



Captive Insurance in the Cayman Islands: Stability in a world of uncertainty

Key themes from the 2009 Cayman Captive Conference

INSURANCE

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Foreword

“We hope you will benefit from the insights provided in this publication and we look forward to seeing you at the Cayman Captive Forum in 2010.”

John Ferrari

The 2009 Cayman Captive Forum (Forum) provided a number of informative sessions acknowledging that despite a turbulent and uncertain market, the captive insurance industry has remained stable. Although the global climate continues to breed caution and uncertainty, the Cayman captive insurance industry has remained strong.

As Ron Sulisz, Chairman of the Insurance Managers Association in Cayman (IMAC), mentioned in his opening remarks, the forum sessions have evolved to reflect the growing maturity of the captive industry in Cayman, offering even greater educational benefit to delegates.

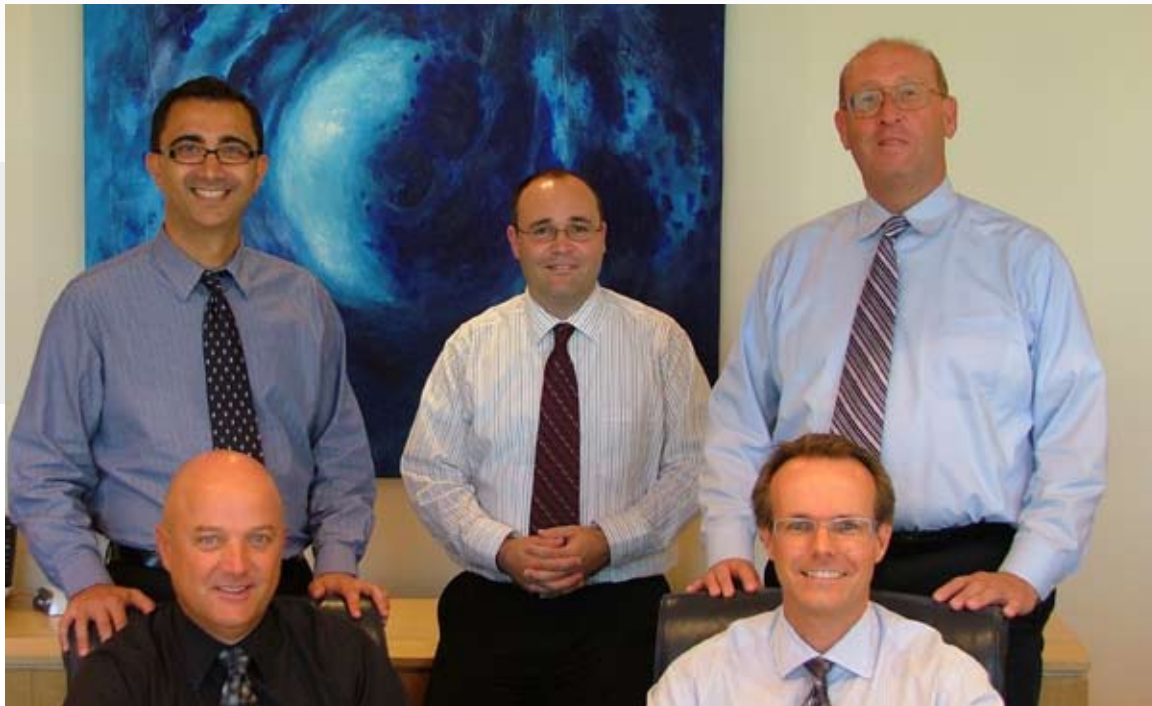
Although there was broad acknowledgement that the current global climate continues to breed caution and concern, the Cayman captive insurance industry has remained strong, with few liquidations and a consistent number of formations since the significant growth period of 2003. It is reassuring that the number of captive formations grew in 2009 and most forum participants expect to see a continued upward trend through 2010 and the foreseeable future.

With the commercial insurance market on the brink of change, the Forum could not have been better timed. The prevailing soft conditions that followed the global financial crisis do not appear to be sustainable,

which may increase demand for alternate insurance. In his presentation “A crash diet,” Gordon Rowell, Head of Insurance Supervision at Cayman Islands Monetary Authority (CIMA), observed that new challenges will arise from any change.

He encouraged early captive formation as a way of locking in available fronting arrangements and collateral agreements, to take advantage of the current ease of availability.

Many of those attending felt that risk and capital management will remain important over the coming year, and also expect to see more consultation on regulation in the industry.



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01 Chairman's opening remarks

Despite the background of global economic uncertainty, IMAC Chairman Ron Sulisz delivered an upbeat opening message, commending the spirit of co-operation that has helped build the Cayman captive industry into its current healthy, growing position. He also expressed his delight and encouragement at the remarkable attendance figure of 851 delegates – the second largest on record.





“The many projects of IMAC, including the forum, are a result of the co-operative efforts of the IMAC members that have helped to build the Cayman captive industry to what it is today.” Ron Sulisz

This set the stage for the Forum sessions, all of which encouraged captives to remain firm, whilst ensuring that they challenge their status quo and prepare well for the future. With the global crisis at the forefront of everyone’s minds, many of the presentations reflected this concern, but Mr. Sulisz also emphasized the continued confidence in the Cayman captive market, as well as the educational and networking value of the Forum.

IMAC educational scholarship fund

The Chairman paid a tribute to Tom Clark of HSBC, who passed away on 26 August 2009. Tom was one of the two initial directors of the IMAC Educational Scholarship Fund and thus was highly instrumental in its establishment and ultimate success. Mr. Sulisz observed, “The fund is something for IMAC members to be extremely proud of.”

Whilst IMAC is the main contributor to the fund, primarily through proceeds from the hugely successful forum, other contributions are received as donations from captives, service providers and individuals within the captive insurance industry.

