

Virtual round table



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Seven key players in the Cayman captive sector sat down around an e-table and answered five big questions.

To see what Cayman's insurance people are thinking, *Cayman Captive* arranged an e-round table late in October. We asked five questions of managers, the regulator, brokers and an insurance attorney. They replied electronically from various points on the globe as they travelled, or from their offices in Cayman.

THE PARTICIPANTS WERE:

Monique Jackson, senior vice president,
Global Captive Management Ltd

Conor Jennings, managing director,
Caledonian Insurance Services (Cayman) Limited

Daniel MacLean, managing director,
Aon Insurance Managers (Cayman) Ltd.

John Pitcairn, managing director,
Artex Risk Solutions (Cayman) Ltd.

N. Clayton Price, managing director,
captive solutions, *Marsh*

Gordon Rowell, head of insurance supervision,
Cayman Islands Monetary Authority

Paul Scrivener, partner,
Solomon Harris

1. What are the three most important reasons why any new captive should be domiciled in Cayman?

Pitcairn: My three reasons would be:

- 1) A solid infrastructure of knowledgeable captive insurance professionals
- 2) Regulatory flexibility within a sound supervisory environment, and
- 3) A deep well of experience built up over the 30 years since the initial captive legislation took form.

Jennings: I'd say:

- 1) Experience of the regulator and service providers

Cayman has been an active and successful captive centre since the 1970s. Over this time, its insurance regulator, the Cayman Islands Monetary Authority (CIMA), its captive insurance managers, auditors, tax consultants, bankers and lawyers have all built up an enormous amount of experience in helping clients with their own particular risk financing needs. This is a major competitive advantage to Cayman over many newer domiciles.

- 2) Ease of access and accommodation

Cayman has direct flights to and from many major cities in the US, and this, coupled with an excellent choice of top-class hotels, makes Cayman an easy place to reach and an enjoyable place to stay. Regular meetings between the captive directors and CIMA are encouraged.

- 3) Capitalisation costs

Although government fees have recently been increased, Cayman still offers a competitive level of minimum capitalisation at \$120,000 for general business and \$240,000 for long-term. Other domiciles, especially onshore, are generally higher than this, with some charging as much as \$2.0 million.

Scrivener: A number of factors have contributed to the Cayman Islands achieving and retaining its position as the world's second-largest domicile for captives. My top three factors, in no particular order, would be: the regulatory environment, the quality of the service providers and the political stability of the jurisdiction.

Let me expand on this a little. The regulatory regime is measured and proportionate, and overseen by a regulator, CIMA, which is much more accessible than its onshore counterpart. In my experience, clients establishing their first Cayman captive tend to be both surprised and impressed at just how accessible CIMA is to its licensees. Over the years, Cayman has been largely successful in ensuring that its regulatory regime remains current and accords with international standards, and the upcoming revisions to the Insurance Law are a good example. In terms of service providers, since Cayman's fledgling captive industry began in the 1970s, a wealth of knowledge and expertise has been built up amongst Cayman's insurance managers, audit firms, law firms and banks that captive owners can leverage off. There is little that these service providers will not have seen before. Cayman's political stability, underscored by its status as a British Overseas Territory, has always provided a high level of comfort to captive owners and that is still the case today. In June this year, Moody's, the rating agency, assigned a credit rating of 'Aa3' to the Cayman Islands, indicating a very high economic, institutional or government strength.

MacLean: We seem to be in agreement. I would lead with:

- 1) A long-standing captive jurisdiction recognised and accepted by the global insurance and reinsurance markets
- 2) A prudent but pragmatic, accessible and internationally compliant regulatory environment, and
- 3) Top talent and infrastructure.

The captive insurance concept, once looked upon as exotic, is now a fixture in the global insurance marketplace, and the Cayman Islands is one of an elite handful of jurisdictions that can boast a 30-year track record as a leading captive jurisdiction. A jurisdiction will not succeed unless it is recognised by other international insurance and reinsurance markets that are willing to front or reinsure captive risk. Cayman captives interact on a daily basis with all major insurance markets, whether domestic or offshore, or US or European-based. We have gained the trust of the markets and this is critical.

