

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS



ISSUES PAPER ON THE REGULATION AND SUPERVISION OF CAPTIVE INSURANCE COMPANIES

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Issues Paper on the regulation and supervision of captive insurance companies

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1. Introduction

1. This paper is intended to act as a source of reference for supervisors on the nature of captive insurance and to increase the understanding of both its role and its relationship to traditional insurance and reinsurance markets. The paper will also cover some of the economic aspects of captive insurance and has been prepared for information and educational purposes. It is not intended to be a guidance document.

2. In most cases a captive insurer's owner and ultimate insureds are one and the same, which results in captives being different from commercial insurance companies. A key principle of regulation, the protection of the policyholder, may have a different emphasis when the insured is the owner of the company. The regulation of captives may take account of the ownership relationship when reviewing the required level of regulatory protection. (See paragraph 32 for a broad outline of the different types of captives).

3. In the last 25 years growth in captive insurance companies has been substantial, rising from over 1,000 in 1980 to over 5,000 in June 2006¹. In 2003 captives were estimated to account for approximately 10% of the world's commercial insurance premiums.² With approximately 30% of captives domiciled in the US, net premiums written by these US domiciled captives alone amounted to over \$9bn in 2005.³ (See also Appendix 5.) There are limited sources for statistical information on captives. AM Best are widely regarded as an acceptable reference.

4. As discussed in Appendix 1, there are many potential definitions of a captive. Largely following the definition⁴ included in the IAIS Enhanced Disclosure Standard a captive can be described as "an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties."⁵ For the purpose of this Issues Paper the above definition has been used.

5. Most captives only insure the risks of their owners. Many captives have an exposure to third parties⁶, by underwriting classes of business such as employers' liability or workers' compensation. Some captives also have an exposure to unrelated parties. Third party risks will normally have to be insured through insurers licensed in the country where the risk is located. Most insurers ceding business to captives require, either by regulatory requirements or normal business practice, some form of security for the captive's obligations. The IAIS therefore recognises that the standards of supervision that apply to captives must be compatible with international standards whilst taking account of each captive's particular features.

6. The IAIS Insurance Core Principles (ICPs) cover a number of aspects of insurance regulation and supervision including conditions for effective insurance supervision, the

¹ Source: A M Best Captive Center

² Source: Swiss Re Sigma 1/2003

³ Source: A M Best Special Report, August 2006

⁴ This definition only differs from the version in the Enhanced Disclosure paper in that it does not exclude captives of insurance or reinsurance companies as we know that there are some of these vehicles in existence.

⁵ See also IAIS Standard on disclosures concerning technical performance and risks for non-life insurers and reinsurers, October 2004

⁶ "Third parties" within this paper are persons who have a claim against a policyholder of a liability insurance or reinsurance policy written by the captive. Where reference is made to "unrelated parties", they are defined as policyholders of the captive who are not associated by ownership with the owner of the captive.

supervisory system itself, the methodology used to carry out supervision, prudential requirements for insurers, market and consumer aspects and anti-money laundering (AML).

7. When applying these principles, it is important to recognise the specific nature of the insurer and the risks posed. The supervisory regime tailors its approach so that policyholders are protected and financial stability is maintained, without applying regulation that, with regard to the nature of the company, is unnecessary and may hinder the efficiency of the market.

2. History of captive insurance

8. The concept of forming an insurance company to insure the risks of its owners can be traced to the infancy of insurance. There are instances as early as 1782 of mutual insurance companies being formed by members of a particular industry to provide insurance coverage. In 1860, in response to increased insurance rates, a group of London merchants formed their own insurance company called Commercial Union. Similar situations were beginning to occur in North America as well. In the 20th century corporations became more and more involved in forming mutuals or their own insurance companies. In the 1920's and 1930's several major companies, including ICI, BP, Pilkingtons and Unilever in the UK and Lufthansa in Germany, had formed their own insurance companies. A captive was being formed in Guernsey as early as 1922.⁷

9. The modern concept of captive insurance companies did not develop into a real growth industry until the 1950's, when Fred Reiss, the widely acknowledged 'father' of captives took a special interest and initiated the development of the current industry profile.

10. Mr. Reiss was a US fire protection engineer assessing buildings for the Ohio Inspection Bureau. He consistently heard complaints from clients on how difficult it was to obtain coverages from the insurance industry. Owing to losses on failed research and marketing, the confiscation or nationalisation of assets and new health and safety requirements in respect of, for instance, oil plants and new buildings, large corporations were, at that time, faced with enormous premiums in the traditional insurance markets.⁸ Reiss was quick to realise that this was an opportunity with a unique and simple solution. What corporations sought, but were unable to find, was a method of financing the covering of their own exposures in a way that could, ultimately, bring down the net cost of insurance to the corporations.⁹ Initially, Reiss based his concept on the simple principle of setting up subsidiary companies to insure the risks of the parent companies in Kentucky and Ohio.

11. Reiss began to call such subsidiaries a 'captive', a term believed to originate from his first client, a manufacturer who owned its own mines to produce the company's raw materials that they called 'captive mines'. In 1958 he incorporated American Risk Management and began to assist corporations in setting up captives.

12. Each captive company would insure only the parent's risk and needed only a low level of capital set aside against future losses. At the time, US regulators did not acknowledge the controlled risks of a captive and, as a result, required captives to have the same level of capital as a traditional insurance company in order to be incorporated. Additionally, with no distinction between controlled captives and traditional insurance companies, captives were also required to file annual returns with the National Association of Insurance Commissioners (NAIC).¹⁰ All of this made it prohibitively expensive to form a captive in the United States. There were similar regulations in the UK and in many other countries.

⁷ See Guernsey Financial Services Commission website at www.gfsc.gg.

⁸ Bottom Line, May 1993, 'Capturing the Market' by Howard Rose, pp. 31-37

⁹ Held Captive: A History of International Insurance in Bermuda, C. R. Duffy, p. 38

¹⁰ Held Captive: A History of International Insurance in Bermuda, C. R. Duffy, p. 39

13. Reiss began to search for other jurisdictions that would understand the nature of captives.

14. In 1962 the United States passed the Tax Reform Act, which identified certain kinds of subsidiary income that would become subject to current income tax imputed to the US parent and resulted in investment income earned by the captive being taxed. The Revenue Act in effect wiped out the tax advantage of captives writing domestic risks, while retaining it for captives with 95% of premiums coming from foreign risks.¹¹ An additional factor, which influenced some European clients at this time, was the existence of tariff insurance markets, which were unable to provide realistic pricing and discounts for self-insured deductibles.

15. The Tax Reform Act also contained the first provisions for taxing offshore US-controlled companies. Business Insurance Magazine later noted that the Tax Reform Act aimed "...for the first time to set official ground rules in place for the tax treatment of offshore captives". This clarification led many companies, including Mr. Reiss's clients, to search out overseas locations offering secure and suitable domiciles for their subsidiaries and, by extension, their captives.¹² Reiss moved to Bermuda and in 1962, by special Act of Parliament, incorporated International Risk Management in order to establish and manage captives for international clients. Initially the major international brokers and large insurance groups opposed the captive insurance concept but subsequently there was a change of heart and by the early 1970s other brokerages and insurance managers formed in Bermuda to take advantage of the growing market for captives. Initially the majority of these companies were set up by US corporations in Bermuda. It was not long before the captive formation trend expanded to non-US corporations.

16. There was significant interest in Bermuda following the relaxation of exchange control restrictions in the early 1970s. From the mid 1970s captives were also formed in additional jurisdictions other than their parent company home territories.

17. At that stage, a captive was defined by Sidney Pine, a US lawyer who was a recognised authority on captive insurance, as "a bona fide insurance or a reinsurance company owned by a non insurance company and which insures or reinsures the risks of its parent or affiliated companies".

18. The major reinsurance companies and, over a slightly longer time scale, the direct insurance market began to realise that a client which retained a portion of its own risk was likely to manage these risks more effectively. A major development around this time was the establishment of reinsurance pools, and underwriting committees were established involving representatives from the major reinsurance players. The underwriting criteria required by these committees encouraged the use of risk engineering programmes to establish credible probable loss estimates and to encourage risk improvement. It was predominantly the European reinsurance market (Swiss Re, M&G and Lloyds), together with General Re of America, which drove the development of these programmes.

19. The 'captive' insurance and reinsurance company concept offered a micro-economic solution to a number of challenges posed to commercial and industrial companies as the economic and regulatory environment in major countries was frequently not conducive to the formation of captive companies within their borders.

20. The principal rationale for captive insurance companies arises from the greater level of physical risk control exercised by the parent company and the consequent reduced physical risk, which permits the insurance programme to be priced at a lower level than the insurance market can offer, and also permits greater flexibility in policy covers and wordings. However potential captive owners frequently found that insurance legislation in their own country did not provide the flexibility which they desired. Essentially legislation and capital requirements in

¹¹ Business Insurance, 18 August 1969, 'Bahama Islands get first insurance code; captives seek new home'

¹² Held Captive: A History of International Insurance in Bermuda, C. R. Duffy, p. 41

most jurisdictions were focused on prudential and/or market controls (rating and policy wording authorisations) of the existing open-market insurance industry and these restricted the captive's ability to add value to the parent company's overall operations.

21. As a consequence, potential captive owners sought jurisdictions where the environment was more suitable for captive formation. At that time there was no supervision of insurance and reinsurance in some of those jurisdictions and an appropriate regime was only implemented later. In addition many of those jurisdictions had low or no-tax arrangements, which were a significant attraction to captive owners in their search for value.

22. Once a small number of jurisdictions had been identified as offering the appropriate economic and regulatory framework, captive owners were drawn to those jurisdictions by the specialist and enhanced skill sets offered by the service-industry players there; that is lawyers, accountants, banks with relevant products, actuaries and especially the insurance managers. Today a wide range of skills specific to the management of captives exists in specialist captive jurisdictions.

23. Rental captives started in 1976 when a Bermuda-based captive executive identified a market requirement by smaller companies who wanted the services of a captive without incurring all of the expenses and expertise needed in managing a captive. At that time, companies in Bermuda segregated their activities by way of a Private Act of Parliament.

24. In 1977 the IRS in the US issued ruling 77-316, which specifically denied the admissibility of insurance between a parent and a wholly owned insurance subsidiary that insured only the risks of the parent on the basis that there is no transfer of risk out of the economic group. This led to some changes in the industry and there was a move to form group captives rather than wholly-owned captives, or expanding business to include underwriting unrelated party risks, thus turning captives into bona-fide commercial insurance companies. Many parent companies however continued to form wholly owned captives, as tax considerations were not relevant to the greater efficiencies obtained through focused risk management, nor to the access provided by a captive to speciality insurance coverages.

25. In response to the increasing demand for captives Bermuda enacted legislation for the growing insurance market in 1978. Other jurisdictions quickly followed suit and enacted their own legislation for captive insurers such as the Cayman Islands (1979), Vermont (1981), Guernsey (1986), Hawaii (1986) and the Isle of Man (1986).

26. The 1981 introduction of specific captive insurance legislation in Vermont, predominantly designed to accommodate workers compensation and property/casualty exposures, established a trend which many States have now followed. US captives now represent at least 30% of global captive insurance entities and these captives have now diversified into other areas such as product liability and employee benefits.¹³ US captives are currently one of the most significant growth areas.

27. The protected cell company (PCC) legal structure was developed in Guernsey in 1997 and was soon utilised for captive insurance companies. Other jurisdictions have subsequently introduced similar legislation, sometimes using other names such as "segregated cell company". The protected cell structure has encouraged the growth of rent-a-captive companies in which individual cells are owned by different parents under a common corporate structure. Further detailed information on PCCs is given in Appendix 2.

28. Statistics relating to the growth of captive insurance company numbers and jurisdictions are given in Appendix 5.

¹³ Further information can be obtained from the Captive Insurance Companies Association www.captiveassociation.com

3. General overview

29. A captive insurance company may operate either as an insurance or reinsurance vehicle, or both. Captives are often domiciled in jurisdictions that specialise in captive business. The parent company or its subsidiaries may not be permitted to insure certain classes of business directly with the captive and in these circumstances the risk is often insured with a commercial insurance company, which in turn acts as a front by reinsuring with the captive. A captive may also transfer some or all of the risk to commercial reinsurers.

30. Typical risks that a captive could insure include property and business interruption risks, third party products and liabilities risk, employers' liability and workers compensation risk, marine, transit, fidelity and credit risks. Some captives also insure employee benefit risks including medical benefits, personal accident and in some cases, whole life insurance. It is also possible that the captive will insure directors and officers and professional indemnity liability

31. While many jurisdictions do not distinguish between captive insurance and commercial insurance in their legislation, a number of jurisdictions have established a specific regulatory framework for captive insurance companies that recognises the structure and operation of captives.

3.1 Classification of captive

32. In the most simple form a captive can be described as a wholly owned insurance entity that covers the risks of its parent (for more detail see Appendix 1). In practice supervisors in captive jurisdictions tend to use the following classifications:

Pure captives – single parent companies writing only the risks of their owner and/or affiliates.

Group and/or association captives – multi-owned insurance companies writing only the risks of their owners and/or affiliates, usually within a specific trade or activity.

Rental captives – insurers specifically formed to provide captive facilities to unrelated bodies for a fee. They are used by entities that prefer not to form their own dedicated captive.

Diversified captives – captives writing a limited proportion of unrelated business in addition to the risks of their owner and/or affiliates. Some jurisdictions consider that an insurance company writing any unrelated party business cannot be classified as a captive.

33. With regard to diversified captives there is no suggestion that captives underwriting significant unrelated business would be treated other than as a normal commercial insurer. In some territories notably in North America, captives do underwrite some unrelated business as they are required to do so to obtain tax deductibility for the insurance premiums of the parent. Because many captives are in this position there are arrangements established in various forms that provide them with a percentage of unrelated risk premium but the risk exposures are extremely limited by contract or by reinsurance agreements. Supervisors have the flexibility to determine what level of supervision to apply to such entities. This is consistent with the IAIS standards on Enhanced Disclosure with respect to Captives as referenced in Appendix 1.

34. Captive insurance companies can take various legal forms such as limited companies, limited partnerships or limited liability partnerships. Captives are also increasingly being established as cells within protected cell (or segregated cell) companies (PCCs) under the legislation of some jurisdictions. These cell captives are covered in Appendix 2 of this paper and an example is shown in Appendix 3.

3.2 Fronting arrangements

35. Fronting is a term that describes a particular form of reinsurance frequently employed by captive insurers. Commonly, a commercial insurer licensed in the jurisdiction from which the risk emanates issues a policy to the insured. Subsequently, the risk is transferred to a captive insurance company by way of a reinsurance contract also known as a fronting agreement. The insured receives a policy written by the licensed commercial insurer, but the economic risk of that policy resides in the captive insurance company, although the ultimate liability remains with the fronting insurer. In some jurisdictions, it is a legal requirement for either all, or certain classes' of business, to be written by a local insurer. Hence, if the captive is established in a domicile other than that where the risk resides, then fronting arrangements are mandatory.

