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NAIC testifies before Congress

Florida insurance commissioner Kevin McCarty has testified during a hearing before US Congress on behalf of the National Association of Insurance Commissioners (NAIC) on the need to coordinate insurance legislation to protect policyholders and benefit US markets and companies.

The hearing was held by the US Senate banking, housing and urban affairs committee.

"While we are committed to collaborating with our federal and foreign counterparts where we can, we have a responsibility to the US insurance sector," said McCarty.

"We will not implement any international standard that is inconsistent with our time-tested solvency regime that puts policyholders first," he added.

McCarty's testimony specifically addressed concerns regarding domestic and global capital rules for insurers.

He added: "Capital requirements are important, but if imposed incorrectly or without regard to difference in products and institutions, they can be onerous to companies, harmful to policyholders and may even encourage new risk-taking in the insurance industry."

McCarty will return to Capitol Hill in order to testify before the US House Financial Services Subcommittee on Housing and Insurance.

That hearing will focus on international regulatory standard-setting. McCarty's remarks will cover how US regulators are working internationally to strengthen open and competitive insurance markets globally, while protecting US interests.

PICA continues longevity risk growth

The Prudential Insurance Company of America (PICA) has announced its first longevity reinsurance transaction with UK-based insurer Pension Insurance Corporation (PIC), a specialist insurer of defined benefit pension funds.

Under the terms of the agreement, PICA will provide reinsurance to PIC for longevity risk associated with pension liabilities for more than 6,700 pensioners.

This longevity reinsurance transaction follows other recent reinsurance transactions in the UK, including 2014's British Telecom Pension Scheme (BTPS), which stands as the largest offshore risk transaction to date.

"This transaction represents another milestone in our efforts to expand our strategic partnerships with UK insurers, like PIC, to bring secure retirement to UK pensioners," said William McCloskey, vice president of longevity reinsurance at Prudential.

Prudential has completed the largest known pension risk transfer transactions in North America, including those with General Motors, Verizon, Motorola, Bristol-Myers Squibb and most recently, a transaction with Kimberly-Clark Corporation in the US, as well as the transaction with BTPS.

Khurram Khan, head of longevity risk management at PIC, added: "This collaboration represents a further channel for the flow of PIC's longevity risk to the reinsurance sector."

"We're pleased to begin this new partnership, which brings increased efficiency and capacity to PIC's reinsurance capability. This means we can offer better solutions to our customers."

Ally Financial replaces Mitsubishi captive

Ally Financial has become the preferred financing source for Mitsubishi Motors in the US, replacing the brand's captive finance company, Mitsubishi Motors Credit of America.

The agreement broadens the existing relationship between Ally and Mitsubishi Motors North America (MMNA), continuing to make Ally's full suite of automotive financial products and services available to all Mitsubishi dealers and their customers.

Through the agreement, Ally will provide use of its retail and lease financing, wholesale financing, remarketing, and insurance offerings, at Mitsubishi's nearly 380 dealerships across the US.

Don Swearingen, executive vice president of MMNA, commented: "As we pursue our growth plans in this dynamic landscape, we are pleased to have a financial partner like Ally that can support us with the products and services that our dealers need and that will be integral to our success."

London launches IIAL

The chairman of the Islamic Insurance Association of London (IIAL), Max Taylor, has claimed that London has the ability and willingness to drive the growth of shariah-compliant insurance products.

Taylor was speaking as he joined the London mayor Boris Johnson, CityUK CEO Chris Cummings and others, to launch the IIAL at the Mansion House.

The association has been formed to create a representative body to support the work of those in the UK reinsurance markets that are transacting Islamic finance.

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Insurance and reinsurance has been the last of the financial services sectors in London to establish shariah-compliant operations.

With Islamic nations in Asia, the Middle East and North Africa now among the world's biggest economic success stories there is a growing market for the provision of transparent and trusted shariah-compliant insurance and risk products.

The IIAL will provide its members with a platform to meet, network and have their say on how they wish to shape London as a provider of Islamic insurance and risk solutions.

It will provide analysis on the development of the wider Islamic financial market and how insurance will play a part in that development.

The aim of the IIAL is to play a major part in the efforts to drive and develop principles for the transaction of Islamic and shariah-compliant commercial reinsurance business, creating a set of principles that can be used as a basis for a future international standard for shariah insurance products and their transactions.

Taylor commented: "[The] launch of the IIAL comes in response to a clear need from the market both in the UK and globally."

"It comes at a time when the Islamic risk and insurance sector was undergoing a period of rapid growth."

"However, to enhance the sector and deliver change there is a real need for greater expertise and knowledge and this is where the London market can play a leading role."

He said the Islamic insurance sector remained one of the most dynamic sectors in the industry and there is a demand for high quality underwriting and capacity, which is ready-made for London to deliver.

Taylor added: "To be in a position to make the most of those opportunities London needs to engage with Islamic businesses and markets."

"The IIAL allows those in the London market to speak with a single voice and our message is that we are serious about the development of the Islamic insurance industry."

Another new cat bond for JLTCM

Jardine Lloyd Thompson Capital Markets (JLTCM), part of JLT Re, has arranged another private placement catastrophe bond, Market Re 2015-1, which closed at $10 million.

The new bond provides one year indemnity-based collateralised catastrophe reinsurance coverage for the cedant's Florida book of business.

Market Re was established in 2014 to continue to make the capital markets more accessible to issuers looking to do smaller-sized cat bonds.

"At JLTCM, we remain focused on keeping down the costs of doing transactions, which allow us to efficiently execute deals of different sizes," said Rick Miller, managing director and co-head of insurance-linked securities at JLTCM.

"For investors, Market Re creates a tradable instrument that can provide the opportunity for liquidity."

Michael Popkin, also managing director and co-head of insurance-linked securities at JLTCM, added: "As the Market Re platform broadens, we are seeing its versatility."

"We continue to work closely with our partners to simplify the process and reduce the frictional costs of bringing cedants to market. As we lower the barrier for cedants, we are finding attractive risks for the dedicated ILS investors."

Crowe Horwath acquires Saslow, Lufkin & Buggy

Crowe Horwath LLP has reached an agreement with Saslow Lufkin & Buggy LLP (SLB) to have its partners and professionals join Crowe on 1 July. Financial terms were not disclosed.

Based in Simsbury, Connecticut, with an additional office in Burlington, Vermont, SLB is an accounting and consulting firm serving insurance clients throughout the US.

With the addition of clients from SLB, Crowe will nearly triple its number of insurance clients and its insurance industry revenue. These will be the first Crowe locations in Connecticut and Vermont.

Established in 1999 by Richard Buggy, Glenn Saslow and Robert Lufkin, SLB is one of the US's leading providers of accounting, tax and consulting services to the property and casualty insurance industry.

The firm, which has 90 professionals, including eight partners, also serves a variety of New England healthcare entities and hospital systems and has a well-developed employee benefit plan practice.

"Our goal is always to provide an exceptional client experience and, with SLB personnel joining our team, we're able to enhance our deep specialisation in the areas of insurance, healthcare and benefit plans," said Crowe CEO Jim Powers.

Richard Buggy, managing partner of SLB, added: "Joining Crowe is a great fit with our values and way of doing business. Being part of a national firm that is part of an international network will provide our clients with access to broader resources while also providing significant benefit to our personnel through expanded career opportunities."

Soft market a challenge for reinsurers, says Xuber

Ongoing soft market conditions have been cited as the biggest challenge facing reinsurers, while analytics and modelling represent the greatest opportunities, according to research from Xuber.

The software house surveyed senior professionals including insurers, reinsurers, brokers, industry organisations, lawyers, insurance-linked securities (ILS) investment managers, analytics firms and modellers, across the UK, US, Bermuda, Canada, Channel Islands, Cayman Islands, Germany and Switzerland.

Of those surveyed, 81 percent listed soft market conditions among their top five concerns, and this was followed by competition from third-party capital and mergers and acquisitions (both 66 percent).

According to Xuber, the problems caused by a soft market are being compounded by "the emergence of alternative capital flooding the industry" in the form of catastrophe bonds and other sources of ILS.

As one survey respondent explained: "The real threat is publicly-listed insurers and reinsurers who have to maintain scale to appease their shareholders. Ergo, they're writing everything."

"What happens to all those classes of business that (for years) have been propped up by property catastrophe? If the margin in [catastrophe] continues to be eroded, how can businesses afford to maintain these marginal lines?"

The last 12 months have seen a wave of mergers and acquisitions activity as reinsurers have joined forces to achieve scale and most observers are predicting this will continue.

Although revealed as a joint second challenge, respondents generally viewed this as a positive force as mergers and acquisitions create opportunities for smaller organisations to create niche and specialist offerings.

Better use of analytics and modelling was cited by 71 percent of executives as the top opportunity to refine the identification of risk and reward to empower better business decisions.

Partnering with third-party capital was the second top business opportunity with 69 percent of respondents listing it in the top five.

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Although third-party capital was also listed as one of the key challenges, Xuber stated that reinsurers "understand that new investors entering the market do not possess the unique expertise to expertly manage risk". Consequently, reinsurers have a distinct opportunity and advantage over alternative capital.

