CIT
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Unease gathers around Canadian captives

Canadian captive insurance vehicles may be in for a rough ride in the wake of the majority government's budget.

The budget, delivered by federal minister of finance for Canada Jim Flaherty, has revealed that certain planning involving captive insurance affiliates and captive offshore banks is being curtailed.

While the budget does not affect personal or corporate tax rates, the reinforced foreign accrual property income (FAPI) rules are expected to prevent taxpayers from shifting certain Canadian sourced income, or passive types of income, to lower tax rate jurisdictions.

"[W]here the affiliate's risk of loss or opportunity for profit in respect of the insurance of one or more foreign risks can reasonably be considered to be determined by reference to one or more other risks (the tracked risks), and at least 10 percent of such tracked risks are Canadian risks, income from the insurance of the foreign risks and any income from a connected agreement or arrangement will be included in computing its FAPI," according to Deloitte.

Although the government is addressing some of these avoidance methods through the general anti-avoidance rule (GAAR), there are fears that the amended FAPI rules could effectively shut down captive insurance arrangements in the country altogether.

Kim Moody of Moodys Gartner Tax Law LLP, in an article on the 2014-2015 budget, wrote that the amendments alone are expected to increase the country's tax revenues by $250 million per year.

The new rules will apply for taxation years that begin on or after 11 February 2014.

Bermuda is a likely destination for Canadian captives. The offshore domicile and Canada signed a tax information exchange agreement (TIEA) in 2010, offering Canadian companies tax incentives to locate in Bermuda.

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Frontier establishes Connecticut captive

Stamford-based Frontier Communications has chosen Connecticut for the location of its captive insurance subsidiary.

The new captive, Frontier Services Corporation, is also headquartered in Stamford and recently obtained its licence from the Connecticut Insurance Department.

Frontier Communications Corporation has been headquartered in Connecticut since 1946. The company is expanding its footprint in Connecticut with the acquisition of AT&T's wireline business and statewide fibere network in the state.

Frontier Services Corporation is the state's fourth licensed captive since governor Dannel Malloy's 2011 comprehensive jobs legislation cleared the way for the state to begin licensing these specialty insurers.

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Cayman captive industry 'buoyant'

The Cayman Islands captive insurance sector remains buoyant in a testing environment as 2013 maintained a steady pace following on from the year of growth experienced in 2012.

The Cayman Islands secured a combined total of 39 licencees issued during the year and an increase of 3 percent in the total number of licencees to 761. Cayman's captive industry earned $12.6 billion in total premiums and had $69.2 billion in total assets as at 31 December 2013.

Captives are gaining global acceptance as evidenced by the increased licencees granted year on year.

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Unease gathers around Canadian captives

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Speaking in December 2013, Bermuda Business Development Corporation CEO Stephen Lund commented: "[T]he TIEA in place between Canada and Bermuda levels the playing field on taxation as compared to other domiciles."

Canada also has double taxation agreements in place with other captive domiciles, including Barbados.

Frontier establishes Connecticut captive

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The state's third captive, Apple Risk Insurance Company, was licensed in October 2013.

Malloy said: "Giving employers the tools they need to manage their costs and reinvest in their employees and products is a commitment we have made from day one. These specialty insurers are just one example of the steps my administration has taken to support business, encourage competition and create jobs. We welcome Frontier Communications, a company with deep roots in Connecticut, to this growth sector."

Insurance commissioner Thomas Leonardi said: "Captive insurance has proven to be an effective cost-management tool for employers and many states have enacted laws to attract their business. However, not every state has the skilled insurance workforce expertise or the regulatory expertise that we have here in the Insurance Capital. Governor Malloy's vision and commitment to grow the industry have been instrumental in making sure our laws and regulations continue to attract this growing sector."

Cayman captive industry 'buoyant'

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According to A.M. Best, there are currently more than 5700 captives globally compared to an estimated 1000 in 1980, and there are more jurisdictions offering captive domiciliation.

Each of these domiciles records statistics in a different way, making direct comparisons of size of their respective industries difficult to ascertain, but Cayman counts each of the parent companies, not subsidiaries or individual 'cells'.

The Cayman Islands Monetary Authority (CIMA) reported that it oversaw 761 class B, C and D companies as at 31 December 2013, with 406 of those pure captives and 148 as segregated portfolio companies (SPCs) making, Cayman one of the world's largest captive domiciles.

Rob Leadbetter, chairman of the Insurance Managers Association of Cayman, said: "We view the continued growth as a result of a collection of factors: the increased awareness of the benefits a captive can offer to companies looking to more efficiently manage their own risk."

"Cayman's longstanding history in establishing and managing captives; and the steps IMAC has taken over the past year to better communicate with our stakeholders through a new brand, new website, improved social media strategies and an all-time record of 1400 in attendance to our annual Cayman Captive Forum."

Global insurance pricing declined in Q4 2013

Global insurance rates trended downward at the end of 2013, driven by average pricing declines in all regions except the US, according to Marsh's latest Global Insurance Market Quarterly Briefing.

Overall rates tracked by the Marsh Risk Management Global Insurance Index in Q4 2013 fell in the UK, Europe, and most significantly in the Asia-Pacific region and in Latin America. The US was the only region in the global index to show a rise in overall rates.

The market saw lower rates for global property programmes renewing in Q4 2013, though by a smaller magnitude than in the previous quarter, according to the briefing. In Latin America, the typical rate reduction on renewal approached 10 percent, driven by competition and available capacity, along with acceptable loss experience.

The Asia-Pacific region also saw decreases in property rates averaging 5 percent as an abundance of capacity across the region, particularly in Asia, kept rates low for non-catastrophe-exposed risks.

Globally, casualty insurance programmes typically renewed with a slight decrease, led by falling rates in Asia-Pacific, continental Europe, and Latin America; while falling financial and professional liability rates in Asia-Pacific, the UK, and Europe led to an overall decline in rates for those programmes globally.

David Batchelor, president of Marsh's international division, said: "Strong capital positions, plentiful capacity, and ample competition within the global insurance industry are leading to favorable conditions for clients, especially those with well-managed risks."

Robert Bentley, president of Marsh's US and Canada division, added that in the US, insurers are competing aggressively for profitable business and new entrants are helping to moderate any rate increases.

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Tax challenges
Rent-A-Center v Commissioner answered some questions, but posed others. Alan Fine of Brown Smith Wallace explains
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Howden targets Latin American growth

Colombian insurance brokers Wacolda SA and Proseguros SA are soon set to fall under the mantle of Howden Broking Group, a part of Hyperion Insurance Group.

Wacolda is a corporate insurance broker with capabilities including property, construction and life and has offices in Bogota, Medellin and Cali in Colombia, Quito in Ecuador and Lima in Peru. Proseguros is a public sector insurance broker focused on affinity programmes, general liability, and government and infrastructure projects.

The combined businesses will be one of the largest Howden operations outside the UK and will be led by Carlos Quinones Machler, who has experience of the Colombian market. They will be a major part of Howden's Iberoamerican retail broking platform, which serves clients in Spain and Latin America.

During a 40-strong British trade delegation trip to Colombia and Mexico, David Howden, CEO of Hyperion Insurance Group, said that the growing Colombian economy was proving to contain huge opportunities for companies that want to invest and be a part of its growth, and that the country was also an important springboard to much of central America.

"By bringing together the specific product and sector experience of Wacolda and Proseguros, aligning them with our other operations in Spain and Latin America and more widely with those in Europe and Asia, we will be able to offer our clients across the region a great depth and breadth of expertise supported by a strong international network."

"Our Iberoamerican broking platform now comprises more than 250 employees in eight countries, and the intention for Howden to become the leading Iberoamerican broker is well on the way to becoming a reality."

Howden Broking Group has agreed to acquire 70 percent of Wacolda and 100 percent of Proseguros, though both acquisitions still remain subject to regulatory approval.

PwC estimates £630 million flood damage

PricewaterhouseCoopers has estimated the cost of flooding to the UK economy at £630 million.

The rain in southern and central England has made January the wettest in 250 years, according to MET office figures.

Mohammad Khan, insurance partner at PwC, said: "Although there was a lot of rain in January and clearly people have been adversely impacted, the damage to the UK was not nearly as bad as the damage caused by the weather in December."

"However, we have revised our total cost estimates upwards, taking into account the January weather. Our expectations are that the insurance industry will have up to £500 million of costs from the January and December weather and the economic damage will be £630 million."

"Given the weather forecasts for this week and further into February, we would expect further flash flooding and for these estimated costs to rise."