Thank you to all delegates and sponsors

Mr. Sulisz thanked his future successor, Monique Jackson for all her efforts, wishing her every success in her new role in 2010. He thanked the sponsors and delegates for their continuing support, singling out KPMG – who has been the main sponsor of the forum for a number of years. He also expressed his delight and encouragement at the remarkable attendance figure of 851 delegates – the second largest on record.

In conclusion, the Chairman commended the captive industry’s success in building an effective working relationship between the private sector and government, which has led to a refined consultation process on new laws and regulations for the industry. IMAC’s success is entirely dependent upon the hard work of its members, as Mr. Sulisz noted, “The many projects of IMAC, including the Forum, are a result of the co-operative efforts of the IMAC members that have helped to build the Cayman captive industry to what it is today.”



02 Keynote speaker Ken Schmidt

In the midst of a worldwide recession, this year's key note speaker argued that the key to survival lies in connecting with your customers. Ken Schmidt, Marketing Visionary and former Director of Communications for Harley-Davidson, is a frequent speaker to business groups and academic communities throughout the world. Mr. Schmidt provided a captivating presentation and provided some insights into human behavior that really challenged the audience's preconceptions about how to gain competitive advantage.





“Humans like to talk about themselves and be noticed, so by engaging their heart, you are more likely to win their business”

Ken Schmidt

On the recovery of Harley Davidson

In his account of the mistakes made – and lessons learned – in Harley-Davidson’s recovery from almost certain bankruptcy in the mid 1980s, Mr. Schmidt described how the company used an early form of what is now known as social networking to create the largest motorcycle owners association in the world. In the early 1990s this association was subject to ethnographic studies and widely recommended as a model for member organizations.

On gaining competitive advantage

Mr. Schmidt strongly rejected the over-use of phrases such as “quality”, “commitment” and “excellence” in marketing materials and advertising, claiming that consumers did not trust such words, since virtually every

company used similar promises. He was equally scathing about the over-reliance on market research data – such as market share – as it stifled creativity. Interestingly, he felt it was futile to try to compete on the basis of quality alone, and that marketers in general were guilty of commoditizing products.

According to the presenter, marketing communications must show a better understanding of human behavior, resulting in a more human touch that will get consumers to actually “like” your company. Marketers should be aware that most purchasing decisions transcend logical thought and are rather irrational and unpredictable; therefore the key is to treat consumers as real people and develop a genuine dialogue that recognizes their individuality.

“Humans like to talk about themselves and be noticed, so by engaging their heart, you are more likely to win their business,” he said, stating that Harley Davidson did not sell motorcycles, but was in the “dream fulfilment business.” This year’s delegates were not disappointed, with controversial ideas on transforming corporate culture and rewriting the rules of marketing.

This witty and engaging speaker concluded that it was lateral thinking, rather than strict business rules, which helped the company recover from a seemingly impossible situation.

“I love to startle people by exposing them to proven ideas and concepts they’ve never imagined.” – Ken Schmidt

“Whether I’m talking about how perfectly average people can do extraordinary things - which is now an everyday occurrence at Harley-Davidson - or how to build an entirely new corporate culture, rekindle relationships with customers, or reach out to new ones in completely untraditional ways, I’m teaching people to throw conventional approaches out the window. I see opening hearts and minds as my life’s work.” **Ken Schmidt**

Global economic climate and the captive market

03 Global economic impact on the market

The extraordinary events of the global financial crisis have had far reaching negative effects. Top rate guidance and predictions regarding economic recovery are necessary to facilitate planning for 2010 and beyond.

In his presentation, Craig Wright, the chief economist at Royal Bank of Canada (RBC), shared his views on the global economic impact on the markets.

Craig leads a global team of economists and strategists to provide economic, fixed income and foreign exchange research to RBC clients and the media.





“The roots of the global recession lay in the US and the UK. It was not home made and therefore the solution cannot be home made either.” **Craig Wright**

On the global crisis

Describing the extraordinary events of the global crisis, Mr. Wright argued that the turning point came in October 2008 when the G10 countries took concerted action by cutting interest rates. This, along with further G7 measures to address liquidity and take a financial stake in certain failing institutions, helped restore confidence and stimulate the various economies. Consequently many economists now predict a moderate recovery, although the timing remains uncertain.

According to the speaker, the crisis was caused by a combination of interest rates being too low for too long, unsustainable fiscal policy and massive liquidity injections. He also felt that if recovery was too slow, there was a danger of rising inflation.

On the global financial markets and stability

“The post-recovery world will look very different,” Mr. Wright warned: “there will be a ‘new normal’ characterized by continued risk aversion, volatility, higher cost and reduced availability of credit, greater transparency and increased regulation.”

These comments were supported by a number of key indicators demonstrating that the recovery is well underway. The Risk Aversion Index (S&P 500), which runs at an average of 20 points, spiked to 90 points in October 2008, but has recently touched 20 again.

Secondly, the TED Spread: Treasuries relative to Euros (considered a good gauge of trust across banks), which averages at 25 basis points, reached 400 in October 2008 but has returned to normal recently. The cost of short term borrowing relative to the overnight interest rates, usually around 8-10 basis points, had risen in October 2008 to 400 basis points. Although lower in December 2009, there is still some heightened borrowing cost from banks. Finally, Mr. Wright observed that credit is still tight but it is not expected to tighten further, and added that in the US, banks only supply 25 percent of total credit. The rest is supplied by the equity and bond markets, the latter having now returned to normal.

On global growth

Referring to the latest International Monetary Fund (IMF) reports on growth prospects, he noted that although the latest predictions for 2010 indicate growth this is predominately from China and India. Amongst the G7, growth level predictions are mixed but generally stronger in commodity-rich countries such as Canada and Australia. Mr. Wright’s overall view was positive. “Technically, the recession, which has been the deepest crisis since World War II, is over for all G7 countries with the exception of the UK.”

