital levels have to be carefully monitored to ensure they are appropriate for the increased risk. Operating systems and controls will also become more important. Many healthcare captives will therefore look to formalise their underwriting and claims committees as they take on more risk and exposure.

> The return to prosperity is likely to be over a prolonged time period and captive owners should not make hasty, short-term decisions
>
> **Jeff Kehler**
> **Programme manager of alternative risk transfer services**
> **South Carolina Department of Insurance**

The formation of accountable care organisations (ACOs) may also have an impact on captives. An ACO can be comprised of a hospital and its non-employed physicians. Hospitals are looking more to develop their physician alignment strategies because of the ACO creation as a means to control costs and increase patient care. These captives are more likely to remain in offshore domiciles such as the Cayman Islands and Bermuda.

Kehler: The Patient Protection and Affordable Care Act (ObamaCare) will probably affect captive growth and utilisation as a result of ACOs that are part of the Act. As the aggregation of healthcare providers takes effect, the number of hospitals and physician groups using or creating captives to enhance their risk management programmes and retain a portion of their risk may grow dramatically.

What do you expect to be the big challenges for captives before the end of 2012?

Charnley: The insurance market is in a state of transition. As rates continue to firm, companies will be forced to look at retaining more risk in order to manage their commercial premium spend. As a result, the number of captive formations is likely to increase. In an economic recession, however, a continuing challenge for captives will be the requirement to justify the rate of return for the organisation over and above other company investments.

Kehler: Perseverance and discipline will undoubtedly be the biggest challenges before the industry this year. The return to economic prosperity is likely to be over a prolonged time period and captive owners should recommit to staying the course and not make hasty, short-term decisions regarding the use of their captive companies.

Risk management and risk financing are still the core principles for forming a captive company irrespective of market conditions. It is important for captive owners to avoid the temptation of low premiums in exchange for short-term gains. The market will change, as it always does, and those who have persevered through this time and maintained the utilisation of their captive will be all the better for it.

Underwriting and pricing discipline are critical for group programmes where the temptation is to relax the standards to attract more members or increase utilisation from existing members. This is a recipe for disaster. Captive participants and managers must avoid this temptation and stay focused on the long-term goals. CIT

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Catching flies with honey

Vermont has historically been the top dog for large captives, but the IRS and Dodd-Frank are making things tough for the US state, as CIT finds out

GEORGINA LAVERS REPORTS

It's a US state most famous for the sweet offerings of maple syrup and Ben & Jerry's ice cream, but Vermont has been proving since 1981 that it is in no way sugary-soft when it comes to captives.

After Bermuda and the Cayman Islands, Vermont is the third largest domicile in terms of captives licensed. It is also second in the world in terms of insurance company assets, and recorded 900 licensed captive companies as of December 2010.

The deputy commissioner of the captive insurance division at the Vermont Department of Banking, Insurance, Securities and Health Care Administration (BISHCA), David Provost, is confident that Vermont sets itself apart from other domiciles with current law and regulation, a large captive trade association (the Vermont Captive Insurance Association, or VCIA), and the expertise of players in the captive game.

"We have the most experienced and knowledgeable regulatory team anywhere," he says. "As a result, applications are processed quickly, exams are cost effective and performed by experienced examiners, minimising your cost and your time. It also means that business plan changes are handled quickly, most in a matter of days, or quicker if needed."

Climate control

In 1981, Vermont's legislature passed the Special Insurer Act, which was designed to provide a unique and attractive statutory framework for captive formation.

The objective of the legislation was to establish a 'business friendly climate' for companies forming captive insurance operations.

The law permitted the creation of single parent, association and group captives, and stipulated reasonable capitalisation requirements that may be met with a letter of credit. It also allowed new captives to cover nearly all commercial lines, including excess workers' compensation, directors and officers liability, and property and casualty insurance.

Also, the law did not require approval of rates and forms, or minimum premiums. On top of this, pure captives had no investment restrictions.

There was a slew of changes to the law in 2003, including a significant reduction in captive premium taxes, and the permission of pure captives to insure controlled unaffiliated businesses.

