



Legal battle could prove monumental for reinsurers worldwide

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The upcoming court case of AstraZeneca Insurance Company versus XL Insurance (Bermuda) and Ace Bermuda Insurance will have far-reaching implications for reinsurers across the globe.

Several lawsuits were brought against the London-based pharmaceutical company AstraZeneca over one of its products, an antipsychotic drug named Seroquel.

It was alleged that Seroquel, used to treat schizophrenia and bipolar disorder, had caused diabetes, and in some instances death, in its users.

Before the suits, the drug had sales of \$5.3 billion and was the company's second-biggest seller behind cholesterol-reducing drug Crestor.

Without admitting wrongdoing, AstraZeneca settled more than 28,000 claims in the US, paying out ap-

proximately \$25,000 to each patient to the grand total of \$647 million.

The company also agreed to pay \$520 million to settle a suit brought by the US federal government, which claimed that the drug had been illegally marketed to be used for anxiety, sleeplessness and post-traumatic stress disorder (PTSD) — for which the US military regularly prescribed it.

AstraZeneca Insurance Company, the pharmaceutical giant's captive, reimbursed the costs and then turned to its reinsurers to indemnify the claim.

However, its two Bermuda-based reinsurers, XL Insurance and Ace Bermuda, which have a potential coverage exposure of \$200 million, have both refused the claim on the grounds that the cases were settled, arguing that a court did not enter a liability ruling.

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Vermont sticks to 'steady as they go' adage

The State of Vermont soldiered on at a steady pace in 2012, licensing 32 new captives with strong showings from the construction and manufacturing sectors, which each had five new licensees.

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Randall & Quilter strikes again

Randall & Quilter Investment Holdings (R&Q) has acquired the entire issued share capital of Hickson Insurance Limited (HIL), an Isle of Man-domiciled captive insurer, for £525,000.

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Legal battle could prove monumental for reinsurers worldwide

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Lawyers said that the case would introduce new questions of reinsurance law, including whether there is a belief that under a liability, policy coverage is only for actual and not alleged liabilities.

Disputes over insurance policies are typically settled through arbitration, but this case will be battled out in the UK's Commercial Court.

Vermont sticks to 'steady as they go' adage

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Data from the Vermont Captive Insurance Division was announced by state governor Peter Shumlin, who shared the results during the Vermont Captive Insurance Association's (VCIA's) Legislative Day, a meet-up of owners of captive insurance companies from throughout the country, government officials, and service providers.

"We're very pleased with the results for 2012," said Shumlin. "We will remain committed to preserving Vermont's captive leadership role in 2013 with a priority on clarifying the ambiguities in the federal Dodd-Frank legislation which have caused undue confusion for the captive insurance industry."

"The quality of the new captive insurance companies over the past year has been excellent," said David Provost, Vermont's deputy commissioner of captive insurance.

"[Twenty-eight] of the 32 were pure captives, an extremely high percentage of the overall total for 2012."

Vermont licensed 41 captives in 2011. In addition to the 28 pure captives, three were sponsored and there was one risk retention group in 2012. Some of parents behind the newly licensed captives include Deutsche Bank, Conoco Philips, Tyco and Allstate. Another continued trend in



2012 was the strong presence of the non-profits with new formations.

"The healthcare and religious organisation activity was very strong in 2012," said Dan Towle, Vermont's director of financial services. "That trend has continued with two newly licensed captives in 2013 both being in the healthcare sector."

"Although there have been many different lines, the top industries licensing captives in the past year in Vermont continue to be insurance, hospitals and medical groups and manufacturing," said Richard Smith, president of the VCIA. "Vermont was also busy with activity in risk retention groups which continue to be a growth sector."

Last year's new licensees brings Vermont over all total to 984, with 588 active captive insurance companies. This year is starting strongly with two

new captives licensed, with an active pipeline of prospective captive insurance companies.

Randall & Quilter strikes again

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HIL has been in run-off since 2002 and wrote a mixed book of business from 1988, including public and products liability, property, general liability, marine, death in service and motor accidental damage.

In a statement, Ken Randall, chairman and CEO of R&Q, said: "The purchase of HIL further evidences the increasing level of acquisition activity we are seeing as a group."

"It also continues to demonstrate our ability to provide attractive exit solutions for captive owners who have put their captives in run-off or are contemplating ceasing writing new business.

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This will be our first captive acquisition in the Isle of Man.”

In an email interview, Paul Corver, director in the insurance investments division at R&Q, said: “Many captives will have written long tail liabilities such as employers liability or general liability. Claims on these policies can take a number of years to reach satisfactory conclusion; something often not fully appreciated by captive owners who operate outside the insurance sector.”

“As reported in our announcement, Hickson was no longer carrying claims reserves as all known claims have been settled. The captive therefore faced paying annual fees for a company that was in effect inactive. As the company had contracts with a variety of different front companies it was perceived that reaching agreement to finalise their position with each of these fronts would be a time consuming task. A sale to R&Q would therefore appear to be a more expedient solution, and we completed this in a little over five months.”

At the end of 2012, R&Q acquired LINPAC Insurance Company (LICL) from LINPAC Finance for £450,000.

The Guernsey-based captive insurer was in run-off since 2006 and wrote business from 1994, including employers liability, public and products liability, and workers’ compensation.

The LINPAC takeover was R&Q’s fifth acquisition of 2012 and its fourth in Guernsey.

Corver added: “There are plenty of captives either in run-off or carrying legacy liabilities that they would like to remove. These companies are now realising that there are alternatives to commuting with the front companies.”

NRRA not for captives, says subcommittee chair

The departing chairman of the subcommittee of insurance in the House of Representatives, Judy Biggert, has reaffirmed that the Non-admitted and Reinsurance Reform Act (NRRA) was never intended to apply to captive insurance.

In a letter to the new chairman and ranking member of the committee, Biggert wrote: “As a supporter of NRRA and an advocate for its inclusion and passage as part of Dodd-Frank, I can tell you unequivocally that the NRRA was never intended to include the captive insurance industry.”

“This provision (NRRA) was intended to create certainty in the tax treatment and regulation of the surplus lines and in the reinsurance industry. Despite this very specific purpose, a couple of states are misinterpreting the application of NRRA’s definition of ‘Non-Admitted’.”



Last year, the Vermont Captive Insurance Association (VCIA) formed the Coalition for Captive Insurance Clarity to push for clarity that may include legislative language to reaffirm that the NRRA was never intended to apply to captive insurance.

Dan Towle, Vermont’s director of financial services, said: “A few domiciliary states and opportunistic service providers are clearly exploiting the present situation which is not in the best interest of their clients or the industry as a whole.”

Richard Smith, president of the VCIA, said: “This endorsement from the outgoing subcommittee chairman, who played a substantive and important role in crafting the NRRA, makes it crystal clear—captive insurance is not and never was intended to be included in Dodd-Frank.”

For a comprehensive look at the situation with the NRAA, turn to page 10.

New property and catastrophe reinsurer for Everest Re

Everest Re has formed Mt Logan Re, a new special purpose reinsurer for the global property and catastrophe market.

The new sidecar reinsurance vehicle, which is domiciled in Bermuda, will allow it to attract investor capital and collateralise reinsurance business.

Everest Re will provide initial funding of \$50 million to Mt Logan Re. Additional funding from

investors will help it to reach its target capacity of \$250 million.

Everest Re has brought in Rick Pagnani, who previously worked at reinsurance broker and risk/capital management advisor TigerRisk Partners, as CEO to run the new business.

In a statement, Joseph Taranto, chairman and CEO of Everest Re, said: “Having successfully led prior reinsurance ventures, we are fortunate to have an executive of his calibre join us to launch this new operation.”

“For Everest, this vehicle adds yet another tool to our underwriting arsenal that allows us to meet the dynamic demands of the reinsurance marketplace and enhance the returns of our investors.”

Bermudan marine reinsurer NEWGT is rated A-

A.M. Best has assigned a financial strength rating of “A- (Excellent)” and issuer credit rating of “a-” to NEWGT Reinsurance Company in Bermuda.

The ratings reflect the Class 3 general business reinsurer’s stable operating profitability, aided by its retrocession coverage in its general account and the implicit support from the parent company, Itochu Corporation.

