StrategicRISK

GUIDE TO:

Captives

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Carving a niche

Offshore or onshore, captives are an evolving part of the insurance landscape, and their appeal is spreading

THE ALLURE OF CAPTIVE INSURANCE continues to grow and evolve as it has for more than a century now. Around the world there are more than 100 domiciles that license and regulate captives, with the number of domiciles growing and remaining competitive. Today there are in excess of 5,000 captives globally compared with roughly 1,000 in 1980.

The growth of captives once closely mimicked the wider insurance cycle, with parent companies setting up captives at times when commercial insurance pricing rose.

These days the factors leading to captive growth are more varied. The wide number of captive structures – including cell companies – has lowered barriers to entry, allowing mid-sized organisations to self-insure. While the mature captive domiciles of Bermuda, Cayman, Vermont and Guernsey continue to appeal, other jurisdictions are growing in popularity. In the US there is a distinct movement onshore, with captives lured by favourable conditions including tax breaks.

With the macro-economic shift from West to East captives are expected to gain more attention from multinationals based in emerging markets, in regions such as Asia, Latin America and the Middle East.

Captives have shown they can weather the storm, evolve and have entered a new phases of growth

While regulation remains a concern for captives, particularly within Europe as the Solvency II regime looms ever closer, it is clear that regulatory and capital requirements are not deal-breakers. There are no signs of a mass exodus from Europe, although growth within the EU remains muted amid ongoing uncertainty surrounding captive treatment under the new regulatory framework.

Captive insurance will continue to retain its appeal as the world becomes more complex and global. In spite of the challenges posed by regulation, emerging risks and a difficult economic environment, captives have shown they can weather the storm, evolve and have entered a new phase of growth. Part of this phase will see the maturation of existing captives, as owners adapt them to better meet the needs of today's world. **SR**

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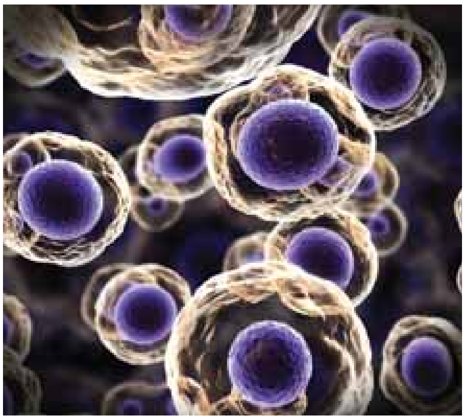

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Out of sight

Uncertainty surrounding Europe's impending insurance regulation continues to mute captive growth

IMPLEMENTATION OF EUROPE'S NEW regulatory regime for the insurance industry is now unlikely to occur before 2016. However, it continues to leave a shadow over the captive insurance industry.

At the time of writing it was not known whether the three-way discussion between the European Parliament and Council and the Commission had resolved the stalemate over the regulatory framework's Omnibus II measures. However, Professor Karel Van Hulle, who retired as head of pensions and insurance at the European Commission in March, has warned that any further delays will hurt European insurers. "This is an area where Europe can show leadership," he said.

Former Ferma president Jorge Luzzi, says: "The continuing delays to the adoption and implementation of Solvency II are already creating uncertainty for captive owners who do not know what capital and reporting requirements they will have in future."

For European captives, the ongoing uncertainty has become a fact of life. "Solvency II has been on the horizon for many years and, far from getting closer, at times it has disappeared over the horizon and out of sight," notes Airmic technical director Paul Hopkin.

"Putting together a captive from start to finish takes 18 to 24 months these days to get the structure and profile right," says Kane group chief operating officer Clive James. "Solvency II has put a question mark over where the captive is going to be in two or three years' time, whether they're going to be in an EU domicile, so yes, it has created some uncertainty."

What's missing is clarity on how captives will be treated under the new rules, which, as many in the captive sector are keen to point out, were never devised with captives in mind. "The Solvency II regime so far has shown a profound disregard for industry and corporations that exercise prudent risk management by owning and operating captive insurance companies," said managing director of Aon Insurance Managers in Guernsey Paul Sykes, speaking at a captive insurance masterclass in London last year.

"While the capital requirements of Solvency II may be appropriate for commercial insurers that are dealing with the general public, many captive managers and owners believe the IAIS [International Association of Insurance Supervisors] international regulatory standards will be sufficient for most traditional captives."

Niche insurers to suffer

Large, mature and well-capitalised captive insurers will – for the most part – meet the »

» requirements under Solvency II's standard formula. Equally, very small captives and cell companies are unlikely to fall within the scope of Solvency II. The rules will affect insurance entities (including captives) with gross premium income exceeding €5m or gross technical provisions in excess of €25m.

Come 2016 or beyond it is therefore the mid-sized self-insurance vehicles that are most likely to feel the full punch of the regime, with its need for additional capital and reporting. "We are also concerned that Solvency II could result in a reduction in the capacity of the market to cover emerging risks and unusual exposures," says Luzzi. "We fear that some niche insurers that provide useful specialist capacity could find their business no longer attractive once they have to meet the new capital requirements of Solvency II."

The lack of clarity on Solvency II's effect on these captives is despite a high degree of lobbying from the captive community over several years. While the directive talks about the "principle of proportionality to reflect the nature, scale and complexity of their business", the capital and compliance burden is generally expected to increase.

While Ferma welcomes a rigorous and consistent prudential regime for European insurance companies, it has repeatedly stressed that the regulations should be proportionate to the risk. "Solvency II should make a clear distinction between insurance companies serving the public and captive insurers whose only business comes from their parent companies," says Luzzi.

Some experts suggest would-be captive owners are holding back. However, with a fairly saturated market and the additional challenges of the current economic climate, these could also be factors hindering captive

Guernsey is Europe's leading captive insurance domicile and number four in the world – 40% of firms on the London Stock Exchange own captives there

growth in Europe. Growth was flat in 2012, with Europe accounting for 24% of captives globally (according to Marsh), the same proportion as in 2011.

"We've seen fewer captive formations in the EU because of the uncertainty around Solvency II and what it means for capital," says Marsh UK and Ireland captive advisory leader Nick Gale. "The capital requirement is dependent on the insured programme, catastrophic exposure and default risk, among other factors.

"There's no simple rule of thumb to give clients a quick indication of how much capital they'll need in a captive," he continues. "You've almost got to design the programme – work out what the capital is and tweak the programme to optimise the capital versus the insurance of that programme. It can be a multi-step process to get to the optimal structure and that incurs cost, so the benefits have got to outweigh that cost. It's certainly been a barrier to captive formations over that past year or two."

Non-EU beneficiaries

Guernsey actively markets its decision not to apply for third-party country equivalence under Solvency II and this is having a positive impact on the island's reputation as a captive insurance destination. "All of the offshore captive-led domiciles to a degree have stated or implied that they will not adopt Solvency II for their captives," says Gale. "That includes Bermuda which has committed to Solvency II equivalency, but not for its captive industry.

"Clients that want offshore captives aren't being put off because they believe Solvency II won't affect them, or won't affect them anytime soon," adds Gale. "Those clients that would consider an EU onshore captive-led domicile are being cautious about making that decision until they have evaluated the likely impact of Solvency II."

Figures from Guernsey's financial services regulator show that there were 732 international insurers licensed at the end of December 2012. This comprises 242 limited companies, 68 protected cell companies (PCCs), 404 PCC cells, five incorporated cell companies (ICCs) and 18 ICC cells.

It compares with a total of 687 international insurers being licensed by Guernsey at the end of December 2011. Much of the growth has come from cell companies. "The decision we made means we've been able to give certainty to our own clients, but also to new and prospective companies looking to set up captives," says Guernsey Finance chief executive Fiona Le Poidevin.