36. Fronting insurers who are fully regulated and supervised in their home jurisdictions may retain an element of the primary risk as well as providing retrocession on the risks ceded to the captive. If fronting facilities are offered, frequently enhanced security is required from the captive by the fronting company. The enhanced security can take the form of letter of credit, security trust arrangements, deposit premiums or other third party supported arrangements. Significant opportunities therefore exist for the primary or reinsurance market to offer policy issuing and fronting facilities, often involving some retention of risk by the primary carrier, as well as to offer some traditional reinsurance capacity. By participating in a formal sharing of risk, it is possible to price the transfer at an attractive level. In addition, there is the opportunity for the fronting insurer to supply other services such as loss prevention surveys and claims management.

37. A significant attraction for insurers to provide fronting facilities to captives arises where a client has strong risk management and loss control systems in place. Further, fronting a captive can boost gross premiums and provide top-line growth for an insurer. It also provides a method of enhancing relationships with commercial clients and furthering broker relationships. Captive owners often use a fronting insurer as a means of consolidating their worldwide insurance programme through a single direct writing company.

38. Captives, by utilising fronting insurers, are in effect placing the onus of complying with local supervisory, statutory and premium tax requirements firmly on the fronting insurer.

39. As with any insolvency of a reinsurer, the insolvency of a reinsurance captive may not only affect the insured, but could also lead to financial impairment of primary insurers, thus potentially jeopardizing other policyholders.

40. Some supervisors are concerned about licensed insurers undertaking fronting activities as such arrangements may prejudice their integrity. Prudent underwriting procedures and adequate security arrangements may mitigate these concerns.

3.3 Sharing and spreading of risk

41. Throughout the evolution of the captive insurance market, the reinsurance industry has progressively supported the captive concept and significant reinsurance pools were formed to provide extensive capacity at prices that were commercially attractive to major buyers of insurance. Many of the original captive insurance programmes were based on property insurance of well-protected risks that were subject to extensive loss prevention surveys, exposure analysis and active management of the exposures.

42. The placing of group risk within the captive and active management of that insurance risk has provided the opportunity for the captive insurance owner to accept higher deductibles on its primary programme and by insuring them through the captive obtain reinsurance coverage at lower cost.

43. Often a captive will be established to insure or reinsure the deductible of its parent's insurance policies with a conventional company and will have an agreed maximum level of

claim payments in a particular period. These deductibles (also known as retentions) are an agreed amount of each claim, which the insured company will meet from its own resources before receiving payment from its insurer.

44. Some captive insurance programmes offer a good spread of risk exposures that are well managed and realistically priced at a level where there is a minimal cost of administrative and claims handling activity. The working risk is effectively managed by the captive insurance company in conjunction with the parent, which in itself encourages better inherent risk management. The appeal of captive market partnerships for the insurance industry is that financial interests will be mutually aligned. The financial benefits of aggressive risk management can be shared by both parties and should lead to lower retained losses and less expensive charges for the risk transfer.

45. However, there are situations where captive insurance companies do not have a good spread of risk exposures, leading to a concentration risk that needs to be recognised and managed. This may be achieved by increasing capital or by reinsurance or through diversification.

3.4 Reinsurance and its role with captives

46. Captives can operate anywhere in the insurance chain, from direct writers to reinsurers to retrocessionaires. Many captive insurance vehicles operate in a reinsurance capacity alone.

47. The majority of pure captives are owned and utilised by non-insurance companies that are looking for stable and economic premiums, an increased retention in the quantifiable and manageable risks of the entity or secure insurance cover where there is little capacity available from the conventional market.

48. Commercial and industrial companies continue to look to captive insurance as a solution to their business needs, the economic life cycle of the captive insurance owners may affect the level of insurance risk that is retained in the captive entity.

49. Acquisition costs related to captive insurance tend to be lower than those for open market and broker-controlled programmes. Often broker services are provided to captive insurance programmes on a fee basis for both insurance and reinsurance, specifically net of commission.

50. Self-retention and finite risk reinsurance are forms of alternative risk transfer (ART), as compared with conventional insurance products. A captive, which itself is an ART vehicle, may involve itself with other types of ART strategies, such as loss portfolio transfer, or may adopt a specialised form of incorporation, for example a protected or segregated cell company (legislation permitting). ART techniques can represent a significant aspect of modern risk financing programmes.

51. Where captives retain a limited amount of the risk transferred to them, reinsurance is particularly important to their financial soundness. When considering the suitability of the reinsurance programme key aspects include,

- Where a captive is the ceding insurer, whether the reliance placed on reinsurance partners reflects prudent consideration of the latter's financial position.
- Whether premiums are commensurate with the level of risk involved. An exceptionally low premium may be indicative of poor reinsurance security and an excessively high premium may be indicative of financial malpractice.
- Whether reinsurance cover is consistent with the underlying contracts and adequate to contain the intended level of risk, as any gaps may result in unforeseen or unplanned exposure and loss to the captive.

- Whether reinsurance contracts are appropriate for the type of risk involved. For example, excess of loss (non-proportional) reinsurance lends itself to high value/low frequency exposures and quota share (proportional) reinsurance to low value/high frequency business.
- Where third party or unrelated party liabilities exist, whether run-off reinsurance is in place to enable these third party liabilities to be settled in the event of the failure of the parent.
- The degree of reliance placed on contractual clauses, along with any related cash flow implications (e.g. pay as paid or funds withheld clauses).

3.5 Finite reinsurance¹⁴

52. Finite reinsurance (or financial reinsurance) is a generic term, which can be used to describe an entire spectrum of reinsurance arrangements that share limited risk for a limited amount of premium. Although there is no accepted global definition of finite reinsurance, a typical transaction may include, but not be limited to, provisions for aggregating risk, for aggregating limits of liability and for explicitly recognising the time value of money.

53. Captives may utilise finite risk reinsurance as part of their overall risk-financing programme by focusing on other exposures, including investment risk (asset security and return on investment), credit risk (non payment by reinsurance partners) and protection against adverse timing of cash flows. This represents a valuable mechanism used occasionally by captives in their strategies to meet capital requirements and to demonstrate awareness of wider financial issues.

54. Finite risk reinsurance will constitute either an insurance contract or a financial instrument, therefore any assessment takes account of risk transfer, i.e. if there is minimal transfer of risk then the arrangement may fall under the definition of a financial instrument, and therefore not treated as an insurance contract for accounting purposes. The purpose of the transaction must be assessed from the viewpoint of both the insured and the reinsurer, so that that its treatment in the financial statements is appropriate.

3.6 Producer owned reinsurance companies

55. Producer owned reinsurance companies (PORCs) are captives, or cells of protected cell companies, that are beneficially owned by the producers of the business that is ultimately reinsured into the company through an independent fronting insurer. There are additional risks associated with these companies since the producer could be in a position to influence the placing of business with its own captive and could control the level of premiums or commissions that apply.

56. With PORCs, there may be a program manager to handle the basic day-to-day operations of the fronted program, as well as an insurance manager.

57. There may be a need for additional corporate governance and transparency requirements to apply to PORCs to mitigate the risk of abuse.

3.7 Macro economic aspects of captive insurance

58. Although most parent companies establish captives for microeconomic reasons such as cost reduction or risk control, captives can also provide economic benefits in the parent's country of domicile. Captives give increased financial strength and competitiveness to their parents. Owning a captive has brought risk management to higher prominence in many major

¹⁴ See IAIS Guidance paper on risk transfer, disclosure and analysis of finite reinsurance, October 2005.

international companies, focusing the interest and support of company boards on reviewing and managing all risks, including uninsured risks.

59. There is a view that retaining and developing insurance risk capacity in captives can reduce the impact of insurance market cycles on risk pricing which can enhance the stability of the market both generally and to captives specifically.

60. While premium may be diverted from local insurers, there are compensating factors in the continued use of the global insurance and reinsurance industry, where alternatively major corporations may adopt alternative risk financing strategies not involving the insurance market. The overall result is that significant funds are retained in major financial centres because of the investment of premium income and reserves.

61. The operation of a captive encourages a new management awareness and better understanding of risk and its impact on group profitability. Although in principle these could be achieved through a self-insurance programme, it is often more efficient if contained within a separate entity such as a captive.

3.8 Why insureds form their own captive insurance companies

62. As explained in paragraph 1, the purpose of this paper is to provide information and education about the issues related to captives. This section and section 3.10 provide an overview of the most frequently cited reasons given by applicants for establishment of captives.

63. Whilst historically there has been a widespread view that the primary motivation for captive formation is tax mitigation, the fact is that captives are formed for other economic reasons, some of which are highlighted in the following section.

64. Often captives are formed solely as a means of focussing management and the owner/insured's attention on the costs of the risks inherent in the business by concentrating the costs of insurance in a single cost centre. Captives can mitigate the impact of the 'insurance cycle' and often increase their retention of risk in a hard market to enable insurance to be obtained on reasonable terms. In some hard markets insurance for certain risks may only be available through a captive.

Increased awareness and implementation of risk management practices

65. This is perhaps the most important reason for forming a captive. Most major companies recognise the part that risk management plays in the overall profitability and efficiency of their business. They institute safety and physical loss prevention programmes with the object of achieving lower cost claims and diminishing frequency, leading in turn to a reduction in the level of insurance premiums.

66. Companies have also been able to motivate management and staff to recognise that part of each loss is actually retained within the group and have built up a strong team spirit emphasising the loss prevention aspects of their operation. They have developed technical loss control expertise and in many cases drastically reduced their legal costs associated with certain types of losses. The effects of a self-insurance programme are more evident and manageable if contained within a central separate entity such as a captive rather than being dissipated over a number of operating units. An effective risk management programme can result in recognisable profits for the captive and the parent. The captive can also be used by a multinational to set global deductible levels that allow the local manager to insure with the captive at a level suitable to the size of his business unit, while the captive purchases reinsurance appropriate to the group as a whole.

Stable and lower insurance prices

67. The insurance market is cyclical and fluctuating costs have an undesirable impact on budgeting and profit forecasting by captive owners. In recent years the insurance market has

experienced, across the board, fixed percentage increases in premium rates and these premiums are not felt by many captive owners to reflect the real risks for their particular organisation. A captive can operate at reduced expense compared with traditional commercial insurers because it will probably not have marketing expenses. It will benefit from lower personnel costs, lower underwriting expenses, lower overhead expenses and be willing to accept a minimal underwriting profit. Consequently a captive can accept risk at a higher loss ratio than the traditional market is willing to accept.

68. The portion of commercial premiums paid that are attributable to profit, overhead and acquisition costs can be as high as 40% of the whole amount charged. The establishment of a captive seeks to mitigate these extraneous costs by allowing the company the benefit of retaining profit for its own account and participating in the risk exposure by paying a premium that more accurately reflects the parent loss history.

Better reinsurance access and terms

69. A major benefit of captive insurance is the ability to access the wholesale reinsurance market, which can also reduce the cost of insurance protection to the parent company. As outlined in paragraph 67, by accepting cessions from captives, reinsurers benefit from improved risk management and loss control by parent company of the captive as well as gaining a more complete understanding of the nature of the risk. Consequently reinsurers may sometimes offer more competitive terms. Reinsurers take comfort from the fact that the insured is itself financially involved with the risk through the captive. Most captives are managed by specialists who themselves have ready access to both the traditional reinsurance market and also to specialist captive reinsurers, who provide an excess coverage which is sometimes difficult to achieve commercially. An example is given in appendix 3.

70. A captive may earn commission on its reinsurance premiums, which reduces overall costs and may be able to negotiate specific profit commission arrangements.

Cash flow

71. The insurance premiums paid by a company to a commercial insurer are usually paid at the commencement of the year of risk and attract, for the commercial insurer, an amount of investment income. If the premiums are paid to a captive, this can achieve improved cash retention and control by:

- a. Structuring premium payments over a financial year.
- b. Paying insured losses appropriately as they arise.
- c. Retaining premiums within the group until claims become payable and hence deriving investment income from those accumulated premiums.

Placement of specialised risks

72. Certain types of risk such as sensitive product liability risks, environmental impairment, pharmaceutical liability and selected professional indemnity, regardless of the claims history, are frequently either extremely difficult or even impossible to place in traditional markets. Alternatively they demand either high premiums or unacceptable terms and conditions even though the insured may have an acceptable claims history.

73. A properly structured captive may not only cover the required risks but with more favourable access to the reinsurance market can ensure that a sound programme is in place. Additionally captives facilitate the provision of cover to satisfy legal and contractual obligations, which could not be offered by a self-insurance fund or are too small to warrant obtaining cover for in the commercial market. The captive can provide a greater variety of options for the insured in unusual situations.

Communication

74. The insurance industry has been criticised for the lack of communication between insurers and the insured. This problem is reduced for captives because they are close to the insured and are normally part of the same corporate group.

75. As the captive usually insures group risks, its mentality is closer to that of a risk manager than of a commercial insurer. An example of this is time horizon. A risk manager often considers a much longer time frame than a commercial insurer. And this attitude can be significant to the insurance strategies of captives and their parents.

Customisation

76. Insurers may apply rating guides or tariffs for particular trades and however good the experience, the insured is likely still to be tied to a minimum trade rated premium, i.e. a basic minimum below which insurers will not quote, almost regardless of risk management expenditure. Whilst premiums may increase in the event of adverse experience, the end result of this particular system is that the better quality or better performing insured with favourable loss experience tends to subsidise the higher risk or worse performing insured with poor loss experience. In addition, insurers are sometimes reluctant to provide customised policy wordings or tailored coverage. A captive can provide the parent with the cover it seeks provided that the cover is appropriately priced and sometimes leverage the insurance or reinsurance market at a higher level.

Control of cover and cost of multi-national programmes

77. A captive enables a multinational company to apply group net insurance retention at a higher monetary level than can be justified at local subsidiary level. There is greater diversity of risk at the group level and there will be no need for the subsidiaries to purchase potentially expensive full coverage with low deductibles in their local insurance market. There is additionally more control on claims through a single group captive. However small the captive participation, and whether or not this passes through a fronting company, the parent becomes aware of all the claims. It can track these and their development, obtaining all necessary information on the reason for their occurrence which in turn feeds back into the group's risk management policies and practices. This is a further tool to risk management. Geographically remote subsidiaries may otherwise have an adverse claims or loss experience, which is never apparent to the parent but is information held between the subsidiary and the local insurer. Another advantage where a group has operating units in a variety of countries is that simplified global policies can be issued.

78. By innovation captives have encouraged:

- New methods and new classes of insurance which have expanded the insurance market.
- Detailed attention to positive risk control. Whilst this often saves premiums, it also saves uninsured losses and claims. It is interesting to note that reinsurance of captives is regarded as one of the more profitable sectors of reinsurance because captive risks tend to be good risks.
- Greater discrimination in rating so that higher quality risks are more likely to attract better rates and substandard risks are rated accordingly.

