CAYMAN ISLANDS 2014

From the publishers of

CAPTIVE REVIEW

REPUTATION
The Islands maintain their status as a leading captive domicile

REGULATION
CIMA keeps a firm eye on the jurisdiction to ensure the Islands remain transparent

RELAXATION
Why Cayman offers more than just a business opportunity for managers wishing to domicile there

Foreword

It has been another successful year for the captive insurance industry in the Cayman Islands, allowing the jurisdiction to remain the second largest captive domicile worldwide.

The Islands continue to remain the preferable choice for many captive managers and as of June 2013 there are approximately 30 captive management firms licensed by the Cayman Island Monetary Authority (CIMA).

Holding the number one position in the world for healthcare captives, the Islands have become the domicile of choice for many US companies seeking to (re)insure their medical malpractice risks – a growing concern in the US.

The implementation of the Insurance Law 2010, issuing stricter reporting and solvency standards has also contributed to a robust regulatory structure, which has been very well received by captive managers.

Boasting positive growth figures, it is evident that Cayman's captive sector will continue to expand and maintain its brilliant reputation as a leading captive jurisdiction. Various industry professionals have been gathered to share their expertise on the Islands' offerings, progress and predictions for the future, in this, the *Captive Review Cayman Report 2013*.

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LEADING THE MARKET

Captive Review speaks to Pedro Reis of CIMA about Cayman's status as a leading captive domicile

The Cayman Islands has long been an attractive choice for captives. The domicile's regulator Cayman Island Monetary Authority (CIMA) has played a key role in ensuring the Islands remain competitive. Pedro Reis of CIMA discusses how Cayman will continue to be a leader in the industry.

Captive Review (CR): Do you think the status Cayman has enjoyed as a leading domicile will continue over the next decade? Why or why not?

Pedro Reis (PR): The Cayman Islands, as the second largest captive domicile in the world, will maintain its leadership role in standard setting in the captive insurance industry and continue to do its part as a responsible member of the global community.

Cayman's reputation among the international business and regulatory community is that of an international financial centre of quality, with an internationally-lauded regulatory and legal framework, modern infrastructure, business-friendly environment, and expertise of service providers, making Cayman a market leader in many areas.

Cayman will also continue to:

- Play an active role in the International Association of Insurance Supervisors (IAIS), the international standard-setting body responsible for developing and assisting in the implementation of principles and standards for the supervision of the insurance sector. Cayman is an IAIS founding member, and part of the Executive Committee. The Cayman Islands became a signatory to the IAIS Multilateral Memorandum of Understanding (MMOU) in July 2011.
- Work closely with other regulatory bodies in dealing with cross-border issues in the financial services sector.
- Assess and update its regulatory regime as necessary.

Written by
Pedro Reis

Pedro Reis, deputy head of the Insurance Supervision Division of CIMA, has served as a regulator for the Insurance Division of the Cayman Islands Monetary Authority for several years, where he is primarily responsible for regulating Cayman's international and domestic insurance industry. He has over 12 years of experience in both the financial services industry and insurance regulatory fields.

CR: How will the CIMA continue its mission to enhance the economic wealth of the Cayman Islands?

PR: The Cayman Islands is still internationally recognised as a growth market for financial services activities for the insurance industry, and beyond. This is evidenced by the growth in the hedge fund market, where Cayman now accounts for a significant market share of the world's offshore hedge funds. This influx of capital helps provide increased confidence in Cayman as a domicile. The country also maintains an extremely broad base of financial services, as evidenced by its strong banking, fiduciary and funds services.

The country's regulatory framework reflects recognised international standards, as set by the International Association of Insurance Supervisors (IAIS), and open communication is encouraged by CIMA as part of the regulatory process to cultivate, and maintain, positive relationships with licensees, service providers and international agencies associated with the domicile. Enhanced international co-operation and collaboration has undoubtedly contributed to safeguarding the interest of the jurisdictions which fall within the international sectors. Since this is of paramount importance to the Cayman Islands, CIMA consistently commits both time and resources to actively participate in international initiatives with the IAIS, OECD, FATF and IMF, including their various sub-committees.

Also, the joint efforts of CIMA and the Insurance Managers Association of Cayman (IMAC) have significantly contributed to Cayman's on-going success as a captive domicile. In fact, the Cayman Captive Forum, organised by IMAC, has expanded well beyond expectations and is now recognised as a prominent educational conference within the captive industry. Attracting almost 1,300 participants in 2012, the Cayman Captive Forum is the world's largest captive conference and provides exceptional networking opportunities for captive owners, IMAC, CIMA and other service providers.

Regarding Cayman's International Insurance industry, 2012 was a year of tremendous growth for the Cayman Islands. To put this in perspective, in 2012 Cayman received the highest number of captive applications since the hard market of 2004. 2013 continues to show steady growth for the Cayman Islands.

CR: In what ways will the CIMA strive to innovate the Cayman insurance industry to remain competitive?

PR: CIMA is confident that the new Insurance Law and associated regulations will significantly strengthen the already rigorous supervisory framework, as well as present new business opportunities and allow for innovation.

Going forward, CIMA will continue to assess and update its risk-based regulatory regime, continue to encourage open communication with its licensees, service providers and international agencies associated with Cayman, and continue to enhance its international co-operation and collaboration.

CR: How will Cayman adapt to the increased global push for transparency in

order to maintain the domicile's reputation in the near future?

PR: Cayman has complied with all international regulatory initiatives and has worked with the International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), Financial Action Task Force (FATF) and others to create a stable and well-regulated legal financial system. The 2013 OECD Peer Review Report highlights the effect of these efforts, in which the Cayman Islands was cited as having "… a well-developed legal and regulatory framework".

Cayman has also signed 31 Tax Information Exchange Agreements (TIEA) with various countries such as the United States in 2001, United Kingdom, Canada and other G20 countries.

Again, Cayman's compliance with international standards of financial regulation, anti-money laundering and tax co-operation has been assessed repeatedly by independent bodies, including the IMF, FATF, OECD. They have all acknowledged this jurisdiction's high level of adherence. Their reports are in the public domain.

In addition, Cayman demonstrates its commitment to international co-operation and the maintenance of high standards through our extensive involvement in international standard-setting bodies.

Cayman is a member of the Steering Committee and Peer Review Committee of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and is the current Chair of the Caribbean Financial Action Task Force (CFATF).

Cayman is also a member of the International Organisation of Securities Commissions (IOSCO) and a signatory to the IOSCO MMoU which signifies our compliance with the standards of regulation and co-operation in the investments and securities sector.

We adhere to the Basel Core Principles for Effective Banking Supervision and have assumed the post of Deputy Chair of the Group of International Financial Centre Supervisors (formerly the Offshore Group of Banking Supervisors). In November 2011, Cayman completed a two-year appointment on the Board of the Association of Supervisors of Banks of the Americas (ASBA).

These are just some examples of Cayman's involvement with international groups and initiatives, and provides ample evidence of Cayman's commitment to high standards.

Worth noting are UK Prime Minister David Cameron's recent comments in Parliament, after the G20 Summit in St. Petersburg, where he acknowledges the sound regulation and transparency of UK overseas territories such as the Cayman Islands.

CR: In regards to the 2010 amended insurance law's new classification system, are you beginning to see insurers benefit from this? How do you see this system shaping the future of the industry?

PR: The introduction of the new Insurance Law, 2010 and the new supporting regulations have been very well received. The revisions to the Insurance Law are broad based and include stricter reporting and solvency standards for domestic insurers; a restructuring of Class "B" companies into four categories, depending on the amount of related party business; a new class of insurer for "Reinsurance" companies and Insurance Linked Securities; and a harmonisation of solvency provisions that are appropriate to the type of risks being undertaken. As mentioned above, CIMA is confident that the new law will significantly strengthen the already rigorous supervisory framework, as well as present new business opportunities, such as the development of the reinsurance market in Cayman. In fact, the global reinsurance markets have also reacted positively to the new Insurance Law, and a number of reinsurance entities are in the process of establishing, or already have established, a reinsurance presence in the Cayman Islands. During the course of 2014 this trend is expected to develop with greater momentum.

