



Tennessee grants its 20th captive licence

The Tennessee Department of Commerce and Insurance has licensed its 20th captive insurance company.

Captive insurance legislation in Tennessee dates back to 1978, when the first iteration of the statute was passed.

In 2011, the legislation was overhauled to improve Tennessee's prospects as an on-shore domicile. On 7 June 2013, governor Bill Haslam signed new legislation to make the state more accessible to captive insurers.

Insurance commissioner Julie McPeak said: "Tennessee was one of the first states to have a captive insurance statute, and with the governor's support we have revitalised the legislation and really developed this industry."

[readmore p3](#)

Results see global insurance rates slip in Q2

Insurance rates in most major regions declined modestly in Q2 of 2013, according to Marsh's latest global insurance quarterly briefing.

Outside of the US, rates typically fell between 1 percent and 3 percent, resulting in a decline in the Marsh Risk Management Global Insurance Index for the first time since its inception six quarters ago.

The US was the only region in the index to show an increase of rates on renewal, with a rise viewed across all lines of business of 1.6 percent.

Rate increases were most prevalent in professional liability and financial institution liability lines, which renewed on average flat to up 10 percent in the quarter.

[readmore p3](#)

Offshore centres celebrate stellar results

The Cayman Islands and Bermuda both registered quarter-on-quarter increases in issued licences in Q2 2013.

The Cayman Islands captive insurance industry has amassed \$13.5 billion in total premiums and \$82.8 billion in total assets—its highest ever-recorded figures.

The figures—as of 30 June 2013—are up 52 percent and 5 percent respectively over the same period in 2012, which then was considered a banner year for growth in the industry.

The Cayman Islands Monetary Authority reported that it oversees 740 class B, C and D companies, with 412 of those pure captives and 134 segregated portfolio companies.

The majority of these captives belong to North American-based companies, with 34 percent of them relating to medical malpractice and 21 percent covering workers' compensation.

The Cayman Islands also recently signed a tax

information exchange agreement with Brazil, providing a gateway to new markets and the opportunity to the continued growth in that region.

Rob Leadbetter, chairman of the Insurance Managers Association of Cayman, said: "[Last year] was considered a year of phenomenal growth for Cayman captives with 20 new licences granted in the first two quarters (53 for the whole year), and over the same period this year we have attracted 24 new captives."

"This is very encouraging and demonstrates the fact that Cayman continues to attract solid business because of its high level of transparency and regard for international regulatory initiatives and its history of integrity."

According to the Bermuda Monetary Authority, 34 new insurers were registered in Bermuda during the first half of 2013.

The figure reflects a quarter-on-quarter increase within the period, with 21 new insurers registering in Q2 2013, versus 13 in the first quarter of the year.

[readmore p3](#)



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Offshore centres celebrate stellar results

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Shelby Weldon, director of licensing and authorisations at the BMA, explained in a statement that the new registrations spanned the entire breadth of the industry, including captive insurers, commercial carriers, and long-term (life) insurance businesses.

There were 10 new captive insurers registered and four commercial insurers encompassing class 3A, 3B, and long-term C.

"In addition, 12 of the new registrations for Q2 2013 were special purpose insurers (SPIs) with anticipated premiums of over \$700 million," added Weldon.

"These registrations included six SPIs underwriting over \$1 billion of excess of loss property catastrophe reinsurance business over the next five years."

SPIs registered in Bermuda in 2013 are projected to underwrite more than \$5 billion in the next five years across business activities, including property catastrophe, retrocession and industry loss warranties, catastrophe bonds, and insurance linked securities.

Tennessee grants its 20th captive licence

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Captive insurance director Michael Corbett added: "We are truly excited about the progress we have made since the revised captive laws were signed by governor Haslam back in 2011."

"With the unwavering support of commissioner McPeak, we have put together an outstanding staff dedicated to captive formation and the unique needs of the captive marketplace. The remainder of 2013 looks especially bright and we look forward to announcing the next 20."

Results see global insurance rates slip in Q2

Continued from page 1

Financial institutions in parts of the eurozone also saw liability rate increases during Q2, with rates up on average between 10 percent and 20 percent in Italy. Rates typically renewed flat to up 10 percent in France and Spain.

Increased competition among insurers, increased capacity, and the absence of major catastrophe losses saw property insurance rates typically fall or remain stable across all regions in the quarter.

Dean Klisura, Marsh's US risk practices and specialities leader, said: "Despite rate increases in several lines of business in the US, insurers are competing aggressively for profitable

business, and the market continues to experience an influx of new capacity."

"All of this is resulting in generally favourable market conditions for most clients."

Companies need help protecting their reps, says ACE

Reputational risk is the most challenging category of risk to manage, according to a new study from ACE Group conducted across 15 countries within the Europe, Middle East and Africa (EMEA) region.

Reputation at Risk showed that 92 percent of companies struggle to maintain reputational risk.

While 81 percent of companies that participated in the study see reputation as their most significant asset, many admitted that they struggle to protect it—highlighting a number of reasons why they find the risk so challenging to manage.

More than half (56 percent) of companies said that social media has greatly exacerbated the potential for reputational risk to affect their businesses. Sixty-six percent of companies also felt inadequately covered for reputational risk from an insurance perspective.

Many companies also believe that information and advice about how to manage reputational risk is difficult to find, compounding the sense of uncertainty and confusion about how best to manage it.

Reputation at Risk highlighted a number of solutions that companies could adopt, including a clear framework to manage reputational risk; sharpening up crisis management plans; and working harder to measure how reputations are perceived.

XL Group partners with Stone Point for ILS offering

XL Group and Stone Point Capital have formed a new Bermuda-based company to act as an investment manager in insurance-linked securities (ILS) and other reinsurance capital market products.

Global insurance and reinsurance company XL Group provides property, casualty and specialty products to industrial, commercial and professional firms, and insurance companies.

Stone Point is a financial services-focused private equity firm based in Greenwich, Connecticut.

XL Group has a 75 percent ownership stake in the company and funds managed by Stone Point have the remaining 25 percent ownership.

The company will focus on ILS and index-linked products as well as XL-designed reinsurance

CITINBRIEF



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Richard Smith spills the beans about the VCIA's annual conference and the state is this issue's domicile focus

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New domiciles

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Dr Beppe Sammut of GANADO Advocates puts forward a case for PCC structures as a means to overcoming regulatory hurdles

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products. The parties intend to invest up to an aggregate of \$135 million in funds to be formed, alongside potential third-party investors.

The new venture will offer investors access to both reinsurance capital markets products as well as more traditional reinsurance opportunities, including certain risks currently written by XL Group.

Investors will also benefit from XL Group's underwriting, enterprise risk management, analytical strength and reinsurance market experience.

Mike McGavick, CEO of XL Group, said: "Given the combined strength of XL's 20-plus years of world-class reinsurance underwriting expertise and Stone Point's proven track record of investment success in the insurance and reinsurance sectors, this initiative fits perfectly with XL's continuing objective to offer innovative products to our clients and enhance profitability and long term value for shareholders."

Charles Davis, Stone Point Capital's CEO, added: "Stone Point is delighted to be partnering with XL on this venture. Stone Point's relationship with XL dates back to 1986 when our team assisted with the formation of the company. We believe that the convergence of the traditional insurance and reinsurance markets, and the capital markets will continue."

"This initiative with XL is designed to offer third-party investors an opportunity to invest in this asset class in partnership with one of the world's premiere reinsurance underwriters."

Guy Carpenter acquires Smith Group

Guy Carpenter & Company has acquired Maine-based disability reinsurance risk manager and consultant Smith Group.

Smith Group employees have extensive experience in the areas of actuarial science, market research and risk management. The company will continue to operate in Maine.

Andrew Marcell, CEO of Guy Carpenter's US operations, said: "As our life, accident and health insurance clients continue to seek ways to grow profitability, the addition of Smith's comprehensive offering of reinsurance products and services encompassing all aspects of long-term disability insurance business enhance our ability to deliver highly differentiated solutions to meet these clients' unique needs."

"We are excited about the addition of Smith Group. Over the years, they have built strong relationships with their clients by delivering outstanding service and in-depth knowledge of the long-term disability market."

RenRe expands in US specialty market

RenaissanceRe Holdings has formed RenaissanceRe Underwriting Managers US, a specialty reinsurance agency based in Connecticut that will support the growth of new products and services in the US specialty market.

RenaissanceRe Underwriting Managers US will provide specialty treaty reinsurance solutions on both a quota share and excess of loss basis.

Initial classes of business will include professional liability, general liability, general casualty and other specialty lines.

David Marra, senior vice president of RenaissanceRe Holdings, and who is responsible for the company's specialty business, will lead the initiative in addition to his current role in Bermuda.

Kevin O'Donnell, president and CEO of RenaissanceRe Holdings, said: "We are pleased to announce the expansion of our global reinsurance operations to the US, bringing us closer to specialty clients there."

"RenaissanceRe Underwriting Managers US will allow us to expand our market access to business that does not normally come to the

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Stable outlook for Preferred Contractors RRG

A.M. Best has revised the outlook to stable from negative and affirmed the financial strength rating of "B+ (Good)" and issuer credit rating of "bbb-" of Preferred Contractors Insurance Company Risk Retention Group (PCIC).

The ratings reflect PCIC's adequate level of risk-adjusted capitalisation and recent improvements in operating performance.

The ratings also reflect PCIC management's substantial expertise in marketing the type of business it writes.

In a release, A.M. Best said: "Partially offsetting these positive rating factors are PCIC's volatile operating results during the first five years of operation, high expense ratio and limited business profile."

"An additional offsetting rating factor is the execution risk associated with the implementation of PCIC's business plan."

The stable outlook recognises two consecutive years of PCIC's improved underwriting results, therefore reducing A.M. Best's concerns surrounding its historical volatile performance.

Upward rating movement is unlikely over the medium term. However, deterioration in PCIC's underwriting and overall operating performance or a substantial weakening in its risk-adjusted capitalisation could result in negative rating pressure.

EMEA insurers encounter Solvency II concerns

Nine out of 10 insurers based in Europe, the Middle East and Africa (EMEA) say that preparing for the implementation of Solvency II is a challenge for their businesses, with 31 percent citing it as a major challenge.

The findings, which came from a global insurance survey commissioned by State Street and conducted by the Economist Intelligence Unit, also highlighted that almost half of EMEA insurers (49 percent) are proactively approaching Solvency II.

More than 80 percent of the 300 senior insurance executives surveyed said that adapting to evolving insurance regulation represents a challenge to their businesses.

Three quarters of survey respondents added that ensuring transparency of business policies and procedures presents some level of challenge.

Only 17 percent of insurers did not view the regulatory environment as posing a challenge at all.

Sven Kasper, director of regulatory, industry and government affairs for EMEA at State Street, said: "As one would expect, Solvency II tops the list of European insurers' regulatory challenges. However, there are other significant regulatory initiatives impacting European insurers that may become equally as challenging, such as FATCA (Foreign Account Tax Compliance Act) by increasing the data and reporting requirements, or the EU11 Financial Transaction Tax leading to increased transaction costs and lower returns."

"This rapidly changing, more complex and demanding regulatory environment has a significant impact on insurers' overall operations as well as their plans for meeting new and challenging demands from their customers. They need to closely follow regulatory changes impacting them and their clients and maintain adequate systems to accommodate the numerous new regulatory obligations, in particular with regard to transparency and reporting."



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Jeffrey More
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Jeffrey.More@ctplc.com

Captive Management

Andy McComb
+1 441 278 7700
Andy.McComb@ctplc.com

Risk Management (US)

Chris Moss
+1 972 447 2053
Christopher.Moss@ctplc.com

Risk Management (EU)

Martin Fone
+44 207 767 2918
Martin.Fone@ctplc.com



GC Securities forms unique storm surge cat bond

GC Securities has completed the placement of the series 2013-1 notes—with notional principal at \$200,000,000—through a new catastrophe bond shelf programme.

MetroCat Re will benefit First Mutual Transportation Assurance Company (FMTAC), a New York-licensed and domiciled captive insurer and subsidiary of the Metropolitan Transportation Authority (MTA).

