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Captives feature on IRS 'Dirty Dozen' list for third time in a row

The Internal Revenue Service (IRS) has named micro captives on its 'Dirty Dozen' list of tax scams for the third consecutive year.

The 'Dirty Dozen' list calls out tax scams that the IRS will be targeting in the coming year. Under section 831(b) of the tax code, captive insurers that qualify as small insurance companies can elect to exclude limited amounts of annual net premiums from income, so that the captive pays tax only on its investment income.

The IRS warned that in abusive micro captive structures, promoters, accountants or wealth planners could persuade owners of closely held entities to participate in schemes that lack many of the attributes of genuine insurance.

Captive insurance policies may attempt to cover the same risks that are covered by the entities' existing commercial coverage, but the captive policies' 'premiums' may in fact be double or triple the premiums of the policy owners' commercial policies, according to the IRS.

The IRS suggested that captives may invest in illiquid or speculative assets. They could also loan or otherwise transfer capital to, or for the benefit of, the insured, the captive's owners or other related persons or entities.

Captives may also be formed to advance inter-generational wealth-transfer objectives to avoid estate and gift taxes. Promoters, reinsurers and captive insurance managers may share common ownership interests that result in conflicts of interest, according to the IRS.

IRS commissioner John Koskinen said: "Taxpayers should avoid unscrupulous promoters who encourage the use of phony tax shelters designed to avoid paying what is owed. These scams can end up costing taxpayers more in penalties, back taxes and interest than they saved in the first place."

On 1 November last year, the IRS released Notice 2016-66, which formally labelled micro captives as 'transactions of interest'. The IRS advised that micro captive insurance transactions have the potential for tax avoidance or evasion.

Transactions of interest are a type of reportable transaction first established by the IRS in 2006 and since then, only six transactions have been labelled as such, including micro captive transactions.

The notice requires reporting by any taxpayer involved in micro captive transactions over a number of past years, in which the open statute of limitations applies.

Tim Tarter, a captive audit defence expert, suggested that the notice "fails to provide any definitive guidance" as to which micro captive entities will survive Tax Court scrutiny, adding that "it is unlikely to deter most informed micro captive participants from moving forward with their planned captive transactions".

On 29 December last year, the IRS granted a 90-day extension, to 1 May, for 831(b) captives that need to comply with the notice.

In addition to Notice 2016-66, Congress has also acted to curb micro captive abuses. The Protecting Americans from Tax Hikes Act, effective 1 January this year, established diversification and reporting requirements for new and existing captives.

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Montana introduces dormant status

Montana's lawmakers have introduced a new captive bill that will allow inactive captive insurance companies to apply for dormant status.

The new bill, introduced to the legislature on 13 February, will provide dormant captive insurance fees and requirements, if it comes into effect.

The bill, sponsored by senator Daniel Salomon, defines a dormant captive as a captive insurance company, other than a risk retention group, that has ceased transacting the business of insurance, including the issuance of insurance policies, and has no remaining liabilities associated with insurance business transactions or insurance policies issued prior to the filing of its application for a certificate of dormancy.

A dormant captive will possess and maintain unimpaired, paid-in capital and surplus of no less than $25,000 within 90 days of each fiscal year end, and will be required to submit a report to the insurance commissioner of its financial condition.

The dormant captive will also have to pay a $1,000 annual dormancy tax, due on or before 1 March of each year, for any portion of the preceding year in which the captive held a certificate of dormancy.

Dormant captives will also be exempt from the insurance commissioner's five-year audits.

IMAC chair to focus on innovation

The new Insurance Managers Association of Cayman (IMAC) chair Linda Haddleton has revealed her goal to focus on innovation in the captive sector and to "diversify this domicile's remit".

Haddleton, who started in her role as chair at the beginning of February, took over from Kieran O'Mahony, senior vice president and client services leader for Marsh Management Services Cayman.

Haddleton said: "We have accomplished much in the captive insurance industry, and Cayman is recognised as doing what it does in this space very well. But there are untapped industries and geographies that I think we can expand into."

For the last two years, Haddleton has served as vice chair and legislative and regulatory committee chair for IMAC.

She said: "I have been a part of IMAC for decades and we are proud of the role we have played in Cayman's development as a domicile for captives and other alternative risk transfer structures. I want to ensure this development continues well into the future."

Haddleton is also managing director in the Cayman office of Artex International. She leads the Cayman office staff and operations, consisting of insurance-linked securities, structured transactions and captives.

WTW launches BEPS captive product

Willis Towers Watson has released a new base erosion and profit sharing (BEPS) product, Radar, for captive owners.

Radar will combine captive and analytical consulting to help captive owners identify and respond to the challenges posed by BEPS.

The new product will provide advice around transfer pricing, economic rationale, substance, documentation and evidence.

In addition, it will help captive owners with BEPS compliance, captive value and future strategy.

Ciaran Healy, director of consulting at the Willis Global Captive Practice, said: "Radar is a multifaceted BEPS service that provides captive owners with a framework to positively respond to the BEPS challenge."

Utah approves Caitlin Morgan

Caitlin Morgan Captive Services has been approved by Utah to serve as a captive manager in the state.

Caitlin Morgan provides captive management solutions, including insurance, risk management and underwriting expertise to captives; developing and evaluating business plans and preparing financial statements; managing captive service providers and vendors; producing financial reports for the captive's board of directors; and maintaining regulatory reporting.

As of January, Utah had a total of 462 active captive companies and 74 active cells.

The Utah captive insurance division licensed 68 new captive insurance companies in 2016, as well as 13 cell captives.

The Utah captive division also implemented new processes for insurers, including an upgrade to its online forms and applications.

Bermuda licenses 13 new insurers

Bermuda welcomed 13 new captives in 2016, with the majority coming from the US.

Of the 13 captives licensed by the Bermuda Monetary Authority (BMA), two came from South and Central America. As of 31 December, Bermuda was home to 776 active captives.

Craig Swan, managing director for supervision at the BMA, said: "The authority continues to ensure that Bermuda's captive sector—which has made significant contributions to Bermuda's economy for well over 50 years—remains appropriately regulated."

"The global companies that operate captives from Bermuda expect top-quality regulatory standards. As such, the authority ensures that its supervisory framework for captives, has remained aligned with the insurance core principles of the International Association of Insurance Supervisors."

Safety National adds captive services

Safety National has added captive services and guaranteed cost workers' compensation to its list of client products.

The captive service will provide coverage flexibility and services to maximise the company's contribution to the captive's overall risk financing strategy.

The captive service is aimed at captives that require a risk-sharing partner and supplies admitted and non-admitted paper.

Additionally, it provides statutory coverage for workers' compensation and flexible limits for other lines such as auto liability, commercial general liability, miscellaneous liability and inland marine, with rent-a-captive options also available.

Lisa Lacey Willitts, national director for captives, is the primary contact for inquiries and business requests.

The guaranteed cost workers' compensation product, which requires a minimum of $750,000 for programme eligibility, will serve large employers that need a first-dollar programme. The company prefers specialty classes, including hotels and related hospitality, light manufacturing, technology, retail and food-related industries.

Abbie Berg, large guaranteed cost underwriting manager, is the primary contact for inquiries and business requests for cost workers' compensation.

Tom Hebson, vice president of large guaranteed cost workers' compensation and captive services at Safety National, commented: "Both of these product lines are a natural and logical fit for Safety National."

"They fit firmly into our specialised expertise, containing many of the same characteristics of our core business offerings, and also align

nicely with our overall capabilities. We are extremely pleased to make these new options available to our clients and look forward to developing risk-financing solutions that best meet their needs."

MAXIS GBN opens London HQ

MAXIS Global Benefits Network (GBN), a joint venture between MetLife and AXA, has selected London for its global headquarters, as it looks to capitalise on global demand for employee benefits programmes from multinational companies.

From its London headquarters, MAXIS GBN plans to expand its range of solutions, offering the latest developments in pooling and global programmes.

The firm has also developed a new IT platform, Bridge, which will allow it to provide pricing and data analytics to its members and clients.

Mauro Dugulin, CEO of MAXIS GBN, commented: "[The company] will be centrally managed and this enables us to offer better control, greater consistency and the opportunity to review reinsurance pricing and underwriting conditions from a truly global perspective, all for the benefit of our members and their clients."

"Diminishing returns on multinational pooling, increasing interest in the use of captives, a greater thirst for information and rising healthcare costs make for a challenging environment for international benefits and compensation and risk managers."

Dugulin added: "The new MAXIS GBN has been developed to meet these challenges and offer technology-led solutions to help drive employee benefit programmes forward."

After gaining 50 new clients last year, MAXIS GBN is targeting a 20 percent growth in overall volume of premiums in 2017.

According to MAXIS GBN, the firm will look to increase its global market share, particularly with existing clients, as well as building on relationships with employee benefit consultants.

The company is planning to target markets such as the US, France, Germany, the UK, the Netherlands and Switzerland.

MAXIS GBN was established by MetLife and AXA in 1998 and specialises in employee benefits networks.

Johnson wins kudos for work in NC

North Carolina's insurance commissioner Mike Causey has congratulated representative Linda Johnson for her help in establishing the captive insurance company programme.

In a meeting with insurance executives in Raleigh, Causey said: "Thanks to representative Linda Johnson and her hard work to help establish North Carolina's captive insurance programme, we have continued growth in that industry and look forward to its further development."

Last year, the number of captive insurers in North Carolina more than doubled, and the number of cells/series approved increased by more than 50 percent.

The state is now in its third full year of operation. It has more than 550 risk-bearing captive insurance entities under the regulation of the North Carolina Department of Insurance, as of 23 January this year.

Of the total number of captive insurance entities, 190 are captives and 363 are cells or series approved or provisionally approved.

Of the standalone captives, 150 are pure captives, 23 are protected cell captives, 12 are special-purpose captives and five are risk retention groups.

Johnson said: "I am so thankful for the support of the legislature for this new industry for our state. The steady growth of the captive insurance industry is something we can count on to produce jobs and help our economy."

"I greatly appreciate the support of Causey and look forward to continuing to work with the North Carolina Department of Insurance to help grow this industry."

Record numbers for Tennessee

Tennessee licensed a record number of 104 risk-bearing entities in 2016, the Tennessee Department of Commerce & Insurance (TDCI) has reported.

The new captives include 30 pure captives, five protected cell companies, one association captive, one risk retention group, and 67 new protected cells. Nine of the new captives were redomestications.

Last year's licensed captives bring the state's total to 159 captive insurance companies and 379 protected cells formed, totalling 538 risk-bearing entities.

Julie Mix McPeak, TDCI commissioner, said: "We are proud of the progress made last year to expand Tennessee's captive insurance market."