NEWGT reported favourable operating performance in its general account over the past five years, mainly driven by its major line of marine cargo product, which is diversified globally.



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NEWGT's retrocession coverage against its major product line helped it to stabilise its underwriting results during the past years.

As a single parent captive, NEWGT receives support from Itochu to grow in the captive market in the form of capital injections, as well as support from its integrated risk management system.

Partially offsetting these positive rating factors include NEWGT's continuous expansion into the third party business; NEWGT will participate in Lloyd's Syndicates in 2013, which accounts for a significant proportion of its consolidated net premium income in the forecast periods.

Although Itochu will support this new business by injecting capital, the increase in the third-party business could increase volatility in NEWGT's operating performance.

NEWGT reported a sharp increase in its loss ratio in the segregated account in fiscal year 2010 as it has experienced several large claims from the catastrophe business that has been in run off since 2012.

The uncertain economy outlook could impact NEWGT's operating performance, as the sales of marine cargo are susceptible to trading activities.

Life insurers increasingly using domestic captive subsidiaries

Life insurance companies are continuing to undertake "redundant" reserve financings and are now mainly using domestic captive subsidiaries/affiliates, said A.M. Best in recent a report.

In the rating firm's wrap-up of the US life and annuity sector, it stated that life insurance companies were increasingly using domestic captive affiliates to maximise capital efficiency, "which has become more important in the current low interest rate environment."

Despite concerns with certain macroeconomic factors, especially the low interest rate environment, A.M. Best indicated that its rating outlook for the US life and annuity sector remains stable.

The stable rating outlook reflects generally strong risk-adjusted capital positions, favorable GAAP and statutory operating earnings and continued efforts at improving balance sheet fundamentals through enhanced risk management and continued de-risking initiatives.

Additionally, A.M. Best noted that life insurers' investment portfolios have held up well, with most insurers reporting relatively modest investment impairments in 2012 and relatively large unrealised gain positions in their fixed income portfolios.



As experienced during the financial crisis, asset portfolio valuations can swing wildly in times of systemic market distress. A.M. Best has observed that selected organisations have refined their investment allocations to help offset the impact of low new money rates.

However, for the most part, A.M. Best has not witnessed wholesale changes in investment strategies to enhance yield. Rather, for the most part, companies are making modifications around the edges.

Qatar Central Bank takes charge

A new law has been passed handing over the licensing and supervision of insurance and reinsurance companies to the Qatar Central Bank (QCB).

The Law of the Qatar Central Bank and the Regulation of Financial Institutions was enacted on 2 December 2012.

The new law will help to advance the framework for financial regulation and supervision in the state of Qatar.

Under the law, QCB will be responsible for the licensing and supervision of insurance companies, reinsurance companies and insurance intermediaries that were previously under the remit of the Ministry of Business and Trade.

QCB plans to publish further details on the new regulatory framework for the insurance sector in due course.

Sheikh Abdullah Saoud Al Thani, governor of the QCB, said: "The new law is an important step in continuing to build a resilient financial sector for the State of Qatar that operates to the highest international standards of regulation and supervision and best practices."

Lion Reinsurance receives roar of approval

A.M. Best has affirmed the financial strength rating (FSR) of "A- (Excellent)" and issuer credit rating (ICR) of "a-" of Lion Reinsurance Company, a start-up in Bermuda.

The ratings of Lion Re acknowledge its strong initial capitalisation, conservative operating strategy and the explicit parental support, also considering Lion Re's strategic role as a captive reinsurer of ASSA Tenedora.

Also inuring to Lion Re's ratings is its sound business plan, upon which the profitability and liquidity measures of these ratings are based. The ratings are supported by an amount of capital that meets A.M. Best's requirements for newly formed companies as measured by its Capital Adequacy Ratio.

Lion Re operates as a Bermuda-based reinsurer focused on writing a combination of property, casualty, health and group life business from affiliated insurers.

These positive rating factors are partially offset by execution risk due to the unproven start-up nature of the company.

Insurance-linked securities are on five-year high

New catastrophe bond issuance for Q4 2012 reached \$1.89 billion, and \$6.25 billion for 2012 as a whole—the highest insurance-linked securities (ILS) issuance volume since 2007, said Aon Benfield.

Aon Benfield Securities, the investment banking division of global reinsurance intermediary and capital advisor Aon Benfield, revealed the news in its latest report on the ILS market.

A total of seven catastrophe bonds closed during Q4, including Compass Re 2012—the largest single transaction in that quarter—which secured \$400 million of US hurricane and earthquake capacity for the National Union Fire Insurance Company of Pittsburgh, an affiliate of insurer AIG.

Meanwhile, the majority of Aon Benfield's ILS Indices posted mark-to-market gains in Q4 2012, with the All Bond index rising to 2.1 percent (2011:1.7 percent), the BB-rated Bond index decreasing to 1.4 percent, the US Hurricane Bond index increasing to 2.2 percent, and the US Earthquake Bond index increasing to 1.6 percent (2011:0.7 percent).

Full year results for the indices were even more impressive, particularly for the All Bond index, which increased to 9.9 percent (2011:3.2 percent).

Paul Schultz, CEO of Aon Benfield Securities, said: "Fourth quarter 2012 ILS issuance volumes were strong adding to the consistently impressive quarterly performances for the year as a whole. The All Bond index outperformed all the major benchmarks for the fourth quarter, mainly due to coupon returns, in what was a relatively steady pricing environment."

Aon Benfield Securities forecasts strong ILS issuance volumes throughout 2013, with a solid pipeline for the first half of the year, primarily driven by US risks.

Lloyd's warns of \$168 billion insurance shortfall

There is a \$168 billion annual shortfall between levels of insurance and actual economic losses caused by natural disasters across the world, according to research that was recently published for Lloyd's.

With 17 out of the 42 countries that were analysed considered to be significantly at risk, Lloyd's is urging governments, insurers and businesses to do more to close the gap.

To ensure long-term viability of their business, portfolio manager of Quant Solutions at Aviva Investors North America, Sindhu Srivastava, suggested that assets be managed versus liabilities in such a way that there is almost no risk to the viability of their firm.

"Liability streams need to be matched in a risk framework that considers riskiness of investments over the full cycle. This requires a multifaceted approach to investing that generates superior total return accounting for both short term and long term risks, but also meets cash flow needs with high confidence over long horizons."

"Investors need to think outside the box. They do not necessarily always need to match their liability stream with mostly high grade bond investments, as is the usual approach. Consider, for example, a small allocation into non-fixed income assets that produce high cash flows. Real estate and high quality high dividend equities could produce cash flow streams that are quite stable over time and might also be able to protect against a high inflationary environment."

"The key is to either develop these capabilities or be ready to outsource, before the actual need arises. These can add the value, the margin that insurance companies typically need."