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On the US economy

Referring to Federal Reserve’s “rapid and aggressive” response to cut interest rates and ease credit, Mr. Wright commented that the balance sheet has ballooned from US\$8 billion to US\$2.4 trillion, and the fiscal policy deficit rose from US\$459 billion to US\$1.6 trillion. He feels the private sector must step in to assume this debt to avoid the risk of tax increases and public spending cuts. He also suggested that the US may have to introduce a value added tax (it is currently the only OECD country without such a tax).

Mr. Wright also noted that US consumers – who are responsible for 70 percent of the economy – are currently struggling with debt, although at least the housing market appears to have bottomed out. In the short term the Fed is expected to wind down non-conventional initiatives, mop up excess liquidity and normalize interest rates by Q4 2010.

On the impact upon the Cayman market

Wrapping up his highly informative talk, Mr. Wright stated that Cayman’s financial services will recover at a similar pace to the US with signs of the tourism industry starting to pick up, albeit slowly. Referring to the role of Cayman, he said, “The roots of the global recession lay in the US and the UK. It was not home made and therefore the solution cannot be home made either.”

04 2009 – A year in review “The crash diet”

The Cayman Islands Monetary Authority (CIMA) plays a vital role in the success of the Cayman captive market. The delegates were therefore very keen to hear the views of the Authority’s Head of Insurance Supervision, Gordon Rowell. Having acted as director on a number of captive boards, between his tenures with CIMA, Mr. Rowell was able to call upon his extensive understanding of both the industry and of regulation to deliver a perceptive assessment of current conditions.





“CIMA’s objective is to remain prudent, responsive, focused and to continue to pursue development opportunities, such as a reinsurance market, and to raise awareness of its international co-operation activities.” **Gordon Rowell**

Setting the scene for his presentation, Mr. Rowell described recent economic and market history as “gluttony” in 2007 (financial institutions taking on more risk than they could handle) followed by “remorse” in 2008. He was also quick to point out that weaknesses such as incompetent risk management, distorted incentives, poor investor due diligence and weak regulators and rating agencies, mostly related to the international banking industry and not to the international insurance industry. Finally he described 2009 as a year of “diet” for the insurance industry, as it tries to cope with demand contracting faster than supply.

On Cayman captive market growth

Looking at growth determined by the number of new captives, Mr. Rowell reported that despite the soft market, captive formations had increased by 28 percent in 2009, net premiums had remained stable and expense ratios stayed around 10 percent or less. In addition, significant movements in leading industries and employee benefits show that there are good alternative markets.

On insurance law reform

In addressing this ongoing question, Mr. Rowell summarized the reform proposals and concluded that the majority of captives had little to worry about, since the changes are predominantly geared towards the domestic market. Those reforms that are applicable to captives are geared towards those writing a significant proportion of third party business.

On International co-operation

Acknowledging that offshore financial center regulators have always faced ongoing scrutiny from onshore centers, Mr. Rowell believes that such a state of affairs is unlikely to change in the foreseeable future. However, he emphasized the determination of CIMA to represent its members’ interests effectively. He noted that the authority is a founding member of a number of international standard setters, including the International Association of Insurance Supervisors (IAIS). CIMA is also actively involved with the Committee of European Insurance and Occupational Pensions Supervisors on the issue of Solvency II. The Head of Insurance Supervision went on to say: “CIMA’s objective is to remain responsive, focused and to continue to pursue development opportunities – such as a reinsurance market – and to raise awareness of its international co-operation activities.”

On economic outlook and captive challenges

Referring to the current soft market, Mr. Rowell stressed that: “The regulator will remain resolute in its mission, but in doing so the conditions of the market must be considered. Fundamentally though, stability is important.”

Closing what was a highly topical and compelling presentation, he stressed that for most captives challenges have not so much changed as become exaggerated by the economic climate. He predicted that a hard market was coming, possibly in 9-12 months time, with rates starting to rise slowly at the start of 2010. This in turn could mean that it may become tougher to maintain sufficient collateral, fronting arrangements and reinsurance protection. He therefore urged those present to act now in forming a potential captive and securing its needs – rather than simply wait until the market hardened.

05 Beyond basics: Managing captives in incredibly difficult times

To survive the economic downturn, captives will have to review their business model and their operations. This hard hitting tutorial was presented by a highly experienced panel of experts.

Key presenters Bill Cassetta of Honigman Miller Schwartz and Cohn and Tom Hermes of Towers Perrin have together accumulated up almost 60 years of experience in the captive industry. Joined by Seamus Tivnan of Strategic Risk Solutions and Dwight Merren of the Cayman Islands Monetary Authority (CIMA), this pre-Forum tutorial discussed how to manage captives in the current environment, paying particular attention to legal and actuarial issues.

The panelists acknowledged that since the crisis began, only a handful of captives had suffered involuntary liquidations, whilst the industry has also witnessed 34 new formations in 2009 showing the captive industry is remaining strong and resilient.

Mission statement

Captive owners have traditionally formed and owned captives to minimize risk considerations and the cost of risk, and to support a parent company. However the panel urged owners to fundamentally rethink these reasons, challenging assumptions about, for example, letters of credit, which in recent times have become more expensive, difficult to obtain and laden with conditions and restrictions. Owners were also encouraged to question their chosen confidence levels, and possibly come up with new levels that fit their own unique situation.





“Currently, medical malpractice is free from crisis although the well established cycle suggests that this is due to change”

Bill Cassetta

Governance

Since a successful captive relies on a team effort, all service providers and stakeholders were encouraged to work together collaboratively. Current corporate travel restrictions were felt to provide a false economy as they often prevented directors and service providers from attending captive board meetings. This could lead to a neglect of the captive’s needs, particularly any legal requirements on how the captive was managed.

The panel members also called for the cycle of meetings and reporting within the captive to be organized more effectively and efficiently; for example: ensuring that claims reviews, actuarial reports, audits and board meetings occur within the same time period.