"Forming over 100 risk-bearing entities in 2016 and over 500 entities in five years is quite a feat. TDCI remains committed to its role of maintaining proper regulation of captive insurance in Tennessee."

Michael Corbett, director of TDCI, added: "The redomestication of nine captive insurance companies to our state shows that more and more leaders in this industry are comfortable setting up their captives here. We especially appreciate the efforts of the Tennessee Captive Insurance Association in helping to make this growth happen."

Natural cat losses hit $39 billion

Insured loss estimates from major natural catastrophes are around $39.5 billion for 2016, the highest since the annual market losses of $60 billion seen in 2012, according to Willis Re.

In the US, Hurricane Matthew accounted for the largest single insured loss at about $2.3 billion, while the Fort McMurray wildfire in Canada caused insurance losses of approximately $3.5 billion.

The joint effects of Windstorms Elvira and Friederike in late May and early June led to Europe's largest market losses of 2016, roughly $2.48 billion.

In Asia, the Kumamoto earthquake in Japan accounted for the largest single insured loss of 2016, reaching over $4.8 billion.

The Ecuador Earthquake in Esmeraldas Province caused the largest impact in Latin America, with estimated losses currently standing at anywhere between $325 and $850 million.

John Alarcon, executive director of catastrophe analytics at Willis Re International, said: "As our report shows, despite natural catastrophe insured losses falling in the last five years to 2016, they are still significant, and lower-profile perils such as the wildfire around Fort McMurray have the potential to cause substantial losses."

He added: "Importantly, our report also highlights that economic losses continue to be higher than insured losses, and substantially so in some regions."

"Clearly the insurance industry has a significant role to play in helping economic recovery by supporting resilient societies and closing the protection gap between insured and total economic loss when natural catastrophes occur."

Kroger captives remain 'excellent'

A.M. Best has affirmed the financial strength rating of "A- (Excellent)" and the long-term issuer credit rating of "a" to Queen City Assurance and Vine Court Assurance, which are both domiciled in Burlington, Vermont.

According to A.M. Best, the positive ratings are based on Queen City and Vine Court's individual and joint profiles as single-parent captives of The Kroger Company. The positive ratings are also due to both captives' capitalisation, substantial net income and underwriting profitability, as well as their growing capital base, conservative investments and strong adherence to the parent's robust risk controls and overall risk culture.

A.M. Best also noted that the captives' return measures on a group and individual basis are frequently positive, which highlights the company's prudent pricing and deployment of capital.

Partially offsetting these strengths are the companies' risk concentration—a consequence of being single-parent captives of The Kroger Company—and the significant aggregate limit retained by the captives.

A.M. Best recognised the aim of the captives and the financial resources and support they are offered as part of The Kroger Company.

Follow Bermuda's example for ILS

London needs to demonstrate that it can compete with Bermuda in tax and regulation if it is going to become a hub for insurance-linked securities (ILS), according to a new report from Willis Capital Markets Advisory (WCMA).

The report asked industry professionals what they thought the key regulatory and tax requirements are for a successful ILS framework, and Bermuda was cited as the prime example of how to do it properly.

Julian Enoizi, CEO at Pool Re, commented in the report: "Bermuda not only [possesses] the necessary infrastructure and knowledge that supported the reinsurance and ILS market, but also offered attractive tax advantages."

Bermuda already claims a significant share of the ILS market.

Last year, the Bermuda Stock Exchange reported record ILS listings, with more than 60 listings worth a total of $6.16 billion.

In total, the number of ILS-listed vehicles on the BSX increased from 151 to 175, a 16 percent increase.

However, to the UK's credit, the country is striving to create a framework that will make it competitive.

At a City & Financial Global conference on ILS in London, Nick Gardner, partner at Ashurst, explained that the UK government's focus for tax is to create a level playing field for insurance special purpose vehicles established in the UK. Without this, the tax cost of moving onshore alone would be prohibitive.

The government most recently said its aim is to "create a regime that is internationally competitive and in line with the UK's move towards a territorial tax system".

In the WCMA report, Katherine Coates, partner at Clifford Chance, commented: "Once in place, the new regulations will mean that the UK becomes the first onshore centre with suitable ILS regulations, and this, together with the strength and the expertise of the London insurance market, should enable the rapid development of an ILS market in London."

WCMA also questioned industry professionals about Solvency II compliance.

According to Coates, if the requirements, as interpreted by the Prudential Regulation Authority, are either "unclear or too onerous", then the UK will not be as attractive as other Solvency II-compliant markets, such as Gibraltar or Malta.

At the same time, Coates questioned whether London would be able to compete with non-Solvency II equivalent locations such as Bermuda or Guernsey.

She said: "The key areas for further discussion with [regulators] are the interpretation of the fully-funded requirement and the timing of the application processes for initial authorisation and for approval of individual cells."

Luca Albertini, CEO of Leadenhall Capital Partners, suggested that one of the key issues will be educating regulators on how to apply Solvency II to the very specific matters of ILS transactions.

Albertini said: "We have seen a couple of features in the proposed regulation which look more restrictive than what is required in another Solvency II compliant jurisdiction and in other Solvency II equivalent jurisdictions, and we are working with the regulator to explain why such features are not only not necessary but would also create a very unfavourable regime in London."

BNY Mellon captives bank solid ratings

A.M. Best has affirmed the ratings of BNY Mellon captives BNY Trade Insurance and The Hamilton Insurance Corporation.

The financial strength ratings of "A (Excellent)" and the long-term issuer credit ratings of "a+" reflect the captives' strong risk-adjusted capitalisation, consistently excellent operating performance, solid liquidity and "conservative operating strategy".

Partially offsetting these positive rating factors are the companies' limited market scope, business profiles and product mix, as well as their dependence on third parties for processing, servicing and administration.

A.M. Best recognises BNY Trade and Hamilton's "robust" enterprise risk management frameworks, as they follow those practices of their ultimate parent, BNY Mellon.

BNY Trade and Hamilton provide comprehensive reinsurance coverage and products to their parent.

January weather costs $1 billion

US January weather economic losses for insurers exceeded $1 billion, after the country recorded the highest amount of tornadoes in January in the last 17 years, according to Aon Benfield's Impact Forecasting.

In the second half of January, tornadoes struck Georgia, Mississippi, Alabama, Louisiana and Florida, destroying and damaging homes, businesses and other structures.

The US National Weather Service preliminarily confirmed that at least 130 tornadoes touched down during the month, the highest since 1999 when 212 were recorded.

Aside from the tornadoes that struck the US, consecutive weather storms hit the country earlier in the month causing at least $700 million in damage, while public and private insurance losses listed around $300 million.

Steve Bowen, director and meteorologist at Impact Forecasting, said: "January proved to be a highly active month for global natural hazards compared to recent years, especially when we look at the events in the US, where the powerful thunderstorms and winter storms had a devastating effect on people and communities, as well as causing a significant economic loss for country."

Stable outlook for Sony captive

A.M. Best has revised the outlook of Sony Corporation's Captive, PMG Assurance (Bermuda), from negative to stable.

The ratings agency also affirmed the financial strength rating of "A- (Excellent)" and the long-term issuer credit rating of "a-".

According to A.M. Best, the ratings reflect PMG's "excellent" capitalisation, "strong" operating performance and the "strategic" position of the captive insurance company of its parent, Sony.

PMG is a pure captive of Sony and its role is to meet certain global insurance requirements of Sony Group Members.

The captive writes proportional property and marine reinsurance business with a small amount of employee benefits coverage for Sony employees.

According to the ratings agency, PMG continues to be an "integral component" of Sony's risk management platform.

2016 'a new high point' for captives

The Alabama Department of Insurance has revealed that 11 captives, two protected cell captives and one risk retention group were formed last year.

As of 17 January, the total number of risk-bearing entities domiciled in Alabama totalled 62. Last year, the state saw seven captives surrender, three due to redomestications.

According to Arsenal Insurance Management, 2016 marked "a new high point" in captive and protected cell creation in Alabama. In July last year, the Alabama governor Robert Bentley signed an updated and modernised captive bill into law in an effort to make Alabama more competitive.

Young but mature

As the sun sets on his tenure as CICA president,
Dennis Harwick explains why this adolescent industry is wiser than its years

What is the main focus of this year's conference? What sessions are you most looking forward to?

I would love to say that it is my going away party, but I guess that isn't the main focus.

When planning the Captive Insurance Companies Association's (CICA) 2017 International Conference, which takes place between 12 and 14 March, we arrived at the defying disruption theme, and since then I have been fascinated at how much discussion there has been around this topic in the industry.

It has worked very well for us to focus on this theme. We have asked speakers to look at their individual sessions and to identify how disruption might be a factor for them.

A key feature of this year's conference is talking about the next generation of the captive industry. I think our keynote speaker is going to be interesting, when we told Lindsey Pollak about our defying disruption theme, she couldn't believe it, as it was perfect for her.

Pollak is recognised as an expert on the millennial generation in the workplace and how members of all generations can thrive in today's multigenerational work environment. For someone like me who is at the tail end of his career, particularly in the association world, it will be fascinating to hear Pollak discuss the impact of generational differences.

If you look through the agenda, you will see the disruption topic pop up again and again. We will have a session on Tuesday morning on finding and attracting the next captive workforce, which is an issue that has been emerging over recent years.

The session will explore the captive industry's need for new employees and survey current strategies being used to find and attract newcomers. The top of the session will review the results of a survey of captive leaders done specifically for this presentation, and panellists will explain what their firms are doing to address the impending 'expertise shortage'.

I have spoken on this 'next generation' topic a couple of times, and I show a chart that highlights that 25 percent of the insurance industry workforce is going to retire in the next five years.

The projected workforce to fill that gap simply isn't that big, but I'm an optimist. When starting our careers, none of us thought that we would end up in the captive insurance industry. We all got sucked into it laterally and I'm highly optimistic that will happen for the next generation. Although you can't predict where they will come from, they will, because there is an opening and something interesting about captives has caught their eye.

We will also be talking about the issues of disruptive technology, disruptive events in the claims process, and defying disruption by optimising captive lines. If you ask for our main focus, it will be identifying and addressing whatever disruptive changes are coming the industry's way.

Tax has been a big topic of conversation over the last 12 months. What are the main concerns around tax for the captive insurance industry in 2017? How will it be covered at the conference?

We always have one big taxation session, which focuses on recent developments in federal and state tax issues. It normally occurs at the end of the CICA event and is the most widely attended session.

This panel will be led by panellists Bruce Wright, a partner at Sutherland Asbill & Brennan; Tom Jones, partner at McDermott Will & Emery; and Chaz Lavelle, an attorney at Bingham Greenebaum Doll.