Our regulatory environment is second to none and, in my opinion, remains a competitive advantage. While adhering to the highest international standards prescribed by the International Association of Insurance Supervisors (IAIS), CIMA has also practised a consultative and accessible form of oversight. Our regulators don't sit in ivory towers and cast judgement. They meet face-to-face with almost every captive client and listen to their business plan. Our clients appreciate the opportunity to have this dialogue, and this regular contact allows CIMA to maintain closer oversight.

Lastly, unlike most other major captive jurisdictions, Cayman has the benefit of a sophisticated international financial services

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industry with several pillars: captive insurance, banking, investment management and fund administration, along with the benefits of spin-off business tourism. Development of a reinsurance sector is also on the radar screen of the jurisdiction. What this provides is a savvy jurisdiction with a depth of professional service providers that you would not find in any other captive jurisdiction.

Rowell: I wanted to add something different to the mix, and it is especially pertinent arising from the recent economic crisis. Failings of risk management have been a fundamental theme both from the G20 group of nations and, admittedly, from the US private sector (banking and funds) themselves. A fundamental premise of risk management is understanding the underlying business and I think that, in the Cayman Islands, we are not talking about captive management and ownership versus the regulator versus the policyholder, we are talking about a business partnership in which the parties not only understand their own roles, but also understand the roles of the other parties in the financial structure, because we all come from risk management backgrounds.

This may not be so useful in times of economic stability, but when times are unstable, it is useful to be able to adjust risk management strategies (e.g. absorb greater risk, declare dividends, etc.) with the comfort of a regulatory environment that both understands and approves the change.

Price: I'm not about to disagree. I'd say:

- 1) Regulatory environment
- 2) Being the world's second-largest captive domicile, the availability of intellectual capital and resources, and
- 3) Synergies and benchmarking due to the critical mass that can be shared by captive owners, especially those who participate in the IMAC conference, which had more than 800 registrants in 2008.

Jackson: For me, the most important reason is the vast experience of our service providers in the captive industry. This continues to be one of our competitive advantages as more domiciles add captive legislation without having experienced personnel on board to form and regulate their captives. Here in the Cayman Islands, we have been working with captives for more than 30 years and, with this experience, we know what captive model will form a successful part of the risk management process. Another advantage is our up-to-date and flexible legislation—while the insurance legislation is about to be amended to reflect more current guidelines, it still should allow captives the flexibility to provide coverage (both traditional and non-traditional) without being subject to overly onerous requirements.

2. As Ms Jackson says, we understand that the Cayman Islands will amend its current Insurance Law, with the new law to be enacted possibly before year end 2009. Although alignments may be anticipated with the IAIS core principles, what enhancements is Cayman seeking to incorporate into the new law to ensure it stays on the leading edge for domicile choice?

Rowell: Good question and, to answer, we have to look at the roles of the different types of entities in the mix. We have domestic insurers, pure captives, captives writing third-party risks, special purpose vehicles and reinsurers. It is now a good time to start looking at how we regulate these licensees to make sure the appropriate level of regulation is focused at the appropriate entity

risk level. This is the premise of risk-based regulation.

The suggested law changes, which are presently under review, will affect captives minimally but will, however, gear resources more heavily toward domestic insurers and reinsurers. For example, we want a level of capital appropriate to the level of risk, but to make this prescriptive for reinsurers would also affect captives, unless we were to separate them into different licensee categories. The new law seeks to address this and, yes, the capital requirement for pure captives will remain the same. This is an acceptable method both from an international perspective (IAIS core principles) and from a business development perspective.

I should however point out that the law has only recently been drafted and still requires extensive consultation with the private sector before we can enact any provisions.

Scrivener: Work began on proposed revisions to the Insurance Law in the early part of this year, with CIMA and the Legislative & Regulatory Affairs Committee of IMAC at the forefront of the initiative, evidencing that the often talked about public/private sector partnership in the Cayman Islands is very much alive and well. The 2008 revision to the law was a consolidation of various amendments that had been made since the previous revision and did not contain any substantive changes.

The revision that is being worked on now is substantive in nature and is designed to ensure that the law fully responds to IAIS core principles. As far as I am aware, the details are still being worked on, but it is anticipated that the new law will enhance CIMA's authority and place less reliance on the use of guidance notes; will address the capital and solvency requirements for captives that write unrelated third-party risk; and may also include provisions with regard to segregated portfolio companies. The exact timing of the passage of the bill into law is not yet certain, but it is expected in the near future.

