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Marsh charts captive evolution

Marsh's annual captive benchmarking report has found that only one-third of US captive owners treat their captives as insurance companies for US federal income tax purposes.

The finding suggests that captives are being used more as a tool to generate operational and risk management value rather than for their tax efficiencies.

The report, *The Evolution of Captives: 50 Years Later*, is based on the activities of 1148 captives under Marsh's management, including a vast array of all types of captives, risk retention groups (RRGs), non-traditional captives and life insurance company captives.

It found that of the 664 captives benchmarked with a US parent, only 37 percent are deducting captive premiums on US federal income taxes.

Among the captives that are being treated as insurance companies for tax purposes, the number of new small captives, or so-called 831(b) captives, is trending upwards.

These captives, typically created by mid-sized companies writing less than \$1.2 million in premiums, represent the most common new captive formations in the US over the past five years and have led to the significant growth of domiciles such as Utah, Kentucky, Montana, and Delaware.

According to the report, a majority of small captives, 68 percent, are opting for the brother/sister approach—where a captive owner is a holding company with several subsidiaries in order to qualify as insurance companies for tax purposes.

Twenty-two percent are taking a hybrid approach (brother/sister and third party writings), and only 10 percent are achieving it with a third party risk approach, according to the report.

With the growing popularity of smaller pooling facilities, which is an approach to securing third-party risk, Marsh stated that it expects the pooling approach to grow significantly in the future.

Julie Boucher, Marsh's Americas captive leader, said: "Marsh has always advocated that captives be viewed as a tool to help companies better deal with fluctuating market conditions, unstable regulatory environments, and global economic shifts, rather than just view them as a tax benefit."

"We counsel our clients to explore innovative ways of using captives to manage risk."

For example, more real estate investment trusts (REITs) are forming captives today to access funding from the Federal Home Loan Bank (FHLB) system at favourable rates.

Captive membership in the FHLB is a significant new opportunity for REITs and other types of real estate finance clients, and has been growing at a rapid rate since the summer of 2013, noted the report.

Results reaffirm Bermuda's strength

Statistics released by the Bermuda Monetary Authority (BMA) have shown that the country's international insurance sector achieved substantial underwriting results, recording over \$120 billion in gross premiums written in the latest reporting period.

Craig Swan, managing director of supervision at the BMA, said Bermuda's risk transfer industry continued to write significant volumes of premiums, helping buyers to manage exposures in the face of changing market conditions.

In addition, Bermuda's insurers hold substantial amounts of capital and surplus as well as total assets.

The latest available statistics show that the Bermuda insurance market recorded an increase of aggregate gross premiums written of \$120.5 billion, up 12 percent year-on-year from the \$107.6 billion recorded the previous year.

Net premiums written totalled \$98.1 billion, up 3.7 percent year-on-year from the \$94.6 billion written the previous year.

Overall, the market recorded aggregate total assets of \$505.5 billion, up 11.8 percent year-on-year from \$452.2 billion, and held capital and surplus of \$193.0 billion, up 14.4 percent year-on-year from \$168.7 billion.

The 12 new insurance companies registered in Q1 2014 ran the whole gamut of insurance: from captives and small commercial insurers; to long-term (life) insurers and special purpose insurers.

BP captive gets A- from A.M. Best

A.M. Best has affirmed the financial strength rating of "A- (Excellent)" and issuer credit rating of "a-" of Saturn Insurance of Burlington, Vermont. Saturn is a captive of BP, an integrated global oil and gas company.

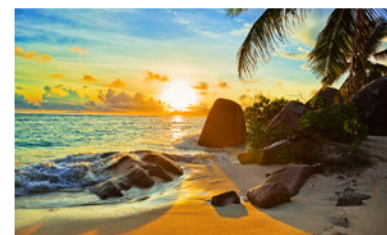
Saturn's ratings reflect its strong risk-adjusted capitalisation resulting from excellent group reinsurance support and the full retention of after-tax profits.

Saturn benefits from low investment risk as it maintains half of its investments in cash or short-term deposits, with the remainder loaned back to BP with excellent liquidity conditions.

In addition, the ratings also factor in BP's financial strength and commitment toward Saturn.

Saturn's strong risk-adjusted capitalisation supports the company's developing business

CITINBRIEF



Domicile profile

Bermuda's rise to prominence as a captive domicile continues, despite onshore regulators unnecessarily poking their noses in

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Guernsey ILS

Captives offer opportunities for family members to transfer wealth

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Captive accounting

Audited financial statements are worthwhile, but invasive procedures that are expensive, redundant and self-serving are not, says Linda Nethery of Venture Captive Management

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Conference preview

While you could be forgiven for imagining the US captive industry as a solely competitive arena, the states of Arizona, Missouri and Utah have allied to advocate the rewards that come from solidarity

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Captive cells

Large companies have been able benefit from captives for years. Now, companies that do not own one are looking to do the same, and captive cells may be the answer, says David White of AIG

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Captive considerations

Link insurance purchase strategy to risk management and financing efforts to realise a captive's maximum potential, says Stuart King of FR Global Advisors

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People moves

GC adds to its speciality practice, Willis appoints new CEO and Colosi is now a Great American (employee)

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profile and is able to absorb an increase in underwriting risk. Going forward, it is expected that the company will gradually increase its net risk retention and accept new lines of business.

In addition, Saturn benefits from a comprehensive reinsurance agreement with its sister company, Jupiter Insurance.

The importance and integration of the company in BP's overall risk management framework is also positively reflected in the ratings. In addition, BP's financial strength and commitment toward Saturn is similarly assessed as a positive rating factor.

Upward rating movements are unlikely at present.

Negative rating actions may arise from a material deterioration of Saturn's risk-adjusted capitalisation. In addition, a significant increase in the retention levels on Saturn's current and planned programmes without a commensurate increase in the capital base would likely lead to a review of Saturn's ratings.

Japanese captives still lagging

Japanese-owned captive insurers remain a small fraction of the total number of captives globally, primarily due to the close relationship between the country's insurance companies and industrial groups, according to a new report from A.M. Best.

The report, *Ties Between Insurers: Industrial Giants Limit Scope of Japan's Captive Market*, stated that the comparatively low number of captives in Japan can also be attributed to the country's small liability insurance market, relative to the Western market.

The Japanese government covers workers' compensation risks, while that line of business in the US is fully employer-funded through either commercial insurance or self-funded insurance.

Prospects for growth of the Japanese captive market are mixed.

"A strong near-term increase in the number of new Japanese captives is not likely," said Seewon Oh, senior financial analyst at A.M. Best Asia Pacific.

But Oh did claim that the role of captives in Japanese companies is expected to develop gradually, based on recent observations of both rated and not-rated captives owned by Japanese companies as well as discussions with market participants such as multinational brokers.

A.M. Best praises Pacific Lighthouse strength

A.M. Best has assigned a financial strength rating of "A- (Excellent)" and an issuer credit rating of "a-" to Pacific Lighthouse Re LLC (PLRL).

The ratings for PLRL are based on its risk-adjusted capitalisation, history of positive operating performance and effective management of exposures.

Based on the existing capital within PLRL and its new property/casualty and life-reinsured businesses that began in January 2014, A.M. Best has predicted that the company's capital position will remain favourable following the significant growth in its premiums.

Along with the strengths of PLRL, A.M. Best recognises there is residual risk with the company's parent, AAA Northern California, Nevada & Utah, with respect to operations, geographical concentration and profitability of the parent.

Although the outlook for PLRL's ratings is stable and the ratings are not expected to be upgraded, nor its outlook revised within the next 12 to 24 months, A.M. Best could downgrade the ratings and/or revise the outlook if unexpectedly large losses materially impact the company's capitalisation on a risk-adjusted basis.

Guernsey enjoys captive growth

The Guernsey Financial Services Commission (GFSC) licensed 99 new international insurers in the 12 months to the end of March.

This includes eight limited companies, five protected cell companies (PCCs), 73 PCC cells,

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three incorporated cell companies (ICCs) and 10 ICC cells.

Further data on these newly licensed entities shows that their owners' geographical origin is approximately split into thirds: one third from the UK; one third from the Cayman Islands; and one third from other jurisdictions including Ireland, Luxembourg, Switzerland, Bermuda, the US, Singapore, South Africa and Australia.

Fiona Le Poidevin, chief executive of Guernsey Finance, said: "There appears to be no let-up in the number of international insurance license applications being approved by the Guernsey regulator."

"We are seeing continuing growth in new entities related to Insurance Linked Securities (ILS) transactions but also a steady stream of more conventional captive insurance vehicles."

Not all doom and gloom, says GC

Workers' compensation reserves appear to be improving, despite noted deterioration over the last year, according to Guy Carpenter's updated analysis of the reserve cycle.

Guy Carpenter examined accident year data for 11 lines of business to update its analysis of the reserve cycle.

Medical professional liability and commercial multi-peril lines also appear to be making

tentative turns to show greater reserve release, while other lines such as commercial auto liability have continued to exhibit deterioration.

"Guy Carpenter looks at the reserve cycle differently, by studying reserve movements by accident year, rather than financial year," said Jessica Leong, lead casualty specialty actuary at Guy Carpenter.

