

Morgan Owen medal entry

The Impact of Corporate Governance

on the

Captive Insurance Sector

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Introduction

Barely a day goes by without a news report referring to a breakdown in governance. It does not seem to matter whether the governance is at the centre of a country's financial system, at the heart of a local council debate or documented in the processes of a public or private company, corporate governance is the all-embracing buzz-phrase that means, when the unthinkable occurs, someone will be at fault and blame can be apportioned.

There is no escaping from the requirements of good governance but all too often it is applied with inadequate appreciation of the underlying processes. It seeks the lowest common denominator and protection for the innocent is developed from that point. Fear of prosecution prevents rational human beings from taking a reasonable view: is the risk of accident or adverse public reaction a one in ten year, one in a hundred year or one in a thousand year event? One is no longer permitted to rely on prior experience – even before school students leave a classroom there must be a risk assessment, and if that assessment is wrong, quite simply there will be resultant accountability. Risk assessment does not protect the participant, but protects those who permit the activity.

The financial services sector is at the centre of corporate governance requirements. Reports in multiple countries have sought to enforce and reinforce procedures to be adopted to ensure full and proper accountability within companies. The processes all, ultimately, rest with a company's board and any failure at board level sees sanction against one or more directors, initially through removal from the board and, depending on circumstances, with criminal prosecution ensuing.

Company management – the board – is directly responsible for failure of accountability, perhaps none more evident than in relation to the “Herald of Free Enterprise” disaster¹. A formal investigation blamed company management for failing to give clear instructions about safety procedures, yet would any reasonable individual have believed a ship could have sailed with bow doors open to the sea? Corporate governance affords no scope for free interpretation and, with that as the case, business must respond to ensure compliance or face the consequences.

For many companies, the establishment of a captive insurance company is the first occasion where there is direct involvement between the parent company and a financial regulatory authority. In many cases, this goes further as the parent company finds itself introduced to insurance managers, lawyers, offshore bankers and non-executive directors, all of whom are effectively appointed on trust. On first introduction to the minefield of offshore corporate services, the parent company stands to find itself on the periphery of compliance with good corporate governance practices. How far must the parent company go to ensure that all new service providers are vetted as to their suitability?

The captive insurance sector has evolved over a fifty year period. While many practitioners now believe that developments in corporate governance requirements are presenting unacceptable threats to the sector, it may well be that these developments assist with the continuing evolution and innovation that has been the sector’s hallmark. This paper seeks to examine how the captive insurance sector has responded to the opportunities and threats that 21st Century compliance requirements demand.

Food for thought

In November 2009, in a captive insurance oriented journal², a debate was resurrected, or perhaps a minor spat developed, between Josh Gold³ and Malcolm Cutts-Watson⁴. The crux of the matter was, as with so many debates, the issue of which is better – in the case in question, is the broker-owned captive management company better for the client than the independent captive management company? Both commentators aired their views coherently, the latter, in rebutting comments of the former, fully acknowledging his own position as Chairman of a leading broker's captive management practice.

The views of the parties ultimately supported the stance of their respective organisations, but is one option better than the other? Does a broker-owned captive manager offer a more comprehensive range of services than the independent company? Is the captive a part of an integrated risk and insurance management programme or is it truly a stand-alone insurer that is led and controlled by a board independent of vested interests? The articles merely skimmed the surface of a perennial discussion in captive management circles without delivering tangible advice to existing or prospective clients. Styles of direction, corporate governance and management of captive insurers appear to fly in the face of more traditional corporate governance techniques. There may be every reason to believe that the articles served no purpose beyond delivering profile to respective employing companies, however, they did reopen the door on the dichotomy presented by the development and management of captive insurers.

The position is not assisted by a number of external bodies, not least the International Association of Insurance Supervisors which accredits no less than twenty-eight categories to

its definition of a captive insurer. This is a far cry from the simple, long-standing and effective definition:

“A captive insurance company is a wholly owned subsidiary of a non insurance parent created to insure some or all of the parent’s insurable risks”⁵.

In recent years the captive insurance sector has been bombarded with legislation and regulation. Much of this has come from within captive jurisdictions while legislation in parent company territories has also had a significant impact on the development and management of the sector. The forthcoming Solvency II regime in the European Union presents some of the greatest opportunities, and threats some may say, that the captive sector has seen. It is critical for the captive sector to present a unified response to new regulations and legislation, whether it be opportunity or threat. Does the independent manager have the resources to address or capitalise on the issues presented or is the broker-owned manager permitting convergence of underwriting and broking activities through the use of in-house resources that are perhaps less suited to insurance company regulatory issues?

If the role of the captive manager is critical to the arrangement, who really leads, controls and manages captive insurers and are the techniques deployed compatible with present day corporate governance requirements? In addressing the points flagged by Messrs Gold and Cutts-Watson, consideration is also given as to whether there may be alternative solutions available to satisfy development, management and corporate governance issues without compromise to the financial and risk management benefits that captive strategies deliver.

Why are brokers managing captives?

The simple answer to such a question is that insurance brokers operating in the commercial sector are the dominant providers of insurance strategies, and captive insurance companies, irrespective of management styles, are an integral part of such strategies. Insurance strategies embrace not just the purchase of insurance from insurers but the cost effective application of deductibles, the design of reinsurance programmes, the collection of claims and multiple risk management and advisory services. As with any business, the ultimate aim of the broking house is the delivery of enhanced levels of profit to its own shareholders through the provision of fee or commission generating services to clients. The provision of captive management services is entirely complementary and a natural adjunct to the mainstream activities of larger commercial brokers. However, the supply of these services provides some interesting parallels with activities at Lloyd's prior to the Lloyd's Act 1980 reaching the Statute Book.

Lloyd's and the captive sector – the similarities

In the 1970s, Lloyd's saw an unprecedented growth in the number of Names⁶ joining the market and a resultant increase in its capacity to write insurance business. The flood of new capacity assisted in maintaining Lloyd's position at the centre of the insurance industry but it also brought some new and unwelcome issues. Crippling losses from computer leasing contracts, fraud, general mismanagement and poor standards of trading all demanded remedial action. First came self assessment by Lloyd's, through the commissioning of the Fisher Report⁷, then The Lloyd's Act, 1980 followed swiftly as the statutory response to address problems in the market.

