



# 180°

A guide to what's hot in the world of captives and ART



Strategic Risk Solutions

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## Rent versus Own

With the creation of protected cell and segregated account companies in the past few years, there has been a strong interest in the use of these rent-a-captive facilities rather than creating owned captives. In this issue we compare the relative benefits of owning versus renting captives.

**Background** - Traditionally prospective captive owners have had the option of capitalizing their own insurance companies or participating in an existing group facility. In the latter case rather than provide capital, participants pay a fee to “rent” the existing capital, licenses and services within the facility. Historically a major drawback to the rental facility has been the possibility that a participant may be exposed to the adverse claims experience of another participant. This was eased with the creation of protected cell legislation in many domiciles. This legislation, first passed in 1997 in Guernsey, provides for the legal separation of the different accounts within the captive – essentially the creation of a “firewall” between account holders. Protected cell laws now exist in most domiciles although often under different names: Segregated Account Companies (Bermuda), Segregated Portfolio Companies (Cayman), Sponsored Captives (Vermont), Protected Cell Companies (Guernsey) – collectively Protected Cell Companies (PCCs). With the legal separation of accounts in PCCs, individual accounts have many of the same characteristics of an owned captive without the need to capitalize the company. However, there remain differences in the structures that need to be fully assessed in evaluating the decision to rent or own.

**Costs** - PCCs have lower management and initiation costs.

- *Management costs* should be slightly lower under a PCC due to the sharing of some costs, such as audit, actuarial, accounting, legal and regulatory compliance. However the difference is not significant as the majority of the accounting functions need to be performed for the individual account in the same way that they would for the owned captive.
- *Initiation costs* can be significantly lower with a PCC as the prospective participant is taking advantage of an existing facility rather than incurring the time and expense of creating a new facility. Some owners of PCCs may provide feasibility services free of charge. This is particularly true where the captive program is integrated into an insurer's product offerings.

**Capital** - This is perhaps the most significant difference between the two approaches. Utilization of a “cell” in a PCC does not require the provision of statutory capital to the captive, as this is provided by the owners of the facility itself. An owned captive on the other hand will require the funding of a minimum amount of free and clear capital to satisfy regulatory requirements. This will typically be equivalent to the minimum levels of capitalization for the domicile. For a single parent

captive this is \$250,000 in most onshore domiciles and \$120,000 in most offshore domiciles.

**Collateral** - Collateral is required to protect against the credit risk associated with the captive's underwriting position. This is true for any self-insurance program where there is a counterparty involved, such as a fronting insurer. For PCCs, participants are responsible for losses within their cell accounts. This requirement is usually documented in the participation agreement between the captive owner and the cell participant. The captive owner faces a credit risk that participants will not be able to meet their obligations under the participation agreement. To protect against this risk, PCC participants are required to subscribe for capital or post collateral. Both PCC participants and owned captives may also have to post collateral to fronting insurers. While a single collateral provision will suffice both fronting insurers and PCC owners, the need to satisfy two masters may lead to more onerous collateral requirements under PCC programs. One strategy employed by captives to eliminate collateral requirements is to underwrite direct wherever possible. However writing direct business may not help a cell participant, who will still need to post collateral to the owner of the PCC.

**Risk sharing and stability** - It is worth reiterating that as loss experience is legally separated into separate accounts, there is no greater stability in participating in a PCC than in an owned captive. PCCs are often positioned as being a suitable solution for smaller accounts. While there may be reduced formation costs associated with these programs, they do not benefit from any greater risk spreading than an owned captive. Owned or rented options should be neutral in terms of the stability of risk financing costs.

**Flexibility** - A cell program is governed by the parameters of the PCC's license with the local domicile and the captive's by-laws. This may impose limitations on the lines of coverage that may be insured, the acceptance of any third party business and underwriting direct. A PCC owner typically seeks approval for all lines of business to provide flexibility for participants using the facility. An owned captive provides a great deal more flexibility in the design and structure of programs as the requirements of the PCC owner do not have to be met.

**Ease** - The process to create and approve a cell program is significantly shorter than that of an owned captive. The creation of an owned captive involves regulatory application and

approval. This usually requires a minimum of 30 days for approval from the regulators after the business plan and application has been developed. There can also be significant internal delays in securing the capital investment required to create an owned captive. On the other hand, once a cell program is approved by the owner of the PCC, the regulators in most domiciles must be advised and approval granted, but this is usually a 24-hour expedited process. Also, as no capital investment is required to create a new subsidiary, the internal approval process can be considerably faster.

