

CAPTIVE CATS

Recent catastrophic events give us pause for thought. Not only do they remind us of the power of nature and the terrible consequences of its awful actions and indifference to human life, but it also forces us to examine critically our perceptions of catastrophic risk exposures and indeed risk in general.

As our televisions continue to convey the terrible magnitude of the Japan tsunami and consequent nuclear threat, we recall that it was this that replaced on our screens pictures of the devastation of the Christchurch earthquake – a story that is still unfolding and would undoubtedly still be grabbing headlines had it not been so abruptly eclipsed by this latest disaster.



Three consequences immediately follow: firstly that we will question our perception of the regularity of extreme cat events; secondly that we will adjust our assessment of their potential consequences; and thirdly that the insurance market will review their pricing against such changing perceptions of exposures

This must lead to some adjustment to our approach to insurance buying. With finite market capacity and pressure to address the balance-sheet threatening top end cat exposure rather than the cash-flow inconvenience of lower end “working” layers, it may be time to look again at these competing priorities. Put this in the context of potentially hardening insurance markets and it is not hard to see why larger companies are moving towards greater retentions across all risk areas, and are focusing their buying of commercial insurance on business-critical risk areas outside their direct control.

Claims modelling specialists are helping to identify the optimal retention levels across all classes by analysing claims against multiple programme designs. These help not only with devising programme structure but also with the pricing of risk and the assessment of the capital costs involved. These captive programmes involve the use of

spread of risk across classes and geographical area, requiring more sophisticated captive business plans and set a challenge to the captive industry to delivering the quality of underwriting, governance and management necessary to achieve maximum value. This challenge is one that Willis recognises and to which we are responding.

The era of strategic captives is upon us and those who embrace it will be best prepared to meet challenges of the future.

BANK CAPTIVES POST BASEL 2

Basel 2, the regulatory capital regime for banks, is not captive friendly. Banks, in making an assessment of their capital charge for operational risk, can take credit for insurance protection that they purchase, provided that the insurances satisfy a number of criteria. One such criteria is that the insurance must not be purchased from a captive insurance company. To make matters worse, banks, when assessing their available capital, must disregard any capital invested in a wholly owned insurance company. So, they cannot take credit for the cover provided by a captive, and cannot take credit for capital invested in the captive.

Notwithstanding the above, most of Europe’s major banks have captive insurance companies, and most continue to use them. So why is that? The simple answer is that banks understand the benefit that a structured risk retention mechanism can bring. A captive is a formalised risk retention tool that enables the Bank’s risk management function to retain risk in disciplined way, and enables individual business units to manage their risk exposures in a cost efficient way. In short, the advantages outweigh the disadvantages.



So what do Banks use their captives for?

TRADITIONAL COVERAGES INSURED BY CAPTIVES OWNED BY FINANCIAL INSTITUTIONS INCLUDE:

Money – protecting against theft by third parties, fidelity losses identified within short discovery periods, unexplained discrepancies, safety deposit and ATM losses.

Bankers Blanket Bond – protecting against crime including fidelity guarantee, professional negligence and computer fraud. With limited capacity in the commercial insurance market typical attachment points for insurers can often

exceed £25m, £50m or £100m per loss and so the captive could offer infill protection. This cover can be extended to include full civil liability, including the costs of complying with regulatory remedies, though not regulatory fines.

Material Damage and Business Interruption – banks often have significant portfolios of property to be insured, whether owned or leased. One significant development arising from the downturn in the economy particularly in the UK and USA is the number of properties being repossessed arising from mortgage defaults and the respective banks needing to have these insured. This can often mean a material change in the profile of the property type insured which may not be attractive to commercial insurers at the prevailing rate applied to the bank's own office premises. A captive could play a part in re-structuring the bank's insurance programme to pick up these exposures.

Equally, captives can also offer economies over the rates charged in the commercial insurance market in areas such as the provision of terrorism coverage, particularly in the UK through membership of Pool Re.