There are also three other tax sessions on this year's agenda. On Monday afternoon, there is a session on the definition of a business risk and an insurance risk.

This session will explore the position taken by the Internal Revenue Service (IRS) in many captive insurance company tax cases that a business/investment risk is not an insurance risk.

A decade ago, the IRS decided that if something was predictable and it was going to happen, then it wasn't an insurance risk, but what about life insurance? Everyone is going to die, as far as I know.

Secondly there is a session on Tuesday morning that takes a different approach to the tax conversation. This session provides a foundational discussion of tax items that may affect a captive arrangement, including recent or proposed changes to tax law that may help or hurt the captive's tax status, as well as provide insights and updates on pending items that could have a future impact.

There is also a regulatory interaction panel giving the small-captive perspective on the evolving state and federal climate on Tuesday morning. Panellists will discuss the role of state and federal regulators regarding small captives that make an annual election under Section 831(b) of the Internal Revenue Code, specifically in the wake of recent IRS scrutiny.

The discussion includes how the differing perspectives of regulators affect small captives and how federal regulators view both small captives and state regulation. Panellists will also discuss how new federal policy has affected the role of state insurance regulation, as well as the captive industry.

The big issue is the changes in the Protecting Americans from Tax Hikes Act, and the increase in the amount that's deductible, but with the additional restrictions around what you're doing with it. There are also the issues around Notice 2016-66, which has now been deferred until 1 May.

There has been a great division within the small-captive sector and many in the industry are questioning how to respond, what it means, and what we need to do. It is a very hot topic and it has split people within the sector. It is going to be a dramatic year for them.

The industry is also expecting a decision in the Avrahami case at some point, which will cause some headache, but may also provide some guidance and clarification.

It really is going to be an interesting year for people in the small-captives sector. They have expansion, because of the increase in premium tax from \$1.2 million to \$2.2 million, but also the reporting requirements for the IRS's Notice 2016-66. It is going to be a wild ride.

What are the other pressing issues you think the captive industry should be aware of? And what is CICA doing to help educate captive professionals?

You can hardly predict what is going to happen in this industry. If you look at what has come on the scene, particularly tax wise, this year, you have people whose firms follow this type of thing daily and read the federal register every day, and others who follow the Organisation for Economic Co-operation and Development (OECD), yet every time these things seem to fall out the sky.

I do think this year—at least from an IRS perspective—is going to be very active, especially around the small-captive sector.

Our conferences are a big opportunity to educate the industry on these problems. We also host a webinar series that we continue to roll out this year.

One of the things I have learned in the 35 years of association work is that people's busy calendars are the biggest challenge to educational programming, so we pick sessions from the conference that scored well and had a big attendance, and produce them in the following months as webinars.

We inevitably see 100 people attend the webinar who weren't able to go to the conference. We also have the ability, if a hot topic comes up, to do a webinar on that as well.

As you leave your role as president of CICA, what are your thoughts on the industry? Do you think this is the best it has been?

I went back and started reading minutes of the board meetings from three or four years before I became president at CICA. When you're at the early adolescence of the industry there are some great friendships and bonds that go with that experience.

Some of the names that pop up are people such as Hugh Rosenbaum, who has been around since the Earth cooled. Mike Mead, Mike Lusk and Ian Kilpatrick are people who have been active for the past 20 or 30 years.

We now move into what I would call the late adolescence, where you have this process for a still young industry, but it's maturing. It means there are a lot more people coming into the captive industry who don't share many of those experiences of the early years.

Now our higher profile brings more scrutiny with some popular names such as the IRS, the National Association of Insurance Commissioners and the OECD. Because we are maturing, we will face even more scrutiny in the future.

My friend Ian Kilpatrick, who spent most of his career in the Cayman Islands, was once at a board meeting where he said he had read the obituary of the captive industry four or five times during his career, yet we have managed to make it through each one of these challenges.

Now the industry is well established, it probably no longer faces an existential threat, and that's a good thing. There will be increased scrutiny in the future, and I don't want to be too casual about it, but we will survive it. Such scrutiny comes with the territory and our maturing industry.

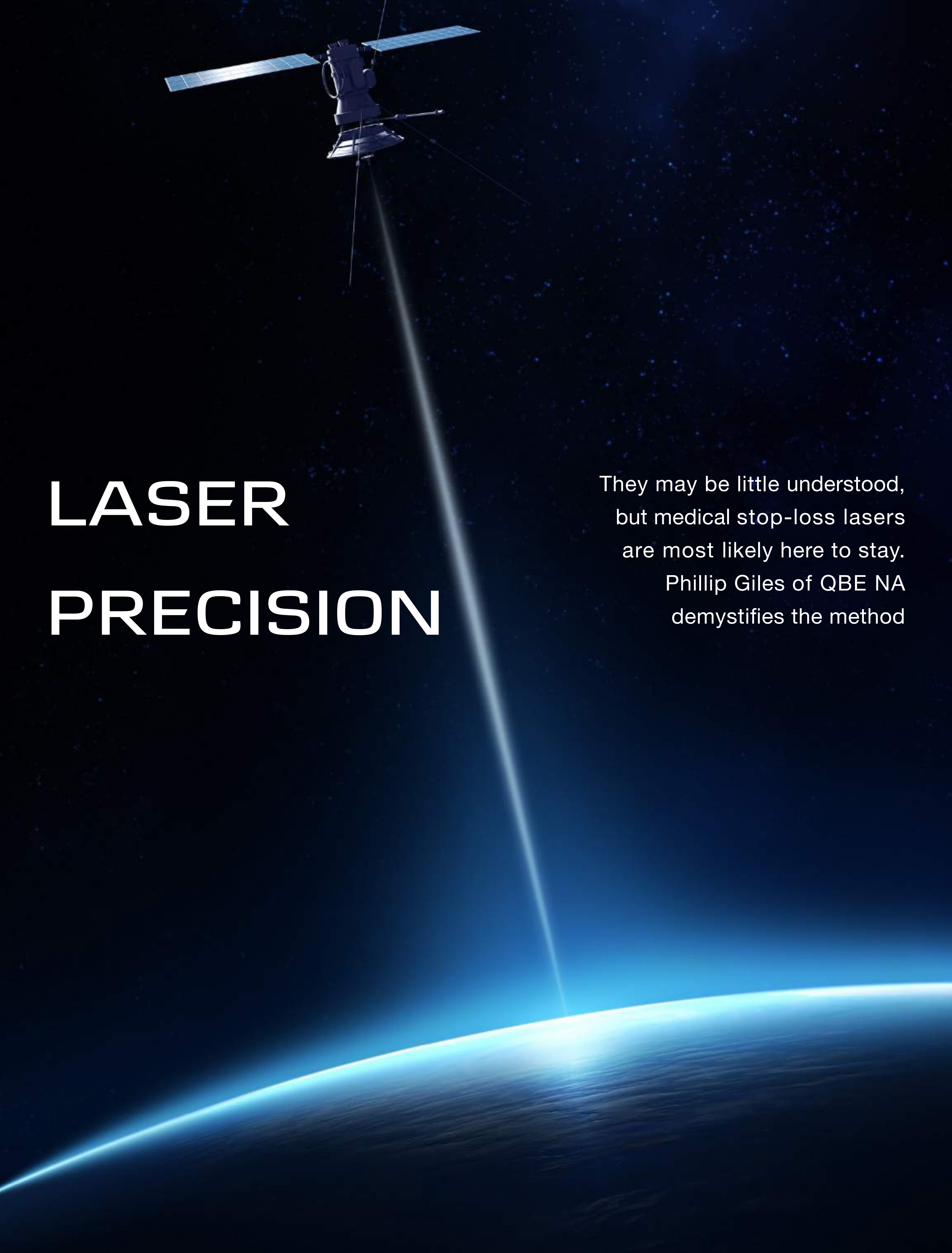
At CICA, we have always advocated a 'do them (captives) right or don't do them at all' philosophy. The opportunities that occur in the captive industry normally arise from insurance challenges where either it is difficult to find coverage, or the pricing is extraordinarily high.

In the old days, people used to say that captives will only be around during the hard market. We have had a soft insurance market for years now and, guess what, captives are still here and they are still growing because, strategically, they make sense.

As I ride off into the sunset, I'm optimistic that captives will continue to grow while solving insurance and risk management problems. This is what makes captives work and I think they will be around for a long time. CIT

"I'm optimistic that captives will continue to grow while solving insurance and risk management problems. This is what makes captives work and I think they will be around for a long time"

Dennis Harwick
President
CICA



LASER PRECISION

They may be little understood, but medical stop-loss lasers are most likely here to stay. Phillip Giles of QBE NA demystifies the method

> THERE ARE KNOWN KNOWNS. THESE ARE THINGS WE KNOW THAT WE KNOW. THERE ARE KNOWN UNKNOWNS. THAT IS TO SAY, THERE ARE THINGS THAT WE KNOW WE DON'T KNOW. BUT THERE ARE ALSO UNKNOWN UNKNOWNS. THERE ARE THINGS WE DON'T KNOW WE DON'T KNOW.
>
> **- Donald Rumsfeld**

One of the basic principles of any alternative risk programme is being able to assume predictable known segments of risk while transferring more unpredictable unknown risks to insurers, the premise being that a known or 'expected' risk can be budgeted and held more efficiently as retained risk by the employer rather than being transferred, redundantly, to an insurer at a higher cost-fixed premium.

Many things have a tendency to become controversial when they are not fully understood.

Lasering has always been a provocative topic, however, for most self-funded employers it is a long-accepted practice within the self-funded structure. The concept of lasering has a tendency to become more controversial as self-funded employers become smaller.

The Affordable Care Act has fueled an expansion of self-funding with much of this market growth coming from employers with less than 250 employees.

Considered small by self-funding standards, many employers in this size category do not have the financial agility to comfortably absorb a significant stop-loss laser.

What is lasering?

Within self-funded medical programmes, individuals with serious ongoing medical conditions that are likely to incur large expenses related to those conditions are known risks that are frequently isolated by a stop-loss carrier to receive a higher specific deductible in relation to the rest of the insured population.

Isolating specific individuals for a higher stop-loss deductible is known as lasering and has always been a common practice in the medical stop-loss industry.

As an over-simplified illustration, assume that a 250-life employer group has a $100,000 specific stop-loss deductible. An individual in the group is currently being treated for cancer with an expected treatment cost of $500,000 during the plan year.

Medical stop-loss coverage with a $100,000 specific deductible is issued to the employer for each covered individual except for the cancer patient, who will be 'lasered' with a $500,000 specific deductible.

In short, a laser is a direct reflection of an underwriter's estimation of what an ongoing medical condition is going to cost.