"By analysing the cycle the same way actuaries do, by accident year, the trends are clearer. We can help our clients better understand the drivers of the cycle and navigate through it. According to our analysis, 2013 shows more releases than 2012, not less, as we had been expecting."

A major driver of the continued release of reserves can be attributed to homeowners and private passenger auto lines, which are responsible for 70 percent of the improvement for accident year 2012.

But there is a lack of a clear cycle for short tailed lines, which makes it challenging to predict whether accident year 2013 will continue to show releases in 2014.

"The somewhat random movement of the reserve cycle for short tailed lines of business, such as homeowners and private passenger auto lines, makes it harder to predict what the future holds for the 2013 accident year," said Leong.

"However, long tailed lines such as workers' compensation, medical professional liability and commercial multi-peril, also released more reserves for accident year 2012 than for accident year 2011. That is much more interesting, since these long tailed liability lines are very cyclical."

Arizona joins list of SBS states

The Arizona Department of Insurance has licensed State Based Systems (SBS), a regulatory tool that is owned and operated by the National Association of Insurance Commissioners (NAIC).

SBS is a back-office software system designed with the help of state insurance regulators. Offered as a benefit of NAIC membership, SBS offers a variety of product services for producer licensing, company licensing, consumer services, enforcement, fraud, exam tracking and revenue management.

Arizona's insurance director, Germaine Marks, commented: "We are confident in the ability of SBS to help us significantly streamline our processes and improve our services."

"Uniform functionality licensed by 27 other NAIC members, state of the art self-service tools used by our industry stakeholders, and the guarantee that SBS will maintain pace with all NAIC initiatives are all key reasons why the Arizona Department of Insurance chose SBS."



READ OR DOWNLOAD

Marsh's 2014 Captive Benchmarking Report

THE EVOLUTION OF CAPTIVES: 50 YEARS LATER

To access the report, please visit marsh.com or contact your local Marsh representative.

Adam Hamm, the NAIC president and North Dakota insurance commissioner, said: "I congratulate the Arizona Department of Insurance on its decision to implement SBS and its full set of benefits to licensees, companies and consumers."

"The NAIC continues its strong support of state-based insurance regulation through a variety of member initiatives like SBS with substantial state participation."

In addition to Arizona, SBS is currently the system of choice in Alabama, Alaska, Arkansas, Delaware, the District of Columbia, Florida, Illinois, Iowa, Kansas, Maryland, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Puerto Rico, Rhode Island, Tennessee, US Virgin Islands and West Virginia.

A.M. Best upgrades USHEALTH

A.M. Best has upgraded the financial strength rating to "B (Fair)" from "B- (Fair)" and the issuer credit ratings to "bb" from "bb-" for the subsidiaries of USHEALTH Group, which include Freedom Life Insurance Company of America (Freedom Life) and National Foundation Life Insurance Company.

The outlook for all ratings has been revised to stable from positive.

The rating upgrades reflect USHEALTH Group's successful strategy to focus on products that

are not subject to the Patient Protection and Affordable Care Act (PPACA)—the sales of which resulted in profitable growth, strong operating results and improved capitalisation.

In addition, the holding company repaid a portion of its debt and refinanced the remaining portion on more favorable terms during the Q1 2014.

USHEALTH Group remains focused on further enhancing its "exempt" and ancillary product offerings, expanding captive distribution into new geographies and maintaining long-term customer relationships as a means of increasing its scale and brand recognition in the marketplace.

Partially offsetting these positive rating factors is USHEALTH Group's need to service its remaining debt. A.M. Best claims that USHEALTH Group's capital and surplus growth will be impeded by debt service, as it relies partially on dividends from Freedom Life to repay its debt in the next few years.

Sunset Capital to create first captive

Financial services firm Sunset Capital Assets is to form and license its first captive insurance company, Sunset Capital Assurance.

The captive is being formed through Sunset Capital's subsidiary company Alternative Risk Concepts (ARC). Sunset Capital Assurance will be a segregated portfolio company domiciled in the Cayman Islands for the purpose of

developing other segregated portfolios or cell captives within the company.

The first captive cell to be licensed will provide workers' compensation coverage to the staffing industry with premium estimates in excess of \$20 million within the first three years. Other captive cells are in various stages of development and represent several different industries and lines of insurance coverage.

Monica Thomason, principal of ARC, stated: "We firmly believe it's time we bring the benefits of captives to small and mid-sized organisations. We are excited to be able to offer affordable and flexible options to companies looking to create better, more cost-effective risk management and insurance programmes."

"One of the unique advantages of the Sunset Capital captive is the expertise and resources we offer in the development of startup programs and the capacity to partner with our clients and take risk with them. This option allows us to provide real, value-added services to our clients and to distinguish our offerings from others in the alternative risk market."

Bert Watson, chairman of Sunset Capital Assets, commented: "The incremental benefits and expertise this revenue source will bring to our partners, joint ventures, clients and financial platform of services is very appealing. Our projections estimate Sunset Capital Assurance will add \$11.5 million in earnings per year to our firm."

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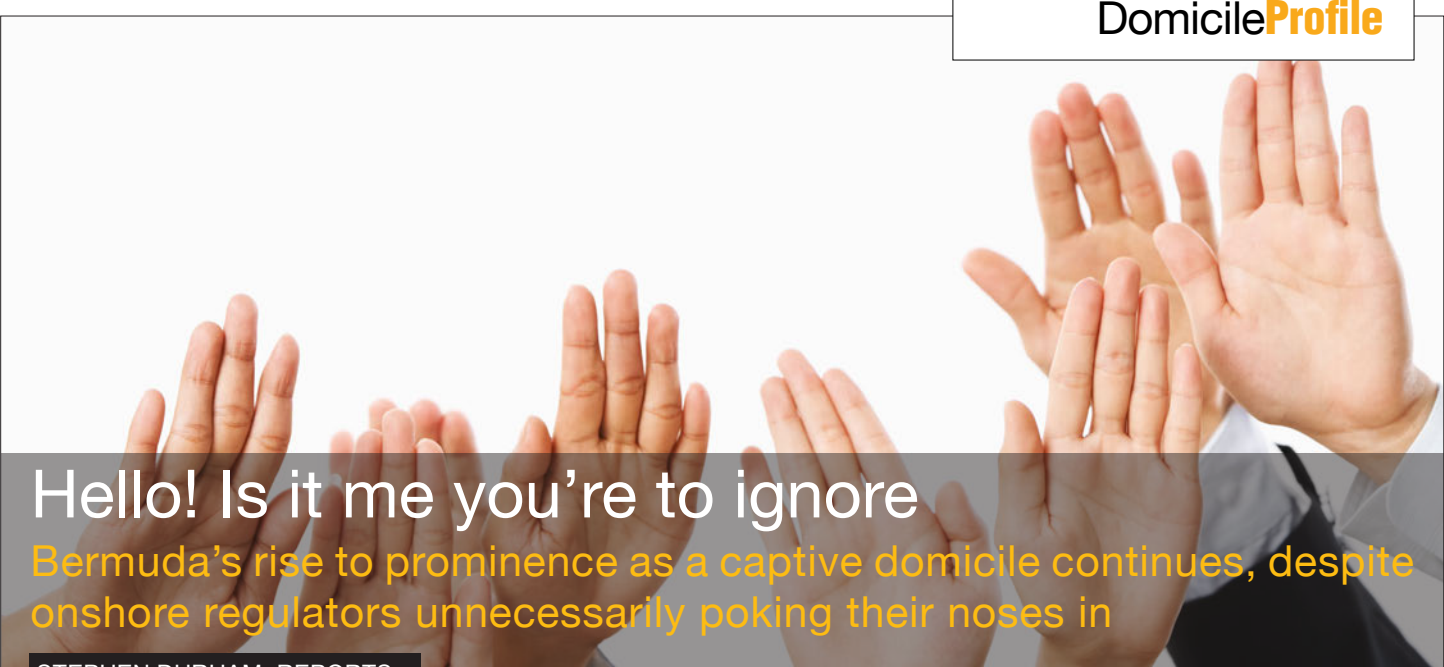
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Hello! Is it me you're to ignore

Bermuda's rise to prominence as a captive domicile continues, despite onshore regulators unnecessarily poking their noses in

STEPHEN DURHAM REPORTS

Bermuda has a developed captive market that has been active since Fred Reiss set up the first captive, International Risk Management, in 1962. More than 50 years later, new captive incorporations continue to come from a wide variety of industries.

The Bermuda Monetary Authority (BMA) was the first insurance supervisor to participate in the National Association of Insurance Commissioners's (NAIC) expedited process for approving qualified jurisdictions, and remains at the forefront of changes to and cooperation with its international supervision peer group.

There are currently 831 captives active in Bermuda, according to a BMA spokesperson. The number of new captives registered in Bermuda in 2013 doubled the totals recorded in 2012, with 24 new captives registered in 2013 compared to 12 in 2012.

So does this mean that a domicile such as Bermuda is that established that it no longer has to work to attract new clients? CEO of JLTGroup, Killian Whelan, claims that this is not the case.

"Bermuda is certainly not adopting the attitude that biggest is best and the clients will simply come to our shores. Indeed, in the last couple of years, the Bermuda Business Development Agency (BDA) was formed in order to promote all forms of international business in Bermuda, and not just captive insurance."