Since then, captives have been allowed to form as limited liability corporations, the process of converting a for-profit captive to a non-profit captive has been streamlined, and the rules for consolidating captives for premium tax purposes have been clarified. More clarification was

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Bolstering this regulation is BISHCA, the largest governmental staff of captive insurance professionals in the world. Alongside BISHCA is VCIA, whose membership is made up of management companies, law firms, banks and accounting firms.

A recent VCIA survey found that the largest industry sector that is served in Vermont is manufacturing, representing 19.7 percent of all Vermont captive insurance companies. This is followed by healthcare, at 16.8 percent, with banking and finance in third place at 11.8 percent.

"Regarding type, pure captives represent the majority of Vermont captives at 70.8 percent," the report stated. Association, industrial insured and risk retention groups account for 21.4 percent, with sponsored and special purpose financial captives rounding out the remaining types of captives in Vermont.

Growing pains

Though Vermont has been enjoying continued success for the last three decades, the state has mostly focused on large captives due to the tax structure, with mid-market companies tending to fall by the wayside.

"Vermont has been especially active in domiciling employee benefit captives for larger US companies, which require a US domicile under Department of Labour requirements," says the CEO of Capstone Associated Services, Stewart Feldman. "If one were to analyse the number of net new captives in Vermont, deducting out liquidations and otherwise inactive captives, there would be little growth."

Stipulations that have hindered growth include the Internal Revenue Code, which historically provided two pronounced tax advantages to small insurance companies, including captive insurers, in order to provide them with additional financial resources to pay claims. The regulations, which are contained in sections 501(c)(15) and 831(b) of the code, were amended with the passing of the Pension Funding Act of 2004.

While US Congress did not abolish 501(c)(15) insurance companies outright, it instead created a $600,000 maximum limit for gross receipts of both the insurance company and other companies that are held by the same control group.

"Considering the mid-market captives under Internal Revenue Code Sections 831(b) and 501(c)(15), which Vermont has dissuaded from domiciling in the state because of the little tax revenue, Vermont is likely to be seeing little growth going forward," says Feldman.

He marks the '1000 pound gorilla in the room' as the US Dodd Frank Act's Non-admitted Insurance and Re-insurance Reform Act of 2010 (NRRA), "which strongly pushes a captive to domicile in its home state, [when] that is where most of the ultimate risks are located."

"Absent a clarification in the NRRA, because few companies are headquartered in Vermont, this new federal statute should lead to an erosion in the captive business prospects for Vermont," added Feldman.

However, Provost disagrees, concluding: "We're still growing. As a mature domicile, the number of captives is holding relatively steady, as new companies are formed, some older companies merge with others, some companies close up shop, some move out, and some move in. The companies that remain continue to grow, so premium volume has steadily increased." CIT

Expert opinion

David Provost and Stewart Feldman break down forming a US captive.

What are some of the important legal and tax implications of captives?

David Provost: It's important for prospective captive owners to keep in mind that they are creating another legal entity within their corporate family, with an entirely new set of reporting, corporate governance, and other compliance requirements. A captive may be a business' first experience managing a regulated entity.

One of the most important tax considerations of captives is to be sure that the captive is a viable alternative without any tax advantage gained. In other words, a captive should be created to address insurance issues first and foremost. Tax considerations can be crucial in the determination of the financial feasibility of the captive, but they should always remain secondary to the insurance and risk management needs of the parent organisation.

Stewart Feldman: First and foremost, a captive is a living, breathing, operating insurance company. It is a regulated financial institution. It operates based within the parallel rules of the domicile's superintendent of insurance and the Internal Revenue Code. These are constraining parameters. Each domicile has, or should have, a body of law that deals with investments, reserves, reporting requirements, reserves, representation and other matters. Similarly, the Internal Revenue Code supplemented by IRS pronouncements and court decisions over the last 50 years or so, provides additional guidance on the operations of a insurance company generally and a captive in particular. Forming and operating a captive is hardly virgin ground.

What are some of the disadvantages of captives?

Provost: A captive is a separate legal entity, with specific compliance and management requirements; it's an insurance company and it will take time to operate efficiently. The time involved in managing a captive needs to be considered in determining feasibility. Captive owners may not be accustomed to being regulated, and may bristle at the idea.

