



AFTER 200 EDITIONS?

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The next 100 editions could see more tailored legislation among domiciles, large companies taking on more risk, and more profit-centre captives

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Captives have come a long way. Or they haven't. Depending on your view. What is true and has been true over the past 30+ years is the fact that captives are flexible and those in the industry are resourceful. And resourcefulness leads to revenue.

As far back as 1977, challenges to the industry were apparent. Rev Rul 77-316 and Rev Rul 78-338 had many managers and owners wondering whether captives were going to survive into the 1980s. Fast forward to 2007 and the IRS' proposed regulation disallowing separate entity treatment for insurance transactions was defeated by the coalition of CICA and VCIA. There are and will continue to be challenges to the captive industry. That's nothing new. But captives evolve. They

are no longer just expense reduction vehicles. They deliver savings but have also become revenue generation vehicles. And the mix between expense reduction and revenue generation may lead to opportunity and growth. So, where might we be after *Captive Review* publishes another 100 issues?

Regulation and education

Competition between domiciles has, to some extent, driven regulation over the past decade. Fractional premium tax rate reductions, investment policy flexibility and local director requirements have all been offered as reasons to change domicile. As captive regulation matures, domiciles will rely less and less on such marginal improvements and will focus on appropriate, tailored legislation. A maturing regulatory system will bring everyone into line with a proportional, risk based platform, even if that platform isn't exactly Solvency II in its current form. The Federal Insurance Office's (FIO) role will develop as regulations evolve, leading to greater uniformity between domiciles. Insurance will still be regulated at the state level but the NAIC and FIO will gather momentum.

Solvency II in Europe will eventually come to pass. Captives will be affected but in a watered-down version. The US, through the NAIC, will take the Solvency Modernization Initiative to conclusion, creating governance guidelines that bring single parent and group captives more into line with risk retention groups and traditional insurance companies. States will be able to implement a proportionality principle, much as Bermuda has done. Without proportionality and a bifurcated approach to regulation, states will realise that mobile captives can re-domesticate. The states will also see the possibility of the Solvency Modernization Initiative becoming a vehicle for the FIO to assert authority and will band together to address proportionality.

Captive business plans will be written, accompanied by mandatory exit plans. With the ease of entry and exit into the captive market, regulators will look to captives to define corporate exit strategy at the outset of a captive's life.

The existing issues with NRRRA (Non-admitted & Reinsurance Reform Act) will receive clarification with captives continuing their operations, much as they did after clearing the hurdles outlined above.

Domiciles

Bermuda's race towards Solvency II equivalency will ultimately lead to stronger client-facing regulation. Bermuda's captive community will benefit as a result. Cayman's risk management framework will be seen positively, as will their existing stance on Solvency II. Neither domicile will benefit greatly from Solvency II for captives, one way or the other.

The number of US domiciles will continue to expand. Advantages from domiciling a captive in a company's home state will increase captive efficacy. There will be some re-domestication but any movement will be slow.

As seen in the past, some domiciles will struggle with growth. States such as Utah, Montana, Delaware and Missouri will look to undertake captive audits for the first time, placing staff under stress. This stress will lead to slower approvals for new captives and business plan changes. Arizona will continue to struggle without meaningful captive income. Vermont, Hawaii, DC and the offshore domiciles' struggles as new captives consider them first as their infrastructure becomes a leading reason to choose a domicile.

Captive growth

For large captives, although saturated in number, growth will be achieved through the assumption of more risk. Large corporations, as their risk appetites expand, will look to take on third-party (controlled unaffiliated) business to expand their portfolio. They will leverage their size to access greater control over their relationships. As well as the expansion of outside business, we'll continue on a growth path as market cycles drive interest in captive use. The hard market will come and go and captives will respond, as they always have, by looking to their owners' risk management strategies to control a company's overall cost of risk.

Captives will become more and more important in the development of corporate risk strategy. Traditional carriers will become increasingly associated with large corporations' desire to control outcomes and will become vehicles to support captives as much as vehicles to which risk transfer premium is ceded. Data and the ability to analyse data will affect behaviour and the change in

behaviour will change corporate views of retention strategies.

Group captives will expand as smaller companies' ability to capture, analyse and act upon risk management data improves. Group captives will drive benefits to smaller companies through delivery of outsourced risk management based around group results. Homogeneous captive groups will outgrow heterogeneous captives in profitability as a result.

Private equity and hedge funds will look to segregated cell captives to aggregate their exposure by line of business, looking to risk management more as a controllable, aggregate cost than a series of individual transactions. These captives will necessarily be large entities with the attributes of small insurance companies.

Micro captives such as 831(b) companies will continue to grow but under increasing scrutiny by the IRS. Legitimate

As the industry develops and should regulation become onerous, there may be a trend to a review of vehicles such as discretionary mutuals. These vehicles are not regulated as insurance vehicles and no premiums are paid to the entity. Rather a contribution is made to the entity along with an application to be protected from certain risks. Any claims on the mutual will be adjudicated at the sole discretion of the individual or board appointed by the members.

Non-risk bearing vehicles, such as Bermuda's special purpose vehicles are becoming more popular, as ease of entry and exit without excessive regulation become more important.

Conclusion

The more things change, the more they stay the same. One constant throughout the captive industry's history is that creative thinking is not the exception, it is the

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structures will remain intact but scrutiny over structures in which no losses are paid, arms length pricing is challenged and capitalisation slight will increase. Entities, including MGAs, will look for controlled, unaffiliated business that can be captured, potentially in a segregated cell structure, maximising the returns on that control.

Coverages and competition

TRIPRA will be looked at very closely in 2014 and will receive great scrutiny at renewal. There is a chance that it is non-renewed.

Employee benefits represented the hard market for 2011. Exploration of captive uses within the employee benefit market will continue although what the government will do with this class of business in the coming years is very unclear. All I can say is that I probably won't like it.

norm. Captive management is not about accounting. Captive management is about delivering results for corporations. Risk management through captives is now as much about control as developing profit. What matters to the captive industry's constituents has not changed except for the development of a profit motive. Control and market access is what Fred Reiss was looking for in the 1950s. He delivered an insurance solution. Today, solutions are delivered but they solve different issues. The issues have developed – drive profit. Manage cost. Captive insurance companies are transforming from traditional risk retention vehicles to truly critical business tools and profit centres. In the coming years, they will strip profit from the risk transfer market to the benefit of their owners. And they will do it in a regulatory environment that, while evolving, will always be managed by the industry. ☺