The country has always benefited significantly from having modern, innovative and practical legislation. Since the legislative framework of a domicile is fundamental for a successful, sophisticated business environment, this is recognised as being an ongoing requirement to the country's future growth as a market leader.

"As mentioned above, CIMA is confident that the new law will significantly strengthen the already rigorous supervisory framework, as well as present new business opportunities, such as the development of the reinsurance market in Cayman"

CAYMAN ISLANDS FACTS

The Cayman Islands Monetary Authority

Over the last 36 years the Cayman Islands have matured into one of the world's largest international financial centres and the second largest captive insurance domicile.

As the primary financial services regulator, the mission of the Cayman Islands Monetary Authority (the Authority) is to enhance the economic wealth and reputation of the Cayman Islands by fostering a thriving and growing, competitive, and internationally recognised financial services industry, through appropriate, responsive, cost-effective and efficient supervision and a stable currency.

To this end, the Authority enforces robust regulatory laws along with working closely with home supervisors on regulatory co-ordination and implementation of pragmatic and effective regimes for group supervision and co-ordinated crisis management. Thus, the framework within which the Authority operates addresses key elements and principles as outlined by the IAIS as well as by maintaining active membership with international standard setters in the insurance sector in particular: International Association of Insurance Supervisors (IAIS) since 1995, Offshore Group of Insurance Supervisors (OGIS) since 1993, International Organisation of Securities Commissions (IOSCO) 2009, Caribbean Association of Insurance Regulators (CAIR) 2009.

Additionally, the Cayman Islands hold the number one position worldwide for healthcare captives; this sector continues to be the primary class of business, while the second largest sector provides workers' compensation coverage. The Cayman Islands' captive insurance industry is composed mainly of companies emanating from North America. Nonetheless, the next most important geographical source is the Caribbean and Latin America, collectively.

Enhanced international co-operation and collaboration will undoubtedly continue to assist in safeguarding the interest of the jurisdictions which fall within the "offshore sector" and "the Caribbean" and as this is of paramount importance to the Cayman Islands, the Authority consistently commits both time and resources to actively participate in international initiatives with the IAIS, OECD, FATF and IMF.

The Cayman captive insurance market is quite varied, with prominent risk types including healthcare, workers' compensation, property and general liability. More recently, Alternative Financing Vehicles (also called Special Purpose Vehicles (SPVs)) have been formed to allow reinsurers access to capital markets for catastrophe cover. Segregated Portfolio Companies (SPCs), also called Protected Cell Companies, that typically provide captive products for smaller organisations, are also a major part of the market; as at 30 June 2013 there were 134 licensed SPCs, which include a total of 657 segregated portfolios. Cayman has developed particular expertise in medical insurance, and with healthcare captives representing 45% of all Cayman captives.

> "All relevant financial services business in Cayman must adhere to internationally accepted standards with respect to anti-money laundering and combating terrorist financing"

Another immediate development is the positive reaction to the new Cayman Islands Insurance Law, 2010 by the global reinsurance markets. A number of reinsurance entities are in the process of, or already have established a reinsurance presence in the Cayman Islands, and during the course of 2013 this trend is expected to develop with greater momentum.

Regulatory framework- CIMA

The Cayman Islands Monetary Authority (CIMA) bases its regulatory regime on the core principles issued by IAIS. These principles are applied in the context of the risk profile of the particular licensee such that the regulation is appropriate to the risk of the business undertaken. CIMA's regulatory framework consists of the Insurance Law, 2010, regulations and various statements of regulatory policy and guidance. In addition, all relevant financial services business in Cayman must adhere to internationally accepted standards with respect to anti-money laundering and combating terrorist financing as specified in the Proceeds of Crime Law, 2008 and the Money Laundering Regulations, 2010.

CIMA recently issued Rules & Statements of Guidance to the insurance industry on Risk Management for Insurers as well as on Market Conduct for Class A Insurers, Agents and Brokers. The measures are directly in keeping with the IAIS Core Principles and specifically deal with the areas of market conduct, internal controls, insurance policy wording, disclosure and assessing customer needs, and enforce-

ment. Among other stipulations, it requires that agents and brokers have internal controls and/or protection to safeguard customer assets and only act within the limits of personal competence and authorisation.

As the primary financial services regulator our mission is to enhance the economic wealth and reputation of the Cayman Islands by fostering a thriving and growing, competitive, and internationally recognised financial services industry through appropriate, responsive, cost-effective and efficient supervision and a stable currency.

Legal structure: Wholly government-owned body corporate (Statutory Authority; operationally independent since 10 March 2003)

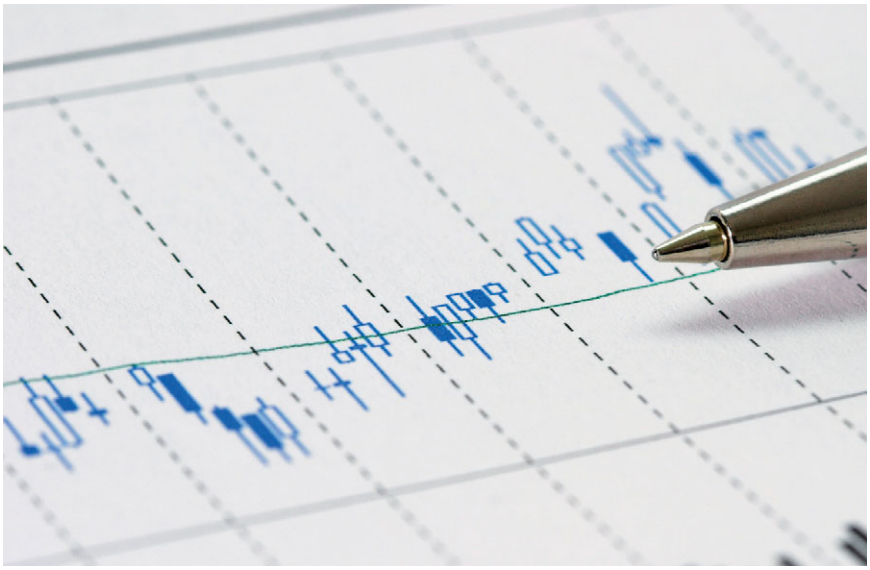
Legal basis: Monetary Authority Law (2011 Revision)

Functions

1. **Monetary** – the issue and redemption of the Cayman currency and the management of currency reserves.
2. **Regulatory** – the regulation (including licensing) and supervision of financial services, the monitoring of compliance with money laundering regulations.
3. **Co-operative** – the provision of assistance to overseas regulatory authorities, including the execution of memoranda of understanding to assist with consolidated supervision.
4. **Advisory** – the provision of advice to the Government on monetary, regulatory and co-operative matters.

Obligations

To act in the best economic interests of the Cayman Islands; promote and maintain a sound financial system in the Cayman Islands; to use its resources in the most efficient and economic way; to have regard to generally accepted principles of good corporate governance; to endeavour to promote and enhance market confidence, consumer protection and the reputation of the Cayman Islands as a financial centre; to reduce the possibility for the use of financial services business for money laundering or other crime; to recognise the international character of financial services/markets and the need to be competitive for consumers and suppliers while complying with appropriate and relevant international standards; to recognise the principle that a burden or restriction that is imposed should be proportionate to its expected benefits; to recognise the desirability of facilitating innovation in financial services business; to be transparent and fair.



Market size

The insurance industry in the Cayman Islands has two distinct sectors:

1. The domestic market (the insurance of local risks by locally incorporated or registered insurers) consisting of 27 companies of which eight are local and 19 are approved external insurers.
2. The international market (the insurance of foreign risks by insurers from within the Cayman Islands) consisting of 750 insurers.