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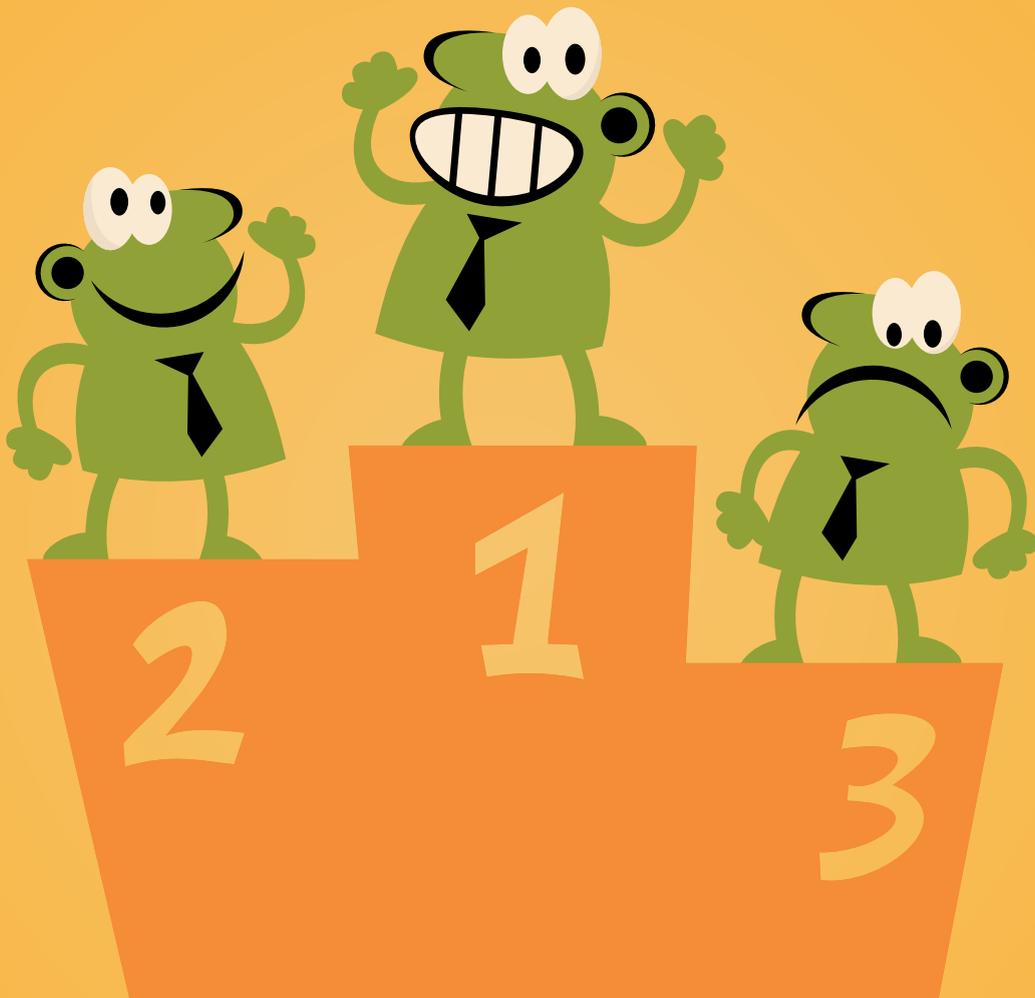
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Measuring up

CIT goes behind the scenes of A.M. Best with Steven Chirico to discover how the ratings process really works

JENNA JONES REPORTS



What information do you need to rate a protected cell captive?

The information is not dissimilar to the information that we would need for any rating that A.M. Best carries out. We would require audited financial statements from all the cells and the general cell, and an actuary report for all of them. We'd also get the reinsurance and vendor contracts for all the cells. We basically treat them as discreet entities from a ratings perspective. We consider each individual cell as a separate company, so we get a look on a standalone basis of what each cell looks like.

Other information that we require is management biographies. We would have to understand the cell captive and its operations from a qualitative perspective and then the purpose of each cell. Sometimes cell captives are grouped together with disparate businesses and some of them are businesses that are related in some way, but either way we have to understand from a qualitative perspective why this cell exists, what its purpose is, how it is functioning and how it is used.

There are other bits of information that we would require if we had specific questions, such as liquidity or if there's substitute capital in the form of letters of credit, we would have to understand those and get those documents, but those are particular to certain scenarios. Finally, we always require a meeting, almost always face-to-face on an initial rating, and that's any rating, so it would also apply to cell captives.

There are a lot of different terms for protected cell companies and similar structures depending on the domicile—are they all rated in the same way?

It's a little bit of a different process because of the caveat with cell captives. The legislation in all of the domiciles that we are aware of wants to make each cell discreet financially from any other cells, so that you can't use the assets of one cell to satisfy the liabilities of another cell.

But the problem is that whether you are in the British system or the US system, the Cayman Islands or Guernsey, and you have cell captive legislation, there hasn't been one good court case to look at when a cell or a number of cells have gone bankrupt, that the assets of another cell could or could not be used to satisfy those obligations. So the permeability of those cell walls is still open to the subjectivity of a court.

Because of this, we take a little bit of a different approach. We do an analysis on each individual cell from a capital strength (risk adjusted capitalisation) perspective and then we rank them in order from weakest to strongest cell. This gives us an idea of how weak the weak cells are and how strong the strong ones are, and the probability of the weaker cells becoming compromised becomes part of the ratings determination. We have to be confident that the weak cells aren't going to

be able to drag down the strong cells. In my view, it is the most unique kind of rating that we do.

How does rating captives differ to rating traditional insurance companies, and what are the key issues to consider?

From a raw financial perspective, there is very little difference. We use the same capital model that we would a commercial insurer.

We evaluate operating performance in a similar way, but we take a little bit of a different look at operating performance, for example, net income, as we understand that captives have a different mission. A captive's number one mission is not to make money, but to provide as low a cost and stable coverage for its parent company, or if it's a group captive, its policy holder owner/s, as possible.

So we'll look at dividends to policyholders, or a dividend from a single parent captive to its parent company, and view operating performance in certain cases before those events happen. We'll also look at pre-dividend operating performance and particularly if the captive has the ability to not pay a dividend to its parent company or to its policy-holder and they have the willingness and the ability not to do that. We base that on financial flexibility and we give them a different take of operating performance as making money is third or fourth on the list for a captive as opposed to its main goal.

Do you physically visit every captive before rating it?

That is an interesting question for captives because sometimes the captive manager is where almost all the work is done. Some captives are virtual meaning they have no employees and no physical presence—they'll just have a mailbox in Bermuda or Vermont! If this is the case, we visit the captive manager because that's where all the work is done. In a single parent captive, we like to go to the parent company's home office, so generally on an initial rating there is a face-to-face meeting. They also have the option to come to the A.M. Best offices for their rating meeting.

In subsequent years, we either visit or we conduct conference calls depending on the size of the company, the complexity and what's going on in a particular year. Sometimes nothing changes for a captive and we just do a conference call with management. But sometimes captives have a lot of stuff going on such as putting in new lines of business, having a tax challenge from the US Internal Revenue Service, or planning to re-domicile, and in those types of scenarios an interactive meeting would be required.

Why would a company decide to leave the ratings process?

Captives generally leave the rating process because they don't need the rating anymore. For example, say a captive was writing a line of business and the decision was made to write that

business in the commercial market, and a captive wrote other lines of business that really don't need a rating, it may look at the frictional cost of a ratings fee and decide to halt the process.

Another reason is that if a company merges with or acquires a business, it could end up with two captives while only needing one, so it will put one of the captives into run-off and continue on with its main captive. Sometimes, depending on where a company is in the world, it might decide to refocus where its risk management activity is done, so a global company would have its risk process decentralised in each of the large countries in which it does business, and then make the decision that it is going to consolidate risk management activities. And if it consolidates it in, for example, an Asian market, then the rating is not really required. Frankly, we are a little bit of a pain as we require a lot of information and communication and we ask a lot of questions, so it takes quite a bit of time for any rated company to maintain its rating.

Company ratings are currently voluntary. Do you think there will come a time when the rating process becomes mandatory?

I think that there's going to be a higher level of global insured solvency work being done, but I'm not sure if it is going to be done through ratings agencies, governments or associations. In Europe, there's Solvency II and there's an implementation process and it is quite complex, and while some would argue that there are quite strong benefits to it, others would say that there are actual anti-competitive components of it that aren't any good. I think that there is definitely an eye toward better global insurer and solvency regulation and I think that ratings could absolutely be a part of that.

I think that we're moving towards a more robust analysis being done. Where that's done is frankly less important, but the answer is that insurance companies should be well capitalised for the risks that are being rated and how you get there remains to be seen. Until Solvency II is implemented in the EU, I think we'll only be able to guess, and after it is implemented, we'll see what solutions are proposed. **CIT**



Steven Chirico
Assistant vice president
A.M. Best

Seeing clearly now the NRRRA has gone (or not)

Adam Forstot of USA Risk Group weighs into the debate on the controversial piece of Dodd-Frank legislation that is, was and could always be a pain for captives

The Non-admitted and Reinsurance Reform Act (NRRRA) was a piece of the historic Dodd-Frank financial industry oversight regulation that went into effect in July 2011. The primary intent of the NRRRA was to create a more simplified and efficient regulatory system by limiting regulatory authority of surplus lines transactions to the home state of the insured, as well as establishing federal standards for the collection of surplus lines premium taxes. Most captive industry observers interpreted the NRRRA to specifically exclude captive insurance.

Unfortunately for the industry, a number of individual states interpreted the NRRRA otherwise. A number of the largest states declined to participate in 'compacts' relating to the distribution of premium taxes and administration of surplus lines insurers. The two compacts have yet to secure sufficient membership to become formally operational. Some of these states continue to insist on their share of premium taxes and require non-admitted insurers (including some captives) to file financial and other regulatory reports.