Insurer results next year could be affected, but it is too early to tell, said Khan. "Last year, the weather was very benign from January to October and insurers' results from household and commercial property business were positive, even allowing for the December storms and floods."

Dom Del Re, insurance catastrophe expert at PwC, said: "The continued adverse weather highlights the impact that storms, coastal and river flooding, and flash flooding can have on the British economy and the UK insurance industry. In past flood events, such as the summer 2007 floods, business claims made up around 25 percent of the total claims."

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"Claims arising from business interruption could be a significant driver of the overall insured loss. Home and business owners who have planned for flooding will be better equipped to deal with the disruption and damage."

"Policyholders continually impacted by flooding—even those not in traditional flood plains—should consider taking remedial action on their properties to help mitigate and prevent damage caused by flooding."

NCCIA arranges first annual conference

Alex Webb, the chair of the North Carolina Captive Insurance Association, has scheduled the association's first annual conference and trade show.

The event will take place between 24 and 26 August at the Ballantyne Resort in Charlotte.

The programme will begin on Sunday with an optional seminar on the basics of forming a captive insurance company.

NCCIA hosted its first educational event in December 2013, in Raleigh.

The one-day event, which was attended by more than 60 registrants, focused on the roll-out of the North Carolina captive insurance act, and had insurance commissioner Wayne Goodwin as the keynote speaker.

Cayman to implement tax exchange initiatives

A working group has been set up in the Cayman Islands to assist with the development of its legal framework for the automatic exchange of information for tax purposes.

This is being done in response to international initiatives such as the Foreign Account Tax Compliance Act (FATCA).

Group chairman Roy McTaggart has said that the working group will provide recommendations regarding draft primary legislation, for consideration by the Legislative Assembly during its May session.

Mr McTaggart said: "Automatic Exchange of Information (AEOI) is rapidly becoming the global standard for tax information exchange. While the public is increasingly familiar with the terms 'US FATCA' and 'UK FATCA', it is important for them to understand that those initiatives are mechanisms for the automatic exchange of information for tax purposes. Other mechanisms will develop, whether by individual countries or on a global scale.

"The working group is therefore assisting with the development of Cayman's legislative and regulatory framework to meet both the current needs of US and UK FATCA, as well as future AEOI initiatives."

Wells Fargo cautiously optimistic on 2014

In a new report on the insurance market outlook for 2014, Wells Fargo gave a conservative estimate of the year ahead.

The report said: "2014 should provide a stable to somewhat competitive environment for business insurance."

The report found that market capacity is currently at an all-time high for most major lines of business, and that the insurance-linked securities (ILS) market for catastrophe perils has grown by 16 percent annually over the last three years.

Slow growth in traditional investments has also contributed to the success of ILS, and market practitioners have taken advantage of the fact.

Hedge funds and other capital market investors find these vehicles increasingly attractive as an uncorrelated area of risk with generally superior returns.

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The report calculated that if this rate of growth continues, alternative capacity could reach a global market share of approximately 25 percent by 2020.

The report is optimistic about surplus in the year ahead.

It said: “2014 portends to offer a reasonably competitive environment for business insurance. The industry has had a more profitable year in 2013 with the combined ratio falling to 95.8 through nine months from 100.7 in the same period last year. Industry wide return on average surplus rose through the first nine months to 9.5 percent from 6.5 percent during the same period in 2012.”

AXIS insurance establishes healthcare liability

AXIS Insurance has formed a healthcare unit that will focus on providing professional liability insurance and associated standard casualty coverages for physician groups, hospitals, allied healthcare facilities and individual physicians.

Kimber Lantry, who recently joined AXIS Insurance as an executive vice president, will lead the unit. Lantry will be based in Northern California.

Peter Wilson, president of AXIS Insurance’s US operations, said: “We believe the healthcare industry represents an attractive and highly complementary business opportunity for AXIS Insurance to bring to bear its specialty underwriting expertise, service capabilities and capital strength.”

“We are very pleased that Kimber Lantry, a seasoned industry veteran with more than 37 years of professional liability experience and 20 years directing healthcare insurance operations, has joined us to lead this new initiative. We look forward to the contributions of Kimber and his team in developing a world-class Healthcare Professional Liability unit at AXIS Insurance. In line with our commitment to this specialty line, we expect to add to the founding team as the business develops.”

Lantry joins AXIS Insurance from the Hudson Insurance Group where he directed healthcare insurance operations since 1997. Prior to Hudson, he had a similar role at Firemen’s Fund. He also formerly held positions at The Doctors’ Company, NORCAL Mutual, Marsh and McLennan and the captive insurance company for the Adventist Health System.

AXIS Capital is a Bermuda-based global provider of specialty lines insurance and treaty reinsurance, and has locations in Bermuda, the US, Europe, Singapore, Canada, Australia and Latin America.

Swan Group Holdings launches Swan Re

Swan Group Holdings has launched its wholly-owned subsidiary, Swan Re.

The company has received its licence as a Class 3A reinsurer from the Bermuda Monetary Authority. Swan Re was sponsored by Swan Wealth Advisors of Durango, Colorado.

Swan Wealth, through an investment management agreement, will manage the assets of Swan Re utilising its defined risk strategy.

The DRS structured asset management strategy is designed to not lose capital during market downturns.

It focuses on capturing the upside of the market while hedging the downside. This strategy has proven successful over its 16-year history generating 9.3 percent average annual net returns to investors, while exhibiting only half the volatility of the S&P 500 Index.

All of Swan Re’s reinsurance business will be sourced by MultiStrat Re, a Bermuda special purpose insurer, through a quota share reinsurance agreement alongside other participating reinsurers.

Randy Swan, chairman of Swan Group Holdings, said: “We are pleased to offer investors an opportunity to seek high returns by combining our low risk DRS investment strategy with MultiStrat Re’s stable, low volatility reinsurance business.”

Ratings round-up: The Kroger Co, Lone Star and Panamanian reinsurers

Queen City Assurance and **Vine Court Assurance** have received results that are unchanged from their review last year by A.M. Best.

The ratings firm again affirmed the financial strength rating of “A (Excellent)” and the issuer credit ratings of “a” of Queen City Assurance and Vine Court Assurance, both domiciled in Burlington, Vermont.

The ratings are based on Queen City and Vine Court’s individual and combined profiles as single-parent captives of retailer **The Kroger Co** in Cincinnati, Ohio.

The ratings are also based on the companies’ “excellent” risk-adjusted capitalisation, substantial net income and underwriting profitability, a growing capital base, conservative investments, and a strong adherence to the parent’s robust risk controls and its overall risk culture.

Additionally, return measures on a group and individual basis are consistently positive, reflective of the organisation’s prudent pricing and deployment of capital.

These significant strengths are partially offset by the companies’ risk concentration, which is the result of being single-parent captives of The Kroger Co., coupled with a substantial aggregate limit retained by the captives.

Key rating triggers that could result in an upgrading of both companies’ ratings include a consistently profitable operating performance coupled with a substantial increase in risk-adjusted capitalisation.

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Rating enhancement or a deterioration in the capitalisation of the parent could also result in an upgrading or downgrading of the ratings.

A.M. Best has assigned a financial strength rating of "A (Excellent)" and an issuer credit rating of "a" to **Lone Star Alliance**.

Lone Star is an risk retention group based in the District of Columbia. Its ratings reflect its excellent risk-adjusted capitalisation, A.M. Best's expectation of a modest operating performance (being a start-up company), and strong reinsurance protection.

The company's initial capital was provided by its sponsor, **Texas Medical Liability Trust**. Significant reinsurance support is provided to Lone Star by Texas Medical Insurance Company, which is a subsidiary of the trust, as well as a state regulated property and casualty insurance company.

These positive rating factors are partially offset by Lone Star's risk of adverse losses from being a start-up company, expanding into new states and the concentration risk of primarily writing one line of business in a somewhat limited geographical area.

The ratings further reflect the limited permanency of capital as Lone Star's entire capital is in the form of a 26-year surplus note. However, this is mitigated by the long maturity of the note and the anticipated very low underwriting leverage represented in Lone Star's business plan, said the rating firm.

It added that the company maintains a conservative investment portfolio with minimal returns expected. Therefore, underwriting performance will be the primary driver of surplus growth.

The outlook is based upon the organisation's, (which includes both Texas Medical companies) cycle management capabilities and capacity to successfully manage any changes to the tort, regulatory and competitive environments.

Positive rating actions could result from a long-term continuation of strong underwriting results for the organisation, as well as careful evaluation of the enterprise risk management risks and opportunities with appropriate actions taken to enhance the value of the organisation.