3.9 Uses of captives

79. Captive insurers can provide greater flexibility and additional benefits to parent companies including:

- Since premiums paid to captives are calculated to pay losses incurred during the policy period and because the captive establishes a quantified loss reserve, the captive user is financing its risk in a more prudent manner than if it retained the risk and made no provision for the payment of the losses.
- Captives allow flexibility in the structuring of the insurance programme and can leave a higher level of risk control in the hands of the parent through, for example, self-insurance and control of claims handling.
- Captives may be able to offer cover for a wider spectrum of risks than the commercial insurance market or where it is unable or unwilling to respond to the particular insurance needs of a company in a cost effective manner.
- Captives can offer flexibility, global consistency and longevity in the structure of insurance programmes. External premium expenditure can be concentrated on catastrophe exposures.
- By insuring its risks through a captive, the company or group may subject itself to disciplines of risk evaluation and measurement which will help it to improve its risk management, improve cash flow management and reduce costs.
- A captive may operate as a separate profit centre by writing unrelated risks. This type of risk is typically very predictable with a large number of small exposures (e.g. extended warranty business).

3.10 Misuse of captives

80. Misuses can occur in captives as well as in the wider insurance and reinsurance market. The potential for the misuse of insurance has been highlighted by the IAIS¹⁵ and can occur in all jurisdictions, whether they are smaller captive jurisdictions or major insurance markets. Examples of situations (which are not unique to captives) are:

Money laundering

- Supervisors' experiences of money laundering activities in captive insurance are few in number. Laundered proceeds of drug running have been identified as the source of funds to capitalise a life insurer. In another instance, individuals were identified as attempting to establish a captive in order to launder very significant funds.

Fraud

- Poor corporate governance practices led to a fraud hiding the true identity of the ownership of a captive insurance company and fraudulent transactions resulted.
- A broking company secretly owned by a captive parent's finance director was fraudulently used to divert premiums before passing reduced amounts to the captives.
- Asset values of a captive were fraudulently overstated and liquid assets were siphoned out to fraudulent investment managers owned by a small number of directors of the parent.
- An actuary fraudulently colluded with captive owners to substantially under-reserve, which enabled the captive to fraudulently continue trading when technically insolvent.

Tax evasion

- Taxation evasion or avoidance in both cases may previously have been a misuse of the captive structure and it is a reasonable assumption that a number

¹⁵ See IAIS Guidance Paper on combating the misuse of insurers for illicit purposes, October 2005.

of companies were formed for tax evasion or avoidance reasons. Tax authorities have largely eliminated this risk today.

- Although tax minimisation may have been an early driver for captive formations, many tax authorities have now largely eliminated tax minimisation advantages through CFC tax legislation that consolidates the profits of captives with those of the captives' parent companies. Where this is not the case, the possibility of deferring tax through the use of a captive still does exist. This could lead to some misuse of the captive where excessive premiums are charged and profits artificially inflated

Producer owned reinsurance companies (PORCs)

- If a captive insurance or reinsurance company is owned by a producer, there is the risk that the owner will channel business to its own captive rather than seek to obtain the best terms for its clients in the market. There have been examples of this type of misuse involving Title Insurance sold to purchasers of domestic properties in the USA.

Commission payments

- Where brokers own captive insurance managers, there is a risk of inappropriate market practices occurring, such as the payment of contingent commissions to the brokers in return for the managers placing the captives' reinsurance business with certain reinsurance companies.

81. Captives are usually managed by third party professional insurance managers, who are themselves normally regulated and are subject to compliance and regulatory reporting requirements - see section 3). Captive supervisors often have a close supervisory relationship with the regulated entities through the insurance managers and are consequently more likely to be able to identify misuses.

82. The recent paper on reinsurance from the G30¹⁶ concluded that an event resulting in the loss of some 20% of global reinsurance capacity would only have a limited effect on the financial system. Given this analysis it seems unlikely that any misuse of captives would have an impact on global macro economic stability.

4. Captive insurance managers

83. Some captives are set up as freestanding insurance companies with a complete set of management resources. This will usually be cost-effective only for large captives such as those set up by major multi-national corporations. More commonly, some or all of the captive's management will be outsourced.

84. Supervisors normally have the statutory powers to insist that captive insurers employ competent managers. Most jurisdictions license and regulate the insurance management companies to ensure that there is control by fit and proper persons possessing the appropriate degree of expertise.

85. There are specialist captive management companies, including subsidiaries of most of the major worldwide insurance brokers. There are also a number of independent insurance management companies. It is not unusual for the client of a major broking group to appoint a different group as captive manager and this action may be considered from a prudent governance angle. Managers typically operate a number of insurance companies on behalf of their owners.

¹⁶ Reinsurance and International Financial Markets January 2006 www.group30.org

86. Captive insurance managers are independent and provide services to captive insurance companies and these include company management, administration, accounting, company secretarial services, underwriting, the arranging and placing of reinsurance, claims handling and compliance functions. In the case of managed captives, compliance with the requirements for anti-money laundering and combating the financing of terrorism will probably also be outsourced to the captive management company. Insurance management companies are central to the operation of the vast majority of captives.

87. The captive manager usually acts as the contact point between the regulator and the captive's shareholders and directors. In addition to providing market knowledge and expertise to the captive industry, the manager also provides experienced professional staff and other related services. With the manager responsible for carrying out most of the day-to-day transactions of the captive, misuse would tend to require collaboration with the third party manager. Most captive domiciles legislate that the captive's managers must report deviations from business plans or required ratios on an immediate basis. The manager is responsible for the initial vetting of new clients and for carrying out appropriate due diligence. Managers maintain separate client bank accounts, ensure fund separation and maintain other assets separately for each of the companies that they manage.

4.1 The broker's role and relationship to insurance management companies

88. Major broking houses placing insurance and reinsurance programmes for captives may also provide captive insurance management services. If a broking house offers a broking service and a management service there is a potential for a conflict of interest, which needs to be controlled by the captive owner and its board. Sometimes separate houses provide broking services and captive insurance management services.

89. This relationship means that many companies have ready access to advice about market alternatives, giving the buyer increased flexibility when it comes to risk retention.

5. Regulation

90. The purpose of insurance regulation is to protect policyholders (who are in most captives also the shareholder), investors and other stakeholders through the provision of tools provided to ensure that companies operate in accordance with acceptable standards of corporate governance, financial strength and market conduct. This in turn promotes efficient, safe, fair and stable insurance markets, which encourage growth and competition in the sector.

91. In applying insurance regulations to captives, regulators may adopt a risk-based approach, which takes account of both the nature of the captive insurance market and the form of the individual captive¹⁷. For example the risk posed by a captive that only underwrites the property risks of a single parent without recourse to reinsurance is little different from the risk posed by retaining the risks on the parent's balance sheet. On the other hand a captive, which is significantly exposed to risk from unrelated business, is no different from a normal commercial insurer. Whilst the owner/captive relationship permits the owner to exercise significant influence over its captive, it is important that the captive practises good corporate governance to ensure that the captive continues to meet its solvency requirements and maintains adequate technical provisions.

92. It is normally felt that all captive insurers should be subject to insurance regulation, even 'pure' captives which underwrite only the risks of their parent company. Even if no third party risks are involved, pure captives often undertake transactions with fronting companies

¹⁷ The Offshore Group of Insurance Supervisors has published papers relating to captive insurance supervision. See www.ogis.net.

and reinsurers who benefit from and often require the security provided by proper licensing and regulation.

93. The application of appropriate regulation reduces the risk that a captive may become involved in fraudulent activities or be used as a vehicle for money laundering.

94. Even though a captive may not underwrite unrelated party risks, there could still be an impact on stakeholders if a failure of the captive deprived the parent of funds to meet valid claims, for example in respect of public liability risks. In addition, without regulation, it would not be possible to impose minimum capital requirements or reserving standards.

95. Captive insurance is in addition an alternate form of capacity available to finance commercially uninsurable risks, or risks that are otherwise retained. The establishment of the captive requires investment of capital to support the taking of risk. When underwriting profits are retained in the captive, rather than distributed, then additional capacity is created. If captives fail, capacity is likely to be reduced, because future captive owners and users will be less likely to invest capital in order to finance their risk in a captive. Confidence in the integrity of the captive mechanism needs to be maintained in order to ensure availability of this extremely important source of alternative capacity.

6. Application of the IAIS Insurance Core Principles

96. This section considers some of the issues that arise in the application of the Insurance Core Principles (ICPs) in respect of captives. For the avoidance of doubt, this paper does not in any way seek to qualify or provide guidance on the ICPs. The IAIS Insurance Core Principles provide a globally accepted framework for the regulation and supervision of the insurance sector. They also provide the basis for evaluating insurance legislation and supervisory systems, practices and procedures and are used for that purpose by the IMF and the World Bank. They apply to the supervision of insurers and reinsurers, whether private undertakings or government-controlled, wherever and however their business is conducted.

6.1 General principles

97. In common with all insurers, the application of the ICPs to the supervision of captives takes into account the nature, risk and size of the captives' business. Growing awareness of captives by IAIS members has been reflected in recent disclosure papers,¹⁸ in which consideration is given to the nature of captives in determining the scope of those papers.

98. A number of ICPs are general principles which are equally applicable to captive insurers. For ease of reference these principles are:

ICP 1: Conditions for effective insurance supervision. Insurance supervision relies upon:

- A policy, institutional and legal framework for financial sector supervision.
- A well-developed and effective financial market infrastructure.
- Efficient financial markets.

ICP 2: Supervisory objectives. The principal objectives of insurance supervision are clearly defined.

ICP 3: Supervisory authority. The supervisory authority:

¹⁸ See IAIS standards on disclosure.

- Has adequate powers, legal protection and financial resources to exercise its functions and powers.
- Is operationally independent and accountable in the exercise of its functions and powers.
- Hires, trains and maintains sufficient staff with high professional standards.
- Treats confidential information appropriately.

ICP 4: Supervisory process. The supervisory authority conducts its functions in a transparent and accountable manner.

ICP 5: Supervisory cooperation and information sharing. The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.

ICP 11: Market analysis. Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurance markets. It draws conclusions and takes action as appropriate.

ICP 14: Preventive and corrective measures. The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.

ICP 15: Enforcement or sanctions. The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.

ICP 16: Winding up and exit from the market. The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.

ICP 24: Intermediaries. The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.

99. The following ICPs have been considered in respect of their specific application to the supervision of captives:

- ICP 6: Licensing
- ICP 7: Suitability of persons
- ICP 8: Changes in control and portfolio transfer
- ICP 9: Corporate governance
- ICP 10: Internal control
- ICP 12: Reporting to supervisors and off-site monitoring
- ICP 13: On-site inspection
- ICP 17: Group wide supervision
- ICP 18: Risk assessment and management
- ICP 19: Insurance activity
- ICP 20: Liabilities
- ICP 21: Investments
- ICP 22: Derivatives and similar commitments
- ICP 23: Capital adequacy and solvency
- ICP 25: Consumer protection

- ICP 26: Information, disclosure and transparency towards the market
- ICP 27: Fraud
- ICP 28: Anti-money laundering, combating the financing of terrorism

6.2 Regulatory system

a. Licensing

ICP 6: Licensing. An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public¹⁹.

100. Since a captive is often just one part of its owner's risk management programme, it is important that the supervisory authority has a clear understanding of how the captive fits into that programme and its particular goals and objectives. The captive's owners may not be familiar with the operational requirements of an insurance subsidiary. It is therefore important that the supervisory authority satisfies itself that the captive will be managed by experienced professionals. Often the day-to-day management will be carried out by a captive management company licensed in the domicile and known to the supervisory authority.

101. Any licence application will be accompanied by relevant licensing details, which will include information on proposed beneficial owners, directors, controllers and managers and also a business plan. For the reason given in 88 above, and following ICP 7, consideration is given to ensuring that the key persons involved are fit and proper and have the commensurate experience, skills and capacity to fulfil the responsibilities of their roles. If the captive is to write life insurance, pensions or long-tail non-life insurance risks, consideration will be given as to the details of the proposed actuary or actuarial support and to the requirement of an actuarial report to accompany the business plan.

102. Prior to granting authorisation to write business, the supervisor will want to be satisfied that a captive has been properly established, that it is conceptually sound and has adequate resources to conduct its insurance and/or reinsurance business appropriately from the outset, as well as to the availability of additional financial resources at a later date should this prove necessary. Captive owners may be required to show that they have contributed adequate capital to allow the owner to take and retain risk and also treat any third party claimants or unrelated party insureds in accordance with acceptable rules of conduct. A business plan would typically be required in a prescribed format, and would include a projected balance sheet, profit forecast, cash flows, intended classes of business and cover, limits of liability, details of reliance placed on reinsurers and an outline of investment and dividend strategies. This business plan would normally be reviewed by the supervisor. It may also be reviewed by the proposed auditors who themselves will be expected to have the necessary skills and capacity to act as auditors of a captive.

103. Prior to issuing a licence, the supervisor will want to be satisfied with proof of the captive's incorporation, copies of its memorandum and articles of association (or equivalent), draft key agreements, a declaration and statement of source of capital funds and confirmation of capital received and shares issued, including any relevant legal opinions which are deemed necessary. It is common for the owners of the captive, and their operations, to be from a different jurisdiction from that in which the captive itself is placed. This will be taken into account in performing due diligence on the owners which may involve the exchange of information between regulators in different jurisdictions.

104. EC 6a notes that insurance legislation should include a definition of insurers. For jurisdictions with a captive market, their country legislation, in some manner, addresses the

¹⁹ See also IAIS Licensing Standard

various types of insurers in their jurisdiction, including captives. This may be accomplished by having various classes of insurers further differentiated in the legislation (see Appendix 1).

105. An important consideration, which might be included in the licensing criteria, will be to ensure that the captive owner has paid due attention to whether the home jurisdiction's legislation allows for the transfer of the insurance risk to the captive, and does not impose requirements, such as fronting arrangements, that are not part of the captive's business plan.

106. EC 6h, the ability of the supervisor to impose additional conditions or restrictions on an applicant, is important in the supervision of captives. It is common for supervisors in captive jurisdictions to place specific restrictions on a captive to ensure that it conducts business in accordance with its business plan and to require notification of business plan changes. Common restrictions include limiting business strictly to related-party risks, permission to conduct business only through a fronting insurer, or limiting the captive to certain lines of business.

107. The licensing criteria of EC 6b require the suitability of significant owners and key functionaries, as specified in ICP 7 (suitability of persons), to be assessed prior to licensing. A prospective owner of a captive must be fit and proper for that role, therefore investigations are often undertaken to satisfy the supervisor of a candidate's suitability.²⁰ In some instances, in common with other commercial organisations, the captive may be part of a complex structure. The ultimate beneficial owner, together with any intermediate structure will be identified and assessed with regard to the proper operation of a captive. Here AML due process can provide useful guidance as to what constitutes appropriate investigation.²¹ Consideration will be given to an owner's ability to provide future funding as well as their commitment to the captive's risk gap (see paragraph 157), especially in relation to any unrelated party business. Distinction is made between a captive providing cover only to its parental organisation and one undertaking third party business where the supervisor is charged with protecting the interests of unrelated potential creditors.