Risk management

Referring to the recent CIMA Rule requiring insurers to have and review frequently a risk management strategy, the presenters were concerned that in some cases this was only carried out at a token level. Risk management should be a core feature of captive management, going beyond the minimum CIMA requirements to include regulatory risk, reputation risk, cumulative risk and succession/leadership risk.

Taxation

The implications of a number of filings and IRS rules were highlighted in some detail. These included the Federal Excise Tax (FET) audit, noting recent interpretations of FET treatment of “pass through” reinsurance. Also considered were the indicative changes in the IRS approach to what constitutes “true insurance” which, if formalized, would require a review of the structure of the program. Secondly, the panel looked at the possibility that Foreign Bank Account Report (FBAR) filings may be necessary in relation to captive bank accounts; if so, this would require a review of the captive’s investment portfolio to assess the applicability.

The thorny issue of tax returns was also discussed, with a general feeling that the captive must ensure a consistent approach to the filing of returns, especially where personnel within the parent company are completing the filings and may not appreciate the features and tax peculiarities of the captive.

Healthcare

The speakers reported good news for healthcare captives: that medical malpractice is currently free from crisis. However, they also warned this situation could change as a result of the encroachment of absolute liability, user errors in systems, better technology for diagnosis and human complacency. Further issues to consider were increased Government scrutiny and increased public awareness of issues.

Other factors that could negatively impact loss experience were thought to be the proposed overhaul of the US healthcare system, the still fragile economy, the performance of investments, and any changes in accounting or regulatory requirements.

Investment policy

The panel called for a frequent review of a captive’s investment policy, as any changes could be subject to regulatory requirements. There was also some concern that captive boards may focus solely on the portfolio’s investment returns and pay insufficient attention to the rationale and strategy of the policy. A further worry was that, by putting too much pressure on investment managers to provide above average returns, the captive’s assets – typically covering its reserves – could be placed at risk. The presenters stated that all new strategies should be carefully thought through, to ensure they were fully appropriate for the captive.

Risk and regulation – “New world realities”

06 2009 top ten global risks

The Aon Global Risk Management Survey is an important indicator of current attitudes to risk, capturing the perspectives of senior risk professionals from many of the world’s leading organizations. Given the recent economic events, delegates eagerly awaited the latest findings, which were presented by Stephen Cross, Chief Executive Officer of Aon Global Risk Consulting (AGRC).



Mr. Cross emphasized how difficult it is to measure and compare the changed risk levels globally, due to the sheer volume of money involved. Many captives have exposure to the construction industry, so Mr. Cross highlighted the challenges of quantifying risks in this sector, and therefore the need to continually evaluate – and possibly enhance and extend – relevant risk management arrangements.

What is driving demand?

Mr. Cross summarized the demand for enhanced and extended risk management as stemming from the following drivers:

- Economic volatility
- Increased focus of regulators
- Investor demands
- Natural weather events

The top ten risks, which are outlined by industry in the table below, were fairly consistent with previous surveys. However, the top two – “economic slowdown” and “regulatory and legislative changes” reflected the changing times, as neither of these had been ranked so highly in previous surveys.

Readiness for the economic downturn

Just how well were companies prepared for the risk of a recession? Mr. Cross questioned the fact that respondents gave themselves an average “risk preparedness” of 70 percent, implying that this was way too high, as subsequent events demonstrated. He was even honest enough to admit that his own organization was not as ready as it could have been, in terms of having contingent budget strategies. As a company whose primary asset is its people, AGRC had found it hard to plan for such a market contraction, especially in coping with the cost of personnel.

Supply chain risk

Focusing on supply chain risk, the AGRC CEO urged companies to get to know their suppliers well, and to continually track their market reputation through media reports as well as reliable anecdotal sources. He also controversially suggested that increasing

the number of suppliers could reduce risk, even though this would probably lead to higher costs. Given the huge swings in commodity prices, Mr. Cross suggested that buyers should review the way they insure against such variations, with one solution being to have the insurance premium index linked. This was highly relevant to those with significant transport and manufacturing (especially involving plastics) activities.

The use of risk management specialists

Offering a wider review of risk management practice, Mr. Cross was keen to state the benefits of using a number of different service providers, in order to help an organization gain the broadest possible understanding of the risks it faces. Risk management specialists, he argued, provide a valuable resource to help challenge conventional views. He also warned that salary caps or regulatory controls could mean a loss of talent just when it was most needed.

Industry	Key Risk 1	Key Risk 2	Key Risk 3
Banking	Employee dishonesty	Computer viruses/ malicious codes	Fraud, sub-prime collapse/credit crunch
Construction	Economic slowdown	Sub-prime collapse/credit crunch	Injury to workers
Healthcare	Regulatory/legislative changes	Increasing competition	Cash flow/liquidity risk
Insurance, investment and finance	Regulatory/legislative changes	Economic slowdown	Increasing competition, Damage to reputation

07 State of offshore business

With governments around the world desperately seeking new sources of revenue, Offshore Financial Centers (OFCs) have inevitably come under greater scrutiny. In response to this threat, Cayman Finance (CF) was established as an industry association to communicate the integrity and quality of financial services in the Cayman Islands.





“Promoting Cayman is easy since no spin is required, just a statement of the truth” **Richard McMillan**

Proactive

Richard McMillan, Director of Cayman Finance, began by describing the mischaracterization of OFCs, and the need for a highly proactive approach to protect the Cayman Islands finance industry. Hitting a positive note, he felt that, “promoting Cayman is easy since no spin is required, just a restatement of the truth.”