Feldman: The decision to form and operate a captive is a serious financial decision. It is not planning for the light of heart; it is not for widows and orphans. It is not for those who want to view a captive as a personal checking account. Operating a captive is labour intensive and requires specialised skills spread over a number of disciplines. Even the largest US companies outsource the management of their captives. If a company is not prepared to do the planning correctly, captive planning will prove to be very unsatisfying.

How do companies go about selecting a domicile?

Provost: Qualified captive management firms or consultants that have experience in multiple domiciles are a good place to start. Factors to consider include reputation, infrastructure (availability and diversity of managers, attorneys, actuaries, auditors, banks, and so on), accessibility of regulators, location, cost, and more. Companies should include the total cost of operation over a five-year period to truly assess the cost differences between domiciles.

Feldman: Selecting a domicile is like building a foundation for an office tower: it is the base on which the entire project rests. There are many issues to consider in selecting a domicile. Your lawyer should be intimately involved in the process. As an example, the nature of the insurance for which a licence is sought would affect the particular domicile. Some domiciles have more flexibility on the nature of policies.

Others domiciles require an upfront agreement on policies being underwritten. Upfront and ongoing actuarial requirements differ among jurisdictions, which can have a significant impact on a small captive. Similarly, ongoing investment restrictions differ greatly among domiciles.

On the up

Fiona Le Poidevin of Guernsey Finance discusses the island's strong standing in the captive insurance market and what it is doing for its captive companies

Guernsey's strong standing in the captive insurance market is well known.

The island is the number one captive insurance domicile in Europe and the fourth largest globally, but in an increasingly competitive marketplace, it is vital that Guernsey does not rest on its laurels and remains at the forefront of developments for effective risk management within companies.

It was with this in mind that Guernsey decided not to seek equivalence with Solvency II. Instead, it was decided that we would retain our commitment to meeting the standards of the International Association of Insurance Supervisors (IAIS). In doing so, we provided local industry, as well as current and potential clients, with certainty and clarity regarding the regulation of insurance business in Guernsey.

This is being credited as one factor behind the surge of new insurance licences that were issued in 2011. The fact that 50 percent more licences were issued in 2011 than 2010 is evidence that Guernsey remains a dominant force among captive insurance domiciles. In fact, Guernsey's net gain of 12 international insurance entities was the only tangible growth seen across captive centres in Europe last year. At the end of 2011, 343 captives were domiciled in Guernsey, excluding individual Protected Cell Company (PCC) cells (on the basis that these are not distinct legal entities from the PCC core). An industry survey that collated captive figures put Guernsey more than 100 ahead of its closest competitor in Europe, Luxembourg, with 242 captives, but much further ahead of the Isle of Man (132) and Ireland (101). Globally, the largest captive domicile is Bermuda (862), followed by the Cayman Islands (739), Vermont (590) and Guernsey (343).

Captive expertise

The island's captive insurance market was boosted further at the start of this year with the launch of a UK government-backed product that utilises Guernsey's experience and reputation for innovation and expertise in the use of cell companies. The mortgage indemnity insurance scheme, which was introduced by the UK's Home Builders Federation (HBF) and the Council of Mortgage Lenders (CML) in March, sees mortgage risk for the lenders on new build homes underwritten by house builders and the UK government. By insuring the risk of default losses, the NewBuy scheme allows lenders to offer 95 percent loan to value mortgages on new homes. The JLT Group is managing the scheme through a joint initiative of its operating companies, including JLT Insurance Management Guernsey, which is running the captive insurance company that was established for HBF. As of 2 July 2012, 45 cells had been licensed in relation to the scheme's PCC, with more applications to be submitted and processed in due course.

The strength of Guernsey's captive insurance sector is further underlined by the fact that approximately 40 percent of the leading 100 companies on the London Stock Exchange with captives have them domiciled in Guernsey. Indeed, some 60 percent of the international insurers that are licensed in Guernsey have their parent company located in the UK. However, the island's insurance sector is truly international. Firms from across Europe, the US, South Africa, Australia, Asia, the Middle East and the Caribbean have established captives in Guernsey.

Oil giant BP has its own captive insurance company, Jupiter Insurance, domiciled in Guernsey. Global mining company BHP Billiton has its own captive insurance company in Guernsey too.