Mortgage Indemnity – with uncertainty in the UK housing market an increasing number of enquiries are being received in relation to mortgage indemnity and the prospect of banks seeking additional protection where loans exceed a given loan to value ratio.

Employers' and Public Liability – captive participation is normally as a reinsurance of a locally admitted fronting insurer, particularly for EL, and is likely to be at the attritional loss layer.

Banks are increasingly looking to insure trade credit and political risks through their captives. With lending under tight control, and losses minimal, it can make sense to insure this risk through a captive, and reap the benefits of favourable underwriting results, whilst maintaining control of the insurance programme.

ESOTERIC

Ease of transacting business in both banking and insurance language has been one of the motivating factors behind the development of banking and insurance transformer cells within Protected Cell and Incorporated Cell Companies.

Typical transactions have involved banks transferring via cells, mezzanine layers of debt which they would ordinarily be required to capitalise, to insurance markets offering wider capacity, because it is still possible to benefit from capital arbitrage between insurance and capital markets.

ENVIRONMENTAL INSURANCE AND THE FOUR WINDS OF CHANGE!

There's a storm brewing in the world of environmental liability as a number of dark clouds gather on the horizon of businesses across the world. We take a look at the source of these storm fronts and consider what steps businesses can take to protect themselves from the gathering gloom.

FROM THE WEST.....RISK

We are increasingly finding that general liability insurance policies are potentially no longer providing the risk transfer protection that clients require. Consider this typical gradual pollution exclusion: "...coverage is limited to a sudden and accidental event taking place in its entirety at a specific time and place during the period of the policy cover..."

FROM THE EASTCOMMERCIAL

Across the globe we are seeing a tightening in the standards of Corporate Governance and this is married to corporate communities requiring greater focus on risk. Then there is the introduction of the new Accounting Standard FRS12 to accommodate.

FROM THE NORTH.....FINANCIAL

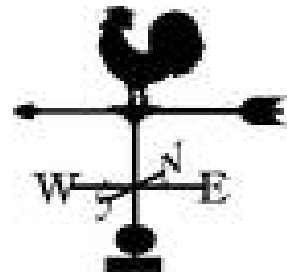
The environmental laws of various jurisdictions impose actual and potential obligations on corporations to remediate contaminated sites, both those currently owned and also, in some cases, those which have been sold. We are seeing CEO's of publically traded companies now making public statements about the significant financial impact to their business environmental risks will bring in the future and the need to effectively manage them.

FROM THE SOUTH.....LEGISLATION, LEGISLATION, LEGISLATION

Around the globe countries are implementing local laws to enforce the polluter to pay. In particular the European Union Environmental Liability Directive (ELD) is being enacted into local laws. In 2010 we witnessed Spain, Portugal, Greece and Hungary pass local laws. Belgium, Netherlands and Sweden are shortly to introduce some provisions of ELD, but at this stage it is not expected to be compulsory. We also had other countries; Argentina, China, Brazil, Russia and India introduce environmental laws.

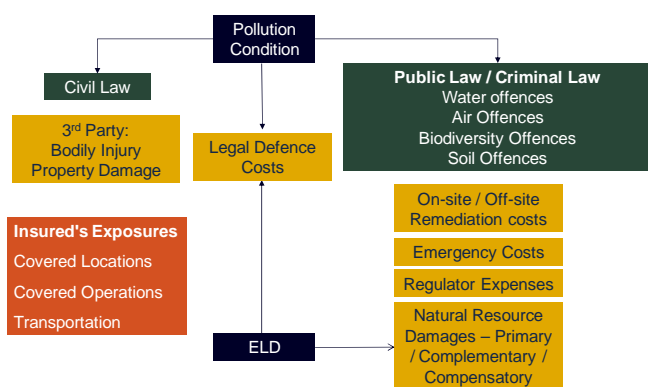
WHAT DOES ALL THIS MEAN?

It's a tougher trading environment with onerous clean up regulations, strict liability/polluter pays principles, and with greater powers for government bodies to bring actions against businesses.



HOW SHOULD BUSINESSES LOOK TO BETTER MANAGE THIS EVOLVING INTERNATIONAL RISK EXPOSURE?