However, even captives located in non-EU domiciles will pay some of the costs of Solvency II, says Kane's Clive James. "Somewhere along the chain the cost of Solvency II will be picked up through fronting costs etc. But in terms of the capital requirements of a domicile, you're much more certain in somewhere like Guernsey what the requirements are going to be, so yes, it has benefited the island. There's no question about it."

Multinational companies based within the EU with captives offshore will at some point need to have their risks fronted by a European insurance company. Many already note an increase in these costs as European insurers respond to increased capital charges under Solvency II for fronting transactions. Even parent companies based outside the EU may be subject to raised costs under the regime, if their captive purchases reinsurance from a European reinsurer, for example. SR

For captives, Solvency II is a

Salil Bhalla, head of risk management at AIG, talks about the major trends affecting the captive sector and predicts that existing captive owners will continue to open up their captive insurers to new lines of business

Tell us about some of the factors affecting captive growth at the moment?

When we look at the amount of captives we may have seen a plateau in the numbers. This is not really a reflection of lack of interest in captives but actually just the result of many years of mergers and acquisitions. Company owners are now looking at their organisations and how many captives they may have ended up with and rationalising it. We may even see a reduction in the number of captives, just from people noting that their company has more than one captive in place.

Are we seeing growth in different types of captive structures, such as protected cell companies, for example?

The cell captive is allowing a lot of people who might not otherwise have gone down the road of having their own wholly owned captive to self-insure. Cells are kind of an easy way to get into the captive world because of the lower capital required, lower start-up and running costs and even the ease of set-up and exit. So we can make a cell captive a more attractive alternative to a wholly owned captive for companies that may not have the size and scale for a wholly owned captive, or are really just taking their first steps towards having a co-ordinated risk management and risk retention strategy.

How interlinked is the captive growth cycle with the general insurance cycle and has that changed at all?

There is some linkage between those two inevitably, but what we have found is actually that captive formations take place throughout the insurance cycle. In fact, if you were to wait for the ideal opportunity it might almost be too late. Once you go down the road of having a captive, clients are making a long-term commitment. What we find is that they actually stick with this approach to managing and retaining their risks throughout the insurance cycle and for the long term.

The captive strategy's motivation is risk management and retaining risk is really a long-term strategy. Any short-term motivation for a captive normally is not sustainable. We will continue to see growth in this book of business as more clients look to captive strategies but, more importantly, existing clients will expand the use of captives for additional lines of business.

So are we seeing evidence that existing captives are being put to greater use?

We have seen examples of people taking their captives beyond the traditional property and casualty lines and into other speciality lines of business. In the past few months we have seen cyber risks put into captives and we've seen quite a lot of environmental and

sledgehammer to crack a nut

trade credit risks also being placed into captives across Europe.

Interestingly, we've also seen marine cargo – the old business that it is – with companies involving their captives where they hadn't done traditionally. There are many lines of business out there and clients should be thinking to themselves, "Is this a risk that we can retain on our own balance sheet within our captive or do we need to transfer this risk?" and that applies to all lines of business.

Have you seen much use of captives for employee benefits?

We have seen several enquiries but not an overwhelming number – and ultimately it's such a challenging line of business placed with a captive because of the local requirements that it's proving quite difficult. If we just take group personal accident for example, from a captive perspective, unless they have a very large employee base, it may be a line of business that, were they to put that into their captives the actual premium spend might not be sufficient to cover an unfortunate event. And they may not have the spread of risk to really allow them to retain that line of business profitably within the captive.

What is driving companies to put new lines of business through their captive?

Solvency II has focused people's minds on their captive and made them think of alternative ways of spreading the risk that they're writing in the captive. It also helps defray some of those additional costs »

'I would expect in the future to see multinational companies from India also looking to have programmes as they expand overseas as well'

» that Solvency II is imposing upon captive owners; by increasing the captive income they're spreading its costs across a wider base of business. It also allows a risk manager to show evidence to the chief financial officer or treasurer that he is also thinking creatively about uses he can put the captive to. It enhances his profile, but also allows him to demonstrate the value that the captive can bring to the organisation.

Is Solvency II still a big issue for the captive community?

In some ways for captives Solvency II may be a sledgehammer to crack a nut. The concerns from a captive owner's point of view are the additional costs and will funding be so readily available and at the same cost in the post-Solvency II environment?

Insurers have not delayed their own preparations despite the delays to the regime – they have continued with the original timescales. Captives should behave in the same way because there are positives and benefits that come from the Solvency II regime.

Will there be implications for European captives that are non-EU domiciled?

One question is will the capital implications for any fronting company be affected by the location of the captive? AIG does a lot of fronting and we have worked with captives in all domiciles. We will continue to do so, but I think we are now more mindful of the capital implications for us dealing with unrated reinsurers wherever they are located.

How is Solvency II affecting choice of domicile?

There are always several factors that help a client decide upon which domicile makes sense for them. Solvency II will be one of the factors that they consider. But different domiciles offer different benefits for different clients and they need to make a decision based upon their own circumstances.

We are now seeing an awful lot of movement of captives from one domicile to another because of Solvency II.

What opportunities do the emerging markets present for captive growth?

They're in the early stages of captive formation and also giving thought to retaining risk. In many of those markets clients are not facing significant deductibles and retentions. They are often able buy their insurances on a guaranteed cost basis that is competitive and meets their needs, so they haven't felt the same pressures to consider retaining risk and having a captive strategy. However, as they grow and expand overseas and look at their international peers, they are beginning to consider the benefit of having a captive or risk retention strategy across all their international operations.

What emerging markets are you seeing activity in, and which regions present the most potential in the medium term?

We see considerable activity in South Africa, which is the home of several multinational companies and we have been writing risk for South African organisations, often through London. We are now also seeing those enquiries coming into our office in South Africa. I would expect in the future to see multinational companies from India also looking to have programmes as they expand overseas as well. **SR**

Captive insurance in the Middle East – a view from Qatar

Driven by a rapid growth of insurable assets, the Gulf insurance sector has grown to more than €11bn (US$15bn) in annual premiums, mostly generated through the corporate sector. However, the captive concept is still in an embryonic stage in the Middle East, with only a dozen or so captive insurers registered in the Gulf region.

Some oil and gas firms (for example, Saudi Aramco) have been using captive insurance for more than 20 years as a strategic risk management tool. However, they chose Bermuda as the place of incorporation. It was not until 2006 that the first captive insurer was established locally, following the introduction of adequate regulatory frameworks. A lack of awareness of alternative risk transfer mechanisms in general and the captive concept in particular remain major impediments to captive growth in the Middle East. In addition, very soft traditional insurance markets provide little incentive for corporations to explore the captive option – whose risk management benefits (in addition to savings on insurance expenses) are largely ignored.

Close to 150 companies in the Gulf Co-operation Council generate annual revenues of more than €371m and almost 300 companies employ more than 5,000 staff, according to MEED, the Middle East business intelligence publisher. This provides an attractive basis for commercial insurance. At the same time, some corporations are starting to examine alternative ways of transferring risk, as double-digit GDP growth rates and economic diversification strategies have added to the complexity of the risk landscape and associated risk exposures.

In addition, infrastructure spending is increasing. In Qatar alone the total additional spending on infrastructure is expected to reach €148bn up to 2022. Huge and complex projects call for increasingly sophisticated insurance and risk management and financing solutions that most local insurers are unable to offer.

Another powerful structural driver is the privatisation of previously owned state assets and roles. This trend generates additional demand for commercial insurance solutions, including captive schemes and the specific risk management benefits offered by them.

A particular area to look at in this context is healthcare insurance, which is being made compulsory across the region and is the fastest-growing line of business. Experts expect a significant increase in self-retained medical schemes to be set up in response to the move to compulsory healthcare.

These structural developments encourage an increasing number of companies to explore the option of captive insurance and the active steering of the corporate risk portfolio. Large family-owned companies already retain risk – in the potentially dangerous absence of a formal risk management framework. Captive insurance could go a long way to promote self-retention in a structured way, meeting the requirements of modern corporate governance.