"The BDA has established focus groups for each industry sector, including one for the captive industry. The captive focus group is comprised of over 30 professionals from across the industry, including managers, lawyers, accounting firms, banking and investment managers."

In addition to the main captive focus groups, additional sub-focus groups have also been

established that target specific markets including Latin America, Canada and the US.

Despite this infrastructure and pedigree, growth has not been as rapid as usual in recent years.

Due to the growth of onshore US domiciles, there has been a significant decline in US-owned captives in particular. This slowdown has also been compounded by the emergence of companies in Latin America that are looking to use captives in their insurance and risk management programmes.

Regardless of this slight drop, Bermuda's captive sector wrote \$46.1 billion in gross premiums in Q1 2014 and reported total assets of \$145.6 billion. In the same period the reported capital and surplus for the sector was \$57.1 billion.

While the country offers a wide range of captive products, new entities known as segregated accounts companies (SAC) are on the rise in Bermuda, leading to more international interest.

Middle market companies looking to establish captive programmes in a more cost efficient fashion than a stand alone captive have been exploring Bermuda's SAC options.

Whelan says: "Another trend we are seeing is companies with diverse business divisions, be they through industry type or varied ownership structure, incorporating a captive insurer and structuring it as an SAC. In doing so, these companies can create a group wide captive strategy but ensure segregation of risk by business unit or group company, as appropriate."

Bermuda's captive industry has also been buoyed recently by a domestic company's victory in a prominent legal case. In the Rent-A-Center case, the US's Internal Revenue Service (IRS) argued that the company's captive was created solely to create federal tax benefits.

But the US Tax Court ruled in January that payments to Rent-a-Center's wholly owned captive, located in Bermuda, were deductible as an insurance expense.

The Tax Court majority found that the Bermuda-based captive is a genuine insurance company because it was created for significant, non-tax reasons and that there was no impermissible circular flow of funds.

It also ruled that the premium payments made by the taxpayer's subsidiaries to the captive insurance subsidiary are deductible.

Whelan states: "The Rent-A-Center victory is a victory for the captive industry as a whole and not just Bermuda. There has been a long running battle for many years between the captive industry and the IRS, which regularly challenges its legitimacy."

"This victory reaffirms that if the intent is there to develop and operate a captive in the way an insurance company should, captive owners can feel a more confident that the IRS won't challenge their captives' legitimacy."

In Bermuda, meanwhile, it's business as usual.

A spokesperson for the BMA comments: "The Bermuda Monetary Authority continues to meet international regulatory standards and apply them in a way that is appropriate for the risk characteristics of the Bermuda market and implement change in a measured, pragmatic way."

"Bermuda remains the domicile of choice for new captives because of the unique access our entities have to one of the world's largest reinsurance markets, a deep and experienced talent pool of captive insurance expertise with a global reputation for innovation and excellence and our effective and practical regulatory environment." **CIT**

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Where everybody knows your aim

Guernsey is well suited to acting as a captive domicile with the advantage of having in insurance and fund investment experts located in one place

STEPHEN DURHAM REPORTS

An influx of new clients has bolstered Guernsey's portfolio with figures as of the end of March 2014 revealing that there are a total of 790 international insurers licensed on the island, comprising 243 limited companies, 70 protected cell companies (PCCs), 439 PCC cells, 8 incorporated cell companies (ICCs) and 30 ICC cells.

This compares to a total of 752 international insurers being licensed by the Guernsey Financial Services Commission (GFSC), at the end of March 2013, which means there was net growth of 38 entities during the 12 months. This also means there has been net growth of 32 entities in the first three months of 2014, as there was only 758 international insurance entities licensed in Guernsey at the end of December 2013.

Further data on some of the more newly licensed entities also shows that their owners' geographical origin is approximately split into thirds: one third from the UK; one third from the Cayman Islands; and one third from other jurisdictions including Ireland, Luxembourg, Switzerland, Bermuda, the US, Singapore, South Africa and Australia.

The country prides itself on strength in depth across both the insurance and investment sectors, which means that Guernsey is ideally placed to serve as a 'one-stop-shop' for potential investors, able to deal with every facet of a transaction. The island also has its own recognised stock exchange, the Channel Islands Securities Exchange.

Unlike some of its competitors, Guernsey is able to provide investment funds internally

as well as expertise on entities such as catastrophe bonds.

The island currently has a large cat bond in the pipeline although, due to the private nature of these types of entities, the details remain under wraps at the time of printing.

Although Guernsey has long been thought of as a traditional captive domicile, this continuing evolution and geographical expansion is thanks, in part, to new entities related to insurance-linked securities (ILS) transactions, as well as the steady stream of more conventional captive insurance vehicles.

Fiona Le Poidevin, chief executive of Guernsey Finance, explains: "It was a relatively organic process."

"Aon moved into this space around 10 years ago and the industry has since grown to include newer captive managers such as Robus, which conducts a lot of ILS business."

"The industry itself has seen a boost and there is a record high in the ILS market. Fitch recently stated that there is a record amount of capital in the market and this growth could continue. Guernsey currently has the most ILS companies listed on the stock exchange outside of the UK. Despite this, a potential manager cannot go into ILS lightly, and a great deal of advice is required from actuaries and insurers alike."

ILS vehicles in Guernsey are regulated under the normal insurance law, while the investment division of the GFSC regulates any investment funds, under the securities law. But

there are a number of conditions, depending on what types of funds are being set up and the identity of investors.

Le Poidevin goes on to say that "sophisticated institutes such as reinsurers and specialist outfits that understand the asset class itself" tend to invest in ILS vehicles.

This sophistication is exemplified by the bespoke nature of the ILS, and as each entity is tailored to suit the individual owner, it becomes more lucrative for advisors and clients alike, as the structure they have works to their specifications exactly.

Despite the complexity of these structures, many potential investors are now being tempted into the market after seeing ILS successes in Guernsey and, to a lesser extent, Bermuda and New York.

Le Poidevin says: "Our work is more bespoke than many of our competitors, though we attempt to make it as accessible as possible. Bermuda may have more off the shelf, simple transactions but Guernsey has seen more bespoke structures and therefore we see a lot of variety. There is continuing growth in our ILS market and the figures speak for themselves."

"We are continuing to see growth in the number of captives coming to the island and we are keen to show that Guernsey is not a one trick pony when it comes to insurance."

"We have a variety of structures across the industry and, because we have over 20 captive managers on the island, there is a huge amount of expertise." CIT



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Rate-creep impact

Colleen McHugh of Barclays Wealth & Investment Management looks at the impact of rising interest rates on captives domiciled in Guernsey

In response to the financial crisis of 2008, central banks across the world opened their monetary floodgates to stem the deluge and revive their economies.

It was half a decade ago that both the Federal Reserve and Bank of England lowered their respective base rates to the unprecedented levels of 25 and 50 basis points, where they have languished ever since.

As interest rates are already close to zero, the next move can only be upwards, although we cannot predict when that will happen and how fast they may go up. Economic indicators are forecasting 25-basis point rate rises in the UK

and US at some point in 2015, with commentators suggesting that the Bank of England may raise rates first.

In Guernsey and throughout the developed world, savers, investors and creditors alike await the reversal of monetary stimuli and with it the long expected uptick in interest rates. The eventual interest rate rise, when it comes, will affect each group differently.

For savers, an interest rate rise will bring some relief, but it will not unfortunately allow these assets to keep pace with the level of inflation. Investors, but particularly creditors, are unlikely to welcome the rise in rates.

Reading the financial press, it is not unusual to see many articles attributing the stock market rally since 2009 to nothing more than the super-easy monetary policies of various central banks.

Obviously, near-zero interest rates and the Federal Reserve and Bank of England's quantitative easing programmes have provided rocket fuel for the stock market. Central banks' 'put', as it has been called, makes stocks (and particularly stock dividends) attractive relative to bonds and cash.

Investors have been encouraged to buy riskier assets as global central banks unleashed



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unprecedented monetary stimulus. Indeed, recently Daniel Tarullo, a Federal Reserve governor, said that loose monetary policy might encourage investors to take dangerous risks as they "reach for yield".

Concern that policies will be reviewed as economic data both in the US and UK proves strong is causing increased volatility in global markets. In February, many asset classes experienced marked sell offs with the S&P and FTSE 100 falling more than 4 percent from their January starting points (later recovering these losses).

The VIX index (a widely used measure of market risk more commonly known as the investor fear gauge) spiked at 22, a level not seen since January 2013.

Data in the UK, for example, shows unemployment has now fallen below 7 percent for the first time since 2009. In the US, inflation—the great enemy of both stock and bond investors—is low.

The economy, following the most severe economic downturn since the Great Depression, is finally gathering strength and consumer spending is up.

Unemployment is high but coming down and the real estate market is on the rebound. US household net worth has just hit an all-time high and corporate balance sheets are healthy with more than \$2 trillion in cash.

We are also in a period of record corporate profits and record profit margins—even if many believe such corporate profits are due exclusively to zero short-term rates and quantitative easing.

Economic data aside, much of the current volatility we see in global markets can also be ascribed to political instability. The uncertainty in Ukraine is having an impact across all asset classes.

Positively on the fixed income side, it's lowering yields and we've seen the 10-year UK gilt and 10-year US treasury fall from 3 percent in December to around 2.6 percent currently.