FMTAC and MTA will use the cat bond market to manage its storm surge risks in the New York metropolitan region. MetroCat Re will be the first ever cat bond to protect solely against this type of risk.

The bond provides three years of per occurrence determined storm surge height protection as measured by up to five calculation locations in the region during the event period of a named storm.

Thomas Prendergast, chairman and CEO of MTA, explained that in the aftermath of Superstorm Sandy, avenues of obtaining insurance and reinsurance “contracted dramatically”.

“We anticipate that this deal represents the start of a long-term alternative reinsurance

option that diversifies MTA’s risk management strategy,” added Prendergast.

Jerry Harley, managing director of Marsh, said: “We worked with the MTA to find an innovative approach to manage its catastrophe risk going forward.”

“By working with our sister company Guy Carpenter, we were able to provide a capital market-based solution that gives the MTA the flexibility to spread risk over a long-term solution and introduce new sources of reinsurance capacity to replace post-storm market capacity reductions.”

Beazley looks to develop Latin American businesses

Beazley has opened its first office in Miami and its 10th in the US. The new office will focus on the development of reinsurance business from Latin America.

Beazley is the parent company of specialist insurance businesses with operations in Europe, the US, Asia and Australia. The move follows the firm’s recent recruitment of Paul Felfle to develop business in the region.

Patrick Hartigan, head of Beazley’s reinsurance division, said: “Miami has been growing as a hub for Latin American business and clients are becoming increasingly sophisticated with their analysis and research.”

“We recognised the need to have a local presence in the city, enabling us to respond to the needs of our clients and build long term relationships.”

A.M. Best places S.A.C. Re under review

A.M. Best has placed the financial strength rating of “A- (Excellent)” and issuer credit rating of “a-” of Bermuda-based S.A.C. Re under review with negative implications.

The rating actions reflect A.M. Best’s concern with the business plan originally presented by S.A.C. Re, which took into account invested assets being managed by S.A.C. Capital.

Presently, there is uncertainty as to whether the invested assets can be managed by S.A.C. Capital as well as whether there will be ramifications concerning any affiliation with S.A.C. Capital on the reinsurance franchise in the future.

In a statement, A.M. Best said: “[We] expect to resolve the under review status upon review of an updated business plan that may or may not include S.A.C. Capital as an investment manager.”

“Retention of key management through the forecasted business plan will also be an important factor in resolving the under review status.”

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The view from the top: an interview with Richard Smith

CIT catches up with the VCI's president to discuss the latest industry happenings and what we can expect from the association's annual conference

JENNA JONES REPORTS

Has 2013 been a good year for captives so far?

Yes, it has been another good steady year for the industry with business leaders, organisational leaders and risk managers continuing to see the benefit of captives as a solution to their risk exposures.

Vermont is actually on the verge of licensing its 1000th captive sometime this year, which is very exciting for the state.

A lot of US states have implemented captive laws over the past few months. How has Vermont viewed this progression?

In general, the competition has been good and it helps to keep us on our toes and for the industry as a whole it is good to have choices. Another positive is that it continues to spread the word about captives—they are no longer a boutique industry and are now seen as a mainstream risk management tool.

The flip side of this is that newer states may not have the regulatory expertise or the wherewithal to regulate their captives to a high standard. This could lead to problems, to the point where some captives perhaps shouldn't have been licensed, or are being run incorrectly.

Captives overall, in terms of solvency and the strength of the industry, outperform the traditional insurance industry. That being said, people are always looking for that one fault in the captive insurance industry. A concern that we have is that the industry as a whole may be affected by the misconduct of a minority of inexperienced states.

States have seen how Vermont has successfully created a niche for itself in the industry, and for us it has been terrific for job creation and revenue. Some states try to emulate Vermont's success to bring revenue into their states. But these states may 'lose steam' and that is a concern to us.

How has Vermont managed to hold its position as the most prominent US state for captives for so long?

Vermont has always possessed strong, consistent regulation that is monitored by a very experienced regulatory team, and I personally think that it is the best in the industry. Even our competitors recognise Vermont as the 'gold standard' in terms of regulation and support.

We also have consistent support from Vermont's political leadership at all levels including legislators, governors, and all political parties. The solid support that Vermont possesses is certainly recognised by the industry, and from that we've amassed a world centre of excellence from the service providers that we attract

here in Burlington. In return, these service providers have excellent track records and create strong relationships with our state's regulators. And while they may have many captives based in other states, their management team, legal team and other service providers are often based in Vermont.

How do you think Vermont will fare throughout the rest of 2013? Are there any prospective challenges facing the industry?

Even with the new competition that we now face from other states, Vermont will still have a good year. As I mentioned above, we will be celebrating the licensing of our 1000th captive this year, which will be terrific.

There are two types of challenges that come to my mind. First, there are the challenges that this industry thrives on such as emerging risks, cyber security, supply chain risks and healthcare. And while these are challenging issues, these are the kind of risks that our industry loves because captives are flexible and are able to create innovative policies that can meet the needs of the risk managers in those areas, which is very exciting.

Second, the continual regulatory challenge is—whether intentionally or unintentionally—a persistent problem for the captive insurance industry. For example, the confusion over whether the Non-admitted and Reinsurance Reform Act was meant to be applicable to captive insurance companies caused a great deal of angst throughout the industry.

Another instance was the intentional flogging of captives by politicians looking to score political points, and I think the State of New York's report on the life insurance reserves of captives is a good example.

Has the shadow insurance enquiry in New York affected the industry?

I don't think that it has actually, but it is maddening. It's frustrating in one way because they've thrown the whole captive insurance industry into this mix when really it is a specialised insurance tool, and the report doesn't match the facts.

That being said, I haven't witnessed anyone in the industry voicing concerns over the way we do business and how we form captives. As a matter of fact, Vermont has still seen these special purpose vehicles being formed.

When New York issues a report people do sit up and take notice, but thankfully it hasn't had an overall effect on the industry.

Vermont recently made amendments to its captive legislation. Have you seen any improvements so far?

We've already seen interest in some of the areas where we changed or modified our laws.

For instance, we created a separate account that allows a captive to establish one or more separate accounts within the captive, so that they can isolate risks that may affect some of the participants but not all of them, so it gives the captive a little bit more flexibility.

Another amendment that we made was to the legislation surrounding protected cells in a sponsored captive. We have made some specific changes to clarify this legislation, which has also been very well received by the industry.

What can we expect from this year's VCIA conference—are there any particular panel discussions that attendees should look out for?

This year's VCIA conference is set to be bigger and better than ever with extra seminars and 80 panellists, of which almost 40 percent are captive owners. I think that having owners share their case studies and personal experiences is a big factor as to why people love to come to our conference. They get to hear first-hand from practitioners and the owners themselves.

Frank Nutter, president of the Reinsurance Association of America, will be the keynote speaker at this year's conference. Reinsurance is such an important tool for the captive industry, and the changes to the industry have been remarkable in the last couple of years, so people are very excited to hear what he has to say.

We also have an enterprise risk management panel—to understand the total risks that an organisation has as it becomes more and more a part of the overall management of an organisation, which I think will be very helpful for attendees.

The conference will also be a great opportunity for new captive domiciles to come and learn more about the industry, as we will have regulators and practitioners from a number of the new domiciles that have recently enacted captive legislation. **CIT**



Richard Smith
President
Vermont Captive Insurance Association



The grand master

As reputations go, Vermont's is among the best. CIT asks how it positioned itself as the go-to US captive domicile

JENNA JONES REPORTS

As one of the smallest states in the US, it is difficult to believe that Vermont is currently the leading captive insurance domicile in the country. With laws passed in 1981, now more 30 years on the state is on the brink of an impressive milestone.

Richard Smith, president of the Vermont Captive Insurance Association (VCIA), explains that 2013 is a particularly special year for Vermont as the state is "on the verge of licensing its 1000th captive ... which is very exciting".

Indeed, there is not correlation between the state's physical size and its economy and captive industry, according to Dan Towle, director of financial services for Vermont's Agency of Commerce and Community Development.

He says: "Vermont is one of the smallest states with a population of around 625,000 and the captive industry is a very important part of Vermont's economy. The captive industry employs over 400 direct jobs, which leads to another 1000 indirect jobs. Captives pay over \$25 million in taxes and fees to Vermont, and at least that much more to local service providers."

Vermont's success can be attributed to its appropriate regulations, captive division, and insurance department, says Mary Richards, executive vice president of JLT Towner,

Richards adds: "Consequently, Vermont's regulations and operations became the standard for other states to adopt and follow. [JLT Towner] continues to promote Ver-

mont as a domicile because we know that the captive division staff who license and examine captives are extremely competent and responsive, that Vermont's governor and legislature have been unwavering in the support regardless of party affiliation, and that there is an infrastructure of skilled and experienced attorneys, auditors, actuaries, and managers in [the state]."

Nancy Gray, regional managing director for the Americas at Aon Risk Solutions, feels that costs and geographic preference also work in Vermont's favour.

"Vermont is very competitive on costs as most of the newer emerging domiciles in the US have adopted captive laws very similar to Vermont law and do not offer an advantage on costs. From a geographic standpoint, Vermont is an attractive domicile for captive owners located on the East Coast and Mid-West."

For Towle, consistency is the key to Vermont's continued success. In his words: "The state licenses top quality captives, and regulates them in a manner that considers the unique risks [that] each company faces."

"Not many would have imagined that Vermont would grow from one captive to be the third largest domicile in the world. Vermont is here for the long term with a reliable, consistent operating and regulatory environment. It is what has earned Vermont the reputation as 'the gold standard' of captive domiciles."

While the state's successes cannot be denied, there are some instances when going elsewhere, or in fact staying at home, may be a better option. Gray explains that if a captive owner is writing a significant amount of direct premiums for US risks, then it may consider forming a captive in its home state.

Gray adds that this "will minimise any potential self-procurement or non-admitted taxes under Non-Admitted and Reinsurance Reform Act (NRRRA) as the captive will only be assessed for the captive premium tax as an admitted captive insurer in the home state".

Richards says that for clients of JLT Towner, the only drawback is Vermont's requirement to hold an annual meeting in the state, but that being said, it is an obstacle that Vermont's regulators are trying to resolve.

As Richards explains: "It's not easy to get [to Vermont] from everywhere else in the country. But Vermont has responded to that concern by allowing only a quorum of directors to physically come to the meeting, while others can participate via conference call. To my mind, the biggest drawback of having to hold a meeting in Vermont is that once you visit, you may not want to leave!"

Compete off the heat

As it currently stands, there are now more than 30 US states with captive legislation, with Texas, North Carolina and New Jersey most

recently entering the industry, so competition is at an all time high. If Vermont wants to maintain its position as leader, it may have some work to do.

Dave Provost, deputy commissioner of captive insurance at the Vermont Department of Financial Regulation, welcomes the competition.

He says: “We welcome more jurisdictions and often help them get started. We are proud that Vermont is often the model used when other states decide to pass captive legislation. [But] our chief concern with the proliferation of domiciles is the potential dilution of talent and its impact on regulation.”

“Many other states have noticed Vermont’s success, but few remember that it took us 30 years of hard work to get where we are. Passing a captive law does not create a successful domicile overnight.”

Speaking on behalf of JLT Towner’s captive clients, Richards feels that the added competition hasn’t harmed Vermont’s reputation. In fact, she says that the state’s position is as strong as ever.

“We’ve seen some interest in other domiciles, mainly dependent upon where the parent is headquartered, but really have not seen a decrease in interest in Vermont. In fact, we’ve

seen companies redomicile their captives to Vermont from some of those newer domiciles.”

“Several states seem to have passed captive legislation without also making the necessary investments in staff and systems to operate the programme. When we look at potential domiciles for new captives with prospective clients, and compare them with the infrastructure and experience of the captive team in Vermont, it’s a pretty easy decision to domicile here.”

Gray adds that there have been a few captives that have redomesticated to their owners’ home states, but those have been bids to minimise any potential tax exposure as a result of the passage of the NRRRA.

Push back

Looking ahead, Towle feels that Vermont will continue to do well in the marketplace. “The captive insurance industry has a positive story to share. We all need to take on the responsibility of sharing that story so that captives and the insurance industry will be portrayed in a more positive light. Improving the image of captive insurance will also enhance the growth of the industry.”