Prior to the Lloyd's Act of 1980, Lloyd's brokers substantially had to be under British ownership. In turn, members' and managing agencies were frequently owned by broking houses. Effectively, there was opportunity for one controlling party to establish one, or more, syndicates to write the risks, provide the Names to give capacity to the syndicates and to provide the infrastructure to manage the syndicates and once all these matters were in place, to ensure that suitably good quality business was offered for the syndicate to underwrite. In addition to the general influences that some broking houses were able to exert, so called baby syndicates, running with parallel management to a mother syndicate, were a less than desirable feature of the market, more often than not, reserved for preferential risks with an equally preferential number of favoured Names participating.

Certain key requirements must be present for a captive insurance company to deliver benefit. There should be an underlying better than average loss ratio, there should be a willingness to commit to good risk management standards and there should be preferential risk selection processes. The sector as a whole, focussing as it does on larger commercial risks, is not available to everyone. The reality was that there was a captive insurance environment within the Lloyd's community. It was not the captive insurance environment promoted in today's risk management circles but similarities between captives and Lloyd's were present and comparisons can still be made. In the case of Lloyd's:

1. better risks were identified – often by the broker;
2. those risks were offered to favoured syndicates, and those syndicates were often strongly supported by Working Names⁸, many of whom were broking house employees;

3. a number of managing agencies had, so called, baby syndicates reserved for perceived better risks and participation on those baby syndicates was generally reserved for more favoured Names, often friends and family of the syndicates' Underwriters⁹;
4. the combination of a modest number of favoured syndicates and a small number of baby syndicates offered limited capacity which, combined with business showing better than average loss records and additional risk selection, readily allowed improved returns for the favoured few;
5. if matters went wrong then it was individual personnel, the Names, who were left to pick up the pieces as the syndicates' costs, including the salaries of underwriting staff, were met by fees charged by the managing agencies. Losses were not a feature for the managing agency as its exposure was contained to a reduction in the level of profit commission earned on the business underwritten;
6. broking houses had provided themselves with risk free income through direct commissions, reinsurance commissions, managing agency fees and profit commissions, and members' agency fees. Meanwhile, should matters not go as planned, the risk of loss rested with the Names alone.

The Lloyd's Act not only put an end to this but in doing so asserted the position through the forced divestment by broking houses of financial interests in syndicates' managing agencies and members' agencies. The problems at Lloyd's, attributable in part but not exclusively to lack of transparency, went far deeper than the foregoing suggests but the position outlined

above can, in some ways, be compared to that of the captive insurance company promoted as part of a general broking strategy:

1. better risks are identified – often by the broker;
2. the broker undertakes a feasibility study, using its own personnel, sometimes billing for such services;
3. where a captive is recommended, the captive manager would be a subsidiary company of the broker so the broker would stand to increase its revenues and, where a feasibility study was undertaken without charge, recovery of development costs can be achieved through ongoing management fees;
4. personnel from the broker's management company would often be appointed directors of the captive creating an exposure where, if so minded, the captive manager could not be dismissed;
5. reinsurance is frequently a critical factor in success of the captive generating additional revenue opportunities for the broking house;
6. the combination of niche capacity, improved loss records and risk selection readily permit improved returns for the client;
7. the broker thus benefits from additional points of client contact and client retention rates improve alongside multiple enhanced revenue opportunities;

8. the broker continues to earn brokerage, the captive manager earns management fees, the reinsurance broker earns reinsurance commissions and the captive retains residual profit – ultimately reduced insurance costs for its parent, the broker's client;
9. if things go wrong, it is the client who bears the brunt of the retained losses as brokerage, reinsurance commissions and management fees all remain payable.

Improved discipline has been delivered to the Lloyd's community under the terms of the Lloyd's Act and through subsequent divestment of conflicting interest and improved levels of transparency in business dealings. In a not dissimilar vein, it has been delivered to the captive sector, present in multiple offshore territories, by insurance and companies' legislation together with corporate governance rules. It was not the case that the captive insurance community was rife with the conflicts of interest and preferential dealing that tarnished the name of Lloyd's in the late 1970's but there were clear similarities to the approaches to business. As practitioners maintain that captives are fully fledged insurance, or reinsurance companies, where does one draw the line between client and self interest?

Brokers do manage conflicts

Beyond the insurance industry, the role of the wholesale insurance broker is poorly understood. The, much maligned, High Street broker is often regarded more akin to a tied agent as relatively modest business volumes restrict choices and rival internet sales continue to develop. In many cases, claims handling is little more than a post box service. This somewhat unfair view must not pervade the wholesale broker where the weight of regulation and compliance is more readily absorbed into business overheads and the scale of business propositions and the risks presented go far beyond the mouse-click, or simple check-list,

required of the domestic client. All brokers, and particularly so the major brokers, are required to achieve optimum insurance arrangements for their clients. The broker's duty is to its clients: to develop, construct, place and administer clients' insurance arrangements and, when claims arise, to address such claims with the market, seeking a prompt, efficient and equitable settlement.

So, if a client is both insured and insurer does a conflict arise? The answer should, of course, be that no conflict arises but certainty of such situations calls for transparency and careful management. The issue of contingent commissions has long been, and continues to be, debated. If additional commissions are to be received based on enhanced business volume targets, does this not create a conflict of interest? If an insurer places a reinsurance contract through a particular broker, is there an undeclared, unwritten, unstated expectation that the broker will assist in ensuring acceptable business flows inure to the reinsurance contract? In its worst case, this manifested itself as the LMX Spiral¹⁰ where the same insurers all but paid the same claim in diminishing amounts at frequent intervals for several years.