International co-operation

Referring to the global recession, the Cayman Islands had proved remarkably supportive of the US during these tough times, according to Mr. McMillan, who noted that: “In 2008 when the US financial system was highly dependent on foreign capital investments, Cayman was responsible for an inflow of US\$3.6 trillion”

Mr. McMillan was very upbeat about Cayman as an OFC. He stated that “The international co-operation efforts of the Cayman Islands would ordinarily be seen as exemplary.” Since 1980 the US has been able to obtain information on possible criminal activities that may take place in the Cayman Islands through the US Mutual Legal Assistance Treaty. Furthermore, since the 2001 US tax information exchange agreement was reached, a fewer than expected number of cases had been assessed as deserving of investigation. Finally, under the EU Savings Tax Directive, revenues from Cayman investment received by EU tax payers must be reported, yet, as Mr. McMillan observed, in 2008 this figure was less than US\$26 million – most of which would already have been reported in the home country.

Encouraging credit supply and competition

Another positive (and often ignored) effect of OFCs is that they improve credit supply and encourage competition in domestic banks, as Mr. McMillan observed, “A recent Society of Trust and Estate Practitioners report found that banks with nearby OFCs have lower rates and are more competitive. Without OFCs, many onshore banking markets could become monopolized or quasi monopolized.” He went on to conclude that the tax competition provided by offshore centers

actually made governments more efficient, as it gave them a greater incentive to keep tax rates low – which in turn encouraged more cost-effective use of their resources.

Mr. McMillan said that many G20 countries are intrinsically against tax competition, despite public statements to the contrary. Many member states pass laws specifically designed to improve their competitive position in relation to OFCs, he observed, with the ultimate aim of eliminating all tax competition to improve their ability to generate revenues. OFCs are actually contributing to global economic performance, therefore increasing the total taxation base.

Conclusion

Mr. McMillan felt that the three key factors to the success of Cayman as an OFC were transparency, cooperation and substantial local activities: the latter being particularly important in the face of international scrutiny, amid allegations of “lack of mind and management” in the OFC. It was therefore important to avoid “brass plate only” entities, to increase transactional volumes and develop local infrastructure.

Mr. McMillan further stated that Cayman would continue to welcome businesses and professionals with relevant skills and continue to defend its position and reputation in the shifting political landscape.

08 Risk factors: The new world reality

Reinsurance has always played a crucial role in managing a captive, but the current market conditions call for a radical re-think of the way businesses are protected, according to presenters, Len Goldberg, Chief Executive Officer, and Brendan Barry, Senior Vice President of Greenlight Re, a specialist property and casualty reinsurance company based in the Cayman Islands.

The presenters began by explaining how the predicted hard insurance and reinsurance markets for 2009 lasted a mere six weeks, after which the failing companies of 2008 were revived, the stock market bounced back and low inflation and even deflation prevailed.

We now face a new reality in the form of a very competitive insurance market; a recession causing falling asset values and a high cost of protection; low interest rates; reduced availability and high cost of collateral; social inflation and tort and healthcare reform.





Coping with a competitive insurance market

As reinsurance rates are lower than normal, it was suggested that captives should take advantage of the opportunity, especially with a potential hard market around the corner. Those looking to strengthen their balance sheets could now take advantage of cheaper reinsurance and perhaps buy reinsurance for less than actual loss costs. Mr. Goldberg and Mr. Barry recommended buying additional reinsurance in order to preserve capital for the long term.

Impact of a recession

The downturn has had several consequences for example, top line insurance industry performance has dropped and the relative value of exposure bases are changing; doctors are working with fewer resources; measurement of liabilities is changing; and redundancies have changed the profile of the workforce. Therefore these changes must be measured and reflected in the insurance program. It was considered especially important to review minimum premiums where applicable, as minimum premiums protect the amount of income across the portfolio as exposures decrease.

Low interest rates and availability and cost of collateral

With negligible rates of interest and higher letter of credit costs, Mr. Goldberg says it now costs money to hold collateral. Therefore it was a timely moment to reconsider traditional insurance purchases, as well as choosing alternative structures available such as “Funds Held” and “Loss Corridor” structures, where the amount of collateral required by the captive could be dramatically reduced.

Social inflation

The current climate is resulting in increased fraudulent claims for auto, physical damage, and personal injury. In a soft market, the speakers recommended taking more reinsurance generally, but each captive owner needs to understand how social inflation impacts their book in a shrinking economy. Once that is understood, you could decide to buy more or less reinsurance.

Tort and healthcare reform

The presenters assured delegates that new risks always result in new opportunities, and that reinsurance can help give them some real benefits. While no one knows which way healthcare reform will go, there could be an opportunity for new company formation or to back-integrate your captive into a paper provider. They gave examples of utilizing quota share reinsurance, which is easier to obtain than equity, which would reduce the capital required by a factor of

five. They also gave examples of combining quota share reinsurance with other tools to reduce the collateral requirements of the captive.

World outlook for risk

Closing their lively and detailed talk, the presenters urged businesses to do their analysis, but do not bet the farm on the results, as risk assessment is either not always possible or inaccurate.

Summary of their key top-level messages:

- Long term inflation risk may make it advantageous to take out more excess loss reinsurance.
- “Harder” rates are expected by the end of 2010, fuelled by lower interest rates and negative cash flow, which means that captives should ensure that reinsurance protection is in place.
- Financial and capital markets are still in crisis, which causes continuing uncertainty.
- Risks move fast, so all must ensure that protection is in place for the next shock.
- In order to survive, entities must identify the real risk factors to be managed and retain the maximum flexibility.

09 Rule on risk management for insurers

A rule on risk management for insurers was introduced by the Cayman Islands Monetary Authority (CIMA) in March 2009 requiring insurers to adopt a risk management strategy to address the key risks it faces.

A panel including captive owners, a claims manager and a regulator discussed strategies for complying with the new rule. While the panel comprised of experts from the healthcare industry, the moderator Ruth Kilduff of Integro Insurance Brokers, ensured that the discussion was relevant and useful for all captives. The panel also included Ellen Banach, Southcoast Health System, Clare Bello, Vertical Claims Management, Charles Whipple, Hallmark Health System, and Gordon Rowell of the Cayman Islands Monetary Authority.