Provost adds that 2013 will be full of challenges for Vermont and the captive industry as a whole, with image coming top of the list.

“The insurance industry is often portrayed as the bad guy, and captives are a complete unknown outside of the small group directly involved. Captive insurance provides societal benefits that few are aware of—for example, consider the market for medical malpractice insurance in such states as Pennsylvania and Connecticut.”

“In Pennsylvania in the early 2000s, there came a time when doctors and hospitals could not buy insurance. In Connecticut, doctors were leaving the state because they could not insure their practices. Captives provide an alternative, and since the doctors and hospitals now own their own insurance companies, the focus on loss prevention is heightened, to the ultimate benefit of patient care.”

Towle believes that the whole industry needs to take on the responsibility of sharing the story of captives to ultimately portray the industry in a more positive light.

Provost adds: “The captive insurance community is a creative group. As captives have grown, they naturally have begun pushing the envelope into areas that weren’t imagined even a few years ago. As captives push out, others, particularly other regulators, will push back. We will continue to work with other regulators to find an appropriate balance.” **CIT**

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Inside story: going it alone

CIT hears from SRS president and CEO Brady Young, who charts the captive management and consultancy firm's progress since its split from Credit Suisse

MARK DUGDALE REPORTS

SRS is the result of a management buy-out in 2002—how did that come about and what sort of direction did you want to take the business in?

At the time, Credit Suisse was in the middle of exiting the insurance business. As part of that, our business was not viewed as a strategic priority. Credit Suisse looked at different exit options and decided that selling to management was the cleanest way to exit the business. That was the genesis of Strategic Risk Solutions.

My feelings at the time, which haven't really changed much, were that we could carve out a nice niche in the captive business focusing entirely on captive consulting and management. I thought there was a need for a strong independent firm and at the time the business was very much dominated by the broker-owned captive management firms. This was before the big shake-up in the brokerage business, so our timing was good.

Personally, I was tired of the management responsibilities that come with working at a large company. I spent most of my time managing people, going to meetings and that sort of thing. I grew tired of it. I wanted to focus more on working with clients and being more involved in the business. Buying SRS and being able to work with clients and get my hands dirty were motivations of mine.

Do clients appreciate it when a senior figure such as yourself is directly involved?

Clients like having access to senior members of the firm both for their experience in the captive industry and the ability to make decisions on behalf of the firm. We now have more than 200 clients under management, so my own ability to meet all of the clients is limited, but I try to spend as much time interacting with clients as possible. We have also attracted a great group of senior people over the years, many of whom have been at the forefront of the industry. They are actively involved with our clients and have developed strong client relationships at SRS and before. As a firm we make sure that a director and/or employee owner of the firm is involved on all our accounts.

What direction have you taken the company in since 2002?

For the large part, we have just gone deeper in the captive business. We really thought we should stay focused, so we have resisted the temptation to get into other businesses and branch out. I'm often asked why we don't look to move into asset management or brokerage, but I say that everybody else's business always looks easier than your own and for the most part there are a lot of good firms that do those things. At the same time, a lot of those firms are

our trading partners, so we stick to what we do and we like to deal with people who specialise in what they do.

SRS recruited Jeff Kenneson, who will have a particular focus on the small captive market—why is SRS targeting small captives, and what does it hope to achieve?

We've been active in the small captive market for some time, but we haven't had a focused proactive effort. We decided that it made sense to put a little more effort in that space.

In terms of what I hope to achieve, it is more about quality than quantity. With our experience and skill set, we can service the small captive segment of the market well. We're going to approach it on a controlled, managed basis. We're not trying to grow it too fast and oversell or over-promote it. We're going to pick clients that are a good fit for us and value our approach to the business, which I would describe as perhaps a little more conservative than some other firms that are out there.

We've set some loose goals about developing something like 100 small captive clients over the next several years. There are a lot of firms that already do a lot more than that, so we would still be a relatively small player in that segment of the market. But the key is that our approach fits well with those kinds of clients.

How much of an opportunity does the small captive market represent?

The middle market in the US, if you look at companies with \$50 million or more in revenue, is very large. There are thousands of companies that are potential parents for captives, but their risk profile is different to traditional captives. Fortune 1000 captives typically cover workers' compensation, liability, and more basic insurance coverage and are used as an alternative to buying commercial insurance or self-insuring. Small captives are often looking at uninsured risks, but ones that are critical to the success of the business, for example, loss of key employees or business partners. They're kind of fun because there is an opportunity to be more creative and do some different things. We enjoy the chance to be cautiously creative.

How has SRS had to change in the past decade to keep up with trends affecting its clients?

Clearly, the amount of scrutiny that our clients are under has increased. With some of the problems going on in the financial industry, I think the expectations that clients have of us, and the standards they hold us to, have gone up. We've always operated under strong inter-

“ They're kind of fun because there is an opportunity to be more creative and do some different things. We enjoy the chance to be cautiously creative ”

nal peer review and professional standards, but several years ago we decided to take it a couple of notches higher. We decided we wanted to be one of the first captive management firms to get a Statement on Auditing Standards 70 certification (it's now called the Statement on Standards for Attestation Engagements 16). There are two levels to that review, but together they show that internal procedures and controls are as advertised, and are actually carried out. We've done those and passed.

The benefit of an external audit is that it forces us to continually refine what we do and how we do it. Having an outside firm come in and validate it gives our clients some additional comfort. It also makes the audit process with our clients go a little smoother, because a lot of them rely on us being audited.

How much scrutiny are captives under these days?

In the US, there are regulators in the different states, the IRS, and then there are the auditors that work for the parent companies of the clients, so there are a lot of different constituents that we need to keep happy and respond to. The captive world, just like every other financial business,

has become more complex and expectations and demands are higher for everyone.

We have to spend more time and make more resources available. It's not insurmountable—it's just a part of the business—but there is a lot more to be done now than in the past. In the end, if you're in the business you have to do it and do it well. You have to be consistent and sweat the details or there will be unhappy regulators and auditors, and if that happens, there will be unhappy clients.

How demanding have captive regulators become?

I don't think regulators have become more demanding or unreasonable. The experienced regulators understand what the issues are and can zero in where they need to and ask the right questions. I think the less experienced domiciles are learning on the job. They're feeling their way into the business—they're not like a Vermont or Bermuda with 25 to 30 years of experience regulating captives. But that's not a problem, because we work very well with the regulators and see it as a kind of collaborative relationship.

We've formed quite a few captives and I've said

it a lot to regulators: I'm more concerned about the captive being successful than you are. I don't want a captive to blow up. We all want strong, successful captives and not insolvent, financially weak ones. Nobody needs the aggravation, so we work hard to do due diligence on the clients and the captive and make sure we're comfortable with the business plan and the clients before we get involved. **CIT**



Brady Young
President and CEO
Strategic Risk Solutions



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Sharing's caring

With its popularity soaring, CIT takes a look at the mutual insurance arrangement to see why it is a viable option for retailers and even football clubs

JENNA JONES REPORTS

Mutual insurers are in a prime position to capitalise on changes in the traditional reinsurance market, found Willis Re in a recent report.

The 1st View April renewals report found that changing distribution models, coupled with a flood of alternative capital, have left many reinsurers concerned over both their existing portfolios and their access to future growth.

These changes in the market have provided mutual insurers with the opportunity to strengthen their existing relationships with traditional reinsurers to and, also forge new partnerships.

Gregor Pozniak, secretary general of the Association of Mutual Insurers and Insurance Cooperatives in Europe, explains that a mutual or cooperative insurance company is simply an "insurance undertaking that is owned by [its] clients".

According to Willis Re, as mutual insurance companies are ultimately owned by their policyholders, they have less access to other forms of capital, and as a result, are often reliant on reinsurance to provide them with additional capital to deal with catastrophes and other large losses.

Speaking in April, John Cavanagh, CEO of Willis Re, said that the "seismic changes occurring in the traditional reinsurance market are clearly favourable for mutual insurers".

As interest in the industry grew, Guy Carpenter & Company introduced its own mutual company specialty practice, which focuses solely on the unique needs of mutual insurance companies.

In a recent statement, Guy Carpenter explained that mutual insurance companies are currently faced with competitive pressures, limitations on raising capital, the implementation of new regulatory and compliance guidelines, and increased demands for actuarial services.

John Haldeman II, executive vice president of the mutual company specialty practice at Guy Carpenter, said: "The new practice provides solutions for all these concerns ... The members of our practice provide an unpanelled depth and breadth of knowledge about the market and deliver Guy Carpenter's full suite of state-of-the-art

products and solutions to clients who are seeking new avenues of growth and profitability."

To facilitate the growth of the mutual and cooperative insurance market, a number of associations have been set up. Martin Shaw, chief executive of the Association of Financial Mutuals (AFM), explains that the association's chief aim is to promote the value of mutuality and the interests of its members.

The benefits of becoming a part of a mutual insurance company are many, according to Shaw. "We have undertaken extensive research, all of which demonstrates that people get a better deal with a mutual. Customers enjoy much better standards of service, and fairer claims handling."

"Because we don't have to syphon money off to pay shareholders, we can afford to pay better investment returns, or to charge less. Because we aren't fixated by the quarterly reporting cycle, we can run our businesses for the long-term, and in the best interests of our customers. And most importantly, people trust mutuals at a time when the general reputation of financial services remains in the gutter."

Another benefit that Shaw notes is the sheer scope of companies and organisations that can participate in a mutual arrangement—stating that there are no obvious barriers, with health services, retailers, football clubs and even school participation.

"There are a million people in the UK employed by mutual across a range of industries. Now [the] government is looking to explore how some departments can be mutualised, even the Post Office. Mutuals are very much in vogue and enjoying real interest and growth."

Riding out the storm

Over the last five years, the insurance market has been subdued, as many bigger insurers have focused on bolstering their balance sheets instead of competing for new business—with many people highlighting mutuals as the fastest growing part of the insurance sector, says Shaw.

He adds: "Mutuals tend to be well capitalised,

which meant they rode out the recession well, and in the last five years we've seen growth in the sector of over 50 percent."

Pozniak agrees that the sector is definitely becoming more popular, not least as a consequence of the financial crisis.

He says: "A recent study by the International Cooperative and Mutual Insurance Federation has proven again that in the past couple of years the mutual insurance sector in Europe has gained market share."

"In times of crisis, the cooperative and mutual movement has a strong argument. It stands in contrast and offers an alternative to profit-maximising models, eg, in investment banking, but also in insurance where exchange-listed insurers have to produce higher earnings per share every quarter and therefore look at short-term balance sheet visible gains ... Mutual ideas in a wider sense are strong in times of crisis."

But despite the clear benefits of a mutual insurance arrangement, Shaw doesn't always recommend them as the most suitable option. He explains that while the AFM sees real value for mutuals, they may not always be the answer.

"Where a mutual wins out is the ability of the owners to have a clear say in the running of the business, and to share in its success. For example, when the livery companies in London wanted to find a new solution to their insurance needs, they elected on a mutual (a member of AFM), because this would dramatically reduce the price, and allow them to benefit from significant profit sharing."

Impediments when it comes to setting up a new mutual insurance company are also a challenge, which could ultimately deter potential insurers from pursuing the option.

Shaw explains: "The challenge for many people is that the barriers to setting up a new mutual are high—the initial capital requirement in particular is an obstacle for setting up a mutual in the retail environment as you need to create capital from members before you have them. I tend to find people look to establish cooperatives or credit unions more readily as they have low thresholds for start-ups." **CIT**



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PCCs: are they for you?

Derek Patience and Donna Weber of Marsh put forward a case to CIT for choosing a protected cell company over a single parent captive

JENNA JONES REPORTS

Why would a company use a cell in a PCC rather than implement its own single parent captive?

Donna Weber: In our view, there are several reasons why a company would want to use a cell in a protected cell company (PCC) instead of creating its own single parent captive. For starters, there is a faster and lower cost of set-up and closure if necessary. Cells additionally benefit from lower ongoing administrative costs, given that they jointly share a portion of the service provider costs. Cells also require less of a time commitment on behalf of the parent company forming the cell.

Derek Patience: Another point is where there is a disconnect between the client regarding the various wishes, ie, the risk manager wants some form of a captive solution and maybe the other members of the board might say that they are not in the business of owning an insurance company.

