TIME TO CELEBRATE

2012 is a massive year of celebration and commemoration. An iceberg sunk the Titanic 100 years ago and this year we celebrate the bicentennial of Charles Dickens’ birth. Add the Queen’s diamond jubilee and the Olympics coming to London and you have a hectic season of activities.

How best to recognise these events?

Typically through a retrospective and prospective assessment and I see no reason to change this. So with apologies to Charles Dickens I propose to adapt one of his most famous novels to “A Captive Carol”.

CAPTIVE PAST

This is the retrospective bit! Having been in the captive industry for 30 years, there is a temptation to slip into nostalgia and reminisce about the good old days. However if we take 10 years ago as the starting point, we saw a very different insurance world. The impact of 9/11 was reverberating; insurance markets were extremely nervous and offering reduced capacity and rate hikes. There was a realisation that the modelling techniques used by risk carriers were inadequate and that aggregation risk and extreme disaster scenarios had not been properly considered.

The chasm in the perception of risk between the insurance buyer and supplier had never been greater and this led to fraught renewal negotiations. Captives provided some stability until the market found a kind of equilibrium. In many cases, this led to captives taking risk above their normal comfort level of predictable attritional losses and required adoption of better risk management disciplines by the captive management and shareholder. This emphasis on analytics, governance and management information was a positive development as it gave momentum to captives playing a greater role in companies’ risk strategy as a risk participant rather than as a money box.

This focus on the role a captive could play within a risk financing strategy developed beyond risk taking but also into an aggregator of a company’s risk (and capture of associated exposure and claims information). For many organisations with diverse businesses, the captive assumed the role of a consolidation vehicle enabling informed decisions on risk retention and insurance buying. To successfully achieve this, however, required an investment in the captive infrastructure to provide the necessary support for underwriting and other functions and management information capture.

The credit crisis of 2007 onwards exacerbated the demands on captive management with captive stakeholders demanding evidence of a sensible business plan, robust operational platform and strong corporate governance. I would say the development of the strategic captive is a major force for good. It has moved captives from a tactical role and has enabled owners of risk to take control of their destiny whilst reducing the overall cost of risk.

CAPTIVE PRESENT

An analysis of the 2010 insurance market shows that (re)insurers’ exposure modelling was again flawed and failed to take into account the scale of the natural disasters that occurred. Despite underwriting losses and low investment returns, any rate increases look to be modest and capacity remains available in all but a few distressed classes.

What will be the impact on captives? The hoped for (by insurance market practitioners anyway) hard market seems illusive so any arbitrage in retention rather than transfer of risk will be driven by insureds’ analysis of their risk rather than prohibitive market pricing. I see the role (and value) of the strategic captive continuing with the concept being adopted by global corporates across the globe. A thorough understanding of a corporate’s risks will lead in most cases to increased group risk retention, aggregation of insurance buying and improved loss control. All of which will be managed through the captive.

The disciplines required to successfully operate a strategic captive are integral to compliance with risk based solvency regimes being introduced across the globe. At a fundamental level, the requirement for directors and management of a captive to fully understand the risks of all aspects of the business and to have in place appropriate controls and adequate capital is hard to argue against. However as Solvency 2 practitioners will vouch, the challenge is in arriving at a control and governance framework...
that is proportionate to the risks of the business rather than adopting the highest standard by default.

Expect this to be the hot topic of 2012 as domiciles come to terms with the practical realities of these new solvency regimes. Management of captives will need to invest in technical expertise, a robust operating and control platform and IT systems. Expect also robust fee negotiations as outsourced captive managers look to recapture the cost of these investments from clients under management.

This is more a plea than a prediction. What has struck me over many years, given the material premium volumes written by captives (difficult to quantify but many commentators assess as in excess of USD$50bn), the importance of captives in successful risk financing strategies and how captives touch most parts of the insurance world, is the lack of recognition as to the value the captive industry generates. Why is this?

Maybe as much of the industry is based in offshore centres with the whiff of tax avoidance, maybe because some in the insurance industry either view captives as not real insurance or as a threat and maybe because captive stakeholders don’t always feel the need to publicise the role of their captives. Either way, I cannot help feeling there is a need to raise the profile of the captive industry and make the captive value proposition an integral part of the risk offering.