Stein Insurance Company has assets of approximately $1.3 billion and it had revenue of $214 million in 2011. Stein covers property damage, business interruption, construction, terrorism, marine cargo and some primary general liability for BHP Billiton.

Matthew Frost, vice president of risk finance at BHP Billiton, recently said that the company's finance risk management committee looked at the issue of domiciles approximately 18 months ago, particularly when it significantly increased its self-insurance, and asked whether BHP Billiton was starting "all over again from scratch, given where the management teams are based, would we have a captive and, if so, where it would be located?" Frost said that Guernsey came out on top, along with Singapore, but after BHP Billiton established the pros and cons of each domicile, "Guernsey came out significantly ahead".

This endorsement of Guernsey comes as no surprise when the island's innovation and expertise in this field is considered:

- Aon's White Rock Insurance Company PCC was established in Guernsey as the first PCC in the world. Since inception, it has been used by more than 50 corporations as a cell captive facility and grown to be the largest structure of its kind in the world
- White Rock Insurance Guernsey ICC (Incorporated Cell Company), which is also owned by Aon, was the first ICC in the world to be insurance-licensed
- Guernsey-based Heritage Insurance Management achieved a worldwide first in 2010 by amalgamating two PCCs—with 17 cells between them—into one
- In 2011, law firm Bedell Cristin, in Guernsey, advised Swiss ILS manager Solidum Partners on a CAT bond transfer, namely a private transformer of catastrophe risks into $12.4 million of securities in three separate deals through a Guernsey-based incorporated cell structure, Solidum Re.

These examples are all of companies using the cell company concept for insurance purposes. Guernsey pioneered the concept in 1997 with the introduction of the PCC for use in the captive insurance sector.

A PCC is a company that is made up of a core and individual cells. Each cell is distinct and therefore the assets and liabilities cannot be mixed. The legal segregation ensures that no claim against one cell will be covered by the funds from another. The ICC, like the PCC, has cells, but in an ICC they are separately incorporated and distinct legal entities. This offers the advantage of greater flexibility in terms of individual cells being able to migrate away from main structure and also potentially amalgamate or merge with other incorporated entities.

Solvency II

The decision not to seek equivalence with Solvency II has given current and potential clients certainty and clarity regarding the regulation of insurance business in Guernsey. Furthermore, seeking equivalence was not in the best interests of the island's insurance industry.

Solvency II has been designed to address systemic and group risks within commercial insurance markets, yet these are risks that are not generally faced within Guernsey's insurance industry, which is predominantly comprised of captive insurance companies. A captive is usually formed for a specific purpose, primarily self-insurance, and it is called a 'captive' because, in its purest form, it is set up by its owners only to insure the risks of its parent and/or fellow subsidiaries. The concept is reliant on the ability to be flexible and adaptable in order to ensure that risks are managed in the most cost-effective and capital-efficient way for the parent.

Guernsey will continue to meet the standards of the IAIS—the International Monetary Fund has commended the island for having high levels of compliance with the 28 insurance core principles of the IAIS—but the principles of proportionality mean that Guernsey will provide a more attractive environment for captive owners and other niche insurers. Under the current proposals, Solvency II is set to impose a number of inflexible requirements.

Guernsey believes that applying Solvency II as it is currently constructed would burden insurers on the island with additional costs and render currently effective captive business plans uneconomic. Only by remaining outside of the regime can Guernsey ensure that it is able to continue to offer a viable set of captive products and services. It also means that Guernsey's proposition may be attractive for captive owners and their insurance vehicles that are currently based within EU domiciles, especially where they are writing business outside of the EU. This may become increasingly so if the uncertainty regarding Solvency II continues and/or if the implications for captives appear particularly onerous.

Other non-EU jurisdictions such as Bermuda, Switzerland and Japan are adopting a different stance. These countries were in the first wave of equivalence applications, but they were not seeking equivalence for their captives, but to protect their international commercial reinsurance industries. Bermuda in particular is seeking to mitigate the impact on its captive insurance business and we will continue to monitor these developments closely.

Positive 2012

If the end of last year and the beginning of 2012 are anything to go by, Guernsey remains a dominant force among captive insurance domiciles. It is certainly something that firms have picked up on. Paul Sykes, the managing director of Aon Insurance Managers in Guernsey, has reported that the number of insurance licences that are issued continues to increase as the implications of compliance with Solvency II become better understood by captive managers and owners.