So a cell might be a way of appeasing both parties, ie, the risk manager gets his captive solution, albeit through a cell, and other

members of the board get their wish in that they don't have a fully owned subsidiary within their group.

Where are Marsh's PCCs domiciled and why?

Patience: At the moment we have companies in the Isle of Man and Washington DC. The Isle of Man primarily meets the UK and European market, and Washington DC is for the US.

Weber: We chose these two domiciles to begin with for their strong regulations relating to complete segregation of assets between the cells—we felt they were extremely important.

Washington DC is a great US domicile because it has a parity provision that generally permits cells and captives domiciled in DC to write any business that is permitted in other US or foreign domiciles, so cells have the flexibility to write most insurance lines.

Another reason for choosing Washington DC was that the domicile allows for the formation of cells as incorporated entities through incorporated cell company (ICC) regulation. This allows

companies to form cells under various organizational structures to facilitate liability protection and tax planning. Incorporated cell formation also makes it easier for cells to make certain US tax elections, such as 831(b).

Are there any other destinations that Marsh has thought about expanding into?

Patience: We already have vehicles that are non-Marsh owned in a number of domiciles, including Guernsey, Malta and Bermuda. But there are other domiciles that Marsh is considering.

Is there a typical client profile for Marsh's PCCs?

Patience: A PCC is similar to a fully established captive in that really all lines are feasible, though it does depend on the risk profile of the client itself as to what the most appropriate insurance lines are for them.

Still the most popular, whether its captives or PCCs, are the likes of property, general liability and workers' compensation.



In terms of a typical client profile, again it is similar to captives in that it will suit all industry types. So I don't think that there is a typical client profile, so to speak, but I do think that in terms of cost and pricing it may be more suitable for 831(b)s in the US.

Additionally in the UK, amendments to the controlled foreign companies (CFC) rules have lowered the threshold for profits, so we are seeing more interest from small- and medium-sized enterprises looking for a captive solution in itself, and probably what would be more appropriate for them is the cell option.

The threshold on diminutive profits rose from £50,000 to £500,000 and there were also changes to foreign subsidiaries risk not being taxed in the UK. So again, we are seeing greater interest as a result of both of those factors.

Where do you see the most potential for growth in the PCC sector?

Weber: As far as the US is concerned, we expect significant growth from cells that are set-up under IRS section 831(b). Companies that establish a captive or cell under this election can write up to \$1.2 million of premiums annually, building underwriting profits free from federal tax.

In order to make the 831(b) election, the cell needs to meet IRS tests for risk transfer and risk distribution—the latter of which is often harder for companies to achieve.

Marsh is soon going to be launching a strategy

to use health wellness incentives to help companies achieve risk distribution within a cell or a captive structure. So Marsh is quite excited that through this strategy companies will be able to both address rising healthcare costs, and create some economic savings through an 831(b) structure.

Patience: With both UK CFC and 831(b), it's given a certain impetus there. What I would say is that captives, whether they are fully blown or cell solutions, are still effectively at the mercy of the traditional insurance market. The insurance market has been somewhat soft over the last few years, so we are less inclined to get many deals that go direct to the insurance market—should market conditions change, captive and cells will be in higher demand.

Are there any noticeable downsides to the PCC structure?

Patience: A potential downside of the PCC structure in the Isle of Man is that we have separate PCC and ICC legislation. This means that you can't morph into both—a PCC can only have protected cells and an ICC can only have incorporated cells.

If there was a need for a client to move from a protected cell to a single parent captive, it would need to be done by portfolio transfer of liabilities from the cell to the captive. It can't simply spin off in a way that a cell in an ICC could.

Weber: I haven't heard of any, and there have been no complaints yet! **CIT**



Derek Patience
Head of office
Marsh Management Services Isle of Man



Donna Weber
Senior vice president
Marsh Captive Solutions



Captive tune-up: are you making the most of your captive?

Regularly looking under the captive's hood to assess its operations can provide the owner with tools that will keep the captive performing well for years to come, says Robert Gagliardi of **ALG Captive Management Services**

Typically, a captive insurance company is formed to solve a specific risk management concern. Many times, captives are formed during a hard insurance market when premium rates are on the rise, or when a company is unable to find the type of coverage it wants in the traditional insurance or financial marketplace.

But as with all things in life, time passes and situations evolve. Perhaps changes in the insurance market have made the desired coverage available. Through focused safety measures and claim mitigation procedures, the captive owner may have improved its loss experience

thereby reducing its insurance costs. There may have been acquisitions or divestitures at the parent level that have significantly increased or decreased insurance exposures. Perhaps there has been turnover within the risk management or finance functions, and much of the institutional knowledge of the captive programme has been lost.

Whatever the situation, you can be certain that today's environment is not the same as it was when the captive was formed. For a mature captive, it makes sense to periodically assess the functionality and financial effectiveness of

the existing programme, as well as to consider additional lines of coverage for the captive. As a colleague of mine once said, a captive may not quite be "a many splendored thing", but it is a very flexible risk management tool that can be utilised in a variety of ways to benefit the parent organisation.

This periodic assessment of the captive's operations has many names—captive audit, utilisation review, etc—but I like to think of it as a 'captive tune-up'. Like a fine automobile, a captive can bring its owner years of satisfying performance, but to keep it operating at peak

efficiency, a professional needs to regularly look under the hood and make sure everything is working properly and performing to its full potential. The tune-up is a chance to review the objectives of the parent and determine if there are areas where the captive can better respond to evolving insurance needs and corporate strategies. Determining how often to conduct a tune-up will depend upon the complexity of the parent organisation, but as a general rule, we recommend every five years.

In many ways, the tune-up is a type of SWOT (strengths, weaknesses, opportunities and threats) analysis:

- **Strengths:** what is our captive doing well? How do we expand on these areas?
- **Weaknesses:** what has not been going well? Do we have any operational issues that are hindering the captive's growth and development?
- **Opportunities:** does the parent have problems that the captive may be able to address? Are there changes in the market that make coverage through the captive more attractive?
- **Threats:** are there regulatory changes that present a threat to the captive's business?

Once the initial broad assessment of the captive and its current operating environment is completed, the review should move into more detailed questions regarding:

- **Domicile:** does the current domicile remain the best fit for the captive? This analysis should include a review of the allowable business in the domicile, the costs relative to other domiciles, and political support for the captive industry.
- **Taxation:** does the current captive structure optimise the tax position of the parent company for state, local, and federal purposes?
- **Service providers:** have there been any service issues with the captive manager, fronting company, auditor, tax specialist, legal counsel, actuary, or third party claims administrator? Are the service fees competitive in the marketplace?
- **Current programme structure:** does the current programme reflect the optimal retention for the parent company? Based on current market pricing, would there be additional savings by retaining a lesser or greater amount in the captive? Clearly, this is an area to be reviewed in the tune-up, but ideally it has also been evaluated during each renewal of the programme.
- **Future programme structure:** what other programmes should be considered for the captive? This is an area that can make up a significant portion of the tune-up report that should include an evaluation of: current corporate insurance programmes not included in the captive and any existing uninsured exposures; and the potential to assume business into the captive from affiliates, business partners and employee affinity programmes.

There are a number of non-traditional areas

where using a captive is being considered by experienced captive owners. For example, there is a significantly increased interest in cyber risk as companies become more aware of exposures surrounding information security. Banks and hospitals are particularly sensitive to cyber risk due to both the amount of personal information they hold that must be kept private and their dependency on electronic data.

Often, the existing general liability, errors and omissions and/or crime policies do not adequately address the risks associated with an increasingly digital world. Even specialised cyber insurance policies may not provide all of the protection that a company seeks. A captive can craft a customised policy to allow the parent to provide coverage and to fund for potential claims related to:

- Network business interruption;
- Wrongful disclosure of personal information or protected health information;
- Failure to guard against threats such as hackers, viruses, worms, etc; and/or
- Costs related to restoration or re-creation of data or software.

Another area where captives have continued to emerge in recent years is employee benefits, specifically medical stop-loss. The enacting of Obamacare created significant uncertainty for most businesses in the US as to how healthcare expenses will be paid. So while the Department of Labor may have suspended the ExPro process for approving the funding of Employee Retirement Income Security Act (ERISA)-regulated benefits through a captive, interest in using a captive to help fund employee benefits costs may be at an all-time high. For a company that self-funds its medical plan, a stop-loss captive programme can help provide specific and aggregate insurance protection for the owner. In many cases, medical stop-loss is provided on a group basis, however, individual owners can optimise their self-insured retention and cash flow through the use of their captive.

Mergers and acquisitions are events that can often result in new exposures for organisations. Captive owners can turn to their captive insurance subsidiary to help them handle exposures that they have not faced before. Perhaps an acquisition results in new territories or jurisdictions where the parent company does business, and the captive can expand its existing coverage to these new locations. During an acquisition, the captive can also be used to assume the risk of any coverage gaps in the target company's historic insurance programme.

For manufacturers, we are also seeing interest in using the captive for product recall risk or for various extended warranty products. These coverages can each provide benefits to the parent company but must be carefully reviewed to ensure that they will be treated as insurance products.

When evaluating any new coverage for the captive, the risk appetite of the parent is a major consideration. While the economic analysis of a

programme may indicate that using the captive would result in long-term underwriting income, if the parent company is uncomfortable with the risk due to its potential volatility or some other uncertainty, then self-insuring through the captive will not ultimately occur.

Any changes to the captive structure may increase the capitalisation required in the captive, as well as the costs to operate the captive. Therefore, the consideration of a new programme must include the cost of capital that will need to be committed to the captive to support the new coverage.

Ultimately, the tune-up report should include:

- An evaluation of the captive's performance in meeting the objectives of the business. This evaluation should include both the case for the continuation of the existing captive and a counterpoint discussion on the potential disadvantages of having a captive with commentary on alternative risk structures;
- A review of the original business plan of the captive compared to current writings, illustrating historical growth of premium, losses, retentions, capital/surplus, and retained earnings;
- An operational analysis describing the data flows and internal controls within the captive, as well as an overview of all service providers and the roles they play in the overall delivery of services;
- An outline of potential new risks together with underwriting considerations that could be written by the captive, including the rationale to do so and the potential opportunities for the parent company. In addition, commentary should be made on those opportunities that were identified but ultimately not recommended for inclusion in the captive and why; and
- Additional capitalisation needed for the captive's expansion, if necessary.

Ownership of a captive insurance company can provide many benefits. A captive, however, does require regular maintenance if the owner wants to enjoy maximum operating performance. A 'captive tune-up' can provide the owner with tools that ensure that the captive will continue to perform well for years to come. **CIT**



Robert Gagliardi
Senior vice president and worldwide director
AIG Captive Management Services



Will the Asian captive market take off?

Asia's captive market remains underdeveloped compared to Europe and the US. Daniel Koepfer of NMG Risk Solutions explains why and elaborates on factors leading to the captive market in this region taking off

While economic and financial difficulties in Europe and the US persist, Asia remains economically strong. Over the last decade, companies in Asia have grown and become regionally and globally more present, making them suitable captive candidates. Yet, even in Asia's largest captive domicile, Singapore, most captives originate from Australia and not Asia. The take up rate of large corporate enterprises remains significantly lower compared to Europe and the US.

This is partly due to very soft insurance markets and regulatory constraints in this region, but also because captive service providers

have not accommodated all needs of Asian corporates.

Cultural and economic differences

Corporates in many Asian countries operate in an environment, where labour cost is significantly lower than in Europe or the US. Providing a captive solution where the costs are driven by salaries in offshore islands such as Bermuda or Guernsey, are not very appealing. For an Asian captive owner, it is difficult to understand why tasks that can be done for less than half the cost in Asia, are priced at the rates currently offered in these domiciles.

In addition, geographical and cultural distance makes the relationship between management and the owner of the captive more difficult. Not many captive managers in Bermuda or Europe have professionals who are able to explain an issue in Chinese if need be. Difference in time zones, a different expectation on response times to queries and service standards create a challenge to traditional captive centres.