108. The owner's location may also have an impact on the licensing decision because transparency and reliability of financial information can vary between countries and differences in accounting practices can complicate assessment of ongoing financial strength. Further, some jurisdictions may restrict outward investment through exchange and other controls, potentially inhibiting cash flows or financial support to the captive.

b. Suitability of persons

ICP 7: Suitability of persons. The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

109. It is unlikely that a board of directors representing the interests of the shareholder and policyholder will have the level of insurance knowledge that would normally be expected in a commercial insurance company board. The expertise of professional insurance managers will likely be utilised together with that of the parent's risk manager. The captive's board must ensure that it can oversee the managers effectively. Corporate governance issues relevant to captives would include unrelated party issues, related party transactions, perceived or actual conflicts of interest and compensation levels.

110. The majority of captive jurisdictions require the captive to have a local office, and a representative. To meet these requirements, most captives use the services of independent captive management companies, which have the necessary insurance knowledge and skills. As already explained, these management companies are often owned by major international

²⁰ See IAIS Standard on fit and proper requirements and assessment for insurers, October 2005

²¹ See IAIS Guidance paper on anti-money laundering and combating the financing of terrorism, October 2004

insurance brokers. As noted in ICP 7, the supervisory authority will want to be satisfied that significant owners and key functionaries have the appropriate level of competence for their roles. The nature of captives does not relieve supervisors from assessing suitability, but the assessment may need to be done in a different manner from those undertaken in respect of a commercial insurer.

111. All companies have risk exposures; they have assets and employees that the company protects through insurance. A captive is formed to handle that company's insurance risk and the competence of its owner in handling insurance matters is not relevant to the existence of that risk. Many captive owners are large publicly listed groups with their own legal expertise and risk management teams. Some also gain additional insurance expertise by buying in from insurance brokers, consultants and captive management companies. Thus, supervisors usually do not assess the fitness and propriety of captive owners on the basis of whether the owner or its board has sufficient experience in insurance.

112. Supervisors find it more important to examine the suitability of those assigned to manage the risk placed within the captive. This could be in conflict with EC 7b, which requires supervisors to take appropriate action, including requiring significant owners to dispose of their interests, if the owner does not meet fit and proper criteria. Most captive owners would not meet a jurisdiction's fit and proper criteria in the sense of having the insurance expertise that would be expected of management of commercial insurers. It is important however, to note that supervisors do assess the fitness and propriety of owners of captives, in areas unrelated to those of insurance expertise.

c. Changes in control and portfolio transfers

ICP 8: Changes in control and portfolio transfer. The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer.

The supervisory authority approves the portfolio transfer or merger of insurance business.

113. The criteria set out in ICP 8 apply to captives just as they do to commercial insurers. It is rare for a captive to undergo a change in control to an unrelated party because a captive really has no value in excess of its net assets. As the cost of establishing a captive is not significant, there is little point in a new entrant to the captive market paying a premium to purchase an existing captive and its licence. However, portfolio transfers in the form of novations of outstanding claims portfolios are indeed encountered. Changes in control occasionally occur when the captive's parent is purchased or merged with another entity, thus changing the ultimate owner of the captive. Nevertheless in those situations the insurance risk remains within the corporate grouping.

d. Reporting to supervisors and off-site monitoring

ICP 12: Reporting to supervisors and off-site monitoring. The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.

114. Under ICP 12 it must be emphasised that reports to the supervisor are as important for captives as for any other insurance company. While captives frequently pose reduced risk to external stakeholders or to the financial stability of the insurance market, supervisors will normally still receive timely reporting to monitor solvency and to identify potential problems in addition to preparing market statistics and analysis. Supervisors set the requirements for the submission of information (EC 12a) and in defining the scope and nature of the information to be provided, some jurisdictions modify their standard reporting requirements in the case of captives, based on the captive's particular business and the amount of third party and/or unrelated party insurance exposures, if any.

e. On-site inspections

ICP 13: On-site inspection. The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

115. ICP 13 cites on-site inspections as a valuable tool in the supervisory process, allowing the supervisor to capture and verify reliable data in order to assess an insurer's solvency, detect problems not easily assessed in off-site monitoring and assess the competence of managers and the internal controls. In the case of captives, the risk profile of the insurer, including the amount of any third party and/or unrelated party business, will be considered in establishing the extent and focus of the inspection, especially when considering the frequency of inspections. This is reiterated in the IAIS framework for insurance supervision,²² which notes that supervisors should tailor their review to the risk profile and specific circumstances of each insurer. The approach is important when examining captives because a number of aspects of an on-site inspection geared to a commercial insurer are of limited applicability when inspecting a captive.

116. Nevertheless all criteria listed in ICP 13 are applicable to captives. Supervisors therefore will typically have the power to conduct on-site inspections, on a full scale or focused basis, to acquire information to assist them in their regulatory duties and analysis. Captives frequently pose less risk to external stakeholders and to markets than do commercial insurers or reinsurers, which enables supervisors to tailor inspections to cover key issues such as solvency, asset quality and adequacy of technical provisions. They may omit from inspection areas such as market conduct, which, whilst important when examining a commercial insurer, are of lesser importance or applicability in a captive.

117. In most jurisdictions insurance managers are regulated persons and are subject to on-site inspections in their own capacity and as managers of captives. These inspections are frequently a primary tool for supervisors as the managers' systems, procedures and level of controls are often common to the captives they manage.

f. Group wide supervision

ICP 17: Group-wide supervision. The supervisory authority supervises its insurers on a solo and a group-wide basis.

118. As noted, captives are owned by a wide variety of companies in order to manage the insurance risks of their owners. The vast majority of captive owners are not an insurance group or other financial entity. In the context of EC 17a, which requires supervisors to define an insurance group or financial conglomerate and determine the scope of supervision necessary, supervisors will usually find that no other insurance supervisor is involved in the supervision of the corporate group. Supervisors will consider the overall structure of the group and use risk-assessment techniques to determine whether further supervision outside the captive is necessary, for example if the captive has significant related-party assets.

g. Insurance activity

ICP 19: Insurance activity. Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums.

119. As a pure captive only receives premium from the parent, its underwriting and pricing policies will probably be based on the parent's experience in the line of business being insured

²² See IAIS A new framework for insurance supervision: towards a common structure and common standards for the assessment of insurer solvency, October 2005.

by the captive or they will be driven by the reinsurance market. While most supervisors would be reluctant, or indeed do not have the legislative powers, to dictate the premium that a company must pay to its captive, the supervisor's solvency and capitalisation requirements can influence and ensure adequate premium payments by the captive's owner. If the captive is party to a fronting arrangement, or reinsures most of its risk, then the fronting or reinsuring company will influence directly the level of rates and premium; this will reflect a market rate.

h. Consumer protection

ICP 25: Consumer protection. The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.

120. Unrelated parties are unlikely to approach a captive to obtain insurance coverage and captives do not operate offices or branches geared to obtaining business from such parties. In respect of group or rental captives, if applicable, the captives business plan will explain its marketing programme and what information will be provided to prospective owners or users.

121. ICP 25 recognises that, for certain types of transactions, the requirements for consumer protection should differ. Paragraph 25.5 notes that the supervisory requirements: "...should distinguish between particular types of customers. In particular, detailed conduct of business rules may not be appropriate for reinsurance transactions or in respect of professional customers." Contractual relationships of a captive insurance company are with the owners of the captive, or with a commercial insurer or reinsurer if the captive has arrangements with such entities. The criteria of ICP 25 become of limited applicability in this regard, since requirements for fair treatment of customers, assessing insurance needs before advising customers and dealing with complaints are less pertinent to a captive insurer.

122. When a captive company underwrites liability risk, supervisors will recognise and take account of the fact that there may be unrelated parties claiming against the parent.

123. There is a distinction between compulsory and voluntary liability insurance issued by the captive for the purpose of formulating a regulatory and supervisory regime.

6.3 Corporate governance

ICP 9: Corporate governance. The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.

124. In principle, the governance issues for a captive insurer are similar to those for a conventional insurer. In practice however there are some important differences:

- Many captives are small and have a relatively simple risk profile.
- The parent company, and therefore the directors representing its interests, may have limited expertise in insurance.
- It is common for much of the management and operations of a captive to be contracted out, usually to a firm of professional insurance managers.
- In some captive structures, for example rent-a-captive or segregated cell companies, ownership of the captive may not rest with a single company or group whose risks are insured.

125. Captive managers, their boards, officers and service providers need to understand the implications for governance in the entities in which the captive results may be reported or consolidated. Regulators often recognise the need to avoid overburdening captives with

governance arrangements such as risk management committees or requirements regarding directors, designed for larger or publicly held companies. On the other hand, supervisors ensure that captives are well managed and that the board can adequately oversee the business. They also ensure that there are directors and managers who can, both in principle and in practice, be held accountable for any failure.

126. The nature of a captive will be addressed by a supervisor when evaluating corporate governance. In a jurisdiction with a diverse range of insurance companies, the supervisor will focus attention on insurers and activities where there is a greater likelihood of risk to policyholders and other stakeholders or there is risk to the development or maintenance of a viable, stable insurance market. Additionally, to maintain an efficient market not constricted by unnecessary regulation, the supervisor will be thoughtful in their approach to corporate governance standards and in considering the costs and benefits of the supervisory processes.

127. Since most captives have only a few policies and transactions, single-owner captives and many mutual captives do not generally have an extensive board of directors and only a limited number of managers. The supervisor takes this into account when developing policies on corporate governance. Many of the policies that would be suitable for a large commercial insurer could be impractical, or even hinder the captive from operating in an efficient manner.

128. If a captive management company is used, the supervisor may review the corporate governance practices of the management company to ascertain that it is suitable for the management of captives.

6.4 Risk

a. Risk management

ICP 18: Risk assessment and management. The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively.

129. As with ICP 9 (corporate governance) and ICP 10 (internal controls) the risk management processes set up in an insurer are heavily dependent on the complexity, size and nature of the insurer's business. ICP 18 addresses this specifically, both in the introduction to the ICP and in EC 18b and EC 18e. Captive supervisors review and monitor captives' risk management controls within this context.

130. Many risks normally associated with a traditional insurance company are mitigated or are of less impact in a captive insurer. Legal risk is generally quite low since the captive frequently insures just its owner, although it is important that the terms of reinsurance contracts are properly expressed and aligned with the primary cover. In some instances, such as a fronting arrangement where the risks to the fronting insurer are fully collateralised, credit risk and market risk in the captive are reduced. Operational risk may be low if the captive has few transactions or a limited number of policies; this is common in many captives. On the other hand it is common for captives to out-source many of their management functions so that the control of risk within a captive may be higher or of a different nature from that of a commercial insurer. Altogether the risk management system in place in a captive may be significantly different from that of a commercial insurer. Supervisors, when setting requirements or providing guidance on risk management systems, may incorporate these differences into their guidance.

131. ICP 18 requires the supervisory authority to ensure that insurers recognise the range of risks to which they are exposed, as well as to assess and manage them effectively. Insurers should have risk management systems adequate for the nature and scale of the business in question, allowing supervisors to use their discretion in determining and establishing criteria appropriate to the licensing and on-going supervision of captives.

132. The lower risk to insurance consumers and financial markets posed by captives does not exclude the supervisory regime from having proper criteria in place to ensure that the captive has an adequate, well-thought out business plan, proper expertise in place to manage its insurance risk and provides adequate information on its insurance and reinsurance arrangements.

b. Types of risk

133. Captives share some of the risks common with commercial insurers in respect of the nature of the risks to which they are exposed, but they differ in the degree and diversity of exposure. Captives will still be exposed to the following principal risks:

Underwriting risk	- Class of business and typical claims 'tail' - Typical/expected volatility of underwriting results - Current market conditions and rates - Extent and sophistication of previous portfolio's statistics - Underwriting process and authorities - Concentration risk
Claims risk	- Reserving methodology - Accuracy of reserving from run-off statistics - Claims handling systems - Claims handling authorities - Claims information systems and reports - Claim cost inflation
Reinsurance Risk	- Suitability of reinsurance programme - Level of retentions - Security rating of reinsurers
Management Risk	- Technical knowledge of promoter's directors and managers - Management experience - Authorities of managers
Counter-party Risk	- Receivables exposure including reinsurers
Operational Risk	- Management error - Cash fraud/defalcation - Expenses risk - Systems – policy and accounts
Investment Risk	- Appetite for risk - Expected volatility of portfolio - Policy/strategy statement - Compliance with asset valuation regulations - Board reporting and control - Investment authorities - Counter-party risk
External Risks	- Economic environment risk, for example inflation - Market changes risk - Legal environment risk - Social changes risk - Technology changes risk - Reputation risk to parent company

c. Internal control

ICP 10: Internal control. The supervisory authority requires insures to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.

134. EC 10a notes that supervisors should take into account the nature and scale of the company's business when assessing internal controls. In common with other insurers, the board of directors of a captive will exercise its judgment in determining the nature and scope of the risk management and internal control systems and practices that are necessary. As outlined, most captives are not complicated operations which require extensive internal audit functions or complicated internal risk management functions. Nevertheless most captives will be subject to the internal audit disciplines of the parent company. This will be reflected when the supervisor addresses the internal control requirements for captive insurers.

135. It is common for the supervisor to focus more on a review of the internal controls of the captive manager as opposed to those of the captive itself because the captive manager is usually handling directly transactions and the assets of the captive and will also have accountability for the correct valuation of liabilities.

6.5 Liabilities

ICP 20: Liabilities. The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.

136. ICP 20 requires supervisors to ensure that insurers comply with standards for establishing adequate technical provisions and other liabilities. The underlying principles behind ICP 20 apply to captives equally as to commercial insurers. A supervisory regime will normally have legal provisions requiring the establishment of appropriate technical provisions and the authority to review their sufficiency through on-site and off-site monitoring, including the use of appropriate actuarial skills, and to require an increase in those provisions if they are not deemed sufficient.

137. As previously discussed, captives have some unique qualities that will be incorporated into a review of liabilities by a supervisor or when creating regulations regarding captive liabilities.

138. In some cases, the captive itself may retain little risk, as most of the risk may be reinsured. Captive supervisors take this into account when devising regulations for technical provisions that could only provide partial credit for reinsurance. In the case of a captive, which only insures parent company business, there is an issue as to whether or not to give full credit for reinsurance, subject to satisfactory reinsurance security.

139. Likewise, the valuation of reinsurance recoverables can be a significant issue when examining captives because captives with a high percentage of reinsured risk will probably have reinsurance recoverables as their largest asset. General limits imposed for valuation of recoverables, as required by EC 20f, are more flexible when applied to captives. The limits commonly applied to commercial insurers may make the capital requirements unrealistically high for the captive and indeed turn a conglomerate away from using a captive to handle its insurance risk. On the other hand, increased counterparty risk may exist for captives that reinsure to a high degree and this is a significant factor.