International market

The following information has been updated as at 30 June 2013:

- **Captive numbers:** There were a total of 750 active class "B", "C", and "D" licencees as at 30 June 2013 (709 class "B", 39 class "C", and 2 class "D"). Class "B" refers to international insurers, class "C" to SPVs, fully funded vehicles, and class "D" to commercial reinsurers.
- **Premiums**: Gross written premiums were US$13.5bn, from $11.83bn as at 31 December 2012 (14% increase), 11.75 billion as at 31 December 2011 (15% increase), $8.66bn as at 31 December 2010 (56% increase), and $7.48bn as at 31 December 2009 (80% increase).
- **Assets**: Total assets as at 30 June 2013 were $82.8bn, from $88.1bn as at 31 December 2012 (6% decrease), $68.5bn as at 31 December 2011 (21% increase), $57.9bn as at 31 December 2010 (43% increase), and $44.7bn as at 31 December 2009 (85% increase).
- **Premium and assets increase**: These significant increases are a direct result of new captive formations during 2010, 2011 and 2012 (116 new captives licensed, including 53 during 2012). 2012 was a year of tremendous growth for the Cayman Islands, with a total of 53 licences granted. To put this in perspective, in 2012 Cayman received the highest number of captive applications since the hard market of 2004. 2013 continues to show growth for the Cayman Islands, with 24 licences granted during the first two quarters of 2013, compared to the 20 licences granted during the same period of 2012.
- **Types**: As at 30 June 2013, Cayman had 412 pure captives (55%), 134 SPCs (18%) and 124 group captives (17%). Other categories include 39 special purpose vehicles (5%) and 39 commercial insurers (5%). The 134 SPCs include a total of 657 active segregated portfolios (SP).
- **Location**: As at 30 June 2013, North America accounted for 90% of the Cayman market, followed by Caribbean and Latin America at 3%, Europe at 2%, and the remaining global market at 5%.
- **Industries**: The five biggest industry segments, by number of captives, were healthcare (45%), financial services (25%), construction (8%), tertiary services (6%) and transportation (6%).
- Casualty lines: Regarding casualty lines, medical malpractice liability was written by 254 captives (34%), followed by workers compensation with 156 (21%) and property with 90 (12%). Other major lines include general liability with 74 captives (10%) and professional liability with 69 (9%).

ADVANTAGES OF CAYMAN SPCS

Segregated portfolio companies have become a useful tool for captives in separating risk in the Cayman Islands and beyond. Fiona Moseley of AIH explains the benefits of this type of portfolio management as well as what should be considered for choosing directors and maintaining good governance

Written by
Fiona Moseley

Fiona Moseley, president, Advantage International Management (Cayman) Ltd

As a premier insurance jurisdiction, the Cayman Islands offers a number of valuable products to its clients to manage risk. One such well-established product is the segregated portfolio company (SPC). SPCs emerged in the Cayman Islands in 1998 as a means of providing legal separation of assets and liabilities.

The ability to register as this type of company under the Cayman Islands Companies Law originally only applied to insurance companies but has since been expanded to include any exempted company. The Cayman Islands stands out among other jurisdictions offering SPCs due to a robust legal and regulatory regime as well as new legislation to provide increased flexibility.

Since their introduction, there has been an increase in demand for SPCs as they have proved to be a useful tool for both the insurance industry and the fund industry to separate risk. For captives, these companies can provide separation for individual lines of insurance, different owners, or product lines. Each SPC is a legal entity with cells created around the core company. When a group comes together to form a captive, they may have very different types of risk and want to segregate those risks along a variety of criteria. For example, short tail risks could be placed in one cell to allow for quick release of assets while longer tail risks are placed in a different cell. This structure would also be beneficial if the core business of the parent was in healthcare where the captive owners may decide to place each clinic or doctor group in its own cell, so that the cell would follow the fortune of that particular group. There are several advantages of using SPCs over other traditional methods of legal divisions within a portfolio. Setting up an SPC can offer a cost saving advantage and is less unwieldy than setting up subsidiary companies as well as providing a statutory regime that is a much more robust legal argument when compared to other methods. Ring-fencing of assets provides a considerable amount of comfort to investors as well.

> **"When choosing a director to oversee an SPC, a thorough knowledge of the regulatory environment and the Cayman insurance sector is essential"**

One of the most important decisions in setting up an SPC is the appointment of directors. The role of the director is crucial in the operation of an SPC. They must ensure that the SPC maintains good governance and operates in a manner to ensure the segregation of assets and liabilities within cells. In order for a segregated portfolio company to stand up to scrutiny, it is very important that the directors and officers of that company understand the legislation that they are operating under. Ensuring this can present challenges for companies with a large number of cells where directors have to quickly change their mind-set depending on which cell they are acting on behalf of that day. The business plan of SPCs is more onerous for directors than that of normal captives due to the fact that while the SPC may be a single legal entity, it may be operating under several business plans. When choosing a director to oversee an SPC, a thorough knowledge of the regulatory environment and the Cayman insurance sector is essential. They must fully understand the risks that they are taking personally, the capital requirements and the solvency requirements of the cell and of the company itself. Therefore, there is a lot of emphasis placed on directors who must make sure they are operating under the best interests of each cell.

At Advantage, we are committed to working with firms to set up and maintain successful SPCs. We currently have our own SPCs

that we utilise which clients can participate in using a pooling mechanism. In addition we have set up a number of SPCs for our clients and continue to give them support and advice such as ensuring corporate documentation is up to the needed standards and everything is segregated appropriately. With the inherent complexities of SPCs, we are able to provide clients with the needed expertise on the requirements of the CIMA and Registrar of Companies to make sure there are no issues on a regulatory level.

Over the next few years, we do expect to see an increase in the number of SPCs in the Cayman Islands. New legislation on the horizon is set to increase the demand. In March of this year, the Cayman Islands introduced new incorporated cell legislation for the insurance sector that is set to come into effect soon. It will allow for an increase in flexibility by permitting the set up of a regular Cayman exempted company, called a portfolio insurance company (PIC), once it comes into force. The widely anticipated PIC will enable each cell to be a separate legal entity under insurance law and will pave the way for new business in the Cayman Islands. PICs will not need an insurance licence but rather will operate under the umbrella of the SPC licensed insurer.

A PIC will allow companies to set up cells as its own legal entity which can be beneficial in terms of tax and in terms of governance. Generally it is difficult for a cell to take a tax election as this normally applies to the entire legal entity, but a PIC will ensure any difficulties under the prior SPC legislation is clarified. Under a large segregated portfolio company with a lot of cells, there may be owners of those cells that want to be on the board of directors but are solely interested in being on the board of their own cell and a PIC would enable them to take a board position on only their particular cell. Care still needs to be taken around drafting contracts and transactions from cell to cell, however the flexibility this will offer promises to be a great motivator.

I believe SPCs will be around for a long time and as the world changes, hopefully the Cayman Island's legislation will blend with it to continue to provide a robust regulatory environment that is attractive to investors with the best possible products.

TWO WORLDS APART

Andrew Cater, of United Insurance, talks to *Captive Review* about the development, implementation process and benefits of MGAs

For many a year, US MGAs writing profitable business on licensed local insurance papers have had the ability, and indeed many were encouraged by those same insurers, to take some "skin in the game." In short they were and are encouraged to form their own "mini" insurance company to accept some of the risks they underwrite, thereby participating in the underwriting profits. Effectively insurers saw that MGAs who participated in their own risks had an interest to ensure profitability of their portfolios of business, aligning interests of both the insurer and the MGA.

The means of achieving this was the formation of reinsurance vehicles owned by the MGA/producer which are generally segregated portfolio companies (SPCs or PCCs or SACs in other jurisdictions) based predominantly in offshore domiciles. In short, SPCs are cells, or mini insurance companies, attached to a "core company" that is licensed in its own jurisdiction. Each cell is legally and financially separated from other cells attached to the core. The "core" is managed by a professional captive insurance manager. Cayman has many such companies.

By contrast, other areas of the world have not seen such development with MGAs. Indeed on recent travels in Western, Central and Eastern European countries, I explained the concept to many high level directors within MGAs and broking executives who were not even aware that such a product was available. Virtually all of them instantly saw opportunities to participate in the profits they make for their carrying insurers.

Written by
Andrew Cater

Andrew Cater is an assistant vice president at Aon Insurance Managers (Cayman) Limited and a senior underwriter for United Insurance Company, specialising in marine business. He has also run several MGAs, concentrating on cargo business. Having spent 15 years in Central and Eastern Europe, he joined United in Cayman in January 2012.