On 7 January, the captive industry received some good news. Departing chairperson of the US House of Representatives's Subcommittee

on Insurance and Financial Services, Judy Biggert, stated in a letter that the NRRRA was "unequivocally" not intended to include captives. With this announcement, the industry breathed a collective sigh of relief. Despite this positive statement, it does not appear the issue is completely settled. Later in her letter, Biggert suggested a technical amendment to the NRRRA may be necessary in order to clarify the issue on captives. Given the current level of dysfunction in the US Congress, it is not clear how quickly and easily such an amendment might be passed.

Also, it remains unclear if some of the larger states will comply with the act. As noted above, several states declined to participate in compacts on premium tax or other information sharing agreements. It appears some states may be taking a similar position under the NRRRA as they have taken with risk retention groups (RRGs). The Liability Risk Retention Act (LRRRA) has clear language regarding the limitations on information that can be required of RRGs by non-domiciliary states. But several states continue to require RRGs to become 'approved' before they can write business in that state. Even with federal law on their side, most RRGs comply with the requirements of individual states. For

most RRGs, the financial and administrative burden of challenging such requirements are prohibitive. Outside of efforts by industry groups and some sympathetic legislators, support at the federal level has been limited at best.

Despite this turmoil, there are steps that captive owners can take with regard to the NRRRA to reduce the uncertainty. Some captive owners decided to re-domicile or form branches in their home states. Fledgling captive domiciles aggressively marketed to businesses in their states to 'bring their captives home' by making commitments to stand by the letter of the NRRRA and protect those captives from other states seeking to collect additional premium tax. The increasing number of states passing captive laws made this option viable for numerous captive owners. As this option will add administrative burden and cost, it needs to be weighed against the overall potential expense of possibly having to comply with the 'worst case' interpretation of the NRRRA. This option is obviously not available for captive owners with businesses based in non-captive states.

Even with the 'home state' option, there are steps all captive owners should be taking to mitigate their exposure to non-domicile regulatory scrutiny. Even if the NRRRA is interpret-



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ed in favour of captives, certain activity could subject a captive to the jurisdiction of a non-domicile regulator.

One step is to ensure that no insurance business is conducted in the non-domicile state. All agreements and policies should, ideally, be executed in the domicile state. Board meetings and other decision making activity should also be conducted in the captive domicile. For an offshore captive, this may not always be possible, but business should be conducted in a non-US jurisdiction.

Another step is to make sure the captive is current with all domicile requirements relating to filing of reports and the payment of fees/taxes. Also, all captive policies should be issued directly to affiliated insureds on an indemnification basis. This means that any claim payments will be made directly to that insured, even if the loss involves a third party. The use of 'pay on behalf of' language that is common in most commercial insurance policies could put the captive in the position of conducting business with third parties. Doing so would not only violate the regulations of the captive domicile, but also subject the captive to fair claim practices and other guidelines of the non-domicile state. Both transgres-

sions could lead to significant regulatory actions in their domicile and non-domicile states.

A final step is to understand if the parent company is subject to self-procurement tax or not. Some states levy a self-procurement tax as a way of generating some tax revenue from entities that use captives or similar vehicles. Other states have what is called an 'industrial insured exemption' in which an organisation meeting certain size and risk management expertise requirements can procure coverage directly from alien insurers. The current definition can vary from state to state. A similar exemption is included in the NRRRA, so the individual state definitions may change if the NRRRA is formally adopted. In the absence of an industrial insured exemption, a captive owner may be subject to self-procurement tax. This issue should be reviewed by captive owners with their tax/legal advisors.

While the NRRRA may ultimately provide the captive industry with the non-domicile compliance standards that it has fought so hard to establish, it is not clear how or when this issue might be decided. Captive owners and their advisors need to keep up-to-date on developments with the NRRRA and continue to press their elected officials to support the position proffered by Big-

gart. In the meantime, they also need to closely follow the rules of their captive domicile and those jurisdictions in which they have insurable risks. Even if the NRRRA ends up supporting captives, it is not a panacea. Captive owners will need to remain vigilant and be sure that their captives remain in compliance with their domicile state while avoiding activity that could put their captive under the authority of a non-domiciliary and likely unfriendly state regulator. **CIT**



Adam Forstot
Vice president
USA Risk Group

Confusion reigns

The NRRRA has been a continuous source of misunderstanding when it comes to captives. CIT talks to Richard Smith of the VCIA in an attempt to see if there is light at the end of the tunnel

GEORGINA LAVERS REPORTS

A chairman of an insurance committee in the US House of Representatives caused quite a stir on her exit. Judy Biggert, an Illinois Congresswoman, caused a sigh of relief for captives everywhere, as she reaffirmed that the Non-admitted and Reinsurance Reform Act (NRRRA), a part of the Dodd-Frank Act, was never intended to apply to captive insurance.

Domiciles and service providers can presently manipulate the interpretation of this federal act and pressure companies to domicile in their home state

In a letter to the new chairman, she wrote: "As a supporter of NRRRA and an advocate for its inclusion and passage as part of Dodd-Frank, I can tell you unequivocally that the NRRRA was never intended to include the captive insurance industry," adding that a technical amendment may be necessary for solving this misperception.

"This provision [NRRRA] was intended to create certainty in the tax treatment and regulation of the surplus lines and in the reinsurance industry. Despite this very specific purpose, a couple of states are misinterpreting the application of NRRRA's definition of 'Non-Admitted'."

The Coalition for Captive Insurance Clarity, formed under the leadership of the Vermont Captive Insurance Association (VCIA), has been pushing hard for clarity that may include legislative language that would reaffirm NRRRA was never intended to apply to captive insurance.

"A few domiciliary states and opportunistic service providers are clearly exploiting the present situation which is not in the best interest of their clients or the industry as a whole," according to Dan Towle, Vermont's director of Financial Services, who recently spoke on the subject.

Richard Smith, president of the VCIA, explains whether the confusion can, and will be, cleared up.

How is the current regulatory landscape, particularly with the ongoing NRRRA confusion?

The regulatory landscape has not changed as there has been no legislative fix to the NRRRA in the Dodd-Frank Act as of yet. Our hope is that the letter from the departing chair will help both in educating regulators and the captive community that NRRRA was never intended to include captives.

Why was it a departing chairman who confirmed NRRRA was never meant for captives? Are you still looking for a current chairman to reaffirm the claims?

It was important to get the departing chair's view on the situation since she was instrumental in the original concept, drafting and passing of the NRRRA. It verifies our view all along that NRRRA was never meant for captives and that it has exactly the opposite effect on the captive industry that it was trying to fix for surplus lines. Our hope is that the current chair will take this into consideration as we seek a legislative fix.

Dan Towle has stated that a few domiciliary states and opportunistic service providers are clearly exploiting the present situation—how so?

Some domiciles and service providers may presently manipulate the interpretation of this federal act and thereby pressure companies to domicile in their home state either to generate tax revenue for the state, or expand the business of the service providers. This practice (or behavior) is hardly in the best interest of that company or the captive insurance industry as a whole.

When the NRRRA is clarified, where do you see captives flocking?

I don't think captives will necessarily 'flock' to any specific domiciles once NRRRA is clarified. What I think it does is take out an unintended factor for companies looking to domicile captives or grow their captive business. Compa-

nies need to have the choice of where they domicile based on regulatory strength, not based on tax ambiguity.

How are captive company figures doing in Vermont?

In 2012, Vermont licensed 32 new captive insurance companies bringing the total number of licenses to 984, with 22 single parent captives, one risk retention group (RRG), three sponsored, and six special purpose financial captives. Last year's new captive insurance licenses brings Vermont's overall total to 586 active captive insurance companies.

What lines are proving particularly popular at the moment?

Although there have been many different lines, the top industries licensing captives in the past year in Vermont continue to be insurance, hospitals and medical groups and manufacturing. Vermont was also busy with activity in RRGs, which continue to be a growth sector.

How receptive are US domiciles to captives wanting to cover emerging risks (eg, cyber)?