It would make good sense for large businesses that currently centralise their risk management to consider environmental liability programmes alongside your general liability programme. The flow chart diagram below illustrates the identification process of an event resulting in some form of pollution (commonly referred to as a “pollution condition”)



INSURANCE PROGRAMME DESIGN AND A ROLE FOR YOUR CAPTIVE

The specialist insurance markets that write this exposure currently encourage clients to take meaningful risk share on programmes. It is a natural fit for clients in particular with international operations to use their captive to fund the primary layer of risk. Fronting for clients captive companies is one option, or for European based businesses there's the option of a direct writing EU based captive. Willis is able to offer a cell captive with Lime Street Insurance PCC, Malta, as an option for businesses without a captive, but wishing to explore this risk financing option.

SUMMARY ADVICE

- Environmental liabilities, through public law can no longer be completely covered under a General Liability policy - *Develop EIL programme - amount of risk / limit retained – possible use of captive / risk transfer and insurance market solution?*
- Environmental events result in very lengthy, complex scientific and legal issues, and costly claims scenarios - *Require specialist broker / legal advisor expertise.*
- The majority of EU countries are planning to adopt a compulsory insurance approach - *Multinational corporations should consider an umbrella risk financing response.*

There is a wind of change and it's important we best prepare for its impact. Our specialist broker team in

the Environmental Practice and consultants from Global Captive Practice would be pleased to open talks about structuring risk transfer and captive solutions.

PROTECTED CELL COMPANIES

When the term “Lite” is attached to a product, it usually implies that it is, in some way, a slightly slimmed down version of the original. Think Pepsi Lite and it conjures up a tasty soft drink, full of all the flavour of Pepsi, but without the calories. Think Nintendo DS Lite or Walkers Lite crisps and it reinforces the point.

Whilst the concept of a “Lite” version of your favourite snack might be a common sight in the supermarket, not everyone would associate the term with the captive industry. And yet, in many ways, that is precisely what a Protected Cell offers – a kind of “Captive Lite” concept.

Protected Cells offer almost all of the advantages of a traditional captive – the opportunity to exert greater control over insurance costs and the flexibility to be developed as a highly creative part of a wider risk retention strategy – but with lower set up, capitalisation and operating costs.

The structure of a Protected Cell Company (PCC) is simple to understand. The PCC is established as a core entity, usually by an independent, third party sponsor. Protected cells can then be attached to that core and act as independent, ring-fenced structures. The assets and liabilities of each cell are protected from one another enabling different business entities to use them to protect their own risks, safe in the knowledge that they are unaffected by any underperformance of any other cell within the same PCC.

As the costs of establishing the core of the PCC have already been borne by the original sponsor, setting up a cell is a comparatively inexpensive exercise, bringing the benefits of captive technology to a far wider audience. By the same token, protected cells will often obtain regulatory approval more expeditiously than their captive big brother, as the core PCC will already be approved by the appropriate regulator.

Protected Cell Companies can be found in many major captive domiciles. In Malta, Willis sponsors our own vehicle, Lime Street Insurance PCC, which is ideal for clients looking for an onshore, EU approved entity. Alternatively, we offer an excellent offshore PCC facility through our Guernsey office which provides exceptional flexibility and value.

Our Global Captive Practice will help you to explore the potential advantages of a Protected Cell as part of your own risk retention approach. We will identify the ideal domicile to suit your requirements and will talk you through the costs and process involved to establish your own "Captive Lite".

LIME STREET PCC

Lime Street Insurance PCC Limited - the Willis owned European PCC based in Malta, has celebrated its first operational quarter.

As expected, enquiries have flowed in from a variety of geographies, covering a number of applications and usage.



The flexibility of the PCC has proved attractive to mid market companies seeking to use the PCC to gain access to the benefits of captive technology, at a fraction of the cost and administrative burden of a fully owned captive.

A volume of enquiries have also come from captive owners outside the EU, particularly those based in North America - seeking to both reduce counterparty risk, fronting costs, and improve compliance of local insurance programmes.