DC conference to follow SIIA

The Captive Insurance Council of the District of Columbia (CICDC) has confirmed that its annual conference will feature multiple sessions with a specific District of Columbia focus, including an update from key Department of Insurance, Securities and Banking (DISB) regulators.

A case study presentation on how companies are making the most of the District of Columbia's cell captive law will also be included, as well as a guide to redomesticating captives to the District of Columbia.

Sessions will also cover tax updates, innovative governance strategies, finding new ways for captives to deliver value, and trends in risk retention groups.

In March of this year, the District of Columbia amended its Captive Insurance Company Act of 2004 ito strike any and all references to segregated accounts within the legislation.

The amendments have also permitted the commissioner of the DISB to extend or waive the requirement to conduct a financial examination of captive insurers every five years upon the satisfaction of certain criteria.

The CICDC conference will be held on the back of the Self-Insurance Institute of America National Conference & Expo, which is also to be held at the same venue.

Mission successful, says BDA

Top-level executives have attended information sessions in Toronto and Calgary to hear the benefits of establishing captive insurance companies in Bermuda from a 20-strong delegation led by the island's Business Development Agency (BDA).

"Our working relationship with Bermuda's regulator and business community was once again reinforced by the depth and professionalism displayed by the Bermuda delegation in Toronto and Calgary," said economic development minister Grant Gibbons, who led the roadshow and gave opening remarks at each session.

Bermuda has been of growing interest to Canadian corporations following the June 2010 signing of the Canada-Bermuda Tax Information and Exchange Agreement (TIEA), which allows Bermuda-based subsidiaries of certain Canadian corporations with international operations to be eligible for Canadian tax benefits, including the tax-free repatriation of certain dividends to Canada.

The forums featured an opening plenary session, moderated by BDA CEO Ross Webber with Gibbons and Michael Horgan, a former deputy minister of finance for the Canadian government, as panellists.

The delegation has claimed to have picked up several promising leads as a result of the mission, with industry practitioners in "continuing dialogue" with several of the prospects who attended.

"This initiative is being implemented according to our agreed strategy of finitely targeting regions, sectors and audiences. We deliberately showcased actual case study examples. This is highly persuasive for those who are on the fence," said Webber.

The captive session explained what a captive insurer is, a captive's structure, key reasons to set up a captive, along with common risks insured, citing several case studies.

Panels featured the Bermuda Monetary Authority's Leslie Robinson; David Gibbons of PwC Bermuda; Oceana Yates, of R&Q Quest Management; Philip Cook of Omega Insurance Holdings; David Downie of KPMG Canada; and David Platt of Encana Services Company.

Guernsey receives kudos from EC

The chief minister of Guernsey has welcomed support from European parliamentarians and the European Commission for the "positive contribution" the island makes to the European economy.

Jonathan Le Tocq who, along with Jersey's chief minister Ian Gorst, met with members of parliament from the UK, Germany, Ireland, France, Luxembourg, Denmark and Portugal to discuss the contribution that Guernsey's finance sector makes to the EU's economy and the jobs that it supports.

Le Tocq said: "The Channel Islands's funds sector is a conduit for around €200 billion of inward investment into Europe."

"We are an important economic partner of the EU, and that is the message that we have been delivering in Brussels—that continued access to European capital markets for the Channel Islands is good for the EU."

Gorst added: "In our meeting with the chair of the Tax Committee, Alain Lamassoure, we were able to offer our expertise and input into the work that they are doing over the next few months on tax transparency."

"Our meetings with Luxembourg's and the Netherlands's permanent representatives to the EU also means that we have a growing understanding of the emerging priorities of the next two EU presidencies, and that they have an understanding of areas where we can offer input."

The chief ministers also met with representatives from Scotland, the City of London, Andorra, the Faroe Islands, Gibraltar and the Isle of Man, among others at a briefing event organised by the Channel Islands Brussels Office.

RRG average premium hits high

Average risk retention group (RRG) premium increased more than 10 percent during 2014, its highest growth rate in a decade, according to JLT Towner.

Although the actual number of RRGs dropped, with 19 retirements during the year, the remaining RRGs had an average annual premium of $12.6 million.

"Some RRGs go into and out of business in lockstep with commercial rate movement, so it isn't surprising that we see retirements continuing, considering the soft market," said JLT Towner partner Len Crouse.

"What these results show, however, is that the remaining RRGs are well run. [RRGs] remain a viable alternative for organisations whether markets are soft or commercial prices increase."

CICA responds to IRS definition

The Captive Insurance Companies Association (CICA) has submitted a response to the Internal Revenue Service (IRS) in objection to the proposed definition of "active conduct" in its Exception from Passive Income for Certain Foreign Companies.

Consequently, CICA has requested a public hearing to resolve the matter.

"As currently drafted, the language would not allow an insurance company to operate through the utilisation of independent contractors or the officers and employees of subsidiaries, which is contrary to the manner in which thousands of captive insurers operate and to current IRS practice," explained Dennis Harwick, CICA's president.

CICA's response cited Rev. Rul. 2002-89, 2002-2 C.B. 984, which says an insurance company "may perform all necessary administrative tasks, or it may outsource those tasks at prevailing commercial market rates."

The association also questioned the need for the proposed regulation in light of the existing statutory authority to address the level of capital necessary to conduct an insurance busines.

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CICA cited existing provisions that require that more than half the insurance company's business be from insurance and reinsurance.

The proposed regulation was issued by the IRS in late-April 2015.

Ratings revision for Restoration Risk Retention Group

A.M. Best has revised the outlook to negative from stable and affirmed the financial strength rating of "A- (Excellent)" and the issuer credit rating of "a-" of Restoration Risk Retention Group (RRRG), domiciled in Burlington, Vermont.

The revision of the outlook to negative is due to what A.M Best has called a "significant reduction" in risk-adjusted capitalisation in 2014 coupled with a "material increase" in the accident year loss and loss adjustment expense ratio in the past two years.

The reduced level of capitalisation, as measured by Best's Capital Adequacy Ratio (BCAR) model, was primarily a result of RRRG increasing its investment in equities, which increased the capital requirement to support those assets.

Common stock leverage is now well above industry norms, according to A.M Best. As such, BCAR is only minimally supportive of the ratings.

That agency stated: "It is A.M. Best's belief that risk-adjusted capital may not support the current ratings if there is a material correction in the equity markets, should growth not be supported by a proportional increase in surplus or should underwriting performance diminish overall earnings."

In addition, BCAR would continue to be weakened by further increases in equity leverage.

Additionally, pre-tax operating income was negative for RRRG in 2014, continuing a three-year trend, mainly due to weaker underwriting performance.

The affirmation of the company's ratings was based on its historically better than average profitability, produced primarily by underwriting income and realised capital gains supplementing net investment income.

In addition, the company has expertise in providing general liability, pollution liability and limited service and repair liability insurance coverage to franchisees of Servpro Industries, RRRG's sponsor.

RRRG's balance sheet strength had historically been very supportive of the ratings, achieved mainly through organic surplus growth, moderate underwriting risk growth, favourable reserve development, strong liquidity measures and conservative investing, as well as the initial contribution of Servpro.

The ratings may be downgraded should risk-adjusted capital weaken further, if the decline in profitability does not reverse or if reserve development continues to trend unfavourably.

The rating outlook may be changed to stable with material deleveraging of the investments in the near-term or sustained improvement in capitalisation over the mid-term.

Utah clears up LLC language in captive code

Utah's captive code will include language specifically addressing the use of limited liability companies (LLCs) as a type of captive formation, following a recent legislative session.

Although LLCs were permitted, specific structure and direction were absent, with previous language only addressing stock company formations.

The changes will take effect on 1 July.

Utah has also increased the captive exam cycle from a three year to a five-year period. Under the new language, the required minimum of

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$250,000 to be maintained as paid-in capital and free surplus may be accomplished through any combination of either.

The captive code previously specified a minimum requirement for each element separately, with a paid-in capital requirement of $100,000 and a free surplus requirement of $150,000.

Capitalisation of a cell captive sponsor remains $1 million.

However, the new language indicates that only a minimum of $350,000 must be provided by the sponsor, and this balance may be provided by the cell companies.

Pooling can now take place within the sponsor of a cell captive, and each sponsored cell captive will be required to pay an annual license renewal fee of $1,000 per cell.

The Utah Department of Insurance's captive division has stated: "[We] believe these changes will be advantageous in allowing us to better provide services as regulators."

"We foresee these as being beneficial to our Utah domiciled captive companies. Additionally, we feel that the changes made will continue to contribute to a positive business friendly environment for all."

Captives thinking outside the box, says Marsh

Captive insurance vehicles are increasingly being used by businesses to provide cover for non-traditional risks, according to a new benchmarking report published by Marsh, with the number of captives doing so rising by 11 percent overall in 2014.

The biggest increase came from political risk, where the number of captives that include political risk rose 83 percent in 2014.

Additionally, the number of captives writing cyber liability grew 18 percent.

"As more companies use data and analytics to better quantify their emerging risks and optimise their retained risk, the utilisation of a captive to finance retained traditional and emerging risk is a logical next step," said Christopher Lay, president of Marsh Captive Solutions.

In the US, 22 percent of the 374 captives under Marsh management currently access the Terrorism Risk Insurance Program Reauthorization Act of 2015, by writing either conventional terrorism coverage for property damage or the excluded nuclear, biological, chemical and radiological perils.