What's known is known (except when it isn't)

Medical stop-loss is actually a form of excess of loss coverage rather than primary coverage. The intent of excess coverage is to protect against larger, and more unpredictable, risks, whereas primary coverage secures the ground-up 'working layers' of risk. In theory, when a known condition can be identified, thus becoming expected, placing a higher specific deductible on the anticipated financial liability is a prudent expectation of a stop-loss carrier by a self-funded employer.

The practice of lasering aligns with the self-funding principal of retaining known, or expected, risk and only purchasing insurance for unknown (and unpredictable) risk.

It is also important to understand that medical stop-loss is not a pooled product. This means that large claims are not spread across a multitude of other insureds within the insurance carrier's coverage portfolio as they typically would be under primary, fully-insured,

coverage. Large losses are charged directly to each employer's self-funded plan without any pooling-related credits to offset. It is worth noting that some medical stop-loss group captives will seek to absorb lasers by spreading them across all group captive members on a pooled basis. This is more common within the large 'open-market' group captive programmes that specifically target smaller employers. These programmes, if large enough, can be effective in enhancing the stability of self-funding to some smaller employers.

Strategic imperatives for combating lasers

Some stop-loss carriers will offer no-new-laser (NNL) contract options. These options are typically written on new, as opposed to renewal, accounts to the stop-loss carrier. At the inception of a new contract, the stop-loss carrier may establish initial lasers. However, upon renewal, the carrier will not add any new lasers to existing insureds within the plan.

The NNL contract will also typically come with a renewal rate cap, which specifies the maximum rate increase that can be charged upon renewal. The premium rate load for an NNL contract option will range from 5 percent to 15 percent with rate cap maximums ranging from 40 percent to nearly 100 percent. Generally, a 10 percent load for a 50 percent rate cap is considered to be fairly standard.

Many lasers are attributable to issues such as cancers, kidney failure, premature births, and conditions requiring organ transplants. Having a network of recognised centres of excellence that specialise in these types of conditions as part of the plan requirements should be helpful in negotiating lasers with underwriters. At the very least, these centres will be helpful in mitigating the ultimate cost of claims incurred within the self-funded plan and paid by the employer.

A few stop-loss carriers also offer standalone organ transplant 'carve-out' coverage, which provides first-dollar coverage for transplants. Since this coverage effectively carves out the transplant exposure of the self-funded plan, the need for lasers attributable to transplants is effectively nullified. This coverage is economically priced and premiums can be efficiently offset through corresponding rate discounts provided by stop-loss carriers.

The use of captives can also be effective in absorbing stop-loss lasers. Single-parent captives can retain the 'soft cost' of lasers as increased retention or converted to an appropriate premium charge for increased insurance provided by the captive to cover the laser.

Some group captives will seek to reduce or absorb lasers by pooling them across all group captive members.

Each of these options has proven to be fairly effective for reducing or eliminating an employer's susceptibility to increased self-funded retention in the form of lasers.

Setting to stun

Lasers will always be a part of most self-funded plans, especially as the cost of large, potentially catastrophic claims continues to increase. Since the Affordable Care Act, the cost of large claims has increased dramatically. Many claims that used to cost $100,000 or $200,000 are now regularly eclipsing $500,000 or more, and the frequency of $1 million-plus claims has risen to unsettling levels.

With the growth and increased frequency of large claims, it is safe to assume that the application of lasers by stop-loss carriers will also continue to increase. Employer perspectives of the theoretical and practical applications of lasering continue to differ according to the employer's size and financial agility. **CIT**

Phillip Giles
Vice President for sales and marketing
QBE North America

Latin America: Time for a captive boom?

Regulatory reforms are sweeping Latin America and, according to Daniel Message and James Bulkowski of EY, they are changing the insurance industry in the process

Regulatory reforms in Latin America are changing the landscape of the insurance industry. Increased focus on global solvency standards, enhanced corporate governance and advancing risk management frameworks are indicative of a rapidly maturing market. In such a fluid environment, entities with interests in the region face challenges of how to stay ahead of the curve—or at least keep up with the latest developments—to maintain their competitive edge. Despite slowing regional GDP growth, the insurance outlook is promising and the market appears well positioned for a growth in captive insurance.

There are more than 7,000 captives worldwide, but less than 3 percent are from Latin America. While the captive concept has been widely embraced in the US and Europe, adoption has been somewhat slower in the region. A key driver of this has been a historical local lack of demand for insurance, compounded by challenging regulation and a limited appreciation of potential captive benefits. With the risk function becoming more established and the regulatory environment undergoing significant change, entities are now focusing more on risk management and the associated reduced cost of risk that may be accessed via captives.

Regulatory reforms

A steady progression of risk-based capital rules and regulatory frameworks modelled after Solvency II is currently underway. Mexico was the first Latin American country to adopt these measures. Effective 1 January last year, Brazil was granted a 10-year period of provisional Solvency II equivalence, and Chile is now following suit.

Having already approved the Own Risk and Solvency Assessment, effective next year, Chile is now seeking approval of its own framework, modelled after Solvency II.

Elsewhere in Latin America, close attention is being paid to these developments, possibly in anticipation of similar frameworks being implemented. Regulators in Argentina, for example, are tabling a number of initiatives to improve the regulatory environment, including risk-based capital.

Colombia, the Latin American country with the most captive momentum to date, is also moving towards a more risk-based and

economic value-based approach, although without full adoption of a Solvency II regime thus far.

What does this mean?

With the greater regulatory oversight required as part of these reforms, more emphasis is being placed on risk management, particularly in the context of reporting and compliance. In some cases, a new risk manager's role may be required to fulfill these new responsibilities, where it was previously the domain of a treasurer or CFO, or may not have existed at all.

As this culture of risk management proliferates, risk managers, or those managing their insurance programmes, will become more numerous and more sophisticated, developing in tandem with the broader insurance environment. At the same time, they will look for new ways to achieve their objectives, including improving coverage and reducing the overall cost of risk.

Having seen the value obtained from captives elsewhere, a subsequent increase in captive interest may seem a logical progression, particularly for those entities with a long-term commitment to a comprehensive risk management programme.

Enhanced transparency and some harmonisation with more widespread Solvency II-type regulations are also drawing the attention of interests from outside the region. Combined with growing premiums and large infrastructure projects, competition and foreign investment are picking up. Other changes are serving to further propel the industry, as well as increase capacity for firms with interests in the region.

For example, Colombia's 2013 insurance laws liberalised the industry for foreign insurers and gave them the same rights and obligations as domestic insurers, further increasing the value proposition to foreign firms.

While this competition may drive rates down, the flexibility, control and potential cost savings afforded with captives will still provide a compelling value proposition to some. Coupled with an enhanced risk management culture—driven by natural market evolution and accelerated via greater integration with the risk culture of global entities investing in the region—conditions appear to be conducive to captive growth.

It is not only new captive interest that will be the product of these developments. Spurred by rapid growth in the region, merger and acquisition activity has seen more than 57 deals signed since 2011. Foreign entities investing in the region may already own a captive and subsequently look to bring their Latin American interests into their existing programmes. As such, it is not only the number of captives that looks poised to increase—so too could the scale of some pre-existing captives.

Potential challenges

Some key challenges exist, despite the largely positive captive outlook. For example, the rapid pace of regulatory change is leading to demand for more skilled personnel with appropriate technical and modeling capabilities. This is needed to comply with greater regulatory reporting requirements and the ability to design and implement new risk management frameworks, potentially with a captive element.

A US policy shift under the Trump administration could also have implications on the economic growth of the region, which would in turn impact the insurance and captive market. The Organisation for Economic Co-operation and Development's base erosion and profit sharing project is another key challenge, including for captives, and one that will demand very careful strategic planning, review and execution for any captive strategy.

Outlook for the region

The Latin American insurance industry is on a path of rapid development, which looks set to continue as insurance demand increases and regulatory reforms proceed apace. This presents a complex blend of challenges that will perpetuate a need for up-skilling in key areas, including technical modelling, IT and risk management, and will require careful planning to successfully navigate.

The result has been—and will likely continue to be—an increase in insurance capacity, either via expansion in the traditional market or via increased use of alternative vehicles and captives.

This is a promising trajectory for Latin America as a whole, with better access to greater coverage helping to narrow the gap between economic and insured losses, supplemented with a corresponding surge in captive interest. CIT

Source: EY 2017 Latin American Insurance Outlook

Disclaimer: the views expressed in this article are those of the authors and do not necessarily reflect the views of any member firm of the global EY organisation.

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Captive data: The key to unlocking its potential

Generali's Vittorio Zaniboni suggests employee benefits captives have evolved from risk financing tools to proper risk management vehicles

How has the use of data within employee benefits captive programmes evolved?

Generali Employee Benefits has been involved in reinsurance and captives since the very launch of employee benefits captive programmes in the 1990s. Over time we have shifted our approach from simply duplicating operations and procedures from the pooling world to adopting a tailored response to the specific needs of these arrangements.

First of all, captives tend to use data more intensely to gather a business insight, by closely monitoring how schemes are performing, their structure and evolution, the generosity of coverages in place, and the overall profitability of the schemes.

Secondly, captives have different types of users and information needs: not only insight on business performance for the captive manager, but also accounting information from the formal reinsurance flow.

You were recently part of a panel at the World Captive Forum focusing on the importance of benefits data. What were the main findings?

Captives use data to inform key management decisions. At the World Captive Forum we discussed how gaining new insight has been affecting key areas, from the captive set-up, with the feasibility study and request for proposals, to the pricing and reserving decisions.

One of the areas where we have seen most innovation happening is the use of data to price new business and to steer renewals. We have been investing a particular effort into facilitating data-informed pricing and renewal decisions. This is quite challenging because the time frame is very short from the moment networks receive meaningful local data flows to when captives issue renewal instructions to their subsidiaries.

Reserving is also an area that attracts high attention from captive managers, particularly in relation to incurred but not yet reported, and outstanding claims reserves.

We work together with each of our clients to help them understand how to ensure they are reserving enough for future liabilities. As an example, we may think that the answer lies in the calculation methodology—how the locals calculate the reserves that pass over to the network and ultimately to the captive—but we also need to ensure that the methodology is applied correctly and get more visibility on what is behind reserving numbers.

This is another area where our network has been putting in a tremendous effort, striving to define the best answer to this need.

We believe reserving should not be treated in an isolated way but in an interconnected environment to derive what makes sense and why.

Furthermore, we should not only look at the environment internal to the captive but also open up to benchmarking insights.

From data to insight, what are the challenges and the expectations?

We have more and more data available and the technology to support the handling of a huge amount of information. So certainly, collecting data per se is not an issue any more. But, what remains a challenge is to navigate this sea of information, to validate efficiently and to derive better visibility and understanding.