He said that they recognised that Guernsey offers a robust and rigorous regulatory environment that is responsive to innovation while not forcing captives to adhere to the disproportionate demands and excessive capital requirements of Solvency II.

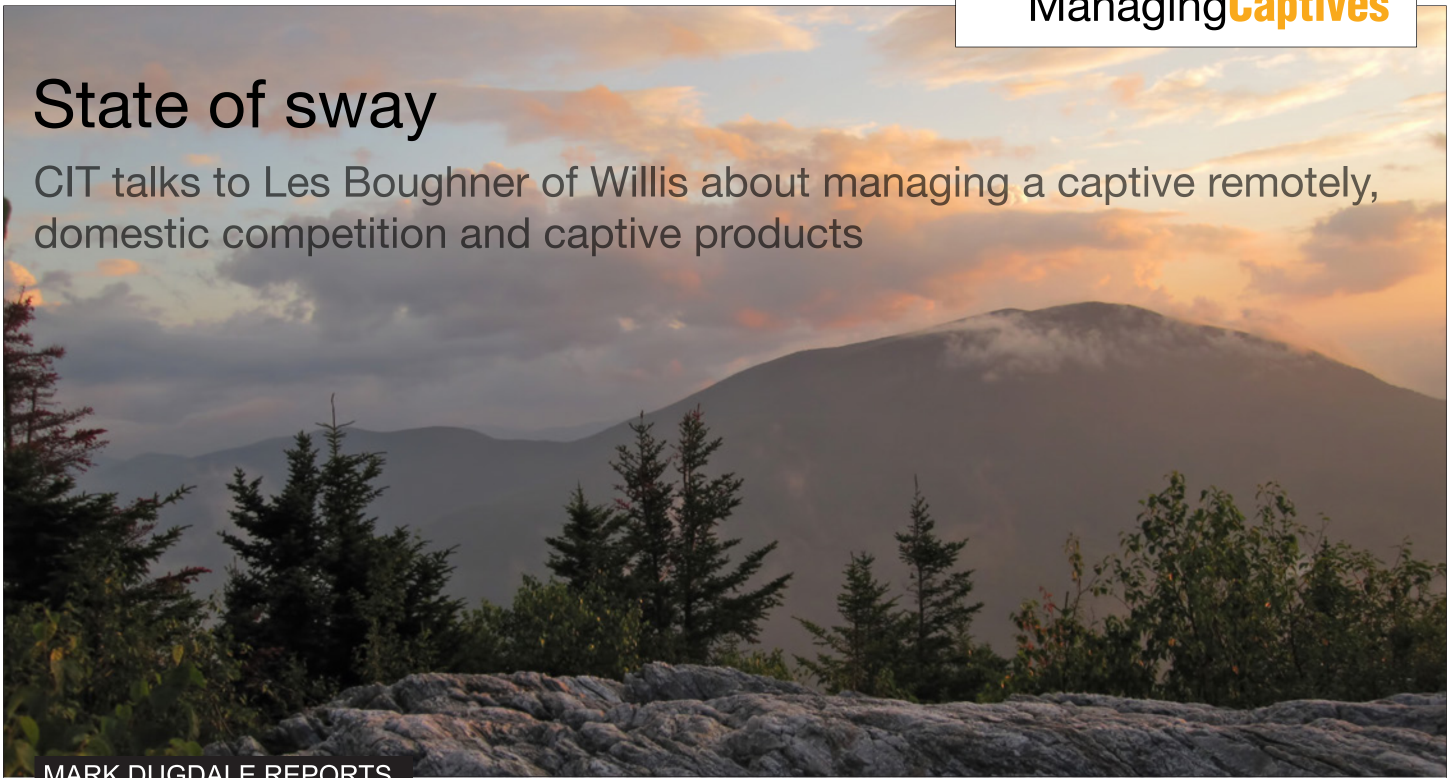
Other non-EU jurisdictions such as Bermuda, Switzerland and Japan are adopting a different stance

Sykes believes that—so far—the Solvency II regime has shown a profound disregard for industry and corporations that exercise prudent risk management by owning and operating captive insurance companies. While the capital requirements of Solvency II may be appropriate for commercial insurers that are dealing with the general public, many captive managers and owners believe the IAIS international regulatory standards will be sufficient for most traditional captives.