Across international markets, the EU is continuing to see an uplift in formations driven by increasing certainty around Solvency II, according to Marsh.

The report has also claimed that other regions like Latin America, Asia and the Middle East are all experiencing "significant activity" in exploring the use of captives as risk financing becomes more sophisticated.

Financial institutions represent the largest users of captives worldwide, with 269 captives writing $20 billion of annual premium and holding a combined surplus in excess of $35 billion.

While the number of captives owned by communication, media, and technology companies ranks seventh among industries benchmarked, they generate the second-largest amount of premium totalling $3.2 billion.

The report stated that there were eight captive redomestications in 2014, down from 11 in 2013 and 16 in 2012, once again showing no large-scale trend in captives moving domiciles.

Hong Kong now has three captives and has goals of attracting many more, including companies from China, according to Marsh.

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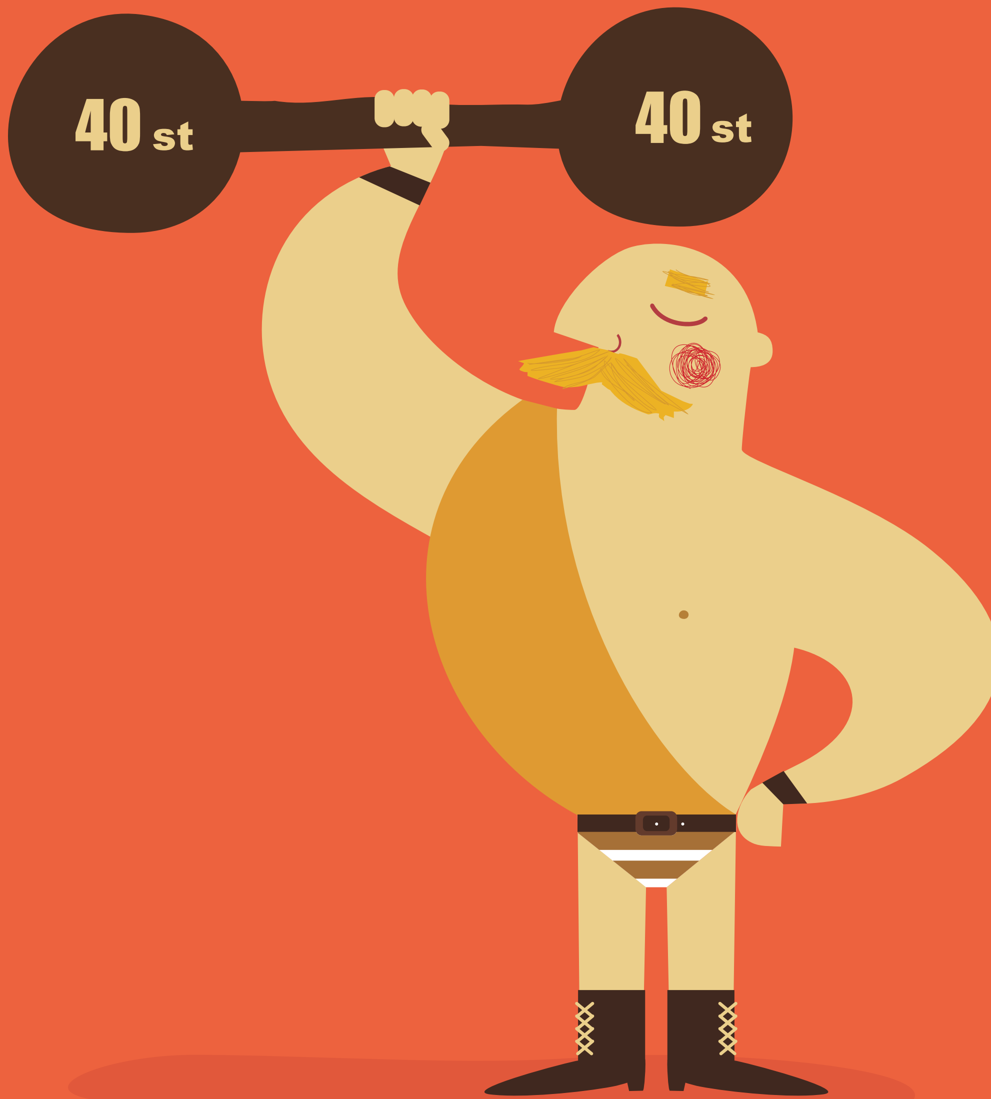

Pound for pound

Bermuda's captive industry has had to move with the times to keep its place among heavyweight competition

STEPHEN DURHAM REPORTS

Proliferation—that is the word that rears its head in more or less every conversation about the current state of captive insurance in the US and the Caribbean. It is often said that there is a proliferation of captive insurance domiciles and an exhaustible amount of business to go around.

As well as competition from the US in the shape of established domiciles like Vermont, there is also mounting pressure from newer domiciles, such as the District of Columbia, which cater for smaller programmes.

While Bermuda's growth is admittedly—and understandably—not reaching the peaks of its captive insurance heyday, there remains encouraging statistics to support the view that competition is acting as the perfect catalyst for progress.

The total insurance market in Bermuda saw 65 new insureds registered in 2014, including pure captives, commercial insurers and reinsurers, while 28 special purpose insurers (SPIs) were also licensed.

Overall, 18 new captives were registered, which remained in line with previous years. Although these numbers did not match the 91 new insureds registered in the domicile during 2013, the total was skewed somewhat by a bumper year for SPIs, in which 51 were registered overall.

Perhaps unsurprisingly, given its breadth of experience, Bermuda offers the full suite of captive programmes, including significant property and employee benefits book, with an increasing interest in cyber risk and warrantee business. Unlike some of its nearest competitors, Bermuda has avoided reliance on one particular type of captive programme. For example, of the 760 captives that filed statutory financial returns in 2014, only 43 were healthcare captives.

As is often the case in the more developed captive domiciles, Bermuda has embraced the mantra of 'quality over quantity' when it comes to healthcare captives.

Board member of the island's Business Development Agency (BDA), Paul Scope, comments: "In recent years, Bermuda has allowed well-capitalised healthcare captives from corporations and non-profits, but we remain selective in that area. We are not heavily dependent on this class, but nevertheless, we have seen growth over the past five years."

"Bermuda now has about 40 risk professionals writing healthcare insurance and reinsurance, and our market has capacity to write up to $400 million for any single healthcare risk."

From both a regulatory and tax perspective, the US does not pose a direct threat to offshore domiciles such as Bermuda for the majority of structures, especially insurance-linked securities (ILS) and other third-party business. However, for the traditional US domestic-owned captives, US domiciles do offer credible competition and, in many cases, can offer an equivalent domicile option.

"That being said, there are some instances where Bermuda can provide the best option for US owners, specifically where there is a mix of US and international business," adds Robert Eastham, who is managing director of Kane Bermuda.

One of these instances is the provision of ILS services, which is fast becoming a priority for insurers in Bermuda. Shelby Weldon, director of licensing and authorisations at the Bermuda Monetary Authority (BMA), says: "ILS as an alternative risk management vehicle seems to be getting more significant in the global insurance space. We want to continue to grow our ILS market while making sure that area is appropriately supervised."

He adds: "In order to do so, we do not have to do anything radically different—just make sure we are in a position to stand up to international scrutiny."

While the US continues to be Bermuda's largest target market, both Canada and Latin America have become increasingly profitable sources of new business. During 2014, a quarter of Bermuda's captive registrations came from Canada and Latin America.

This expansion has been assisted by the signing of Tax Information Exchange Agreements (TIEAs) with numerous jurisdictions worldwide—Bermuda has 41 such agreements in place as of April 2015.

Scope states that, of the 20 insurers already established in Q1 2015, three are from Latin America. In order to maintain this level of interest, Bermuda has agreed to host ALARYS (the Latin American Congress on Risk Management) in September 2016.

In addition to these priority areas, Weldon says that Bermuda has gained new captives from Africa and continues to see captives from the EU and even the Asia Pacific region.

While he concedes that there is not currently the same level of insurance penetration in the Asia Pacific, Weldon maintains that opportunities are there.

Earlier in 2015, a delegation from Bermuda travelled to China to educate businesses and government in the finer points of the captive concept, while attempting to establish preliminary business relationships.

For Bermuda's regulators, the main way for the domicile to attract new business from around the globe is to maintain its reputation as a thorough but fair regulator, while staying on the cusp of international regulatory standards.

Weldon explains: "For the jurisdiction as a whole, the key objective for us is to secure full equivalence under the EU Solvency II directive in advance of the implementation date in 2016. That continues to be a focus for us. We have recently been granted qualified jurisdiction status by the National Association of Insurance Commissioners in the US—which remains a key trading partner for us."

As well as being an attraction for the more diligent among prospective captive managers, there are also many that find Bermuda's regulatory philosophy to be beneficial to the growth of the captive industry itself.

Oliver Heyliger, managing director at Willis Management in Bermuda, explains: "The Bermuda regulators have continued to be very supportive of the captive industry. This is no more evident than in their effort to bifurcate the level of regulations between captives and commercial insurers."

"They understand that risk-based regulations should focus more attention on that type of insurer that potentially poses the greater risk. Captives do not fall into that category."