Maclean: CIMA has always been guided by the core principles of the IAIS. Cayman's Insurance Law has been robust enough to stand the test of time since the mid-1970s, with negligible failures due to solvency. The alignments are largely targeted at Cayman's domestic insurance market.

The proposed changes to the law affecting the captive sector are timely, however, since the IAIS issued captive-specific guidance on supervision in late 2008. Until this time, there were no international standards on the supervision of captive insurers. The enhancements are likely to formalise the classification of captives and the risk-based approach adopted by CIMA to date. I believe the proposed changes will result in CIMA continuing to risk-profile captives and to maintain a more pragmatic approach to regulation for the majority of captives that present relatively little regulatory risk, and to focus more on captives engaged in underwriting third-party risk.

Pitcairn: Whatever the changes are, I would expect that we will continue to have responsive regulation that is flexible and supportive to the captive industry.

Jackson: Since the law hasn't been released as yet, I can only respond in general terms. As far as we're aware, the enhancements to the law will introduce some solvency initiatives for captives as per current regulatory guidelines, but this will be done in a practical manner and should not inhibit future growth of our industry. Any increased focus will be on those with higher risk profiles; this should not be seen as a negative development but a practical one. Captive

principals should be assured that the Cayman Islands is committed to ensuring that we maintain a quality jurisdiction.

3. How will recent news commentary about the Cayman Islands' revenue shortfalls and financial condition affect the Cayman captive industry?

Jackson: Cayman is committed to maintaining a successful financial industry and is by no means down for the count, as some recent negative news stories seem to infer. There's a local expression that says "when the US sneezes, Cayman (and the rest of the world) catches a cold", and the simple truth is that we have not been immune to the effects of the global recession and are just now feeling the real impact of the world's financial crises. This should not be unexpected, nor is it catastrophic. And, as other financial markets do expect to recover, so do we believe that we will weather this economic storm.

Price: As with all governments worldwide, shortfalls in revenue will need to be addressed. Cayman has sought to reduce the size of government through attrition and to nominally increase various fees, including the annual insurance licence fee by \$1,000.

MacLean: As a global financial service centre, it should come as no surprise that the Cayman Islands has also been affected by the events affecting every major global economy. The Islands' two main industries are financial services and tourism, and neither has escaped the economic downturn, resulting in the revenue decline. The recently elected Government has reacted quickly and prudently, and tabled a budget at the beginning of October that is projected to bring the country back to an operating surplus for the 2009/2010 fiscal year. The Government has reiterated its position that it will not revert to such direct revenue measures as corporate income tax or premium tax.

The revenue shortfall will be addressed through a combination of expense reductions across the civil service, along with select revenue measures, including increases in import duties, work permit fees and other government fees. The direct impact on the captive industry is expected to be minimal. For example, the annual insurance licence is expected to increase from C\$7,500 to C\$8,500. This is a relatively modest increase when you consider that the licence fee hasn't changed in years.

I don't believe these events will change the minds of existing clients or prospective captive owners. Those entities that were not inclined to set up an offshore captive may use this news to reinforce their thinking. However, most prospective captive clients will be guided by the recommendations of a domicile feasibility study and Cayman will continue to stack up well against other jurisdictions, particularly the myriad of newer captive jurisdictions.

In fact, this situation may play out with a positive result. The Government has consulted extensively with the private sector and we may see a wave of impetus measures directed at the financial services sector.

Jennings: Now that the dust has settled and the special relationship between the Cayman Government and the UK has been explained, things are back to normal. In fact, many clients, being risk managers at heart, welcome the fact that special permission has to be sought from the UK before the Government can borrow funds from banks, as it acts as an external audit check. Although the above was a worry initially, of far greater concern to the captive owners is the state of their own economies. In situations such as

this, it is only natural that their captives will have to take a back seat until their parent's core businesses are back in order. The credit crisis has already resulted in a number of older captives or captives in run-off being closed down during 2009, but none of this will have been as a result of Cayman's financial condition.

Rowell: Let me make one point here. The Cayman Islands is suffering from the effects of the global economy as much as any other nation, but unlike the US, European Union and other regions, where budget financing has outstripped GDP, Cayman is still well within reasonable debt limits and has many revenue-generating options available to it. It has not even used the most obvious form of revenue generation, i.e. direct taxation. The Cayman Islands Government continues to operate a system of indirect taxation as it is an appropriate method of funding. However, Cayman has these options open for revenue generation, unlike a number of countries both developed and developing—and indeed the European Union, where raising direct taxes would stifle consumer spending, further stifle credit and extend recessionary pressures.