This is not the place to dwell on the reasons why there are two different worlds when it comes to such vehicles however what I am able to do is point out the benefits, pitfalls and structures that are possible. I can also state quite categorically that MGA owned reinsurance companies are pretty much possible everywhere in the world. I speak from experience.

MGA owned reinsurance companies' principles

The main principle of an MGA owned reinsurance company is for the MGA/broker to retain a good share of the profits it generates for the insurer whom it is underwriting for, by participating in the risk. Generally this is done by the MGA accepting shares or layers of their business into a cell. That is the main principle, however there are other important benefits.

A number of times in my career I have come across highly professional MGAs and brokers who have faced issues with insurance carriers on profitable portfolios of business. Those issues normally stemmed from: an insurer suddenly coming out of a class of business that they were previously involved with; a decision from the carrier to support another MGA owing to politics on other products; change of underwriting staff; an insurer pulling out of that region etc. The tales go on.

The MGA is left sitting there with a good, profitable portfolio and no carrier. They then have to explain their portfolio, philosophy and needs a hundred times to various management levels of a myriad of insurers while trying to retain their existing business, having just lost their carrier. Decisions from insurers on new MGAs do not come quickly. Clashes of interests abound within the potential new insurer's existing portfolio, in short a frustrating process as each insurer has to fully investigate and underwrite the portfolio from new, despite the existence of an already well underwritten and profitable programme.

Owning a developed mini reinsurance company can allow the MGA to control the new carrier selection. Effectively an MGA with a developed segregated portfolio reinsurer is asking a different question of the insurers he approaches.

He is saying: "I have a profitable programme with reinsurance already in place, which I would like you to front for, and maybe

have some participation if you so wish." Owning your own mini reinsurer can become a game changer.

How do you set up an MGA owned reinsurer?

The MGA can easily set up a cell within an SPC in whichever domicile he so wishes. Here in Cayman it can take as little as 21 days to do so, as long as the Cayman Islands Monetary Authority (CIMA) and the board of directors of the SPC approve the business plan. The process is relatively simple:

1. The SPC or captive manager develops a business plan with the MGA/broker outlining the business to be placed in the cell.
2. The same business plan includes details of the capitalisation of the cell, the expected premiums, the reinsurance, LOC or other collateral to be provided to back up the writings of the cell.*
3. A legal document such as a Private Placement Memorandum is signed between the SPC and the new shareholders of the cell: the MGA. This outlines the agreed capital and business to be underwritten, as well as the fees charged by the SPC manager, CIMA etc. Note, no directors are appointed by the MGA, the MGA is "renting" the cell from a company where the infrastructure already exists, as opposed to a full captive where you must create your own structures, board of directors and so forth.
4. The business plan is submitted to the board of directors of the SPC and to CIMA for approval.
5. Once approval is given, the capital is paid in and business can commence.

Reinsurer's point of view

As with a front carrier, if an MGA is prepared to take a slice of the risks they underwrite, then that is an alignment with reinsurers' interests. Reinsurance markets can be more flexible than direct writers in terms of what they allow in a cell structure, and can open a whole new world of possibilities to segregated portfolio or captive owners.

United Insurance Company is the only reinsurer in the world, rated by A. M. Best and Co as A- (Excellent) that is completely dedicated (since 1975) to providing reinsurance solutions for cells and captives. Those solutions can be providing cells from United SPC, fronting for unrated cells/captives so as to provide acceptable security to the direct writing companies, to offering novations, commutations and other exit strategies.

Summary

In short there are many benefits to an MGA or broker owning a cell or captive structure. The main ones are the participation in underwriting profit and having greater control over the MGA's destiny, while minimising the exposure to direct writer changes of direction/underwriting policy. Increasing interest and business from Europe, CEE and now the Far East, as well as continued growth in the US are demonstrating that the concept is becoming better understood worldwide, which has to be good news for the industry as a whole.

**Depending on the type and size of business, collateral for the full extent of potential liabilities accepted by the cell must be posted. This collateral can take many forms such as cash, letters of credit, other securities and/or, reinsurance. Owning a cell provides access to the reinsurance markets. Reinsurers can provide coverage on a quota share, excess of loss, stop-loss or similar basis to protect the cell from adverse loss experience in the early years, while allowing ceding commissions and profit commissions to assist the growth of capital, surplus and risk retention ability of the cell. The cell retains more risk as time goes on, the reinsurers act as "incubators", gradually pulling back as the years pass. Capital requirements vary depending on each case. We have some with capital as low as $20,000 and others in the hundreds of thousands.*

Underwriting profits in the early years are also retained by the cell to increase capital and surplus and allow more writing of business. In general, subject to CIMA's approval (in Cayman), we would expect to see the first dividends from underwriting profit payable to the shareholders in years three to five, depending on the class of business.

CAYMAN CONTINUES TO PERFORM

The Cayman Islands see positive captive formation growth figures year on year and middle-tier captive management firms grab a significant portion of new appointments. Stuart King explains

The Cayman Islands continue to remain a preferable choice for many captive owners to establish their captives. With 28 new formations to September 2013 the Cayman Islands look set to achieve (not including closures) approximately 3% to 5% growth year-on-year.

It is interesting to consider which captive management firms are benefiting from this growth and explore some of the benefits and challenges associated with competing for new business. As of June 2013 there are approximately 30 captive management firms licensed by the Cayman Island Monetary Authority (CIMA), most of the top 10 global firms having a presence on the islands.

In Cayman it would appear that middle tier firms (those not part of large broker firms) secured circa 60% of appointments with overall firm growth of about 6% and smaller firms securing 30% for the year to date. I suspect that large firms do not lack appetite for winning new business but rather balance up. The cost of a tender process, bidding a lower management fee which often negatively impacts wider group financial performance metrics and business development resources required between captive feasibility to captive formation suggest that larger firms are focusing resources on growing their significantly larger client base, ensuring client service levels are maintained versus actively pursuing new formations which perhaps has a less material revenue impact on overall firm growth in comparison to middle and smaller tier firms.

Published management firm statistics indicate that productivity performance measures, such as captives under management to staff employed averages at 2.5 times.

Written by
Stuart King

Stuart King FCCA is managing director of FR Global Advisors which provides management advisory services to the captive management industry, including insurance premium tax and regulatory compliance solutions and operational efficiencies for captive management firms.

Staff productivity of larger more established firms indicates a slightly higher and closer range of performance ratios in comparison to middle-tier firms, in part perhaps attributable to standardisation, automation and use of technology.

Higher performance ratios could perhaps be attributed to an efficient approach to client management, multi-discipline of staff duties or negatively it could perhaps indicate over-worked service teams evidently leading to client quality issues. In contrast, lower performance ratios may indicate an inefficient workforce, duplication of tasks undertaken or a manual approach to client service – either way captive firm leadership would be best placed to include staff productivity as well as financial metrics when reviewing overall firm performance.

Considerations

In the past, middle-tier firms would be somewhat collective in their desire to win appointments from larger firms, however, according to Cayman statistics this would appear to have changed somewhat as there appears to be increased competition between one another. Firm leadership may wish to consider the following when preparing for a tender situation:

- Consider a centralised strategy and establishment of a business development network of individuals whose performance metrics are not domicile-specific. Providing sufficient resource and commitment, recognising the often significant time delay between day one prospect engagement to securing management appointment;
- Engage with prospects early, get to know them, understand their corporate strategy and style and key influencers in the decision making process;
- Put forward a service team aligned to the culture and expectations of the prospect. Introducing the team early on that will serve the client and not change on appointment, demonstrating stability of staff;
- Approach the tender response as a project with clear deliverables, timing and allocation of tasks. Appoint a project manager/owner so as to ensure consistency in flow and language;
- Draft a response that addresses the tender requirements but also includes subtle competitive advantages in language used. Perhaps avoid the temptation to include too much generic text opting to include more graphics;
- Allocate as much time preparing for the presentation as the written response with every presenter familiar with their firm's value proposition if challenged;
- Where permitted continue dialogue with the prospect after the bid which may allow for clarifications and demonstrate a desire to do business with them.