Thirty years has seen manifest changes not only at Lloyd's, it has also borne witness to the implementation of corporate governance regimes and the arrival of the, truly, global company. Crises and scandals still arise and new responses continue to be developed. The increase in costs through regulatory burden is a significant by-product of these developments. Do these developmental changes have any bearing on the involvement of insurance brokers in the day to day handling of their business and what does this mean in the context of clients being suppliers also? Do the responses to the Lloyd's Act of thirty years ago have any continuing place in a world of regulation and compliance? The simple answer to both is akin to the warranty in an insurance policy and the ongoing obligations it imposes on an insured.

There is a real and ongoing duty to promote transparency and to transact business in a true and fair manner without self interest at stake. None of this presents a bar to the involvement of insurance brokers in the captive insurance sector.

The key question that does arise is whether the captive insurance company has outgrown its *raison d'être*, demanding new approaches from the insurance management community irrespective of ownership issues? Can the captive, or should the captive, be at arm's length from the parent company in every respect? If the captive is, as the captive community asserts, a risk financing tool then it must not be denied the full range of integrated services that can be delivered, whether from a broking house or an independent provider, and the conflicts that do exist must be managed in an effective manner permitting a client to benefit from all available services on offer.

So who does what?

The case of HMRC v DSG International¹¹ (DSGI) was not an insurance case directly involving a captive insurer. Its primary focus related to transfer pricing and whether the setting of premiums and commissions was appropriate in relation to the extended warranties provided in the group's stores. However, offshore insurance arrangements featured strongly in the case as did the commercial reactions on the part of DSGI. When faced with a change in the rate of Insurance Premium Tax (IPT), applying to the extended warranty insurances offered throughout the group, matters came under intense scrutiny. Prior to the increase in IPT (from its initial rate of 2.5%), like so many other retailers, DSGI had offered extended warranties as an adjunct to the sale of brown and white goods in their stores. Profit could be generated on extended warranty insurances which attracted IPT at the then prevailing rate of 2.5%. Extended warranty insurances had already come under criticism as a result of the high

profit margins involved and here was a ready mechanism to encourage consumers to buy these covers, or even be provided with them “free”, allowing a 12.5% saving on part of the sale price of goods through redistribution of VAT then levied at 15%.

The model worked extremely well (not just for DSGI). High returns from underwriting, good investment income, improved price competition benefiting consumers and profit generated in a low tax area all contributed to a significant profit stream. The Inland Revenue (as it then was) identified, at a fairly early stage of Britain’s IPT regime, the loopholes afforded to the travel and retailing sectors and higher rate IPT was introduced to match the rate of VAT, with the full intention of capturing, what it considered to be, lost tax revenues.

DSGI, with their insurance brokers, sought to explore, and identified, alternative means to deliver a similar financial result. As with any corporate entity, their actions were in the best interests of the company and were considered, articulated, detailed and addressed in a tight timeframe. The brokers assisted considerably in the process seeking to re-evaluate and address multiple contracts ultimately leading to a situation where an offshore insurer assumed risks based entirely in an offshore environment. With all insurance risks and all insurance contracts effected outside of the United Kingdom, there was no liability to United Kingdom IPT.

The findings of the Special Commissioners to HMRC are not of specific relevance to the issue here but the connection arises as to whether the actions of the broker, the client and the captive were independent, or were they acting as one collective entity? Did DSGI receive a better standard and level of service because the parties were closely linked? Was there a critical flaw in the response of DSGI to the change in IPT because too much underlying work

was evaluated in the United Kingdom? All of these questions can be boiled down to one simple question: did the captive insurer receive underwriting options to consider, or was it presented with a strategy that had been considered, perhaps even accepted, by DSGI group management, implicitly denying the captive's directors any place in the risk taking activity other than to rubber stamp the business decision before it?

The play by Brian Clark "*Whose life is it anyway?*"¹² draws some interesting parallels. A bed bound patient is addressed in the third person as multiple decisions are taken as to his ongoing treatment. The patient, who maintains all his mental capabilities, is steadfastly ignored. The captive insurer can present similar characteristics. As corporate entities go, it is certainly curious. It has developed from a reassessment of insurance placing techniques and its development is the domain of the specialist. However, the specialist's role may be short lived, addressing the critical issues at arm's length, as with the play's lead character, but without involvement in the execution of those actions. Why does such a situation arise? To appreciate the issue here, it is important to have a wider understanding of some of the driving forces that govern captive insurance business. The following definition, while wider than the simplistic definition provided earlier, provides some insight as to the scope of activity required by a captive:

*"A risk-financing method or form of self-insurance involving the establishment of a subsidiary corporation or association organised to write insurance. Captive insurance companies are formed to serve the insurance needs of the parent organisation and to escape uncertainties of commercial insurance availability and cost. The insureds have a direct involvement and influence over the company's major operations, including underwriting, claims, management policy, and investments."*¹³

From this definition it can be appreciated that the captive presents the following characteristics:

1. it is a subsidiary company (or a structure within a third party company¹⁴);
2. the insured party has a direct involvement in the activity of the captive;
3. as an insurer the business of the subsidiary will be subject to regulatory supervision;
4. as a company it will be subject to corporate governance requirements.

Each of the foregoing points has considerable relevance where one is considering a company delivering a tangible product - a company with premises, staff, products that can be seen and purchased. They have equal relevance where a company is creating and delivering a financial product as is the case with an insurance policy. However, the captive insurance company, in a considerable majority of situations, does not have its own staff or premises or even a shareholder in a similar line of business. Captives are a by-product of the requirements or recommendations of others; they are intangible entities created and used to deliver financial benefit but, due to the distancing and separation of roles, captives are companies that lack a central identifiable core. It is the relationship with the intangible benefit afforded that gives rise to multiple questions in regard to central management and control of the company. This is particularly so where a strategy may have been developed in one jurisdiction yet the key decisions as to implementation need to be taken in a manner to demonstrate central management and control in a different jurisdiction – issues that were very much to the fore in the case of DSGI.