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I think that this is a positive situation that has somehow been misinterpreted as a negative situation.

Pitcairn: You may see some small government fee increases but as licences and other filing fees have not changed for quite some time, I do not think that this will have any effect on formations or on the operations of existing captives.

Scrivener: Unfortunately, there was much misreporting in certain parts of the international media concerning the new Cayman Government's need to borrow in order to balance the country's books. Not surprisingly, this caused a level of consternation amongst those who were not aware of the facts. Comments that Cayman was bankrupt and was having to go to the UK for a bailout were headline-making, but plain untrue.

It was perhaps less newsworthy to report that the Government had already secured the borrowing it needed from international banks, was not seeking borrowing (let alone a bailout) from the UK and only needed to seek UK approval for the borrowing because certain self-imposed financing ratios had been exceeded. As I mentioned earlier, Moody's had very recently assigned an 'Aa3' rating to the Cayman Islands, which indicated the jurisdiction's strong economic position. In my own experience, for those clients who asked about the financial situation, once the true position was explained, any concerns quickly went away.

There was, however, a lot more initial concern among captive owners when talk of the possibility of direct taxation emerged.

This came from a push by the UK for Cayman to look at means of widening its revenue basis, with suggested possibilities being a payroll tax and a property tax. Such a proposal was resoundingly rejected by the Cayman Government and, instead, the books were balanced by increasing various fees and duties, but it was inevitable that the press would get hold of this one.

To be absolutely clear, no direct taxation has been or is proposed to be introduced, and even if this were to change at some point, it would be inconceivable for it to extend beyond those living or working in the Cayman Islands. I am entirely confident that no direct taxation would be applied to exempted companies such as captives. As I mentioned, the budget was balanced by raising fees and duties, but indications at this time are that increases in captive licence fees and company fees will not be material.

4. US healthcare entities form one of the largest industry groups using captives. How will CIMA and IMAC maintain focus on this industry, faced as it is with potentially dramatic changes in the healthcare delivery system of the US?

MacLean: I'm not sure that anyone has a clear picture yet of the impact of healthcare reform in the US and how it may affect the captive industry. Not surprisingly, however, regulatory and legislative change was the second-most cited business risk (second only to economic slowdown) by more than 550 of our largest clients across 40 countries, according to Aon's 2009 *Global Risk Management Survey*. And as we know, the healthcare industry is one of the most highly regulated industries in the world.



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International Management Services Ltd

Box 61, 4th Floor Harbour Centre, George Town,
Grand Cayman KY1-1102, Cayman Islands BWI
T: 1 345 949 4244 F: 1 345 949 8635 E: mhoward@ims.ky
www.ims.ky



While economic conditions have resulted in an overall decline in merger and acquisition activity, I believe the healthcare industry will see an increase in consolidation and M&A activity, resulting in fewer providers as healthcare systems strive for greater efficiencies and reduced costs. Aon has seen this trend within our healthcare captive client base already with the merger of at least two systems in the past year.

The projected growth in healthcare costs is threatening the sustainability of the entire system. With any proposed reform bill, healthcare providers will be under pressure to cut costs. Cayman will need to be sensitive to this pressure and also be prepared to address the perception that doing business offshore is more expensive. We will need to continue to re-emphasise our value proposition as the leading healthcare captive jurisdiction and ensure that clients continue to benefit from our unrivalled experience in this industry sector.

Having said that, we have an endless number of case studies that demonstrate how the formation of a healthcare captive has led to a reduction in the client's overall cost of risk. So while we may see a decline in the overall number of healthcare captives due to M&A activity, we may also see other health systems jump in and form captives to begin to self-insure in response to cost reduction pressure.

Rowell: Having worked in the healthcare industry myself, both as a board member of a hospital and as a health insurer, I recognise the dilemma facing the US healthcare system and there is no easy answer. However, we must separate a couple of items here. Firstly, regardless of what delivery system is chosen, the same dynamics will continue to play, including patient demands on both timeliness and cost of delivery; practitioner demands in terms of compensation; medical inflationary pressures from both new treatments and improved treatments; the absence of evidence-based medicine; and the tort environment. These do not disappear because of a new method of delivery, nor by extending that delivery to a greater population.