I would like to point out the example of medical reporting, since healthcare costs represent an urgent area to address for employers and individuals. Just five years ago, networks were only providing pure accounting information on medical experience, which could not really provide actionable insight.

With the launch of our medical reports back in 2013, we changed this landscape. We integrated a more complete set of data that can explain the underlying cost drivers in the medical claim experience of a specific population and allow for identifying a tailored corrective course of action.

We also discuss with our clients the need for providing relevant benchmark to fully understand the medical performance by putting it into context: even a bad performance in absolute terms can be normal in a given country, or the opposite can be true.

What main trends are you seeing in data consumption?

We have observed three main trends over the last few years. The first one relates to the role played by employee benefits captives in a company's risk management strategy. We have seen employee benefits captives evolving from mainly risk financing tools to proper risk management vehicles, with companies investing to better understand and improve the performance of their schemes and the wellbeing of their people.

A second, and related, trend refers to how the role of the benefits provider has been evolving. While at the beginning we acted as a fronting partner, focusing on the reinsurance infrastructure, we have enlarged and sharpened our scope.

Building on our privileged position—and access to employees' data—network providers are, more and more, acting as business partners that can coordinate and deliver value-added services to enable our clients to take well informed-decisions on their employees' risk, from renewal support to benchmarking and tailored wellness programmes.

Finally, another trend we have been observing relates to the need to develop industry standards. Captives tend to use more than one network and expect them to align terminology and metrics to help consolidate information and facilitate a coherent overview of their benefits schemes around the world. **CIT**

Vittorio Zaniboni
Chief technical officer
Generali Employee Benefits

What's in YOUR risk budget ?

The risks of a captive insurer's operations tend to be narrower and less diversified than those of typical multi-line insurers, but, according to Anjanette Fowler of Madison Scottsdale, this can be a double-edged sword

Capital market risk is in a heightened state these days. Equity indices are near all-time highs. Interest rates have moved sharply higher in a relatively short period. The economy appears poised for continued expansion on the wings of potentially stimulative fiscal policies from a new administration. When so much 'good news' dominates the headlines, we find it a valuable exercise for our insurance clients to take a step back and re-visit the risks inherent across their enterprise.

Captive insurers traditionally make money from their investment portfolio and in some cases from their insurance operations. Each of these parts of an insurer's business involves different, but quantifiable, risks.

The risks of captive insurer's operations tend to be narrower and less diversified than those of typical multi-line insurers. This can be a double-edged sword: the narrower scope of insured risk is more easily defined, but the lack of diversity makes the insurance operation more susceptible to unforeseen, black swan events, which are difficult to absorb.

For many years, the investment side of the enterprise was where captives made their money. The multi-decade bull market in bonds and a near-tripling of stock market values since 2009 lows have provided reliable tailwinds for investment portfolio profitability. This has helped captives weather, and prosper, during periods of uneven underwriting results.

In the last few years, however, as interest rates fell to historic lows and stock market performance became increasingly volatile, profits from the investment portfolio have become more uneven and captives have had to increasingly rely on underwriting results to sustain their operations and build surplus. Indeed, according to A.M. Best, US captive net investment income has been flat-to-down over the last five years while net underwriting income has continued to grow.

Today's low yields, tight credit spreads and full equity valuations reflect a capital market environment exposed to a heightened level of risk. This backdrop demands that captives pay attention not just to the operational side of their risk budget, but also to the risk budget as it relates to their investment portfolio. Does the investment portfolio adequately balance and reflect the risks on the underwriting side? Are they outsized or over-exposed in any particular area? How have operational risks changed and how should the investment portfolio be re-positioned to be more responsive to operational risks? And, most importantly in today's environment, has the capital market environment itself shifted in a way that places the asset side of the balance sheet at greater risk?

Headlines recently highlighted the Dow Jones industrial average breaking the 20,000 level. Other market indices have consistently set new highs over the last several months. Yet, despite this good news, many of the forward-looking stock market indicators on which we focus are flashing caution. Volatility, as measured by the Chicago Board Options Exchange Volatility Index (VIX), has settled down after several brief periods of heightened uncertainty in the past year. The current low level of the VIX can be interpreted as an indicator of investor complacency, which is often a pre-cursor of volatile periods ahead.

Similarly, there's been a big shift recently in money flows by individual investors. For the better part of the last few years, individual investors have been pouring money into bond funds even as interest rates fell to historic lows. Recently, as interest rates began to rise last fall, investor preferences have shifted away from bonds and back toward stocks. Historically, leaning in the opposite direction of individual investor money flows has been rewarding.

Stock market valuations are currently somewhat stretched and reliant on future growth in earnings, which may be difficult to achieve in an environment of a strong US dollar and ongoing weakness in overseas economies. While we wouldn't be surprised to see equities continue to move grudgingly higher for a little while yet, the risk/reward equation at current levels is at best symmetrical and, more likely, skewed toward more risk and less reward.

Interest rates have begun to move higher as the economy has firmed and Federal Reserve policy has adopted a more hawkish tone. Indeed, in December of last year the Fed raised the federal funds rate by a 0.25 percent. The Fed and the markets seem to be in sync in their expectation for more increases in short-term interest rates in 2017. In response, longer-term interest rates have moved decidedly higher from the generationally low levels seen in the summer of 2016.

In an historical context, the approximate 100-basis point jump in long-term yields seems small, but it's nonetheless been painful as there is little income yield in the equation to offset the decline in market prices experienced on high-quality bonds. The mathematics of bonds and bond duration highlight this point, as more of a bond's total return these days comes from price change rather than income yield. Credit spreads, the premium received by investors for purchasing riskier bonds, have consistently shrunk in sympathy with an advancing stock market and sustained growth in profits. Yet much of the gain in corporate profits has come from balance sheet management as companies buy back their own stock using low-cost debt, leading to an overall increase in balance sheet leverage in the private sector.

And finally, political risks have risen. The change of administration in the US, and rising protectionist sentiments globally, has fostered a backdrop of heightened geopolitical risk, which could upset currency markets and trading relationships. While the new US administration's proposed fiscal policies, at face value, have a pro-growth undertone, they come at a time in the US economic cycle when the unemployment rate is low, inflation is rising, and incomes are advancing at the strongest rate since the end of the 'great recession'. While not currently in problem territory, inflationary pressures are building and bear watching.

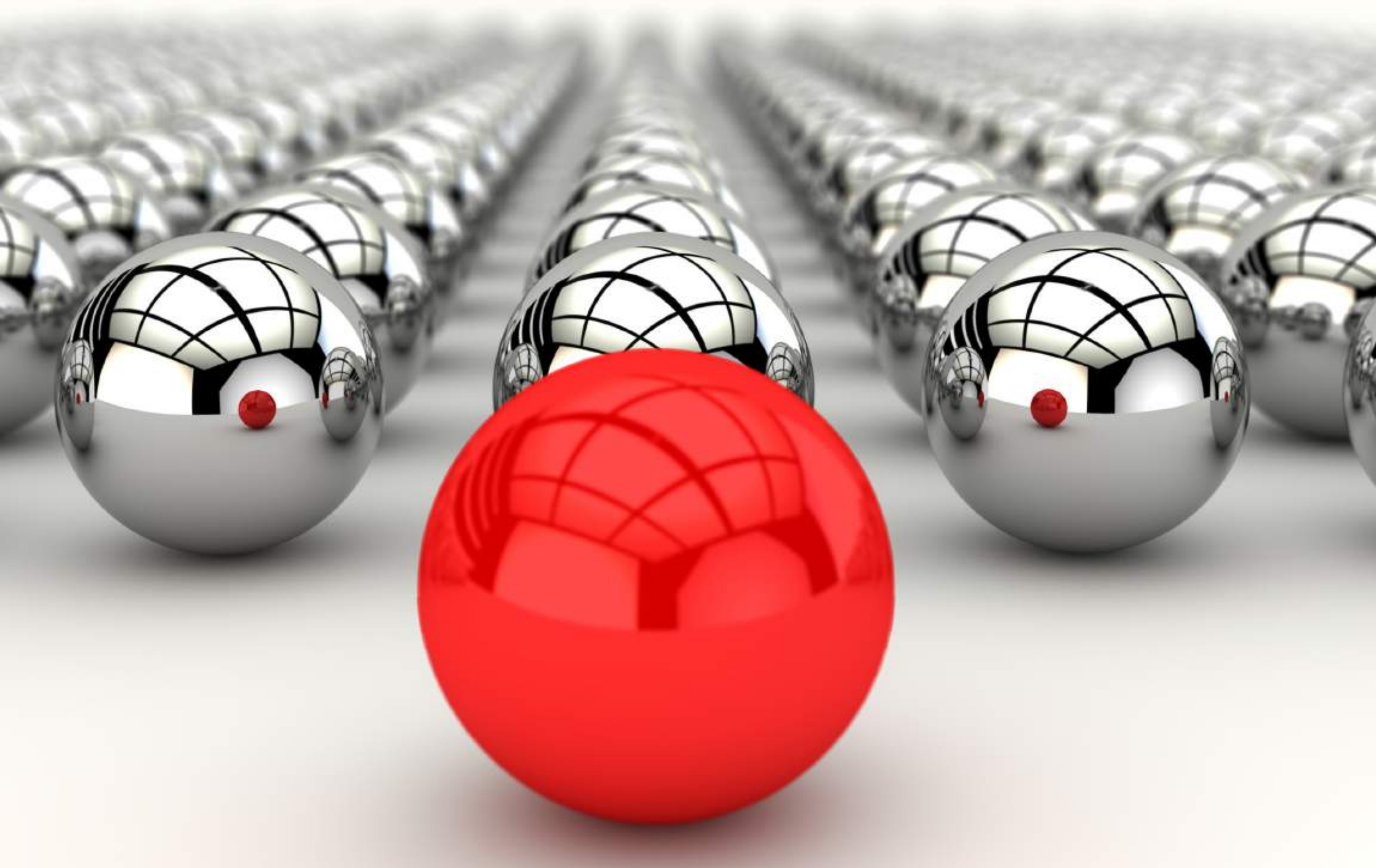
Madison Scottsdale is an active manager of our clients' insurance assets, but the term 'active' doesn't mean that we're jumping into and out of asset classes to capture market moves. Rather, the 'active' in our approach is designed to respond to our clients' overall risk budget. When risks rise on the operational side, captives should seek to temper the risk in their investment portfolio to ensure that it is operating within its risk budget.

Conversely, when operating results are expected to be strong, it's often advantageous to tweak the risk in the investment portfolio if the available rewards justify. In today's environment of heightened capital market risk, we believe that captives need to pay close attention to the quality of their investment portfolio to protect the asset side of their balance sheet.