A.M. Best has also affirmed the financial strength rating of "A- (Excellent)" and issuer credit rating of "a-" of **Istmo Compañia de Reaseguros** and its subsidiaries, **Del Istmo Assurance** and **Liffey Reinsurance Company Limited**.

The companies are all domiciled in Panama City, Panama.

The ratings of Istmo Re reflect its strong risk-adjusted capitalisation, stable underwriting performance and established competitive position in the domestic insurance market.

In 2013, Istmo Re continued its strong underwriting and operating profitability, which it received in part from favourable overall earnings. Partially offsetting these positive attributes are potential changes in the regulatory environment that could negatively affect the company's ability to write business, its rapid expansion and the risks associated with writing catastrophe business.

However, Istmo Re has not experienced any major catastrophe events since 2007 and has limited exposure to oceanfront property business.

Istmo Re has established an enterprise risk management framework to identify measure and monitor both existing and emerging risks across its respective business entities and to allocate capital accordingly.

The company's strategy is to focus on the needs of the small to mid-sized market players and to provide customised products, technical expertise and superior customer service to its clients. This strategy has proven successful for Istmo Re and is evidenced by its strong working relationships and high client retention levels.

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Positive rating actions could occur if Istmo Re maintains its consistently strong underwriting performance and long-term profitability in conjunction with an upgrading of Panama's country risk tier.

Negative rating actions could occur if there were a significant decline in the company's risk-based capitalisation, sustained adverse operating performance or a downgrading of Panama's country risk tier.

The affirmation of Del Istmo Assurance's ratings reflects its supportive risk-adjusted capitalisation, favourable operating performance and experienced management team that is very familiar with its written business.

Offsetting these positive rating factors is Del Istmo Assurance's limited business profile as it writes primarily performance bonds in Panama.

The ratings of Liffey Re recognise its adequate risk-adjusted capitalisation, stable operating profitability aided by its retrocession coverage and the support it receives from Istmo Re. Liffey Re is a single-parent captive of a Dublin general business reinsurer.

Liffey Re reported favourable operating performance over the past five years.

The company's performance has been aided by its strong retrocessional coverage with a diversified panel of global reinsurers. Offsetting these positive rating factors is the company's limited business profile as it currently only assumes business from its parent.

Positive rating actions may be considered in the long term if Liffey Re maintains strong operating results and capitalisation levels.

Irish reinsurance sees 14.7 percent growth rate

Research and Markets has compiled a report on reinsurance in Ireland, finding that reinsurance recorded an overall compound annual growth rate of 14.7 percent during the review period between 2008 and 2012.

Ireland has a developed international insurance and reinsurance industry, with many of the world's leading insurers and reinsurers operating in the country.

Ireland's double taxation treaties with many leading industrialised nations, as well as its favourable tax environment, have made it a leading global destination for captive insurance.

During the review period the country's reinsurance segment registered varying annual growth rates due to the adverse impact of the global financial and European debt crises.

Irish reinsurance revenues are primarily generated from the non-life and personal accident and health segments, with Irish non-life insurers ceding 22.4 percent of their written premium and personal accident and health insurers ceding 38 percent to reinsurers in 2012.

This was due to increased regulatory compliances and the forthcoming Solvency II directives which are expected to be implemented by 2016.

The regulatory compliances brought increased capital requirements leading to high demand for reinsurance services.

Beechwood Re to close $590 million transaction

Beechwood Re, a life reinsurer, has executed definitive documents to complete a reinsurance transaction with subsidiaries of CNO Financial Group.

The deal will have CNO Financial Group's subsidiaries cede $550 million of statutory reserves and approximately $40 million of other capital associated with closed blocks of long-term care insurance underwritten by Bankers Conseco Life Insurance Company and Washington National Insurance Company.

The reinsurance transaction and associated structures have obtained all required regulatory approvals necessary to proceed.

Beechwood Re CEO, Mark Feuer, said: "We are very pleased to have entered into this

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agreement with CNO. These transactions exemplify the creative reinsurance solutions that Beechwood Re has to offer. We look forward to working with our new partner through a smooth transition and providing them with ongoing reinsurance support."

Ed Bonach, CEO of CNO Financial Group, said: "Our reinsurance agreements represent a meaningful step forward in addressing our run-off business. We are pleased to have Beechwood Re as our partner in this transaction and look forward to a successful relationship moving forward.

Marsh and McLennan acquires Bond Network

Marsh & McLennan Agency, a subsidiary of insurance broker Marsh, has acquired the Bond Network, a surety bonding agency based in North Carolina. Terms of the transaction were not disclosed.

Founded in 1985 by Thomas Dawkins, the Bond Network generates $1.1 million in annual revenue and offers commercial, contract, and special risk surety bonds to private contractors throughout North and South Carolina.

Dawkins and the rest of the agency will operate out of Marsh & McLennan Agency's mid-Atlantic region.

Thomas Brown, vice chairman of Rutherfoord, a Marsh & McLennan Agency LLC company, said: "The Bond Network is a well-known and respected surety specialist in The Carolinas and is an excellent addition to MMA's mid-Atlantic region as it further strengthens our considerable construction capabilities. I'm thrilled to welcome Dawkins and his team to MMA."

Dawkins said: "Joining MMA is an excellent opportunity for the Bond Network to build upon its success over the last 28 years. With the resources that MMA brings to bear, our clients now have a wider range of products and services that address their emerging needs. We look forward to enhancing our commitment to the construction industry."

National Interstate celebrates 25th year

National Interstate Corporation is celebrating its 25th year of serving the insurance industry. Established in 1989, National Interstate provides commercial insurance products including traditional insurance and alternative risk transfer options.

National Interstate offers its products and services through several operating subsidiaries including National Interstate Insurance Company, Vanliner Insurance Company, American Highways Insurance Agency, Explorer Insurance Agency, TransProtection Service Company, and Safety, Claims and Litigation Services.

Dave Michelson, president and CEO of National Interstate, said: "It is with great pleasure that I reflect on the road our company has traveled over the past 25 years. Back in 1989, National Interstate was a start-up company with just a dozen employees marketing only passenger transportation insurance. Through the years, we have reached many significant milestones including becoming a market leader of transportation insurance, as well as alternative risk transfer, or captive, insurance programmes."

"The 1990s were times of growth for National Interstate as we opened an office in the state of Hawaii to market transportation and general commercial insurance, launched our first group captive programme, and began offering specialty insurance to recreational vehicle owners."

Tony Mercurio, executive vice president and COO, said: We are an entrepreneurial company that embraces opportunities in the marketplace that other insurance carriers might shy away from. Our ability to design specialised products and enter new markets has resulted in significant and continuous growth over the last 25 years. While we now have almost 600 employees, National Interstate still operates with the flexibility of a small company."

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Malta's talents

A tidy tax regime is just one reason why companies are opting for the EU island

DANIEL JACKSON REPORTS

Having obtained EU membership in 2004, Malta has spent the last decade repositioning itself within Europe as a financial services centre that can punch above its weight.

The island nation has been successful because it has been willing to adapt to the changing needs of the global economy, while maintaining a strong standard of regulation.

John Stivala is the general manager of JLT in Malta. Asked about the effectiveness of the Financial Services Authority, he says: "The MFSA is very approachable. If we need to speak with them we can set up a meeting within two weeks. They are a firm regulator, they apply the rules, and we are able to discuss issues that might come up from time to time."

"We have a good working relationship with them. If you try to break or bypassing the regulations you are not going to succeed, they are very concise and detailed with regards to due diligence enquiries on shareholders and new applicants for business. This safeguards the jurisdiction against any bad publicity."

Tax refund

Apart from the robust regulation, Malta has another advantage over competing domiciles. It is a low-cost, low-tax regime, and shareholders of companies within the country are eligible for a 6/7ths tax refund.

A public company in Malta is taxed at a standard, flat rate of 35 percent. In most cases, the tax refund of a company shareholder is 6/7th of the tax paid by the company on the profits out of which the dividend is distributed.

"This applies to all companies," says Stivala. "The tax paid by the company is paid on behalf of the shareholders, so the tax paid is imputed in full to the shareholders when they declare their own tax return. Shareholders can benefit from this 6/7ths refund."

"Company directors will decide in advance of the end of the financial year whether they intend to recommend a dividend distribution, then approval from the regulator is required for these dividends. Once that is obtained the financial status is finalised and the tax can be paid to the authorities. Within 14 days a refund is obtained by the shareholders."

As with the vast majority of European jurisdictions, insurers in Malta will soon be required to demonstrate compliancy with the Solvency II directive. How are companies in Malta coping with the adjustment?