The Gulf region's potential as a captive domicile is not limited to regional companies. European corporations in particular are set to explore the region as a potential captive domicile as their centre of gravity moves further east. The Gulf region could serve as an attractive conduit between West and East as they adjust their captive insurance strategy to the changing nature of their value and supply chains.

Akshay Randeva,
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Domicile location

With risk management increasing in emerging markets countries need to consider where to locate captive domiciles

WITH CAPTIVE GROWTH STAGNANT in many mature captive domiciles, some experts think the next phase of growth will come from emerging markets.

The mature captive domiciles of Bermuda, Cayman, Vermont and Guernsey continue to dominate the market. But there are now more than 100 domiciles that license and regulate captives around the world. The top three account for 36% of all captives globally, but emerging captives are gaining in popularity.

Some of these domiciles are in developing markets such as Latin America, Asia and the Middle East. While the majority of captive owners are in the Americas (70%) and Europe (24%), with only 6% in the Asia-Pacific, risk management is increasing in sophistication in countries such as India, China and Brazil. The growth of multinationals and global brands is likely to encourage more captive


Captive domiciles have been increasing in developing markets

insurance in markets that have not traditionally tapped self-insurance solutions.

"Several Asian companies are getting bigger through acquisition growth and now are big regional and global companies," says Kane group chief operating officer Clive James. "In Asia there is good potential."

One factor that could play to the success of domiciles in these markets is Solvency II. With ongoing uncertainty surrounding the new regulatory regime, organisations considering setting up new captives are more likely to consider domiciles outside the EU. Organisations with significant operations in Latin America, the Middle East or Asia could see the appeal in keeping their captive closer to home.

Latin America has shown increased interest and significant growth in alternative risk transfer programmes, notes Marsh in this year's benchmarking study. "We've had a couple of significant captives formed this year out of Brazil and Argentina that have gone to Bermuda," says Marsh Risk Consulting's captive advisory UK and Ireland practice leader Nick Gale.

Latin American corporates have shown they are comfortable with locating their captive operations in offshore jurisdictions, with Mexican firms opting for places as far away as Luxembourg. Bermuda is keen to capitalise on its standing and expertise in the sector to win new business as the pipeline picks up.

"We have seen captive use in Bermuda and the Cayman Islands from Latin America," notes AM Best senior financial analyst Janet Hernandez. "It's more microinsurance and some of the smaller risks the banks were writing. Now those countries have changed some of the laws for captives and require more capital, so instead of strengthening those captives in Latin America they're writing some of that business offshore in Bermuda and the Cayman Islands."

Currency fluctuations and inflation are factors prompting firms in emerging markets to form a Bermudian or Caymanian reinsurer to provide more stability to currencies and buffer some of the local economics, says AM Best assistant vice-president Steven Chirico.

"Countries in Latin America, Eastern Europe and even parts of the Middle East are changing their regulations to allow companies to do this," he explains. "They're becoming globalised – half of your investment portfolio can now be in foreign sovereign securities. Some of the rated Panamanian insurers have 30% to 50% of their assets in US treasury bonds. This adds stability to what would normally be a currency fluctuation exposure."

Lower entry barriers

Gale thinks there might be more activity in the future from Middle Eastern companies as they continue to formalise their risk financing arrangements. With growing interest surrounding takaful captive structures, the Middle East and Asia (Labuan) are the obvious domicile choices for organisations wanting to go the Shariah-compliant route.

A growing number of countries in the region offer captive and protected cell company legislation, including Dubai, Bahrain, Jordan and Qatar. As of November 2011, the region boasted eight captive insurers. The Middle East's first captive insurer – Tabreed Captive Insurance Company – was set up in Bahrain in 2007. »

Top captive domiciles for emerging market captive owners

BERMUDA
The world's biggest captive domicile is proving attractive to the Latin American region. Approximately two-thirds of all Latin American captives are formed in Bermuda

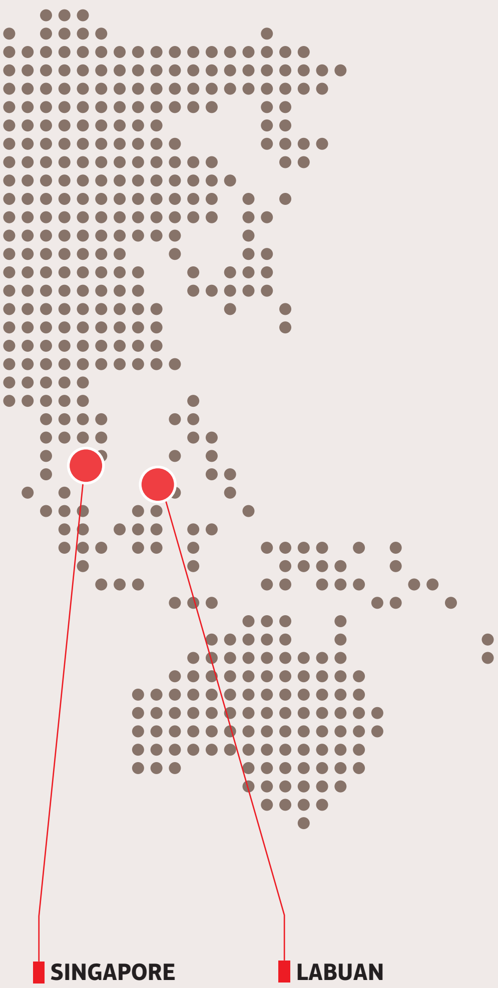
BRAZIL
Home to the captive reinsurer of Brazilian bank Banco BTG Pactual

GUERNSEY
Europe's largest captive domicile set up the first incorporated cell company with an Asian parent in 2013. Saudi-based oil company Sabic has a captive in Guernsey

BAHRAIN
Home to two captive insurers – Tabreed Captive Insurance Company and Masheed Captive Insurance Company

QATAR
Home to Al Koot, set up by Qatar Petroleum in 2008

DUBAI
Home to two captives and one cell company



» Dubai is home to two captives and one cell company and Qatar currently has one captive insurer. This is Al Koot, set up by Qatar Petroleum in 2008 to meet the energy company's risk retention needs.

Several more Middle Eastern-owned captives are located in other captive domiciles. It is understood that one UAE-based group is currently opening a captive in Guernsey. Three Saudi-based groups (including Saudi Aramco and Sabic) have captives in Bermuda and Guernsey, and Kuwait Petroleum International has its captive Woodstock Insurance Company domiciled in the Isle of Man.

"A lot of Middle Eastern captives, maybe 10 or 12 in the world, are in the UK offshores," says Gale. "Because of the tax regime in the Middle East they look for other tax-neutral jurisdictions. Those captives that might look to the EU would be the Middle Eastern clients that have significant EU business interests."

With 6% of captive owners based in the Asia-Pacific, this is already an important market for captive insurance. At present, Singapore is the largest captive market in Asia, boasting 66 captive licences and captive premium of S$812.8m. It is followed by Labuan, with 41 captive licences (up substantially from 34 captives in 2011) and captive premium of $177.4m.

Rapidly developing countries such as India and China are expected to fuel some of the captive growth in the coming years. India already has a number of global brands, including Tata, Oberoi, Mittal and Birla, and China is expected to follow suit. AM Best reports that companies are becoming more sophisticated with their insurance purchasing and are exploring different alternative risk transfer options.

In 2011 the rating agency assigned its first Asia-based captive rating to Energas Insurance Ltd in Labuan, Malaysia – the primary insurance carrier for Malaysian state-owned oil and gas company Petronas. This marked the "latest step in the growth of captive usage in Asia", noted the rating agency, adding that: "The global practice of major corporations self-insuring through captives shows further signs of establishing itself in the major insurance markets of the Asia-Pacific region."