Further anomalies arise when one addresses the composition of the board of directors of the captive, in particular whether there may be a role for the shareholder on the board of the captive. A typical captive board comprises three, or perhaps five, individuals the majority of whom would ordinarily reside in the captive's territory of incorporation or, at least, outside the territory of establishment of the parent company. The entire board structure would appear to fly in the face of the requirements of the Cadbury Report¹⁵ which states:

“Every public company should be headed by an effective board which can both lead and control the business. Within the context of the UK unitary board system, this means a board made up of a combination of executive directors, with their intimate knowledge of the business, and of outside, non-executive directors, who can bring a broader view to the company's activities, under a chairman who accepts the duties and responsibilities which the post entails.”

Few captive insurance companies are self-managed, that is, the development and strategy of insurable risk retention in the parent company is developed, promoted and managed in house. The corporate returns of those self-managed captives arise from internal initiative, drive and recommendation. These are not managed entities but the domain of companies that understand their own business and understand the role that an insurance company can perform within their business models. Conversely, the managed captive is not driven from within but is led from outside the corporate body. What matters in the case of the managed captive is the quality and manner in which the management services are brought together and delivered rather than consideration as to whether a broker owned management company or an independent management company is better than the other. The prerequisite is an intimate knowledge of the business and the business in question is insurance. The critical element is

that any captive should be established following consideration of appropriate professional advice and then it must be directed and managed in a manner whereby proper corporate governance procedures can be adopted and maintained.

The considerations

Any company considering establishment of a captive needs to be certain that the structure will deliver financial benefit and comply with relevant legislation. More often than not, the captive is established in an offshore jurisdiction¹⁶, or another jurisdiction¹⁷ with relevant companies and insurance laws. The manner in which a would-be parent company determines on a particular jurisdiction and the actual selection of jurisdiction can be influenced by multiple factors, but once a captive has been incorporated in a particular territory it is essential that it complies in all respects with the laws and regulations governing business in that territory. A key test is considered to be determination as to where central management and control of the company lies. The accepted response to this is that it is the place where key decisions of the company can be exercised through its board and implemented by its managers. As noted earlier, a simple majority of the board should be ordinarily resident in the territory where the captive company is incorporated and where the board meets. Legislation, in all credible offshore territories, supports this position requiring a locally resident general representative and/or locally resident executive director of the captive to hold accountability to the regulatory authority. What the foregoing effectively means is that, unless there is an active corporate subsidiary of the parent company in the offshore territory, the control of the captive is vested either with the insurance manager or with non-executive directors.

De facto, one has created a captive insurer to provide a key insurance resource and, at the same time, divested the same captive of the controlling interest of parent company representatives on the board together with the specialist development advice and resource required to drive the company forward – contrary to the very issues flagged within the Cadbury Report.

Addressing the issues

Who actually is directing the captive? The simple answer is the board, but how, within the constraints of legislation and regulation, can a captive's board effectively deliver the strategic lead to the company that regulation and compliance demands of it? Just as Shakespeare's *"As you like it"* states that *"One man in his time plays many parts"*, the same is equally true in the development and management of a captive insurance company. There are multiple issues presented with multiple parties all seeking to deliver profit to their shareholders. The matter thus becomes an issue of the management and resolution of conflict calling, firstly, for analysis of the roles undertaken by the various parties and then for reassessment of these roles to determine upon effective management and resourcing.

The client, the parent company, has authorised, through due process including its own corporate governance procedures, the incorporation of a new subsidiary company in its group and this has been undertaken on advice from a broker or consultant who is present to advise. In the case of a broker, the matter goes further, as the same broker may well be required to negotiate the best terms with insurers, one of which, the captive, he is now advising in relation to development of a retained insurance strategy and development of premium income, for that ultimately is what a captive presents. On the one hand, the broker is seeking the optimum terms on which to buy insurance for his client while, on the other, he is

recommending as to establishment of a company the primary aim of which is to return an underwriting profit. The International Association of Insurance Supervisors has addressed this matter in its Issues Paper on the Regulation and Supervision of Captive Insurance Companies:

“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 ¹⁸.”

In Appendix 1 of the same Issues Paper the IAIS concludes, having explained various captive definitions, including 21 listed by the ratings organisation A M Best, that:

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

This simple sweeping statement is curious in its own right as it implicitly states that, since the vehicle cannot suitably be defined, there are question marks over the level of regulation that must be required and, if there are question marks over the level of regulation required, then certainly there are differences in the scope of management service standards required, offered and delivered. If, indeed, there are differences in the management service standards required then, in exactly the same manner as insurers and reinsurers may focus on the provision of specific layers of cover in the market, there is every reason for captive management companies to focus on differing types of client company requiring differing servicing resources.

The issues presented go even further. At the point of development of the captive strategy, the parent company's finance director or insurance manager is likely to be immediately involved in considering and approving the strategy to incorporate the new captive entity within the group. The finance director or insurance manager will have been advised by a broking team or perhaps a specialist captive development team. Now, the same individual becomes the link between the offshore captive and the parent. As the captive is a subsidiary of the parent company there must be full expectation that the parent company will have board representation yet its finance director is unlikely to be an insurance professional. If the parent company has an insurance manager and he is charged with procuring the optimum terms for insurance purchase, it hardly permits scope for him to occupy a seat on the captive's board seeking to develop premium income and profit from the parent company.

The IAIS does not even contemplate a representative of the broking house being on the board of the captive yet, as acknowledged, the broker (or consultant) may be the party best suited to providing the corporate lead to the captive having established the risk financing initiative.

The captive board cannot be compared and contrasted satisfactorily with the board of a company selling a tangible product. As with any insurer, the captive is providing an intangible promise to pay in the event of a set of circumstances occurring. It is not established or created by entrepreneurs or shareholders intimately involved in the business, but it is established on the recommendation of an unconnected third party. Can the captive therefore be subject to the key criteria required from corporate governance regimes? Its performance is only as good as the ability of the board to procure suitable advice and thereafter to contract with appropriately qualified parties to deliver the requisite levels of outsourcing.