Again, this raises the point that Bermuda has accrued enough experience to pick and choose the entities it licenses, as well as taking to time to develop a philosophical synchronicity between industry participants and its regulator.

Scope comments: "Bermuda's captive industry has a long and strong relationship with our regulator, the BMA. The BDA leads numerous targeted overseas business development initiatives annually, with a true 'Team Bermuda' focus—incorporating members of government, industry and the BMA within its delegation so that the message is consistent, supportive, and clear."

In terms of the future of the domicile, it is simply a case of maintaining tried and tested methods, embracing opportunities such as ILS and geographic expansion, and improving transparency. Weldon says that, while no significant changes are planned in terms Bermuda's regulatory approach, the domicile will be introducing an enhanced financial return system that will be centred around gathering more robust statistical data about captives operating within the jurisdiction.

He explains: "The rationale is three-fold. Firstly, to ensure that the BMA is appropriately informed about the captive companies at work in the domicile, which will guide us to make the right regulatory decisions. Secondly, the data will assist internationally as captive standards evolve."

"Finally, the data will also help to promote the jurisdiction, as the market will be better informed about what being domiciled in Bermuda is like." CIT

Great expectations

Adrian Sweeney of Zurich explains why Asia is looking to take the captive concept beyond the usual risk transfer, and how far the region has come

STEPHEN DURHAM REPORTS

What do those without the financial strength of China, such as the Cook Islands or Labuan, have to do to compete? Is it a case of carving out a niche?

Most of the smaller domiciles distinguished themselves from a stronger domicile, such as Singapore, and so have already set their target audience, their niche and their strategy. Each one has their own speciality and appeal to support their existence, be it by providing for a specific market, such as Micronesia for Japanese companies, or to a certain segment of customers such as Labuan with the protected cell company legislation.

How important is Asia's economic development to the coming-of-age of its captive insurance industry?

The economic developments have started people on the path to seeking new solutions and learning how to better utilise and protect their assets. Risk management is growing in importance and the captive industry is benefiting from this development.

As the growth and cash flow slows and costs rise, alternative solutions gain ground and the captives' offer of keeping the cash flow within the group becomes highly attractive.

We see many more Asian companies buying or opening operations globally, and a captive can be a useful tool to centralise the corporation's risks in one location as an aid to risk management and risk financing options.

Are there opportunities in Asia to use captives as part of an investment strategy?

There are possibilities to take captives beyond the usual risk transfer and create something more akin to a profit centre, which then can fund further risk improvements and lead to further profits in the captive. This creates a self-investment tool that can be part of the investment strategy of the company.

As a captive matures there is often a surplus of capital that is built up and this can be used in a variety of ways to assist the parent company, including as part of an overall investment strategy.

What role will regulators play in the development of Asia?

Regulators will have a strong influence on the development in the region, as can be seen by the encouragement of the Chinese regulator in respect of creating captives.

Similarly, the increase of the tariff in Indonesia has started many companies to seek an alternative solution for their insurance needs.

Regulators will be a strong force in the development and the direction captives will take in Asia.

What is Zurich's current focus in the region? Are particular domiciles being prioritised?

Zurich prioritises the customer, not a particular domicile. For us it doesn't matter where the customer has their captive.

We focus on bringing innovative and proven solutions to customers in the region and help them to further understand the possibilities of captives and support them in creating tailored solutions.

How is Asia overcoming a lack of experienced practitioners?

Education and knowledge sharing are of utmost importance and Zurich is always more than happy to share their understanding and knowledge with customers and brokers. We host and support various events across the region.

How are captive insurers being used to access cheap capacity through the reinsurance markets?

The tendency seems to be to use the cheap capacity and push it to the front line through the captive, bringing down the premium cost of the insurance.

This can be seen across various industries.

While this improves impact of insurance cost on the company's profit and loss, it also cuts down the premium flow to the captive and limits it abilities to function as a risk management and risk transfer tool.

A captive that is used to access cheap reinsurance creates an alternative problem for the company—that of the credit risks of the reinsurance being bought.

In Asia, we are seeing a much stronger growth in captives that form a key component of the parent company's risk management strategy working with a partner that can service their needs globally, providing fronting, risk engineering and risk transfer capacity in support of the parent company. CIT

Adrian Sweeney
Chief underwriting officer, Asia Pacific
general insurance
Zurich Insurance Group

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Captive cash-makers: who will yield?

Whether at the mercy of Solvency II or not, Colleen McHugh of Barclays says it is imperative that the captive insurance industry remains aware

STEPHEN DURHAM REPORTS

What are the most popular ways for a captive to employ an investment strategy in Europe? Has this been the case for some time?

The majority of captive insurers here in Guernsey underwrite risk for UK-based parents, so most of the potential liabilities are sterling-denominated. Therefore, a Guernsey captive will often implement a sterling-denominated investment strategy. Prior to 2008, in any captive jurisdiction, cash was king and could achieve a decent return. The 5 percent-plus yield on that cash alone was often enough to cover the operating cost of the captive, making it self-funding.

In honesty, there was probably no need to move away from cash as an investment strategy, but the prevailing low interest rates over the last six years and concerns with concentration risk have led captives to actively seek yield while trying to minimise the risk of maintaining all their assets in banks.

In order to do that, captives have embraced this concept of segmenting their cash reserves into different classifications—operating, core and strategic. While operating and core need to be liquid, the strategic cash can be used to invest in longer-dated securities. That is where yield pickup can be maximised while minimising volatility.

The first step for such a captive would be something like a short-dated bond portfolio, which has very high credit quality and typically has a duration of around 18 months. The objective of that portfolio is, first and foremost, captive preservation, although it will try and pick up yield as well. There might be a 100-basis point return on that type of portfolio, which is of course better than cash, but the crucial fact is that the captive is getting counterparty diversification by investing in a portfolio of high-quality, short-dated bonds.

We do not see much European investment in equities, but I believe that the larger, more mature captives should look at dedicating a very small allocation to them.

Are these investment strategies gaining widespread popularity or are many captive owners still unaware/uninterested?

It varies from domicile to domicile, but we are seeing more and more captive entities

and their parents looking for assistance around formalising an asset allocation approach. This translated into how best to integrate non-cash assets into a portfolio. I am seeing an increased level of investment engagement by captive managers and owners here in Guernsey, but the Guernsey Financial Services Commission (GFSC) statistics show that more than half of the gross assets held by captives are still tied up in loan-backs to parents. This is something of a trend within Europe, Guernsey and the Isle of Man at present.

What are the main reasons a captive would employ these kinds of investment strategies?

In terms of the revenue streams available to a captive insurer, it has underwriting profits and investment income. For a number of years, captive insurers have been adversely affected on the insurance side of things by the protracted soft insurance market, which affects underwriting revenue. On the asset side they are suffering too, thanks to the protracted period of low interest rates. If you throw into the mix the fact that the cost of running a captive is creeping higher—the pressure is really piling up to drive returns on assets and avoid the captive being squeezed.

Certainly then, developing a more tactical and formal investment approach can show captive managers the options available in order for them to generate that elusive yield and total return, while keeping the volatility low.

We are constantly reminded that investing for captives is different to other types of clients in that the primary purpose of a captive is to act as an insurance vehicle to meet the claims responsibility of its parent. As a result, the assets need to be invested in safe, liquid investments in order to ensure that they can meet any future claims. That is the conundrum facing these captive insurers.

What are the main investment considerations for captives?

It all comes back to the fact that a captive has a unique profile, and this means that the investment guidelines of the parent become a primary consideration. For example, a UK-based FTSE 100 company with a captive in Guernsey will have a desire to have some input into the investment strategy itself, despite the fact that it is only a subsidiary.

Another differential is the captive's life-cycle. This impacts the captive's investment requirement and dictates what their investment strategy can be. A newly formed captive would require all the assets to maintain predominantly in cash as it is initially funded but, in contrast, a more mature captive could engage in an investment programme of matching assets and liabilities—looking to risk the assets and potentially even allocate to some equities.

“A captive could be tempted to reduce its holding of long-term corporate debt in favour of sovereign bonds, as it would get better capital treatment. The problem is that European governments are trying to reduce their levels of borrowing, despite corporate balance sheets being in good health. A shift from corporate to government paper at this point in time is somewhat counterintuitive”

The actual line of insurance that is being underwritten can also affect a captive's strategy. For instance, if a captive is underwriting long-tail risk where the claims might take years to emerge (such as casualty risk) then it could be afforded a more developed and sophisticated investment strategy. This would be in direct contrast to, say, property risk, which is short-tail and limits the investment universe for a captive.

The collateral requirements or fronting restrictions that a captive is subject to could also affect the investment considerations, as do the complex regulatory requirements.

What is the attitude of regulators towards captives employing an investment strategy? Are there strict guidelines to follow?

Again this varies as each domicile's regulator will have different permissible assets that captive can invest in. The GFSC has recently published risk-based solvency rules that require insurers to hold capital in relation to their risk profiles and access insurance risk, credit risk and market risk. In Guernsey there is no longer an approved asset regime.

Of course, an investment strategy can still be employed but it is crucial that the adequate capital is maintained to meet the risk posed by that investment strategy.

Given its freedom from Solvency II, is Guernsey an ideal domicile in which captives can invest their assets?