A factor hindering the growth of captives in the Asia-Pacific is the soft commercial insurance market. The high number of catastrophes in the region in 2011, including the Tohoku earthquake and tsunami, caused some short-term hardening in pricing. With so much competition for business in the region, there is once again downward pressure on rates. However, in countries such as Thailand and Japan property catastrophe reinsurance rates remain high.

Beyond pricing, companies may be encouraged to consider self-insurance because of some claims issues that arose out of catastrophes such as the Thai floods, owing to disputes over hours clauses, for example. "Insurance has always been traditionally cheap in Asia. That's changed with the Thailand floods and issues like that," says Kane's Clive James. "There have been issues with claims payments, so it has focused the minds of the corporates out there.

"We are looking at some potential Asian prospects, although at this stage we're not exactly sure where they will actually domicile," he adds. "There's good reason to be close from a logistic point of view, but longer term from an insurance and regulatory point of view it might be better to locate in other areas." **SR**

Looking good

The use of captives is no longer dependent on the commercial insurance market

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FROM SATURATED AND UNCERTAIN markets in Europe to the onshore revolution on the other side of the Atlantic and from there to a growing trickle from emerging markets, there are few obvious trends dictating captive growth. One thing is increasingly apparent, the insurance cycle has changed and with it the reasons for captive formation and usage have also changed.

The global insurance and reinsurance industry is currently awash with capital. Investors from the capital markets, unable to make a decent return from traditional asset classes in the low interest rate environment, have turned their attention to insurance, which offers relatively attractive returns and investments that are not correlated to the wider financial markets. As a result, commercial insurers and reinsurers have plenty of capacity and competitive forces have kept premium rates on the soft side.

Even Superstorm Sandy, the third most expensive hurricane in US history (costing insurers $18.8bn of claims according to Insurance Services Office's Property Claim Services), failed to harden rates in a meaningful way. Rate rises were limited to loss-hit accounts, and these spikes are expected to be short-lived thanks to the fungible nature of capital flowing


No significant weather catastrophes have struck Florida in the past eight years, so market prices there are 'going through the floor'

into the industry to take advantage of post-event hardening.

Changing insurance cycle

"We may be out of the days of global hardening in broad-brush lines of business," says AM Best assistant vice-president at Steven Chirico. "Superstorm Sandy is a good recent example. It did a lot of damage in New Jersey, New York and other states along the Eastern seaboard and if you have property coverage or personal auto in these areas the insurance rates have gone up to pay for those Sandy claims."

"On the flip side in the Florida market the prices are going through the floor," he continues. "The commercial reinsurers are telling me they're not even going to write in Florida because the rate on line doesn't support anything. It's been eight years since a significant event in Florida and there's extreme softening. We're both on the east coast here in the US and you have very severe hardening in one area and very severe softening in another area. That's what we're going to see in the future."

Growth in the captive insurance market was once driven by insurance market contractions (everyone remembers workers' compensation and the medical malpractice crises of the 1970s and 1980s in the US). Today – with a changing insurance cycle and a more sophisticated approach to self-insurance – captives are no longer a temporary risk financing tool to manage the insurance cycle, says Chirico.

"When I first started in this business 15 years ago I was told fairly frankly that captives will grow in a hard insurance market and they will shrink in a soft insurance market," he says. "The reason is in a hard market nobody wants to pays the increased premiums – they'll put the coverage in the captives." »

Captive formation comparison: onshore v offshore

Year formed	Onshore	Offshore	As total percentage of all captives formed
Pre-1981	5%	95%	8%
1981-90	32%	68%	13%
1991-2000	35%	65%	27%
2001-11	52%	48%	52%
Total formed	41%	59%	100%

Captives seem to grow whether we're in a hard market, or a soft market …

Steven Chirico, AM Best

» "In the past five to six years I've noticed a trend completely opposite to that. Captives seem to grow whether we're in a hard market, a soft market, in a good economy, in a bad economy. The biggest benefit for captive owners is they can get control of their risk financing and risk management. They're able to customise loss control and claim mitigation strategies around their business and there's a qualitative and quantitative benefit that can't be produced in the commercial market."

"So we find captives increasing," Chirico continues. "Five or six years ago there were a lot of Bermudian and offshore formations and now there are a lot of domestic formations. We're up to 31 US captive domiciles and the progress of captives doesn't really seem to be affected by the insurance cycle or economy."

The US anomaly

Growth in the US market has to a great extent been propping up the captive growth statistics year on year and bucking the trends elsewhere. The growth of US onshore domiciles has been a big feature of the past decade. From 2001 to 2011 52% of captives were formed onshore versus 48% offshore. This is a significant shift in ratio from the earlier decade (1991–2000) where 35% were formed onshore, versus 65% offshore.

This reflects the efforts by US states to enact captive legislation and entice businesses to move or set up captives. After Vermont with 586 captives in 2012, according to the Marsh Global Captive Benchmarking survey, the largest US onshore captive domiciles are Utah, with 287 captives, Hawaii with 179 and South Carolina with 149.

Among some of the newer US states to offer captive legislation are New Jersey, which licensed its first captive in 2011, and Connecticut, which licensed Thomson Reuters Risk Management as its first captive in July 2012. Florida, Maine, Oklahoma and Tennessee

Onshore captive domicile comparison*

Domicile	Number of captives
Vermont (US)	186
Luxembourg	69
Dublin	47
Hawaii (US)	44
South Carolina (US)	39
Singapore	37
New York (US)	17
Malta	16
Sweden	11
Arizona (US)	10
Switzerland	6
Australia	5
Qatar	1
British Columbia (Canada)	1
Dubai (UAE)	1

Offshore captive domicile comparison*

Domicile	Number of captives
Bermuda	194
Cayman	113
Guernsey	42
Barbados	27
Isle of Man	21

* For Americas-based parent companies

Source: Marsh/Strategic Risk

have overhauled existing captive laws to become more competitive. And Maryland and Texas have legislation proposed and may be viable domiciles in the future.

"The US as a country is forming more captives than just about anywhere else and that's a threat to the established captives and that includes Vermont," says Marsh Risk Consulting's captive advisory UK and Ireland practice leader Nick Gale. "The fact there are more options means it's more likely that established domiciles will attract less market share. There will still be the favoured domiciles because of their expertise and their experience, but there will be niche markets that will develop."

Companies based in the Americas tend to be more comfortable with taking significant risk for primary casualty coverages (workers' compensation, general and product liability, and automobile liability), notes the Marsh benchmarking survey. In addition, tax breaks on property and casualty reserves in the Americas and Europe provide an additional economic advantage for captives, compared with self-insurance.

Other factors aiding growth in the US market include uncertainty in the economy and rising healthcare and other employee benefit costs. Meanwhile, the lower barriers to entry of 831(b) 'mini captives' have encouraged more small and medium-sized enterprises to consider self-insurance. And group captives (including mutuals and risk retention groups) have not lost traction in the US market as they have done elsewhere.

Anti-tax haven sentiment in the US may have also bolstered growth onshore. "Between 20% and 25% of the commercial market is now in alternative risk and I venture to bet my retirement account it is among the best of that commercial market that is self-insured through the use of captives," observes Chirico. »

The US as a country is forming more captives than just about anywhere else and that's a threat to the established captives

Nick Gale Marsh

Insurance buyers need to build a strong business case for keeping a captive in the insurance programme

Paul Hopkin, Airmic

» "A lot of profit has been taken out of the commercial market over the past 30 years by alternative risk, so there's definitely a head-to-head competition between alternative risk and the commercial market, and the commercial market has a significant lobby, so you have this back and forth pressure. But by and large captives are not used as tax deferral vehicles anymore."

"Clients decide they're going to form a captive for insurance reasons," agrees Gale. "Then when they select a domicile they naturally select the most tax efficient. It's a consideration, but it's secondary to the commercial reason for forming a captive."