The captive's structure and resources

From the foregoing it can reasonably be ascertained that the majority of captives develop passive rather than active income¹⁹. A self-managed captive insuring the risks of its parent alone or developing new, complementary income and profit to its group can reasonably be viewed as generating active income in this context. However, in order to determine whether a broker can manage a captive more effectively than an independent manager a prerequisite has to be a full understanding of the processes and functions involved in captive management.

The successful management of a captive insurer calls for multiple areas of resource in order to deliver the key objective which is the profitability of the captive, a tool in the insurance armoury of the parent company and an integral part of its insurance placement. However, the captive is only a means to an end and the end game, as with any company, is the development of long term shareholder value. As a corporate middleman, the captive, together with its directors, managers and advisors, is an anathema. Multiple companies within a single global corporation are an accepted facet of modern business life. The demand to establish a company is increasingly driven, not by development of profit in the subsidiary but the need to contract through a limited liability company in a given territory. The company is a cost of business but the very moment that the company is established, legislation further demands that a board of directors is appointed, books of account maintained, an annual audit undertaken and financial statements signed off in accordance with the laws of the territory in which the company is established. The simple shell company is no longer acceptable. However, in so many ways, nothing changes other than providing a local (overseas) company that can sue, and be sued, in the courts of the overseas territory of incorporation.

While the statements above ring true in relation to an investment in property or an employment company, different issues arise where a company may be used to arbitrage tax liabilities or to effect sales into a third party territory or to hire staff in a shifting global environment²⁰. It is perhaps here that the traditional offshore company can best show its colours, assuming all contractual responsibilities in relation to staff or sales, for the parent, are conducted from a single territory. It is also here that the differences and complexities of varying strategies arise. The insurance industry, in so many ways, is at the centre of global economic compliance with regulators and ombudsmen seeking to protect shareholders and consumers. In so doing, each regulatory authority is looking after its own country, demanding that capital and surplus are retained in a manner approved by them, and for the benefit of consumers in their country. These regulatory requirements have themselves assisted in the development of insurance innovation. The global master insurance programme, placed by a London broker, requires an insurer with authorisation in all of the territories in which a client company transacts business. The client is then able to secure multiple policies under a single umbrella knowing that a uniform level of cover is present. Matters do not end there as demands for insurance protection will themselves vary between territory both in scope of cover and the limits of cover procured. Local difference in conditions policies are then effected to address any incidental exposures otherwise unprotected. The list of requirements goes on, as premium needs to be paid in the territory where the insurance is actually effected and only then, using an admitted insurer in the territory, does the local operating company gain tax deduction on the premiums paid. In the absence of such arrangements between insurer and client the situation can be far worse: claim settlements can be considered taxable income or the placement of non-admitted²¹ insurance deemed illegal rendering company directors subject to criminal sanctions.

The captive insurance company, as a passive company in a corporate structure, is thus thrown into the midst not only of the requirements of the territory of incorporation but also into the midst of legislative requirements wheresoever it may wish to transact business. Again, it is flying in the face of traditional business controls as the obligations it creates demand added compliance, in many cases presenting the first occasion that a parent group will have had to comply with any financial regulatory authority, unless the parent's own business is subject to financial regulation.

Captives are subject to legislation and regulation and this has ensured the presence of structural credibility, and structural credibility is only achieved with comprehensive management systems. Nothing states that comprehensive management systems, including technical and specialist support, must be delivered by the one organisation but legislation does require a single appointed representative to serve on behalf of that captive. The representative can be an executive director of the captive or, more generally, the appointed insurance manager.

It is the executive director or the insurance manager, in the selected domicile, whose mantle includes full delivery of all the services required by the captive. It is that legal person who must identify, procure, resource and deliver the required services. They must manage conflicts of interest and pricing. They must have sufficient executive authority in their own organisation to carry out the management functions of the captive and to respond effectively to the instructions of the captive board and/or where so needed, to advise the board. The same legal person has the responsibility also to respond to regulatory authority but *The ultimate responsibility for sound and prudent management of the insurer rests with its board of directors.*²²

Does the question end here?

If the board of directors must carry the ultimate responsibility for sound and prudent management, the reality is that there is no foundation to the spat between Messrs Gold and Cutts-Watson as neither the broker owned manager nor the independently owned manager is taking the critical decisions in relation to development of the captive insurer.

There is full expectation, often requirement, to outsource day to day functions to appointed managers but any failure to appoint suitable managers rests not with the management company but with the board of the captive. As with any company board, the captive board is responsible for the establishment of strategy and policy together with a framework for implementation irrespective as to the level of outsourcing that may be required. The issues raised are not in themselves curious but they stand to deliver a chicken and egg dilemma, and a dilemma that is of particular significance to the broker owned captive management sector.

As insurance broker and programme adviser to the client there is an obligation to deliver insurance terms that are in a client's best interests. The tagline, attached to email correspondence from one leading broker states:

"We thoroughly understand our clients' needs and their industries," and it goes on to state, *"We develop client solutions with the best markets, price and terms²³."*

The objectives are undeniable and delivery of these objectives will, in some cases, involve the establishment of a captive insurance company. However, the board of any captive insurance company that may be established will be beyond the control both of the parent company and the insurance broker. The aims of the captive will be to deliver profit to its

shareholder, yet the manner in which its board believes shareholder profit can be delivered can be at odds with the party recommending establishment of the captive and with the shareholder's insurance strategy.

In seeking to satisfy corporate governance requirements the captive board must act at arm's length and with transparency and accountability. Consequently, it must consider the option to secure captive management services from any provider and not just the provider that may be recommended by the broking house. It is perhaps here that we have, at least, an interim answer to the discussion between Messrs Cutts-Watson and Gold: the broker owned management company cannot rely on its own corporate sister businesses to support its appointment. This, of course, is at odds with the aims of the respective global broking business as a whole and it means that the broker owned manager has to win business that is already, rightfully, in its domain. To win business in such a situation demands greater pro-activity, demands a wider range of services and demands service levels that unquestionably exceed those of its peer group. There is no alternative but for the broker manager to deliver those heightened service standards to ensure that captive manager appointment remains properly an arm's length decision of the captive board.