Solvency II will not affect us like it will other European domiciles after it is implemented next year. In terms of the impact from an investment perspective for European captives and/or their parent companies, the reality is that the Solvency II rules will encourage the diversification of investment, which is a good thing.

The reason for that is because different capital charges will apply for different levels of concentration risk.

If we look at the proposed regulations, they give a zero-spread weighting to all AA-rated sovereign debt. This would mean that a captive could be tempted to reduce its holding of long-term corporate debt in favour of sovereign bonds, as it would get better capital treatment.

The problem here is that European governments are trying to reduce their levels of borrowing, despite corporate balance sheets being in good health. A shift from corporate paper to government paper at this point in time is somewhat counterintuitive.

The world is a very different place than it was even a couple of years ago, and it is incumbent that the industry remains constantly aware of these regulatory changes. **CIT**

Colleen McHugh
Captive insurance investment adviser
Barclays Wealth & Investment Management

Locally addicted to change

Significant developments within the sector in Gibraltar and Europe may have a lasting impact, says Steve Quinn of Quest Insurance Management

The insurance industry in Gibraltar has grown rapidly and is now entering its period of maturing adolescence, where it starts to discover some of the more difficult aspects of life as well as attractive opportunities that exist out there, which need to be tamed and won over.

No article on major issues facing the insurance sector at the present time would be complete without referring, first and foremost, to Solvency II.

As a reminder, this is the long-heralded project to harmonise solvency requirements and corporate governance policies, procedures and reporting for insurance companies across the EU. Implementation will be mandatory with effect from 1 January 2016 onwards (subject to limited transitional arrangements). The Financial Services Commission (FSC) in Gibraltar already requires insurers to demonstrate that certain plans have been in place since 31 December 2014.

It can be argued that the consequences of the solvency or capital aspects of Solvency II are that some Gibraltar insurers are starting to question the long-term viability of their businesses if additional capital is to be required.

For some time now, the FSC has gradually been guiding insurers to raise their capital bases to meet the expectations of Solvency II and have set 200 percent of the required minimum margin (RMM) under what we could call Solvency I as the benchmark that they would wish to see insurers meeting.

From initial modelling of the financial requirements expected to be faced by Solvency II, the FSC was absolutely spot on to set this as its expectation, and in some cases this may not be sufficient.

New and existing insurers should expect to see solvency requirements of 200 percent to perhaps 300 percent of the current RMM. Or put a different way, new and existing insurers should expect to see solvency requirements of between 40 percent and 50 percent of standalone (ie, without proportional reinsurance support) gross written premium.

In the medium term, there will potentially be fewer but larger insurance companies. There is an appetite at the moment from large private equity houses to acquire insurance companies, and in particular motor insurers, with a belief that better times may be ahead for this sector as rates improve from the rock bottom levels of the last two years or so.

This appetite is being sated in both the UK and Gibraltar, with several ongoing projects to acquire existing companies that may well come to fruition in 2015.

At the same time, and as stated above, the shareholders of some Gibraltar insurers are apparently considering whether now is a good time to exit the market rather than potentially invest further funds to meet the evolving solvency demands. The golden era of the owner-managed Gibraltar insurer will gradually draw to a close if the existing businesses are unable either to show that they will meet the new solvency requirements from organic capital base growth since establishment, or can demonstrate an ability to raise the additional funds required.

Other issues that are being faced by insurers relate to continued uncertainty of what the

new world will ultimately look like. I have every sympathy with our local regulator, which is required to interpret somewhat opaque and convoluted legislation that has been written for the 27 different countries within the EU (and beyond for those who are seeking equivalency), while taking account of the differing languages and cultures that make up the incredibly diverse and cosmopolitan continent that is Europe.

The FSC is still getting to grips with the requirements of Solvency II at a point where we are only a few months away from formal implementation of all requirements. One obvious example of this is with the interpretation of groups, where non-trading investment or holding companies that may contain debt may well have a negative impact on a subsidiary insurance company via the group's solvency position.

As a business, we are working closely with the FSC to ensure that wherever possible, common sense will prevail in attempting to interpret the bureaucratic jargon that has been set down to date.

We are also starting to see insurers looking at rating agency accreditation, an area that has not been addressed in Gibraltar previously. Larger companies are well served by being rated by the likes of A.M. Best and Standard and Poor's, as this generally allows certain products to be more marketable to brokers in Europe. This has not been a particular constraint for the traditional Gibraltar motor insurance market, but some liability-centred insurers would certainly benefit from a good security rating.

There may be implications on the insurance managers, too. An insurance manager is the vehicle by which the overwhelming majority of insurance companies in Gibraltar have started their lives and grown, perhaps to a position where they have either partially or wholly fled the nest and set up their own local structure.

The insurance managers have undoubtedly been crucial in growing the business locally and I believe they should continue to play an important role in the future. That role may well be changing, however, and the level of technical expertise required by the insurance managers is also developing.

An insurance management outfit should by now contain considerable expertise in all requirements of Solvency II and be able to guide and assist clients (and perhaps non-clients alike) in producing both governance documentation and robust capital models.

This has now become a core function of the insurance manager alongside other traditional areas such as the general accounting requirements, compliance and company secretarial matters, and being intelligently informed about the sector in which the client operates and the investment markets that an insurer may wish to utilise to maximise returns in a prudent manner.

The subject of Part VII transfers has progressed well in 2014 but has sadly not reached a conclusion. As a reminder, a Part VII transfer is so called as it is a reference to that part of the Financial Services and Markets Act 2000, and is effectively the movement of an insurance portfolio from its home in the UK either to another home in the UK or to another EU member state.

When the legislation was drawn up in the UK, regrettably Gibraltar was not named separately as a European economic area state, and so there has been uncertainty ever since as to whether a judge needing to approve such a transfer to Gibraltar would believe that such a move is legal.

For many years, leading players in the local insurance industry have been lobbying the Gibraltar government to apply pressure on the UK Treasury to make the necessary changes. An announcement was made in July 2014 to the effect that Gibraltar now had the ability to accept transfers from the UK, but unfortunately it seems the issue has not been resolved fully as yet.

The UK Treasury has written to the government of Gibraltar indicating that it would raise no objection to such a transfer being approved, but no parliamentary order has been tabled to codify this.

The danger, therefore, remains that a judge, when asked to opine on a transfer, may still question the legality of the transaction and not

give approval. In many quarters, to a potential acquirer of a portfolio, the execution risk is viewed as being too great.

If this situation can be resolved to everyone's satisfaction—and the industry believes this can still only be done via a UK parliamentary order—the opportunity for Gibraltar is predominantly in the run-off or discontinued business arena.

There are many portfolios of insurance that are owned by larger companies, where new business has not been accepted for some time, and where the incumbent owner would be open to disposing of the asset, where Gibraltar would be the obvious choice if this issue could be resolved.

Gibraltar has already tested the mechanics of the run-off sector by accepting business from Ireland where, along with all other EU countries, perversely there are no problems in effecting such transfers.

Areas of future promise include the government of Gibraltar stating its case to become the European domicile of choice for insurance-linked securities (ILS) business.

This strategy has been supported by the emergence locally of specialist ILS insurance management operations, and more significantly than this, the first ILS transaction, which completed in April.

The government has shown a willingness to embrace what is required in this respect by engaging with the FSC as well as global industry experts from all relevant fields such as lawyers, ILS managers, and other service providers, to produce a product which it believes to be market-leading.

This is clearly an area that is new to Gibraltar, but the belief is that the soundings taken by the local authorities have provided a framework for a sound business proposition that is well-positioned to gain traction in this rapidly developing sector of the industry. Winning a very small proportion of the global market here would be a significant step forward for Gibraltar.

We have also seen more demand in Gibraltar recently in the arena of intermediaries, or managing general agencies (MGAs). There is no separate definition of an MGA in Gibraltar but we have noted the emergence of several MGA-style operations in recent years, and I believe that this has the potential to develop further in the future, especially as a result of the uncertainties brought about by Solvency II for smaller insurance companies.

For MGA-style businesses, Gibraltar offers regulation at and above minimum EU standards, while at the same time enjoying the passporting rights that allow a business to operate in any EU jurisdiction. There would be a requirement for such a business to demonstrate physical presence in Gibraltar, but access to the regulator and the speed to licence will be considerable draws to businesses such as this in the future.

Gibraltar is clearly developing into a most attractive insurance jurisdiction, but this has not been without the growing pains you would expect to see.

The key is to be aware of those areas that require further work to be sure the jurisdiction can deliver on these in a manner that produces an image that is as stunning as the Rock of Gibraltar on a clear day. CIT

Steve Quinn
CEO
Quest Insurance Management (Gibraltar)

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Start up and go

Gibraltar is the domicile of choice for many start-ups. Steven Lawler of Aon Insurance Managers explains why this is the case

Gibraltar is seeing an increase in enquires for open-market insurance company start-ups.

Helping to facilitate this growth is Aon Insurance Managers in Gibraltar, which is owned by Aon Corporation, the largest insurance manager in the domicile.

In addition to providing captive management and fronting solutions through its cell company White Rock, Aon has developed a range of solutions to help start-up companies establish themselves in Gibraltar.