Domiciles are effective in promoting their particular offering and have developed loyal customer bases. There are some captive owners groups that are domicile neutral (CICA and ECIROA come to mind immediately) and these do take a position on specific key issues affecting the captive industry. Regional risk manager associations often establish captive special interest groups. But much of captive promotion appears defensive and responding to industry threats rather than engaging in a debate on the captive positives. Maybe through more accurate assessment of the actual value a captive provides, both quantitatively and qualitatively, we can advance the captive cause.

CAPTIVE FUTURE

Finally, and if I can extend the use of analogies to the Titanic, what are the icebergs out there threatening to collide with the captive ship? Clearly the most threatening iceberg is that of overbearing and inappropriate regulation. This is not exclusive to the captive world; it is a challenge for all sectors in the financial service industry. In my opinion global and local regulators are struggling to get to grips as to how to respond in an appropriate manner to current economic realities. The present operating method of requiring the industry to supply masses of detailed information and demand adoption of multiple new procedures and rules (often without full industry consultation) does not get to the heart of the issue, adds cost and complexity and little or no value to the consumer.

I recognise this is a huge iceberg with great momentum but a pragmatic interpretation of global regulatory initiatives by captive regulators should enable the underlying intent of new requirements to be achieved in a proportional manner to the relevance of the risk to the captive.

I also expect tax authorities to take a closer interest in the transfer pricing of risk located in their jurisdiction and ceded to a captive. Evidence of robust independent underwriting will be required and the old solution of obtaining a desk quote from the insurance broker or a friendly market may no longer pass muster.

Captive management will need to bring a broad range of technical expertise to respond to the above challenges and should be looking to determine whether additional skills need to be brought in. This is no longer counting the coins in a money box of yesteryear, but requires holistic management of a regulated entity in a dynamic environment.

I entered the captive world 30 years ago looking to learn about new businesses and their challenges, develop close client relationships and add value by being a trusted adviser. My goals today are no different albeit that we now play on a much larger global stage. Opportunities to add value abound just as do the challenges to the captive industry. As Charles Dickens wrote, “it was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness”.

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NEW ZEALAND INSURANCE LEGISLATION MOVES INTO THE 21ST CENTURY

The Insurance (Prudential Supervision) Act 2010 received Royal ascent on 7 September 2010 and has a 3 year transition period. The Act replaces the following Insurance Acts of New Zealand:
- Insurance Companies Deposits Act 1953
- Life Insurance Act 1908

The purpose of the new Insurance Supervision Bill is to:
- Promote the maintenance of sound and efficient insurance sector
- Promote public confidence in the insurance sector

The Reserve Bank of New Zealand has been named the official Regulator of Insurance Companies in New Zealand. They have stated that this new Prudential Supervision Act will achieve the purposes stated above by establishing a system for licencing insurers, imposing prudential requirements upon those insurers, supervising compliance with these requirements and empowering the Reserve Bank to act in respect of insurers in financial distress.

The Reserve Bank further goes on to state that there were a number of principals that they must take into account in respect of their duties and responsibilities under the Act. These principals include:
- The importance of insurance to members of public.
- The importance of maintaining the sustainability of the New Zealand insurance market.
- The importance of dealing with an insurer to adequately protect policyholder interests and the public interest, in conjunction with ensuring that the failure of insurer does not have the potential to significantly damage New Zealand’s financial system or economy.
- That it is not the purpose of the Act to eliminate all risk of insurer failure.
- That members of the public are responsible for their own insurance decisions.
- The desirability of providing adequate information to enable members of public to make their own insurance decisions.

In short, the New Zealand Insurance legislation has been dragged into the 21st century by adopting a light handed best practice approach for supervising all insurers located in New Zealand. This includes general insurers, life insurers and captive insurers. The Act has a three year transition period to ensure all insurers operating under the previous legislation at the Royal ascension of this Act are fully licenced.

The key dates going forward are:
- 1 February 2011
  – An entity carrying on insurance business in New Zealand may apply for a licence.
- 7 March 2012
  – All insurers operating in New Zealand must have a full or provisional licence. (100 insurers and 15 captives were given provisional licences).
- 7 September 2013
  – All insurers must be fully compliant with the requirements of the Act. All insurers must have a full licence by this date.