Taken together, full equity valuations, rising interest rates, paltry risk premiums and rising geo-political uncertainty paint a challenging backdrop in which to invest and lead us to pose the question: what's in your risk budget? **CIT**

Anjanette Fowler
Managing director and portfolio manager
Madison Scottsdale

Bonds are subject to certain risks including interest rate risk, credit risk, call risk, risk of default, liquidity risk and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds.



Take notice

The IRS labelled micro captives as 'transactions of interest' last year. Alan Fine of Brown Smith Wallace outlines who is involved and what is required

The Protecting Americans from Tax Hikes (PATH) Act of 2015 made significant changes to Section 831(b) of the Internal Revenue Code and also included new annual reporting requirements for electing captive insurance companies. The PATH Act increased the maximum premiums for insurance companies making the election to be taxed solely on investment income from $1.2 million per year to $2.2 million per year, and included certain eligibility requirements for making the election.

On 1 November last year, the Internal Revenue Service (IRS) released Notice 2016-66, which formally labelled micro captives as 'transactions of interest'. The IRS advised that these transactions have the potential for tax avoidance or evasion. Transactions of interest are a type of reportable transaction first established by the IRS in 2006, and since then only six transactions have been labelled as such, including micro captive transactions. The reportable transaction is part of the larger reporting regime created by the American Jobs Creation Act of 2004 and the corresponding regulations to identify tax shelters.

It is important to note, however, that a reportable transaction is not the same as a 'listed transaction', and therefore, the 831(b) captive has not been determined to be a listed transaction.

The purpose of the notice is to provide the details for those disclosures, including which taxpayers are required to submit the disclosures, the timing for that submission and the specific information the IRS is requiring.

Who is required to file these disclosures?

Where applicable, owners of the captive, the captive itself and the insureds of the captive are required to prepare and file the disclosures. These participants are to report the required disclosures on Form 8886, the reportable transaction disclosure statement.

The notice addresses captive insurance transactions making the 831(b) election if the owner of the insured entities or one or more persons related to the owner of those insureds owns more than 20 percent of the voting power or value of the captive and either of the captive's loss ratio is less than 70 percent (premiums are measured after taking into account any policyholder dividends, or after the captive has provided financing or otherwise conveyed funds to the owner or related parties from the captive's surplus in a nontaxable transaction).

Under the terms of the notice, the relationship tests are determined utilising the various attribution rules provided in the Internal Revenue Code, which include ownership through partnerships and trusts as well as that by siblings, ancestors, spouses and lineal descendants.

Specifically excluded from the reporting requirements, however, are captive arrangements insuring employee compensation or benefits, which have received a prohibited transaction exemption by the Department of Labor.

Material advisers, defined as an adviser receiving $50,000 or more in fees resulting from the transaction, also have disclosure requirements, which are to be reported on Form 8918, the material advisor disclosure statement.

What information is required to be disclosed, and when are the disclosures required to be filed?

Pursuant to the notice, the following must be disclosed to the IRS:

- How the taxpayer became aware of the captive transaction.
- Whether the filings are being made because the captive's loss ratio was less than 70 percent, it made related party loans, or both.
- Where the captive is domiciled.
- A description of each type of coverage issued by the captive and for which years.
- A description of how the premiums were calculated for the years in question, including the name and contact information for any actuary involved in the pricing.
- A description of any claims paid by the captive, as well as any loss reserves reported by the captive.
- A description of the assets/investments held by the captive.

Form 8886 also requires a description of the tax benefits involved with the transaction, the material advisers to the transaction, as well as a listing of any related parties involved.

The notice originally required these disclosures to be made by 30 January 2017, but after requests from organisations such as the Self-Insurance Institute of America as well as a member of the Senate Finance Committee, the IRS extended the filing deadline to 1 May this year.

Under the terms of the notice, transactions entered into on or after 2 November 2006, need to be considered, and disclosures need to be made for the five most recent tax years.

If the captive has been in existence for less than five years, the disclosures should be completed for each year of its existence.

Why is the IRS asking for this information?

According to the notice, the IRS is requesting this information in order to determine which characteristics of the 831(b) captive arrangements are indicative of "tax avoidance or evasion".

The IRS also raised concerns around topics including:

- Are the premiums paid to the captive determined on an arms' length basis and with a supporting underwriting or actuarial analysis?
- Do the payments made to the captive greatly exceed what is commercially reasonable for the given coverages?
- Are the risks covered implausible?
- Is there a business need for these coverages?
- Do the coverages duplicate those obtained in the commercial insurance marketplace?
- When the insureds incur losses, do they file claims with the captive?
- Does the captive have sufficient capital for the risks it is insuring?

Doesn't the IRS already have this information?

The IRS actually receives most of the information being requested annually when the captive files its tax return. The annual report or statement generally contains information regarding lines of business, losses incurred, the domicile of the captive, as well as investments and other assets held by the captive.

For the several hundred captives currently under examination, the IRS has obtained extensive documentation with regards to all aspects of the captive, its formation and its operations.

This approach is not unusual, however. When the IRS begins an examination, generally their very first request is for copies of the tax returns for the years being audited.

What are the consequences of not filing?

Penalties will be assessed if it is determined that a taxpayer was required to disclose their participation in a reportable transaction but did not.

The penalty is 75 percent of the amount the tax decreased by participating in the transaction, with a maximum penalty of $10,000 for individuals and $50,000 for other taxpayers.

The penalties are essentially a 'strict liability' penalty, meaning it is only in few circumstances this penalty will be abated. CIT

Alan Fine
Partner
Brown Smith Wallace

Can a captive $ave us from ourselves?

With a solid enterprise risk management strategy, a captive can increase in value and reputation, says Michael Zuckerman of Temple University

Is a captive insurance company: a money pit; an inconvenient chequebook needed simply to support a fronted self-insurance programme; or a risk management vehicle that can drive an insured/member strategic enterprise risk management (ERM) programme?

There is no doubt that captives can be expensive. They require capital and incur significant administrative costs. However, if a captive is simply a chequebook to support a fronted self-insurance programme, then maybe the parent should rethink the need for a captive.

Regardless of the captive's parent position, there is a significant research question that deserves the attention of both the academic and professional risk management community.

Can a properly managed captive insurance company be a driver of traditional and/or ERM maturity? Specifically, this research needs to address whether a captive managed according to generally accepted captive management best practices can be used as a vehicle to promote and improve the insured/member ERM programme over the long term.

This article will focus on just one of many issues for which a captive can provide invaluable ERM support. Studies indicate that CFOs will talk about earnings shortfalls and accounting irregularities as risk issues that keep them up at night. Consequently, a possible credit rating downgrade is also a significant financial and strategic exposure, for most profit and many non-profit organisations.

A credit downgrade is a key risk indicator that the organisation is not effectively managing the operational, financial, and strategic risks that will eventually negatively impact its earnings before interest, tax depreciation and amortisation (EBITDA).

Moreover, a credit rating downgrade affects the cost of capital, increasing interest rates that may cause liquidity and budgetary instability. Ultimately, this could damage the organisation's reputation. These are the type of issues that a well-thought out risk financing strategy, which includes the use of a captive, is intended to alleviate.

An organisation that self-insures an exposure to loss, such as professional liability or workers' compensation, must account for these losses as loss contingencies on its income statement (ASC 450). The organisation must, therefore, accrue for these expected losses for the fiscal period in question as a business expense, which is offset as a liability for retained loss reserves on its balance sheet.

Any manipulation of this accrual, such as understatement of expected losses caused by an overstatement of the discount rate, which cannot be supported by market conditions, or the use of a confidence level loss forecast that clearly does not recognise the variability in actuarial projections, puts the organisation at financial risk. Under-reserving claims is also a source of concern.

These aggregated issues may cause budgetary instability resulting in earnings volatility. In summary, corrupted loss data caused by systemic claims management issues, or manipulation of actuarial assumptions, could lead to an understatement of expected losses. This, in turn, may negatively affect EBITDA, creating a liquidity issue for the organisation when actual losses to be paid exceed expected losses. EBITDA volatility may result in a credit rating downgrade increasing the cost of capital, or at a minimum creating a major distraction for management caused by budgetary instability.

This is how financial exposure is better managed with a captive. A captive is a regulated legal subsidiary with its own board of directors. A director has a duty of care, loyalty, and candor. Specifically, this duty of care requires the director be informed about material captive operations including financial-and risk-related information to allow the director to be able to exercise the appropriate due diligence to make decisions and provide the required oversight of captive operations.

There are a series of regulators requiring transparency and knowledgeable oversight by the captive's board, including the broker/consultant, actuary, auditor, lawyer, captive manager, and even the captive domicile regulator. They all provide a layer of analysis, oversight and regulatory input that may not otherwise be available to guide the parent's risk financing strategy.

For example, a firm that is self-insured does not have to use an actuary to calculate expected losses. While the firm's external auditor and internal audit function are absolutely an important source of risk management oversight, they are not solely focused on risk financing issues with the same acuity that a captive regulator, actuary, auditor, broker consultant and management company would have.

Again, if the captive director is exercising their legal duty of care then they must be informed on the key operational, financial, and strategic issues facing the captive to be able to make reasonable and knowledgeable decisions in the best interest of the captive. In the spirit of Sarbanes Oxley, an act passed by US Congress in 2002 to protect investors from the possibility of fraudulent accounting activities by corporations, the director must be present at board, and relevant committee, meetings and given the appropriate risk management information to be able to ask questions and raise causes for concern about the captive's claims management programme (data source) and expected loss forecasts. These include key variables such as discount rates, confidence level variations, and actuarial methods.

This is an important aspect of captive due diligence required to assist the insured/member or parent in ensuring that its risk financing programme is meeting its goals of maintaining liquidity; to ensure ability to pay for losses; and to reduce the cost of risk and earnings volatility. The parent and captive risk management actions are interconnected and in this case, the captive's management process is driving the parent's due diligence, positively impacting the parent's risk financing goals. These risk financing goals are established to enable the parent to grow stakeholder value, and at the end of the day protect its reputation. In other words, enabling the success of ERM.

The captive's actuary, auditor, captive manager, broker/consultant, and attorney are the captive's human capital. The captive is also the product of an active and knowledgeable board, supported by this human capital that ultimately ensures that the captive is seeking and receiving an appropriate level of funding to pay its expenses and losses.

The captive board meeting, therefore, is an appropriate and efficacious conduit by which the directors are provided information about the appropriate steps taken to address risk data issues (audit of the claims reserving practices), expected loss variability, and the application of the appropriate financial variables and actuarial methodology needed to protect the parent's financial stability and reputation.