The playing field is not levelled by demands for higher service standards. Board composition will influence selection of a captive manager yet the original selection of a broker and development of a captive insurance strategy will itself influence recommendation of any appointments to a captive board. The parameters of the underlying debate, as to which management company is better, must change. The broker owned manager must demonstrate beyond all reasonable doubt that the services it provides to captive clients are superior to those of the independent manager, which is not encumbered with conflicting corporate

interests. However, the broker owned manager must, even more perversely, see many of its own corporate resources placed at arm's length to his own requirements and even see them placed equally at the disposal of a rival organisation.

Many, if not all of the issues that arise are compounded, if not actually created, through the need to develop and maintain a veil between onshore and offshore work but there is a non-productive cost to much of what has to be done in maintaining that veil. The non-productive cost reduces profitability of a sector which was itself created to provide more cost effective insurance solutions. In order to restore the original aims of the founder²⁴ of the captive movement there is a clear requirement to embrace new approaches to business allowing clients unfettered access to effective insurance and risk management tools, fully compliant with regulatory and governance requirements and without undue compromise to improved financial results and shareholder value.

Is a credible response available?

The simple answer is that multiple responses are available but whether the responses are suited to any given organisation requires appreciation and understanding of the concept on offer. The key concept on which this discussion has been based is whether one management offering is better than another. The answer to that question is that the broker owned manager does appear more likely to have immediate access to all the resourcing issues that a captive insurer may demand. However, any captive manager will be required to ensure that procurement of services, whether reinsurance broking or claims handling or actuarial review, is conducted at arm's length to the captive and under the direction of an independent board. The strength of the board is the critical element in recognising what services need to be procured and when these services should be procured in order to deliver an effective product

– the robust, profitable insurance company. However, when board numbers are frequently constrained by costs, there is critical requirement to examine alternative solutions that permit strategy clearly to be delivered at board level.

The response to this predicament has been provided through the very significant development and acceptance of the protected cell company. While establishment of pure captive (wholly owned subsidiary) companies has been static, and in a number of jurisdictions fallen back, the protected cell company has truly flourished.

The protected cell company concept was first introduced in Guernsey in 1997 and presented statutory protection to a company's assets allowing a company to transact multiple lines of ring-fenced business for multiple stakeholders and/or shareholders²⁵. The concept's initial application sought to deliver low cost captive insurance solutions in a manner that was more robust than the so-called rent-a-captive concept which had widespread appeal in the United States. However, development of the protected cell company, and its application across multiple business sectors, rapidly attracted attention and has established itself as the significant area of development in the self-insurance sector at the present time.

The protected cell company²⁶ (PCC) addresses the interests of multiple parties including cell owners and cell participants, shareholders of the core company and a further category termed owner operators.²⁷ However, the key attribute of the PCC, as a response to deficiencies of management within the pure captive sector, is that its board and management can, without the severe costs restrictions that, of necessity, must be at the forefront of the pure captive, be developed so as to establish a single, powerful, authoritative board with the ability, through the number of directors and diversified expertise, to provide the strategic leadership for the

company as a whole, which embraces also the governance of individual cell participants and/or shareholders.

The critical difference between the pure captive, constrained by costs and the size of its board, and the PCC is encapsulated in the following paragraph:

“The reality is this: *the promoter places itself in the same position as the owner of a pure captive but with one significant difference—the risks to be written will not be those of the promoter, but ring-fenced risks of third parties.* As a result, the board of the promoter owned PCC assumes full regulatory compliance and anti-money laundering and financial crime responsibilities over the business written on behalf of and for the benefit of other parties.”²⁸

Notwithstanding the multiple definitions afforded to a captive insurance company, its central component is the provision of insurance capacity to its owner. Whether the owner is insuring its own risks or risks generated by its business activity does not matter; what does matter is the central direction and management of the company.

The PCC stands to deliver simplicity of approach allowing the insured party to focus on procurement, not delivery, of insurance. It can allow management companies to develop their own responses to clients’ needs, working with third parties to ensure that cost effective risk taking is a viable tool for their clients. Significantly, it removes the requirement for a client to establish a company, frequently in a different jurisdiction, and more often than not, as previously observed, the first exposure on the part of a client to managing a business in the financial services sector.

It is here that the subject matter begins to turn full circle as the rules and regulations which a captive is required to consider apply also to a PCC. However, a PCC is a single legal entity irrespective of the number of cells it may have established. As a single legal entity it thus has one board, one manager, one auditor and, depending on the wishes of its owners, multiple individual cells none of which convey any rights beyond the right to participate in the underwriting activity of a cell and to share in the profits or losses of that particular cell. A single cost effective structure is provided with a spread in its client base and, therefore, greater ability to bear the costs now associated with the strategic leadership that companies demand.

The effective captive

In order for a captive insurer to provide an effective solution to its parent company there are three key components: the underwriting of a profitable insurance account, adequate premium volumes to merit the risk taking factor to the parent's business model and a modest cost base that permits the captive undertaking to produce greater returns than a traditional insurance solution. Each of these components also has to be present where a PCC solution is considered and the PCC demands a further consideration – the preparedness to provide capital and premiums to a vehicle that, ultimately, has contractual obligations to the policyholder participant²⁹ rather than in the case of the pure captive where there is connected shareholder control. A cell in a PCC can be likened to an offshore trust – ultimately, an organisation seeking to use a cell in a PCC has to be satisfied that its interests will be respected and the actions of the PCC board will not only be in the interests of individual cell participants but also the company as a whole.

The global captive insurance market is believed annually to generate between \$40 billion and \$50 billion of premium income between some five thousand captives³⁰. The general profiling of those captives is not known but, in common with a risk transfer pyramid, the greater number of captives will have lower premium volumes whereas a more modest number will have premium volumes significantly greater than the average annual premium volume of \$10 million derived from the foregoing figures. Cost containment in captive insurers thus assumes an extremely important role and imposes limitations as to procurement both of experience and resource.