Dermot Finnerty, general manager of Aon Risk in Malta, says that companies have been making strides to comply with the requirements in time for 2016.

Stivala says: "I think we are coping quite well. We have some opportunities with Solvency II because we are a relatively low cost jurisdiction. When Solvency II comes in there will be an increase in operating costs with the additional reporting and the solvency calculation, so as a lower cost jurisdiction compared to Luxembourg and Ireland, there is some opportunity to win some business from the other domiciles."

"With regards to offshore jurisdictions, we are attractive because fronting costs would increase for European fronting insurance if the captives are located offshore reinsurance captives. Many jurisdictions are not Solvency II compliant yet, so there is an opportunity in terms of getting that business."

"The authorities are pushing licence holders and captive managers to come up to speed, they are issuing questionnaires to see how license holders are coping, they are organising interviews and one on one meetings."

Despite the ongoing eurozone crisis, insurers in Malta are not struggling with with reduced liquidity and capital flows, according to Stivala.

"I don't think there is such a great exposure in Malta. The crisis seems to have peaked some years ago, although we can't say we're out of it yet. There hasn't been any negative impact reported locally, so I don't think there should be any problems going forward."

The future

If Malta hopes to maintain its pace of growth, local investment is essential, particularly when it comes to fostering local talent for the insurance industry.

Stivala says: "There is always more that can be done, but there has been a local chartered insurance institute branch since the 1980s."

"Many insurance practitioners sit for their ACII exams here. There is also a degree which includes banking and insurance, so there is a lot that has been done in the last two decades."

"We have the right teachers and the right syllabus to take our jurisdiction forward in line with the business and opportunities that come to Malta. The government have recently introduced new RSVP regulations, and we need expertise in that area. A lot has been done but there is more that can be done to keep us competitive in terms of human resource expertise." CIT

"Humour and business"…

…is Captive Insurance Companies Association vice chairman Scott Beckman's summary of what to expect at this year's CICA conference

STEPHEN DURHAM REPORTS

What are some of the highlights to expect at the CICA conference?

The 2014 Captive Insurance Companies Association (CICA) International Conference should be a vibrant and thought-provoking industry event. The theme is 'Captives: Global Opportunities and Solutions', and we are looking at what captives are doing around the globe and how captives serve the business interests of companies that operate in different countries.

We are kicking off the conference with a dynamic keynote given by a husband and wife team that will make the audience think about life and how it influences working relationships. This keynote should infuse good-natured humour into the early part of day. Following this session, the audience will hear from a leading insurance industry economist, who will project where the industry is going and help provide insight how best to position our captive businesses to continue on a path for success.

What are some of the key topics shaping the conference as a whole?

The session topics are fresh, diverse and will appeal to risk managers, captive owners and attendees of all levels of experience. We placed an extra-emphasis on captive success stories and best practices approaches through a myriad of captive operational and financial issues.

We want to provide our captive owners with the tools to enhance their understanding of business risks, reduce their losses through risk management, be aware of new products within the captive industry that are not being offered by the traditional insurance market and develop sound funding based upon loss experience and industry data. We also developed a couple of sessions focusing on the role of enterprise risk management within captives.

How have the industry events and trends of 2013 affected the conference programme? Was it a positive year for captives?

Heightened scrutiny into 831(b) elections led to the development of a session entitled 'Best Captive Practices for 831(b)s—Do them right or don't do them at all'. Additional topics regarding captive governance, complex tax issues, ensuring capital adequacy and financial audits were designed to enhance current knowledge on critical captive operational issues.

Overall, we believe it was another positive year for captives as many domiciles experienced growth with over 66 domiciles and 6000 plus captives worldwide.

What are the new trends to expect in 2014?

We expect the trends of recent past to continue in 2014, with perhaps even an increased examination internationally on regulation.

The programme focuses a great deal on regulation and best practice exit strategies. Do you believe that this represents an inexorable trend, and that the industry is growing more and more tightly regulated?

Yes. This and future programmes will continue to educate captive owners and service providers on the recent developments on the regulatory front whether from the Organisation for Economic Co-operation and Development (OECD), IRS or other regulatory bodies. CICA is committed to demonstrating the value of captives through data and best practices and advocating on behalf of its membership.

I believe the greater good is a balance between responsible regulation and facilitating the sustainability and growth of the captive industry internationally. CIT

Scott Beckman
Vice president of claims
ISMIE Mutual Insurance Company

The future of ILS

Industry players are watching the insurance-linked securities story with interest

DANIEL JACKSON REPORTS

Hurricane Andrew was the most devastating hurricane in US history. The category 5 hurricane caused 65 deaths, destroyed more than 800 homes and was responsible for $26.5 billion of damage.

It was the first time that the US had experienced a natural disaster of this magnitude since the post-war economic boom. Home ownership was higher than ever before, and as such insurable losses were massive.

It was against this backdrop that catastrophe-linked capital market instruments first appeared. It was assumed, owing to the unprecedented scale of the disaster, that traditional reinsurance and retrocession capacity would shrink markedly.

Following developments at the Chicago Board of Trade, futures contracts were created with a direct link to catastrophe losses in the US. Within a few years, the first securities were issued on this basis, and these days the industry

> The growth of ILS has been phenomenal, and analysts expect it to continue in the year ahead, as investors look for products that are going to meet their increasing demands for income

sees in excess of $15 billion trading between capital market investors.

The market for insurance-linked securities (ILS) was created as a response to large, unpredictable risks, and this has proven to be very attractive to insurers and investors alike.

ILS in Guernsey

The domicile of Guernsey has embraced ILS enthusiastically, due to a combination of factors, according to Robin Fuller, executive director of Dexion Capital.

"We have two of the essential components here. We have a mature captive insurance industry, which gives us a lot of insurance management expertise. We are also a very large fund centre, so it is the coming together of those elements, insurance management expertise together with a large alternative investment industry offering a rich source of capital."

In December 2013, the EU's insurance advisory service called for further supervision of the ILS market. The industry has enjoyed tremendous growth, and this has piqued the interest of the regulators from a financial stability standpoint.

According to the European Insurance and Occupational Pensions Authority (EIOPA), the independent body that is a part of the European System of Financial Supervision, ILS issuance has, since 2007, allowed large capital inflows across the insurance industry and helped to increase global reinsurance capital to an all-time high.

EIOPA believes that insurance supervisors should monitor ILS transfers more closely because the instruments could obscure the overall risk transfer picture.

In a statement on financial stability, EIOPA said: "The availability of so much reinsurance capacity creates a strong competitive environment. Developments in ILS also need close monitoring by supervisors as the extensive usage of ILS tends to cloud the picture in terms of understanding the risk transfer."

Is the level and quality of regulation in Guernsey adequate? Fuller says: "The insurance and investment industry are regulated by the GFSC, and investment vehicles tend to be regulated by its insurance division, or the investment division, or both. The insurance regulator here is very credible, and it sits on the international insurance supervision organisations, just as the investment division is part of IOSCO. Guernsey is very much attuned to international regulations on both the insurance and investment side."

The Guernsey Financial Services Commission licensed 89 new international insurers during 2013, meaning that there were 758 international insurers licensed in the island by the end of December 2013.

Fiona Le Poidevin, chief executive of Guernsey Finance, says that a significant proportion of the licences issued last year were associated with structures related to ILS.

"It is pleasing to see that Guernsey remains a popular international insurance centre. These figures build on last year's very strong performance and together mean that nearly 200 international insurance entities have been licensed in the Island during the last 24 months. The increases continue across the different types of entities, although there is particularly strong growth in PCC and ICC cells and especially in relation to ILS structures."

"Guernsey's international insurance expertise, our close proximity to both London and Zurich and our access to major global capital markets mean that we are increasingly viewed as a centre of choice for ILS. We are looking to build on this during 2014 through a number of different marketing and promotional activities which will highlight that Guernsey not only has a particularly experienced insurance sector but also a large investment funds community so is able to bring together both sides of the ILS equation."

The future

The growth of ILS has been phenomenal, and analysts expect it to continue in the year ahead, as investors look for products that are going to meet their increasing demands for income.

Fuller says: "With interest rates and bond yields at a historic low there is a lack of income at the moment. If you look at the investment market and what's selling, it tends to be anything that's offering income. Of course, with insurance products investors hope to make a profit at the end of the year which offers distributable income."

"From an investor's point of view, ILS is an attractive source of income which is uncorrelated with other asset classes. Much of correlation comes with the way the product is packaged. If you package it as a listed company, and something happens that impacts confidence in the market as a whole, there will be an element of contagion. Correlation comes through in the way the investment is structured, but the returns are largely uncorrelated with other major asset classes."