PPACA: RISKS AND OPPORTUNITIES ON THE HORIZON

Clayton Price, of Marsh, discusses the effect of PPACA on captive healthcare and the transition towards Accountable Care Organisations

The Cayman Islands has long been known as the domicile of choice for US healthcare companies seeking to (re)insure their medical malpractice risks. More than 250 healthcare-related captives call Cayman home today — representing one-third of the domicile's total captive population. While the impact of the Patient Protection and Affordable Care Act (PPACA) will likely shrink the number of healthcare captives due to increased merger/acquisition activity, it also will likely result in new opportunities.

Since the passage of the PPACA in 2010, several health systems have merged with larger systems in order to more easily comply with the Act's expense control mandates. Examples include: Catholic Health East and Trinity Health; Tenet Healthcare Corporation and Vanguard Health Systems; and the Northeast Health System and Lahey Clinic Foundation. In addition to the amalgamation of health systems within the US, some US systems are seeking to expand globally either through acquisition or through the establishment of medical tourism facilities, which can offer greater operational freedom, less bureaucracy, and more reasonable recovery rates than traditional hospital systems.

While such merger/acquisition activity may reduce the overall number of healthcare captives, the growth in size of the resulting entities creates opportunities for expanded captive use, especially as it relates to Accountable Care Organisations (ACOs) and medical stop-loss insurance.

Written by
Clayton Price

Clayton Price is the office head for Marsh Management Services Cayman, Ltd., with over 120 captive insurance companies under management. Price has more than 30 years of expertise in the industry, working in Atlanta, New York, and Bermuda and is the chairman for the Insurance Managers Association of Cayman.

Accountable Care Organisations

Healthcare organisations are steadily moving to join or form ACOs, as encouraged under the PPACA. ACOs are networks of healthcare organisations that aim to deliver cost savings and better patient outcomes to an assigned population of patients. It will be critical for those participating in ACOs to carefully manage the potential new risks associated with the transition, as several of these activities have the potential to expose organisations to new reputational, legal, and compliance risks. These include establishing provider networks, entering into new at risk payor contracts, developing transitional care models, sharing data, and physician integration.

The captive structure that healthcare systems have become accustomed to for their own self-insurance is a viable option to transfer some of the new risks associated with ACOs.

For example, healthcare captives are likely to cover more medical professional liability exposures as physicians continue to align with hospitals. Interest in covering cyber risks in healthcare captives is also expected to rise. A key component of achieving better patient outcomes through an ACO is the sharing of electronic medical records and other data across the network, which results in a greater potential for data breaches in the future, particularly during the transition phase.

Captives can also be used to provide insurance to nursing homes or other network members that the hospital system itself does not own. Some healthcare organisations have undergone the process of transforming their single parent captive into a Segregated Portfolio Company (SPC) with the intent of separating into individual cell structures the liabilities that may arise out of the outcomes of their populations. By doing so, they also separately aggregate the exposures within each of the separate cells. While the separate cells would typically be used to insure the risks of separate ACOs, they are flexible and could accommodate different populations.

With the Insurance (Amendment) Law, 2013 (Law 16 of 2013), passed earlier this year, healthcare companies with SPCs will soon be able to establish incorporated cells known as Portfolio Insurance Companies (PIC), which offer wider opportunities than a traditional SPC structure. Under the new law, an SPC cell can maintain ownership of one PIC, which is incorporated as a separate company, with its own independent board of directors. The PIC operates off the SPC's captive licence and must operate within the parameters of the cell's business plan and maintain its own margin of solvency. If desired, the PIC can seek an employer identification

number (EIN) from the US Treasury Department, trade with other PICs, and accommodate portfolio transfers between cells.

Thus, two merging healthcare systems with separate captives will soon have the ability to convert to an SPC with two (or more) cells with subsidiary PICs in order to maintain the prior two boards of the two captives. This enables the healthcare systems to appoint directors that are the most knowledgeable of the exposures written by the respective cells.

Perhaps further down the horizon as ACOs are able to better quantify their risks and develop robust data, an opportunity will develop where several ACOs pool their risks using an existing captive or a PIC structure and then seek excess insurance either directly from the commercial insurance market or from the capital markets.

Indeed, by crystallising the ACO data captured in a captive or PIC structure, it may only be a matter of time before more capital market applications become a reality. Catastrophe bonds, now referred to as Insurance Linked Securities (ILS), had once been the domain for commercial insurers in need of capacity for a finite period of time without having to issue additional shares of stock. ILS structures are now being adopted by governmental bodies and transportation authorities to cover their catastrophe risks. Life and health insurers also have placed bonds to cover risks arising from their mortality exposure.

It is conceivable that, once credible data is available on the outcomes of the populations that the ACOs are responsible for, a pooling facility among captives could be developed and funds could be raised from the capital markets, much the same as ILSs are used for cat bonds based on the projected outcomes of the data.

Medical stop-loss insurance

The PPACA also makes self-insured employee benefit plans more attractive for small and midsize employers, many of which are showing increased interest in using a captive to fund stop-loss insurance.

By doing so, organisations have greater input into the design of their plans and can focus on mitigating catastrophic medical losses and expenses through the implementation of sound loss prevention initiatives like health risk assessments and wellness programmes.

However, the unlimited maximum benefit that self-insured employers are exposed to under the PPACA could leave a captive exposed to significant pay-outs. In addition to ensuring the captive is well-capitalised for the increased exposure, captive owners will likely want to purchase reinsurance for high-risk exposures and chronic high-cost claimant populations.

A number of broker-owned group captives, including one owned by Marsh, exist to aid midsize employers in managing their healthcare expenditures.

Conclusion

Although the number of healthcare captives will likely shrink as a result of the PPACA, the premium and asset size and the breadth of the risks written into the captives will likely increase as health systems and physician groups take on more care management in a holistic approach to patient care. Captives have withstood the test of time as a sound alternative risk financing option. As employers map their way through the unchartered waters of the Patient Protection and Affordable Care Act, captives will undoubtedly be an integral part of the solution in how healthcare is delivered.

> **"The PPACA also makes self-insured employee benefit plans more attractive for small and midsize employers, many of which are showing increased interest in using a captive to fund stop-loss insurance"**

TIME TO TAKE CONTROL

Chad Kunkel, of Artex Risk Solutions, talks to *Captive Review* about the benefits of group captives

Insurance carriers today are looking for more underwriting information, loss information, financial information and are also looking at the classes of business they insure. This underwriting discipline that is happening in the marketplace leads to increased rates and potential coverage restrictions for middle market companies today. While rates may not be increasing significantly in all areas, workers' compensation is definitely a leader in rate strengthening and this line of coverage is one that fits extremely well in a group captive.

Group captives are an excellent way for middle market companies to reduce their insurance premiums over time. This is done by being able to take your company out of the hard and soft insurance cycles and becoming an owner in a group captive. A group captive typically will price insurance premiums directly off the historical five to six years of loss experience. Companies that have above average experience will be able to maintain a lower cost of insurance particularly in a market where the insurance rates are increasing. In addition, if the premiums that were charged were in excess, a group captive will return the underwriting profit back to the insured to further reduce the insured's risk management cost.

While group captives are an excellent way to help middle market companies manage and reduce their insurance costs, not all group captives are created equal. Each captive programme is unique in its structure and can vary by a number of areas that buyers and brokers should consider before an insured goes into a group captive.

Written by
Chad Kunkel

Chad Kunkel is division executive vice president – group captives for Artex Risk Solutions, Inc.

Size

Group captives are an excellent way to gain control over your insurance programme. When looking at a group captive you will want to make sure you understand how many insureds there are. A larger group captive may provide lower fixed costs, but you could lose a significant amount of control or voice over the direction of your captive programme. Captives over time can change service providers, retentions, carriers, lines of coverage, investment strategies and classes of business to insure. When picking a captive to join you will want to be comfortable with the group and size of the organisation you are joining so you can have control in the decisions being made.