The captive insurance industry is specifically equipped to quickly respond to emerging risks and opportunities. Any well-established captive domicile will be very responsive to a well thought out business plan, no matter what the risks may be. CIT



Richard Smith
President
VCIA



It's the taking part that counts

Though Florida may be yet to get off the mark, the state is ready and willing to support the alternative transfer vehicles, as CIT finds out

JENNA JONES REPORTS

Although there are three industrial insured captives in Florida, there are no domestic ones, despite the fact that the state's captive insurance legislation, which allows for the creation of both, came into effect in 1982.

"It is not unusual for it to take some time before a new domicile begins licensing captives", says Patti Pallito, director at Aon Risk Solutions.

"Once the first captive is licensed, a precedent is established, and others tend to follow. Florida seems to have made a commitment to attract captives; it's had captive legislation in place for some time. However, last year, the Florida leg-

islature decided to modernise the statutes and make them more competitive."

In July 2012, a new law came into effect to attract potential insurers. House Bill 1101 specified criteria for the formation, incorporation, coverage, reporting, licensure and reinsurance of captive insurers.

Kevin McCarty, Florida's insurance commissioner, encouraged the implementation of the new legislation, saying: "We welcome captive insurers to Florida's insurance marketplace. The new law will encourage the formation of new captive

insurers, which will promote increased investment in our insurance marketplace."

Belinda Miller, general counsel at the Florida Office of Insurance Regulation, says that House Bill 1101 was implemented because a number of companies interested in forming a captive that were interested in domiciling in the state stressed the stringency of its law to legislators.

The changes that were brought about by House Bill 1101 have yielded positive results. She says: "We're expecting relatively slow moderate growth. Currently we have two companies that

have been talking to us about forming a captive and one re-domestication from another state.”

There are now more than 30 states in the US with captive legislation in place, so there generally needs to be a compelling business purpose for establishing a captive in a new, untested jurisdiction and foregoing a ‘tried and true’ domicile, explains Pallito.

“This could be regional proximity to the insureds, the requirement for admitted paper, a specific nuance in the respective captive law, etc. Aon works closely with our clients to understand the mission and objectives for their proposed captives, and we then recommend domiciles that are best suited helping them achieve their goals.”

Mark Ouimette, managing director at Beecher Carlson, thinks that Florida is anxious to put some captives on its books to prove that it is a legitimate domicile option that should be considered. He also says up-and-coming domiciles face difficulties when trying to establish themselves.

He says: “I feel it is very difficult for any new domicile to establish itself in the current market. The captive business is far more mature than it was just 10 years ago and some domiciles have become very successful attracting new captives through the use of a multi-platform marketing approach.”

“The State of Florida has a large population, strong business climate, an excellent tourism infrastructure and is home to many household names in corporate America. I feel the best way for them to initially compete will be through a homegrown ‘we’re open for captive business’ campaign that focuses on the agent, broker and risk manager community in Florida.”

Miller says that while the Florida Office of Insurance Regulation was amenable to modifications to the law that would satisfy and secure some captives in the state, it is less welcome to those that aren’t genuine.

She says: “What we aren’t looking for in our market are captives that are not real. We’ve had a series of companies that claim to be exempt from the Florida Certificate of Authority, which aren’t really insuring themselves but advertising for everybody else.”

Florida is limiting its exposure because of this and focusing purely on clients that are genuinely interested in setting up proper captive companies.

It also wrote exemptions into House Bill 1101 that would protect the state and companies that do business there.

Under the law, captives cannot write life and health insurance. Miller says that life insurance has been omitted because policies are very long tail and solvency requirements surrounding a

true life insurance company are “particularly important and people depend on that coverage”.

Health insurance has been omitted because the state has had bad experiences with multiple employer welfare arrangements (MEWA)—when a group of employers pool their contributions in a self-contributing benefit plan for their employees—in the past.

Miller says: “Companies became insolvent and in some instances they were assessable and so the receiver had to go back and try to assess people to pay medical claims. It was an absolute mess.”

Opening up its borders to agreeable captives through relaxation of its law does not mean that the state will go easy on them in the future. Miller says: “We want a successful programme, we’re not looking to take the most risk”.

What will be, we’ll see

While domiciles such as the State of Vermont dominate the market, Miller insists that Florida’s intentions for entering the industry aren’t based on competition.

“We’re not getting into this to have more captives than Vermont or Delaware. If a company wants to form a captive here we would like to facilitate that and make it successful. We’re not doing it just for the annual convention requirement and it’s not really a revenue builder in itself. [Our aim] is to facilitate businesses located in Florida to set up operations here.”

Though competition may not be high on Florida’s agenda, it does need local infrastructure in place if captives are going to set up shop and stay in business. Miller says that the state’s existing resources are adequate for the time being, and once captives have been formed, additional infrastructure plans will then be put into action.

Ouimette insists that a ‘go to’ individual, who can represent the state and convey its captive mission, is paramount when establishing a successful infrastructure.

“[Florida] will also need to identify whether things like new captive application review, actuarial review and company examinations will be handled within the Florida insurance department or outsourced to qualified third parties. Some domiciles have built their reputations on consistent, predictable processes that captive managers and formation consultants know they can rely on with respect to their clients. While it is to be expected that there will be a few issues initially, there are some excellent US domiciles that Florida could use as an example of proper infrastructure.”

Pallito adds: “Nearly all of the nationally recognised brokers have offices in Florida, as do the other usual captive service providers—auditors, actuaries and attorneys. Once Florida has es-

tablished that it is a captive friendly jurisdiction, these service providers are poised to quickly have dedicated staff in the state to service the new companies”

Ouimette says that successful domiciles find a way of balancing “firm regulatory scrutiny with an open-minded bullish approach to captive formations and growth”. He adds that if Florida can achieve this balanced approach to new licences, then quality formations will follow.

Something that could get in the way of new formations is Dodd-Frank’s Non-admitted and Reinsurance Reform Act (NRRRA), which organises the way that premium taxes are collected from surplus lines insurance companies. It has been concern for domiciles because clarification as to whether it applies to captives is still undecided.

But they received a boost recently when Judy Biggert, the departing chair of the House of Representatives Sub-committee on Insurance, which initially drafted the NRRRA law, wrote a letter to her replacement confirming that it was not intended to apply to captives.

Pallito says: “The hope is that the new chairman, Jeb Hensarling, will take up Biggert’s recommendation to eliminate ambiguity in the NRRRA around direct placement tax remittance. However, it should be remembered that the NRRRA did not change the potential underlying tax obligations of captive insureds that existed before Dodd-Frank was passed into law.”

Indeed, Ouimette says that the clarity of the NRRRA may have derailed some potential re-domestications of existing captives.

“Premiums paid by Florida insureds to a foreign captive insurance company may have been subject to self procurement tax before NRRRA’s enactment and may be if a technical amendment excluding captives is passed by congress,” explains Pallito. “While Florida’s tax rate of 1.75 percent on premiums written by domestic captives is much higher than that of other jurisdictions, it is much more favorable than the 5 percent assessed on surplus lines premiums and self procured coverages.”

“Whether or not NRRRA applies to premiums paid to captives, if an organisation has significant risks in the state or is headquartered there, establishing a Florida captive may offer substantial premium tax savings. Given its favourable business environment, potential tax savings, and the state’s apparent commitment to captives, we anticipate that Florida will attract new companies quickly.”

Mary Mostoller, director of company admissions at the Florida Office of Insurance Regulation, is looking forward to the state licensing its first captive.

She says: “Florida is excited about the 2012 changes in its captive law and looks forward to welcoming its first captive since the legislation went into effect 1 July 2012.” **CIT**

Negotiating the maze

Lawrence Walters of Aon Risk Solutions looks at the challenges of reserves, LOCs and reinsurance relationships

The Cayman Islands hosts a wealth of management companies that will assist with the creation and management of a captive insurance company. The best managers follow these practices to ensure that the captive is a successful investment over the long term.