One reason for the growing popularity of ILS is that it is universal, which explains its global appeal. Across the world, governments are struggling with shrinking budgets in a slow global economy.

ILS is one way in which an area traditionally financed by governments, catastrophe insurance, can be offloaded into the private sector.

This follows the example created in another area of difficulty for insurers, terrorism. The success of the US government's Terrorism Risk and Insurance Act programme has left its proponent hoping that it will be extended beyond its current expiry date at the end of 2014.

Slow growth in traditional investments has also contributed to the success of ILS, and market practitioners have taken advantage of the fact. Traders in ILS in 2014 will benefit from years of research, innovation and increased choice in the market.

With a steady increase in third party capital, reinsurers are having to get competitive to bring in business, and this is helping to lower the cost of ILS structures, and to make this relatively new class of security an attractive investment.

While ILS is still very much a niche in the gargantuan securities market, its growth is being watched closely by major industry players, meaning that its significance is only going to increase in the years ahead. **CIT**

Turning disaster into opportunity

Carey Olsen's Christopher Anderson takes an in-depth look at ILS

The recent disastrous floods in the UK were caused by a succession of European windstorms (the latest being Windstorm Ulla). While devastating for those unfortunate enough to be affected by the floods, European windstorms and other natural disasters can provide a unique opportunity for others to invest in the pure insurance risk associated with the chance occurrence of natural catastrophes. Such investments are often structured through a somewhat esoteric investment called an insurance linked security (ILS). These investments involve the convergence of both investment and insurance expertise. For that reason, it is perhaps not surprising that Guernsey has seen an increase in ILS transactions in the last year or so. This article considers why Guernsey is such an attractive jurisdiction for ILS.

What is ILS?

An ILS is an instrument that provides investors with the opportunity to obtain exposure to pure insurance risk, usually over a short timeframe. Pure insurance risk (which depends on whether or not an uncertain future event occurs) is often entirely uncorrelated to traditional investment assets. For that reason, an ILS can be a

very attractive investment during times when traditional investments (eg, the stock market and interest rates) are providing poor returns.

The classic example of an ILS is a catastrophe reinsurance bond. In a cat bond, investors lend money to an special purpose vehicle (SPV) in the form of bonds that are often listed on a reputable securities exchange. The SPV writes an insurance or reinsurance contract (or even an International Swaps and Derivatives Association (ISDA) documented swap) under which it receives a premium in return for agreeing to provide cover to specified assets in respect of a particular risk (usually a natural catastrophe such as European windstorm) for a specified period (usually a year). If the windstorm season passes without incident, investors receive back their principal plus the stated coupon in full, which is funded out of the unspent premium received by the SPV. If not, investors may receive a reduced coupon or even lose some or all of the principal amount of the bonds they acquired.

Since they are often listed securities, cat bonds are available for investment to a wide range of investors. In the current economic climate, an increasing number of specialist investment funds (some established in Guernsey) are targeting ILS as an asset class. However, those funds are not limiting their investments to cat bonds. Instead, these highly sophisticated investors have established a number of "private placement" structures in Guernsey to obtain more direct exposure to the risk.

Those private placement structures typically involve the establishment of an SPV, which is owned and capitalised by the fund. The SPV directly writes the relevant risk, often through a reinsurance contract or an ISDA documented swap. Since there are fewer parties involved and no listing requirements to meet, the structure involves lower frictional costs than a cat bond. As a result, the fund stands to make a gain in excess of the amount of the coupon stated on a cat bond if the risk does not eventuate.

Why Guernsey?

Insurance

Guernsey is the leading European captive domicile and the fourth largest such domicile globally. It has been providing captive expertise for almost 40 years, and yet continues to show remarkable growth—there were 737 international insurers licensed in the island at the end of December 2012 compared with 687 a year previously. All of the major insurance brokers are represented, as well as a number of independently owned insurance managers.

Insurance regulation

Since the SPV in an ILS transaction is accepting risk on to its balance sheet, it may require to be regulated if it is conducting insurance business. Where the risk is accepted under an ISDA documented swap, on the other hand, such regulation may not be required. It is worth noting that there is no prohibition on a Guernsey-licensed insurance company entering into an ISDA documented swap. Indeed, a large number of transformer transactions have been conducted in Guernsey over the last 10 to 15 years.

In many jurisdictions, obtaining authorisation to conduct insurance business can be a lengthy process.

However, in Guernsey where the business is to be transacted through a protected cell of an already established Guernsey protected cell company, the necessary approval can usually be obtained in a matter of days. A number of insurance managers in Guernsey have already established protected and incorporated cell companies with cells that are available to third parties that wish to utilise them in this way and many ILS transactions have already been conducted through Guernsey cell companies.

SPVs utilised in ILS transactions are invariably fully funded. Accordingly, the Guernsey Financial Services Commission (GFSC) is able to take a pragmatic approach to solvency requirements.

Indeed, in some circumstances a self-certification process may be available for SPVs that meet certain specified criteria. If the SPV meets the eligibility criteria, the local Guernsey appointed insurance manager can obtain the necessary regulatory permission without having to wait for the GFSC to respond to an application. The speed and certainty with which this process provides gives Guernsey a key advantage over many competitor jurisdictions.

Funds industry

Guernsey has a world-class reputation as an investment fund domicile. As at Q3 2013, the net asset value of funds under management and administration in Guernsey was £267 billion. As noted above, a number of those funds invest in ILS products. For example, Carey Olsen advised on the establishment of DCG Iris Limited, a London-listed and Guernsey-registered closed-ended investment scheme that raised £40 million in 2012 to invest in ILS. Carey Olsen is also advising on the establishment of another listed fund that will invest in Lloyds' capacity through the cell of a Guernsey protected cell company. There are a number of other such funds and, for practical reasons, an investment fund already established in Guernsey is likely to use an SPV located in that jurisdiction, all other things being equal.

However, the growth seen in Guernsey ILS transactions has largely been due to the proximity of fund managers in London and Zurich that are familiar with Guernsey as a well regulated international finance centre. To them, Guernsey's combination of both insurance and investment fund expertise can be compelling.

Listings

Although traditionally cat bonds have been launched through the Caribbean jurisdictions, Guernsey is well placed to accommodate this business, too. Guernsey's dominance of the listed sector is well documented—it remains the domicile of incorporation for more non-UK entities listed on the London Stock Exchange than any other jurisdiction globally. Indeed, the establishment of a Guernsey holding company in order to facilitate the IPO of an overseas trading group on the London Stock Exchange is common.

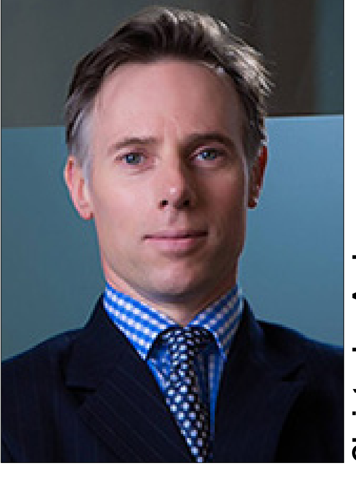
Foundations

Guernsey has recently introduced the continental legal concept of a foundation. Many SPVs used in ILS transactions must be "orphaned" and the foundation is an additional tool that can be used to achieve this, instead of the traditional common law trust. One of the key benefits of using a foundation instead of a trust is that its legal basis is often more readily understood in continental jurisdictions where the concept of a trust is unfamiliar.

Express company formations

Since the introduction of the online Guernsey Companies Registry in 2008, it has been possible to form a Guernsey company within a very short period of time. Standard formations are guaranteed to be turned around by the registry within 24 hours (but, in practice, are often approved the same day). For a slightly higher registration fee, four-hour and even 15-minute formations are possible.

It is not yet clear what impact this season's flooding in the UK will have on returns to investors in ILS transactions. However, what is clear is that the ILS has become a fixture of the investment and insurance landscape demonstrating the agility and value that a product created through the convergence of the insurance and investment sectors can have. Its strength in both sectors and the pragmatic approach of the regulator should mean that Guernsey's position at the centre is assured. CIT



Christopher Anderson
Partner
Carey Olsen

Entrepreneurial spirit

Scott Geromette of Honigman Miller Schwartz and Cohn reveals what he believes to be the biggest challenges facing the industry today, and how he is working on getting captives in to Federal Home Loan Banks cooperatives

DANIEL JACKSON REPORTS

What was your route into the insurance industry?