“The new rule is considered to be a tremendous opportunity for captives.” **Ruth Kilduff**

About the rule

Moderator Ruth Kilduff said. “The new rule is considered to be a tremendous opportunity for captives,” as it drew together a number of components to give a more complete approach to risk management.

Although insurers generally manage certain risks closely (e.g. credit risk; insurance underwriting and reinsurance risks; and investment risk), the rule formally requires them to look at their entire operation in terms of all material risks faced. They then have to apply governance arrangements, internal controls and reviews and reporting (including independent audits or actuarial or compliance reviews) to address these risks.

Mr. Rowell provided some background to the introduction of the rule, citing a Financial Stability Forum Report of 2008, which concluded that risk was not sufficiently addressed by banks and other institutions. He also explained the Solvency II rules (which use a risk based capital framework), recognizing that solvency and financial health are not only affected by capital and premium income but also by risk. He said it was unfair for a company to be penalized for reserving at a higher confidence level by requiring higher capital, as this discouraged healthy competition and is not a reflection of true inherent risk. Finally he explained the basis of the proposed Solvency II rules, noting that the third element (pillar) will entail a quantification of risk.

Rationale of the rule

The rule was not considered absolutely necessary for the captive market, since risk management already forms the key component in the licensing process and subsequent supervision of captives in Cayman, as Mr. Rowell commented, “History has shown that the successful captives are those that have good risk management practices and strategies.” However he also explained that, although the rule was more important for the domestic market, there are some captives writing a significant amount of third party risk, and they may need to extend and enhance their risk management arrangements to comply with the rule.



“History has shown that the successful captives are those that have good risk management practices and strategies.”
– Gordon Rowell

The relevant international standard was suggested to be an October 2007 International Association of Insurance Supervisors (IAIS) Guidance Paper on the Supervision of Captive Insurers. This stated that the nature of risks in captives are similar to those in commercial insurers, but there were differences in terms of degree and diversity, including specific risks for captives – namely outsourcing risk and failure of fronting carriers.

Types of risk

Charles Whipple discussed each of the risks specified in the rule, focusing on strategic and tactical, concentration, compliance and outsourcing risk. The latter is a significant operational risk for captives and Ellen Banach commented that many vendors are selected because they are either a niche player or have connections with the parent company; yet, “...experience shows that the best partners to select and retain are the ones that know the captive, its people and the parent very well.”

Referring to the engagement of a number of service providers, the panel noted that many discussions will take place and decisions made that will affect the captive. In this respect, it was felt that the requirement for the board to consider and formally adopt the decisions will be beneficial to the governance and operation of the captive.

Challenge the status quo

Captives were encouraged to continually challenge their position, decisions and assumptions – an ongoing theme across the forum. This could include: requesting data and reports of relevance; having an attorney review the insurance policies; stress testing the policy periodically and reviewing the market environment, the premium flow and underwriting criteria. According to Mr. Whipple, “The risk manager always considers the worst possible scenario, and the risk management strategy required by the new CIMA Rule is an opportunity to place all relevant analysis and decisions into one document.”

Enforcing the rule

Explaining the arrangements for the rule’s implementation and enforcement, Mr. Rowell mentioned that, although CIMA’s rule impose mandatory requirements with penalties for breaches, a concession has been granted for a transitional period of 12 months. So long as captives review the risk management section of their business plan

filed with CIMA, and make changes in line with the rule by December 2010, they will be in compliance. Mr. Rowell said the rule should be seen as a tool to assist the board in considering its risks, and to gain maximum benefit from advice provided by its service providers.

A positive step for the captive sector

The panel felt that, for the healthcare world at least (which has embraced risk management), the rule is not a threat to most captives but rather an opportunity to re-evaluate their strategies, business plans and policies. It is also a timely reason for reviewing the mission and overcoming any tension in the relationship with the parent; indeed the potential for conflict should be analyzed, measured and recorded in the risk management strategy. There was general consensus that, regardless of the heavy reliance on service providers, the board must scrutinize the advice provided and ultimately make decisions for itself.

As Mr. Rowell concluded, “The rule will enhance not harm Cayman’s competitive position: Solvency II will require entities to assess its risk and manage it, and Cayman has the expertise to address risk management already.”



10 Investment panel

Each year the forum holds an interesting session consisting of a panel of investment advisors providing their insight of future investment returns. This year's investment panel was no exception. Welcomed by the delegates, the panel offered useful ideas and advice on investment strategies and relationships with investment managers. The panel was well represented by nine top tier investment managers and advisors, who dealt with general issues as well as three captive investment scenarios: namely a hospital system, a mature group captive and a catastrophe facility.

Moderator

John Pitcairn, Artex Risk Solutions

Panelists

Hugh Barit, PRP Performa

Simon Cawdery, EFG Wealth Management

William Dalziel, London and Capital

Bassel Durzi, FirstCaribbean International Bank

Scott Elphinstone, Five Continents Financial Limited (Scotiabank & Trust)

Steve Evans, Butterfield Bank

John Heckscher, LOM Securities

Gareth Pulman, RBC Wealth Management

Mike Vandenbossche, Munder Capital



11 Introduction to actuarial analyses: Auditor and consulting actuary viewpoints

The auditor and the consulting actuary both have an essential part to play in promoting the financial soundness of a captive. In this illuminating and detailed presentation, the delegates were given a thorough overview of these respective roles, including an explanation of basic actuarial terminology and estimation techniques. The panel – consisting of actuary Alan Morris, of KPMG in the Cayman Islands and consulting actuary John Mize of Towers Perrin – also discussed key issues concerning funding and loss reserve estimates, including statistical confidence levels, and the practice of discounting estimates to reflect the time value of money.





The panelists began by highlighting the wide and flexible range of benefits that captive insurance companies can offer to entities. These include options to assume financial control, manage and improve cash flow requirements and stabilize insurance expenditures. They can also design appropriate customized insurance coverage programs, and accumulate investment income to help reduce insurance and operational costs.