Hence, Asian captive owners prefer domiciles in the region, such as Singapore, Labuan or Micronesia. While there are limited captive domicile options in Asia, these three domiciles

have emerged as the leading destinations in the region as they are very attractive in terms of capital requirements and solvency regimes, flexibility of investments, as well as reputation and effectiveness of supervision.

Recently, gaps in the regional captive offering have been closed. A good example is the introduction of protected cell company legislation in Labuan, or the evolution of Micronesia as a newly developed and very successful domicile, which predominantly attracts Japanese captive owners.

The introduction of PCC legislation in Labuan and a somewhat similar multiple corporate captive (MCC) legislation in Micronesia has opened the market to medium-size captive owners. Insurance buyers that may have been too small are now able to use these vehicles to optimise their insurance financing strategy.

Local insurance markets

Most insurance markets in Asia are very competitive and insurance premiums and deductibles remain very low. Recent regulatory changes will lead to some consolidation, however, there is still an oversupply of non-life insurance in many insurance markets across Asia.

Other markets have remained concentrated, with only a few insurers dominating. They are unwilling to provide fronting services for commercially feasible terms, as they prefer to retain attractive risks in the market, keeping their home market more profitable.

Apart from Hong Kong and Singapore, virtually all Asian markets require a local licence in order to write local risks. Therefore, fronting is required in a captive programme. Capital requirements for insurers have increased in many jurisdictions, leading to higher capital charges on fronting and hence raising the cost of fronting arrangements.

Therefore, finding commercially viable terms for fronting has become difficult in some markets, where the competition make premium rates in other markets so low, that commercial insurance is often more economical compared to a captive programme.

Sharia-compliant captives

Another issue less present in the Western world is the requirement of some companies to have sharia-compliant insurance programmes. While there are different models of sharia-compliant insurance, all have a requirement to use: (i) a sharia-compliant fronting insurer, or operator; (ii) a sharia-compliant reinsurer; (iii) sharia-compliant investments; and (iv) a sharia board, which ensures that all transactions are sharia-compliant and in line with the internal guidelines of the captive as well as the takaful model chosen.

The takaful insurance market is emerging much faster than the traditional insurance market in

Asia and more options for fronting and reinsurance become available compared to previous years. Sharia-compliant insurance provides a risk and profit sharing between the insurance operator and the policyholder. Given that the captive is usually owned by the same group of companies it is insuring, the sharia model does usually not change the economic attractiveness of the captive, as one way or the other the owner of the captive, which is also the owner of the insured, will benefit.

“ It is the obligation of the captive manager to challenge brokers and insurers—therefore independence is key ”

Forms of takaful insurance

It is commonly believed that insurance is not allowed under Islam, as one of the six articles of faith is predicated on the belief that only God knows one's future. Conventional insurance may include 'unlawful elements', such as interest, uncertainty, gambling and could possibly be considered unethical. Similar to mutual insurance, the concept of takaful is based on risk sharing, rather than risk transfer. The different models have different ways of how profits are shared between the insurer, or operator and the policyholder. The common models are wakala, mudharaba, a hybrid between the two, as well as waqf, which is more common in the Middle East.

However, in a typical captive setting, the owner of the captive and the owner of the policyholders are ultimately the same entity. Therefore, the model chosen has hardly any economic impact from a consolidated captive owner's perspective. However, it will affect the way the captive will be able to accumulate capital.

Sharia-compliant captive domiciles

Labuan has established guidelines for sharia-compliant captives. Yet, no sharia-compliant captive has been established in Asia Pacific. There is, however, the first captive in the pipeline, and we do expect more to come once we have established the first. Apart from the restrictions mentioned above, the economic drivers to establish a captive are similar to traditional captives.

Independent service providers

Finally, the last gap that has been recently closed was the availability of truly independent consultants and captive managers. A good example is Singapore, the leading domicile in Asia. Until recently, all captive management providers used to be owned by an insurance company or insurance broker, with possible conflicts of interest.

A captive manager would hardly challenge the programme structure designed by its own colleagues and even more unlikely recommend changing the structure in a fashion that would reduce the brokerage fee income to his own company. Hence captive managers have become more focused on administration, accounting and regulatory issues.

Moreover, independent brokers were naturally reluctant to introduce the captive concept to their clients, knowing that the captive managers are owned by large brokers, ready to attack their account once the captive is set-up and the entire programme structure is visible to the manager.

Overall, there is an increasing appreciation of the value of independent advice from an experienced captive manager, which may compliment or challenge the views of insurance brokers. There is an increased awareness of possible conflicts of interests if both functions are performed by the same company. Independent firms have the freedom to work in wholehearted partnership with clients to deliver independent, effective risk financing solutions. **CIT**



Daniel Koepfer
Partner
NMG Risk Solutions



Choice of domicile: the last decision you will make

A detailed operational plan should make choosing a domicile less daunting, says Mike Stalley of FiscalReps

Choosing the optimal domicile for your new captive insurance company should be easy. Each location will have key differentiators separating them from other jurisdictions, so the choice should really come down to one's own circumstances. However, when you consider that there are now in excess of 60 captive domiciles across the world competing (including 39 in the US), the ability to differentiate clearly and objectively becomes much harder.

When making such a decision the principal objective is often to focus on the differences, strengths and weaknesses of each domicile. However, before identifying the differences, some thought should be given to the similarities—the issues that are going to exist and that need to be addressed regardless of jurisdiction. Decisions made at this point may have a significant impact on the need to form a captive at all, let alone the captive strategy and choice of domicile. Failing to address these matters at an

early stage may complicate operations further down the line.

Tax compliance is an area that is as much determined by the location of the captive as by its proposed activities. If we assume that the captive owner is a US corporation with international business interests then the two main alternatives are the forming of an onshore captive or an offshore captive.

Onshore captives

Thirty-nine US states have enacted captive legislation, the most recent being Texas. Vermont remains the largest domicile by some margin, although its dominance is likely to become eroded by the greater choice that is now available.

A captive established within the US is subject to taxation under the laws of the state of domicile as well as the federal tax authority (the IRS).

A captive is required to file an income tax return with the IRS in the same manner that any other corporation is required to do so. The biggest issue for determining the correct level of income tax to pay is often going to be the calculation of claims reserves, which will often require actuarial input to validate any provisions.

But for 'micro' captives, an 831(b) election can be used to exempt captives with less than \$1.2 million of premiums from income tax on their underwriting income.

Although legislation can vary, captives would normally be subject to state premium taxes on premiums collected in the same way that general insurers are. This would certainly be the case if the captive was insuring risks within the same state of domicile (ie, the parent company and captive are in the same state). In many states that serve as captive domiciles, premium tax is capped at a maximum level.

Comparison of tax legislation for onshore and offshore domiciled captives

	Onshore Captive	Offshore Captive
US Income Tax	Yes, but 831(b) exemption available to reduce taxes payable	No, unless 953(d) election is made electing to be taxed as a US corporation
US Federal Excise Tax	Only when the US captive cedes premium to a non-US reinsurer that is subject to FET	Yes, unless an FET exemption can be obtained
State Premium Tax	Yes, in the state of domicile	No
State Procurement Tax	Maybe, in the state where the risk is located, although each state has different rules	Maybe, in the state where the risk is located, although each state has different rules
Overseas Premium Tax	Yes, typically based on location of risk and may mean that overseas tax compliance requirements exist	Yes, typically based on location of risk and may mean that overseas tax compliance requirements exist

Where a captive insures risks outside of the state, there may be a liability to additional taxes in the jurisdiction where the risk is located. If these risks are in the US, then Self-Placement Tax may be payable. If the risks are further afield, say in the UK or Germany, premiums charged in relation to those risks would be subject to local premium tax legislation.

In the case of Texas in particular, it would appear that the legislation was introduced in an attempt to persuade Texan corporations to redomicile their captive to Texas, rather than as a domicile of choice for global corporates. While this move could remove the liability to self-placement taxes, other state taxes may then become payable. When you consider the net impact of the tax changes together with the cost of redomiciliation, such a captive strategy may not be commercially viable to the owner.

Offshore captives

A US person may be subject to income tax on certain income earned by a "controlled foreign corporation" of which it is a significant shareholder. Therefore, profits from a closely-held captive domiciled in an offshore jurisdiction are typically subject to US income tax.

At the recent G8 summit in the UK, attendees agreed that combatting tax avoidance and evasion through the use of tax havens is a key target in order to ensure that countries are collecting all tax revenue due to them. Driven by increasing media scrutiny, there is a fear among many tax commentators that even the use of tax avoidance (legally minimising tax bills) is now considered unacceptable. This may have a long term impact on the growth of captive business in offshore jurisdictions—even though the insurance expertise that they offer often far outweighs any perceived tax advantages that may exist.

Consequently, many offshore captives owned by US corporations file a 953(d) election with the IRS, opting to be taxed as a US company. Ironically, that would then offer them the opportunity to make an 831(b) election to legally avoid tax on their underwriting income if their total premiums are beneath the \$1.2 million threshold.

An additional tax concern for offshore captives is Federal Excise Tax. FET is payable when premiums for US risks are paid to non-US insurance companies. There are exemptions available for captives in jurisdictions where the US has signed double tax treaties, although in many of the traditional Caribbean captive domiciles no agreements have been signed. FET is

also potentially payable on reinsurance premiums paid to non-US reinsurance captives.

Although in many offshore captive jurisdictions there are low or even no rates of corporate tax, there may still be tax compliance requirements and taxes payable. Ireland is an example of this, where although the rate of corporate income tax is 12.5 percent (considered low on a global scale), taxes must be calculated and filed annually.

Foreign Account Tax Compliance Act legislation is designed to identify funds that are remitted overseas but remain in the hands of US taxpayers, ensuring that all US taxpayers pay all of the taxes that are due. Although implementation has recently been delayed by six months, this additional legislation is only likely to add to the compliance costs associated with owning captives in offshore jurisdictions.

Overseas premium taxes

In many ways this is the constant issue, almost regardless of the location of the captive. In order to determine which overseas premium taxes are potentially payable, it is important to:

- Identify the location of all risks insured by the captive;
- Apply the national legislation that exists in that jurisdiction;

Comparison of statutory requirements for onshore and offshore domiciled captives

	Onshore Captive	Offshore Captive
Registered Office Address	Yes, within jurisdiction	Yes, within jurisdiction
Local Directors	No	Yes, in certain jurisdictions
Local Representative	No	Yes, in certain jurisdictions
Annual Financial Statements	Yes, in accordance with US accounting rules	Yes, in accordance with local accounting rules
Local Board Meetings	Not typically, but often subject to company rules	Often yes, but varies by jurisdiction

- Calculate taxes based on legislation—exemptions may be available for certain risks;
- Identify the taxpayer in each jurisdiction; and
- Ensure that all taxes are collected and settled in accordance with local requirements.

Premium tax rates, legislation and compliance requirements vary enormously from country to country, so the need to use reliable information and to have access to expert advice remains critical. Tax authorities across the globe are stepping up efforts to collect more premium taxes and that fact, together with the need for corporates to remain tax compliant to avoid negative publicity, means that a robust and rigorous system of premium tax compliance must be built and maintained.

Non-tax issues

Moving away from the tax environment, again there are a number of issues that need to be considered, which are relatively consistent across all jurisdictions, before choosing a domicile. The newly formed captive will need to have a registered office, acquire resources to carry out the work, appoint directors, prepare and

file annual accounts and tax returns, and hold board meetings.

If there is a requirement to hold board meetings locally and to appoint local directors, there may be an argument for domiciling the captive where the corporate is based. Directors' time is valuable so unnecessary travel time could be avoided by doing this. Discipline can also be an issue. If all board meetings have to be held in the jurisdiction, then this must happen without exception. Failure to comply with what appears to be a simple requirement may complicate tax or licensing matters.

Choice of supplier is also key regardless of jurisdiction. More established jurisdictions may have larger infrastructures and more experienced personnel, but it is vital to build a successful working relationship with your supplier—something that is often easier in principle than practice.

Impact on domicile choice

If there is a clear captive strategy and a detailed operational plan that deals with tax, accounting, and financial and board matters, then the choice of domicile should be less daunting.

The strategy and operational plan will drive the decision to locate onshore or offshore, meaning that the choice of domicile will reflect the requirements of the captive owner rather than having to adapt the use of the captive to suit the domicile.