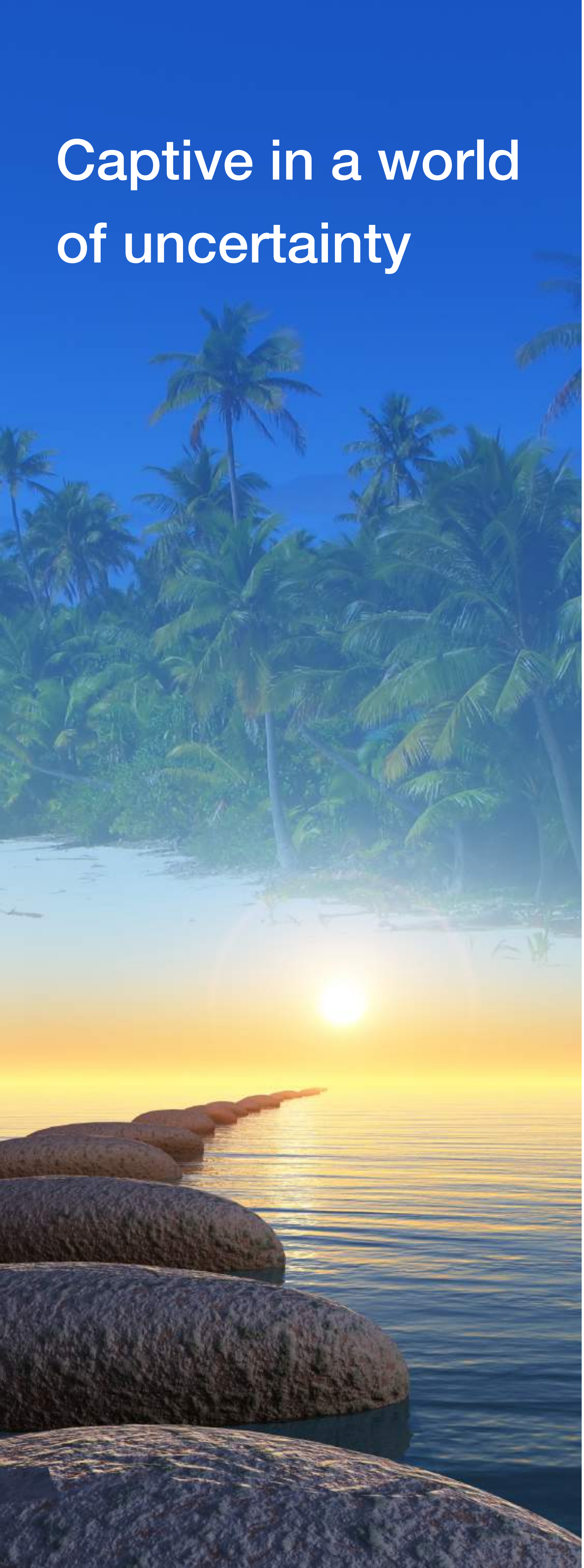
This is a first step in building a transformative captive insurance programme that positively impacts its parent's operations. Captives are expensive to operate. They require capital and an operational infrastructure to manage them properly. Most importantly, the captive requires the time and attention of the parent's senior officers, who sit on the captive's board, creating a critical risk communication pipeline. Without captive management best practices, it is less likely that the captive can contribute to its parent's long-term growth in value.

The captive's return on investment, therefore, should not be simply benchmarked against the parent's cost of capital. The parent must also consider the value of avoiding risk management and financing surprises that force the parent to seek funds to pay for unexpected losses that cause budgetary instability and adversely impact its EBITDA, drawing the interest of the rating agencies.

A credit rating review requires a complex process. Certainly, any threat to EBITDA warrants careful review. The captive can offer a progressive risk financing solution to address this issue, as well as other ERM issues, enabling the parent organisation to grow value over the long term and enhance its reputation. **CIT**

Michael Zuckerman
Assistant professor
Temple University

Captive in a world of uncertainty



In an era of increasing uncertainty, Tamatoa Jonassen suggests that the Cook Islands can be a bridge to financial security in a captive

According to Murphy's Law: "Anything can go wrong, will go wrong." This encapsulates perhaps the most compelling reason for taking insurance. By planning for the worst (and hoping for the best), insurance coverage can provide protection for your home and other assets, cover your healthcare costs and maintain your standard of living, thus ensuring stability for you and your family, and can give you peace of mind.

Sometimes we take the benefits of insurance for granted, perhaps partly because insurance has become so ingrained into our globalising society and is even legally mandated for certain types of activities by many jurisdictions. Captive insurance is the next step up for individuals or businesses, as it addresses insurance market volatility and accessibility to coverage that may not otherwise be feasible.

Although captive insurance is not for everyone, it can give the right wealthy clients greater control over insurance coverage, allowing the potential for cost savings and also granting a degree of asset protection not afforded through traditional self-insurance arrangements. Incorporating the captive insurance entity offshore adds a further layer of protection for clients focused on wealth preservation, which provides further peace of mind.

Era of uncertainty and risk

We now live in an era of increasing uncertainty. The effects of the post-9/11 war on terrorism has changed the way we live. The financial crisis jarred our faith in the banking industry with rippling effects internationally.

The perceived threats of global warming, increased pollution, and changing climate conditions continue to increase our concern around the world our children will inherit. Meanwhile, the global political scene is unsettling as international trade, migration, and transnational relationships are affected by changing political landscapes such as the UK's exit from the EU, and divisive politics such as those seen in the recent US presidential elections.

Furthermore, with American protectionism and aggressive initiatives such as the anticipated EU blacklisting of non-EU international financial centres, the tides of uncertainty continue to surge. In contrast to this, we are also entering an age of unparalleled technology and tax transparency.

Technology has never been more advanced. We seem to now take for granted the ability to instantly video conference in real time with someone who is on the other side of the globe in a different time zone. Even seemingly remote locations on our globe have become accessible by our technology. Now we have even more technological marvels, from pocket translators to recreational and delivery drones to the remarkable potential of augmented reality, technology promises to make our lives more interesting, which undoubtedly will come with new insurable risk.

At the same time that technology enhances our personal lives, technology allows for unprecedented levels of international cooperation which can be seen in the efforts of the Organisation for Economic Co-operation and Development's push for global tax transparency through the implementation of the automatic exchange of information for tax purposes (AEOI) programme. With the implementation of AEOI and the common reporting standard in more than 100 countries, national governments gain automatic access to information of its citizens' offshore holdings which can then be considered within their respective tax regimes. However, any digital data collection of private wealth information is not without its associated cyber risk.

Establishing a captive that will last

Given the current global climate in which we live, it is no surprise that demand for cyber insurance, drone insurance, political risk insurance, stock market insurance, and alternatives to the seemingly doomed Obamacare has increased. Depending on your individual or business circumstances, establishing a captive insurance entity can be ideal to meet your insurance demands.

Known advantages to using a captive include: increased control over handling of insurance claims; flexibility in tailoring coverage to owner needs and providing coverage not otherwise available or cost-effective on the insurance market; reduced costs of risk management; stabilised pricing based on the owner's loss experience, independent of commercial market volatility; ability to direct the investment of premiums and an opportunity to generate investment income; increased capacity to retain risk as the captive matures and surplus grows; and direct access to the reinsurance market, which may reduce costs and increase sources of risk transfer capacity.

There is also a potential for tax advantages, which should be considered in any decision to establish a captive but should not be the primary motivation behind captive formation. Obtaining professional tax advice is recommended before deciding to establish a captive.

Using a captive may also provide a degree of asset protection if established properly. Traditional self-insurance normally entails holding surplus funds to cover possible losses instead of purchasing a commercial insurance policy. If for some reason something goes terribly wrong with your business, the funds held for traditional self-insurance would still be reachable by your business creditors, unlike funds held in a properly formed captive.

Although maintaining a captive may require added expertise and administrative burden, such costs can be offset by contracting with a licensed captive insurance manager. It may also be important to ensure that key staff responsible for maintaining the captive have the required expertise to understand and utilise the advantages of captives over commercial insurance coverage; sometimes changes in such key staff could place the captive at risk if adequate expertise is not maintained.

The captive insurance market continues to grow, with estimates of over 90 percent of Fortune 500 companies already owning a captive. As uncertainty grows and international markets fluctuate, the option of forming a captive becomes more appealing. Understanding the advantages of forming a captive, it is important to ensure that a captive is established as part of a long-term business plan where proper feasibility studies are obtained.

The Cook Islands

In considering the formation or relocation of a captive, it is essential to look at the choice of domiciles or jurisdictions your captive may be established in.

Contrary to some belief, a jurisdiction with little or no regard for regulations may not be the ideal jurisdiction for those seeking to establish a captive that will last. The uncertainty of the times has led to a surge in international regulation and the Cook Islands's 'right-touch' regulatory approach has done well internationally.

In 2009, the Cook Islands ranked in the top 20 percent of approximately 165 nations assessed for implementing international regulatory standards in an evaluation by the Asia Pacific Group (APG) on money laundering, a Financial Action Task Force-style regional body.

The next evaluation of the Cook Islands by the APG will be conducted this year and is expected to be positive. The Cook Islands has further received positive evaluations in both phase-one and phase-two peer reviews conducted by the Global Forum, which has led the Cook Islands to be well respected in the Pacific for its regulation.

The positive evaluations and robust implementation of international standards in the Cook Islands also led to the selection of the Cook Islands as the home of the Pacific Catastrophe Risk Insurance Facility (PCRIF) captive, a truly international effort by respected international organisations. The Cook Islands was selected over other jurisdictions for its established financial services industry and high regulatory standards.

As a disaster risk management programme, the PCRIF captive was established to serve the Pacific region and was only made possible through the efforts of the World Bank, Asian Development Bank, Pacific Islands Forum Secretariat, the Secretariat of the Pacific Community Applied Geosciences and Technology Division, the Global Facility for Disaster Reduction and Recovery, the government of Japan, and the EU.

The Cook Islands financial services industry has qualified professionals still working since the inception of the industry more than 30 years ago. The professionalism, experience, expertise, and global network of these professionals is an asset that speaks well of the Cook Islands. Having gained independence more than 50 years ago, five days before Singapore, the Cook Islands has enjoyed stability through its special relationship with New Zealand and diplomatic relations with over 40 other countries. Although some may consider the Cook Islands 'remote', its ideal location in the heart of the Pacific positions it in the 'middle of everywhere' during this highly technological era.

In a world of uncertainty, the Cook Islands stands as a bridge to financial security in establishing your captive. CIT

Tamatoa Jonassen
CEO
Cook Islands Financial Services
Development Authority

Becky Butcher reports

Although it's typically viewed as a defensive move, BEPS could mean positive things for captives, says Ciaran Healy of Willis

The OECD's BEPS has been an ongoing issue for the captive insurance, how are the major domiciles dealing with this? And where are those domiciles in terms of implementation of the framework?