Retention of risk

Not all group captives will take on the same amount of risk. We administer captive programmes that take on as little as $250,000 per occurrence and can go as high as $500,000. Typically, captives that take on more risk or have a higher retention will have a lower fixed cost structure. While lower fixed costs are typically a goal of the group captive programme, it leaves the door open for potential assessments back to the members as well as risk sharing from other members that don't have enough premium to cover the risk or losses that they have in the captive. Typically, group captives that have a higher retention will usually have a higher average premium per insured to make sure that each insured has a decent amount of loss funds in their premium to cover the claims activity in the captive programme. Depending on the risk appetite of your particular organisation you will want to seek out a captive that is in line with your risk tolerance.

Types of insureds

Group captives can be heterogeneous or homogeneous (industry specific) captive programmes. Each can have its advantages; homogeneous programmes allow like-minded companies in similar industries to come together to reduce their insurance costs over time. These programmes can also tailor and work on specific risk management needs for that particular industry. Best practices can be discussed at every level within these programmes to share ideas not only surrounding insurance, but also other areas of the business if desired. Artex has a number of industry-specific captive programmes and some examples are: warehousing, transportation, construction, food-related organisations and credit unions. These captives enjoy the specific coverage and risk management programmes designed specifically for them.

Heterogeneous programmes can be an excellent way to reduce cost and spread the risk over different classes of business with companies that are best in class and committed to safety. While these programmes underwrite different

classes of business it is important to understand the risks that you are going to share. While heterogeneous programmes take on different types of risk, each programme can have its own personality. Companies in these programmes can be of similar size in premium, revenues and number of employees. When looking to join a heterogeneous captive programme you may want to consider the typical size of the companies or states that the current companies are in; this will allow the services provided, the sharing of risk and the costs to be similar as well for each insured.

Domicile

Captives can be set up in a number of different domiciles offshore and onshore and while there are various domiciles that can work well for a group captive, Cayman is a very good domicile of choice for the group captive structure for a number of different reasons:

- Group captives tend to use a letter of credit (LOC) to support an insured's assessability; this LOC that the insured puts in place counts towards the group captive's surplus requirements.
- Cayman allows for proxies in case members/insureds cannot make board meetings.
- Cayman has the infrastructure in place to handle group captive business and because they handle so many groups, they have a very good understanding of a group captive's needs and structure.
- Last, but not least, even though Cayman is a great place to have a board of director meeting, Cayman does not require a meeting in the domicile each and every year. An insured should understand the commitments of the domicile regarding attendance and the surplus requirements to enter into the programme.

Performance

Not all group captives are run or structured the same. The captive administrator can have a lot to do with the success of the captive programme. There are a number of items to consider when joining a group captive:

- Loss ratios over a five-year period – a lower loss ratio would indicate that the captive administrator is pricing adequately for the historical losses of the insureds in the programme.
- Risk sharing – companies should look to get an understanding of the typical risk sharing that is happening each year in the programme. While risk sharing is necessary in the group captive structure to ensure tax deductibility, customers' risk tolerance should be understood to make sure that they are comfortable with entering into a group structure. Upfront cost savings could be used up with sharing of risk from other insureds within the programme and knowing what has happened historically in the programme can help companies decide what programmes would be a good fit for them. Premium size of the group captive does not necessarily mean less risk sharing in total. If the average risk sharing is 10% of premium on a large captive or a smaller captive programme historically, insureds will most likely lose 10% of premium going forward.
- Assessments – group captives typically have an assessment feature if the losses of the programme are higher than anticipated; the captive can look for the insureds to pay in additional dollars. Companies should understand the history of the captive programmes they are looking at.
- Policyholder returns – receiving money back from captives is always exciting for our group captives. The return performance of a group captive should be considered so companies get a sense for the pricing adequacy of the programme. Understanding a captive's performance and process should be vetted prior to joining a captive programme. While individual performance can vary by captive programme and companies within the captive, Artex programmes have typically returned over 10% of premium on our group captives historically.

> "Group captives should provide insureds with a great way to keep their insurance premiums consistent over the long term"

There are also other things to consider such as rate history, premium growth and the underwriting process.

It is now time to take control over your insurance programmes. Group captives should provide insureds with a great way to keep their insurance premiums consistent over the long term and what I have found is that our insureds in group captives find these programmes to have a competitive advantage in the marketplace. So there is no time like the present to take control.

CHANGING FACE OF THE CAYMAN CAPTIVE: AN AUDITOR'S INSIGHT

Geoff Johnson, of BDO, discusses the success of Cayman as a captive jurisdiction and the impact of the Insurance Law

Cayman has been a main contender in the captive insurance world since nearly its inception and companies continually choose to do business here as evidenced by the new captives launched during the year and the figures for premiums written increasing on the prior year.

The Cayman captive market has seen a number of changes over recent times and, as is often the case, properly and smoothly implementing change takes co-ordination and effort. How have the jurisdiction and the captives within Cayman adapted to this change and what are the resulting trends?

Looking at the captive sector, the introduction of Obamacare in the US is set to have a knock-on impact on the Cayman market. The industry widely believes that the introduction of Obamacare should facilitate the formation of new captives as the American healthcare industry players continue to look for ways to insure themselves and to manage their own risk in the most cost-effective manner.

The introduction of any new legislation, particularly those that are as widely publicised and analysed as this one, will force the conversation in many organisations. Even if they are significantly progressed along their own path to forming a captive, the risk management of the insured are going to be looking very closely at any potential increase in insurance costs, and many will expect their exposure, and with it, their insurance costs, to increase.

Written by
Geoff Johnson

Geoff Johnson is a senior audit manager with BDO in the Cayman Islands. Geoff has over nine years' auditing experience, including five years in Cayman, and is currently responsible for managing a diverse portfolio of Cayman-based captive insurance audits.

For some organisations, this may be the tipping point of the debate, and for others it may simply speed up a timeline that is already in place.

With Cayman so well placed for captives writing business for the American healthcare markets, it would be a logical argument that this will increase the new captive formations here in Cayman, given the heavy weighting that the American healthcare industry has here on the Islands. Often with the increase in numbers, there are always new and different ways that parent companies are trying to cede their risk. Being an auditor is a great vantage point to see the new ways of ceding and retaining risks and the decision process that the companies go through before venturing into the captive arena for the first time.

We can expect at least some of this increase in a number of captives to be offset by another trend in the American healthcare market; that of the consolidation of captive programmes.

When health groups acquire physicians, physician groups or practices, and other health groups, or hospitals, these consolidations can often generate more than one captive in the newly formed group. Consolidation of the captive programmes can result in one larger captive programme.

As captives evolve and increase in size and complexity, they start to mitigate their own risk by way of reinsurance and the captive platform offers an ideal entrance to this marketplace for American companies. This additional layer in risk transfer can mark a change in trend for the captive as it marks the transfer of risk outside the group to an additional third party. This additional scope in the insurance programme can mark a pivotal point in the captive's life cycle.

CIMA have been pragmatic and practical in the formulation and application of the new Insurance Law and its accompanying regulations. This has allowed existing captives to maintain a high level of confidence in the jurisdiction. The smoothness with which they implemented the new Law has not only reinforced this confidence, but has extended it to those looking to launch. This has ensured that anyone launching a captive has had to seriously consider Cayman as an option. The new Insurance Law has also been well received by the on-island service providers, seeing it as being robust, yet simple in its approach. Risk weighting for capital requirements has always been mooted and

compared to other captive jurisdictions. The implementation period for transition also provides a window for captives to assess their current position and debate any future changes. This is certainly generating some interesting conversations between the parent companies, their insurance managers and their auditors.

Often as important as any new legislation which is implemented, is legislation which is not adopted. Cayman will not be implementing any part of Solvency II. This was widely regarded by the industry as a good move for the captive industry and a lot of clients will be heaving a sigh of relief that they do not have to go to the trouble and expense of having to implement this directive, which is clearly better suited for traditional insurers within their captive.

The insurance managers and auditors on-island will not have to increase the scope and cost of the services that they provide to the captives as a result of the effects that implementation would have no doubt required. Should Solvency II become more finely tuned for captives, then CIMA may reevaluate the decision in the future.