They went on to describe two of the biggest challenges facing captive insurance owners, which are: to ensure that programme funding levels are sufficient to cover anticipated claim payments; and to establish an adequate loss reserve provision for known reported claims and incurred but unreported claim events.

To calculate appropriate funding levels and loss reserve provisions, captive owners need to be able to predict the number, timing and cost of future loss events. As the presenters explained, such a task is best carried out by an experienced consulting actuary, who can prepare funding and loss reserve estimates; these then need to be reviewed by the captive's appointed auditor in order to meet financial reporting requirements.

Understanding actuarial estimation techniques

Mr. Mize explained the loss development process and how it is applied to historical loss data to estimate loss reserves and funding requirements. He also described the various basic actuarial methods and discussed how they are utilized.

Moving onto evaluating final estimates, Mr. Morris emphasized how important it was to use a number of different actuarial techniques, as each one can bring out different aspects of the underlying insurance processes. He also looked at important factors impacting the actuarial estimation process, including: the availability and reliability of data; the possible impact of judicial and legislative issues; tort reform and changes in mandated benefits; and unanticipated claims relating to unforeseen exposure (asbestos, mould and pollution).

Importance of communication

The presenters both stressed the value of effective communication between captive owners and directors, consulting actuaries, insurance managers, regulators and auditors. This would help make all parties aware of the key risks inherent in the captive's program of coverage, enable the performance of the insurance program to be monitored and enhance understanding of the captive's business plan, purpose and objectives.

To illustrate this point, Mr. Mize presented a summary of the key issues that captive owners and directors should discuss with their consulting actuary. These included: agreeing where the indicated reserve resides within a reasonable range of estimates; and how trends in data and estimates compare with both the industry and with initial expected outcomes.

Closing the presentation, Mr. Morris summarized what an auditor is looking for in actuarial estimates. Regular actuarial reviews not only provide the required estimates, but also provide a means to evaluate actual versus expected outcomes. There may need to be a clearer link between the consulting actuary's actuarial estimates and the corresponding provisions recorded in the captive's financial statements.

12 Accounting and auditing updates

With new standards and practices issued annually by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), the delegates were keen to hear how the latest changes would impact a captive's financial statements. A heavyweight panel of accountants shared their views of the implications of relevant new standards for 2009 and 2010. Kevin Lloyd of KPMG in the Cayman Islands, Charles Bolland of PricewaterhouseCoopers and Peter O'Leary of Deloitte represented the Cayman Islands Society of Professional Accountants.





New and revised accounting standards

- Uncertain tax positions:** Updates to the existing requirements to account for income tax uncertainties were released in 2009 which reduced the disclosure requirements for non-public entities and provided new implementation guidance. The panel reviewed the significant disclosure requirements and highlighted that captive boards will need to review the captives tax position and consider if any uncertain tax positions exist. When accounting for uncertain tax positions, it is strongly advisable to have a tax professional carry out an annual review of all captive tax positions.
- Measuring fair value:** Many captives invest in mutual funds that are not traded on stock exchanges. The panel noted that entities are now allowed to use the net asset value per share of these non-exchange quoted mutual funds, without further adjustment, as a practical expedient to estimate fair value. Adjustments to net asset value are now only permitted if evidence exists that the net asset value is not fair value.

- Other than Temporary Impairment ("OTTI"):** While there are no changes in the impairment model for equity investments, a new impairment model for debt securities is now effective. This model replaces the "intent and ability to hold" threshold, discussed in prior year panel discussions, with a "more likely than not" threshold.
- Accounting for discounted loss reserves:** Recent reductions in "risk-free" rates of returns have resulted in the selection of an appropriate discount rate being more challenging than in a stable interest rate environment. However, the panel agreed that captive directors should continue to refer to blended "risk-free" rates appropriate for their expected payout patterns as best practice in setting discount rates.
- Subsequent events:** These disclosure requirements were not considered onerous for captives, but they will notify financial statement users of anything significant occurring since the year end and up to the date of the audit report.

FASB codification

As the panel explained, the FASB has reorganized US GAAP pronouncements into accounting topics, using a consistent structure, in order to simplify the disclosure references in the financial statements and reduce time and effort in accounting research efforts. The Codification has now become the official source of authoritative US GAAP.

Healthcare

13 United States healthcare economics: Major changes under the new administration

The proposed US healthcare reforms present huge uncertainty and risk for the many captives operating in this sector. The forum was therefore a timely moment to review the ongoing debate and the implications of the potential changes. Rather than dwell on the pros and cons of the new plans, Ralph Lawson and Mimi Taylor, of Baptist Health South Florida, instead took a wider look at the overall economics of the healthcare sector, arguing that there was a compelling need for change.



The review, presented by the panelists, was careful to consider the widest possible impact of change on hospital systems as well as the US Government and its people.

Key facts at a glance

- Contrary to popular perception, only 15 percent of the population is uninsured. Around two thirds are covered by private insurance and one quarter by Medicare or Medicaid.
- US\$2.2 trillion is spent on healthcare annually, only 50 percent of which is directed to physicians and hospitals.
- National spending on healthcare has risen from 7.2 percent of Gross Domestic Product (GDP) in 1970 to 16.2 percent in 2007, with predictions of a rise to 25 percent by 2025. This compares unfavourably to all other developed countries. For example, France spends only about 10.5 percent of GDP on healthcare, and the UK is about 8.5 percent.
- Healthcare programs are a major cause of the US deficit at US\$1.85 trillion.
- When the Medicare program was established in 1965, there were about four workers for each beneficiary. Today there are only about three workers for each beneficiary which is expected to decline to only two works for each beneficiary over the next 20-30 years.