140. It is common when a jurisdiction sets standards for technical provisions to require a reserve for IBNR since such reserves are required in the realistic valuation of commercial insurers' ultimate net liabilities. However, many pure captives, especially those used by their owners to handle low-frequency/high-severity lines of business, for example marine or property catastrophe, already have knowledge of all reported claims, since their owner is the only claimant. In those cases, the IBNR may justifiably be zero since the captive is immediately aware when an insured event occurs; there are rarely events that have not been reported. Captive jurisdictions usually provide some kind of flexibility, often solely on a case-by-case basis, to allow a captive to set its technical provisions using methods that may differ from those applied by commercial insurers.

141. Where appropriate, supervisors require that the boards of captive insurers take actuarial advice before setting provisions for outstanding claims, IBNR or other reserves. This would apply particularly in the case of classes of business such as liability insurance where claims can take a considerable period to develop fully.

6.6 Investment strategy

ICP 21: Investments. The supervisory authority requires insurers to comply with standards on investment activities. These include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.

ICP 22: Derivatives and similar commitments. The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.

142. Because of the nature of their business, many captives have very straightforward investment strategies. The investment strategy of the captive is generally tied to the investment and risk management goals of its owner.

a. Types of asset

143. Generally, captives invest their assets in low-risk bonds or other secure instruments and in many jurisdictions regulatory requirements only allow credit for secure, liquid investments, in accordance with EC 21a. If there is a fronting insurer, most of the captive's assets will either be held by the fronting insurer, as security against losses, or the captive's assets will be used as collateral for other financial guarantees to the fronting insurer, such as a letter of credit.

144. In some jurisdictions, captives are permitted to make a loan to the parent company paying a set rate of interest. Such arrangements normally require prior regulatory approval and supervisors usually place limits on the amount of these transactions. Captives with related party transactions, or with the majority of their assets held by a fronting insurer or reinsurer, generally do not have intricate investment policies nor would they require investment staff with sophisticated skills and experience. Supervisors of captive jurisdictions recognise that owing to the nature of some captives' business, many systems that are expected to be in place in relation to a commercial insurer's investments may not be appropriate in the captive context.

145. The majority of captive owners are businesses or associations not operating in the industries of insurance or investment. The owners seldom have skills in insurance or investment. Captive owners are aware that they are firstly accepting risk by establishing a captive insurance company and it is common for them to attempt, as far as possible, to avoid or minimise further risk in investing the captive's funds. This generally leads to a very conservative investment portfolio. However ignorance of markets and the desired conservatism can occasionally lead to inappropriate practices such as excessive exposure to counter-party risk, especially to the captive's bank.

b. Investment policy

146. Most captive jurisdictions' supervisors require that captive boards, as part of the business plan, set down an appropriate investment policy (strategy and objectives) to be followed prior to captive formation and will expect that policy to be appropriate to the needs of the captive. Requirements for security, liquidity, low volatility and the expected shape of the liabilities side of the captive's balance sheet including the matching of liability maturities must be borne in mind. In particular cash flow is likely to be a focus of attention since many captives will receive a single premium payment at the beginning of the policy year.²³ The investment policy would also be expected to define what entity will manage and act as custodian for the investments and contain guidelines for proportions of assets to be invested into various categories.

147. Such investment policies will frequently be simple and straightforward, not requiring significant analysis or depth of strategic thinking, especially in the case of smaller captives writing short-tail, e.g. property or deductible buy-back, business. A captive will almost certainly not establish its own investment department and smaller captives will contract out the administration of this role to the insurance manager who in turn may provide some straightforward investment advice but, more likely, will rely on professional advisors or their own or the captive's bankers to supply the necessary skills to develop appropriate policy.

148. Some captives and their insurance managers will, if the business plan demonstrates that the portfolio will attain a significant size, contract out investment policy development, investment management and custody to specialist investment houses or bankers. Frequently investment income does not play a major role in the captive's business plan partly because of the small size of the captive and the generally low level of funds available for investment. If this is the case, portfolio yield will be a secondary consideration compared with the overriding objectives of liquidity and security. It could also be the case that the captive owners and their insurance managers may simply not wish to devote management time to outsourcing investment management to sophisticated investment houses but will rely on their own bankers to place funds. The majority of captives around the world probably fall into this category.

149. Larger companies owning a captive may well have a treasury department which will formulate the captive's investment policy within the corporation's overall funds investment strategy and appetite for investment risk; such treasury departments will frequently also undertake fund placement and dealing activities on behalf of the captive. Captives writing life, pensions, liability or other long-tail classes however require the development of a more sophisticated and longer-term investment policy which is aligned to the expected maturity of policy liabilities and in such cases it is not unusual for investment policy development and management to be outsourced to investment houses. It may be that such captives can accept a higher degree of short-term volatility to the portfolio in order to enhance yield but always accepting that in the longer-term the risk is appropriate to the security required. These captives often take actuarial advice in formulating their investment policies.

150. Supervisors in captive jurisdictions usually require their own agreement to any significant changes in a company's business plan and therefore the development and implementation of a new investment policy for an existing captive will be subject to the supervisor's prior scrutiny. As a captive grows to a point where more strategic input into asset policy or management is required, this will be communicated to, and may require to be agreed by, the supervisor through a revised investment policy statement. The insurance law in many captive jurisdictions does not cover counter-party exposure limits and a captive's own investment policy may equally not cover this subject owing to the small size of the captive. It is therefore an important subject that the captive supervisor will bear in mind when examining

²³ As noted in paragraph 67, these might be structured over a financial period.

both a captive's investment policy statement and the captive's annual returns or when discussing business plan changes.

151. It is relatively rare for captives to wish to undertake equity investment, except in the case of captives writing investment linked life or pensions business where such practice can be expected to be common. For other captives, such as larger captives writing long-tail risks, an investment policy that includes equities and/or property would normally have a specific objective in mind. In such cases supervisors would expect these objectives and the methods by which they are to be achieved to be set out in the investment policy statement. For a small uncomplicated captive it would not be unusual to see an investment policy which states merely that the captive will restrict its investments to cash and bonds with a short-to-medium term duration, whether corporate or government bonds, with a minimum stipulated credit rating.

6.7 Types of capital

ICP 23: Capital adequacy and solvency. The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and required suitable forms of capital that enable the insurer to absorb significant unforeseen losses.

152. EC 23c requires supervisors to define suitable forms of capital. The type of capital will be taken into account within the overall assessment of a captive's capital financing plans, as some types of capital are seen as more permanent than others, from the supervisor's or creditor's point of view. It is important that the supervisor understands the different forms of capital available to investors in their jurisdiction, as specified by applicable legislation, and develops a policy towards their acceptability as captive funding. The various forms of paid up capital may be supplemented by guarantees to provide future funding, subject to supervisory approval based on assessment of the financial position and commitment of the proposed owner.

153. The supervisor may require an owner who is an individual to provide 100% paid up ordinary share capital in cash. A financially healthy public company, on the other hand, may be allowed to issue various types of capital instrument such as a mix of ordinary shares and redeemable preference shares and debt. It may also be permitted to hold a portion of its capital requirement in the form of a contingent guarantee to invest further monies if required such as a LOC issued by a recognised financial institution acceptable to the supervisor.

6.8 Solvency

a. Solvency regime

ICP 23: Capital adequacy and solvency. (See above).

154. As outlined in ICP 23, it is important for a supervisor to ensure that solvency levels are appropriate for the protection of policyholders. In the case of a captive insurer there may be less risk, or in many cases no risk, to external stakeholders in the event of the failure of a captive. When there is no third party or unrelated party to protect, it seems unreasonable to require a captive to tie up unnecessary capital. The captive also poses significantly less risk to the financial system. The insurance risk in a captive will be more closely evaluated and more tightly controlled through the parent company's risk mitigation and management efforts than can be the case in a commercial insurer. Captive supervisors normally ensure that sufficient recognition and importance is given to the adequacy and security of any reinsurance arrangements in place since any failure of these will impact upon the ability of the captive to meet its liabilities.

155. The difference in risk between captives and commercial underwriters will be acknowledged when reviewing captive jurisdictions under EC 23a, which requires that the

solvency regime should look at assets, liabilities, matching and capital adequacy requirements in a consistent manner. For example, in some classes of business, the determination of loss reserves in a captive is primarily based on the loss experience of the owner alone. This occurs where, for example, ultimate net loss reserves are established by actuarial calculation and reference is made principally to the owners' past experience instead of to market experience. A commercial insurer with thousands of customers and where market information is available would probably adjust reserves in the light of actuarial evaluation of market and any other relevant information in order to arrive at an accurate estimate of its ultimate net loss reserves. In the light of a higher probability of accurate ultimate loss reserves in a captive it is unreasonable for solvency levels that would be applied to a commercial insurer to be applied to a captive.

156. EC 23d notes that the capital adequacy requirements should be sensitive to the size, complexity and risks of an insurer. This allows suitable forms of capital and solvency for captives to include, possibly on a limited basis, related party investments. Seldom is a captive part of an insurance group so double gearing is an infrequent concern.

157. A sound and well-developed solvency regime, including risk based solvency requirements, is a vital component of any captive insurance supervisory regime. This is addressed by various jurisdictions and the international standard setting bodies. Key components of a solvency regime are rules on the valuation of assets and liabilities, asset/liability management and the suitability of different forms of capital.

158. Regulators will establish a minimum solvency margin requirement which adequately reflects the risks that are inherent in captive insurance companies. Significant factors to evaluate are:

- The risk portfolio may be unbalanced, consequently a formulaic approach may not be appropriate-see section 6.8 (b).
- Although the policyholder is generally the parent, there may be third party interests to protect, especially if liability business is written.
- If solvency requirements are inappropriately high given the risk evaluation, then companies will not form captives and instead seek alternative means of protecting or absorbing risk.
- It may be costly to a company to tie-up capital in a captive that could be put to more efficient use elsewhere in its operations.
- The level of solvency margin required in the case of captive insurance companies is influenced by the extent, appropriateness and security of its reinsurance arrangements as well as the adequacy of its technical provisions.

159. Where there is a contractual requirement by a fronting insurer for the captive to deposit collateral and because this is usually in the form of cash or an irrevocable letter of credit, this arrangement reduces the financial risk to the captive and therefore the level of solvency required. This collateral also minimises the financial risk to which the fronting insurer is exposed.

160. A jurisdiction will have regulations in place to enforce a minimum level of capital for captives. This minimum level will be based on the overall level of risk retained by the captive, which may be measured in terms of the risk exposure or by the size of premium income or technical provisions. Where third party or unrelated party business is written by a captive, the risk profile is significantly altered and this will be reflected in the solvency requirements.

161. Typically, more directly controlled insurance risk in a captive reduces the pure insurance risk hence depressing sufficient solvency levels compared with conventional commercial insurers.

162. Regulations will generally specify the extent to which certain types of assets are permitted for solvency purposes.

b. Risk gap

163. A key measure of the adequacy of a captive's capital and reserves is the risk gap. This is defined as the projected total of a captive's net retained liability less year one premiums net of expenses, capital, profit and loss account balance and any other free reserves. Captive owners and managers are required to demonstrate how the captive manages the risk gap. Protection strategies may include guarantees of additional capital or premiums, LOCs, or other alternatives in a form acceptable to the supervisor.

164. In the case of a captive that only insures the risks of its parent; a supervisor may take a view on whether a risk gap is acceptable, particularly if the risk of it being breached is remote given the spread of risk or expected distribution and timing of losses.

165. The quality of a captive's reinsurance protection is often more important than capital adequacy. This is because a captive may retain only limited risk and may be exposed to a single event. A consideration for any captive supervisor would be a major disaster affecting the parent and also creating large liability claims. In these circumstances it is not inconceivable that both captive and parent could fail, leaving the claimants unsatisfied. Such scenarios are critical to captive supervisors and reinsurance may be a more effective risk mitigant than capital.

166. Captives often have a reinsurance programme which covers the full run-off of losses. This avoids the potential risk that the parent retreats from the business leaving the captive with insufficient assets to meet claims.

6.9 Confidentiality and disclosure

ICP 26: Information, disclosure & transparency towards the market. The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial positions and to facilitate the understanding of the risks to which they are exposed.

167. ICP 26 is concerned with providing reliable and timely information to stakeholders and for the benefit of policyholders.²⁴ Because captives are closely held companies, there are few reasons why full audited financial statements together with disclosures in accordance with international standards need to be made available to the general public.²⁵ In certain instances public availability would even be detrimental to the captive and to the parent group. Three such instances are:

- Where the captive is the professional indemnity insurer or reinsurer of a professional firm (e.g. auditors, lawyers, architects etc.), it is arguable that it would be inadvisable to disclose the name of the owners or the financial circumstances of the captive to potential claimants. This is to prevent knowledge of the existence of insurance causing a claim to be made or influencing the amount of damages or compensation claimed or awarded by a court. There will, of course, be full disclosure to regulators and to contracting parties. Although the policyholder is generally the parent, there may be third party interests to protect, especially if liability business is written.
- Captives are sometimes used for new, innovative products. Under these circumstances there is a case for keeping the product details from competitors, but not from parties contracting with the captive.

²⁴ IAIS Insurance core principles, explanatory notes 26.1 and 26.2

²⁵ The different nature of captives has been recognised in the IAIS Standard on disclosure concerning technical performance and risks for non-life insurers and reinsurers, which excludes captives from its requirements.

- Some captives or cells of PCCs are set up to provide kidnap and ransom cover. Knowledge of the existence of insurance could encourage the very event that the insurance is meant to compensate.

168. In most instances the captive results are consolidated into the parent's figures and, in the case of a publicly quoted group, the consolidated figures are freely available.

169. Unlike commercial insurance companies, captives have a limited number of parties with which they do business. For most captives, only the owner, supervisor and any fronting/reinsurance entity have an interest in the financial well being of the captive. As the majority of captives do not write any unrelated party business, the public has no financial stake in the captive, nor would the captive's business affect decisions made by the market. Disclosure requirements for captives usually meet the needs of the interested parties: jurisdictions enact regulations to ensure that captives disclose certain information to the supervisor and the owner has access to any financial information it needs.

170. Fronting or reinsuring companies have their own requirements for disclosure, in order to make business decisions, before they will conduct business with a captive. Consequently, supervisors do not usually take steps to monitor the information disclosed to the other parties as outlined in EC 26d.

171. EC 26a lists various criteria to determine the type of information that an insurer should disclose. Some of those items are not applicable or have limited applicability to captives, notably:

- Relevant to decisions made by market participants - As noted above the participants in a captive already have means of ensuring that the captive discloses information adequate to their needs.
- Comparable between different insurers - Captives write specific lines of business for their owners. Loss histories are specific to the owner and are not necessarily reflective of trends in the insurance sector. Pricing, retention levels and investment strategies are also in the control of the owner, limiting the usefulness of comparing captives with one another.

6.10 Fraud and anti-money laundering

a. Fraud

ICP 27: Fraud. The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.