A combination therefore of improving economic data and political unrest is causing jitters among investors, with some calling the end of the equity bull market we've been in since 2009.

What's ironic is that the improving economic data, which theoretically is good and means the economy is finally coming off the life support machine, is having a perverse negative impact on asset prices, at least in the short term.

Guernsey, as the fourth largest captive domicile in the world with some £23 billion of assets in the jurisdiction, has not remained immune to the economic dislocation. Prior to 2008, captives could achieve 5 percent-plus on a 12-month fixed deposit.

The yield on cash deposits alone was often sufficient to cover the operating costs of a captive, and therefore many were self-funding.

The interest rate environment is very different today and although we may see a small uptick next year, realistically, we are many years away from 5 percent. Indeed, the Economist magazine recently predicted that short-term rates in the UK will still be just 2 percent in early 2017.

How, therefore, have Guernsey captive insurers managed their assets these past six years? According to analysis from the Guernsey Financial Services Commission, currently a little over half of gross assets held by international insurers (excluding life assets) are loans to parents.

This is hardly surprising given the low yield currently available on cash, as well as the supportive regulatory regime for captive insurers in Guernsey, which permits such loan backs.

Loan backs aside, there are alternative options to consider for a captive insurer's assets. Cash will continue to form the core of many captive insurers' assets, as cash does something no other asset class does—it protects. While providing high levels of security and liquidity, as I have already pointed out, it currently yields low returns.

A short-dated bond portfolio is another option with a typical duration of 18 months, and high credit quality.

The objective of such a portfolio is first and foremost capital preservation, but it will also provide liquidity, counterparty diversification and hopefully yield pickup in excess of cash. The important thing to remember is that the portfolio tries to pick up yield, but not at the expense of the other objectives. Consequently, you may only see a 100-basis point return on this type of portfolio (duration dependent).

This won't help you out-perform inflation, but it will generate yield slightly better than cash, while not being overly sensitive to an increase in interest rates. Remember, bond prices are affected by rising interest rates, but shorter duration portfolios won't be as sensitive to rising interest rates compared to longer-dated bonds. That's why short-dated bonds are a good first step out of cash for any captive insurer.

High-yield bonds are interesting. Again, they're not so sensitive to rising interest rates. What they are sensitive to is credit default, but in the current climate of improving data, credit default is less of a concern in the fixed income space in contrast to interest rate risk, for example. However, I would caution that there isn't as much value in high yield at the moment, and prices have got a little bit ahead of themselves.

Importantly equities are an asset class that captives could look at. What we've seen over

the last few years is that captive insurers have endured much opportunity cost through avoidance of any allocation to equities. Of course, some will say the whole point of the captive insurer is that it can't take risk with the assets. Those assets have to be available to call upon if there's a claim. But cash isn't exactly the risk-free trade that captives perceive it to be—even with benign levels of inflation.

A larger and more mature captive could have a small allocation to equities. Such captives have the ability to estimate their likely future claims, and on the back of that analysis, they can implement a programme to match assets and liabilities.

Incoming premiums must be examined to understand if they're providing a surplus versus outgoings. Assets are then segregated into different categories—for instance, into core, operating and strategic cash. It's those strategic assets that could be invested in equities.

As many captives cannot tolerate typical equity-like volatility, one way for a captive insurer to invest in equities is through a risk-managed strategy, where the captive could gain exposure to the upside of equities but limit some of the risk through hedging. Captive insurers can have an allocation to equities, but the key is to manage the volatility by managing those market-to-market movements.

The phrase 'a rising tide lifts all boats' springs to mind when examining the impact of an eventual rising interest rate environment for Guernsey-domiciled captive insurers. Certainly, the improvements in the general economy will benefit captive insurers. However, without any dramatic uptick in interest rates, and even with benign levels of inflation, captive assets will continue to produce net negative annual returns.

A diversified approach to investment management must be employed. Incorporate a blend of instant cash, term deposits, money market funds, short maturity bonds, and risk-managed equity strategies. This will enhance returns with only limited impact on liquidity and risk. **CIT**



Colleen McHugh
Corporate investment adviser
Barclays Wealth & Investment Management

Stop chasing your audit trail

Audited financial statements are worthwhile, but invasive procedures that are expensive, redundant and self-serving are not, says Linda Nethery of Venture Captive Management

We're often asked: "Why do you have an audit performed on your clients' captives every year? It's an added expense." Our firm specialises in creating and managing captives for middle market clients. Yes, we do have annual audits performed, and here's why:

- As captive managers, it's our fiduciary responsibility. Simple as that: it's the right thing to do.
- All of our captives make money. In these times of financial instability, our captive owners are doing everything they know how to do to maintain profitable businesses, and their captives are an added profit centre. When our captive owners go to their financial institutions for whatever financial transaction they're making, that audited financial statement is just another 'arrow in their quiver' that supports their businesses.
- Many of our clients have health care-related businesses. They don't just have Internal Revenue Service (IRS) or cash flow concerns. They receive federal and state reimbursements and they have Medicare/Medicaid concerns. If their reimbursements are questioned, all reimbursements stop until the question is resolved. These clients cannot afford to have their insurance expenses called into question. Their audited financial statements go one step further in validating their insurance companies and protecting their reimbursements.

Even for offshore captives, these audits in the past have been primarily functions and procedures reviews. They are beginning to look more and more like forensic audits due to the 2009 implementation of the International Financial Reporting Standards (IFRS) for Small- and Medium-sized Entities (SMEs).

While these standards are less rigorous than those for public companies, their details become more and more time consuming. For example, it isn't enough to supply confirmation from financial institutions with electronic or faxed signatures. All confirmations must be original signatures, of which we keep a receipt, of course. In this electronic age, does this step guaranty more veracity or security?

One of the primary functions of the standards is to ascertain that the captive is, in fact, an insurance vehicle and not just an investment tool. While this may be 'spot on' for the 831(b) rulings for small insurance companies, most clients are just as concerned about their insurance benefits as they are about the financial implications. The two are not separable.

In keeping with our fiduciary responsibilities as a manager, IFRS for SME requires all payments from the captive to be supported by a contract or approved invoice. As simple and straightforward as this requirement appears, all of our telephone conversations must now be documented by a follow-up email, all of our meeting notes must be 'approved' by our clients—the list goes on. It's as cumbersome for clients as for accounting departments.

Clearly, the biggest impact for our clients is in the area of the captive's investments. While offshore venues tend to have broad guidelines for investments, the IFRS puts the captive manager in the spot of second-guessing its investment adviser by requiring additional verification of the values of investments held.

Captive managers are responsible for ascertaining that the methods used to attribute a value to the securities are appropriate and reflect the fair value. So where in the past we, as captive managers, relied on the professional expertise of our captive's investment advisers and their monthly statements to account for our clients' investments, we must now go to a third party source and validate our advisers' work—not just on a monthly basis, but also at year end.

We must know which sources our advisers' used for valuation and find another pricing source to corroborate that for each security held. The expectation is that we, as captive managers, know that investments are properly measured and carried on the books.

This oversight activity is not limited to investment advisors. Third party administrators and actuaries are also meant to adhere to more rigorous standards.

Captive managers are encouraged to use third party administrators that also have internal controls audits performed regularly. Auditors routinely request copies of SSAE16 (formerly SAS70) reports to validate the administrator's functions and procedures. And it's not enough just to provide randomly requested loss files in addition to monthly and annual loss runs. Third party administrators are requested to confirm the details in those files of loss expenses paid, expenses payable, reserves and reserving methods, and so on.

Third party administrators work hand-in-glove with actuaries. And it's the actuary's responsibility to take loss data and make educated guesses as to what the final payments and payout patterns will be based on mathematical

probabilities. It's a captive manager's responsibility to make sure that the actuaries are licensed and that they specialise in the line or lines of coverage of the captive being audited.

While this process is a few hundred years old and certain lines are more predictable than others, it's still an educated guess. Now what we see are auditors second guessing the 'guess'. When an actuarial firm submits a range of reserves from most aggressive to most conservative, auditors are requiring written statements from captive owners as to why they might have chosen any number but the mid-point.

There are as many reasons for maintaining a reserve number as there are for owners to decide to form a captive. When a professional offers their opinion, is it the outside audit firm's responsibility to discount that opinion?

These meticulous procedures are intended to add value to the audit and ferret out unscrupulous captive managers and their clients. Isn't it fascinating that it also increases billable hours?

As you can see, I'm a supporter of audited financial statements, but not of invasive procedures that are expensive, redundant and self-serving. I'm not convinced that the more stringent guidelines will prevent Enron-like companies from circumventing sound business practices, nor will it prevent unethical auditors from turning a blind eye to those unsound business practices.

In the mean time, captive managers are still charged with providing a business model that supports their clients' risk transfer needs and improves the ability of those clients to maximise their companies' profits. **CIT**



Linda Nethery
President/CEO
Venture Captive Management

British Virgin Islands in the spotlight

The foundations are firmly in place to maintain the BVI's longstanding position as one of the leading captive jurisdictions, says Martin Cooke of Hyperion Insurance Management

Recent years have seen a proliferation in the number of domiciles in the captive arena. Prospective captive owners are now faced with a plethora of options, both offshore and onshore. Owners not only have to give consideration to choosing a suitable service partner (note the choice of words, partner not provider) from a rapidly increasing pool of 'specialists', they now also have a growing list of domiciles to choose from.