He believes that Guernsey will sustain its position as European leader and one of the top four captive jurisdictions globally by embracing IAIS international regulatory standards, without seeking equivalence under Solvency II. He is actively advising new and existing captive insurance company clients to help them achieve better capital efficiency and cost savings through restructuring their insurance programmes.

Aon is not alone among providers with its confidence in Guernsey, so while the first six months of 2012 have been extremely encouraging for the island's local captive insurance sector, we are just as confident that the remainder of this year will see the island continue to demonstrate its expertise and position as a dominant force among captive insurance domiciles. **CIT**

Fiona Le Poidevin
Chief executive
Guernsey Finance



State of sway

CIT talks to Les Boughner of Willis about managing a captive remotely, domestic competition and captive products

MARK DUGDALE REPORTS

What is your strategy in the US?

Our vision at Willis is to provide unparalleled expertise in designing, forming, managing and providing strategic guidance to captives of all types in all major captive domiciles. In my role, I am responsible for Willis's captive management and consulting operations in 'The Americas', which includes captives in North America, Barbados, the Cayman Islands and Bermuda, representing roughly 210 captives. In North America, we have offices in Hawaii and Vermont. Vermont is our biggest centre for North American captives, where we manage approximately 110 captives, half of which are not domiciled in Vermont. They are domiciled throughout the US. This highlights our management strategy.

We've seen many US states enact captive legislation, and are supportive of all of them. However, it is a costly investment to staff a local office until a critical mass of clients is achieved. We are prepared to staff an office when it can be both fiscally justified, and we are convinced that we can deliver quality services to our clients, locally.

What are US states doing to catch up with Vermont?

Many states are enacting captive legislation to duplicate the business model that they have seen elsewhere. Some have enacted the legislation without sufficient thought as to an adequate supporting infrastructure. Others have established the infrastructure. Duplicating the success of Vermont is very difficult when you consider the critical mass that Vermont has achieved.

How are new companies, such as small ones, entering captive insurance?

In the US, we have what is referred to as an 831(b) captive, or micro captive. These are small captives with less than $1.2 million in annual premiums. These are attractive for small companies with material levels of self insurance and they allow them to own a captive insurance company in a financially efficient manner. We are very supportive of the 831(b) exemption, but our strategy is to only become involved if they have a sustainable business plan and adequate capital. It is encouraging how the 831(b) exemption has expanded the market for sustainable captives.

We also have risk retention groups (RRGs) in the US. We manage close to 20 RRGs and we have formed several in the last 12 months. They are well-capitalised insurance companies with strong business plans and they are predominantly healthcare related. There is pending legislation to broaden the act to include property. The RRGs that we manage have strong boards, informed underwriting committees, and are well-managed insurance companies.

RRGs also have the potential for considerable growth due to healthcare reform. The healthcare industry is adapting to expanded responsibilities for providing lifetime medical benefits to an expanded population. Healthcare reform also encourages hospitals to attract independent doctor groups. An inducement is to provide facilities for medical malpractice coverage, which can be achieved through captive insurance companies. We are experiencing considerable interest in this area.

It will be interesting to see the use of property in RRGs. I think that the uptake will be more market driven, as it is a hardening insurance market at the moment. Many RRGs that we manage are very interested in taking on more risk, so I would fully expect them to take a serious look at property, if and when the opportunity arises.

When new regulations are mooted, what causes you concern?

We are perfectly happy to work within the US Dodd-Frank Act as long as it is clear how it applies to captives. We do not know what to advise clients, other than to seek their own tax advice. We need to overcome this lack of legislative clarity so that we can determine whether legislation such as Dodd-Frank applies, and if it does, how does it apply and what do our clients need to know. CIT

Les Boughner
Executive vice president and managing director—Americas, global captive practice
Willis

2012

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VCIA's 2012 Annual Conference

Location: Vermont,
Date: 7-9 August 2012
www.vcia.com/annualconference

The conference is a bustling hub of captive activity. VCIA welcomes participants from all over the world to network with key industry players, enhance their captive education, and relax and renew in beautiful Vermont!