My route into the insurance industry was rather direct, which is interesting when you consider the fact that it was not necessarily a conscious decision. I attended college at Columbia University in New York and went to law school at Moritz College of Law at The Ohio State University. Coming out of undergrad and law school, I always planned to return to Michigan because: (i) both my wife's and my family live here; and (ii) the state, and Detroit in particular, have substantial potential for (re)growth and progress, movements that I wanted to experience and to which I wanted to contribute.

My firm, Honigman Miller Schwartz and Cohn LLP, is generally recognised as the premier business law firm in the state and hires an exclusive outstanding group of summer associates and new attorneys each year. I was lucky enough to be offered a summer associate position in 2008 and, during that summer, I gained valuable exposure to the many exclusive practice areas and departments at Honigman.

While the exposure confirmed my enjoyment of the practice of law generally, it also introduced me to a type of practice of which I was previously unaware. Specifically, I worked on a couple of projects with Bill Cassetta, Bill Hochkammer and Julie Robertson, three of the most respected and foremost experts in the captive insurance industry. In doing so, I witnessed the significant level of interaction and close relationships they shared not only with other service providers, but also with clients.

Those interactions and relationships (which I believe are somewhat unique to the captive business, especially on the legal side), as well as the great reputation and significant practice level of Honigman in the captive context, are what attracted me to the insurance industry.

How has your education in law and politics helped in your career?

I think there is a relatively substantial misconception in the US that the purpose of education is to prepare you for a particular profession. As a result, I think many young students lose perspective and take too literal of an approach to college and grad school classes. In my opinion, the goal of a good education should be to teach students how to think across a broad range of subjects and specialties so the individuals can then take those lessons and apply them in the context of their aspirations. I assure you that on a daily basis, I apply very few of the subject-specific concepts I learned in school. What I do apply regularly are the logic and reasoning skills that were important in all my classes, regardless of the subject.

Furthermore, and perhaps more importantly, I utilise the social and verbal skills that were important both in and out of the classroom. One of the best lessons I learned from a college professor stemmed from the comment, "you can be the most insightful and intelligent person in the world, but if you lack either the willingness to deliver the message or the ability to do so in an effective and articulate manner, what difference does it make?"

As a result, in college, law school and even today, I put quite a bit of effort into developing my verbal skills. In addition, I make an effort to communicate with clients either in person or by phone rather than deferring to email. It is certainly a quick and easy mode of communicating, and I certainly don't mean to suggest that it doesn't play a role in my day-to-day activities, but I believe there is a significant added benefit to direct interactions and communications.

What attracted you to a career in captive insurance?

In many other legal practice areas, you deal with clients on a 'one-off' basis, usually when issues or matters arise (ie, disputes, deals, etc). In the captive context and especially at Honigman, there is a more comprehensive approach to our representation. That is, we generally serve as general, outside counsel to the captive and assist/advise on a broad range of legal, regulatory, tax and business issues that arise over the life of the captive. In this regard, the captive insurance practice at Honigman

was very attractive because: (i) it provides the ability to assist clients in achieving their goals in a way that facilitates long-lasting and personal relationships; and (ii) it exposes me to a broad range of new and challenging issues across various legal specialties.

What is the biggest challenge facing the industry today?

In two words: popularity and responsibility. Historically, the captive industry has been very successful in flying under the radar. I don't mean that in a sense that they have tried to avoid regulation, but rather that they have largely been these somewhat isolated, self-sufficient and self-regulated vehicles. Captives generally grew out of necessity related to insurance crises and, as a result, the entities and industries most impacted by the crises searched for alternatives. Consequently, the knowledge of and familiarity with captives was relatively limited.

Now, as captives have become more popular, they are sometimes being used for different purposes outside the pure risk management/finance context and, as a result, there exposure has grown. This exposure can be a good and bad thing. On the one hand, it helps increase the profile and strengthens the perception of the alternative risk market as a stable and viable industry. On the other hand (properly or improperly), it can raise questions from legislators or regulators about whether these vehicles are sufficiently regulated or taxed and/or whether they are being used for proper purposes.

There are several problems with this. The first problem is that too often the people raising the questions do not fully understand captives or how they operate and really don't have a meaningful basis for concern. The second is that whenever there is some, limited basis for concern (ie, a default, IRS ruling, etc), captives are viewed as a collective group and one bad apple can have a perceived spoliation effect on the entire batch.

The final (and perhaps the biggest) problem is that presenting a united front in response to the questions or impending actions is very challenging because captives frequently have different interests depending on facts and circumstances (ie, domicile location, ownership structure, insurance program structure, etc). As a result, what one captive may perceive as unfavorable legislation, another may view as beneficial.

Some examples of recent legal and regulatory activities that illustrate my point regarding the increase in the exposure of captives are as follows:

- Continuing debate regarding the application of the Non-admitted and Reinsurance Reform Act to captives;
- Increase in tax audits;
- National Association of Insurance Commissioners activity;
- Increased scrutiny of 831(b) captives and 'pooling arrangements';
- Potential Federal Insurance Office involvement in captive regulation;
- More state regulatory commentary concerning use of special purpose financial vehicle captives; and
- Increased number of domiciles, captive legislation changes and competition.

What career goals would you like to achieve in the future?

I am a big believer in setting goals as I think they can serve not only as good motivation, but also as a good barometer for success. What I have found, however, is that goals are often defined as these tangible personal accomplishments or thresholds. This can lead to such unilateral focus on achieving the accomplishment or crossing the threshold, which people forget to appreciate the process. As a result, I try to set process/client-oriented goals that, if applied on a regular basis, will hopefully lead to overall success for the clients and me.

I consider myself truly lucky to have the opportunity to practice in an area as personally and professionally rewarding as captive insurance, at a firm as respected and renowned as Honigman, with colleagues as experienced and intelligent as mine, and with such insightful and sophisticated clients. As a result, my primary goals are to continue: (i) to develop my skills and experience as a captive attorney; (ii) expand my relationships with current and new clients by providing timely, efficient and effective legal, regulatory, tax and business advice/assistance; and (iii) always appreciate where I am in my practice and what got me there.

Has your career in captives met your expectations?

There is a famous Confucius quote along the lines of: "Choose a job you love and you will never work a day in your life." This quote holds true for me. My career has more than exceeded my expectations, primarily because I love what I do for a living (for all the reasons identified above—great clients, challenging issues, broad range of legal experience, exceptional firm and well-respected firm and colleagues).

What has been your proudest professional achievement?

As I noted above, Bill Cassetta, Bill Hochkammer and Julie Robertson generally are recognised as the foremost legal experts in the captive insurance practice. I was recently elected a partner at my firm and to be recognised as a colleague and "partner" of theirs is amazing.

However, my proudest professional achievement is still in the process of occurring. Over the last four years, I have been working on developing different organisational and operational models to enable captive insurance companies owned by mortgage companies, real estate investment trusts (REITs) and similar entities to join one or more of the Federal Home Loan Banks (FHLBs).

FHLBs are 12 autonomous, member-owned financial services cooperatives that were created by the Federal Home Loan Bank Act of 1932 to provide liquidity to housing markets. Membership is limited under the act to banks, thrifts, credit unions, community development financial institutions and insurance companies, provided the entities are able to demonstrate a material connection to the FHLBs' mission of supporting the home loan market. Members of the FHLBs are able to access improved and more stable liquidity, normally with significantly better rates and longer terms than what is available in the traditional market. As licensed insurance companies, captives are eligible to be considered for membership in the FHLBs. Mortgage banks and REITs have been using captives for several years as a way to manage their insurance costs and enhance enterprise risk management initiatives.

Furthermore, given the substantial involvement of residential mortgage banks and mortgage REITs in the home loan market, their activities are directly aligned with the FHLBs' mission. These mortgage banks and REITs experienced significant pressure as the credit market constricted during the Great Recession. As a result, a programme that offers access to stable, low-cost and long term funding through a captive vehicle that supports the entity's insurance and risk initiatives while also enhancing its primary operations is very appealing. Furthermore, because of the mission-specific nexus of the REITs and mortgage companies, several of the FHLBs are very enthusiastic about the arrangement.

I am really an entrepreneur at heart. To see a project that I have put so much time and effort into developing and to witness the benefits being achieved by clients has been an incredibly rewarding experience. CIT

Scott Geromette
Partner
Honigman Miller Schwartz and Cohn LLP

The more things change, the more the IRS looks to blame

Rent-A-Center v Commissioner answered some questions, but posed others. Alan Fine of Brown Smith Wallace explains

In January 2014, the US Tax Court released its long awaited decision in Rent-A-Center v Commissioner, addressing the deductibility for federal income tax purposes of premium payments made by brother/sister entities to a commonly controlled captive insurance company. Although the case provides a good review of the litigation history between the IRS and taxpayers in the captive arena and answers some questions, it leaves other key issues open.