**Control** - A PCC program involves an off-the-shelf standard service package with service providers (captive managers, investment managers, bankers, auditors, lawyers) assigned to the captive as a whole. Individual cell participants usually do not have the freedom to choose their own service providers. Should service standards suffer on the program, the cell participant may find it difficult to change service providers. An owned captive is a custom solution with service providers selected purely for that captive. Service providers are directly accountable for the individual captive program.

**Accounting** - FAS 113 requires that there be a "significant chance of a significant loss" in an insurance contract for it to be subject to insurance accounting. Otherwise deposit accounting will apply. The general consensus is that risk transfer is limited in each cell of a PCC due to the legal fire walls inherent in the PCC structure and the collateral requirements of the PCC owner. Typically in a PCC the full limit of each policy is funded through premium and collateral. Therefore, there is no potential for loss and no risk transfer has occurred. While owned captives must be structured appropriately to include the required risk transfer elements, most will meet FAS 113 as capital is being put at risk in the captive.

**Tax Issues** - A related issue applies to the tax treatment of owned captives versus PCCs. There are a couple of issues to consider. Firstly will the captive be treated as an insurance company for tax purposes? This has the benefit of allowing for deductibility of premiums. There is a reasonable body of law that defines parameters for an owned captive to meet this test. However, there is minimal case law applying to PCCs. As mentioned previously, the tax position for a PCC participant is probably significantly weaker than for an owned captive due to the lack of risk transfer.

A second tax issue is whether a captive can qualify under the 831(b) small insurance company tax regulation. This provides that insurers with less than \$1.2 million in premium can elect not to be taxed on their underwriting income. Most small owned captives can qualify for this tax beneficial election. However, if a PCC participant can not qualify as a bona fide insurer due to a lack of risk distribution and shifting, then it can not be considered an 831(b) insurance company. This may result in the loss of significant tax benefits.

**Scrutiny** - Owning an insurance subsidiary may draw undue attention internally. Participating in a PCC overcomes this as the participant is not the owner of the insurance company.

## Conclusion

Like other decisions affecting the creation of a captive program, there are pros and cons with owning versus renting. There is no

single answer to cover all situations. The options need to be evaluated against the characteristics of each insured's situation. Additionally the two options do not need to be considered purely as alternatives. A cell program can also be used as a stepping stone to the creation of an owned captive. In this situation, it will be important to negotiate the exit strategy up front as the holding of collateral by the PCC may limit the funds available to capitalize an owned captive.

## Domicile Update: Cayman Islands

Following the recent Cayman Captive Forum in December 2004, our quarterly domicile review focuses on the latest domicile in which SRS has become a manager: the Cayman Islands

In January 2005, the Cayman Islands Monetary Authority (CIMA) reported that it had licensed 76 new captives during 2004, bringing the total number of captives in Cayman to 694. This is the second highest reported growth in captive licenses in a domicile in 2004, marginally behind Bermuda. Cayman's growth is even more impressive in the light of:

- The number of Segregated Portfolio Companies (SPCs) in Cayman. Individual cell programs are not included in the number of captive licences.
- The damage sustained by the domicile from Hurricane Ivan during the year.

These captive license figures are clear evidence of Cayman's position as a leading captive domicile worldwide and its current popularity.

**Regulatory Environment** - Cayman's captive law was first enacted in 1979 and has been amended several times since. Its licensing is quite unique in that it recognizes only two broad categories of insurer and has considerable flexibility over capitalization requirements.

- An unrestricted class B license which permits all types of insurance. A statutory minimum net worth applies to Class B insurers: \$120,000 for general business and \$240,000 for long-term (life and annuity) business
- A restricted class B license, which limits underwriting to the risks of the insurer's parent or member. There is no statutory net worth requirement.

All proposed insurers must show that they have sufficient capital to support their underwriting. Satisfying this requirement is likely to determine the required capitalization for prospective captives. The structure of the regulation provides considerable flexibility in evaluating each situation on its own merits.

**Why Cayman?** We see three main reasons why captives should look to Cayman as a potential domicile.

- **Industry expertise:** Cayman is the premier domicile for healthcare captives worldwide. This specialty developed from Cayman's first activity in the captive world with the licensing of the Harvard Medical Institutions captive and has continued ever since. Cayman has developed an infrastructure of regulators and service providers that have knowledge and experience in this industry.
- **Flexibility:** Cayman's regulation has more flexibility in its structure than other domiciles. Prospective insurers, both restricted and unrestricted, may find this structure more receptive to the unique needs of their proposed ventures.