With over 30 bi-lateral tax information exchange agreements (TIEAs) with other jurisdictions and being on the OECD White List has increased the international credibility of the Islands. It is further proof that the Islands is taking its presence on the world stage seriously.

This increase in communication and openness is also reflected in the changes in auditing. Parent companies are increasingly involved in the captive insurance audits. This is happening as the captives are becoming more significant in the group both in terms of risk and dollar value, through the common risk management practices, and through updates in auditing standards (specifically the AICPA Auditing Standards Board's Clarity Project, AU-C 600) to ensure that these communications are well defined and documented. This is further increasing the efficiency and effectiveness of the group audit and helps ensure that there are no stones left unturned.

The recent changes in the Insurance Law, the TIEAs, and inclusion on the OECD White List are all helping to lift the mystery and unknown from doing business in the Cayman Islands. This, combined with the strong business ethos of the service providers on the Islands, will only enhance Cayman's reputation in the captive world. We are hopeful of seeing continued improvement in the number of captives launching, and further consolidation of the captives already in the market increasing the business written within, and complexity of, the captives already in operation.

There is also a distinct shift towards openness and the enhanced understanding of the importance not only of being open and transparent in fact, but also being seen to be open and transparent. This conscious shift towards transparency should enhance the Islands as a legitimate jurisdiction in which to do business. The new Insurance Law and its implementation should provide a secure platform for the future both for new and existing captives.

The service providers on the Islands are demonstrating their vast skills and depth of knowledge in the industry, providing quality service and astute insight and driving the jurisdiction forward to maintain it as a premier destination for captive insurance.

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INSURANCE-LINKED SECURITIES IN THE CAYMAN ISLANDS

Andrew Johnson, managing director for Wilmington Trust, speaks to *Captive Review* about Cayman as a top domicile for insurance-linked securities (ILS)

Written by
Andrew N. Johnson

Andrew N. Johnson, vice president and managing director, Cayman, Wilmington Trust

The ILS market has experienced considerable growth over the past few years with the Cayman Islands becoming the top domicile for these structures. We catch up with Andrew Johnson of Wilmington Trust to discuss how Cayman's experience in the captive industry is particularly attractive for ILS and catastrophe bonds (cat bonds) and how his firm provides full administration for these structures.

Captive Review (CR): What has led to the Cayman Islands becoming the top domicile for ILS?

Andrew Johnson (AJ): There are a number of factors that have led to this. The Cayman Islands offer a number of advantages over other domiciles for ILS. The captive industry here is quite mature, having been around since the early 70s. Captive insurers have been developing their expertise and knowledge as well as improving their products and services over the past 40 years.

Cayman's insurance laws which were implemented at the beginning of the domicile's captive history have been kept up to date and revised regularly to remain competitive with other jurisdictions. Our regulation, overseen by the Cayman Islands Monetary Authority (CIMA), strives to support the industry from a business friendly perspective. We are quicker to market than competing jurisdictions and offer a number of cost advantages which has proved very attractive for businesses. As a leading captive domicile, Cayman captive managers are aware of existing clients and insurance industry participants who utilise ILS as an alternative source to purchasing straightforward (re)insurance, so many of the ceding insurers understand that Cayman is the leading domicile for offshore insurance products, particularly cat bonds.

CR: Why in particular have catastrophe bonds become so popular here?

AJ: The cat bond market in Cayman has grown significantly in the past five years. The catastrophe bond transaction is very similar to a structured finance or securitisation one in that some cat bond transactions do not even utilise an insurance or pure risk transfer form. Cayman has considerable experience with structured finance and has also been the premier domicile for many special purpose vehicles (SPVs) over the past 30 years.

Therefore the professional service providers in Cayman such as lawyers, accountants, auditors, trustees and administrators like Wilmington Trust have not only developed considerable experience and knowledge to understand insurance but also to support a structure finance transaction. Wilmington Trust is a leading provider of cat bond administration in the Cayman Islands with significant experience administering these transactions, offering full administration throughout the life of the transaction, from handling licence applications where necessary at inception to providing the formal voluntary liquidation at the very end of the transaction. We have taken a two-fold approach to servicing cat bonds by having an understanding of both sides of the structure.

This knowledge has developed considerably as cat bonds have become more prevalent in the market over the past few years. Cat bonds are a useful tool to tap into the capital and financial markets directly as an alternative to going through the (re)insurance market, especially in times when insurance rates are hardening and (re)insurance becomes more expensive and difficult to buy. In addition, these bonds are an appealing way to diversify portfolios for investors since they are not dependent on interest rates or the stock market.

CR: Do you expect to see the strong recent growth that ILS has experienced to continue in the next few years? Why or why not?

AJ: All factors indicate that the ILS market in general and with good fortune in Cayman will continue to grow over the next few years. Like the rest of the global economy, cat bonds experienced a dip after the Lehman collapse in 2008. However, from 2009 onwards there has been constant growth in the cat bond market.

There has been an increasing amount of issuance and a considerable amount of capital dedicated to ILS funds. These are being set up at a rapid pace to purchase notes issued by the cat bond issuer vehicle. Pension funds and other hedge funds have proved to be huge investors in buying cat bond notes and the investor appetite is continuing to grow. We will continue to build our position as a leading administrator globally over the next few years.

CR: What challenges are currently facing the ILS market?

AJ: There are always challenges in this market; however the main concerns at the moment are centred on recent regulations. The implementation of Rule 17g-5, Solvency II and Dodd-Frank have posed a number of new challenges, but as with other structured finance industry participants, clarification, carve-outs or exceptions have or are being sought by industry associations to various reporting and other overly restrictive requirements from the legislation so that catastrophe bond issuer vehicles can either comply easily, apply for an exception or be exempt as a matter of course.

For example, cat bonds under Dodd-Frank which utilise a swap have a reporting requirement which can be delegated to a more appropriate US-based reporting party in order to comply with the CFTC rules.

CR: Can you tell us about the experience that Wilmington Trust has in providing full administration for ILS?

AJ: Wilmington Trust provides a full range of administration services from an experienced and highly professional team. We provide full administration in Cayman as well as in Dublin, which is also a significantly growing ILS domicile. From a Wilmington Trust perspective, we have been building on our administration experience in Cayman over the last 10 years in providing director and officer, accounting and other various administration services such as liaising with auditors and posting documents and materials to publically available websites so that data is made available for investors and rating agencies on a real time basis.

Our expertise has grown from a structured finance and a corporate service provider background to being an insurance manager in the captive space, so we have considerable understanding of both sides of a transaction. We've been in the Cayman Islands for over 12 years and obtained our insurance (captive) manager's licence in 2005. Since then we have been growing and building our experience in different types of cat bond transactions from straightforward financial transactions to special purpose re-insurance transactions for property and casualty and life and longevity risks. We have a great relationship with CIMA as the regulator who is very business friendly from an insurance perspective, understand these transactions, ask the right questions and provide very quick responses.

CR: What other developments are you seeing in the ILS industry?

AJ: We see the (re)insurance industry as a direct tie in to the ILS industry and recently in the Cayman Islands we have formed a (re)insurance/ILS group that is working to promote Cayman from a (re)insurance perspective. We are focusing on new start-ups in the (re)insurance industry as well as building our reputation as the leading hedge fund domicile with approximately 90% of offshore hedge funds domiciled in Cayman. Many of these funds are either directly affiliated with reinsurers or have ties to the insurance industry, so our newly formed industry group is focused on building relationships with these managers.

A PIECE OF PARADISE

Large resort hotels might be the typical choice for travel to the Cayman Islands, but if you are looking for the perfect place to relax and feel at home, Coral Stone Club just might be your idea of paradise

Whether you are coming to the Cayman Islands for business or for a much needed beach getaway, chances are you will be thinking of one of the many resort hotels on the Islands for accommodation. However, if you are hoping for a bit more room to relax after a busy day, the Coral Stone Club might be the perfect place for the weary business traveller to unwind. Elegant, yet relaxed, the private condos offer a unique personal touch to a stay in the Caymans. Located on Grand Cayman Island and nestled along the famous Seven Mile Beach just next door to the Ritz Carlton, Coral Stone Club offers countless luxury amenities as well as a convenient base to head off to business meetings or take advantage of local shops and restaurants.