172. Despite the nature of their risks, captives, especially those underwriting unrelated party risks such as multi-owner captives or risk retention groups, will be concerned about possible fraudulent activity (see ICP 27). Even in the case of a pure captive, it is possible that an owner could attempt to use the captive for money laundering purposes, third party service providers could become involved in claims fraud, or a single director could be fraudulently active. Supervisors will however take into account the nature of the captive when devising regulations regarding fraud, as some regulations applicable to commercial insurers may be inappropriate for captives. Supervisors will also refer to the IAIS *Guidance paper on combating the misuse of insurers for illicit purposes* for further information about indicators of possible problem areas in an insurance company.

b. Anti-money laundering, combating the financing of terrorism

ICP 28: Anti-money laundering, combating the financing of terrorism (AML/CFT). The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter and report money laundering and the

financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).

173. The criteria listed under ICP 28 deal primarily with ensuring that a jurisdiction has adequate and appropriate AML regulations in place and that the supervisory authority has adequate powers and resources to enforce those regulations. At a minimum, such regulations will apply to insurers and intermediaries offering life insurance products or other investment-related insurance (EC 28e). Supervisors will take these factors into account when assessing the overall acceptability of any licence application and the ongoing adequacy of corporate governance and other risk management systems put in place within a captive.

174. FATF Typologies have increased their focus on the insurance sector but to date have not discussed specifically the possible use of captives for money laundering schemes, while IAIS guidance only mentions captives as a potential AML risk if a fictitious captive is established to try to launder funds. In such an instance, enforcing due diligence procedures within or by the directors and employees of the captive would be ineffective. Any potential risks posed by captives would instead be mitigated by a robust 'customer due diligence' regime implemented by insurance managers and fronting insurers/reinsurers as well as independent audit review and background checks and other due diligence by the supervisor when a captive applies to acquire a licence in the jurisdiction. As noted in paragraph 96, supervisors will keep in mind the importance of having a clear understanding of the objectives of any proposed captive and being satisfied that the ownership and management structure is appropriate for what is proposed.

Appendix 1 – Captive definition²⁶

1. There are a number of definitions of a captive insurer. It is important to define those captive types that might require a different regulatory approach from commercial insurers. The purpose of this paper is not to recommend a single definition, but rather to draw attention to various definitions that exist. We note below a number of definitions that may be relevant.

2. The following definition of a captive is in the IAIS standards on enhanced disclosure:

“For the purpose of this standard, “captive” shall mean an insurance or reinsurance entity created and owned by one or several industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, and only a small part, if any, of its risk exposure is related to providing insurance or reinsurance to other parties.

Supervisors can decide not to apply this standard to “captives” that are considered insurers or reinsurers in the legislation in the jurisdiction, provided there is no potential threat to the financial system, no public interest need for disclosure and no legitimately interested party is prevented from receiving information.”

One of the issues for consideration is whether or not subsidiaries of insurers or reinsurers, underwriting pure captive business for the parent should be included within the definition of captive insurer.

3. The EU Reinsurance Directive defines a reinsurance captive as follows:

“A reinsurance undertaking owned either by a financial undertaking other than an insurance or a reinsurance undertaking or a group of insurance or reinsurance undertakings or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which the captive reinsurance undertaking is a member.”

(The EU Reinsurance Directive applies in the EU, representing approximately 10% of the total worldwide captive insurance market).

4. As an example of a US definition, the US District of Columbia defines a captive insurer as:

“Any insurer that insures the risks of its parent or affiliated companies of its parent, any member organizations of an association and the affiliated companies of the member organizations, or any policyholders or participants that have entered into a contractual relationship with the insurer for the purchase of insurance.”

5. A. M. Best has also defined a number of different types of captives:

	Captive Type	Definition
1	Pure	Insurer that writes only the risks of its owners and/or affiliates.
2	Captive writing connected business	Insurer that writes the risks of unaffiliated companies doing business with the insurer's owners and/or affiliates, in addition to the risks of its owners and/or affiliates.

²⁶ See paragraph 17 for an early definition of a captive.

	Captive Type	Definition
3	Captive writing third-party business	Insurer that writes unrelated risks, open market risks, in addition to the risks of its owners and/or affiliates.
4	Captive of insurer	Subsidiary of a commercial insurer and/or re-insurer that writes only risks assumed from its owners and/or affiliates.
5	Association captive	Insurer that is owned by members of a common industry or trade association for the purpose of sharing risk among its members.
6	Health care captive	Any type of captive writing coverage for hospitals, health maintenance organizations or managed care companies.
7	Multi-owner captive	Insurer that is owned by two or more unrelated parties for the purpose of writing the risks of its owners and/or affiliates.
8	Long-term (or life)	Any type of captive writing long-term (life) business.
9	Composite	Any type of captive writing a combination of long-term (life) business and general (non-life) business.
10	Rent-a-captive	Insurer that contractually provides captive facilities for a fee to parties unrelated to the insurer's owners.
11	Agency captive	Insurer that is owned by one or more independent insurance agents to write high-quality risks that the agents control so the agents can participate in the profits generated by the business.
12	Finite	Any type of captive that writes unrelated risks involving: (i) clearly defined aggregate limits; and (ii) premiums that reflect the underwriter's anticipated investment income.
13	Captive not otherwise classified	Insurer that writes risks on a direct or reinsured basis that was formed to meet the insurance needs of its owner(s) whether it is formed under captive legislation or not.
14	Protected/Segregated cell captive	Insurer that provides captive facilities for a fee to parties unrelated to the insurer's owners. The captive is established by legislation that legally protects, or segregates, each cell's assets so that liability of other cells cannot attach to them.
15	Sponsored captive	Insurer that is owned by one or more insurer, re-insurer and/or captive. Each participant is unrelated to the owner(s) and insures its own risks. Each participant has its assets protected in a separate cell within the facility so that one participant never
16	Branch captive	U.S. domiciled subsidiary of an offshore captive that writes U.S. employee benefits subject to ERISA legislation for the owners of the offshore captive.

	Captive Type	Definition
17	Risk retention group	Multi-owner captive formed under the U.S. Product Liability Risk Retention Act of 1981 or under the U.S. Federal Liability Risk Retention Act of 1986 that writes only liability risks.
18	Governmental pool	Separate, legal, non-governmental, risk-bearing entity that is formed by one or more governmental agencies and/or subdivisions for the purpose of self-insuring its risks.
19	Group self-insurance pool	Separate, legal, risk-bearing entity that is formed by a trade association, common industry or other related group for the purpose of self-insuring the risks of its members.
20	Special purpose vehicle	Any type of captive that transfers insurance and non-insurance risk into the capital markets.
21	Trust	A fiduciary relationship created by agreement in which money from individuals and/or companies is held by a trustee to satisfy the legal obligations of the individuals and/or companies to injured third party claimants.

6. The definition of unrelated parties needs to be carefully considered. For example, a captive could derive more than 50% of its business from unrelated parties e.g. a captive that provides employee benefit reinsurance for the parents employees, the insured employees are "other parties" and this captive may therefore not meet a "pure" captive definition. It is also important to define what is meant by "third party business"²⁷. Many of the definitions of a "pure" captive may exclude the insurance of third party risks and the issue arises as to whether this is a reasonable restriction on a captive of a major industrial or commercial company that provides insurance for workers compensation, employers liability or public and product liability exposures. Liability insurance is purchased to benefit the insured, not the injured party which is why it is a related and not unrelated risk. There is therefore a strong argument that those companies referred to above are regarded as "pure" captives as they are only insuring a responsibility that would ultimately fall on the parent company if no insurance were in place.

7. Other possible definitions exist, for example instead of attempting to define a "captive", the supervisor can focus on defining "captive insurance". This aspect was adopted by Kate Westover in her book "Captives and the Management of Risk".²⁸ In a subsequent book by the same author "Captive Practices and Procedures"²⁹, a captive was defined as "A special purpose insurance company....(that is) not licensed to sell insurance to the general public. Its source of business is the primary business activity of the captive user". A "captive user" can be defined as "the insured, or an affiliate of the insured, or individuals or organisations connected to the insured through some existing business relationship". The above definition would allow for the legitimate use of captive insurance laws by rental captives or by companies that use captive insurers to reinsure unrelated risks, e.g. customers or suppliers, to support their primary business activities.

8. Note that by defining a captive or captive insurance in this manner, the supervisor may then begin to draw the distinction between the different types of captive "users" that require

²⁷ This paper has defined "third party business" and "unrelated party business" in the footnote to paragraph 5.

²⁸ Published by IRMI 2002 ISBN 1-886813-88-4

²⁹ Published by IRMI 2006 ISBN 1-886813-86-8

more or less regulatory protection. This is arguably more logical than making regulatory distinctions based on the number of owners of the captive or the amount of unrelated risks that are underwritten.

9. While historical attempts to define captives have focused on the ownership (owner equals policyholder) the reality is that this does not necessarily serve the regulatory purpose. For example most jurisdictions have rental or sponsored captives that allow the use of the captive by a policyholder that is not an owner. Additionally, captives can be owned by individuals or trusts, not just corporate entities.

10. A single definition of a captive remains a challenge both to the industry and to supervisors.

Appendix 2 – Protected cell companies³⁰

1. A Protected Cell Company (PCC), also known as a Segregated Account Company (SAC) or a Segregated Portfolio Company (SPC), is a single company consisting of a core and an indefinite number of cells, which are kept legally separate from each other. Each cell has assets and liabilities attributed to it, and its assets cannot be used to meet the liabilities of any other cell. The company will also have non-cellular (core) assets, which may be available to meet liabilities that cannot be attributed to a single cell. A PCC can create and issue shares ('cell shares') in respect of any of its cells but the company is managed by a single Board.
2. A variation of the PCC concept is an Incorporated Cell Company (ICC) where individual cells are distinct legal entities.
3. PCCs are incorporated as a single legal entity under company legislation and not insurance legislation. The structure enables different risks to be written in separate cells. In the event of the insolvency of a cell, the creditors only have recourse to the assets of that cell, although in some circumstances there may be access to assets held in the central core. The owner of the PCC receives a fee for the use of each cell. PCC legislation generally places specific requirements on directors of such entities to ensure that assets and liabilities of individual cells are strictly segregated.
4. A cell of a PCC can be used as a captive insurance company, with the cell shares held by the captive's parent. One method of operating is for an insurance manager to establish a PCC, for which it obtains an insurance licence and which it then manages. Individual cells can then be created and offered to clients, to operate as captives, without the need for entire new companies to be set up. This is similar to a rent-a-captive arrangement. Many owners of PCCs require each cell to be fully funded to avoid any cell within the PCC becoming insolvent.
5. The authorised entity will be the PCC and the creation by the PCC of a new cell does not create a separate legal entity or person. In many jurisdictions the addition of new cells to a PCC requires a supervisor's formal approval as in many respects a cell has characteristics similar to a standalone captive.
6. Owing to the cost of establishing and managing a captive and the need for a reasonable amount of premium to be put through the captive in order to make it viable, captives tend to be a more economical option for medium-sized or larger companies/groups. On the other hand PCCs lower the cost threshold to the captive solution, allowing smaller companies to access the benefits of a captive without the need to invest significant sums capitalising a captive insurer.
7. There are a number of aspects of captive regulation that are specific to PCCs. When assessing solvency, a supervisor considers both the consolidated position and the solvency of individual cells. A consolidated calculation may mask problems in certain cells if the deficit in one or more cells is less than the combined surplus in others. Management reporting and the audit process will identify if there are any cells in deficit.
8. Since a PCC is a single legal entity, the legislation may not permit individual cells contracting with each other. It is important that the legal status of the PCC and cells is clearly explained to any contracting party. The responsibilities of the directors of a PCC are the same as those of a traditional limited company although the PCC structure may make those responsibilities more complex.
9. Either by statute or by regulatory practice, a PCC, which is licensed to carry on insurance business, is not permitted to carry on any other non-insurance business.

³⁰ See Appendix 3.

10. PCC legislation is becoming more mature in some jurisdictions. There has been no successful legal challenge to the PCC concept. However, there remains potential uncertainty in some jurisdictions as to the legal separation of the cellular assets.

11. There are many potential uses of PCCs for captive insurance, examples of which are:

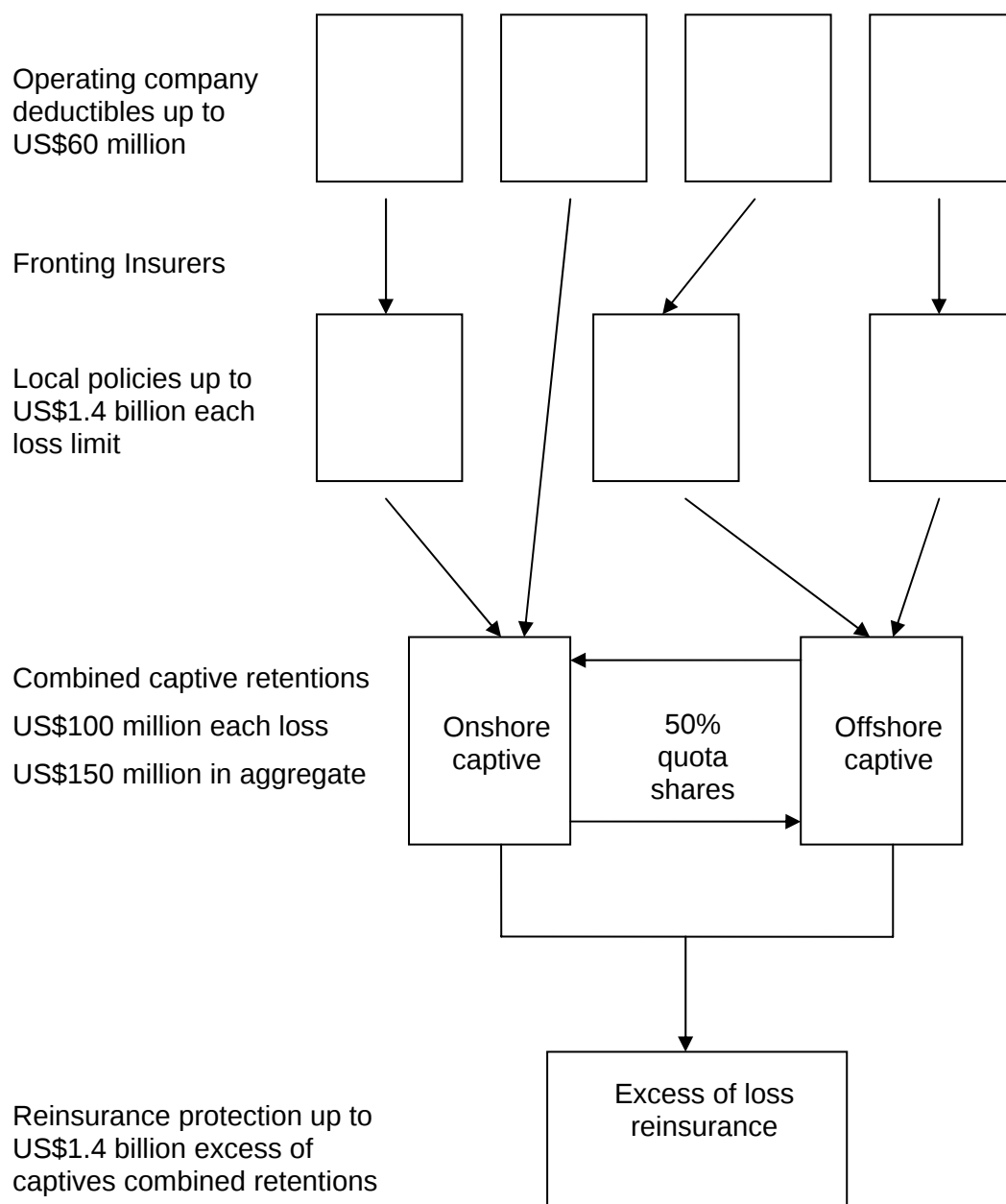
- **Rental captives** - The PCC structure relieves the cell user from the expense associated with establishing and sustaining a traditional captive insurer.
- **Association captives** - A PCC can be economically used by associations or similar groups to provide a cell for each individual member, capitalised as necessary, with legal separation of assets and liabilities, whilst providing a homogeneous insurance programme which can be reinsured more efficiently than through placing individual insurances for individual members.
- **Multi-national companies and joint ventures** – A PCC allows large economic groups to allocate individual cells to different parts of the group; each cell can operate independently under a common group structure. Separate cells may be established for joint ventures with another economic group.
- **Mixed life and non-life insurers** – If legislation so permits, a PCC can allow both life and non-life business to be written in the same legal entity, whilst ensuring that the assets and liabilities of each business are legally ring-fenced.
- **Life assurance** - Utilising a PCC structure, life assurance companies can legally segregate the assets and liabilities of life, pension and individual policyholder funds. In the latter case, a cell for each individual policyholder may be created which can provide robust security and greater investment flexibility to individual investors, particularly high net worth individuals.
- **Reinsurance Pool** – A PCC cell may pool business of common class from unrelated parties before retroceding a share of the overall pool to individual captives (see Appendix 3).