Deficiencies of the healthcare reform proposals

The presenters raised the following concerns:

- A disproportionate focus on physician and hospital costs, with few proposals to reduce the administrative costs that currently constitute approximately 30 percent of healthcare expenditure.
- Healthcare reform is largely focused on reducing the Federal portion of healthcare costs rather than a reduction in spending by all stakeholders.
- A lack of commitment to slowing or reversing the rise in national healthcare expenditure, which could have a severe impact on the US budget deficit.
- A lack of change to the US payment system, which currently does not adequately reward cost saving and efficiency. This means a lack of recognition and compensation for the significant investment in new technologies, which leads to savings in the form of early diagnosis and faster recovery rates.
- A missed opportunity to make easy cost savings by avoiding or mitigating Medicare fraud, which is responsible for a significant proportion of healthcare costs.

What will change?

Regardless of the actual outcome of the reform proposals, the presenters felt that:

- Hospitals will be asked to do more with less
- 2010 will be harder than 2009
- Healthcare reform has placed little emphasis on healthcare provider financial stability

The long term

The presenters showed how the rising incidence of obesity was putting ever greater pressure on the healthcare system at a time when patients' expectations of service were also increasing. The current reforms were not likely to improve the nation's health, and the US needed a clear vision to improve its peoples' lifestyle and become the healthiest country in the world within 10 years (it is currently rated as 37).

The session gave an absorbing insight into healthcare policy and its effect on hospitals, society and economic health, showing some of the problems caused by disjointed policy in a large and significant sector. The content was relevant not just for those managing healthcare captives, but also to anyone who may have to receive treatment in the US.

14 Ask the healthcare captive consultant panel

In this popular and lively session, healthcare captive specialists from a number of insurance consultants fielded questions from attorney Bill Cassetta of Honigman Miller Schwartz and Cohn. The panel comprised Mary Botkin of Willis USA; Ethan Crain of Integro Insurance Brokers; Ruth Goodell of Marsh USA; Giselle Lugones of Aon USA and Phil Reischman of Alliant Insurance Services, Inc.

Challenge the status quo

Phil Reischman urged all captives to review their programmes and missions every three to four years, looking at perhaps conducting captive benchmarks or performance studies and rethinking the cost structure: "Such an objective evaluation provides a track record of the captive's progress and would also give the Chief Risk Officer (CRO) additional ammunition for defending the captive, if so required."

To evaluate the financial health of the captive, Mr. Reischman proposed stress testing the balance sheet by creating scenarios with unexpected large losses. He also felt that captives should take lessons from the credit crisis to improve approaches to asset allocation and capital measurement and allocation. Such an approach could then be used as a formal methodology as required by the new Risk Management Rule issued by the Cayman Islands Monetary Authority.

According to the panel, captives' reinsurance agreements should be challenged for any inconsistencies. It was also felt that frequent catastrophe losses or batch losses could strain the reinsurance relationship, just when it is most needed.





“Captive should provide incentives for good risks and loss experience, enhance communications and engage in a creative use of the programme.” **Ruth Goodell**

Physician programs in a “soft” market

Ruth Goodell continued by highlighting the key themes she had observed from captive board meetings during 2009. In order to continue being successful, Captives may need to review their goals – especially those established during the “soft” market of the past several years. In addition they should review any decision where physicians are assessed as suitable to be employed but are not insured by the captive. She also urged captives to, “provide incentives for good risks and loss experience, enhance communications and engage in a creative use of the programme.” By assessing the value of the program against the costs, they could strive to improve the benefits. Finally, Ms. Goodell encouraged institutional clients to continue to honor their commitments over time as a means of building a reputation based on trust and integrity.

“Captives should provide incentives for good risks and loss experience, enhance communications and engage in a creative use of the programme.”
Ruth Goodell

Exit strategies

Companies often underestimate the amount of detail and work entailed in the winding up of a programme, and this can cause a lot of frustration Ms. Goodell noted, and therefore advised that, “it is wise to consider the mechanics of exit at the time of establishing the captive.” Such an approach should involve building a number of potential exit scenarios.

Board composition

“The composition of the board should be reassessed since the initial board is often selected for political reasons.” This was the advice given by Ethan Crain. Owners should open more communication channels with their consultants and service providers in order to better understand the processes taking place in their company.

Giselle Lugones warned that captives should beware of changes to parent company boards, as this typically leads to a change in the captive’s board and increases risk of lost knowledge. In such cases, captives should look out for exposures risks arising from directors and officers liability. She suggested that, in cases where more physicians are added to the program, or where there is increased third party risk, captives should consider adding the chief medical officer to the board, as they are closer to those being insured. She also recommended that a community representative with investments expertise

be on the board, and that all directors should commit to a tenure. Finally, she felt that board members should have formal job descriptions and furthermore that new members would benefit from a manual for orientation.

Accounting changes

With US GAAP moving towards IFRS, Mr. Crain warned of the need to heed any changes to accounting rules. He recommended seeking expert advice to cope with any differences resulting from new discounting rules.

Business planning

Referring to US healthcare reform, Mary Botkin noted that more physicians will be employed – all requiring cover. Therefore captives should plan at least five years ahead to take this into consideration this and other potential changes. She also recommended a day or two of strategic discussions to approve and adopt the plan so that it can be appropriately assessed and reviewed.

Summary

Bill Cassetta’s concluding words of advice were, “Ensure that the board is fully informed about the risk assumed.” He praised the recent CIMA Rule on risk management, as it forces the consulting team to consider in one place matters previously looked at in isolation.

KPMG in the Cayman Islands provides audit, US tax and advisory including actuarial services. This combination of technical resources and industry experience allows us to help provide multi-disciplinary services to our captive insurance clients. As one of the leading service providers we provide a wide-range of services to a variety of insurance clients including single-parent captives, group and association captives, rent-a-captives, Segregated Portfolio Companies and Class A insurers. These clients primarily provide healthcare, workers' compensation, general liability, professional liability, auto and property risks. KPMG is the Key Sponsor of the Cayman Captive Forum.

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Save the date

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