NEW ZEALAND CAPTIVE INSURANCE COMPANIES

The Act defines a captive insurance company for the first time in New Zealand legislation. A captive insurer is defined as an insurer that is:

a) A subsidiary of an entity that is not an insurer (the parent); and
b) Only insures the risks of its parent or other subsidiaries of the parent (or both).

The recognition of a captive insurance company into the Act enabled the Reserve Bank to allow a series of exemptions for captive insurance companies. These include:
- A captive insurance company is exempt from obtaining a financial strength rating.
- A specific captive insurance solvency standard has been promulgated.
- Captive insurers are required to have a minimum NZD$1 million in capital. This is significantly lower than the general insurer and life insurer minimum capital requirements.
- All captive insurers must have independent directors on their Board. Independent directors have been defined by the Reserve Bank as directors of the parent company.
- Captive insurers must appoint an Actuary.
- Captive insurers are allowed to invest funds back into the parent company.
The Solvency Standard associated with captive insurance companies allocates a minimal capital weighting to inter-company loans due to the nature of the shareholding and policies underwritten within a captive arrangement.

The legislation as promulgated in the New Zealand Parliament is a light handed approach to supervising insurance companies. The exceptions and recognition of captive insurance companies within the legislation provides a world class framework for captive insurers to be domiciled within New Zealand.

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AN UPDATE ON THE AMERICAN CAPTIVE MARKETPLACE

The past year has seen significant activity in the captive marketplace in the US for Willis. Between the changing face of healthcare in the US, the increasingly complex world for captive insurance program regulatory compliance, the expanded interest in US and global employee benefits in captives, an expansion into Cayman and Bermuda of favourable tax treaties with Canada, and the regular world of captive utilization we have been kept rather busy.

With the healthcare reform in the US come several impacts for the captive marketplace. Health systems are re-evaluating their physician engagement strategies, and consequently their captives are becoming ever more critical to that strategy.

Health systems have several options for aligning the interests of their non-employed physicians to their risk management efforts, most of them involve the development of an insurance program for those physicians which almost always includes the deployment captive insurance technologies. As healthcare reform has propelled a re-evaluation of health systems physician engagement strategies, the captives which support existing programs are being re-evaluated, re-deployed, expanded or even shut down.

This is an exciting time in this space, as healthcare reform has prompted a re-look at captive utilization in healthcare and the opportunities which arise, more often than not, demonstrate a captive’s value to an organization and points to ways in which a captive can be ever more valuable.

Another key impact of healthcare reform in the US is a marked increase in mergers and acquisitions of health systems. With this activity comes a need to focus on the captives which may come along with a merger/acquisition. Consequently a great degree of due diligence and operational transitional activity is in the works. The acquisition of another organization is a complex matter, and oftentimes insurance programs are not necessarily at the top of the priority list… we are finding that the existence of a captive is fortunately getting the attention of management and that stakeholders are, to their credit, deploying considerable resource to ensure that they understand the financial, insurance and regulatory implications of acquisitions with captives, which too is keeping us busy. Dodd Frank, a regulatory legislation recently passed in the US, is bringing increased attention to insurance program regulatory compliance for US based captives. The curious thing about it is that no single authority has been able to provide compelling guidance as to achieving compliance. In global captive insurance programs, IPT and non-admitted/permitted compliance is a very complex beast, now the US marketplace is getting a taste of some of those issues. We are watching this issue closely, and will look for increased guidance from regulatory authorities and legal counsel in the upcoming year.

We continue to field a host of inquiries on the matter of employee benefits in captives from both the US marketplace and globally. Captive utilization for employee benefits may provide significant positive financial impact for organizations, usually far outstripping the positive value of P&C captive utilization. Between leveraging and coordinating global purchasing of benefits, taking control of investment and asset management of considerable values, and improved tax efficiencies which may emerge from captive utilization, this topic is gaining increasing momentum. The issues and considerations around this topic vary considerably depending on subject business and regulatory regimes, and we have built an expertise which guides our client through these issues with confidence.