Growth in the onshore US market also reflects localised issues within the US commercial insurance market, says Airmic technical director Paul Hopkin. "There's a much more buoyant market and many more newly established captives in the US. And from my experience that is driven substantially by the funding of workers' compensation payments, with different rules in different states and all sorts of complexities."

Saturated European market

The scene in Europe and the UK, explains Hopkin, is very different. The majority of large European multinationals already have captives and the market is reaching saturation. In addition, the economic downturn has made it harder to justify setting up a captive, while uncertainty surrounding the new regulatory framework Solvency II and what that will mean for captives has muted activity further.

"Airmic members still love their captives," he says. "The traditional benefits of cost saving, positive cash flow (because you don't pay premium to the market immediately on inception) and the ability to influence risk management standards in their own companies … those benefits are still recognised by members."

"But there are counter pressures that means insurance buyers need to build a strong business case for keeping a captive in the insurance programme – more so than they did a decade or more ago – because the captive ties up balance sheet capital and finance directors will want to get a return on that capital," continues Hopkin. "So there's a challenge for risk managers in keeping the captive on the programme. Capital is one of them and the competitive rates offered by the insurance market mean more careful analysis of having the benefits of a captive is necessary."

The largest captive domicile in Europe is Guernsey (with 333 captives licensed in 2012, down from 343 in 2011), followed by Luxembourg (with 238 captives in 2012 versus 242 captives in 2011), Dublin (with 141 captives in 2012, down from 147 in 2011) and the Isle of Man (with 125 captives in 2012, down from 133 captives in 2011).

Malta is the fastest-growing EU domicile, with a 33% increased in captives managed between 2011 and 2012. Of all its captives, 81% are based in Europe, with a special interest from German companies. The emergence of new low-income-tax-rate EU domiciles – such as Gibraltar, Ireland and Malta – and legal precedence supporting the 'freedom of establishment' (allowing an owner to select a domicile and tax rate without challenge from its home country) is a development that continues to fuel interest, notes Marsh.

"Guernsey, the Isle of Man and Dublin do remain very strong – these are key captive domiciles in the British Isles," says Hopkin. "All three jurisdictions from what I hear are comfortable with the level of business they're doing and don't feel they are haemorrhaging business to each other or externally." **SR**

Effective disposal

Winding down a captive is easier said than done, one reason so many captive insurers are simply left dormant

ONCE UPON A TIME A CAPTIVE insurer was set up as a permanent structure. These days, there are wide-ranging issues why a parent may want to wind down its captive. These include the need to free up capital, consolidation of parent companies with multiple captives, Solvency II as well as the opportunities presented by other risk-retention vehicles.

But as pure captives were never really designed to be a transient operation, it is not easy to close them. "Releasing that capital is actually quite difficult because of the long-term liabilities and because if the captive is old and well-established, how easy will it be to account for all of the capital that's in that captive?" says Airmic technical director Paul Hopkin. "There may have been retained earnings going back 10, 20 or 30 years even."

Arcadia head of risk management and compliance Colin Campbell was instrumental in putting a captive into liquidation 10 years ago. He warns there are several costs associated with closing such an entity down that need to be considered. "Actuaries, lawyers and accountants would be involved. If you're selling the liabilities into the insurance market you will probably need a broker or two to help, so there are costs associated with closing."

For a captive underwriting liability classes, such as employers' liability for example, a claim can come in many years after the policy has been underwritten. One way of dealing with these legacy books of business is to put them into run-off with specialist run-off providers. This is becoming a popular and fairly straightforward option, albeit a more expensive one, for unwanted captives.

"Administratively run-off is the easier option," says Hopkin, who put the Rank Group's captive into run-off when he was director of risk management at the firm. "You've still got the difficulty, of course, that you've got capital tied up somewhere and you will ultimately want to repatriate it."

Paying a premium to pass on the long-tail risks within a captive to a third party can be an expensive exercise. An alternative for parent companies that wish to exit their captive is to consolidate it with other captives owned by the group, gaining the benefits of diversification and economies of scale. There are several reasons why an organisation might end up with unrelated captive insurers, a major one being inheriting captives via mergers and acquisitions.

One option for captive parents that want to continue to maintain some form of self-insurance is to transform a standalone captive into a cell company. Using this tactic the parent avoids some of the expenses involved in the day-to-day running of a captive by novating the captive run-off portfolio into a cell vehicle. It can also avoid the need to attend regular board meetings while lowering its administrative costs. For this exercise an incorporated cell captive tends to work better as risks within a protected cell captive cell are typically be fully funded and therefore this can be a capital-intensive exercise for long-tail risks.

> *If the captive is old and well-established how easy will it be to account for all of the capital that's in that captive?*
>
> **Paul Hopkin,** Airmic

It is estimated that about 40% of global captives are dormant. They are closed to new business, but continue to run-off old liabilities, particularly for longer-tail lines of business. One reason for leaving them in this state is that the parent company can mobilise them if conditions change. "Many parent companies choose to keep their captive because it's not costing them a great deal to keep it ticking along," says Campbell. **SR**

Surfing the waves

Heineken Group insurance manager Eric Bloem charts the evolution of the organisation's captive, Roeminck Insurance

What classes of business are underwritten by your captive and how has that developed?
Currently we write liability, directors' and officers', construction all risks, property, marine and just got the licence for motor. We aim to combine this as much as possible in one multi-line programme to offer the operation in the European Union as a simple one-package insurance solution.

Your main focus was initially on the EU – has that now opened up to other territories?
When the regulation changed, leading to more work, we also decided to extend from pure reinsurance to direct insurance to reap the benefits of that extra work. And yes, following that development we will also extend into countries that allow us to do business directly. This is something we're exploring now. And, if not direct, we are active as a reinsurer; consequently our portfolio is spread over 65-plus countries.

How have your captive strategies altered to reflect the changing insurance cycle? There's been talk of insurance prices hardening. Do you get any sense this is happening and how will you respond?
Maybe the cycle still exists, but the waves have been relatively small over the past few years. We have not experienced any major shocks. One day it will change, but the captive instrument proved its value even in the low part of the cycle. So, once premiums go up the captive will become more efficient. The instrument is in place, the structures are tested, we understand the pricing of our part of the risk and we are ready to extend retentions.

How about regulatory pressures? How are they challenging Roeminck?
From the perspective of Roeminck it is indeed a challenge, although it is achievable. The thing that bothers me most is the lack of customisation. As major insurance buyers we fully recognise the need to vet insurers, make sure that they are financially stable and so on. So, from this viewpoint we're happily following the Solvency II parade. However, there are some issues that are trivial for a captive.

It is important to realise that a captive is an insurer owned by the insured. So if we do something wrong we shoot ourselves in the foot. We only insure our owner – no other consumers are involved, so there is not much to protect from the viewpoint of regulator. Nevertheless, we are still being vetted as if we do third-party business.

On the other hand, we have to realise that regulators are being blamed for everything that went wrong in the financial market (although in general this did not involve »

The captive instrument proved its value even in the low part of the cycle. So once premiums go up the captive will become more efficient

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Waves in the insurance cycle have been relatively small in recent years

'It is important to realise that a captive is an insurer owned by the insured. So if we do something wrong we shoot ourselves in the foot'

» insurers) so I hope that over time their oversensitivity disappears and that we return to something more risk-based. In essence, Solvency II is a good thing and as insurance buyers we recognise and support that.

Is there any more clarity for the captive community on how Solvency II will affect European captives?

To a certain extent the captive community is still wrestling with proportionality and other issues. By means of ECIROA [the European Captive Insurance and Reinsurance Owners' Association] we are trying to get that across to EIOPA [European Insurance and Occupational Pensions Authority], Brussels and so on.