Dermot Finnerty, managing director of Aon Insurance Managers in Gibraltar, explains: “While we are still seeing a significant number of captive and cell enquires, we are experiencing a large increase in enquiries for new open market insurance company set-ups.”

“These may be from existing European insurers wanting to go into new lines of business or brokers or managing general agents who view the establishment of a new insurance company as a way of their controlling distribution channels and the ability to tailor their insurance products to the needs of their customers.”

Finnerty claims that these insurers choose Aon as, unlike many of its competitors, it is able to provide an in-house, end-to-end start-up solution—helping with the initial licence application and company set-up, and providing the corporate governance systems, back-office function and operational support.

He continues: “Additionally, through the greater Aon network, we can also provide advice and placement of their reinsurance programme, actuarial support on their Solvency II forward looking assessment of own risks and solvency capital requirement calculations, and even introduce them to capital providers, if required.”

Finnerty goes on to explain that Aon Insurance Managers see its services as helping to incubate start-ups so they can eventually become standalone insurers in their own right.

He says: “By providing menu-driven services we enable start-ups to have all the services without the need to deploy staff that would be underutilised in the early years.”

“As the company grows they can begin to employ full-time staff picking only the functions they require from our menu-driven service offering.”

“This means our clients only ever buy the services they need on their journey from start-up to eventually becoming fully self-managed. Indeed, as the only insurance manager in Gibraltar offering this, our clients can take advantage of group buying power and drive down the costs of employing outside consultants.”

According to Finnerty, Aon has already helped four companies grow from start-ups to self-managed insurers.

He says: “This is a great achievement, and it is pleasing to know we have played a part in the success and growth of these companies.”

With an accessible, business-friendly regulator and legislature, the Gibraltar market continues to evolve with its government recently enacting new legislation allowing cells to be used for insurance-linked securities transactions and Part VII transfer of run-off portfolios.

It is clear that, while Gibraltar remains a significant captive domicile, it is rapidly evolving to become a European insurance centre in its own right. **CIT**

Steven Lawler
Manager
Aon Insurance Managers

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Breaking down barriers

Gus Frangi of AMS Insurance gives an in-depth introduction to the complex and oft misunderstood world of Tax Information Exchange Agreements

In recent years, there has been a rising degree of speculation surrounding the merits of the Tax Information Exchange Agreements (TIEAs), signed by various captive jurisdictions, and their alleged impact on the development of captive formations. The circumstantial evidence points at widespread misconceptions that have helped entrench what we consider to be a false perception on the actual impact of these instruments. Casting technicalities aside, this is a matter that should be assessed in the light of the factual evidence.

Today, it is a widely accepted fact across the profession that tax considerations must not be the driving force behind the design and development of any captive solution. Irrespective of wholeheartedly adhering to this line of thought, we are mindful of the fact that taxation remains a contributing factor to the process and that it must not be disregarded outright.

An objective assessment of the impact of tax vehicles on the development of captives should not avoid exploring the differences that lay behind two fundamental concepts, namely that of TIEA and the double taxation agreement (DTA).

It is worth pointing out that despite being conceived for alternative purposes, the potential for use and extent of the benefits that can be associated to both vehicles remain, by and large, misinterpreted as far as the captive sector is concerned. The absence of clear guidelines on this matter in the professional literature readily available has done little to shed light on the prevailing confusion, having on the contrary favoured the entrenchment of deeply rooted perceptions that are inherently flawed.

The origins of the TIEA can be traced back to the alleged intention of various jurisdictions to exchange information, and in doing so, to contribute to the goal of global transparency.

This behaviour ties in with the prevailing international framework in which the standards set out by the Organisation for Economic Co-operation and Development (OECD) emphasise the benefits that derive from good corporate governance and international cooperation on tax.

Broadly, TIEAs are bilateral agreements binding jurisdictions to cooperate on taxation matters through the exchange of information,

these undertakings must be completed through the enactment of customary parliamentary proceedings at both ends before they can become legally binding. These instruments are used to great effect by those jurisdictions that are deemed neutral from a taxation perspective, ie, that do not levy direct and or indirect taxes.

Far from linking the rise in the use of TIEAs to autonomous jurisdictional decisions, the promotion of these instruments has been encouraged by the OECD as an avenue to remove from its ´black and grey lists´, or those jurisdictions whose taxation practices are deemed lacking in transparency.

The conclusion of minimum set numbers of TIEAs has therefore been imposed as a prerequisite to jurisdictional reclassification.

It goes without saying that a considerable number of these undertakings were concluded under a flurry of excitement following the publication of the OECD's listings, pointing at jurisdictions that were yet to substantially implement internationally recommended taxation standards.

Key offshore captive domiciles were among those that signed several TIEAs as required to ensure prompt compliance with these guidelines, constructing their own TIEA networks to further their own needs.

As to the operational implications of TIEAs, for the actual exchanges of information to take place there needs to be a judicial request on a specific matter, duly issued on a jurisdiction and submitted through the agreed channels to the courts of another jurisdiction.

This request would be subject to a pre-existing case warranting the procurement of information, either on a physical or a corporate person domiciled in the other jurisdiction. Apart from the alleged intention to contribute to the enhancement of the jurisdictional transparency, this modus operandi helps to expedite the resolution of legal proceedings.

TIEAs also have the potential to open the gates to the removal of a captive domicile from the black list of a parent jurisdicition.

DTAs present an overly different proposition. In broad terms, these are bilateral instruments signed by two jurisdictions laying out which jurisdiction will tax a physical or corporate person receiving income from the other jurisdiction. These instruments have far-reaching implications when compared with TIEAs that, as previously stated, are limited by definition to the disclosure of information.

It must be pointed out that DTAs also contain clauses for the release of information that, while not as detailed as similar embedded on TIEAs, are equally effective in their contribution to the goal of promoting transparency.

Historically, DTAs have been well-tried bilateral instruments broadly used for the development and promotion of international trade and foreign investment. Today there are approximately 3,000 of these agreements signed between different jurisdictions across the globe. As is the case of TIEAs, the use of DTAs has not escaped a degree of controversy. Even making allowance for this, the benefits associated with their use are palpable and stand the test, from a conceptual perspective, at least.

First and foremost, DTAs are effective instruments to hinder dual taxation on profits at a corporate level.

> “While the goal of global transparency promoted through the adoption of TIEAs is laudable, we are of the opinion that TIEAs fall well short of delivering a tangible outcome on that front. The presence of TIEAs has proven relatively innocuous to the general progression and development of captive propositions”

Unlike TIEAs, these instruments can only be adopted by jurisdictions that are not neutral from a taxation perspective and therefore impose taxes, be it direct, indirect, or both. As obvious as it may sound, it is worth reiterating that a jurisdiction that is neutral from a taxation perspective (that levies no taxes) is unable to sign DTAs.

The critics of DTAs have drawn attention to the emphasis that these instruments put on the avoidance of double taxation to the detriment of tax avoidance in its broader sense, extolling praises on the allegedly superior nature of multilateral agreements. We would not dwell on these arguments as they are not central to our line of thought and bear little relevance to the needs of the discerning captive owner.

A review of the information disseminated by various captive domiciles reveals that the number of TIEAs signed by a jurisdiction is usually portrayed as a key strength intrinsically relevant to the needs of captive owners. Interestingly, whenever the attention of a specific regional audience is sought, there is mention of the number of TIEAs signed between the captive domicile and the territories in that region as a means to convey the same subliminal message.

While the goal of global transparency promoted through the adoption of TIEAs is laudable, we are of the opinion that TIEAs fall well short of delivering a tangible outcome on that front. The presence of TIEAs has proven relatively innocuous to the general progression and development of captive propositions.

While these considerations are generic and can therefore be extrapolated to captive prospects across virtually any jurisdiction, we are keen to portray the case from a Latin American client´s perspective, on account of the singular nature of this market whose captive sector has borne witness to a remarkable dynamism in recent years. Our findings have been compelling.

It is widely known that most Latin American insurance jurisdictions are deemed 'admitted' territories as their legal frameworks establish that local paper must be issued by local insurers for all risks defined as 'local' under the law. It is also worth pointing out that despite this uniformity in the principles underpinning the insurance model prevalent across this vast economic space, the insurance laws vary considerably from country to country, leading, for example, to convoluted placement layouts such as the infamous 'double frontings' conceived to accommodate arcane reinsurance cession provisos.

Besides, with the sole exception of Panama whose laws contemplate the creation and incorporation of captives, there are no similar undertakings in the legislation of other jurisdictions across the region. Faced with this restrictive outlook, potential Latin American captive owners are forced to look elsewhere in their quest for a suitable domicile in which to set up and incorporate their captives.

For all the ongoing talk about regional integration, to date, an overwhelming majority of the captives emanating from Latin America must be domiciled offshore, much to the chagrin of the captive owners, a sympathetic observer would conclude.

Clearly, as Latin American captive owners are confronted with the tough realities of selecting a suitable offshore jurisdiction for the domiciliation of their structures, they must brace themselves for a process that at times can be complex and should be addressed with utmost caution and attention to detail, so that the key objectives are not missed.

Within the list of factors to be taken into consideration, the identification of a good DTA signed between the parent and captive jurisdiction should be paramount.