Letters of credit

Security is essential in many business relationships, particularly when a Cayman Islands captive elects to conduct business with a US- or

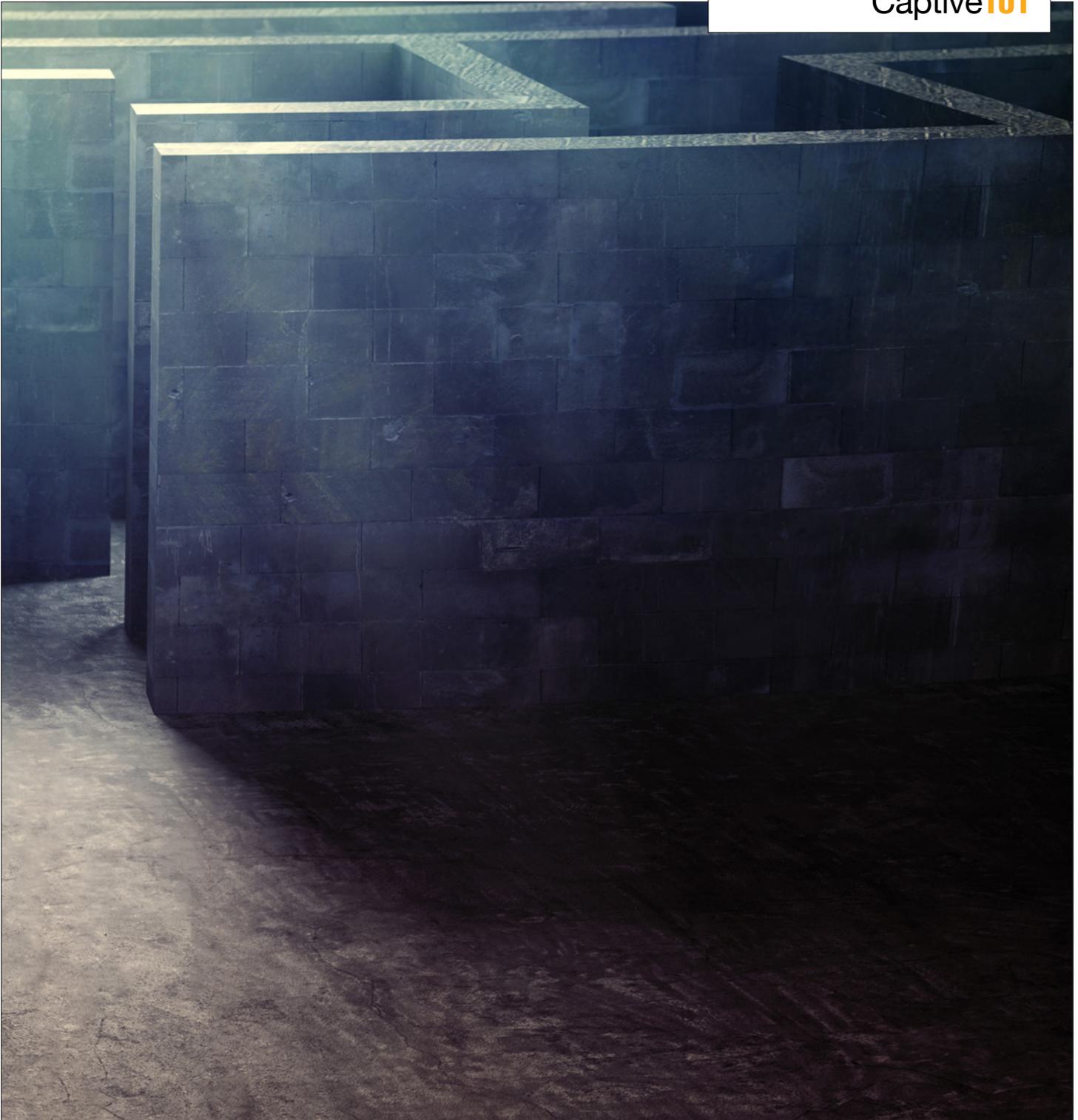
London-based issuing carrier. Most issuing carriers insist on security at inception, and at each renewal. The letter of credit (LOC) is widely used as security.

Planning in the early stages will enable the captive to make judicious use of LOC obligations. Initially, the language in a reinsurance agreement may seem innocuous:

“The Reinsurer shall post a Letter of Credit to the Company in an amount to be agreed by the

parties. The Company shall release all or part of the Letter of Credit when it determines that the liabilities are no longer significant [sic].”

After all, the term of the contract is one year, and the liabilities will decrease over time, presumably resulting in a reduced LOC. Unfortunately, this language is one sided because it lacks criteria that requires the issuing carrier to lower the LOC. Practically speaking, the reinsurance agreement could renew for 10 or more years, with an equal increase in the LOC each year. The issuing carrier may hold



10 times the amount of the initial LOC before it decides that gradual reductions are in order.

A reinsurance agreement should contain language that protects both the issuing carrier and the reinsuring captive. The following satisfies the needs of both parties:

“The Reinsurer shall provide a Letter of Credit to the Company in the amount of the outstanding liabilities. The Company will periodically reduce the Letter of Credit. For the purpose

of this Agreement the term ‘outstanding liabilities’ shall mean the sum of 1) the Company case reserves, plus 2) the Company Incurred But Not Reported Reserves, the latter to be calculated annually by an independent professional actuary [sic].”

These criteria will protect and preserve the liquid assets of the captive.

However, what if the reinsurance agreement does not contain any criteria? What does the

captive do to avoid the ‘bottomless pit’ of quicksand that absorbs the LOCs?

The best approach is to give comfort to the issuing carrier that the captive presents no credit risk. Namely:

- An “A-” or better credit rating from A.M. Best.
- The ability of the captive to say, “we have always paid your cession statements promptly”.
- When a cession statement or claim raises

a question, the captive should look for a solution, not just the problem.

- The captive should pay that part of the claim or cession statement that it owes, and write an explanation (with appropriate questions) targeting those amounts that are unclear.
- The captive might even give benefit of the doubt to the ceding carrier and make the payment in conjunction with a letter to the ceding carrier that: (i) acknowledges that the captive relies on the issuing carrier to present a proper claim; (ii) identifies the issues/questions; (iii) requests that the ceding carrier provide answers to specific questions; and (iiii) acknowledges that the captive will make a payment in good faith to the ceding carrier. However, if the claim is not properly covered in the reinsurance agreement, the captive expects that the ceding carrier will subsequently allow a credit to the captive.

‘Good faith’ is a corner stone of the reinsurance relationship. Strong personal relationships are also critical

The last approach is low risk when:

- The reinsurance agreement includes ‘correction/discovery of errors’ language that states that the parties will be returned to their original position upon discovery of an error, and an interim payment shall not prejudice either party; and
- Significant future payments are expected against which the captive might take credit.

‘Good faith’ is a corner stone of the reinsurance relationship. Strong personal relationships are also critical.

Two other comments regarding the drawing of LOCs are worthy of note.

Practical features, such as the geographic location of the bank that posted the LOC, are important. A Cayman captive may hold an LOC placed by a New York bank on behalf of a US issuing carrier. If the Cayman captive petitions a New York bank to obtain the release of the funds, the captive may find itself traveling to

New York and facing an injunction that the issuing carrier has filed to prevent the drawdown. While on paper the LOC would appear to provide excellent security, legal action in a US court may be necessary. Considering the ‘disinformation’ that such artistic masterpieces as The Firm have generated, the reliance on a decision by a US court is likely to generate at least mild anxiety for a Cayman-based company. After all, it is tough enough for US litigants to reasonably anticipate the outcome of decisions in US courts.

On the other hand, if an LOC is successfully drawn, there is no guarantee that the beneficiary can keep the money. If the LOC is drawn without cause, or based on error, a reinsurer could use the court system to show that the draw on the LOC was not warranted, and that the issuing carrier was ‘unjustly enriched’.

LOCs are best used to provide long term security, not as a short term ‘hammer’ to enforce a position. Clearly, LOCs do not eliminate a loss that arises from a poorly drawn contract, or an underwriting decision.

In order to encourage the reduction of an LOC when the reinsurance agreement does not contain criteria, the captive should rely on internal staff, or outside advisors, that have the experience with ceding carriers, and that can take advantage of long-term relationships. Other factors to consider are the pattern of prior LOC reductions by the issuing carrier on other programmes, an understanding of the reason why the ceding carrier insists on a high LOC, and a working knowledge of actual claims practices in the original jurisdiction. The combined skill sets that are required of point personnel include an accountant’s familiarity with the operation of an LOC, a ‘hands on’ understanding of claims practices, exposures and latent injury claims, and a familiarity with actuarial analysis.