One of the most challenging aspects is that the freedom for local regulators to "gold plate" certain issues does not create a level playing field. This is opening up the road for redomiciliation discussions. Given some of the recent uproar about tax evasion and the preference for certain domiciles, it would be more logical if the EU would indeed keep the playing field level. Otherwise companies will start to shop around for the regulator that best fits their needs. The other thing I wonder as an insurance buyer is whether that strict and rigid manner with which the rules are applied (as if all are equal) will squeeze out the smaller insurance parties. That will lead to:

- more too big to fail;
- less competition;
- less creativity; and therefore
- higher pricing and less attractive products.

This is not to advocate a lighter regime for the smaller players; it is about proportional regulation. As regards market consolidation and the risk of too few players, the discussion about co-insurance is also amazing. Co-insurance is used as an instrument by professional buyers, whereas some regulators believe it should be banned as it is a bad thing for the clients. The opposite is the case. Co-insurance, when correctly applied, creates an open and effective market that works in favour of the consumer.

Do you use your captive as a profit centre? How?

No way. The captive is not a commercial vehicle we have just to optimise the conventional insurance solutions on behalf of the company. We think the captive should not focus on profit; we need capital because of regulatory requirements, but that is about it.

What are your main captive and risk management concerns as we look ahead over the next 12 months?

The major issue is the integration of last year's acquisition of APB breweries, which implies integration of 15 country organisations – a big job, as all those involved in takeovers will recognise.

How might your use of captive insurance change in the coming years?

We do not expect major changes. We will extend the lines of business somewhat, but to a certain extent we have fulfilled the objectives set a few years ago and it is now more a matter of maintenance and evolution with the company and the market. **SR**

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Greener shoots

Actual captive numbers may be stagnant, but many parents are getting more from existing captives

DESPITE THE GENERAL SLOWDOWN in the number of new captive formations, a large number of existing captives are growing organically, putting new lines of business through their self-insurance vehicles and even writing third-party business such as employee benefits. There are a number of reasons for this organic growth. The most obvious is the diversification it brings, improvements in profitability and the potential tax deductibility on offer.

Much of the recent expansion in the use of existing captives can be linked to the financial crisis. As a result of the downturn chief »

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Cyber and environmental liabilities are being put through captives because pricing is seen as varying too widely or being too expensive

» financial officers and treasurers are scrutinising cost centres within their organisations in even more detail than before. Risk managers have to justify the existence of a captive insurer at a time when premium rates for many classes of business insurance are soft.

One way of showing the captive makes sense is to open it up to new lines of business, explains Marsh Risk Consulting's captive advisory UK and Ireland practice leader Nick Gale. "That's almost an evolution that occurs with virtually every captive owner where they form a captive for a specific reason and that may be a specific risk, an industry sector that's hardening and they can't get the cover that they want, so they form a captive insurance company," he says.

"But once they've formed the company then they look for other uses.

"We're getting more enquiries about non-traditional types of risks, anything from supply chain, medical stop-loss, trade credit, crime … there's a whole list of those non-traditional property/casualty risks," continues Gale. "What drives that is businesses are toying with whether to insure those risks.

"It's hard to quantify whether there's merit in shifting that risk to the commercial market, and whether there are commercial market players that have appetite for those risks. So a captive is somewhat of a convenient middle step. It's a way of shoring up the risk without putting it into the commercial market."

'We're getting more enquiries about non-traditional types of risks, anything from supply chain, medical stop-loss, trade credit, crime… there's a whole list of those non-traditional property/casualty risks

Nick Gale Marsh Risk Consulting

Captive diversification

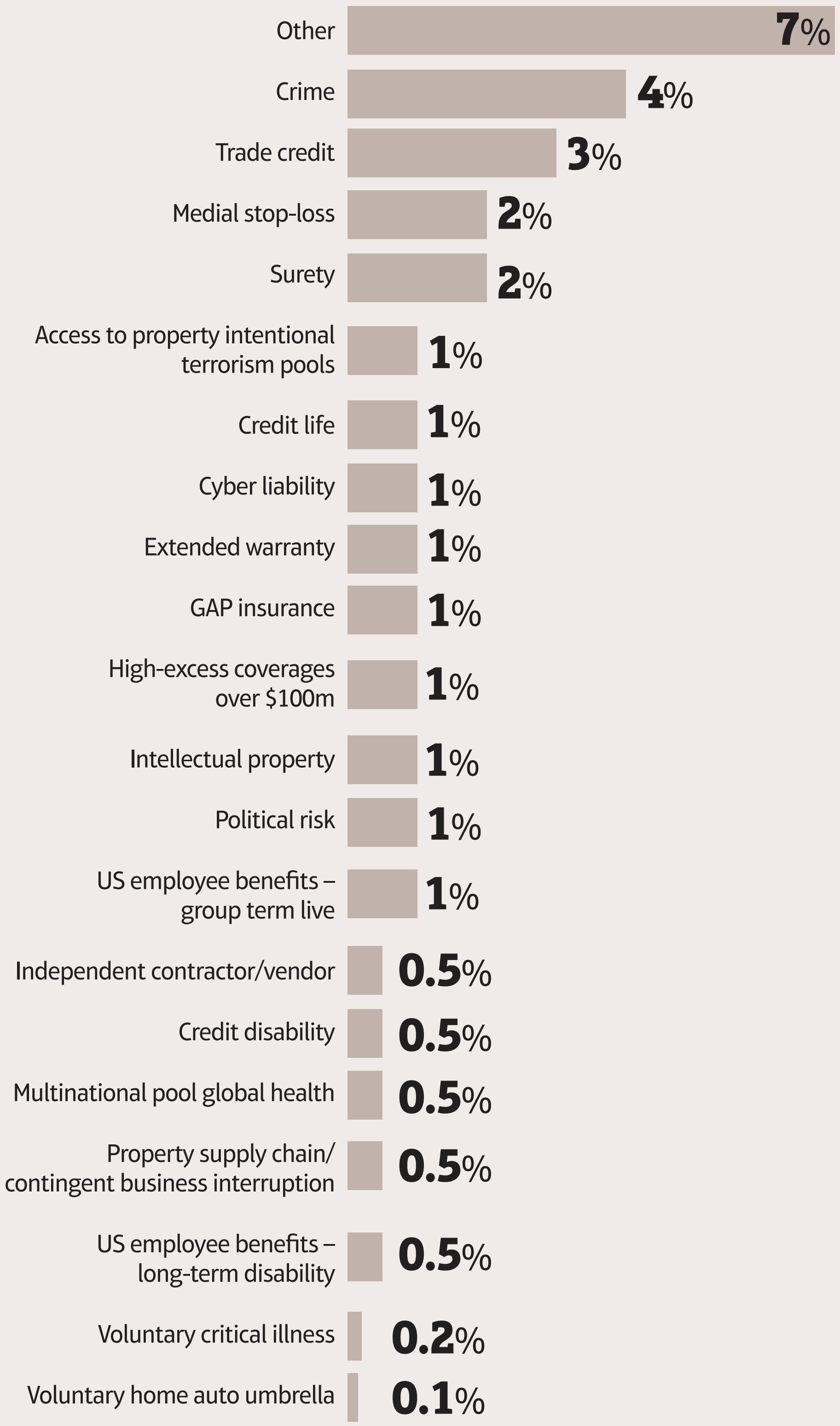
Solvency II could be another reason to encourage captive owners to diversify the risks being underwritten. Monoline captives are more likely to suffer punitive capital charges under Solvency II. But by opening up to other classes and including a mixture of short and long-tail business there is a diversification benefit under Europe's impending regulatory framework.

A diverse portfolio also helps to reduce volatility, explains the Association of Risk and Insurance Managers (Airmic) technical director Paul Hopkin.

"A captive needs a certain level of premium flow otherwise potentially they become very volatile in terms of their results at the end of the year. The more premium flow you can get into a captive, the less volatile it should be in terms of loss performance. You could take into the captive risks that are long-tail risks," he continues. "Many companies use their captives for short-tail risk only."