Appendix 3 – Diagrammatic examples of captive structures

The following diagrams represent actual captive insurance structures of different types.

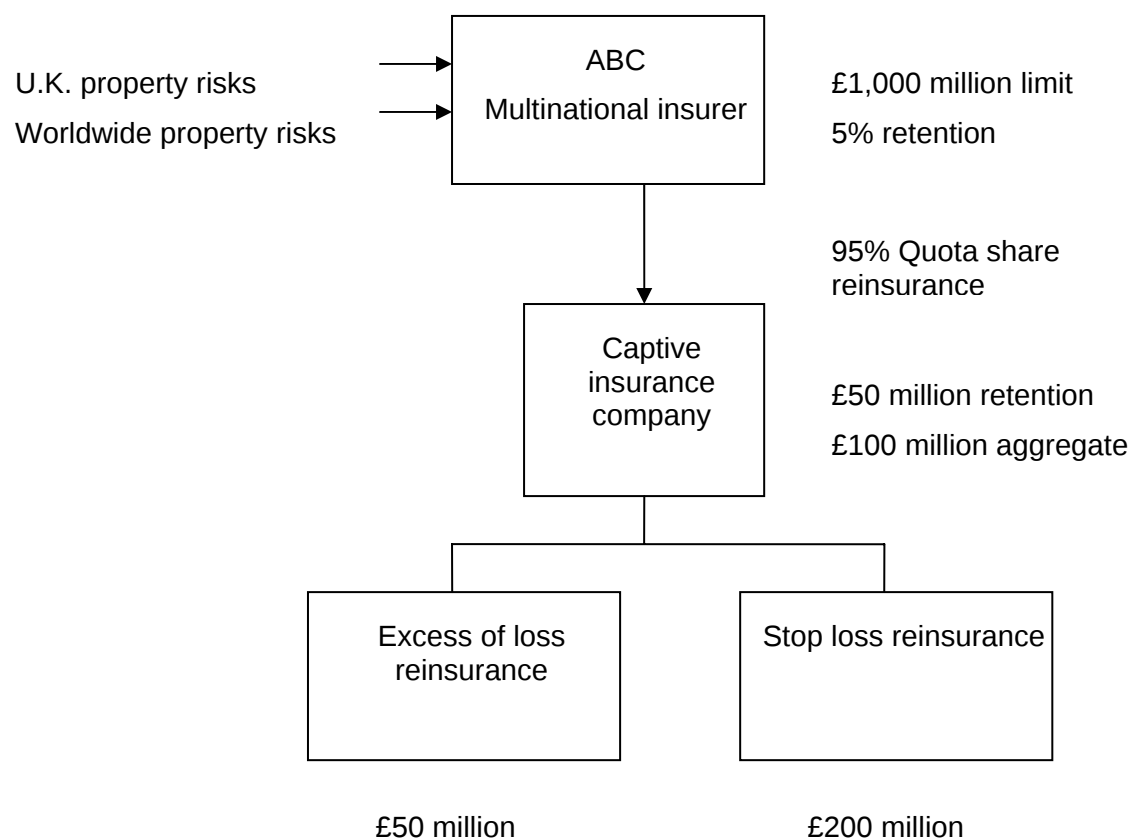
1. Multinational Property Programme

Insured Operating Companies

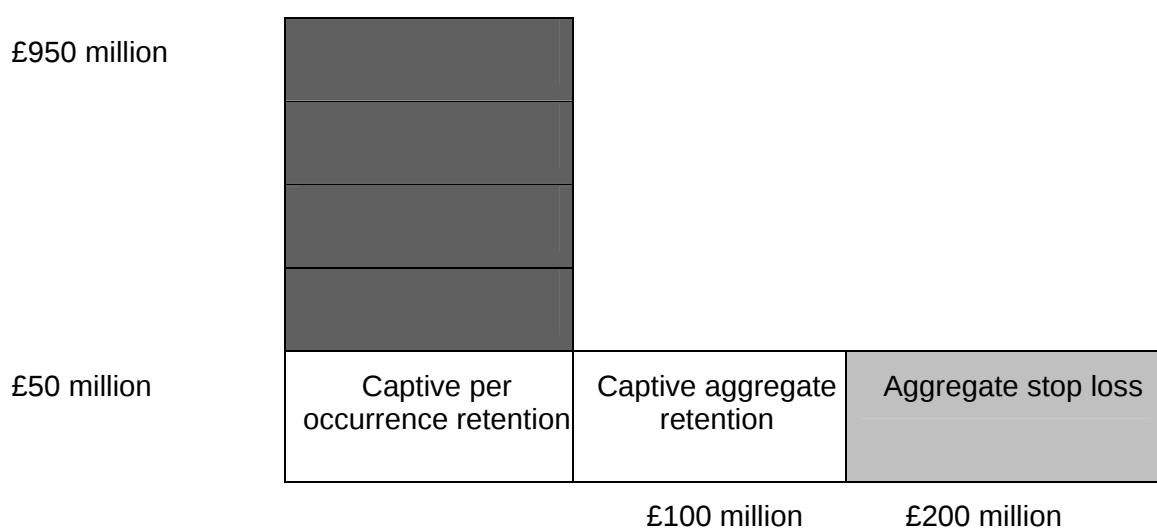


2. Specimen Captive Structure and Reinsurance Programme

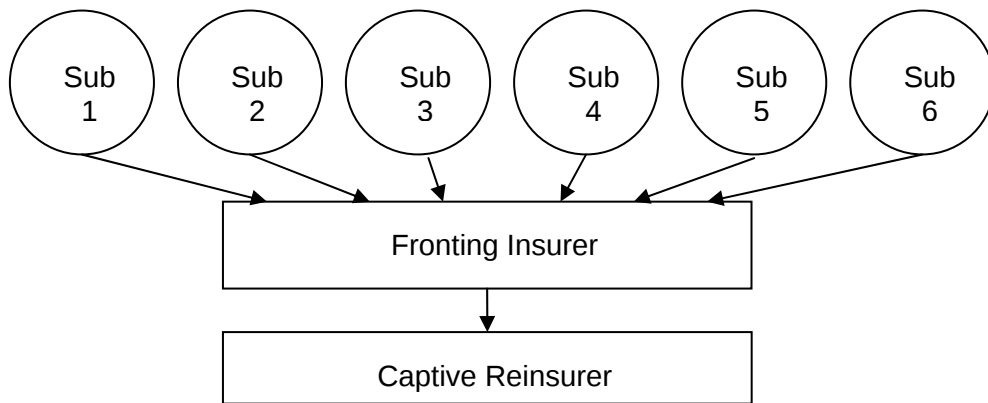
Structure



Programme

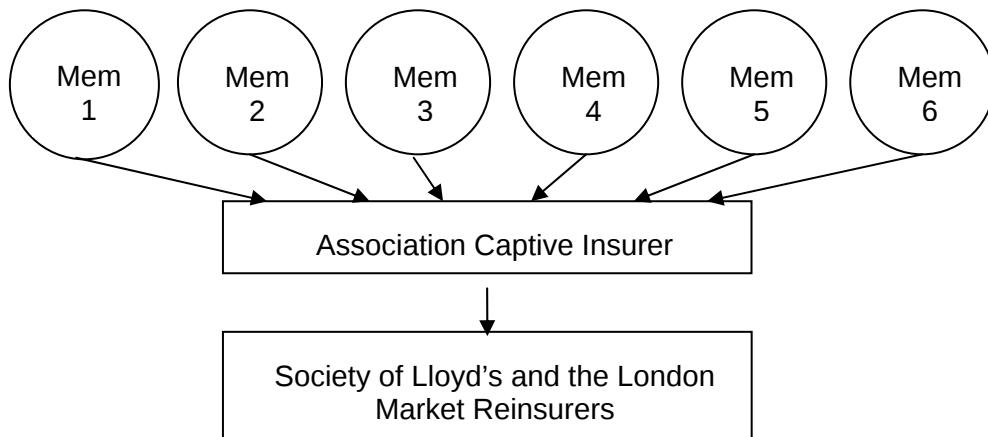


3. Captive Insurer using a Fronting Insurer



1. The owners of a group with a number of subsidiaries wishes to self-insure a proportion of its Workers Compensation risk which has previously generated large profits for insurers. Local legislation requires Workers Compensation insurance to be placed with a licensed local insurer.
2. Policies are issued to each of the subsidiary companies by a “fronting insurer” that is licensed to provide Workers Compensation insurance coverage in the respective home market of the subsidiary.
3. The “Fronting insurer” reinsures a proportion of the Workers Compensation risk to the captive reinsurer.

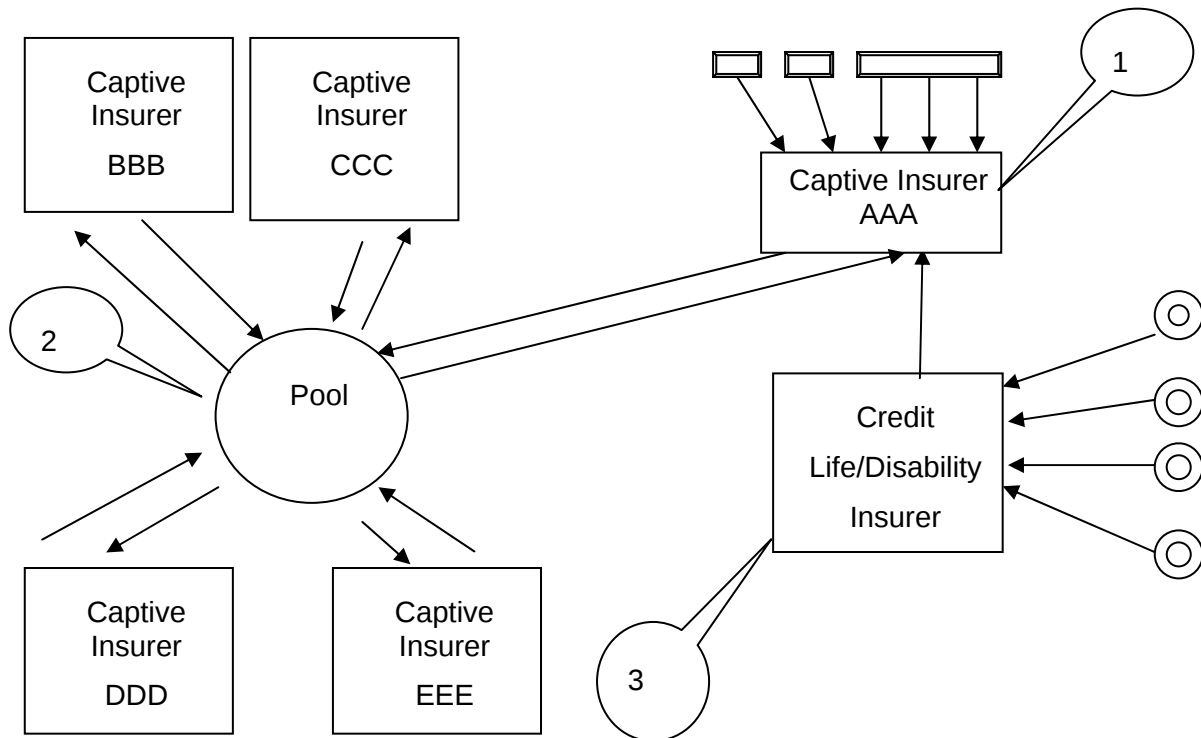
4. Association Captive Insurer accessing the Reinsurance Market



1. The members of an Association of aircraft owners wish to access Lloyd's and the London Market to obtain reinsurance coverage at rates that are lower than can be obtained by purchasing direct insurance for aircraft hull from the conventional direct insurance market.
2. Aircraft hull policies are issued to each member by the “Association Captive Reinsurer”.
3. The “Association Captive Reinsurer” reinsures 100% of the risk to Lloyd's and London Market Reinsurers.