If you get all of the other elements of the plan correct, choosing your domicile should be the last decision you will have to make. **CIT**



Mike Stalley
Chief executive
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A shady state of affairs

Putting captives in the same bracket as ‘shadow insurance’ was bold but not wise, according to industry experts. CIT gives them the floor

Should the National Association of Insurance Commissioners heed New York superintendent of financial services Benjamin Lawskey’s call for a national ban on captive insurance transactions?



Gregg Sgambati
Former executive director
NJCIA

The National Association of Insurance Commissioners (NAIC) should not recommend a national ban on captive insurance. The New York Department of Financial Services’s (DFS’s) call for a national ban on ‘shadow insurance’ transactions should not be interpreted as a call to ban all captive insurance transactions.

The report discusses its investigation of 80 life insurance companies, all of which are based in New York. All 80 companies were required to

respond to the department’s inquiry for information concerning reinsurance with affiliated captive or affiliated offshore insurers, including those with parental guarantees. This is what the department called ‘shadow insurance’.

The report then focused on 17 cases that revealed such transactions. These 17 cases formed the basis of DFS’s argument and eventual recommendations. Its investigation converged on four types of transactions that were evident in these cases.

Captive insurance is a risk management strategy used in many industries. Many captive insurance companies are more straight forward: they are wholly owned, they insure certain risks of their owner more cost effectively compared to market insurance, the insured’s are clearly affiliated with the owner, and the captive is actuarially sound. The NAIC’s position to not heed to the DFS’s call reflects its members’ understanding

of captive insurance outside of these 17 cases. Still, this is clearly a concern for the NAIC as its financial condition committee adopted a whitepaper that addressed these areas.

Perhaps investigations should be initiated in other states. Some states, such as New Jersey, might underline its regulation of captive insurance companies owned by life insurers and highlight its attention to the transactions questioned by the DFS. It might be a good option for Albany, Trenton, and the 17 life insurers to sit at the same table, clear the air, and restructure if necessary.

I do not criticise the DFS report, rather, I thank the DFS for sharing it. If these 17 cases illustrate hazardous transactions, then the NAIC should design remedies and blockades for past and future situations like this. But the entire captive insurance industry does not have to evacuate the building at the sound of the DFS’s June 2013 alarm.

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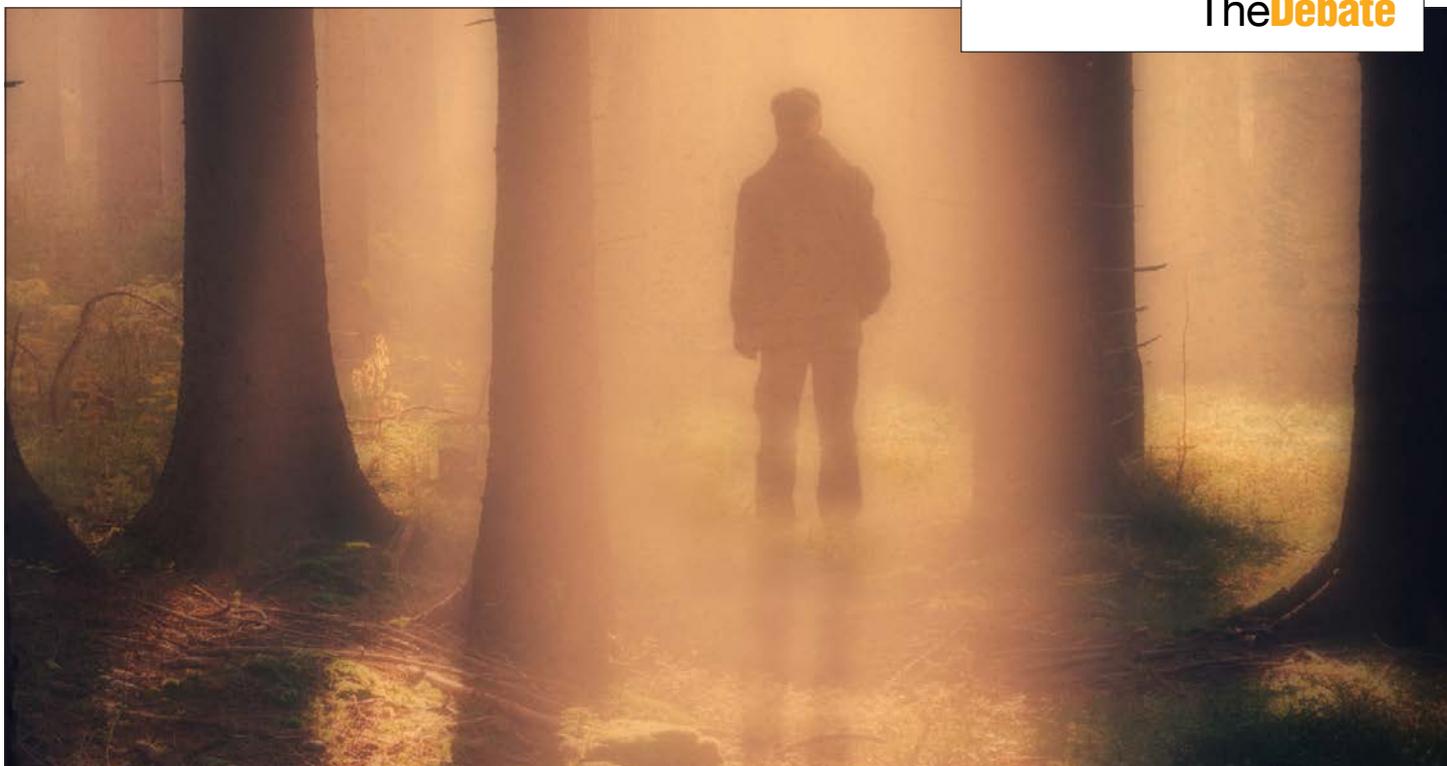
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Dennis Harwick
President
CICA

When New York superintendent of financial services Benjamin Lawskey issued the salaciously entitled report, *Shining a Light on Shadow Insurance: a Little-known Loophole that Puts Insurance Policyholders and Taxpayers at Greater Risk*, his language constituted a casual broadside at the traditional captive insurance industry when the focus of his report (for those willing to drill down into the contents) was on a specific kind of transaction by New York-based life insurance companies utilising ‘special purpose vehicles’—sometimes called XXX captives—to reinsure certain liabilities. However, Lawskey’s use of the word ‘captive’ in this report was sloppy and misleading, especially since a full reading of his report makes it clear that he was not really even talking about the traditional captive insurance industry. Unfortunately, lazy grammar often makes for good politics!

The Captive Insurance Companies Association found itself in the interesting position of commending the president of the NAIC for his response, chiding the New York insurance superintendent for going over-board and for calling for a vaguely worded national moratorium on captive insurance transactions. In NAIC president Jim Donelon’s own words, Lawskey’s call for a national moratorium constituted “a knee-jerk position of issuing a moratorium before the house is on fire”.

More importantly, Lawskey’s grandstanding runs

the very real risk of harming the traditional captive insurance market, which is not even the real focus of his report. We should expect better of those entrusted with regulating this industry.



Jeff Kehler
Programme manager
South Carolina Department
of Insurance

Lawskey issued a report wherein he provided information that supports his contention that captive insurance companies represent a shadow insurance industry and insurance securitisation captives are the worst of all. He fails to clearly define the problem he is attempting to investigate and fails to provide an objective analysis of the relevant facts and circumstances. The report fails as a scholarly report but succeeds in inflaming the emotions of the reader. It is high blood pressure of emotion and anemia of useful information.

The NAIC should not respond to subjective reports like the one Lawskey provided. They should focus on real issues facing the insurance industry and the need for reasonable but prudent regulation. To impose a moratorium on captive business while searching for a smoking gun is ridiculous. The captive industry has demonstrated time and time again the ability to step into the marketplace when the traditional industry has vacated the space. The captive industry has been a lifesaver for many captive owners when they’ve been left high and dry by the traditional industry. To suffocate such a valuable industry

based on Lawskey’s allegations is absurd; plain and simple.

More importantly, Lawskey’s grandstanding runs the very real risk of harming the traditional captive insurance market, which is not even the real focus of his report. We should expect better of those entrusted with regulating this industry.



Jim Donelon
President
NAIC

State insurance regulators continue to assess and monitor the risks that captives and special purpose vehicles (SPVs) may pose to insurers. State regulators have conducted a great deal of work to examine the issues surrounding the use of captives and ways to enhance the regulatory framework and provide insurance departments with standardised tools and processes for reviewing such transactions. The NAIC has a number of groups focused on examining complex issues including transparency and disclosure, accounting treatment and confidentiality. A top priority of the NAIC is ongoing implementation of principle based reserving, which seeks to address, among other things, the perceived reserving redundancies that have precipitated the use of captives for reserving purposes. Ongoing work on principle-based reserving will also specifically examine the solvency, surplus, and risk-based capital impact caused by the use of captives and SPVs. **CIT**

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Having time to act

Alan Pakula and Todd Dashoff of Huggins Actuarial Services outline what captives need to know about economic capital modelling

Economic capital is defined as “the amount of financial resources that an institution must theoretically hold to ensure the solvency of the organization at a given confidence level and given the risks that it is expected to take” (James Lam, *Enterprise Risk Management: From Incentives to Controls*, John Wiley & Sons, 2003). This standard should be recognised as the capital that is needed within a company to achieve its business objectives, not as the baseline amount of capital to be held in order to stave off regulatory action.

Why should a captive insurance company care about economic capital?

Economic capital should be an essential part of strategic and tactical decisions for a captive

insurer. It affects many areas of captive insurance company operations including risk appetite and limit setting, measurement of performance, and investment philosophy. Inadequate funding can lead to ratings downgrades by rating agencies and possible regulatory actions.

One of the main functions of the captive insurance company's board of directors is the oversight and management of risk. This risk exposure can be highly variable and difficult to predict. For example, with the implementation in the US of the Patient Protection and Affordable Care Act, which is also known as Obamacare, captives formed to retain a group's medical malpractice exposure are now faced with the additional uncertainty of the effect that Obamacare will have on the medical malpractice environment and on future loss costs. In turn, these

will have an effect on the membership of the captive. The captive's board of directors need to perform their own forward looking self-assessment review of the risks that may affect the captive and the concomitant existing solvency needs and the adequacy of capital resources.

In 2008, the National Association of Insurance Commissioners (NAIC) looked to strengthen its regulatory framework by studying the European regulators' new ORSA (Own Risk Solvency Assessment) requirement, a part of Solvency II. ORSA originated with the UK insurance regulator, the Financial Services Authority (which is now known as the Financial Conduct Authority). In 2005, under the Individual Capital Adequacy Standards Regime or ICAS, the FSA required insurers to evaluate their own risks and report the amount of capital required to support those

risks. In practice, the FSA discovered that most companies were treating the ICAS as more of a compliance exercise instead of an integral part of the insurer's risk management. The FSA wanted to have the internal capital assessment process integrated into the business operations.

The NAIC determined this approach would represent a more effective framework for the US, and in 2012 it adopted the ORSA Model Act. The NAIC expects to have the ORSA Model Act ready for implementation by January 2015. The ORSA Act will replace the current regulatory framework for captives which, at least in the US, is in the process of moving from review based primarily on reserve adequacy as it relates to overall company solvency, to a risk-adjusted approach that seeks to determine those components of the captive's operations that may have the greatest effect on solvency, and then checks to see whether controls are in place to moderate or eliminate those risks. ORSA, as indicated by its title, is designed to require all insurers, including captives, to perform an internal assessment of the risks that could affect the solvency of their particular operation, and to stress test their operations to determine whether there could be an unforeseen set of circumstances that could cause the captive to suffer a loss of capital that would impair its solvency. If such impairment could occur within the required projected time span, the captive will be required to come up with a plan to modify its operations to eliminate the risk. This might take the form of reducing or shifting the amount of business written within a given line or state, or the implementation of a rate increase, or stricter underwriting.

While the ORSA requirements will initially only apply to entities above a rather high written premium volume, expectations are that the qualification level will be reduced over time. Even if a captive's total premium is far below the cutoff, it is still advantageous to perform such an assessment in order to be sure that there are no 'land mines' that could seriously affect the ability of the captive to continue to operate and to expand those operations to the benefit of its owners.