A reserving philosophy

A reserve is a financial tool that fills a gap in the financial accounts of the company. Its life begins when the party at risk becomes aware of a specific exposure, and its life ends when the known exposure is paid. Operationally, it is the educated best estimate by presumably experienced claims or insurance specialists about the eventual cost of the claim. A property reserve typically has an abbreviated life, and may be paid in one or two years. Workers compensation, medical malpractice, product or general liability claims may be unresolved for many years or even decades—the so called ‘long tail’ legacy exposures. There is a greater risk to a risk bearer if the reserves on the ‘long tail’ claims are understated because the impact is more severe on a cumulative basis.

For our purpose, a reserve is not an evaluation of the exposure. The reserve should be established in the first month or quarter after the party at risk has notice of the loss. Notice often consists of a phone call, email or single-page report with ‘facts’ presented by one party. A reserve

can be contrasted with a ‘settlement’ evaluation that takes place after all facts are available. This evaluation examines (or should examine) all coverage, liability and damage issues. The evaluation answers the question, ‘how much do we pay, if anything?’

An understanding of the function of a reserve is particularly important in regard to large ‘long tail’ exposures. A failure to maintain correct reserves is an impediment to the proper recognition of profit/loss of the company and the wealth (or lack thereof) of shareholders, and so not a good thing.

Within this article, a ‘reserve’ is differentiated from an IBNR reserve, or incurred but not reported reserve, that professional actuaries generate. The equation and standard terminology is: (paid loss + case reserve =) incurred loss + IBNR = ultimate expected loss.

Actuaries can generate IBNR using several different techniques. However, most rely on the case reserve as the foundation for their work.

There is trouble ahead for the risk bearer if different claim specialists (or even different service companies) fail to use a common objective in setting reserves.

There are two extremes in setting reserves:

- ‘Wait for the facts to become definitive’—this approach invites the dreaded ‘stair stepping’ on individual claims, and ‘deterioration’ of the overall book of business.
- ‘Ultimate possible cost’ (also known as ‘worst case basis’)—in the extreme, this invites reserving on a ‘limits’ basis. The problem here is that few cases will exhaust the limit of liability. By volume, the majority of casualty claims are resolved quickly, perhaps within several months or one year of the loss, even if most seasoned claims professionals recall the ‘bell ringer’—the settlement or verdict with many ‘\$000s’.

‘Ultimate probable cost’ is the middle ground and the preferred approach. Because the exposure is new, all ‘facts’ are unlikely to be available, and it might take years before they are available. The approach requires a loss pick from the decision maker based on her/his experience about the likely exposure five or 10 or more years down the road. The decision maker is unlikely to be accurate in a high number of instances.

However, the objective is that the loss picks that are too high will offset the loss picks that are too low. That is: total reserves = total costs.

This reserve philosophy called ultimate probable cost is the essential first step, but the effort falls short if no one knows the objective, or if it is applied inconsistently. Therefore, the objective should be: (i) written; (ii) used consistently over time; and (iii) common to all parties that that have responsibility for establishing reserves. It should be a standard feature in claims manuals and claims service contracts, and recognised by

the captive, the ceding company, and the claims contractor. Based on a consistent underlying reserving practice, the actuaries that project ultimate expected loss will be heroes. The underwriters that renew and write new business will have confidence in their existing experience when they ‘sharpen their pencil’. Importantly, the shareholders of the company will take comfort in the presumed wealth that they accumulate in their captive.

Reinsurance relationships

There were two captive insurance companies in Cayman—Integrity Captive Insurance Company and Haphazard Insurance Company (both are fictitious). Each captive: (i) was owned by a parent company headquartered in the US; (ii) had significant products liability exposure; (iii) (the parent of each captive) treated this exposure in the years before 2002, at least in part, by purchasing an umbrella liability policy with limits of \$5 million X \$1 million (primary layer to include a large deductible) from a large US-based carrier; and (iiii) created a captive in 2002 that issued a policy that replaced the \$5 million layer issued by the umbrella carrier. The reinsurer of the captive \$5 million X \$1 million layer starting in 2002 was part of the family of companies that issued the umbrella policy before 2002.

A lawsuit was filed in 2005 by 100 plaintiffs in the US State of Illinois, a jurisdiction with a reputation for large plaintiff verdicts. The suit alleged various exposures to the product of each company that resulted in lung, pulmonary and other latent injuries. The suit (as is typical) named 50 defendants, all product manufacturers, and alleged that the damages occurred over a long period of time, with exposure starting in 1980, and continuing through the filing of the lawsuit in 2005. In 2012, after significant discovery and the dismissal of most of the defendants, the jury awarded a verdict of \$6 million (later settled in the same amount) against each (parent company) policyholder.

Integrity operated as an independent entity, establishing an arm’s length relationship with its parent company policyholder and its reinsurer. The chief risk officer, Bill Smith, was familiar not only with the terms of the umbrella policy that Integrity issues to the parent, but also the terms of the reinsurance agreement by which the reinsurer provided \$5 million of support to Integrity. When the suit was filed in 2005, the Integrity policyholder sent the suit to all insurance carriers to include Integrity.

Integrity in turn, relying on good insurance and claim expertise, reported the loss to its reinsurer using standard protocol to include the reinsurance agreement reference numbers, and the dates of the agreements that potentially applied. The reinsurer acknowledged receipt of the original notice, and asked that Integrity keep the reinsurer advised. Integrity was keenly aware of the obligations and rights in the agreements to include the obligation to: (i) notify the reinsurer promptly of any event which

might result in a claim against the reinsurer; (ii) allow the reinsurer to inspect all books, records and papers; and (iii) cooperate in every respect in the defence and control of any claim.

While the claim was pending, Integrity sent a letter to its reinsurer on six occasions, to include advice regarding the upcoming trial, the adverse verdict, and the planned settlement. The reinsurer made no specific recommendation about the termination of the exposure, but only asked that Integrity keep the reinsurer advised. Subsequently, Integrity provided to the reinsurer: (i) a copy of the release agreement; (ii) a timely proof of loss; and (iii) the ‘date certain’ that it would pay the \$5 million. In conjunction with the payment date, the reinsurer wired its \$5 million to Integrity, recognising the language in the reinsurance agreement:

“...[U]pon receipt by the reinsurer of satisfactory evidence of payment for which reinsurance is provided, the reinsurer will promptly reimburse the company for its share of the loss”

The president of the policyholder wrote to Bill Smith: “Regarding that unfortunate lawsuit that we resolved, and the involvement of Integrity—I love it when a plan comes together. Thanks.”

The claim for Haphazard took a different direction. The parent of Haphazard treated the captive as part of ‘one big happy family’. Bob Jones, the chief risk officer, was satisfied that Haphazard covered the product exposure, and that reinsurance was in place. To save expense dollars, the in-house claims staff at the parent company notified both the umbrella carrier (in the years before 2002), and the reinsurer of Haphazard (in the years of 2002 and after). The umbrella carrier and the reinsurer, both part of the same family of companies, also used the same group of claim professionals to monitor claims.

There was communication with the in-house claims staff, but because of the lack of detail in those communications, the reinsurer did not create a file until the verdict. The verdict arose as a result of damages that took place after 2002, thus implicating the \$5 million cover of Haphazard. When the in-house claim staff approached the group of claim professionals about assistance to resolve the claim based on damages after 2002, the reinsurer asked, “What claim?” The reinsurer then discovered that it had no claim file and no reserve. It asked for prior notifications. There were none—not one letter from Haphazard to the reinsurer that identified the contracts that were exposed. The reinsurer claimed late notice, and denied the claim to Haphazard.

Haphazard hired a coverage law firm in New York that began discovery in the US and in Cayman. The reinsurance agreement allowed for London-based arbitrators, and the law firm began the arbitration process at the direction of Haphazard. Based on the argument that there was no prejudice to the reinsurer as a result of late notice, Haphazard eventually recovered

most, but not all, of the \$5 million through negotiation. The legal expenses of Haphazard totaled \$450,000 (good lawyers operating in three different countries are expensive). Also, there was significant disruption to the cash flow position of Haphazard.