Ultimately, a captive is a part of a risk management structure and is a means to an end. It will take many years to resolve the issues of healthcare delivery, particularly to the uninsured. A captive not only will have to remain a part of the risk management process, but given the focus it delivers on risk management, will probably also be used more extensively to cover risks other than long-tail risks.

Scrivener: It is certainly the case that healthcare is a major focus of Cayman's captive insurance industry, with approximately one-third of captives being healthcare-related. At this stage, the final shape of President Obama's healthcare reforms is uncertain. While I have not followed every twist and turn of the discussions that have taken place, I would be surprised if whatever finally emerges has any material impact on the way that US healthcare systems use alternative risk management. The business case for establishing an offshore captive, and particularly in Cayman, should remain as strong as ever, particularly among the not-for-profit systems that have traditionally looked to Cayman rather than US onshore jurisdictions to meet their needs. Nevertheless, it is very important that the industry in Cayman continues to closely follow these huge developments in the way that healthcare will be delivered in the US and ensures that our model continues to be fully aligned with the business needs of the healthcare systems.

Pitcairn: Cayman is the leading healthcare captive domicile and, as such, probably has more industry contacts and keeps up-to-date more closely with the healthcare industry than any other location. It should be best placed, therefore, to respond to any challenges or opportunities resulting from future changes in the provision of healthcare in the US.

Price: Individual doctors and practitioners are likely to face change that could negatively affect them; however, hospitals may fare better depending on the final fee schedules. Who knows—perhaps the doctors should consider becoming employees of an onshore subsidiary of their captive.

Jackson: We do not yet know what will be the real impact of the legislation on healthcare entities. Nevertheless, we will adapt the healthcare captive model as necessary and practicable. A captive is a long-term risk management tool and I believe that captives will continue to play an important part in managing risks for healthcare entities.

5. What trends are you seeing in new lines of business that are being added to a captive?

Jennings: Interestingly, as a direct result of the credit crisis, companies are revisiting how they identify and quantify their risks. This has resulted in more attention being paid to enterprise risk management. ERM is the latest wrap-around term to describe

a top-down, dynamic and holistic risk management framework or process. For many companies, the adoption of ERM has already shown that their risk profile is very different from what it was 10 years ago. For example, companies may start to appreciate that their real concerns are not fire or explosion but more modern risks such as loss of reputation, regulatory involvement and IT network problems.

The silver lining of the economic crisis is that ERM will become more and more important to organisations, and the opportunities resulting from this for the alternative risk financing markets such as Cayman are exciting indeed.

MacLean: Specific to the healthcare sector, we are seeing increased interest in the area of medical stop loss coverage through captives, along with interest in providing coverage for medical equipment maintenance insurance.

More generally, while not a new line of business, captives continue to help fund overall corporate risk management initiatives through risk management grants back to the parent company. We have certainly seen an increase in such activity as risk management operating budgets have come under pressure.

All indications point to an inevitable hardening of the insurance market due to a complete lack of investment returns, but the weather has co-operated up to this point and we haven't had any significant storm activity, which may be helping to keep rates under control. Given everyone's focus on cost containment, if commercial

insurance rates spike, I expect we'd see renewed interest in captive coverage across most P&C lines.

Pitcairn: The main difference is that people are focusing more and more on what additional business can be placed into the captive, whether it is to respond to gaps in coverage in their existing programme or to fund for new liabilities. They are discovering what a really useful and flexible tool a captive can be.

Price: Employee benefits are being more closely reviewed again. Intellectual property continues to be a line of interest as well.

Jackson: Trends include an increased focus on the creation of Segregated Portfolio Companies (SPCs) and the addition of new segregated portfolios to existing SPCs, as well as more proposals to add coverages for non-traditional lines of business.

Scrivener: In the healthcare area, we continue to see clients who are looking to expand their existing offering to include self-employed physicians. In these circumstances, it is not uncommon to convert to an SPC, with a view to segregating the new programmes from the existing programmes already in place. Generally, we find the SPC a popular vehicle where there is a desire to establish separate and distinct insurance pools in this way. In other areas too, we have seen existing captives looking to leverage off their existing infrastructure by offering new lines of business with the primary example in the recent past being auto warranty captives.



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