In addition to state insurance departments, A.M. Best Company recently indicated that it will be including an assessment of company-specific risk in a modification of its BCAR (Best's Capital Adequacy Ratio) formula. A.M. Best plans to tie the probability of default and the required amount of capital to the financial ratings it assigns to a company's balance sheet strength. A company's rating will be subject to greater variation from the majority of firms of similar composition if it exhibits a higher risk profile, excessive earnings variability or is involved with comparatively riskier business segments.

For those captive insurers seeking to maintain a high rating, perhaps due to a requirement from their reinsurer or fronting carrier, it will behoove them to assess their inherent risk and develop enterprise risk management tools that will allow them to focus on those facets of their operation that involve the most risk and come up with

ways to reduce that risk, so that their balance sheet is not subject to excessive fluctuation even under unforeseen circumstances. The primary tool to accomplish this is economic capital modelling.

How does economic capital modelling work for a captive?

Economic capital modelling (ECM) is essentially a probability-based scenario generator for determining the future financial results of an insurance organisation. The usual starting point is the modelling of all of the existing and/or proposed exposures of the captive's business through the operational components of insurance, reinsurance, claim and expense payments, and the investment of funds. Detailed information about the insurer's operations is entered into a modelling package and the package generates equally likely alternate versions of the financial statements for a number of prospective years. Key risks modelled in ECM include underwriting, reserve, natural catastrophe, asset, and reinsurance credit risk. A key component of the model includes credible scenario and stress testing that measures the possible variability of the future results.

What data is needed to run the model?

Several types of data are needed. Balance sheet inputs include assets (cash, bonds, common stock, other asset classes, surplus) and liabilities (loss and loss adjustment expense reserves by line or sub-line and payment patterns for existing reserves, unearned premium reserve, and other liabilities). Line of business inputs include direct written premium, underwriting expenses, earnings patterns, and claims counts. Reinsurance inputs include reinsurance contract terms along with specific catastrophe reinsurance terms, reinsurance catastrophe modelling results, ceded premium, ceded reinsurance attachment point, and ceded reinsurance limit.

For a captive, which frequently may have a relatively low retention level, the terms of its reinsurance treaties have particular importance in the model. If loss experience worsens in the coming periods, depending on the relationship of the average claim size to the captive's retention, there may be a significant worsening of loss experience with a corresponding decrease in the available capital of the captive. In addition, depending on the particular perils written by the captive, management should investigate the potential for a single catastrophe to have a negative effect on multiple lines of business, such as property, automobile physical damage and homeowners.

What does an economic capital model report output look like?

An economic capital model will produce pro forma financial statements including balance

sheet and income statement over a number of future years. It should also calculate and display cumulative probability density functions. These functions can compare results based on differing assumptions and include the effect of catastrophe losses.

The functions show the value at risk and tail value at risk (TVaR). The latter is a weighted estimate of the losses in excess of a given probability, such as one in a hundred or one in a thousand. While such losses are by the nature extremely infrequent, good management will still examine the TVaR. If such a loss were to occur, it could result in a loss of capital to the point where the captive might be unable to continue in operation.

The key to success will be the creation of a timely and understandable flow of information across all facets of the captive's operation that will enable management and the board of directors to make timely and appropriate decisions, and to take appropriate remedial action when it is required. Captives that accomplish this should flourish, even in difficult economic times, and will find themselves able to react more quickly to any changes that may occur in the future. **CIT**



Alan Pakula
Consulting actuary
Huggins Actuarial Services



Todd Dashoff
Consulting actuary
Huggins Actuarial Services



A state of resurrection

Mark Koogler of Porter Wright Morris & Arthur tells CIT about Ohio's intentions to enter captive insurance and what it still needs to do to get there

JENNA JONES REPORTS

Why has Ohio decided to enter the captive business?

In January 2011, I approached the Ohio Insurance Department and state legislators to resurrect the state's entry into the captive arena. Several years prior, the state legislature was looking into a captive insurance bill, but due to conflicting interests, the bill did not proceed past interested parties meetings.

However, the new Ohio governor John Kasich campaigned on a pledge to retain and attract business, and create jobs in Ohio.

My idea to resurrect the captive bill in Ohio was a result of this pledge. I believed that this proposal would resonate with the Ohio Department of Insurance because the superintendent of insurance is also the Ohio lieutenant governor.

I also believe a captive bill will complement the new business environment in Ohio and support the robust insurance industry in the state. As a result of my discussions, I was asked to prepare the first draft of the captive bill and I updated the Ohio Department of Insurance with respect to other captive laws and governance matters as it considered the pros and cons of a captive law.

When will the captive legislation in Ohio pass?

The Ohio House of Representatives passed the captive bill on 4 June, and the bill is now with the Ohio Senate. At this time, to my knowledge, the Ohio Senate is expected to pass the bill after the Ohio General Assembly summer recess to allow the governor to sign the bill into law later this year.

What types of captives is Ohio intending to authorize?

The Ohio captive bill allows the formation of two types of captives: pure captives, and protected cell captives.

A great number of established US states currently offering captive insurance. What will Ohio offer that other domiciles currently do not?

The Ohio captive bill is not currently designed to offer significant differences from other US states' captive laws. Ohio is interested in getting its toes into the water and seeing what developments occur as a result of offering an opportunity for Ohio-based companies and companies doing business in Ohio to either establish captives or bring their captive business back to the state.

The Ohio captive bill, particularly the provisions permitting the formation of protected cell captives, is based on the captive laws of several other states that have championed their cause. I believe pure captives will be the primary focus of Ohio businesses after the bill is passed. However, I hope that as the captive industry obtains a foothold in Ohio, interested parties will be supportive of expanding the currently proposed bill.

What has interest in establishing a captive in Ohio been like?

The captive bill has generated a lot of interest in captives for Ohio-based companies and those doing business in Ohio. In addition, a number of insurance professionals are preparing to

educate their clients on the benefits of captives in anticipation of the bill's passage.

In my opinion, the Ohio captive bill may be a catalyst for the redomestication of a number of captives domiciled in foreign jurisdictions by Ohio-based companies, such as hospital systems, manufacturers and insurers.

In addition, a lot of Ohio businesses have heard of captives but do not know much about them. An Ohio captive law will present an opportunity to discuss the formation of captives for these companies. Interest in a captive law predated the current legislation and led several years ago to the establishment of the Ohio Captive Insurance Association. This association, like many of its counterparts in other jurisdictions, is designed to educate existing and prospective captive owners on the benefits and uses of a captive insurer while encouraging the growth of a captive environment in Ohio. **CIT**



Mark Koogler
Partner and chair of the M&A practice
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Celling Solvency II to captives

The PCC structure is being put forward as an advantageous alternative that could help captives mitigate the costs of impending regulations, says Dr Beppe Sammut of GANADO Advocates

The use of cellular structures is widespread across the Maltese insurance and funds industry. Malta has legislation in place that allows for the establishment of protected cell companies (PCCs) and incorporated cell companies in the insurance sector, and SICAVs (with sub-funds), incorporated cell companies and recognised incorporated cell companies in the funds industry. Consequently, Malta is an attractive domicile to those market players looking for alternative structures that best satisfy their business needs.

The introduction of PCC legislation has led to the establishment of 13 PCCs in Malta, with more than 20 protected cells being created over the last couple of years. Even though other jurisdictions have introduced similar PCC legislation, Malta has taken the concept a step further. Unlike other jurisdictions, a PCC structure in Malta may be used not only by insurers, reinsurers and captives, but also by insurance managers and brokers established on the island.

Malta is the only full EU member state that has legislation in place regulating the PCC structure, giving insurers the opportunity to create separate and segregated cells within a PCC while allowing them to write business directly throughout the EU by means of the single passport, and to reap the benefits of their business as if they were a separate legal entity.

Throughout the years the PCC structure has been used for many different types of insurance or reinsurance business models. These range from non-European insurers setting-up cells as fronting facilities in order to reduce their European economic area fronting costs, as well as organisations establishing a cell as a captive risk financing vehicle. Other types of businesses that have been adapted to the PCC structure include reinsurers and insurers setting up cells as reinsurance/retrocession facilities, as well as insurers creating cells for run-off business.

The advantages of the PCC structure become clearer once its commercial and legal nature is understood. In commercial terms, the PCC offers reinsurers and insurers the opportunity to write business while benefitting from the efficiencies of its structure. The unique and innovative nature of the company offers a flexible, feasible and cost-efficient structure that provides economies of scope and scale through the sharing of capital and costs (both set-up costs and ongoing), both to the owner of the PCC and all cell owners.

From a legal perspective, a PCC is seen as a single legal entity comprising within itself separate cells that constitute distinct and segregated patrimonies, which are ring-fenced from each other. The PCC enables the writing of business (or the provision of insurance brokerage or management services) through an individually allocated cell, which constitutes a distinct pool of assets and liabilities separate from the assets and liabilities of any other cell and from the non-cellular assets and liabilities (core) of the company.

Consequently, even though the PCC is considered to be one legal entity, creditors of one cell (or of the core) do not have a right of recourse to the assets of another cell. This concept ensures that assets belonging to a particular cell are protected from the claims or liabilities of any other cell or of the core of the PCC. Besides having a right of primary recourse to the assets of the cell with which the creditors transacted, such creditors also have a right of secondary recourse to the assets of the 'core', but only once all the assets of that particular cell have been exhausted.

In terms of Maltese solvency regulations, while every individual reinsurance and insurance undertaking is required to hold a minimum amount of capital (commonly referred to as the minimum guarantee fund or MGF), each cell within a PCC is not required to individually satisfy the MGF, as it is the PCC as a whole that is obliged to hold the required MGF.

The PCC offers both economies of scale and scope through the common management of the company, since all costs incurred for the management of the PCC (including those related to the core and to the cells) are shared by its owners and by the cell owners. This is a result of the common management and administration of the PCC, which is the sole responsibility of the board of directors sitting at the core.

The benefits of shared capital and common management of the PCC should become more relevant and evident once the Solvency II Directive is implemented. The implementation of the Solvency II regime will mark a radical overhaul to the regulatory landscape for the reinsurance and insurance industry, especially since the establishment of the three pillar system may lead to more onerous costs for captives and smaller mono-line insurers carrying on insurance business throughout the EU. Some of these smaller captives and mono-line insurers may be forced to sell, merge or close down their entities if they do not have the financial and operational resources to meet Solvency II requirements. The PCC will offer a viable alternative to these insurers that may otherwise struggle to comply with Solvency II requirements.

It is anticipated that once the Solvency II Directive is implemented, PCCs established in Malta will be categorised as 'ring fenced funds' (RFFs) as described in terms of the European Insurance and Occupational Pensions Authority's Level 2 implementing measures. Such a categorisation should lead to substantially lower capital requirements for individual cells in terms of Pillar I of the same directive. In fact, while standalone insurers will be required to satisfy both the solvency capital requirement (SCR) and minimum capital requirement (MCR), cells will only be required to satisfy the SCR with no obligation for each individual cell to hold own funds to satisfy the MCR. Since the PCC is one single legal entity, it is the company as a whole (including the 'core' and all individual cells forming part of the PCC) that is required to satisfy the MCR.

Furthermore, where the PCC can demonstrate to the satisfaction of the Malta Financial Services Authority that there is diversification between cells and the 'core', then diversification effects may be considered in the calculation of the SCR.

In terms of the Level 2 implementing measures, where an individual cell does not have sufficient own funds to meet its own notional SCR, the deficit may be covered by the own funds outside of the cell, which could be transferred to meet

“ The PCC offers both economies of scale and scope through the common management of the PCC, since all costs incurred for the management of the company are shared by its owners and by the cell owners ”

Even though a cell does not have separate legal personality, each cell is treated as a separate entity for fiscal purposes as though each cell were an individual company. Furthermore, dividends can be declared and distributed by a particular cell, notwithstanding that the core or any other cells were not profitable in that same financial year.



the deficit. This would be an added benefit for the cell where the cell has secondary recourse to the 'core' (more so where a PCC has a capitalised core). The PCC could lend excess capital held in the core to the cell owner in order for the cell to satisfy its notional SCR.