For emerging risks there may not be adequate or cost-effective solutions available in the commercial insurance market. Here, the captive can be used as an "incubator", building up a claims history and providing some protection until a point at which these risks can be transferred on to commercial insurers. For cyber, for example, a lack of detailed claims data and standardised cyber insurance »

Non-traditional insurance coverage written by captives



Source: Marsh

» products, means that pricing, along with terms and conditions, is varied. There is a feeling that cover is too expensive, with premiums typically 5% of the sums insured, according to the Betterley Cyber Risk Insurance survey.

Cyber liability, environmental liability and non-physical damage business interruption are all being put through captives for this reason. “This is where the external insurance market is responding to requests for insurance in these areas, but development of these products is quite slow,” says Hopkin.

“One way to short-circuit the development is to take the exposure into the captive, either on a heavy deductible or on a substantial co-insurance basis.”

Risk management surveys indicate just how rapidly cyber concerns have risen up the corporate agenda. In part this is driven by constant newspaper headlines highlighting hack attacks and data breaches. But it is also a response to new regulation, particularly surrounding data breach and privacy, driving organisations to notify their customers when personal details have been compromised.

Kane is seeing potential growth in areas such as cyber risk and intellectual property, according to the group chief operating officer Clive James. “This is primarily because there’s been a lack of knowledge in the insurance market in terms of how you manage and control those risks. The marketplace has changed owing to the nature of a whole series of legal firms called trolls, the nature of the risk has changed quite considerably in the past few years.”

However, self-insuring new and emerging risks can be an expensive exercise for the parent too, at least in the early days. “We’re in the rating process for a single-parent captive of a company that’s put cyber risk into their captive, which is very new and they’ve never had a loss so it's hard to predict," says AM Best assistant vice-president Steven Chirico. "But they want to be able to control that risk and, frankly, we're going to make them secure a lot of capital until we're confident four or five years out that the loss footprint they're presenting to us becomes proven over time."

Trade credit is another trend for captives expanding beyond their original scope.

Some US states such as Colorado and New York are allowing captives to write surety bonds, notes Chirico. "Say you're a large telecommunications company, you sell towers all across the country and you have to post bonds for all that work," he says. "If you can absorb some of that – even in just some states – you are literally saving yourself millions of dollars."

"You know you're not going to default – you're very highly rated and why not take on that risk yourself? When you look at the cost benefit it's huge," he continues. "More and more, we are seeing novel ways of using the captive to bring value to the parent company.

"Companies that had workers in unions have put strike insurance – business interruption – into their captives," he adds. "These are new types of cover that they could probably place in the commercial market at some price, but is that going to be available in two or three years' time when there's some huge strike and some large insurance company takes huge losses from that? They will put the predictable working layer into the captive and then buy an excess of loss reinsurance cover for a catastrophic situation on top of that."

Third-party business

According to the Marsh captive benchmarking survey, up to 10% of captives write some amount of third-party business. It notes an increasing trend where captive owners, particularly in retail and consumer products industries, develop insurance products to offer their customers to generate additional revenue. These insurance products are also put through their captive.

In most domiciles this approach changes the status of the captive from writing purely for corporate risks to acting as a third-party insurers, and it brings a number of implications. In the US there are certain tax benefits for writing in third-party business. But in Europe, under Solvency II, captives could suddenly find themselves regulated in the same manner as a commercial insurer with much higher capital charges.

Employee benefits is the main source of unrelated risk for captives writing third-party business, and has developed most in the US. The process of underwriting employee benefits in a captive differs between the US and the rest of the world. The US is more restrictive, however, US captive owners are increasingly assessing the viability of providing medical stop-loss insurance, as the cap on lifetime limits is phased out under the Patient Protection Affordable Care Act.

"Perhaps the best-established trend is putting employee benefits into the captive to varying levels of sophistication," notes Hopkin. "A few Airmic members are multinational companies and they are looking to consolidate their employee benefit programmes into global programmes, rather than offer them as benefits that are purchased separately by the subsidiary in its own location.

"So at its most expansive there are risk managers looking at their employee benefits programmes and looking to globalise those programmes in consultation with their HR colleagues. The loss potential becomes more predictable that way and the captive sits more easily in the global programme." **SR**

EMPLOYEE BENEFIT CAPTIVES

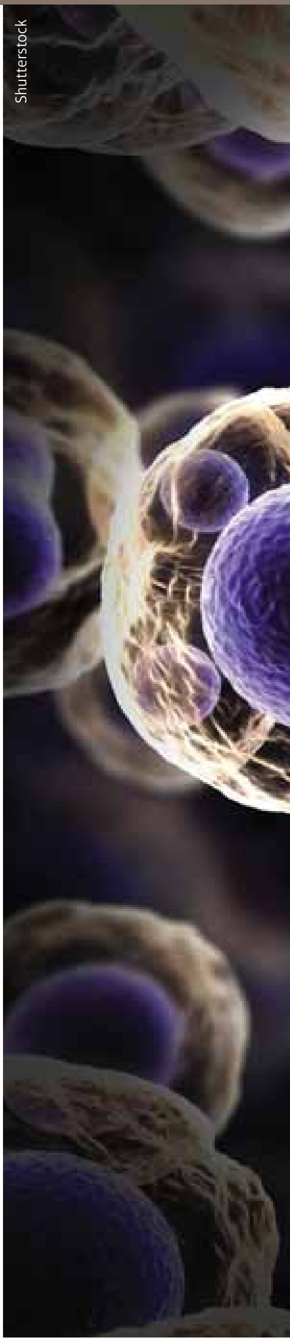
The three main types of third-party employee benefits reinsured by captives:

1. **US employee benefits** (group term life and long-term disability, covered by the Employee Retirement Income Security Act [ERISA])
2. **Global benefits** (multinational pooled benefits)
3. **Voluntary employee benefit**s (home, auto, umbrella, and critical illness).

Captives are likely to continue to seek out additional third-party risk for several reasons, including:

- diversifying the captive's risk profile
- optimising international risk finance of employee benefits;
- achieving profitability in the captive and to offset volatility in related lines of coverage; and
- supporting risk distribution to allow for premium tax deductibility.

Source: Marsh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Cell division

Cell captives offer lower barriers to entry for organisations that may not have traditionally considered self-insurance

With the exception of onshore US domiciles, the growth of traditional captive vehicles has slowed in recent years. Held back by the uncertain economic climate, changing regulation and a soft insurance market among other things, one of the few areas to buck the trend has been cell companies.

For mature captive domiciles like Bermuda and Guernsey, protected cell companies (PCCs) and incorporated cell companies (ICCs) have helped offset sluggish growth elsewhere in the market. More and more jurisdictions are offering cell legislation in an effort to win this business. Forty-one domiciles around the world currently have some form of cell legislation in place, including Guernsey, the Isle of Man, Bermuda, the Cayman Islands and increasingly, several US states.

There are many compelling reasons why cell companies are taking off. They lower the barriers to entry with much less investment, from both a time and capital perspective. And for the purposes of governance and reporting it is the core, not the individual cell, that is responsible for meeting compliance requirements. There is only one board of directors and therefore no requirement for individual cell owners to attend board meetings in various domiciles, as would normally be the case with a captive.