Ranging from the longstanding establishment to the rookies and the reinvented, each has its unique advantages and disadvantages. The right service partner should be able to guide the prospective owner through this complicated maze, emerging on the other side with a domicile that not only matches the clients' ambitions, but affords them with them the optimum means of achieving them.

As any experienced manager will attest, one of the most important factors of a feasibility study is the choice of jurisdiction. For example, why should a client choose Montana over Anguilla? Why the Cayman Islands over Vermont, and perhaps a question more relative to this article, why the British Virgin Islands (BVI)?

Religious teachings tell of how the wise old man built his house upon the rock. Such foresight can be likened to choosing a domicile for a captive. Such as the house built on the sand, while a captive can be established expeditiously with very few questions asked, it is equally important that owners look at the jurisdiction in its entirety, and not just one particular service area to help to ensure the longevity of the project.

The BVI is a British overseas territory. It is self-governing, with a legal system based on UK common law. The laws of the BVI are robust, however, given the status as a leading offshore finance centre, the laws are also very modern, dealing with company law, insolvency, banking law, trust law and insurance.

Furthermore, the BVI has long been established as a major financial service centre, with a strong presence in the investment fund and corporate services sectors as well as insurance.

For example, the jurisdiction is one of the world's premier company incorporation domiciles, with sophisticated infrastructure in place to ensure a smooth and efficient incorporation process. Figures show that more than one million companies have been established in the BVI, with approximately 50,000 new companies incorporated each year.

With regards to securities and investment business, the BVI is the second largest fund domicile globally. At the end of 2013, 2238 funds were registered and licensed by the BVI Financial Services Commission.

From an insurance standpoint, in excess of 400 captives have been licensed in the BVI since the enactment of the Insurance Act (1994), which has been enhanced and updated to the Insurance Act (2010).

From a regulatory standpoint, the BVI has implemented the highest standards of transparency, accountability and information exchange, as set out by the Organisation for Economic Co-operation and Development, the International Monetary Fund and other regulatory bodies. As a result, the extent and scope of local regulation generally exceeds that of most other offshore (and indeed onshore) jurisdictions.

In fact, the BVI is extremely well regarded by a number of international bodies. Our regulators remain active members of the Caribbean Financial Action Task Force (FATF) and played a prominent role in the working group that revised the FATF's anti-money laundering recommendations.

Some domiciles within the offshore industry have been tarnished of late with various tax avoidance/money laundering claims from the global powerhouses of Europe and the US. However, it is important to note that most offshore captives with a US parent generally make a 953(d) election. This means that they have elected to be taxed as if they were a US entity, ensuring full taxation transparency.

It is obviously essential for regulators and insurance managers in any jurisdiction to ensure that capitalisation is sufficient to support the net written premium and exposure levels attributed to the captive, particularly when third parties are exposed. However, for the likes of smaller captives, particularly those qualifying as 831(b) captives, the non-discriminatory requirements of offshore domiciles can have a significant impact on a risk manager's feasibility assessment.

Cost-efficient operating expenses and the absence of direct corporate taxes and premium taxes give us a clear and distinct advantage over our competitors. Other benefits of doing business include the fact that, while BVI-based board meetings are encouraged, they are not mandatory.

Likewise, just as owners have a number of BVI-based audit practitioners of international standing to appoint, they are also able to apply to the BVI Financial Services Commission for 'non-BVI' audit firms to be admitted. Banking assets are not required to be held in BVI facilities, enabling the client to maintain the strong banking relationships it has already built through years of business.

The BVI prides itself on the strength of its service providers. These include all of the leading offshore law firms and big four accounting practices, together with other experienced services providers and insurance managers, providing the jurisdiction with a strong service platform for its clients.

The fee structure remains competitive and significantly lower than many of its offshore and onshore peers.

There are also plans underway to implement a tiered licence fee structure to ensure that fee levels are directly linked to an insurer's or reinsurer's size and ability to pay. These are expected to be implemented in late 2014.

In summary, the BVI is well-positioned to compete in the international financial services arena, primarily as a result of its ability to combine commerciality with adequate regulatory controls. With an active insurance managers association (www.bviaim.org), ensuring constant communication between the private sector, the BVI Financial Services Commission and legislators, the foundations remain firmly in place to maintain the BVI's longstanding position as one of the leading captive insurance jurisdictions. **CIT**



Martin Cooke
Insurance associate
Hyperion Insurance Management (BVI) Limited



HM GOVERNMENT OF GIBRALTAR

European financial services centre

International financial
centre within the EU

Direct access to
EU single market in
financial services

Regulated to EU
and UK standards

Attractive fiscal
environment

High-quality
infrastructure



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That's what friends are for

While you could be forgiven for imagining the US captive industry as a solely competitive arena, the states of Arizona, Missouri and Utah have allied to advocate the rewards that come from solidarity

STEPHEN DURHAM REPORTS

What have been some of the primary drivers for joining together for the WRCIC conference?

David Snowball: Individual states would not be able to bring enough people to the conference, which would be a financial strain on the state of Utah. By banding together it is more cost effective and better for networking. This is a cooperative industry to some extent. As states, we compete to be the domicile of choice, but at the same time feel the need to assist and protect each other and the industry itself. The opportunities are too vast for just one player and so we must cooperate.

Maria Sheffield: With the proliferation of captive domiciles it has become increasingly difficult for people in the captive industry to attend all of the various captive related events being held in each state. In consideration of this fact, we thought it would be helpful to partner with other states in our region to host a conference encompassing various domiciles. The involvement of multiple domiciles increases the dissemination of information and hopefully leads to better regulation of the captive industry in our various states.

Could you give us an idea of what the overarching theme of the conference will be, and what are you looking forward to individually?

Snowball: The overriding purpose of all conferences is networking and getting better acquainted in the industry. The connections we make are the lifeblood of our business as owners, managers, auditors, actuaries, attorneys,

domiciles and the list goes on. Education is also key to progression and at the conference, global business and captive forecasts will be provided, along with the opportunity to receive instruction in other areas such as taxes, and what will drive the future of captives.

It is also a great place to bring captive owners and prospective owners together, in order to get a better feel for the industry and learn more about what they have the potential of achieving with their captive.

Sheffield: The main purpose of a captive is to provide a mechanism for companies to control risk. I think every captive conference strives to provide the education and tools to business owners to allow them to make appropriate risk management decisions for their companies.

The theme of this year's conference is, Back to the Future, Looking Back to See What's Ahead. As with all captive conferences I attend, I look forward to the educational sessions, meeting with both current and potential captive owners, and networking with captive service providers and fellow regulators.

With the proliferation of US captive domiciles, what are you doing to distinguish yourselves and what can be learnt from the competition?

Snowball: We have made a reputation for being fast, fair and competent in this industry. It has been important for us to help those along with less experience so we maintain a strong regulatory backbone for the industry to rely on for the future. There is plenty of business available so we do not have to cut each other in

order to survive. We need to build each other up for the stability of the industry.

Sheffield: From my perspective, I do not think of other domiciles as "the competition". Our focus in Missouri is creating a sound and solid captive regulatory environment that serves as an asset to companies doing business in the state.

We do this by being both responsible and responsive to the needs of the business community and the captive industry.

Our focus is not on the number of captives in our state, but rather the quality of the captives doing business in our state.

While our laws are competitive with other captive domiciles, it is not the law that makes Missouri a top domicile, it is the way in which the law is administered by the experienced team we have in place that is both knowledgeable and accessible.

With more domiciles favouring 831(b) captives, how do you expect the captive industry to look in five years?

Snowball: The business middle market is vast and the time has come when it really can be an advantage for business people to understand the benefits of a captive and then take advantage. It is not for everyone though and we need to diligently work as regulators and captive managers to make sure that we do not seek other captive benefits before the insurance benefit.

“ We have made a reputation for being fast, fair and competent in this industry. It has been important for us to help those along with less experience so we maintain a strong regulatory backbone for the industry to rely on for the future ”

David Snowball, captive division director, Utah Insurance Department



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We consider every captive applicant on the merits of its application and carefully review every captive application to ensure compliance with our laws and regulations

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Maria Sheffield, captive programme manager, Missouri Department of Insurance



As an industry, we must always be diligent to protect what we have and help business to achieve their goals, but not at the expense of the industry.

Sheffield: 831(b) captives are undoubtedly appropriate for certain businesses and are allowed under Missouri law. However, we have not structured our captive programme in Missouri in such a way that we focus on, or favour, this specific type of captive structure. We consider every captive applicant on the merits of its application and carefully review every captive application to ensure compliance with our laws and regulations.

The overall health of our captive industry in the State of Missouri is more important than the number of captives we license each year. We believe steady growth and sustainability is key to a successful captive programme.

How do state regulators feel about captives drawing their parent companies' young employees away from healthcare exchanges?

Snowball: The Affordable Care Act (ACA) includes provisions that dissuade an employer from splitting their employees and sending unhealthy employees to the exchange.

The employers are required to provide similar coverage to all employees within class, eliminating the ability to provide highly compensated individuals a richer benefit plan, rather than a plan provided to all other employees. Additionally, maintaining coverage for only younger individuals, and sending older, sicker employees to the healthcare exchanges may be considered discrimination.