5. Captive Insurer Writing Unrelated Party Reinsurance

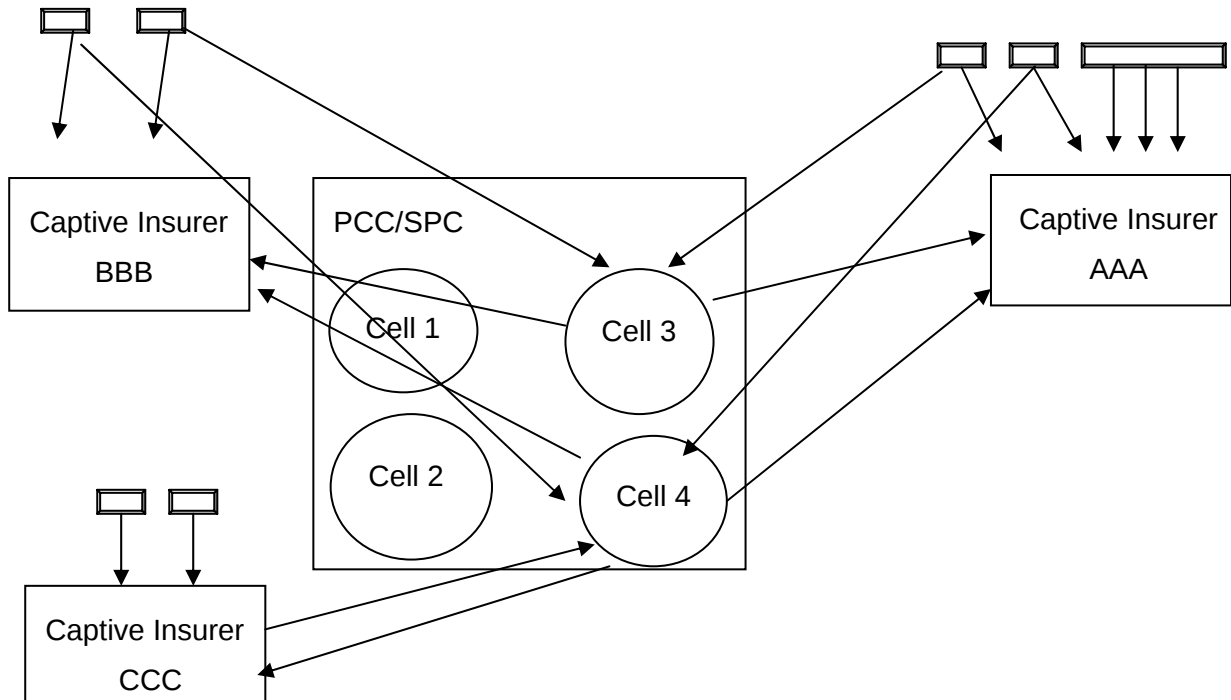
Captives with a common insurance manager or adviser are brought into contact with each other and agree to pool business to better distribute risk among their companies.



1. Subsidiary or Associate Companies of the parent of each captive insurer place one or more insurances with the respective captive insurer. In this example two subsidiaries or associates obtain one insurance policy from Captive Insurer AAA. One subsidiary obtains three separate policies, covering difference contingencies, from Captive Insurer AAA. The insurances might be written directly by the Captive Insurer or by way of reinsurance from a “fronting” insurer if local legislation requires all insurance policies to be underwritten by an “admitted insurer”.
2. Each captive owner signs an agreement whereby it agrees to reinsure a proportion of its insurance liabilities relating to its parent into a pool with risks from other captive insurers that are generally managed by the same insurance manager or share a common adviser. In the case of the latter the captive owners will often be resident close to each other and may be personally known to each other. The proportion of business ceded to the pool will normally be in the region of 15% to 25% of the relevant risks. Each captive insurer will receive a retrocession from the pool that is in line with the volume of business ceded to the pool.
3. Each captive insurer assumes, separately, unrelated party reinsurance from a credit life or credit disability insurer. The policyholders will be individuals who have obtained credit life or credit disability insurance from a licensed insurer in their local jurisdiction to provide protection while they repay a loan.
4. The overall objective of the arrangement is for the captive insurer to insure the risks of its parent companies, but to be able to mitigate its exposure to the limited number of risks underwritten by participating in the insurances of other organisations including those that often share its parent company’s approach to risk management.

6. Captive Insurer Writing Unrelated Party Reinsurance using a PCC

Captives with a common insurance manager or adviser are brought into contact with each other and agree to use a PCC/SPC Cell to pool business to better distribute risk among their companies.



1. The structure of the programme follows that shown in the earlier example. In this example a PCC/SPC cell is used to provide the insurance risk pooling facility. The Cell might only write business of a particular type, such as Workers Compensation or General Liability. The business might be written directly by the PCC/SPC Cell or assumed by way of reinsurance from the captive insurer. Having been pooled risks are then retroceded to the captive insurer.

Appendix 4 – Investment practice by asset category

Cash and short term deposits

1. This is a category favoured by many captive owners. Owners will usually have experience of these areas in their own businesses and see time and sight deposits as providing permanent liquidity and a high level of security. Possibly it may also reflect a degree of conservatism, which is typical of most captive owners. This area of investment tends also to be favoured by captive managers and the captive's own bankers because it is uncomplicated. Depending on markets and market conditions, it is an area which is however unlikely to maximise portfolio returns.

2. Captive supervisors frequently monitor through annual financial filings any potential counter-party over-exposure, which could bring additional risk to the captive.

Money market placements and bond funds (collective investment schemes)

3. Captives of larger companies whose treasury department will often handle the captive's investments may make use of these outlets, which frequently enhance yield whilst providing a high degree of liquidity with measured security. Some captive managers do utilise bond funds for reasons of liquidity/yield as well as for ease of management and administration.

Government and semi-government bonds

4. For those captives undertaking more permanent investment the security and liquidity offered by such instruments is clearly ideal. The portfolio can be constructed to cover a range of maturities such that a relatively short average portfolio life or duration may be maintained. This is a common captive investment objective, but yield may be enhanced by taking advantage of longer-dated and/or higher coupon instruments within the portfolio mix. In some parts of the world taxation advantages are available from investing in government and municipal securities. Life captives can construct a portfolio with a high level of security together with an adequate match of liability maturities.

5. For many very small captives investment in this asset class is uncommon owing to the lack of sophistication of the owners and the small portfolio size. For the larger and more sophisticated captives it would probably be rare to invest in a bond portfolio in this class only. This is merely because the captive's owners will almost certainly outsource their investment management to the portfolio managers of a bank or other investment house. Such managers are likely to advise a mixed portfolio of government, semi government and corporate bonds in order to improve yield above what would probably be available from government and semi-government stocks alone.

6. The principal areas of focus for the captive supervisors in monitoring such portfolios would be the credit rating of the sovereign entity, average portfolio life or duration and the potential volatility of certain components of the portfolio.

Corporate bonds and asset-backed securities

7. Captives investing in this asset class are likely to be larger companies and more sophisticated investors outsourcing this aspect of the business to investment managers. As for any insurance company, the credit quality of the debt instrument and the entity's credit rating will be a prime concern but potential volatility will also be considered.

8. Whilst credit rating will take a higher profile in relation to this category compared with investment in government stocks, essentially the same remarks as set out above regarding government and semi-government securities apply here also.

9. It is very rare to see a captive invest in non-investment grade securities. Where this is encountered it will reflect the captive owner's high appetite for risk and usually will only be permitted by supervisors where a captive has significant excess capital. The captive's aim will normally be to maximise yield. The challenge to supervisors is to approve the investment

policy, in the first place ensuring that relevant safeguards and parameters are in place, to determine what proportion of invested assets may be directed towards this sub-category whilst ensuring that the captive's capital/free reserves remain at an acceptable level in the event of default of any investment, and to monitor that performance remains within the criteria established.

Loans

10. Except as dealt with below, secured and unsecured loans are seldom encountered in a captive's investment portfolio; however where loans are made, this is usually for a specific purpose. In many jurisdictions supervisors require such investments to be subject to their prior approval.

11. Mortgage loans may occasionally be encountered and often require the prior approval of the supervisor. Loans secured over other assets are seldom encountered.

12. A more common loan encountered within a captive's portfolio is an unsecured loan made to a parent corporation or association. Supervisors may require that such loans be approved by them, in advance of the loans being made, and all jurisdictions have criteria for permitting such loans. Such criteria will usually be linked to continued compliance with statutory minimum capital requirements.

Equities

13. The conservative nature of most non-life/pension captive owners means that there is very little appetite for equity investment, principally owing to the volatility of such instruments.

14. There are naturally exceptions. Equities have been used as instruments to achieve very long-term growth. Some captive owners may wish to undertake equity investment in order to obtain growth in the captive's capital and free reserves. Also it is not unknown for a portfolio of very long tail claims with a development period of up to 40 or more years to be matched principally by equities with the objective of maximising growth in the matching assets.

15. There are a number of captives and PCC cells, both life and non-life, whose owners or single owner wish to use the captive or PCC cell as their personal investment vehicle, i.e. their own mutual fund or investment trust, and wish to undertake significant equity investment in order to obtain growth. Such an arrangement may well be constructed in accordance with life assurance or pension legislation in the owner's jurisdiction of residence.

16. Supervisors typically pay close attention to the investment policy statement regarding this category of investment and will monitor compliance with it. Typically also, they will stress test the resilience of the captive's capital to various insurance and investment market scenarios.

17. It is extremely uncommon, but not unknown, for a captive to own sufficient shares or stock in a company for the latter to become a subsidiary of the captive. In such cases the owners always have a specific objective, which will be disclosed to the supervisor.

Property

18. Very few captives own properties and seldom is it appropriate for a captive to invest in this category, principally for reasons of liquidity and marketability but also because the captive would be exposed to the potential volatility in value of a single large asset. However, property investment may be considered as part of the equity investment category so that comparable criteria would apply.

Derivatives

19. Few captives invest in derivatives and most captive managers will not provide sophisticated investment advice. Because of this, most supervisors in captive jurisdictions do not need to focus heavily on regulating the use of derivatives in their captive sector and in some cases will restrict captives from having any dealings in derivatives, either by placing

limits on the amount that may be so held or disallowing such investments altogether, in accordance with EC 22a.

20. For the rare captive that does invest in derivatives, most captive jurisdictions require the captive to file financial statements prepared using well-recognised generally accepted accounting principles (GAAP). Approved GAAPs are usually the US, UK, Canada or the standards produced by the International Accounting Standards Board,³¹ which have extensive rules for valuation and disclosure of derivatives.

21. The great majority of captives are small non-life insurance companies. Consequently the business needs of large insurance companies, which are translated into strategies for areas such as asset diversification by category and limits or guidelines on geographic, currency and sectoral/asset class exposures, are seldom relevant to the business needs of captives. Frequently the business needs of a captive will place liquidity and security as the only strategies to be followed together with a limited statement on the distribution of assets by category.

22. Most captive owners, and indeed many captive supervisors, do not believe that, as a generality, derivatives are an appropriate category of investment for captive companies and investment in this area is rarely encountered. There are captives whose equity investment portfolio contains some options and supervisors may consider such instruments as part of the equity portfolio. The reasons for engaging in this area of investment will be expected to be justified in the investment policy statement with regard to the overall objective and rationale for equity investment.

23. There are some captives that are special purpose vehicles and which may use interest rate swaps for the specific purpose of fixing interest rates. Such instruments will be a key element in the captive's business plan. These are sophisticated vehicles and are significantly different to conventional captives.

24. The use of 'structured investments' by captives has been noted by some supervisors and such investments frequently use various derivatives within the structure. These instruments are offered and guaranteed principally by banks and consequently the captive will have no direct exposure to the derivative and its management. These instruments can be very attractive to captives as they frequently offer enhanced yield with a short maturity. Because of the guarantee the captive and the supervisor will however need to pay close attention to total counter-party exposure if such instruments make up a significant proportion of a captive's portfolio.

Currency

25. Most captives are active in only one currency area and the question of asset allocation amongst currencies will simply not arise. Equally, given the conservatism of most captives, holding foreign currency for speculative purposes is extremely rare.

26. It is however quite common for larger corporations owning captives to operate in a number of different currency locations and in such cases it is frequently the corporation's treasury department, which handles investment policy and dealing. Captive supervisors will expect the investment policy statement to reflect the objective of matching currency liabilities with assets in the same currency. Where the captive operates in 'weak' currency areas such matching may be only in broad terms and 'strong' currency assets may be held to match those 'weak' currency liabilities.

27. Captives are often established in different jurisdictions to their parents and often accept foreign denominated liabilities. In common with other insurers, such captives' asset portfolio will either be constructed recognising the need to hold some foreign assets or the existence of a currency risk.

³¹ International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

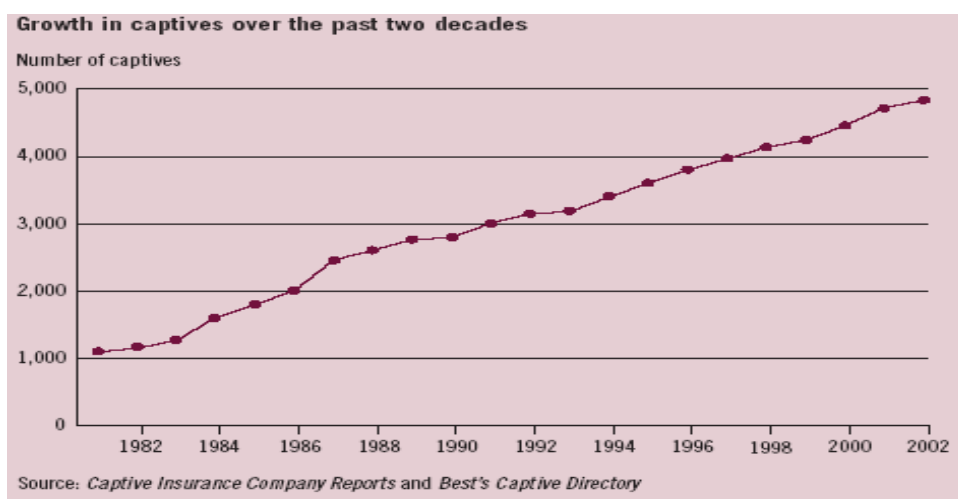
Valuation

28. There is an undoubted preference on the part of supervisors for market values to be used for asset valuation purposes. Most captive supervisors will accept accounts and other returns prepared under the main accounting conventions and the valuation methods set out in them. In this regard, captive supervisors are closely monitoring the development and use of international accounting standards.

Appendix 5 – The captive insurance market

1. There is no absolute source of consistent reference on captive statistics because of a lack of a precise definition of captives, but the figures compiled by A M Best, as drawn from the individual jurisdictions using their own definitions, are a widely recognised reference. A M Best estimates that the captive market has grown by an average of 10% per annum since 1998, with a correlated increase in premiums written by captives. In 2002 Swiss Re estimated that captives accounted for 10% of global premium income, and A M Best estimated that the alternative market, including captives, would account for almost 50% of the US Commercial market by the close of 2003. Over the five-year period ending 2003, domestic US captives saw net written premiums rise 45% year-on-year, with 'admitted assets' increasing in value by 29%, according to an August 2004 report by A M Best. At the same time, loss reserves grew annually by 35%, while surplus levels rose 2%.

2. The growth in captive insurance can be illustrated by the following graph:



By 2005, the number of captive insurers had grown to an estimated 5,500 worldwide.

3. A M Best has also reported that in June 2006, the following locations had more than 20 captives resident³². It is recognised therefore that some jurisdictions are not mentioned and it may be useful in future to obtain information through IAIS sources which would improve the A M Best database.

<u>America</u>		<u>North Atlantic & Caribbean</u>	
Vermont	533	Bermuda	1,326
Hawai	143	Cayman	737
S Carolina	110	BVI	377
Other	723	Barbados	218
<u>Asia Pacific</u>		Turks & Caicos	95
Singapore	57	Bahamas	22
<u>Europe</u>			
Guernsey	387		
Luxembourg	277		
Ireland	199		
Isle of Man	161		
Switzerland	48		
Sweden	42		
UK	30		

³² Source: A M Best Captive Center