The fact that few captives are managed in-house is simply because business flows and business models infrequently demand such a level of dedicated application³¹. Consequently, the role of captive manager has developed to respond to the requirement to provide cost-effective insurance administration services. It is the provision of these services that was the subject matter of the debate between Messrs Gold and Cutts-Watson. The management companies are appointed by the board of the captive, except, as considered previously, those management companies are often part of the same corporate structure as the broking house or adviser recommending establishment of the captive. The adviser, whether a broking house or independent entity, has recommended as to establishment of the captive and, somewhat perversely, is then in a position of limbo, where its associate company can only stand back and wait as an independent board considers the appointment of manager. The reality is that the appointment of manager will have been considered as part of the establishment procedures of the captive, as will appointments to the board. Unless a parent company has first hand experience of the territory in which the captive is established it is highly likely that the services of an insurance manager resident in the chosen territory will be secured.

Again, matters come full circle and the strength of the captive is delivered through the strength of its manager and its board but there can be little doubt, when cherry-picking one's way through regulation and corporate governance requirements, that it is increasingly difficult and in a growing number of cases impossible, to satisfy present day transparency and due diligence requirements.

The captive insurance company is, through the sheer size of the companies owning such vehicles, swept into the domain of substantial corporate governance. Corporate governance demands reflect the complexities of the risks written, those reinsured and those retained for a net account. It reflects on a company that is subject to financial regulation and fiscal review, often beyond its territory of incorporation. It incurs costs and investment in techniques that may have little bearing on the once simple concept that allowed premiums to be set aside to meet the claims of the owner who also happened to be the policyholder. The concept is now a multibillion dollar business but in developing to this position it has become a victim of its own success and captive insurance domiciles have, at best, maintained their business levels in the last three to four years. However, this statement applies to wholly owned captives and does not apply to the PCC.

The PCC was introduced as a low cost entry point to captive insurance techniques seeking to replicate and improve on the United States focussed rent-a-captive concept³². However, its acceptance, as evidenced by enactment of PCC legislation in the majority of captive jurisdictions, has exceeded all expectation and a cell within a PCC is widely accepted as delivering the insurance and financial benefits that can be afforded by a traditional captive but without the requirement for the cell participant to become embroiled in arm's length transactions within their own company, without requirement to travel offshore for insurance

meetings and without requirement to see their service provider pitch against others for business that already has been secured. The PCC stands to offer clients a return to a more cost effective captive insurance solution and allows improved delivery of service at broking, insurance management and board level.

The PCC offering

The first legislation enacted³³ to facilitate the establishment of Protected Cell Companies did not actually address how these companies might operate, who might own them or how business would be secured by them. The flexibility afforded by such an approach has provided opportunity for multiple parties to benefit whether cell participants, sponsors of the PCC or third party advisers and, most significantly, it has through passage of time facilitated a highly credible corporate and insurance solution to the key issues faced by captive insurers – the dichotomy presented by cost of compliance.

The PCC, created for insurance purposes³⁴, is a shell company created to play host to one or more cells. It is a single legal entity and therefore has one board, one auditor, one management company (or it can be self-managed) and is subject to the laws, rules and regulations of one territory and that territory's regulatory authority. It is important also to note what the PCC is not: it is not owned by the cell participants - they have no rights to attend meetings of the company or to a seat on the board; it is not a single purpose captive insurer – one cell may be writing liability risks while another may be writing a marine portfolio and it should not be directed and governed by a board that cannot, in all respects, comply with the underlying requirements of Higgs, Cadbury and Sarbanes Oxley.

The PCC for the 21st century is not the slim-line captive insurer of the 20th century. Its aspirations are driven by shareholders seeking returns on investment through the provision of cells established for the provision of insurance business to third parties. The parent subsidiary relationship of the pure captive no longer exists and any PCC must ensure its offering to new and existing clients meets the exacting requirements of the international insurance community. This is achieved through embodiment of new corporate disciplines

Messrs Gold and Cutts-Watson have both aired their views but neither has focussed on the key issue. That key issue is not a question of the broker owned manager being better or worse than its independently owned counterpart. It is a question, as with any corporate entity, as to whether the board of the company has the requisite knowledge and expertise to lead, direct, control and manage the affairs of the company so that the company may play a full and ongoing part in delivering an effective insurance programme to its parent. As part of that process the board will, in its own right, have the ability to assess the company's service requirements and to appoint the optimum service providers for the management tasks at hand.

It is extremely likely, but not guaranteed, that a broker owned management company will have within its wider group, ready access to a broad range of services that a captive insurer may require. However, the need to procure such services rests with the board and the board can equally be served by its own selection of individual service providers rather than a seamless offering. It is not the strength of management services that is critical, but the diversity of knowledge of the board and how to use the information presented by management. That knowledge must permit the board to assess the risks of the company, determine strategies to address the risks and know when to seek additional specific services. The size of the board is not constrained by administrative costs in the same manner as the

pure captive. A diversity of skills can be introduced through board appointment – insurance, accounting, taxation, investment, law and compliance – experts in each field permitting the pro-active, board led approach demanded by modern corporate governance requirements. It is not an issue whether those services are available through the insurance managers or not as the board is able to make its own judgement as to the company’s development. The constitution of the board of a PCC, through its size, strength and scope of expertise, allows unquestionable compliance with corporate governance issues and, further, ensures that delivery of cellular insurance facilities is provided within its mandate rather than provided through the sign-off of management recommendation.

Summary

The Cadbury report stated, inter alia:

“Our proposals aim to strengthen the unitary board system and increase its effectiveness, not to replace it. In law, all directors are responsible for the stewardship of the company’s assets. All directors, therefore, whether or not they have executive responsibilities, have a monitoring role and are responsible for ensuring that the necessary controls over the activities of their companies are in place – and working.”

Regulation in offshore financial centres makes frequent reference to the principles of proportionality. Application of those principles is intended to ensure that modest sized, financial services regulated companies are not over-burdened with compliance issues that add cost to process without associated security benefits. However, the reality is that the scope of such regulation permits little opportunity to benefit from the flexibility that proportionality is intended to deliver. For the pure captive insurer the cost base associated with corporate

governance requirements variously renders compliance by a captive insurer costly, uneconomic and, in some cases, impossible.