The announcement of the first Lime Street cell is anticipated within the near future.

LETTER FROM AMERICA



Sean Rider writes:

Since I agreed to put together a Letter from America for our Global newsletter I've been reading about Alistair Cooke, and have been astounded at the work he accomplished. His insights on the American view of the world and (what we like to call) culture were sharply insightful and represented a global perspective. While I'll never achieve his balance of literary insight and cultural vision, and I'm bound to get my whites and whilts mixed up... I am hoping to give our global clients and colleagues a glimpse into what's going on in the North American captive space. Over the course of the upcoming year, we'll be including topical pieces on North American captive utilization, technologies, and in general what we are seeing in the marketplace. You can

expect to see 'tweets' from our North American centric domiciles, and to hear about the activities and innovations our associates are developing.

To kick it off, I'd like to offer a brief report on the Captive Insurance Companies Association (CICA) annual conference, which was held last week in Tucson, Arizona (www.cicaworld.com). This year CICA was very well attended, with over 400 registered attendees, it represented an excellent mix of prospective and existing captive owners, service providers (such as consultants, captive managers, investment managers, claims administrators etc), domicile regulators, and captive orientated fronting/reinsurance carriers. Willis comported itself very well indeed, with three presentation spots in the conference calendar: Captives/RRGs 101- The Basics of Alternative Risk Transfer; The Realities of Fronting- including the 2011 Fronting Survey; Strategic Planning for Mature Captives-To Anticipate and Prepare for Inevitable Changes. Willis was able to demonstrate to a wide audience that we have the innovative thinking and technical expertise to deliver solutions across the life of a captive from the initial creative process in feasibility and inception, through challenges in managing fronting relationships, and then beyond to developing strategic direction for expanded captive utilization, consolidation of legacy captive facilities, re-domestication, and ultimately exploring the potential for captive close down.

Sean Rider is Managing Director, Sales and Consulting, for Willis' Global Captive Practice

NEWS BITES

.....Malta has introduced Incorporated Cell Company legislation with effect from 1st February 2011. ICs differ from PCs in that they are separately incorporated and can contract with each other and with the core. The structure is available to insurance and fund business...

.....Standard & Poors, have announced a reduction in Chartis Group's counterparty credit and financial strength rating from A+ to A as a direct consequence of lower than expected operating performance.....

.....On 1 October 2010 the Isle of Man Insurance and Pensions Authority issued its Corporate Governance Code of Practice for Regulated Insurance Entities.....

.....Willis Global Captive Practice and Atlas Insurance PCC have become the first in the insurance industry to use PCC technology to underwrite UK statutory motor liability on a direct basis from an EU (Malta) based cell in a protected cell company.....

.....The Irish Regulator issued a new Corporate Governance Code for all re/insurers late last year. In the Regulator's

words “ in the area of corporate governance we have decided we do not want to simply match best practice internationally but wish to set a higher standard”. Captives were exempted on the basis that a new code for captives will be issued later this year. New internal governance requirements and new fitness and probity requirements for the industry are also expected later this year.....

.....In Australia the Assistant Treasurer, the Hon Bill Shorten MP, released exposure draft legislation on the reform of the controlled foreign company (CFC) rules on 17 February 2011. Uncertainty still exists with regards to the effective date of the proposed legislation but by and large the issues highlighted during the last round of the consultation process, i.e. the potential for captive owners to face severe financial disadvantages compared to traditional insurance buyers seem to have been eliminated by changes made to the initially proposed CFC Group and Integrity rules.....

.....The Singapore Minister of Finance delivered the 2011 Budget in Parliament on 18 February 2011. Key tax changes were introduced in several strategic business sectors to enhance Singapore’s overall competitiveness as a Global-Asia Hub. For the captive insurance sector, proposal was made to extend the captive insurance tax incentive scheme for another seven years to support the growth of the captive insurance industry.Stop...”

If you would like further information about any of the above news bites please contact Willis Global Captive Practice.