SIIA's 32nd Annual Conference

Location: Indianapolis
Date: 1-3 October 2012
www.siia.org

The SIIA National Conference & Expo is the world's largest event focused exclusively on the self-insurance/alternative risk transfer marketplace and typically attracts more than 1,600 attendees from around the US and from a growing number of countries around the world.

HCIC Forum 2012

Location: Waikiki
Date: 22-24 October 2012
www.hawaiicaptives.com

The HCIC 2012 Forum will delve into opportunities to enhance your captive and risk management strategies despite the stagnant economy. This conference will provide a wide range of educational seminars and speakers that will offer tremendous learning and networking opportunities. Sponsorship forms and session submission forms may be found at www.hawaiicaptives.com

Cayman Captive Forum 2012

Location: Grand Cayman
Date: 27-29 November 2012
www.caymancaptive.ky

Plans are underway to provide an informative series of panelists and speakers and quality educational content for the captive owner and those who are seeking information on captive formations in the Cayman Islands. There will be memorable social events that will allow attendees to enjoy a taste of Grand Cayman.

Industry appointments

Spring Consulting Group has hired **Ryan Ralston** as a senior risk management consultant.

Before joining Spring, Ralston provided risk management leadership at Boeing Company, Koch Industries, and more recently, he was director of risk management at Whirlpool Corporation.

Ralston has more than 25 years of experience as a risk manager for companies in industries such as consumer products, oil and gas, aerospace, agriculture and green energy.

He has expertise in enterprise risk management, risk assessment, marketing insurance renewals, risk financing, broker competition and optimisation, captive insurance programme development, contractual risk transfer, risk quantification and pricing, and organisational structure and design.

"Ralston is an accomplished member of the industry and we are excited to have him join our team," said Karin Landry, Spring's managing partner. "He will focus on developing Spring's market leadership throughout the US, working with businesses to develop strategic risk management and captive solutions."

Specialist insurer Hiscox has appointed **Penny Shaw** as its chief risk officer.

She will join Hiscox from ACE and will take over from Bob Thaker, who will become the head of UK claims at the end of July.

Shaw was the European group head of risk management, capital and Solvency II at ACE. She established and led ACE's European Solvency II programme, and delivered on strategic objectives to embed risk assessment and enhanced risk-based decision-making.

Bronek Masojada, the CEO of Hiscox, said: "Shaw has a wealth of experience in driving improvements in risk management, we are very excited to have her on board."

Consulting firm Protiviti has made **Lindsay Dart** a managing director in its London office.

The former Deutsche Bank, PricewaterhouseCoopers and Credit Suisse employee will lead the UK internal audit and financial controls team.

Dart said: "I'm delighted to be joining Protiviti's world-class team, which has an outstanding reputation in the internal audit and risk consultancy market. The challenges of daily technological innovation, data security, regulatory change and the need to enhance business performance are impacting organisations in almost every sector."

"Boards, regulators and other stakeholders are placing ever-increasing reliance on the work of internal audit functions to provide them with assurance across these and other risks. The need for internal audit to have access to specialist skills is therefore greater than ever. Protiviti is ideally placed to help clients meet these needs."

Global professional services company Towers Watson has recruited **Ross Howard** as the global leader for its insurance and reinsurance brokerage business.

Howard will take up the position on October 1, 2012. He replaces Bill Eyre, who is taking up a new role to focus on client and market relationship development.

Howard joined Towers Watson when it acquired Denis M. Clayton & Co in 2002. He was the European COO at Denis M. Clayton, before becoming the regional leader for brokerage in EMEA at Towers Watson.

Tricia Guinn, the global leader of risk and financial services at Towers Watson, said: "Howard brings a wealth of experience to this job—in particular, his strong leadership and exceptional client management—and we are very pleased that he is taking on the global role. He has a clear vision for growing Towers Watson's brokerage business and has an excellent track record as the leader of our EMEA region."

In his new role, Eyre will expand existing client relationships and develop new prospects.

He said: "I am delighted to be turning over the leadership position to Howard, with whom I have worked for many years. While I have thoroughly enjoyed the challenges and successes of leading the business, I am looking forward to transitioning my responsibilities and supporting Howard as we strengthen our existing client relationships and forge new ones." **CIT**

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