States are closely observing the markets and are keenly aware of the possible risk issues with the individual markets. There are several factors that may contribute to the possible failure of the individual markets.

The ACA does include some controls to manage the issue. Individuals wishing to apply for coverage in an exchange are limited to an annual open enrollment period, unless they are eligible for a special enrollment period.

An employee who is eligible for an employer plan may not receive the advanced premium tax credit (APTC) on the individual exchanges. An employer may be penalised when an employee does purchase a plan on an exchange, and receives an APTC.

The ACA includes provisions to assist the individual exchange until the markets are able to stabilise.

What other regulatory issues are important for your state at the moment?

Snowball: Of national concern are the XXX and XXXX issues of life insurance companies shifting reserves off to their captives. Many in the captive industry are concerned that the National Association of Insurance Commissioners (NAIC) is trying to take a broad swipe to remedy the issue, which could hurt many captive owners in the process.

There was a proposal at the last NAIC meeting to broaden the definition of a multistate reinsurer for purposes of credit for reinsurance.

The proposed definition would not only cover the life insurers passing their reserves to captive subsidiaries, but could also have reach in group captives and even small captives who use pooling arrangements. Suggestions are currently being sent to the NAIC to change that language to make it less invasive on the captive industry.

Sheffield: We currently do not have any immediate plans to make any revisions to our captive insurance laws as those we have in place now are working well for our state. Generally, we continue to focus on solvency modernisation initiatives that are important to both the captive insurance industry and the insurance industry generally. **CIT**

WRCIC 2014
WESTERN REGION CAPTIVE
INSURANCE CONFERENCE
MAY 2014
MARRIOTT CITY CENTER
SALT LAKE CITY UTAH

AzCIA Arizona Captive Insurance Association
MOCIA Missouri Captive Insurance Association
UCIA Utah Captive Insurance Association



Do not adjust your corporation

Philip Box of Cunningham Lindsey looks at the demands that captives and risk managers place on their adjusters

Over the last decade, businesses in the developed world have struggled to adapt to competitive pressures imposed by the globalisation of markets. As part of their response, organisations have reduced costs and improved control over losses by retaining increasing amounts of risk.

At the same time, companies are concentrating their resources and capabilities on their core businesses, outsourcing those activities that can be done better and cheaper by service specialists. These changes have had major impacts on the insurance industry and the adjuster's role has had to cope with some major differences in working practices.

In the past, adjusters were almost always appointed by or reported to Insurers. The remarkable growth of the risk transfer market, driven by trends towards companies retaining

more risk and outsourcing, has created an ever expanding market for adjusting services. The impartiality of the claims adjusting firms allow them to work for several customers simultaneously as information comes to light during the claims process. As the loss level increases, the adjuster will work for various layers, ranging from the insured business unit, to the captive and the excess layer insurers and/or reinsurers.

Most captives will have outsourced to captive managers whose main role is to handle the legal and financial aspects of the captive, unlike the traditional insurance company where insurers may have a substantial claims department presence in many corners of the globe.

The adjuster is therefore called on to provide extra services to captives that they would not ordinarily perform for commercial insurers. One of the most important of these services is

to act as the first point of contact for claims instructions, either direct from the local business unit or from risk management. Many captives now provide the adjuster with the authority to take steps on their and the corporation's behalf to approve immediate steps to mitigate the physical damage and potential business interruption. This can include assistance with the recommendation to the business unit of reputable contractors to conduct urgent emergency and protective works, debris clearance, assistance with the appointment of reputable restoration and salvage companies, and legal representation should there be subrogation issues.

These services are provided on a worldwide basis through the adjuster's network of global offices, which have local knowledge of reputable building contractors, restoration experts, and attorneys.

With the advent of web-based services, local business units throughout the world are able to provide important claims data directly into adjuster-hosted websites from which information is instantly submitted or made accessible to risk management, captives, brokers and insurers, depending upon the pre-agreed claims procedures of the global programme.

The ever increasing use of web-based cloud services also enables the easy sharing of information among many parties involved in a claim. These web-based electronic tools considerably enhance the speed and efficiency of communication and, therefore, action, which is so important in the early stages of a loss.

The adjuster is therefore able to seamlessly provide information to a variety of clients as clients change, in effect working for several customers simultaneously and ensuring that they receive accurate and timely information. Adjusters are now routinely called on to maintain a database of all the corporation's claims on a global basis from ground up, ensuring the provision of reliable data to risk management departments, brokers and insurers. The provision of accurate loss information from an impartial party is of great assistance when renewal negotiations commence.

The continuing trends of globalisation and higher retention levels by corporations coupled with continued outsourcing of non-core business means that there will be an increasing need for adjusters with the appropriate skills and extensive global network. The increasing complexity of global business is reflected in the complexity of losses that it produces, and the adjuster's loss-related services have had to change rapidly to keep up with these changes and anticipated future changes.

Risks managers and captives are now looking to adjusters to provide a one-stop shop to handle many more aspects of their claims situations globally. Adjusters are tasked with more loss management functions for local business units in order to free up the local management so that they can focus on returning the business to normal operations.

The larger adjusting companies now have either in-house or through owned subsidiaries, building surveyors, engineers, and accountants, all of which are of enormous benefit to corporations and their captives in mitigating losses and freeing up local operational personnel.

International adjusting firms have considerable experience of disaster situations and can offer ideas and advice to local management, who are often world leaders in managing their particular operations under normal circumstances, but find themselves overwhelmed when faced with a serious loss situation. Local management will often lean on the international adjuster's previous experience of simi-

lar situations, and appreciate the adjuster's ideas for solutions, particularly to business interruption impacts.

The adjuster can offer suggestions to management for rearranging production when faced with reduced production capacity in order to focus on higher margin products. They can also offer suggestions for outsourcing, temporary repairs, temporary storage and the setting up of temporary production facilities in undamaged sections of the business unit site.

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The adjuster will also work closely with local and global management to help put into operation existing global catastrophe plans that relocate production to other production facilities throughout the world, or work with management to refine existing disaster plans where these do not fully reflect the existing circumstances at the time of the incident. There is a growing realisation by risks managers of the importance of the services to be offered by global adjusting firms in assisting business operations' management, most of whom have never faced the chaotic situation that can follow a catastrophic incident. This is resulting in the adjusting firm being looked on as an important arm of the total risk management service delivery to the organisation.

Adjusters are also increasingly being asked to provide clerk of works services to monitor material and labour utilisation, as well as and material contracts, which have to be entered into in emergency situations as there is not time for a formal bid process. The adjuster's wealth of knowledge of local labour and material rates from their in-house building experts can remove this onerous and time consuming task from the local business unit or the global organisation as a whole, to enable them to focus on recommencement of the business.

The provision of the clerk of works services can be extended to monitoring the time and material utilisation of restoration contractors. Adjusting firms can also provide audit assistance either through their own resources or specialist, forensic accountants to supplement the huge amount of additional financial data that will suddenly be required by the numerous parties involved in a major claim. This assistance helps to prevent local management delays, incorrect data and improperly submitted data, which can occur due to lack of experience of claim situations or lack of time to properly concentrate on the additional workload.

Increasingly, corporations' risk management departments, brokers and insurers are seeing the benefit of having one nominated global, impartial adjusting firm to undertake a greater range of services rather than the traditional scrum of multiple parties' teams of experts, all with their own demands on local and global management bringing stress to an already stressful situation.

It is in the interest of all parties to a global insurance programme that the utmost is done to relieve stress on local business managers as their time spent on reinstating and recommencing business is a far better value proposition than diverting their limited management hours to communicating with myriad 'experts'.

Global adjusting firms can therefore be anticipated to broaden the range of their service offerings to meet the above-mentioned demands from global corporations, as well as continue to expand their existing service offerings throughout their global networks.

The adjuster's traditional role of coordinating these services from external sources is now of immense value in coordination of these sources internally. This, coupled with the employment of specialists with technical focus and experience of loss situations, offers considerable opportunities for adjusting firms and their clients in the better management of disaster situations. **CIT**



Philip Box
Executive general adjuster, major and complex
loss team
Cunningham Lindsey



Growing interest in captive cells: who and why?

Large companies have been able benefit from captives for years. Now, companies that do not own one are looking to do the same, and captive cells may be the answer, says David White of AIG

At AIG, we are seeing a growing interest in captive programmes from smaller and medium-sized companies that are often new to the captive concept. Committing resources and capital needed to form and manage a stand-alone captive might not be the right first step for these companies. The right answer may be a rent-a-captive cell where their risk is retained in an account that is legally and contractually segregated from other companies.

Bermuda originated the cell concept more than 20 years ago and permits a segregated accounts company (SAC) to create and rent out segregated accounts.

Other jurisdictions have implemented similar structures such as the sponsored captive insurance company (sponsored captive) in Vermont and other parts of the US, protected cell companies (PCCs) in Guernsey, and series limited liability companies (series LLCs) in Delaware and other US domiciles.

Also effective in 2013, existing Vermont captives have the option to establish separate accounts (SA) in their current structure, which may alleviate the need for relicensing as a sponsored captive.