AFTERTHOUGHTS – WILLIS’ THOUGHT LEADERSHIP EVENT LONDON, 23RD MARCH

It was Steve Jobs, co-founder of Apple Corporation, who once famously said, “Innovation distinguishes between a leader and a follower”.

Leading a business that has successfully created some of the most iconic, must-have gadgets of the 21st century, he clearly knows a thing or two about the importance of constantly pursuing new ideas, pushing the boundaries of the accepted to create a range of market-leading products that have changed the way we all live.

With that philosophy in mind, Willis was delighted to host the first ever Thought Leadership Event at our Lime Street, London offices on the 23rd March 2011. Attended by an audience representing a wide mix of major

businesses, the Event was designed to move away from the traditional captive agenda and to introduce new, thought-provoking topics that would help captive owners generate greater value by viewing their captive from a different perspective.

As event host **Malcolm Cutts-Watson, Chairman of Willis’ Global Captive Practice**, outlined in his welcoming presentation, it is no longer sufficient for a captive to focus only on traditional risk solutions. Instead, captive owners need to be exploring increasingly effective ways to derive value and to contribute to wider Group strategy. By the same token, Willis has long recognised that it is no longer sufficient for a captive manager to merely provide an efficient infrastructure for captive administration and governance. Instead, it is essential that we play a proactive role in helping our clients to squeeze every ounce of value from their risk retention strategy.



Our first speaker, **Dominic Wheatley (Managing Director, Willis Guernsey)** focussed on the importance of communicating the value of a company’s captive to its senior management.

At a time when the resources of most businesses are being stretched to the limit, it has become increasingly important for C-suite executives to be able to fully understand and assess the value that a captive offers.

Focussing on the three “pillars” of effective management communication – Knowledge, Understanding and Commitment – Dominic emphasised the importance of relating captive value to the focus of the individual audience. By way of example, one of the most commonly-raised questions might be “What exactly is a Captive?”. Let’s consider how this might be answered in different ways, depending on the focus of the questioner:

- **To the COO:** “It’s how we promote risk management to the SBU’s.....”
- **To the SBU Management:** “It’s how we highlight your risk management improvements to the COO...”
- **To the HR Director:** “It’s how we ensure consistent delivery of an excellent global benefits package...”
- **To the FD:** “It’s how we minimise the cost of global employee benefits...”

The critical point here is that effective communication of captive value relies on being able to relate that value to the interest of the specific board member. Equally crucial, is the importance of providing the board with regular information about the captive in a relevant, transparent form.

As Dominic emphasised, using the right techniques to communicate to senior colleagues can help to ensure that the captive continues to receive the support, recognition and capital investment that it deserves.

The second speaker was Kathleen Waslov, SVP, Willis Multinational Employee Benefits, who focussed on the growing development of Employee Benefit solutions in the captive market.

As one of the industry's leading experts in the use of captives as Employee Benefit solutions, Kathleen put forward a compelling argument that employee benefit liabilities should be treated in exactly the same way as any other major corporate risk exposure. As such, all companies with significant employee benefits costs need to be looking at captives as potentially the most effective way of managing that exposure, particularly on a global scale.

The audience were taken through a fascinating journey, from the identification of the benefits that lend themselves most suitably to Captive solutions, to the assessment of the key factors – such as Value, Risk Mitigation and Resources – that make a captive solution worthwhile and to the added benefits that this innovative approach can offer:

- Better data control
- More informed decision making
- Better governance

In summarising her presentation, Kathleen told her audience that the financing of employee benefit liabilities will, in Willis' opinion, follow the same best practices and principles of Property and Casualty risk financing and that larger companies are already pursuing the Captive option as an effective and innovative solution to this increasing cost risk.

The final speaker was Phil Ellis, CEO of Willis Structured Solutions (SRS) who chose to talk about the often sensitive issue of Corporate Catastrophes and Reputational Risk.

Perhaps one of the most striking parts of Phil's presentation was the evidence that a large company catastrophe was significantly more likely to affect any major business than might be expected. Using share value as a barometer of the level of that catastrophe, the audience were shown statistical evidence that illustrated the potential for a major downturn in value to occur for most companies at least once in a 20 year cycle.