This, however, appears to be easily overlooked in the frantic search for a captive domicile not blacklisted by the parent's jurisdiction. Such an omission on the part of captive owners can only be regarded with surprise, as a good DTA would not only deliver the selection of a captive domicile acceptable to the parent´s jurisdiction but also open doors to other corporate advantages.

Of special importance is the incorporation of a captive structure in a domicile that has signed a good DTA with the parent´s jurisdiction, which would facilitate the repatriation of the captive´s dividends to the parent company. DTAs make allowance for the selection of the domicile under which income or dividends can be taxed.

For ease of reference, we lay out the following example involving two hypothetical jurisdictions: namely jurisdiction A (captive) and jurisdiction B (parent).

Assuming that the tax rates on dividends are 5 percent for jurisdiction A and 30 percent for jurisdiction B, it would be possible under the terms of the DTA for the parent company to repatriate the captive dividends following payment of the 5 percent tax due to the tax authorities of the captive jurisdiction. Once this has been done, the tax authorities of the parent jurisdiction (B) would assume that the fiscal obligations of the parent company have been discharged and no further tax on dividends will be collected.

Failure to address those considerations previously laid out could have the potential to further isolate the captive from the rest of the parent setup, defeating the underlying intention to transform a captive into a profit centre that, apart from its main underwriting role, could contribute to the parent company´s bottom line when required.

As self evident and obvious as these propositions might sound, they are regularly by-passed by otherwise discerning captive owners across the region as little attention is usually given to the ostensibly superior nature of the solutions available through a DTA, vis-à-vis, those accomplished by relying on the modest merits of TIEAs.

Interestingly, the discerning captive owner will find that there are captive domiciles well suited to underwriting Latin American risks and offering access to a good network of DTAs signed with relevant Latin American jurisdictions. The Mexican case is emblematic as this jurisdiction has already signed DTAs with important captive domiciles. Other jurisdictions across the continent are following in Mexico´s footsteps.

As a closing remark, it is worth pointing out that the flexibility inherent in the redomiciliation proceedings among captive jurisdictions can be used to facilitate and expedite the transfer of Latin American captives towards those jurisdictions that offer attractive DTAs.

We may therefore conclude that there are no impediments hindering the potential re-configuration of the current scenario where a considerable portion of Latin American captive owners appear to have overlooked the advantages that could derive from a revision of the parent´s ability to benefit from the opportunities offered by DTAs. Those captive owners that open their eyes to this situation might be in for a terrific surprise. CIT

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Tax-i for captives

Although the IRS is bent on combatting perceived abuses of micro captives, the US government would be better served treating the cause rather than the symptom, say Richard Euliss and Whitney Fore of Carlton Fields Jorden Burt

Though in the midst of a stifling budget and personnel reduction, the US Internal Revenue Service (IRS) recently announced an increased effort to curb what it sees as widespread abusive applications of so-called 'micro' captives—those that elect under Section 831(b) of the Tax Code to be taxed solely on their investment rather than premium income. Focusing on micro captives is a frugal application of its diminishing resources because the IRS can generate deficiencies against multiple captives and related persons through a single audit of a suspected promoter of abusive schemes.

Once the IRS learns how a particular promoter structures its transactions, it can apply that blueprint against all those linked to that promoter. The industry, therefore, should expect and prepare for heightened IRS scrutiny of micro captives over the coming years.

Most perceived "abuses" of micro captives nevertheless comply with the strict letter of the tax rules governing those entities. Rather than search for technical failures, the IRS will assess the substance of the transaction and tax it accordingly. It is insufficient, therefore, to merely 'tick the boxes' of compliance. Careful planners must take heed of what troubles the IRS and be sure to avoid those attributes in new captive arrangements.

Tax laws relevant to micro captives

An insured's premiums for most types of insurance are deductible as ordinary business expenses under Section 162 and its accompanying regulations. A captive with less than $1.2 million in annual premiums can elect under Section 831(b) to be taxed only on its investment income. The combined effect of these rules allows the money labelled as premiums to go untaxed. While Congress specifically contemplated that outcome, the IRS will challenge any arrangement objectively designed primarily for tax rather than insurance purposes.

A regular issue in these cases, therefore, is what qualifies as "insurance", a term that the Tax Code does not define. In Helvering v Le Gierse, the Supreme Court explained: "Historically and commonly insurance involves [both] risk-shifting and risk-distributing ... That these elements of risk-shifting and risk-distributing are essential to a[n] ... insurance contract is agreed by courts and commentators."

For decades, the IRS took the position that risk-shifting and distribution could not occur within the same economic 'family', and on that basis, it invalidated captive arrangements between parents and subsidiaries, and brother and sister corporations.

Despite some early IRS success, the courts ultimately rejected the IRS's strict view. Following a series of losses, the IRS officially abandoned its economic family theory and acknowledged that, under the right circumstances, brother-sister and parent-subsidiary arrangements could qualify as insurance.

In Revenue Ruling 2002-90, for example, the IRS held that a captive insuring the risks of 12 affiliate subsidiaries of the same parent satisfied both risk-shifting and distribution. The IRS's holding was limited to the particular facts before it, including that no one subsidiary amounted to more than 15 percent or less than 5 percent of the captive's overall assumed risk.

Also notable from the IRS's perspective was the lack of other factors that might otherwise nullify the substantive transfer of risk, such as indemnity, guarantee, or hold harmless agreements. Around the same time, in Revenue Ruling 2002-89 the IRS held that it was acceptable for the captive to assume from its parent less than 50 percent of the captive's total assumed risk. The IRS also held, however, that where 90 percent of a captive's total risk stemmed from its parent, such arrangement was not "insurance".

Though recent Tax Court holdings in Securitas Holdings v Commissioner (2014) and Rent-A-Center v Commissioner might cause the IRS to relax further its application of the risk-transfer and distribution requirements, it has not yet done so, and unless and until it does, one must assume that the IRS will continue to apply these standards. Should a borderline dispute reach the courts, however, there is no doubt that Securitas Holdings and Rent-A-Center are beneficial to taxpayers, as both tend to deemphasise the importance of the number of insureds.

Promoted schemes and abuses

Though the IRS no longer applies the 'economic family' theory, it remains difficult for a captive of a small business to achieve both risk-shifting and distribution. Because small businesses rarely have 12 subsidiaries, affiliated micro captives have no choice but to assume third-party risk. Many captives, therefore, have turned to outside managers to operate the company and secure third-party risk adequate to meet the IRS's exacting standards.

From the IRS's perspective, lurking among reputable managers are promoters of "abusive" uses of captives designed primarily to achieve tax savings. But because most promoters design such applications to comply strictly with the Tax Code, the IRS must rely on what is known as anti-avoidance law in order to challenge the claimed deductions.

Broadly speaking, and while the semantics differ, the judicial doctrines comprising anti-avoidance law hold that technical, but without substantive compliance, with the Tax Code is no compliance at all. So, even where a taxpayer ostensibly observes all dictates of a particular law, if the transaction merely fabricates the circumstances necessary to achieve a certain tax outcome, this jurisprudence will disregard the claimed tax consequences.

The doctrines allow courts to tax the economic substances of a transaction rather than its technical form. Congress recently codified the "economic substance" iteration of this body of law.

There are red flags that will suggest to the IRS that a captive and its affiliates have tax benefits as their primary purpose of existence. While acceptable to consider some off-label uses as fringe benefits, a taxpayer had better be prepared to prove that its primary purpose was insurance.

The IRS particularly dislikes when taxpayers use captives to circumvent gift and estate taxes. These taxpayers transfer 'premiums' to the captive without taxation and place the title of the captive's stock in the names of the intended gift recipients.

Other uses include having the captive purchase a life insurance policy on the parent's owner, which effectively allows that owner to deduct otherwise non-deductible life insurance premiums. Under these and other circumstances, the IRS might contend that tax incentives are the primary purpose of the captive.

Many promoters design their captive arrangements to have only the appearance of risk-shifting and distribution. For example, the parent might purchase a policy on the open market but then have that insurer cede the entire risk to the captive. In other cases, the promoters might create supposed risk pools.

On the outside, the captives would reinsure part of the pool's exposure, thereby acquiring third-party risk. But because the prospect of paying third-party claims is not appealing to many, the promoter might have parent corporations indemnify any claims made to the pool.

Other common tactics include having excessively high deductibles, which make it unlikely that claims will ever trigger the pool's liability. Though the means used may differ, the common theme is for corporate parents to retain rather than shift their risk, but to make it appear otherwise.

The IRS will invalidate a captive insurer if the captive is merely a shell rather than a legitimate, independent insurance company. The captive should be adequately capitalised and the formation and policy papers should suggest due diligence by the captive. Similarly, the captive should underwrite all risks and develop a premium defensible under arm's-length market conditions.

If the insured fails to pay premiums without consequences, that too will suggest inadequate independence, as will a one-sided claims history. No one fact will be determinative, but the goal should be for it to appear objectively that the parent treats the captive as an independent entity.

If it suspects that a taxpayer formed a captive primarily to avoid taxation on the amounts paid as premiums, the IRS will look for certain warning signs. One example includes loan backs, where the parent pays premiums to the captive, both sides take their deductions, and the captive 'loans' the money back to the parent. At the conclusion of the transaction, the parent retains the beneficial use of the money it paid as premiums, but avoids paying tax on those amounts.