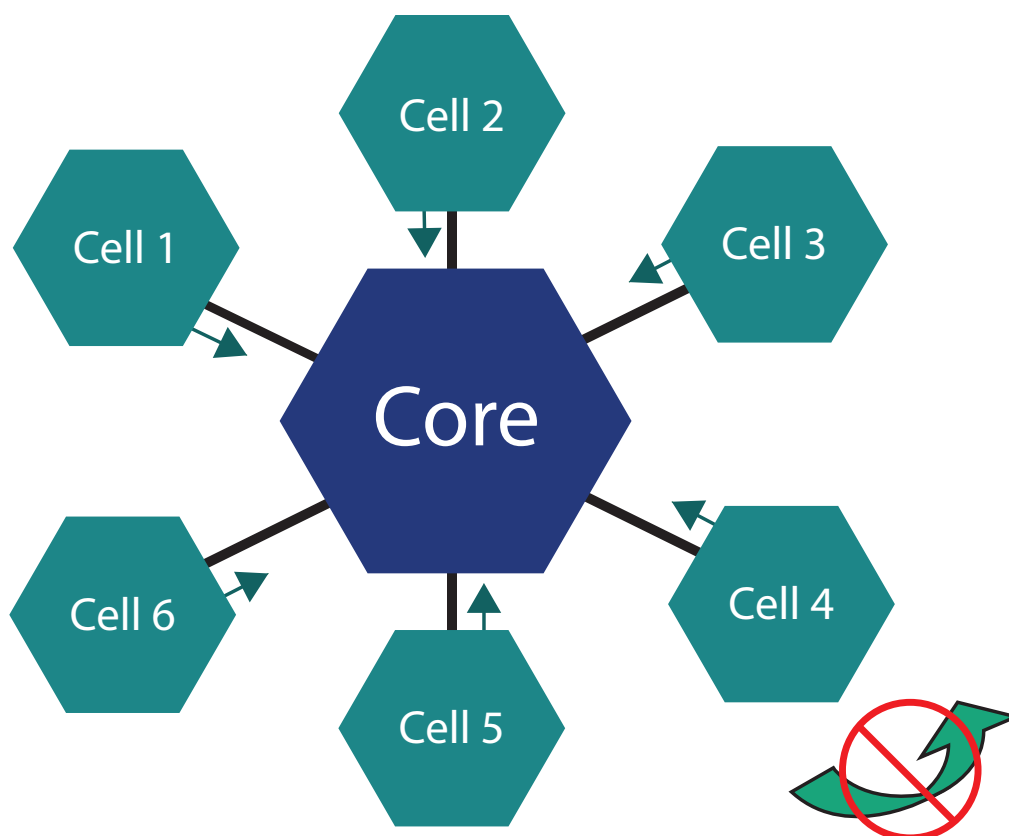
As you can see, there are varying names and locations, each having different legislation

and rules that may need to be analysed prior to selecting a facility.

For all of the varieties, the industry often refers to these types of facilities as 'rent-a-captive' structures. I prefer to use the term 'captive cell' when referring to a rented segregated account.

What is a rent-a-captive cell facility?

As illustrated in the diagram overleaf, a cell facility has a core where the owner of the facility holds the regulatory capital and the insurance license, and runs the day-to-day operations of the company.



The cell facility then contracts with many different third-party clients to form individual cells. Each cell is segregated from the others so that insurance risk, liabilities, assets and other pertinent information are not shared.

In some cases, cells can choose to transact with each other if legislation permits, but the different cells are often unaware of each other.

Some cell facilities issue shares to each cell owner, while others use participation contracts to agree on the terms, rights and obligations of the cell participant. Capital or collateral funding levels may vary depending on the facility or domicile requirements.

Some cell facilities are just one legal entity with multiple cells, whereas other facilities allow for the incorporation of individual cells and so have multiple separate legal entities.

There can be other differences too, such as how the cell facility allocates and charges operating expenses to each cell.

What is a captive cell and how does it work?

A captive cell provides many of the benefits of a standalone captive insurance company, including features that allow the insured to retain a certain proportion of its risks and better manage the associated costs, without the full operating costs of a standalone captive. The key features of a captive cell are:

Formation and capital

- Cells can be formed quickly with minimal start-up costs as compared with a standalone captive.
- Participants sign a participation or similar agreement defining the rights and obligations of the cell.
- Assets and liabilities of each cell are legally segregated.
- The owner of the cell facility generally maintains the minimum core capital as required by the local regulator.
- Participants have no ownership interest in the cell facility but may need to post collateral to a fronting company and/or contribute funds to its cell.

Underwriting

- Similar to a standalone captive, premiums from the insured are written by or ceded to the participant's cell, thereby providing the potential for underwriting and investment profits.
- Annual operating expenses can be significantly less for a cell than for a standalone captive.
- As with a standalone captive, there is potential for enhanced management and control over losses.
- Cells are available for most lines of business, such as general liability, professional liability, workers' compensation, property, warranty, trade credit, cyber risk and medical stop-loss.

- Depending on the line of coverage, a traditionally licensed insurance company may be needed to provide fronted policies on rated admitted paper, programme coordination, claims handling and reinsurance services.

Reporting and regulations

- Local regulatory requirements and administrative tasks are carried out by the owner of the cell facility.
- Unlike a standalone captive, a rented cell does not require a separate board of directors, which means less management time.
- Separate reporting is available to the participant that accounts for income statement activity such as premiums, losses and expenses, as well as the balance sheet position of the cell, including assets, liabilities and surplus of the segregated account.
- Individual cells may or may not receive their own audit report; this depends on the domicile, the cell facility and/or the needs of the insured participant. Typically, the entire facility is audited annually by an independent firm.
- For income tax purposes, each cell is typically treated as a separate entity from the cell facility. Depending upon the facility, its domicile, the location of the insured participant, or the insured risk, the participant may be responsible for filing applicable federal tax returns and paying any taxes resulting from the operations and assets of its cell.

More captive cell benefits

- A cell facility may provide participants with the opportunity to manage risks more effectively so that excess surplus can be distributed to its members. The cell's profit equals premium plus investment income, less claims and expenses.
- A cell may be a stepping stone to forming a fully owned captive, as cells are easily converted into standalone captives.
- Exiting a cell is quicker and easier than winding down a standalone captive.

Who might be interested in renting a captive cell?

Companies seeking an alternative risk management solution, without the costs or commitment associated with a standalone captive, are showing an increasing interest in captive cells.

Another characteristic of companies that would benefit from retaining risk in a captive cell is a loss history that is better than their industry's average. Similarly, if traditional market pricing does not yet reflect a company's improvements in loss control, a captive cell may be a more cost effective solution to managing that risk.

Ultimately, a company will benefit when premiums charged by the traditional insurance market are higher than fees and losses the company must pay when retaining risk in the captive cell.

Groups of small companies sometimes rent a cell together. We have seen groups assume portions of their premiums and losses related to their medical stop-loss policies.

This is often part of an overall strategy that involves self-insurance, along with wellness programmes to control losses, and cost reduction initiatives.

We often think of retaining risk in a captive structure as a way to save on the cost of insurance, but there are ways to use a cell as a new profit centre.

For example, a company might sell products that customers are likely to insure. The company might arrange for an insurance carrier to make that coverage available for purchase to its customers, and then reinsure that risk back to their captive cell.

That cell then receives premiums and pays losses, so the company ultimately shares in the underwriting profit on the insurance product. The captive cell becomes a profit centre capturing additional revenue from existing customers.

Captive cells may also benefit companies that:

- Already own a captive, but would like to segregate a portion of risk from their existing standalone captive programme;
- Need a short-term risk management solution (eg, a transition for captives in run-off or a loss portfolio transfer); and/or

- Have a risk that is difficult to address in the traditional insurance market and an appetite to share in the risk in order to achieve additional capacity and programme flexibility.

Where will captive cells come from?

There has been plenty of discussion about the saturation of the captive market and how most large US companies already have one or more captives. Despite that sentiment, we believe there is growth opportunity, and that growth is likely to come from three areas:

- Large and medium-sized European and US companies looking to retain more of their property and casualty risks such as their workers' compensation, general liability and property deductible layers.
- Small and medium-sized employers in the US grouping together with like-minded employers to share in a portion of the medical stop-loss layer as a part of an overall self-insurance strategy.
- Large companies in new emerging markets where they are not yet as familiar with captives but popularity is gaining due to the advantages captives can offer and the existing sophistication of these large companies. AIG looks forward to working with more Latin American and Asian companies to develop captive programmes.

What are some common alternatives to renting a captive cell?

For larger companies, a standalone captive might be more attractive than renting a cell because there is more control over the investments and operations.

A standalone captive might also offer a corporate structure that is more familiar to the parent company.

For smaller companies, joining a group captive can be appealing. A small company may be concerned about risk distribution and volatility of results when going it alone, and group captives can help stabilise results by having strength in numbers.

Group captives often provide the added advantages of experiencing a healthy level of peer pressure and the sharing of best practices for controlling losses.

Group captives involve sharing risk and that means being subject to the underwriting results of the entire group. While a company can take actions to directly impact its own loss results it may only have indirect influence at best on the loss results of an entire group.

This uncertainty may drive larger, more sophisticated and mature companies to rent their own captive cell or form their own standalone captive.

While group captives may be right for certain companies, renting a captive cell may be a better choice for companies that already keep

losses low, don't need additional pressure or tools from peers, and/or value the confidentiality of their programme.