Although the Organisation for Economic Co-operation and Development (OECD) and G20's action plan was released back in October 2015, with consultations on the initiative taking place for a number of years prior to this, the majority of jurisdictions have yet to enact the action plan guidelines fully. As a result of this, the majority of domiciles are adopting a 'wait and watch' position. This is somewhat understandable given the fact that each jurisdiction has the authority to interpret and apply base erosion and profit sharing (BEPS)-related measures as they deem fit.

It is important to note that it is not only the approach of the jurisdiction where the captive is based that needs to be considered, but more so the jurisdiction where the captive owner is based and potentially the locations of insured parties.

What we are seeing more of in the major domiciles is a rising awareness, and the identification of the need for education on the subject. Captive associations in many domiciles are organising briefing sessions and facilitating Q&As with service providers to socialise the challenge locally. BEPS is now almost a compulsory topic at the usual domicile captive conferences, which is evidence of how important the topic is regarded by the industry.

One of the interesting aspects about BEPS is that, although it will likely affect each domicile, the perception around the extent and nature of the impact differs per domicile, with some locations adopting the stance that BEPS is an opportunity as opposed to a threat.

In the first six months of 2017, what do captives and their managers need to look out for in terms of BEPS?

Positive preparation is key. Although the ultimate guise of BEPS in all jurisdictions is still to emerge, there is enough in the principles covered in the OECD Action Plan for captives to be preparing for.

A sensible approach for the first six months of 2017, and something we are speaking to clients about, will be to review the captives' positions in relation to the principle expectations of the BEPS package. Measuring the captive against key metrics and documenting where positive compliance can be demonstrated, and where remedial action is required, will allow the captive owner to begin thinking about BEPS in specific terms that are actionable.

This can lead to an action plan, which ultimately puts the captive in control of the BEPS challenge and removes much of the uncertainty that currently exists for many captive owners.

The concept of positive compliance is an important one—preparing for the challenge of BEPS is as much about identification and documentation of all the things the captive does well as it is about identifying potential areas that may not be fully aligned to BEPS expectations.

There is no prescribed checklist to mark your captive against to achieve definitive assurance, the BEPS span is more fluid and wide ranging. With this in mind, we would suggest that a self-evaluation or BEPS 'health-check' would be positive first preparatory steps to keep captive owners on the forefront.

Willis Towers Watson recently launched a new BEPS captive product. How will this help clients with implementation?

The purpose of Radar is to provide captive owners with a clear blueprint to BEPS compliance, captive value and future strategy in a format that is reviewable and that supports high-level governance and oversight. Our approach is straightforward—review, analyse, document, action, respond—which was the inspiration for the name.

Captive owners will require a response framework that reflects the multidimensional nature of the BEPS challenge. Our Radar tool blends quantitative and qualitative measurement metrics across three core areas—transfer pricing, economic rationale and substance.

One of the things we were conscious of in developing our offering was the potential mismatch between those less familiar with captive concepts and the captive industry, and the difficulties that this mismatch may cause.

Being able to effectively demonstrate and assign a value to the nuanced and indirect ways that a captive promotes better group risk management, for example, are benefits that need to be considered in the overall BEPS evaluation and something the Radar framework accommodates.

However, to be completely effective, this perspective needs to be bi-directional. Radar also tests key financial metrics in a manner similar to that of a tax investigator, which provides the captive owner insight into where a potential misconception or genuine compliance risk may exist. A key benefit of this approach is that it provides quantitative measures to aim towards, as opposed to unmeasurable qualitative remedial recommendations.

Overall, Radar underlines our approach to BEPS, which is primarily about positive compliance and building on the positive, bone fide risk management benefits that captives provide.

What kind of data flows through a captive in this day and age, and how will analysis and interpretation help captives to navigate regulatory hurdles such as BEPS?

Clearly, financial data is critical, predominantly around losses. Analysis of this data has always been a key plank of any successful captive strategy, whether in respect of risk management, risk financing and transfer pricing, and so on. But a captive can provide indicators of other forms of value too—not necessarily financial but strategic and operational.

Capturing these through captive oversight and analysis, evaluating the benefits from a parent perspective, and ensuring ongoing alignment with a changing market environment and the demands of the business will all help to support compliance with BEPS.

Although generally viewed by the industry as a defensive initiative, BEPS will prompt more captive owners to critically assess the value, in all its many forms, that the captive creates, and data will be critical to this.

Assessment and measurement of value created by the captive will likely lead to improvement actions, which in the long term will be good for the individual captive. If you can't measure it, you can't improve it, and data is the key to measurement. This applies to improvement in the context of BEPS, but also more generally to the entire captive strategy. **CIT**

Ciaran Healy
Director of consulting
Willis Global Captive Practice

Comings and goings at Aon, Guernsey Finance and Dickinson Wright

Dickinson Wright has appointed lawyer Kevin Doherty as a member of its office in Nashville, Tennessee.

Doherty's practice focuses on insurance regulatory law, specialising in captives, risk retention groups, self-insurance funds and other alternative insurance vehicles.

He currently serves as chairman and president of the Tennessee Captive Insurance Association, and in 2011 helped to rewrite the captive insurance laws in the state.

In addition, Doherty is a member, and past chair, of the captive insurance committee at the Self-Insurance Institute of America.

Guernsey Finance has appointed Christopher Chan as its first Hong Kong representative.

Chan will lead Guernsey's promotional efforts in Hong Kong and provide a presence for Guernsey Finance and its member firms.

Chan will also promote Guernsey in the wider Southeast Asia region.

Guernsey Finance opened its Hong Kong office in March last year.

The office is used by Guernsey Finance's China representative Wendy Weng as a base to carry out further promotional activities on the wider Southeast Asia market.

Kate Clouston, director of international business development at Guernsey Finance, said: "We've had a really positive experience since opening our Hong Kong office, so much so that we now require a permanent representative to be based there."

"There are a growing number of opportunities across all sectors and we're therefore excited to be able to share Guernsey's complete offering with the Asia market."

"It has reaffirmed our belief that Hong Kong is an important financial hub and our continued commitment to the region can only be seen as a positive for business prospects and the further development of Guernsey relationships in Asia."

Aon's group president Steve McGill has stepped down.

McGill said he is "incredibly proud" of his accomplishments at Aon, but felt "compelled to explore new opportunities to serve the insurance industry and the UK".

Greg Case, president and CEO of Aon, said: "During his decade at Aon, Steve McGill has developed a well-earned reputation as a tireless innovator on behalf of clients. I am grateful to him for his leadership and wish him the best as he begins a new chapter of his career."

CEO of Aon Benfield, Eric Andersen, and CEO of Aon Risk Solutions, Mike O'Connor, will work jointly in McGill's absence, reporting directly to Case. CIT

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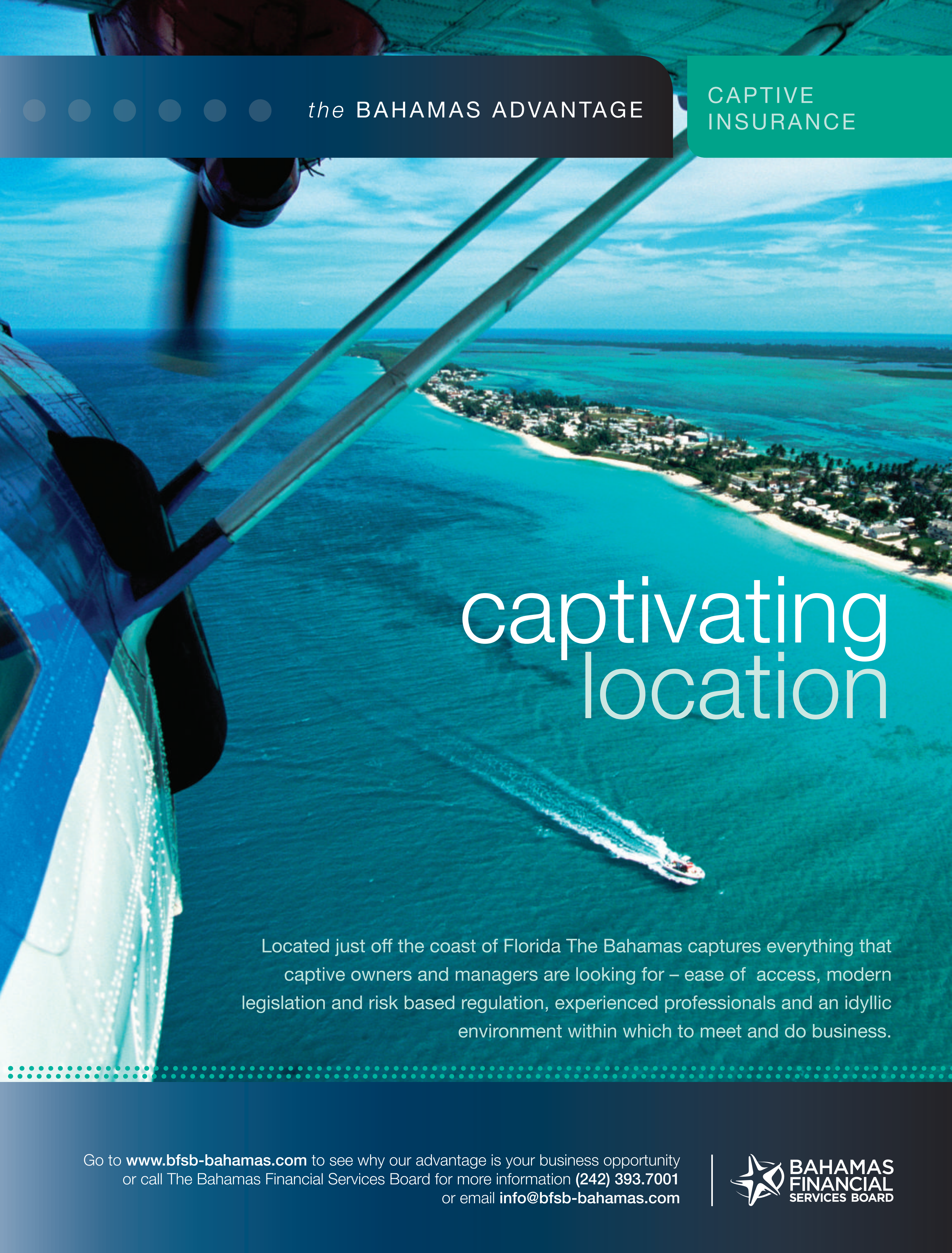

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