Whether caused through product contamination, failed acquisition attempts or wider environmental conditions such as those created following 9/11, the potential for a

major corporate catastrophe is far more likely than most companies believe.

Dealing with such exposures is difficult, Phil went on, but could be addressed through a more sophisticated approach to catastrophic risk engineering, using some of the bespoke tools developed by the SRS team, some of which were impressively demonstrated to the audience.

As a final flourish, Phil teased his audience by making reference to a new and exciting product being developed by SRS which, it was confidently believed, would provide a genuinely innovative solution to some of the risk exposures discussed.

Closing the Event, Malcolm Cutts-Watson reminded the audience that innovation would become increasingly vital in the captive environment and that the Willis Global Captive Practice was committed to playing a leading role in bringing new ideas to market for the benefit of all of our clients.

For more details of the first Willis Global Captive Practice Thought Leadership Event, please contact Dominic Wheatley at

wheatleyd@willis.com. For those interested in hearing more innovative views from the Willis team, a second Thought Leadership Event is scheduled for Wednesday, 14th September 2011. To guarantee your place, please contact Sandra Gee at gees@willis.com.



EVENTS AND DATES FOR THE DIARY

June 5-8 - **Bermuda Captive Conference**, Fairmont Southampton Princess Hotel, Bermuda

June 6-8 - **Airmic Annual Conference**, Bournemouth. UK

July 12-14 - **MCIA's 6th Annual Conference**, The Lodge at Whitefish, Whitefish Montana, US

August 9-11 - **VCIA Annual Conference**, Burlington, Vermont, US

September 26-29 - **Western Region Captive Insurance Conference 2011** Annual Conference, Grand America Hotel, Salt Lake City, US

September 26-28 - **Nevada Annual Captive Conference**, Las Vegas, US

September 26-27 – **Captive Live USA, Conference**, Chicago, US

October 2-5 - **FERMA Risk Management Forum 2011**, Stockholm Waterfront Congress Center, Stockholm, Sweden

October 5-7 - **NRRA 2011 National Conference**, Ritz Carlton, Pentagon City, Washington DC, US

October 9-12 - **31st Annual National Education Conference & Expo**, JW Marriott Desert Ridge Resort & Spa, Phoenix, AZ, US

October 25-28 - **HCIC Forum 2011**, Ritz Carlton, Kapalau, Maui

November 13-17 - **31st IRMI Construction Risk Conference**, San Diego

Nov 29 - Dec 1 - **Cayman Captive Forum**, Ritz Carlton Cayman

DOMICILE TWEETS

THE WORLD OF THE WILLIS GLOBALCAPTIVE PRACTICE IN 140 CHARACTERS OR LESS.....

"Malta Financial Services Authority launches a revamped website and a new careers website that aims to help young people plan a career in the financial services industry in Malta."

"The Isle of Man reconfirmed its commitment to international best practise this month, signing its 24th Tax Information exchange agreement"

"Guernsey believes that the decision not to pursue Solvency II equivalence will spark an influx of new captive enquiries"

"Becoming the first captive manager in the world to attain Chartered Insurer status confirms Willis' status as Guernsey's pre-eminent adviser"

"Willis is considering using Twitter as a means to better communicate with clients. Concern exists over whether 140 letters is enough to com...."

CONTACTS FOR FURTHER DETAILS

Sean Rider
Managing Director, Sales and Consulting
North America
Tel: +1 212 915 7865
Email: sean.b.rider@willis.com

Dominic Wheatley
Chief Marketing Officer
Europe & ROW
Tel: +44 (0) 1481 735 630
Email: dominic.wheatley@willis.com

Peter Lowe
General Manager, New Zealand
Asia Pacific
Tel: +64 9920 2997
Email: peter.j.lowe@willis.com

We **communicate** with you to **understand** your business, providing the **expertise** and **creativity** to develop and **deliver** excellent captive **solutions**, and we do so with **passion**.