It is generally best if companies renting their own captive cell have a corporate structure that supports sufficient risk distribution and enough size to achieve the law of large numbers, which provides stability and predictability of future losses.

Of course, a group captive can also rent a cell. AIG is home to numerous medical stop-loss group captive programmes that rent captive cells. We have the rare experience and capability of fronting for both property and casualty risks and medical benefits coverage. AIG Benefit Solutions provides rated medical stop-loss policies and can reinsure a portion of the risk to a captive cell that is being rented by a group of employers.

In the past two years, this has been a significant area of cell formation growth at AIG. Captive structures are known for focusing management attention on reducing losses. To see more focus on employee wellness initiatives as part of a captive and self-insurance strategy is a true aligning of everyone's best interests.

A captive cell programme is a relatively simple and inexpensive way for a company that is new to captives to gain experience and enjoy many of the benefits of retaining risk in a captive structure. We are excited about the business' opportunities for growth—both from new geographic markets and new types of companies in existing markets.

For years, our sponsored captive insurance company domiciled in Vermont has been providing captive cells to the alternative risk market, and we recently launched Grand Isle SAC Limited, a segregated accounts company in Bermuda.

Renting captive cells to our clients offers a great deal of synergy with our fronting and captive management business. We believe the process becomes stronger when the fronting carrier, cell facility and captive manager are all working together as one team. **CIT**



David White
Assistant director—captive management services
AIG Global Risk Solutions

More than just a link in the chain

Link insurance purchase strategy to risk management and financing efforts to realise a captive's maximum potential, says Stuart King of FR Global Advisors

It is little wonder that many finance leaders often consider a captive to be economically negative from a consolidated group perspective, given its income (premium) is a related business unit expense. However, I am not convinced that this is a true reflection of the positive benefits that a well-structured insurance purchase strategy linked to corporate objectives that optimises captive participation can provide.

It may benefit finance leaders to consider the widely cited statistic that the majority of corporates incur a total cost of risk (TCOR) of circa 1 percent of revenues (or 1 percent of the price of each product sold).

Therefore, considering a corporate with a bottom line margin of 15 percent of revenues, the 1 percent top-line impact translates to a circa 7 percent bottom-line impact. Earning volatility is something that I suspect many CEOs and CFOs seek to avoid—a well designed captive programme may aid understanding and controlling risk to reduce this volatility.

The argument often cited by risk and insurance managers is that a captive provides stability in commercial market premium and terms during times of market unrest.

This argument has perhaps changed of late, in part due to continued stable insurance market conditions following a number of recent world events.

The original drivers for establishing a captive are often overlooked where insurance typically 'renews as expiring', whereas the ultimate parents' needs may have materially changed. Captive owners would benefit by regularly challenging the captive's role to ensure that it remains fit for purpose and supports corporate strategies.

An optimised insurance programme often involves:

- Establishing corporate risks that are suitable for insurance protection;
- Analysing the financial tolerance of the corporate balance sheet and the board appetite towards risk retention;
- Understanding current insurance costs (both life and non-life) and adequacy of policy coverage;
- Designing a programme that links insurance purchase strategy to corporate strategy; and

- Performing own data statistical analysis and trending to market risk more effectively to underwriters.

When developing an insurance purchase strategy it is beneficial to map corporate risks (strategic, financial, hazard and operational) to available and purchased insurance covers. Understanding risks that pose a greater threat to a firm's well-being aids discussions when planning insurance renewals with brokers and underwriters.

Undertaking this approach can often identify duplications of cover, inadequate limits and areas of a corporate balance sheet that may benefit from insurable risk transfer and/or captive participation.

In deciding the amount of risk to retain there are a number of methodologies to establish a firm's financial tolerance and stress testing of analyst ratios. However, it is worth considering revenue and net earnings as the main items impacted—both directly influenced by risk management and financing efforts. Controlling and reducing associated costs has a direct positive impact on bottom-line results and operating margin ratios.

Understanding this impact is important when deciding how much risk to retain and how to fund.

Retention and captive strategies

Once a consolidated risk tolerance amount is established many captive owners may yield benefit to analyse and optimise the allocation between local business units and the captive.

This can often result in a reduction of frictional costs such as capital required in a captive and insurance premium-related taxes. In addition, in the event of a loss, it may be more efficient to absorb the loss against local country income versus the inability to utilise tax losses in zero-tax regime captive domiciles.

Retaining most of the risk in the captive naturally improves claims control and policy management, however, it is perhaps worth considering the cost/benefit in pursuing this strategy versus 'balance sheet funding'. If loss of control is a concern many captive owners may consider adopting the same reporting

principles as their captive in what many term as a 'virtual captive' arrangement.

It is therefore worth considering utilisation of a captive to act as a risk repository vehicle that supports and enhances corporate risk management efforts, linking insurance to corporate strategy rather than an insurance market of last resort, or indeed a vehicle that is available yet never considered in annual renewal cycles.

In summary, many captive owners may yield benefit in considering the following steps when developing insurance purchase and captive strategies:

- Design an insurance programme that is aligned and linked to corporate and risk management efforts, both life and non-life risks;
- Map corporate risks to insurance availability and regularly challenge why insurance is or is not purchased;
- Undertake regular risk tolerance and appetite reviews at both a consolidated and local level to establish the amount of risk comfortably retained and one that makes sense from a premium saving perspective;
- Optimise the retention allocation between local balance sheets and captive, being mindful of capital duplication and frictional costs such as insurance premium taxes and the like; and
- Explore a captive strategy that is part of centralised risk collation/warehousing efforts to improve data analytics and underwriter submissions, speeding up the annual insurance renewal process. **CIT**



Stuart King
Managing director
FR Global Advisors

Industry appointments

Tom Colosi has joined Great American Insurance and will serve in its alternative markets division as divisional vice president of group captives.

In this role at Great American, Colosi will lead the company's existing group captive operation.

Colosi was previously employed by Sparta Insurance, where he began as senior vice president, before being promoted to chief underwriting officer in June 2013.

With nearly 27 years of experience, Colosi has held a number of underwriting and management positions. Before his employment at Sparta, Colosi led The Hartford's countrywide group captive programme business.

In addition, he previously held positions of increasing underwriting and management responsibility at Travelers, Kemper, and Liberty Mutual.

Towers Watson has recruited a new senior investment consultant, **Keith Goodby**, for its insurance investment advisory group.

He will be based in the firm's London office and will report to the Europe, Middle East and Asia (EMEA) head of the insurance investment advisory group, Ravi Rastogi.

Goodby joins from Legal & General with Profits Fund. He has more than 15 years of experience in investment and insurance, which spans to portfolio management, hedge management, asset liability modeling and risk-based capital management.

Goodby also served as an actuarial consultant for Tillinghast Towers Perrin, for nine years.

Ed Francis, EMEA head of investment at Towers Watson, commented on the hire: "Goodby's addition to our leadership team allows us to continue to develop and deliver market-leading services, particularly for our life insurance clients."

Guy Carpenter & Company has hired **Christopher Moresco** and **Charlene Cass** in its mutual company specialty practice.

Cass is taking on a senior vice president and senior broker role in Norway, while Moresco joins the Philadelphia office in the mutual company practice as business development leader and a managing director.

Moresco previously served as territorial leader of the Mid-Atlantic region, at General Reinsurance. He is also currently on the board of the Insurance Society of Philadelphia.

Cass joins from the Stamford office of JLT Towers Re, where she was as an executive vice president. She has more than 20 years experience

in the industry experience in the reinsurance industry and in the broker market and direct reinsurance.

"Moresco's knowledge of the mutual company and regional marketplace strengthens our already extensive relationships within this client segment, which Guy Carpenter has served for decades," said David Domino, who is Philadelphia branch manager at Guy Carpenter.

Rob Collins, a managing director and member of the mutual company practice added: "Cass's experience and expertise, greatly expands our ability to meet the changing needs of our mutual company clients."

"The hiring of Moresco and Cass reflects Guy Carpenter's long-term commitment to our mutual company clients," said Andrew Marcell, CEO of US operations at Guy Carpenter.

Willis Group has a new CEO in its Netherlands branch, Willis BV.

Jerone Everling has been appointed as CEO and will replace interim Alistair Lester, who will still support Willis BV in a non-executive capacity.

Everling has more than 16 years of experience in the insurance industry. He previously served as executive director at Aon Risk Solutions and was a member of the Aon Netherlands senior management team.

Alberto Gallego, regional CEO of Willis Western Europe, commented on the hire and departure: "Everling's broad experience in a range of both domestic and international roles is the perfect background for leading a team in this important market."

Ultimate Risk Solutions LLC has recruited a new CEO.

Bill Keogh joins the firm from Tiger Risk Partners where he worked as a senior member of the decision support and analytics team.

He was the president of EQECAT Inc, which provides catastrophe risk models and global consulting.

Keogh has also worked at AIG, NAC RE, Swiss Re Atrium, and Risk Management Solutions Inc.

Alex Bushel, founder and president of Ultimate Risk Solutions, commented on Keogh's new role: "With continued expansion and new product development, URS will benefit greatly from Keogh's business experience and broad industry knowledge."

Keogh added: "I am thrilled to be joining the URS team. The growing URS client base is a reflection of relentless customer focus and an excellent product suite." **CIT**



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