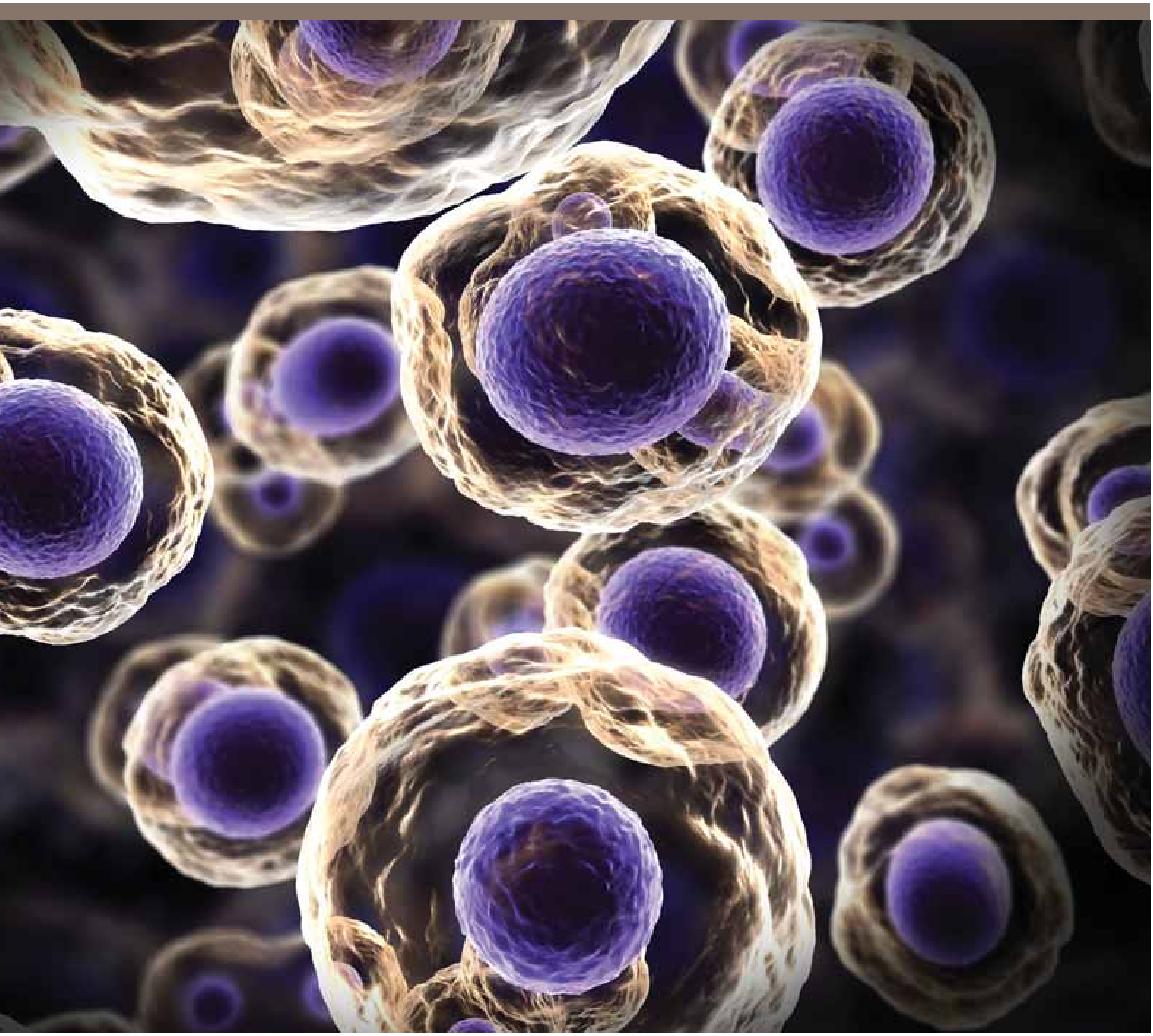
A brief history

Guernsey pioneered the cell company concept in 1997, with Aon's White Rock Insurance Company PCC Ltd established as the first PCC. It has grown to be one of the largest structures of its kind in the world. In the past year Guernsey licensed three PCCs, 87 PCC cells and three ICC cells. Towards the end of 2012, Guernsey parliament also gave its approval to make it possible for a cell of a PCC to convert into a standalone company.

The structure of a protected or incorporated cell company is relatively straightforward. The PCC is one corporate structure with a core cell, or sponsor cell, at its centre which is owned by the overall owner of the corporate structure. Surrounding the core are a potentially unlimited number of cells, each of which can be set up for separate captive-type businesses and are owned, or licensed, by other parties.

The sponsor provides funds for the core of the PCC, but each cell has its own capital and operates as a separate ring-fenced account. The assets of an individual cell are protected from the creditors of both the core and from the other cells so that a cell should not be affected if another cell within the structure becomes bankrupt.

Taking Aon's lead, all the major captive managers are involved in the PCC space, with many setting up and running their own



entities, licensing cells to their clients and taking care of any burdensome administration on their behalf. "There are still barriers to entry in terms of potential accounting issues and also location and potential tax issues – the cell companies have reduced some of those barriers," says Kane group chief operating officer Clive James. "For us as captive managers they are obviously a lot more efficient in terms of what we're doing and the services we provide."

Today, cell companies represent 3% of global risk-financing vehicles, with single-parent captives continuing to dominate (accounting for 84% of the industry). However, this is quickly changing. One trend has been the transformation of traditional captives – both single parent and group captives – into PCCs.

"We've seen it in terms of run-offs and also when [captive owners] are trying to reduce the security commitments on captives," says James. "There are a number of captives, especially where they are being fronted and reinsured into a captive where the security costs of fronting insurers can be quite substantial, especially if you've got long-tail risks such as employers' liability, so [transferring to a cell company] can help. Certainly in terms of run-off, turning them into a cell is much more efficient because the run-off costs can be quite considerable.

"The pure management time for captives is quite significant now because of that compliance, and corporate governance and moving into a cell takes the onus away from the owners more onto the directors of the PCC," he adds. »

Types of risk-financing vehicle ranking and percentage

Rank	Captive type	Percentage
1	Single-parent captive	**84**%
2	Group captive	**8**%
3	Risk retention group	**4**%
4	Cell – SPC, PCC, ICC	**3**%
5	Other captive types and SPVs	**1**%

Source: Marsh

'One of the issues with captives is they are long-term sophisticated financial instruments'

Paul Hopkin Airmic

» Several Airmic members have transferred traditional captives into cell companies, reveals Paul Hopkin, the association's technical director. "That's the most obvious way of reducing running costs," he says. "Instead of having the captive as a standalone company wherever the domicile is, in domiciles where PCCs are allowed (and that's most of the captive domiciles now), you convert your standalone company into becoming a cell within a PCC, and then the management costs are transferred to the manager of the PCC. That reduces the administrative burden and many risk managers have chosen to do that because of the reduction in admin costs."

"One of the issues with captives, of course, is they are long-term sophisticated financial instruments, and that doesn't immediately appeal to many chief finance officers," he adds. "There has to be compelling reasons to use capital to set up an insurance subsidiary, because that won't be a core concern. These are challenging times, but in the right circumstances captives still fulfil a purpose and cells certainly help reduce the amount of capital required for self-insurance."

Lower barriers to entry

Alternative vehicles such as PCCs and ICCs are being used more often than in the past owing to distinct benefits that each offers, notes Marsh in this year's captive benchmarking report. These types of vehicles not only formalise risk financing, but may also operate at a lower cost and with lower capital requirements than traditional wholly owned captives. In recent years, a greater number of non-single-parent captives have been formed.

Regulatory pressures, such as Solvency II in Europe, are also encouraging interest in PCCs. "There are a few ifs and buts – we still don't know how Solvency II is going to affect certain captives – the bigger ones it will affect and the smaller ones it won't," says Kane's James. "Because of the way the cell company will be looked at under Solvency II, in its entirety rather than as an individual cell, there are some obvious benefits."

While there is no legal precedent testing this structure, 14 years and hundreds of cell captives have withstood the test of time and today there is a great deal of confidence in its legal validity. "It has to be a question that if an adjacent cell goes bankrupt, could that affect you?" says Hopkin.

"So risk managers will be aware of that issue but there's a general view that those economies are substantially dependent on being hosts to financial vehicles such as PCCs and therefore an expectation from risk managers that the laws they have introduced will prove to be effective. So it has to be a concern, but it's not such a concern that risk managers shy away from setting up cells in PCCs." **SR**


*References the 2008 Forbes Tax Misery & Reform Index
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