In the same manner as divestment of Lloyd's agencies by brokers created a new era of transparency in the Lloyd's market in the 1980's, the captive sector has responded to heightened corporate governance requirements through the innovation afforded by the protected cell company. The responses of the sector, with widespread adoption of the protected cell company, a reduction in the establishment of new, wholly owned, captives and proper management of potential conflicts have been driven by a need to satisfy regulation. Corporate governance has, indeed, had an impact on the sector and, in seeking to satisfy regulation, there has been significant change from which captive insurance strategies have emerged stronger, fitter and better resourced, from board level down, to respond to the demands of its multi-national client base.

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¹ On the evening of 6th March 1987 the roll-on, roll-off car ferry “Herald of Free Enterprise” capsized off the port of Zeebrugge. The bow doors had been left open on sailing. The resultant inquiry into the deaths of 190 people set a precedent for corporate manslaughter being legally admissible in an English court.

² Captive Review, November 2009 – Pageant Media

³ Attorney with New York firm Anderson Kill & Olick PC

⁴ Chairman of Willis International Captive Practice

⁵ Various sources, subject to minor variation of wording: P.A. Bawcutt, J. Bannister, J.R. Parkinson.

⁶ An individual member of the Society of Lloyd’s was referred to as a Name and the Names provided the capital to the market. A concept unique to Lloyd’s in the insurance market at the time, was the requirement for its Names to have unlimited personal liability for any losses incurred.

⁷ Lloyd’s commissioned Sir Henry Fisher QC, a pre-eminent lawyer, academic and City figure to review its own constitution.

⁸ A Working Name was permitted to become a Member of Lloyd’s on less stringent terms than an external Name. A Working Name, as the term implies, was employed within the Lloyd’s community.

⁹ The Underwriter of a syndicate held a revered position and was responsible for the entire performance of the syndicate. Syndicates were often regarded as the personal domain of the Underwriter and consequently there was opportunity to provide favour in a manner unchallenged by present-day corporate governance techniques

¹⁰ The London Market Excess of Loss spiral resulted from syndicates reinsuring one another under multiple reinsurance contracts. When claims arose, it became immediately apparent that the reinsuring syndicates were one or two collections away from the direct risk which they had already written, and many then found themselves retroceding risk to themselves

¹¹ INTM435090 - Transfer pricing: tax cases - DSG Retail and others v HMRC (TC00001)

¹² “Whose life is it anyway?” premiered in the West End in 1978

¹³ Captive Insurance Companies Association.

¹⁴ Such a structure would arise where captive business is conducted within a cell of a protected cell company

¹⁵ Report of the Committee on the Financial Aspects of Corporate Governance, Adrian Cadbury, December 1992

¹⁶ Offshore jurisdictions are favoured on account of various factors including, but not limited to, suitable legislation, responsive regulatory regimes, infrastructure dedicated to the management of captive insurance companies, and favourable tax regimes

¹⁷ While there is no definition as such, a captive based in Luxembourg, Ireland or the UK would be deemed onshore whereas one in Bermuda, Guernsey or Gibraltar would be considered offshore. The term “offshore” more relates to low or nil tax regimes than geographic location.

¹⁸ Paragraph 88, IAIS - Issues Paper on the Regulation and Supervision of Captive Insurance Companies, October 2006

¹⁹ Passive income, in the context of this article, relates to income that could be derived from activity anywhere – it is not reliant on plant, machinery or a significant workforce.

²⁰ Ships’ crews are frequently hired through offshore companies as there is no single territory that can hold itself out as the country of employment. This extends to the ships also – no longer does the “home port” equate to the port of registration.

²¹ Insurance effected with an insurer that does not have appropriate regulatory approval in a country is referred to as non-admitted. Views as to non-admitted carriers vary depending on the territory where business is to be transacted, from a requirement for business to be offered to local carriers first (as a means of developing and/or protecting local markets) to the entire matter being considered illegal.

²² Bermuda Monetary Authority – The Insurance Code of Conduct, February 2010

²³ The Willis Cause – incoming email from all Willis offices 2010

²⁴ Fred Reiss – a fire engineer from Ohio established what is believed to be the first present-day captive in the late 1950s. However, using IAIS definitions of captive insurers, it is possible to argue that the basic concept of risk transfer could even have been adopted by the Romans.

²⁵ Depending on territory of incorporation of the Protected Cell Company, cell participants can be either preference shareholders bound by a shareholder agreement, or cell participants bound by a management and participation agreement.

²⁶ The Protected Cell Company and its initials, PCC, is widely adopted. However, different jurisdictions adopt their own styling: Bermuda – Segregated Accounts’ Company – SAC; Cayman – Segregated Portfolio Company – SPC. The names vary, but the substance and purpose of the enabling legislation remains the same.

²⁷ Protected Cell Companies-The Teenage Years; Captive Insurance Company Reports, August 2010

²⁸ Protected Cell Companies-The Teenage Years; Captive Insurance Company Reports, August 2010

²⁹ Participation in a PCC is generally governed by a single agreement conveying shareholder and policyholder rights. In addition the PCC would issue policy documentation appropriate to the risks written.

³⁰ www.captive.com and various reports by major broking houses.

³¹ A typical figure in a mature captive management company in the British Isles would have one member of staff to every 2.5 captives under management.

³² The rent-a-captive was offered by insurers with spare underwriting capacity allowing clients to participate in the insurance results of their own business. However, multiple issues, including ownership rights, tax, ring fencing of assets and liabilities meant that the concept was not held to be particularly attractive to a British or European client base.

³³ Guernsey, in 1997, was the first state to introduce PCC legislation by way of so-called enabling legislation i.e. the legislation merely stated what could be done but provided no guidance as to the actual structures to be adopted or required methodology.

³⁴ The PCC is not restricted to insurance purposes but for this discussion reference is to insurance vehicles only.