Based on a consistent underlying reserving practice, the actuaries that project ultimate expected loss will be heroes

The president of the policyholder wrote to Bob Jones: “Regarding that unfortunate lawsuit and arbitration that we resolved, and the involvement of Haphazard, what happened?”

Bob Jones answered that the issue began with the treatment of Haphazard as part of ‘one big happy family’. It was not the type of response that he wanted to make. He subsequently took early retirement.

Unexpected challenges

Most, if not all captives in Cayman, face challenges regarding reserves, LOCs and reinsurance relationships. However, an individual captive may face an unexpected challenge involving: (i) the termination of a contract by mutual agreement in the form of a release, novation or commutation; or (ii) a unilateral attempt on the part of a reinsurer to terminate a relationship using a scheme of arrangement.

A discussion of these topics is beyond the realm of this article. But keep an eye on this space. **CIT**



Lawrence Walters
Vice president, claims
Aon Risk Solutions

Needs must

Andrew Barile discusses underwriting reputational risk insurance in a captive instead of using more traditional methods

There are numerous advantages to captives over traditional commercial insurance. One is the access to underwriting and investment income, and component pricing, which gives the ability to control frictional costs. Another is an enhanced focus on loss prevention and claims handling.

Others include the ability to provide coverage that may be unavailable or overpriced in the market. Similarly, the use of rating plans that reflect groups' own good experience, rather than insurers' pools, and the facility for pooling risks of groups of employers, are advantages of captives over traditional insurance.

The CFO, the general counsel and the treasurer of the corporation are called upon to evaluate the proposal to underwrite reputational risk insurance in their captive

However, there are also challenges. The need to dedicate capital for solvency and reinsurance security, the risk of higher claims and tax costs than expected, complexity, and the 'distraction' risk are just some of the obstacles that present themselves.

Opportunities in the industry are threefold. Firstly, one must define profiles of target captive owners, for example:

- Non-US multinationals with US benefit plans
- US state or territory needed
- Lower operational costs
- Latin American corporations
- Proximity
- Language.

Promotional efforts must be made around the captive, which can involve marketing and business development, representation at captive events, and involvement in news magazines. Domicile selection is also a vital component, where the following must be taken into consideration:

- Capitalisation and surplus requirements
- Stability of regulatory environment

- Experience in business under consideration
- Flexibility in investment choices
- Receptiveness of regulatory environment
- Tax costs
- Qualifies for ERISA benefits (state or territory)
- Quality of local infrastructure
- Service costs
- Availability of expertise
- Proximity to directors and corporate HQ.

Reputational risk: a coverage for your captive insurance company?

Reputation risks for companies are an growing concern for risk managers, who are examining their captive structures for relief. After recent scandals at Pennsylvania State University, News Corp and MF Global, major corporations are covering such exposures through their captives.

The CFO, the general counsel and the treasurer of the corporation are called upon to evaluate the proposal to underwrite reputational risk insurance in their captive insurance company. To evaluate this type of decision clearly puts these very capable corporate executive officers into the insurance business. What is their plan of action? The strategy would be to summon the vice president of corporate taxes and the director of risk management to prepare the proposal as respects the writing of reputational risk coverage in their captive insurance company.

Let me offer a suggested plan of action to understand the concept of insurance product development in a traditional insurance company.

Firstly, examine the exposure as we know the following types of corporations will always be interested in this type of coverage:

- Sports—remember what the public said about Nike?
- Clothing—Ralph Lauren and the Olympics?
- Toys—what about Mattel?
- Fragrances
- Restaurant chains
- Food
- Beverages.

Secondly, look at the traditional companies, global insurers offering the reputational insurance product, global reinsurers offering the product, and Lloyd's Syndicates starting to provide the reputational risk. How do they price the product? It tends to be 'rate on line' which I observed working at Lloyd's as an underwriter in 1967. Forty-five years later, Munich Re's un-

derwriters discuss 1 percent to 2.5 percent rates on line for this coverage.

Just exactly what is covered when we speak of reputational risk coverage? Some underwriters have said that the coverage afforded is a loss of profit or revenue at the corporate level because of the change of consumer perception. What triggers the coverage?

Let's look at the theoretical structure for your captive insurance company:

Self insured deductible
\$1 million
(parent corporation)

Primary layer: captive
\$9 million
(50 percent reinsured to new hedge fund-owned reinsurers)

First layer: global insurer
Direct excess of \$10 million, excess of \$10 million = \$20 million

Second layer: Lloyd's Syndicate
Direct excess of \$25 million excess of \$20 million = \$45 million

Third layer: World's largest global insurer
Direct excess of \$65 million excess of \$45 million = \$110 million

The underwriting of this coverage has many challenging discussions, which must be considered properly before implementation. Factors to consider would be the risk appetite of the parent corporation, what are considered to be the financial losses, and lastly, who handles the claims of this type of coverage. **CIT**



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Industry appointments

Kane has made two senior appointments for its North American operations, with **Carlos Oliveras** becoming managing director of Kane in the US and Stephen White becoming business development director for the US and Canada.

Oliveras will be based in Connecticut and will report directly to Simon Hinshelwood, group chief executive of Kane.

White will report to Oliveras and will work alongside fellow director of business development in the US, Harry Rodgers, on building new business opportunities for Kane's North American, Bermudan and Caribbean operations.

Oliveras joins Kane from insurance consultancy Trinity Holdings Group, where he was its managing member. He previously worked as managing director of Aon's M&A group, as well as chief sales and marketing officer for Alea Group Holdings.

He also worked as general manager of two business units at American Re-Insurance Company, which later became Munich Re.

DUAL, the underwriting arm of Hyperion Insurance Group, has strengthened its risk and governance functions with a number of senior management appointments.

Hazel Beveridge joins DUAL from Markel as chief actuary and strategic director. Prior to that she held various positions with Swiss Re and KPMG.

Rinku Patel has been promoted to chief operating officer and will also continue to lead DUAL's finance function, and **Paul Ferris**, chief underwriting officer, will take on the additional responsibility of chairing the DUAL Risk Committee.

In his role as COO, Patel will be charged with delivering DUAL's external web-based broker platform and management information system to help ensure the provision of market-leading technical breadth and depth to DUAL's capacity providers, including Lloyd's.

Heritage International Fund Managers in Malta has appointed **Nicholas Warren** as head of office.

Warren has worked in the financial services industry since 2004, initially with Deloitte & Touche in Luxembourg, and then in the regulatory unit of the Malta Financial Services Authority.

Grant Thornton has recruited **Lori Davis**, Wichita office managing partner, to its partnership board.

Davis is also a partner in Grant Thornton's tax services practice. Her experience includes tax compliance and developing tax planning across a number of industries, including property and casualty insurance. She also has extensive experience in the area of captive insurance.



White has worked at Canadian financial institutions, including Canadian Imperial Bank of Commerce and Royal Bank of Canada. He was also head of captive solutions at Marsh Canada and vice president at AON Risk Solutions, where he provided captive development services.

Insurance broker and risk management firm, Beecher Carlson, has named **Bruce Dortort** as senior vice president of risk control.

Dortort's responsibilities will include risk assessment and control, strategic planning and management of long-term projects with multiple entities.

Dortort joins Beecher Carlson from Willis Insurance Services, where he previously served as vice president of risk control and Atlantic region industry group practice leader.

JLT Reinsurance Brokers has appointed **Paul Thyer** as partner.

Bradley Maltese, member of the JLT Re Board, said: "Thyer is an excellent addition to our expanding team bringing a wealth of expertise and experience. [He] will be part of the non-marine treaty team and will focus on property retro, property reinsurance and industry loss warranty's."

Thyer was most recently associate director of BMS Re. Prior to joining BMS in 1999, he worked for Alwen Hough Johnson from 1986 placing London market business, and between 1984 and 1986 worked at Jardine Thompson Graham placing US property and casualty treaty business.

Thyer will be based in London and is joining the team immediately.

Development testing company Coverity has appointed executive vice president and CFO of the San Diego Padres, **Fred Gerson**, to its board of directors as chairman of the board's audit committee.

Gerson is currently on the board of directors of Major League Baseball's captive insurance entity and is director and chair of the audit committee of Infoblox, a publicly traded company on the New York Stock Exchange.

Gerson previously held the role of director and chairman of the audit committee of DivX Inc. until its acquisition in 2010. **CIT**

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