In a 10-6 divided opinion, the Tax Court upheld the deductibility of the premiums paid to the captive. This divided opinion, which included a concurring opinion and two dissenting opinions, is unusual given that most Tax Court opinions are generally written by a single judge.

Rent-A-Center (RAC), in response to dramatically rising risk management costs, was advised by Aon that a captive could provide many benefits, including reducing costs and improving its overall risk management. RAC then commissioned Aon to prepare a feasibility study addressing the financial and non-financial benefits of forming a captive, which was then analysed by an accounting firm.

In late 2002, RAC incorporated and capitalised its captive with $9.9 million (the feasibility study recommended the captive be capitalised with no less than $8.8 million). As part of its due diligence, RAC requested a fee quote from Discover Re for the coverages to be insured in the captive. Discover Re responded that it would not insure the coverage contemplated by RAC but estimated that the premiums it would charge would be about $3 million more than the premiums actuarially determined appropriate to be charged by the captive.

During the years in question, the captive wrote policies covering workers' compensation, automobile and general liability claims below that insured by Discover Re.

RAC paid the premiums on behalf of the insured subsidiaries and allocated them back to the subsidiaries through an intercompany payable. The premiums were based upon the actuarially determined amounts calculated by Aon.

During the first three years of the captive's existence, RAC guaranteed the deferred tax asset on the captive's balance sheet in order to meet the minimum solvency margin.

IRS: sham; Tax Court: no

The IRS attacked RAC's captive on several fronts:

- It was a sham.
- The parental guarantee of the deferred tax asset.
- The arrangement between the commonly controlled entities did not qualify as insurance for federal income tax purposes.

The majority decision pointed to the legitimate business purpose leading to RAC's creation of the captive, pointing out that the intent was to obtain coverage for the insureds that was otherwise unavailable, addressing gaps in coverage obtained through the commercial marketplace. Importantly, taxes were deemed to be a consideration but not a driver behind the creation of the captive. The payment methodology of netting premiums and losses was determined to be customary and merely a bookkeeping simplification. The captive's capitalisation, while less than that typically found in the commercial marketplace, was deemed to be sufficient due to the differences in business model between a captive and a commercial insurer.

In addition, the captive was appropriately regulated in a recognised domicile, it charged actuarially determined premiums, and it was adequately capitalised. For these reasons, the majority dismissed the IRS's sham argument.

Qualifying as insurance

The majority next looked at the judicial history of this issue, including pro-IRS decisions they reached in the 1980s and 1990s (which were subsequently overturned on appeal). These cases established a four criteria framework for determining whether an arrangement qualifies as insurance for federal income tax purposes. They are: (i) the arrangement must involve insurance risk; (ii) risks must be shifted; (iii) risks must be appropriately distributed among a sufficient number of insureds; and (iv) the arrangement must meet the commonly accepted notions of insurance.

The majority examined whether the arrangements met the commonly accepted notions of insurance. The fact that the captive was adequately capitalised, regulated by Bermuda, issued valid and binding insurance contracts, charged actuarially determined premiums, and actually paid claims, was deemed sufficient to constitute insurance in the commonly accepted sense.

In this case, the coverage insured by the captive (workers' compensation, automobile and general liability) were clearly insurance (rather than investment) risks, which the IRS conceded.

Risk shifting

With respect to risk shifting, the court reviewed the precedent holding that a parent company insuring with its wholly owned subsidiary is deemed not to shift the risk away from the parent (the reasoning for this is that a claims payment to the parent by the captive subsidiary does not result in a true change in the parent company's economic standing).

The court then analysed the case law regarding insurance in a brother/sister setting, including the outright rejection of the IRS's "economic family" theory (which stood for the proposition that any risk retained within a family of related entities was a non-deductible reserve rather than an insurance arrangement). In these prior cases, the Tax Court had not approved any insurance arrangement among brother/sister companies, but the US Court of Appeal for the Sixth Circuit did in two cases that were appealed from the Tax Court appeal.

The majority then determined that their analysis in the prior cases did not appropriately examine the impact of claims payments on the balance sheet and net worth of the insureds. Unlike the situation where a claims payment by a captive subsidiary to its parent company has no meaningful impact on the balance sheet or net worth of the parent company, claims payments by a captive to one of its sister companies does have a meaningful impact upon that insured's balance sheet and net worth. The majority then examined the parental guarantee of the captive's deferred tax asset.

In this case, since the parent was never called upon to make good on the guarantee, nor was the captive undercapitalised, the guarantee was determined not to affect risk shifting. Accordingly, the Tax Court determined that the premiums paid to RAC's captive by the other subsidiaries did in fact shift risks away from those other subsidiaries.

Risk distribution

The majority looked to the Sixth Circuit cases that determined that distributing risks among a sufficient number of brother/sister entities achieved risk distribution. The majority also relied on the fact that the brother/sister entities owned between 2600 and 3100 stores and operated between 7100 and 8027 vehicles during the years in question. This variety of risks was deemed to be a "sufficient number of statistically independent risks" giving rise to adequate risk distribution.

Lessons learned and unanswered questions

So, what did we learn from this case? Firstly, it is critically important that a captive be formed for non-tax reasons. While the Tax Court did not devote much of its opinion to this aspect, it was clearly an important factor in reaching its decision. Secondly, a captive needs to be adequately capitalised and it should be regulated in a recognised jurisdiction. Actuarially determined premiums and actual payment of claims are critically important. Insurance companies pay claims; so should a captive.

What did the decision not answer? Firstly, it did not answer what is "adequate capitalisation"? The majority determined the captive was adequately capitalised but did not provide much guidance as to how this conclusion was reached, other than pointing out that the capital exceeded both the statutory minimum as well as that suggested by the feasibility study. This was clearly a source of contention between the majority and those judges that dissented.

The majority and dissenters also disagreed about the impact of the parental guarantee. The dissent stated that majority improperly relied upon the fact that the parent was never called on to make good on the guarantee. It's unclear what the appropriate resolution of this issue is.

Perhaps most importantly, it is unclear whether the IRS is now moving away from the brother/sister safe harbor it issued in Revenue Ruling 2002-90. This ruling provided that risk distribution is deemed to exist in a situation where a captive insurance company insured 12 entities under common ownership and where no single insured accounted for more than 15 percent nor less than 5 percent of the total risks being insured. RAC's captive insured 15 of its sister companies, and it was fairly apparent that none of those accounted for more than 15 percent nor less than 5 percent of the total risks.

Three key takeaways

Perhaps these questions will be answered in a future opinion, assuming that the IRS appeals against this decision. In the meantime, it would be prudent for captive owners to ensure that:

- Their captives have more than sufficient capital to meet their obligations;
- Their entities are domiciled in jurisdictions that sufficiently regulate captives; and
- Dealings with their captive are beyond reproach.

This will not guarantee that the IRS will respect the arrangement as insurance, but it will certainly provide obstacles to their attack. CIT

Alan Fine
Partner, insurance advisory services
Brown Smith Wallace

In it for the long haul

CCIA's Thomas Hodson explains the state's captive insurance vision

STEPHEN DURHAM REPORTS

Can you give an overview of the captive industry in a national context?

The captive industry is growing on a national and a worldwide basis. Captives were historically a vehicle used only by large, Fortune 500-type companies to manage risk. This was due, in part, to the novelty of the captive structure itself and, in part, because of the cost involved in organising and maintaining a captive. The novelty is wearing off and the cost of setting up and maintaining a captive is going down. Captives are becoming a more mainstream risk management tool, used by companies large and small.

As a result, I think the future of the captive industry is very bright. It used to be that the number of captive formations rose as the broader insurance market tightened; rates went up and availability of coverage went down. In these cyclical fluctuations, companies would look to alternatives ways to manage risk, like captives. This is not the case any more, as companies are increasingly looking to captives to not only manage the insurance market's effect on premium and coverage, but also to stabilise the structure of their insurance programme, as a whole, and allow companies to more effectively utilise their financial capital.

Are the state's captives in keeping with these national trends?

Yes, I would say they are. For example, in January of this year Connecticut licensed the captive for Frontier Communications, a national telecommunications company headquartered in the state. Frontier is using its captive to stabilise its overall operating cost—allowing it to reinvest the savings in other areas, in particular its human capital. The company recently announced a programme to hire veterans and the long-term unemployed. When a company's cost of managing risk goes down, it frees up capital allowing it to reinvest in growing its business. I think the Frontier example demonstrates that captive programmes are not just insurance vehicles, but that they add additional value to companies as a whole.