Another key advantage offered by the PCC is that the share capital, share premium and retained earnings of the individual cell that are classified as own funds that are used to meet its own notional SCR could be included in Tier 1 eligible own funds for the calculation of the PCC's SCR.

The PCC structure also offers economies of scale and scope in terms of Pillar II through the cost sharing that is present for all PCC and cell shareholders. Since the PCC is one single legal entity, the applicability of the system of governance provisions, the implementation of the key functions and the carrying out of the forward looking assessment of an undertaking's own risks (ORSA) may be carried out by the PCC as a whole and not by each individual cell. Therefore, the PCC could generate one set of policies and procedures that would apply to all cells.

Furthermore, the PCC could implement one risk management, internal control, internal audit and actuarial function, which would be responsible for all cells forming part of the PCC. Additionally, the PCC would only be required to carry out one ORSA, as opposed to carrying out individual ORSAs in relation to each cell.

The increased costs that may arise as a result of the implementation of Pillar II will be mitigated through the PCC, since the structure leads to significant cost burden sharing while granting cells access to a common pool of knowledge and expertise within the common management system at the core of the PCC. Even though

corporate procedures relating to each cell may not necessarily be identical, a common approach may be adopted by the board of the PCC that permeates the structure as a whole.

A similar approach can be taken in relation to the Pillar III reporting requirements, where most of the reporting is to be carried out by the PCC as a whole and not by each individual cell. The majority of the information, data, templates and documents that have to be submitted to the regulator (and public) may be done by the board of directors, who are responsible for compiling, verifying and submitting the same information to the regulator (and public). This results in a cost-effective structure that diminishes the burden on individual captives or small mono-line insurers writing business through a cell.

Malta already has several established PCCs that have the expertise, know-how and resources to offer and 'rent' individual cells to any small captives or mono-line insurers that are interested in taking advantage of the PCC structure.

However, the utilisation of PCCs does not only represent an attractive option for those small captives and mono-line insurers that are searching for alternatives come the implementation of Solvency II, but it also presents an opportunity for those industry players that have the insurance expertise and are willing to set-up their own PCC as a platform that offers the smaller captives and mono-line insurers with the possibility of establishing a cell. Industry players could set-up their own PCC structure and market the sale of individual cells to smaller captives and mono-line insurers, while generating revenue both from a cell facility fee charged for the establishment and 'renting' of the cell, and from any management fees that the PCC would charge individual cell owners for the management, running and

administration of the cell (where management of the cell is not outsourced).

Malta's legislative and regulatory set-up caters for the establishment of PCCs, whether through incorporation, conversion or redomiciliation, as well as through the creation of cells and the transfer of cellular assets from and to other PCCs. The PCC is being put forward as an advantageous alternative, offering a cost effective solution to the increased costs incurred as a result of the implementation of Solvency II, without sacrificing all of the benefits of enhanced corporate governance and a more risk-based approach under Solvency II.

The PCC may also represent an attractive opportunity for those market players that have the necessary insurance expertise to establish a PCC and are willing to offer it as a platform to those smaller captives and mono-line insurers that are interested in establishing a cell, in order for them to better meet their business needs and the present regulatory realities. **CIT**



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Industry appointments

The Missouri Captive Insurance Association has appointed **Maria Sheffield** as its new captive programme manager.

She replaces **John Rehagen**, who has been named deputy director of company regulations.

Sheffield began her insurance career in 1996 with the Georgia Department of Insurance. She then worked as an attorney focusing on insurance compliance regulation.

Insurance brokerage and risk management firm Beecher Carlson has recruited **David Loggins** as vice president of the firm's national healthcare practice.

In his new role, Loggins will be responsible for medical stop-loss business, captive formation and business development assistance.

Prior to joining Beecher Carlson, Loggins was the owner and president of Integrity Benefits. He has also held sales director positions at American Health Group and the RPA Group.

Loggins is licensed in health, life property and casualty in Colorado. He is also an active member and volunteer of the Colorado Healthcare Strategy and Management Association.

Frank McKenna, executive managing director and head of Beecher Carlson's national healthcare practice, said: "We are excited to have Loggins on the team. He has an expansive experience that I am confident will make many positive contributions to the exceptional service we provide our clients."

ACE Group has made **Derek Talbott** division president of North America property and specialty lines. He will be based in Philadelphia and report to John Lupica, chairman of insurance, North America.

Talbott succeeds **Paul McNamee**, who has been named deputy president of ACE's Asia Pacific region.

In his new role, Talbott's responsibilities will cover ACE's network of retail and wholesale broker-distributed property and first part lines in North America, including customised fronting and captive solutions.

Talbott will take up his role on 1 September when he relocates from London, where he is currently serving as executive vice president of international property for ACE overseas general.

Jane Barker has been named as the chairman of Marsh, with effect from 1 August. Barker, who has been a non-executive director of the company since 2010, will succeed Sir Peter Middleton.

Barker is CEO of Equitas, a position she has

held for the past six years, having served as its finance director since 1995. She was previously COO of the London Stock Exchange.

Commenting on the appointment, Mark Weil, CEO of Marsh, said: "Since joining the board, Barker has made a substantial contribution to the company."

"With her extensive background in financial services and her deep knowledge of our business, she is ideally-placed to provide strong advice and guidance for our UK operations."

Following his retirement from the Marsh board, Middleton will remain the UK chairman and country corporate officer for Marsh's parent company, Marsh & McLennan Companies, and chairman of its sister company, Mercer.

Graeme Moore has been recruited to the management team of Willis Re's specialty division. He will report to the firm's global CEO, John Cavanagh.

Moore will join the firm at the end of his current notice period from Aon Benfield's Global Re specialty division, where he was formerly the CEO.

Cavanagh said: "I am truly delighted to have Moore joining Willis Re's senior management team. Moore's extensive knowledge and experience will complement and extend our already strong presence in the specialty arena."

PricewaterhouseCoopers has promoted 17 staff in its Guernsey and Jersey offices to managerial and senior managerial roles.

The Jersey office has promoted five new senior managers and five new managers, while there is a new senior assurance manager and six new managers in the Guernsey office.

Michael Carpenter has been named a senior manager in Guernsey. He works particularly with real estate funds, alternative investment funds, fund managers and captive insurance.

The Guernsey office managers include **Oliver de la Fosse**, who will focus on assurance, and **Sevdalina Magson**, **Jonathan Mauger**, **David Davies**, **Jonathan Marshall**, and **Geraldine Forde**, who will all specialise in audit and assurance.

Valarie Johnston has also joined PwC Guernsey as a manager in the tax team. Johnston, who works with a wide variety of financial services firms, has been with PwC since 2005 and moves to the Channel Islands from the US firm's office in Minneapolis.

In Jersey, the five members of staff being promoted to senior manager roles are **Owen Woolgar** and **Mark Hunter**, who will

both be a part of the advisory team, and **Toby Venables**, **Trudy Dillon**, and **Iain Tait**, who will all specialise in assurance.

Those being made managers in the Jersey office are **Chris Hopwood**, who will focus on assurance, and **Viane Fredricks**, **Kirsty Boyle**, **Randi Hannon**, and **Karolina Nawrociak**, who will all specialise in audit and assurance.

Brendan McMahon, senior partner of PwC Channel Islands, said: "Responding to the needs of our clients, PwC is committed to ensuring that we provide supportive expertise quickly and effectively. Not only to support clients in meeting the regulatory challenges, but to advise on operational enhancements required to convert opportunities in new markets." **CIT**

CIT CAPTIVEINSURANCETIMES

Editor: Mark Dugdale
markdugdale@captiveinsurancetimes.com
Tel: +44 (0)20 8663 9620

Deputy editor: Georgina Lavers
georginalavers@captiveinsurancetimes.com
Tel: +44 (0)20 8663 9629

Reporter: Jenna Jones
jennajones@captiveinsurancetimes.com
Tel: +44 (0)20 8663 9622

Account manager: Joe Farrell
joefarrell@captiveinsurancetimes.com
Tel: +44 (0)20 8663 9627

Publisher: Justin Lawson
justinlawson@captiveinsurancetimes.com
Tel: +44 (0)20 863 9628

Designer: John Savage
design@captiveinsurancetimes.com
Tel: +44 (0)20 8663 9622

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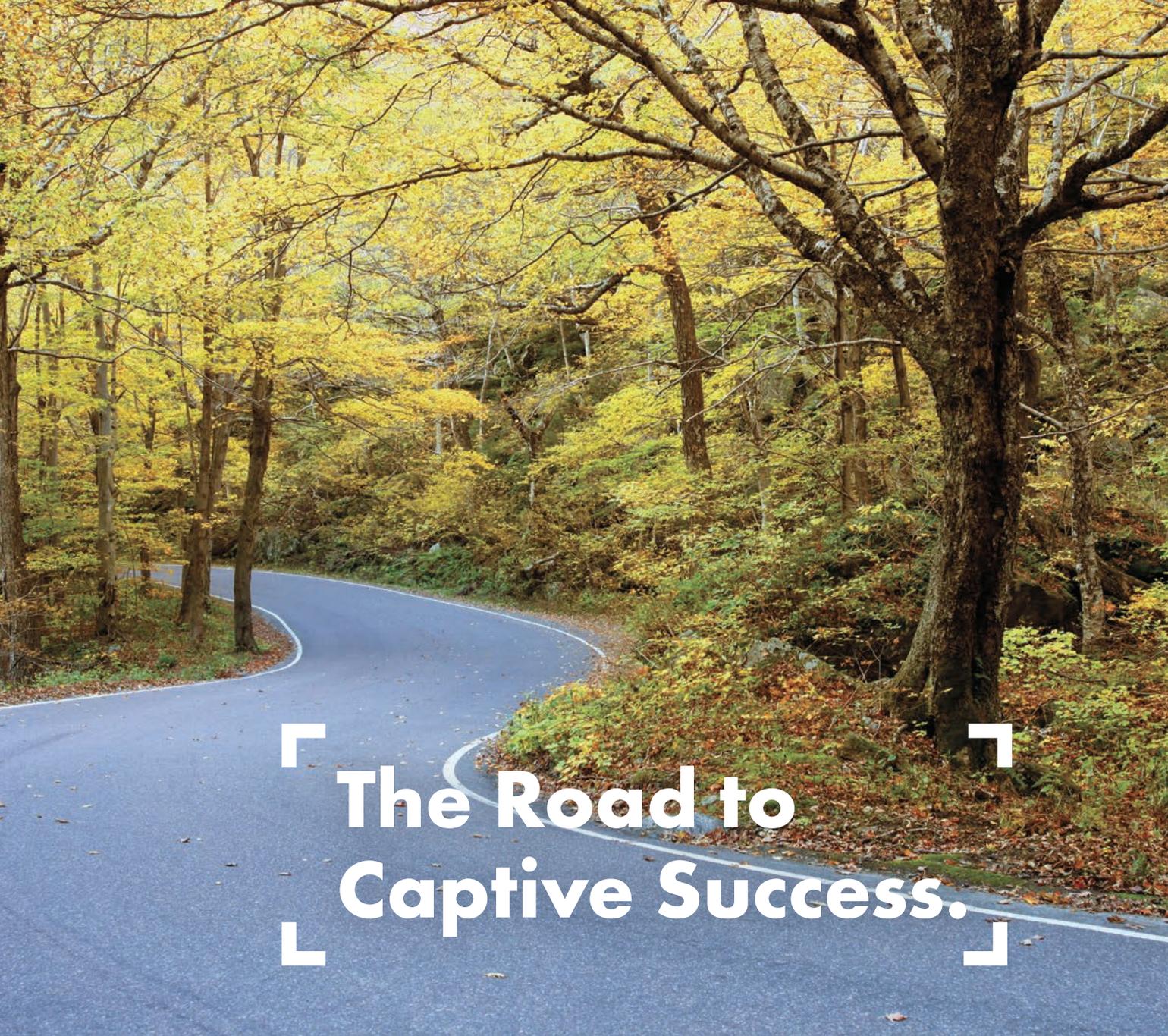
4023 Kennett Pike, #801 • Wilmington, DE 19807

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Phone: 888-413-7388



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