Less obvious indicators are captives that invest much or all of their premium income in the parent, affiliates, or in other ways that benefit the parent. Finally, excessive reserves could signal to the IRS that the captive does not function like a truly independent insurance company.

In each case, though, capital preservation is the goal, so any policy claims would be counterproductive. In order to reduce or eliminate that risk, 'piggybank' captives might assume implausible risks, especially relative to the premium.

When those facts are present, the IRS will suspect that insurance is not the primary motive of the captive. For example, few businesses can reasonably claim to form a captive to insure against terrorism risks. Similarly, a company in the Midwest typically does not view hurricane damage as a reasonably foreseeable peril. Many use such implausible risks to make a captive arrangement appear motivated by insurance, where tax savings are the real prize.

A recent chief counsel memorandum concluded that an otherwise sound captive arrangement did not qualify as "insurance" because the policies covered "investment risk" rather than "economic loss". The IRS explained: "Not all contracts that transfer risk are insurance policies even though the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk."

The IRS continued: "Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event (such as a fire or accident) is at the heart of any contract of insurance." As a result, even if a particular captive arrangement complies with all other requirements, careful planners must be sure that the insured risk is of the variety deemed acceptable by the IRS. No doubt there is a lack of clarity as to where exactly the IRS will draw this line.

Looking forward

It is unfortunate that those who abuse the rules led the IRS to create ambiguity and unpredictability for those who do not. To avoid the IRS's ire, a planner should analyse a proposed structure and objectively question whether insurance rather than tax is the true motivation for forming the captive. So long as that is the case, and assuming it complies with all rules, the captive likely will pass IRS muster.

Should the IRS select a particular captive and/or parent for audit, however, it is critical that the affected parties immediately hire expert tax controversy counsel to devise an effective strategy with a long-term eye towards potential litigation.

Though the IRS is bent on combatting perceived abuses of micro captives, the government would be better served treating the cause rather than the symptom.

There is some momentum in Congress to raise the annual premium cap to qualify for the Section 831(b) election. While one might predict that doing so would only lead to more abuse, if done right, the opposite might actually be the case.

A primary barrier for micro captives to comply with the Le Gierse factors is justifying the trouble and expense of achieving safe harbor risk-shifting and distribution on risk portfolios that can gross no more than $1.2 million per year. That disincentive is what leads many captives to managers, some of whom market the uses disfavoured by the IRS.

By increasing the amount of income a micro captive can earn, however, the Tax Code might alter that calculation and make it worthwhile for micro captives to navigate the regulatory and legal morass of securing genuine third-party risk. **CIT**

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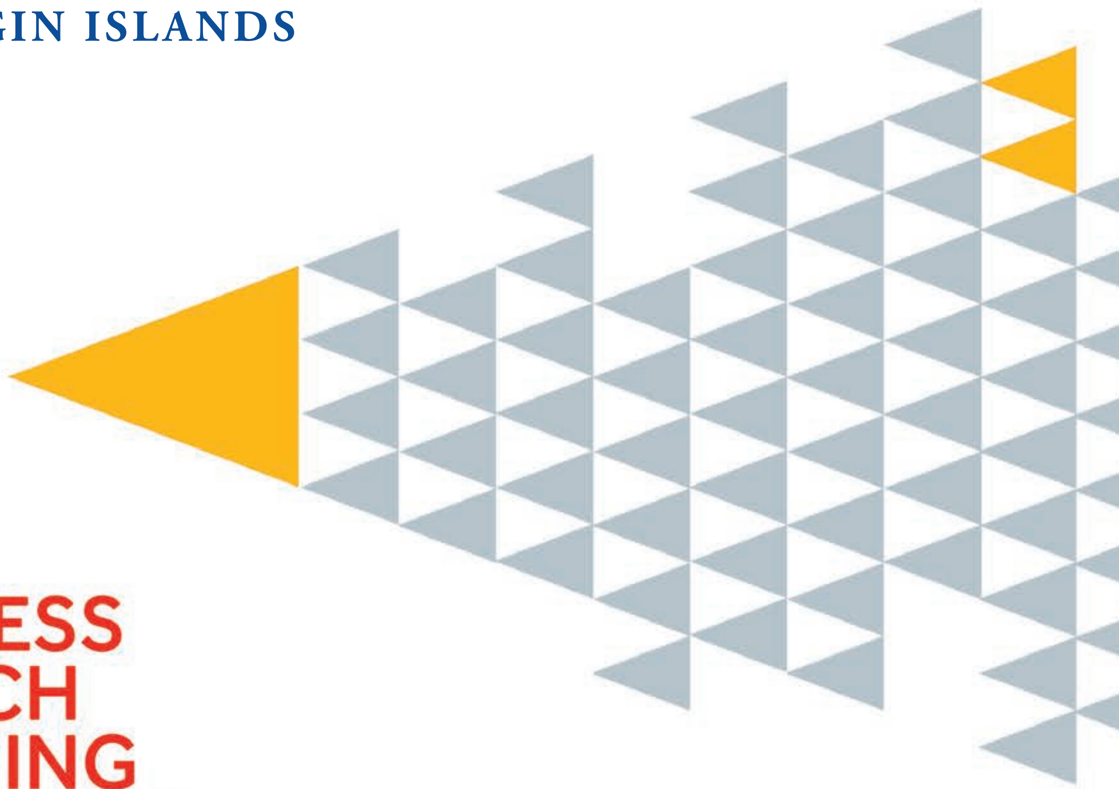

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Industry appointments

JLT Re has made senior appointments across its North American business.

George Daddario has been appointed deputy CEO of North America Reinsurance, while **Tony Marangiello** has been made North America marketplace leader.

Daddario will oversee delivery of intermediary services to JLT Re's clients and prospects in North America.

He will also act as vice chairman of the JLT Re North America executive committee.

He joined Towers Perrin Re in 2003, after working for Tower Group, Willcox and Intere.

Marangiello will be responsible for the operations of all JLT Re offices in the US.

In addition, he will continue to head up the specialty practice business development unit and will expand relations with other JLT Group business in North America. Marangiello joined Towers Perrin Re in 1994 after having worked at Willis.

Craig Darling has been made president of JLT Re Ventures, a unit of JLT Re North America that is dedicated to finding start-up and similar business opportunities and working with JLT Capital Markets.

Prior to the acquisition of Towers Watson Re, Darling was CEO of JLT Re North America, and he led the successful effort to start up Weston Insurance Company.

He spent nearly seven years at Willis Re, eventually rising to managing director of its North American leadership team.

Before joining Willis Re Darling worked at Aon Specialty Re, Security Re and Chubb and Interstate Fire and Casualty Companies.

Finally, **David Johnson** has been appointed to the JLT Re North America Executive Committee and made co-leader of transportation practice group with his brother, Horace Johnson.

David Johnson joined Towers Watson Re in 2011, and prior to doing so he served as president and COO of Axiom Re.

Beazley has appointed **Will Roscoe** to head the company's broker relations activity in the London and European markets.

Roscoe brings experience of the insurance market both as a broker and underwriter.

He joined Beazley's London-based open market property team as an underwriter in 2011, before moving to his most recent role leading the excess and surplus lines property and high-value homeowners teams in the southeast region of the US.

Prior to Beazley, Roscoe was director of broking for the global markets international division of Willis where he led a team placing a diverse portfolio of large non-US international risks in the London market.

James Hole is set to join The Cincinnati Insurance Company as part of the organisation's plans to expand its assumed reinsurance operations.

Hole arrives at The Cincinnati Insurance Company from JLT Re, which he joined as part of the 2013 acquisition of Towers Watson's reinsurance business as managing director of global business development.

Prior to this, Hole was managing director of sales and practice development for both Towers Watson's reinsurance business and its property and casualty consulting business.

He joined the company in 1994.

Mike Reynolds, global CEO of JLT Re, said: "This is a great opportunity for [Hole] who has worked closely with The Cincinnati Insurance Company for a number of years. His knowledge and experience will be invaluable to them as it has been to JLT Re."

Iroquois Captive Services LLC has named **Belinda Fortman** as managing director of captive management.

Fortman will lead Iroquois's captive management team, joining the leadership team of managing director of underwriting and consulting Bob Davidson, managing director Andy Rhea, and operations manager Cathy Colbert.

Fortman previously served as regional manager for Strategic Risk Solutions (SRS) and was responsible for oversight of SRS's clients in Tennessee.

Her insurance career began nearly 20 years ago and includes acting as managing director for a captive insurance subsidiary of a publically held insurance company.

She transitioned to captive management over 12 years ago and, prior to joining SRS, was the operations manager for a large independent captive management firm, where she was responsible for Vermont and Washington DC-domiciled captives.

Fortman has overseen and managed a wide variety of captive insurance companies, including single parent, group, special purpose, protected cell, industrial insured captives and risk retention groups.

Her industry experience includes healthcare, financial services, religious and government entities, real estate, and agriculture.

"Fortman is an outstanding executive who has been a key part of the success of the growth of the captive insurance industry in Tennessee," said Bill McGugin, president and CEO of Iroquois.

"We couldn't be more excited to have her join the Iroquois team and lead our captive management efforts."

McGugin added: "Combined with the excellent professionals we have in place, Iroquois is positioned to become a national leader in the captive management industry." **CIT**

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