What about the local competition for Connecticut?

We don't view our captive initiative as competing with other states. When I first got into the captive industry 18 years ago, clients would ask me where they should domicile their captive. I used to reply by asking them whether they preferred to golf or to ski, as Bermuda and Vermont were the only options available at that time. Now, in the US alone there are over 35 states that have captive legislation, about half of which are relatively active and about 10 or 12 are very active.

It is becoming a geographic question first of all, as to whether or not a company's home state has captive legislation and, if not, whether there is a state close by that does. Then, it becomes a question of whether or not the state has the tools to help companies get the most out of their captive programme. I believe Connecticut has significant advantages over other domiciles.

Connecticut has been known as the 'insurance capital' of the US for over 200 years. This is important to captives because, as a result of this designation, insurance-based intellectual capital is a resource that is abundant in Connecticut.

In light of its prominence as an insurance hub, Connecticut has more captive service providers, including actuaries, accountants, tax professionals, lawyers, captive managers, fronting carriers and reinsurance companies, than in any other state—and I would argue almost any other domicile in the world. Connecticut has more insurance jobs per capita than any other state in the country. In short, Connecticut is known for insurance—which is important when looking for a captive domicile.

What are the downsides to establishing a captive in Connecticut?

It would be hard to identify a downside to having your captive in Connecticut. As I mentioned, the state has a deeper and broader service sector than any other domicile, and it is a convenient location at the crossroads of the northeastern US. I read recently that 13 percent of the US population lives within a 200-mile radius of Hartford, Connecticut, so we are right in the heart of major metropolitan areas, including New York, Philadelphia, Boston, Providence and Springfield. Someone recently described Connecticut as 'the thinking man's domicile', purely because of the insurance-based intellectual capital that we have in abundance in our state.

What is Connecticut doing to attract new clients?

First of all, we are trying to get the message out that Connecticut is a strong, viable domicile for captives. It is about informing and educating the market. Once industry professionals learn about what Connecticut has to offer as a domicile, they are quick to accept it as a serious domicile contender.

Secondly, we are focused on educating companies about the benefits of captive insurance. On 17 September 2014, we will be hosing our third annual symposium on captive insurance and, each year, it has been gaining industry interest.

In designing the agenda for each symposium, we make our content a little bit different; we try to raise the bar. For example, at last year's symposium our insurance commissioner led a discussion on risk capital and how to build additional value in a captive programme. It was a huge success. Our focus is on helping companies more fully utilise their captive and more effectively deploy their capital. After the event last year I received a comment from a well-respected industry veteran who said that in just two years, our symposium has become a 'must-attend' event in the captive industry—and that is a real compliment. It appears that our approach to educating the marketplace is working.

In terms of how Connecticut regulates captives, the approach that the insurance department now uses is different than most states. The focus is not on trying to license as many captives as possible. Connecticut is, instead, looking to help companies better use their captives as a strategic tool, rather than just an insurance or tax vehicle. If companies are more effectively using their captive, then they are able to deploy your capital to other initiatives, such as growing the business. This leads to a more valuable captive programme.

What the Connecticut insurance department is introducing is a more 'principals based' approach to regulating captives, rather than strictly a 'rules based' approach. Instead of simply regulating a captive programme solely to ensure solvency, the 'principals based' approach focuses on ensuring the stability and sustainability of the captive programme. This is not to say that specific rules do not apply. The laws and regulations do provide certain financial requirements and compliance standards.

However, 'principals based' regulation recognises that every company is different, and each company has different goals for their captive programme.

This new approach allows for a balanced regulatory process, recognising both the needs of the insurance regulators and the strategic objectives of the captive's owners—which is very powerful.

This approach to regulating captives is new and it will be interesting to learn more as it is rolled out. CIT

Thomas Hodson
President of CCIA
President and CEO, Charter Risk Management Services

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The captive insurance industry continues to evolve, expand and change. To meet these needs we must understand the issues and opportunities to create solutions in our markets. This year's CICA 2014 International Conference - Captives: Global Opportunities & Solutions highlights the results that come from addressing challenges impacting small domestic captives and large multinational captives equally.

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Industry appointments

Dublin International Insurance & Management Association, which represents international insurers and reinsurers based in Ireland, has appointed **Marco Nuvoloni** chairman, succeeding Stephen Devine.

Nuvoioni has worked across financial service over the last 20 years including periods at both the Financial Services Authority and the Central Bank of Ireland. His industry experience has focused on insurance and investment management from a consultancy and in-house perspective.

He is currently head of compliance legal and risk at Prudential International Assurance, which he joined in 2009.

Debbie O'Hare, CEO of Hannover Re Ireland, remains DIMA's vice-chair for 2014, and **Stephen Devine**, managing director of SCOR Global Life Reinsurance Ireland, remains on the DIMA board.

Eddy Van Cutsem, formerly vice-chairman of DIMA, has retired from the DIMA board after almost 25 years' involvement with the association.

Larry Sherin of Allied Risk Management has also retired from the DIMA board, having been a DIMA member since 1992 and served as chairman of the captives subcommittee and chairman of DIMA during his time as a director.

Nuvoloni said: "It is a great privilege for me to be asked to step up to the Chair of DIMA during a year which sees the 25th anniversary of international insurance and reinsurance in Ireland."

Sarah Goddard, CEO of DIMA, said: "I am delighted to welcome Marco Nuvoloni as chairman of the association."

"We are very excited to be celebrating 25 years of international re/insurance in Ireland this year, and are looking forward to a particularly busy conference in May. Reaching this milestone anniversary cements Ireland's position as a global centre for the industry."

US-based media accounting, tax and advisory firm Elko & Associates has prized **Mark Martinelli** away from certified public accountantsthe Cetrulo Morgan Group.

Martinelli takes over as director of Elko & Associates' tax practice, and will be in charge of the firm's captive insurance and alternative investment interests.

In addition to these duties, Martinelli will also be responsible for any dealings related to auditing, due diligence, internal control development, business plans and cash modelling techniques.

Elko & Associates was formed in 1960 and currently focuses its services on businesses in the Greater Philadelphia area.

Martinelli has more than 20 years of experience serving both the private company industry and the public accounting industry in the greater Philadelphia area.

Prior to joining Elko, he served as chief financial officer for Milestone Partners. He has held similar positions at Brinker Capital Holdings, Berwind Capital Management, and Graham Partners.

Prior to entering the private company arena Martinelli spent eight years at PricewaterhouseCoopers where he was responsible for providing services in the alternative investment company, insurance, and healthcare industries.

Kane has strengthened its business development team in the US with the appointment of **Monica Everett** as business development director and **Hannah Hayes** as business development associate.

Everett will be primarily responsible for building customer relationships and identifying new business opportunities, working in close collaboration with the executive and business development teams in the US, Cayman and Bermuda. Everett joins Kane with more than 30 years of insurance experience and a wealth of knowledge in the captive arena.

Prior to joining Kane, she was vice president of Willis Insurance in North America, focusing on large captive accounts in areas such as construction, renewable energy, real estate and staffing risks.

Hayes will support the business development directors, liaising with existing and prospective clients, researching market opportunities and developing new relationships.

Prior to joining Kane, she was a regional sales operations coordinator for Clearwire Corporation, responsible for project management and operations support for a large sales team.

Commenting on the appointments, Simon Hinshelwood, group CEO of Kane, said: "The continued expansion of our US operations and our US client base is a priority for Kane."

"In a highly competitive market, strengthening our business development team with two new hires further enhances our ability to deliver insurance management products precisely tailored to the changing needs of clients."

Carlos Oliveras, CEO and managing director of Kane USA, added: "Over her 30-year insurance career, Everett has developed a deep knowledge of the risk requirements of a broad range of clients and has become a trusted risk advisor."

"She has been the lead broker on several group captive programmes. Her extensive skill set and considerable experience will prove a key asset."

Willis Group Holdings has appointed **Sara Benolken** as the firm's global industry leader for technology, media and telecommunications.

Benolken, an insurance industry leader who has specialised in advising Willis's TMT clients since joining the firm in 2007, will lead the fifth industry group designed to connect Willis industry experts with product and geography leaders around the world.

The new global industry groups will focus on needs of clients within each sector, and provide them access to a range of insurance products and risk management services.

Willis's TMT industry group will report to Steve Hearn, deputy CEO of Willis Group. **CIT**

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