- *SPCs and group captives:* Cayman was one of the first domiciles to introduce SPC legislation in 1998. Since then, there has been considerable growth in SPCs aided by the flexible regulation structure of Cayman's insurance law. This flexibility has also encouraged the growth of group captives. Cayman is a strong market for insureds looking to participate in an existing facility, with or without risk sharing, or sponsors looking to provide these facilities.

**Looking Ahead** – We believe Cayman is very well positioned to take advantage of two strong trends in the captive market: the continued need for captive solutions in the healthcare sector and the progression of captive solutions into the middle market through the use of SPCs and group captives. Cayman faces some strong competition from new and expanding onshore domiciles. The political pressure for US companies to stay onshore has not harmed Cayman's recent growth and we anticipate that pressure will wane following the Bush re-election and an improving US economy. As the islands fully recover from Ivan and CIMA and service providers become fully resourced to proactively develop captive business, we believe the high levels of growth seen in 2004 will continue.

### Cayman Islands Captive Fact Sheet

#### Applicable Legislation

- The Cayman Islands Insurance Law (#24) of 1979 (1995 revision). Companies Law, 1969.
- The Insurance (forms) Regulations (1980).
- Monetary Authority Law 1996

**Number of Captives.** 694 licensed as of 12/31/2004.

#### Capitalization & Solvency Requirements

	Minimum Net Worth
Restricted Class B	No statutory minimum
Unrestricted Class B - General	\$120,000
Unrestricted Class B – Long-term	\$240,000
Unrestricted Class B – both	\$360,000

All insurers must show sufficient capital to support underwriting. As a general rule, Cayman regulators require a premium to surplus ratio less than 4:1.

#### Premium Taxes

There is no premium tax payable.

#### Incorporation Fees

Annual License Fee	\$8,333
Segregated Portfolio Companies	\$300 per cell, max: \$1,500

#### Local Representation Requirements

- Registered office
- Appointment of a locally licensed insurance manager, unless the company obtains approval to employ suitable local staff

## SRS News

**Client News** – SRS is pleased to welcome the following new captive clients:

- **L. Knife & Son**, a privately owned beverage distribution company has selected SRS to manage its newly formed captive, Finn Mac Cool Insurance Company, in Vermont
- **Cinergy Risk Solutions**, a Vermont domiciled captive and subsidiary of Cinergy Corporation, has selected SRS as its captive manager in Vermont. Cinergy is a gas and electric utility headquartered in Cincinnati, Ohio.
- **American Insurance Funding (AIF)**, has selected SRS as its captive manager in the Cayman Islands. AIF is a subsidiary of Woodhaven.
- **Affinity Logistics**, has selected SRS to manage its newly formed captive insurance company, Affinity Insurance Limited. The captive is domiciled in the Cayman Islands.

**Our People** – SRS is pleased to announce the appointment of Nicholas Leighton as Director of Operations for our Cayman office. Nick has over 15 years experience managing captives and most recently was Managing Director of Caledonian Insurance Services in Cayman. At the beginning of his career, Nick worked for Willis in Guernsey and was involved in forming insurance subsidiaries for some of the UK's largest companies. Later at Aon, Nick was made a Director of the Aon owned Protected Cell Company, White Rock, the world's first rent-a-captive to convert to a "cell captive".

SRS is also pleased to announce that Holly Ann Cholette-Anderson has joined our Cayman office as office manager. Holly Ann brings 25 years of experience working for Bank of America in Cayman to SRS.

**Events** – SRS will be participating in the following upcoming industry events:

- **CICA**, Brady Young will be presenting in the "Ask the Experts" session at the CICA conference On March 6-8, 2005 at LaCosta Resort in Carlsbad, California
- **VCIA Seminars**, SRS is pleased to announce its sponsorship of the 2005 series of VCIA seminars. These free seminars allow prospective captive owners to hear from the Vermont regulators and existing captive owners on the benefits and process of establishing a captive in Vermont. Four seminars will be held around the country, including Boston (February 9<sup>th</sup>) and Washington D.C. (April 6<sup>th</sup>). For more information and to register visit [www.vcia.com](http://www.vcia.com).

SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate. SRS is an approved manager of captive insurance companies in Arizona, Bermuda, Cayman Islands, D.C., South Carolina & Vermont. Through a wholly owned subsidiary SRS is also licensed as an insurance broker in Bermuda.

For more information on SRS, visit us at [www.strategicrisks.com](http://www.strategicrisks.com).

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