Also of note are the execution of tax treaties between Bermuda and Canada, and Cayman and Canada which give Bermuda and Cayman practically the same status as Barbados from the
perspective of Canadian based captive owners. We anticipate an increase in captive re-domestications from Barbados into Bermuda and Cayman and an increase in Canadian based inquiries into captive utilization emerging from this news. We, of course, continue to field inquiries on small insurance company and group strategies, as more legacy HRH clients become introduced to captive technologies, and we continue to work diligently on developing innovative captive utilization strategies for our clients and prospects. All told, the US marketplace for captives remains dynamic and full of opportunity.

In summary the new regime presents an opportunity for existing and new captives. The low profits exemption is much more generous than before and only income from UK contracts will be chargeable. Some captives profits will no longer be taxed at the UK parent. Captives and their owners should be reviewing their existing structures now, in order to determine the tax effect of the new regime.

**COOK ISLANDS CAPTIVE INSURANCE**

Market demand and its unique position in the Pacific have driven demand for new separate legislation allowing for international captives in the Cook Islands.

The Captive Insurance Bill 2012 and accompanying regulations will be passed soon to capture new client work. The natural disasters of 2011 have led to numerous inquiries about clients’ needs to utilize captive companies to cover their catastrophic needs. The Cook Islands legislation will be world leading with regard to its features and will allow the full suite of captive insurance options: Pure Captives, Group Captives, Captive Associations, Incorporated Cell Captives, and Protected Cell Captives.

The Cook Islands plans to build itself into the premier captive domicile in the Asia-Pacific Region. With efforts already well underway in expanding its Asian client base, the Cook Islands is seeing demand for insurance services and stands ready to assist in educating clients in Asia about the advantages of captive insurance in their planning. Long a preferred jurisdiction for US clients, particularly with respect to international trusts, the Cook Islands will position itself to capture both the mature Europe and North America business while at the same time building on the Asia-Pacific growing markets.

The objective and design of the Captive Insurance Bill and regulations is right-touch, rather than light-touch, regulation. Ranked number two behind only
Singapore in the Asia-Pacific Group region for its regulatory standards for international financial services, clients can feel confident that the Cook Islands provides the ideal environment for modern captive insurance business.

Jenner Davis, CEO
Cook Islands Financial Services Department Authority

A WORD FROM OUR DOMICILES

DUBLIN
Another Piece in a Changing Landscape……..

Whilst all EU domiciles are focussing on preparing for Solvency II, Ireland has been quietly undergoing a transformation in respect of insurance regulation with a steady stream of new governance requirements setting best in class standards for the management of financial service providers.

Following on from the introduction of the corporate governance codes for reinsurance undertakings (2007), insurance undertakings (2010), captives (2011) and the Central Bank of Ireland’s risk-based regulatory framework (PRISM) also in 2011, the latest piece of the jigsaw came into effect in December 2011 with the implementation of the Fitness & Probity regime which sets minimum standards for people seeking to hold specific designated positions in the financial services industry.

Bit by bit, piece by piece, the Irish regulatory landscape is being shaped to ensure that all companies in the financial services sector act in the best interests of their stakeholders and provide the reassurance internationally that Ireland is a secure place to do business.

GUERNSEY

- Following critical report of EU Tax code working group, Guernsey has confirmed zero tax rate will apply to captives and will shortly announce changes to its corporation tax regime to achieve code compliance.

- Guernsey has reiterated its policy of not pursuing Solvency II equivalence.

- Review of the International Association of Insurance Supervisors, IAIS, revised core principles is underway with proposed responses expected later in the year.

UPCOMING EVENTS

- 24 – 26 July: MCIA's 7th Annual Conference, Montana, US
- 8 – 9 August: VCIA Annual Conference Burlington, VT, US
- 10-11 September: Captive Live USA, Chicago, US
- 1 – 3 October: Annual National Education Conference & Expo, Indianapolis, Indiana, US
- 5 – 7 October: ASHRM Annual Conference, National Harbor, MD, US
- 8 – 11 October: NRRA 2012 National Conference, Washington DC
- 22 – 24 October: HCIC Forum 2012, Waikiki, Oahu
- 13-14 November: European Captive Forum, Luxembourg

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