The main attraction to the Coral Stone Club is the 420 feet of pristine white sand beach. With as much beach access as many of the larger hotels, there's plenty of room to stretch out and feel like you have your own piece of paradise. Even when the villas are fully booked, there is no feeling that you are sharing a beach towel with the person next to you like many of the packed resort beachfronts. In fact, the Coral Stone Club offers more beach and pool space per guest than any other accommodation on Seven Mile Beach.

If the ideal location and ample beach space aren't enough of a selling point, the villas can also save guests a bit of money. For small groups, the Coral Stone Club can offer a much more economical option than staying at the large resort hotels, without compromising on luxury. Almost every villa offers a three bedroom, three bathroom configuration and can easily accommodate six guests. Along with a living area, dining area, multiple balconies and screen-in patio, guests can enjoy the freedom of a fully equipped kitchen, perfect for a simple evening in rather than eating out at a restaurant. Many of the condos also feature a wine fridge for a cool glass to relax with after a long day. The facilities exude luxury, from the modern fitness centre, lighted tennis courts, two whirlpool spas, to the large zero-entry infinity edge pool, ideal for a quick swim or for enjoying the sunshine on the spacious and beautifully landscaped pool deck. Each villa offers nearly 1,800 square feet of space at a lower price tag than hotels.

"The facilities exude luxury, from the modern fitness centre, lighted tennis courts, two whirlpool spas, to the large zero-entry infinity edge pool, ideal for a quick swim or for enjoying the sunshine"

This can offer much better value for money for a small group coming to the Islands for business.

Traditionally, Coral Stone Club is a popular choice for families, offering a friendly atmosphere and plenty of space. It is often the case that many who do business in the Cayman Islands, such as captive insurers who come to the Islands as part of meeting requirements for offshore captives, will return to the villas with their families for their next vacation after discovering its many charms. The Coral Stone Club is truly a luxury home away from home with many guests choosing to return year after year. The accommodation's website even allows guests to view the condos online, each of which is uniquely decorated, to select the one which suits them the best.

Between dashing from meeting to meeting, the Coral Stone Club offers a tranquil oasis to enjoy some downtime if you have some to spare. In addition to relaxing on the world-class beach, there's no shortage of activities from snorkelling, boating, parasailing, and scuba diving, and the attentive staff on the property are always happy to offer recommendations for what to do and assist with reservations.

> "Many who do business in the Cayman Islands, such as captive insurers who come to the island as part of meeting requirements for offshore captives, will return to the villas with their families for their next vacation"

Guests can spend their evenings on the pool deck or one of the three balconies each villa offers, enjoying a glass of wine or picnic as they watch the sunset over the ocean. The Coral Stone Club has no shortage of breathtaking views and all of the units are ocean front, making it the perfect place to end the day.

So whether your next trip to the Cayman Islands is full of long meetings and busy conventions, or a tranquil escape with family or friends, skip the hotel and indulge in this little piece of paradise at the Coral Stone Club.

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LOOKING INTO THE FUTURES

Rich Consul and Greg Oviatt of Munder Capital discuss a risk mitigation strategy for captive fixed income portfolios

Captive insurance companies insure a broad array of risks, yet they all generally have one risk in common: interest rate risk inherent in their investment portfolios. The traditional captive insurance portfolio is typically heavily weighted in fixed income securities and these portfolios, like any fixed income portfolio, are now facing downside risks that have been given very little attention until recently. Fixed income investors had become accustomed to declining interest rates, which for the past several years have hovered at historically low levels. That trend took an abrupt turn in the second quarter of this year as signs of a stronger economic recovery and policy makers questioning the marginal benefits of additional bond purchases (quantitative easing) sent interest rates significantly higher over the spring and summer months.

One result of the ultra low interest rate environment has been the reach for yield, that is, investors' tendency to invest in longer maturity securities to achieve higher yields in their portfolios. The downside to this strategy is that there is no free lunch; in other words, by extending the maturity structure of a portfolio, the level of interest rate risk rises as well.

Given the inverse relationship between bond prices and yields, rising interest rates negatively impact the value of fixed income securities, and hence returns. The magnitude of the impact depends on the maturity of the security; the longer the maturity, the greater the impact interest rate movements may have on the value of the security. A bond's duration measures this sensitivity of a bond's price to movements in interest rates. For example, a bond with a duration of 4.5 years would be expected to decline in value by around 4.5% for a 1% rise in interest rates. As such, it stands to reason that an investor that holds short term bonds may be willing to stomach the volatility associated with rising interest rates given the lesser impact on market values; but, the investor that holds intermediate (five to 10 year maturity) bonds or long term (10+ year maturity) bonds is likely to be much more concerned with higher interest rates.

There are several strategies that may be employed to help protect fixed income portfolios from the negative impacts of higher interest rates. A generic solution is to transition the portfolio to a shorter strategy whereby the investor sells the intermediate and long-term securities and purchases shorter maturity securities that are less sensitive to interest rate movements. A potentially more effective alternative to this, however, would be to use US Treasury futures contracts to shorten the overall portfolio duration and thus reduce the level of interest rate risk inherent in the portfolio. Important to note is that futures in this strategy are used for risk reduction only and not speculative purposes.

To highlight the differences between these two potential strategies, the example in table 1 will compare moving an intermediate duration portfolio to a portfolio benchmarked against a one to five year index and a strategy using Treasury futures to shorten overall duration while maintaining the existing inter-

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mediate portfolio. As you can see from the table, a move from an intermediate portfolio to a one to five year portfolio reduces the overall duration from 4.07 years to 2.53 years while the portfolio yield drops from 1.96% to 1.10%. This results in the portfolio duration declining by 38% while the portfolio yield drops by 44%. Importantly, there may be significant transaction costs associated with this type of portfolio strategy as a large portion of the portfolio would need to be sold and reinvested into new securities. Furthermore, realised capital gains and losses resulting from these transactions and the associated tax consequences need to be considered as well.

Alternatively, if an investor was to take the existing intermediate portfolio and use Treasury futures to hedge the interest rate exposure of two year and longer maturities, the results appear much more compelling. In this case, the portfolio duration is sliced into buckets; two year, five year, seven year and 10 year and the resulting duration exposure in each bucket is hedged by selling short the necessary quantity of Treasury futures contracts in order to reduce the overall duration in each bucket to zero (or the desired target). In the example given, the portfolio duration declines from 4.07 years to 0.90 years, a 78% reduction while the yield drops from 1.96% to 1.04%, a 47% reduction. As can be readily seen, this strategy employing the Treasury futures allows the investor to reduce overall interest rate sensitivity more (an additional 40 percentage points) while sacrificing only a modest amount of additional yield as opposed to fully transitioning a portfolio to a shorter maturity strategy. Additionally, Treasury futures are highly liquid instruments with minimal transactions costs, which we believe results in a much more efficient means to manage interest risk.

In taking the analysis a step further, table 2 illustrates how differently these strategies perform in varying interest rate environments. Specifically, each portfolio was stress tested through scenarios with interest rates unchanged, a parallel shift in the yield curve down 100 basis points and a parallel shift up of 100 and 250 basis points. In the scenario with interest rates unchanged, the unhedged intermediate portfolio exhibits the strongest returns, an expected outcome given the longer maturity and higher yielding securities held. In the declining interest rate scenario, again, the intermediate portfolio generates the strongest returns given the longer duration securities held, which you'll recall, are more sensitive to interest rate movements. It's the third and fourth scenarios, an increase of 100 and 250 basis points, where the differences between the hedged and unhedged portfolios become abundantly clear. In the rates up 100 basis points scenario, the hedged portfolio is the only portfolio to generate a positive total return. In the rates up 250 basis points, the unhedged intermediate portfolio produced a decidedly negative total return of -8.22% and the one to five year portfolio returned –5.23%, better, yet still undesirable. In sharp contrast, the potential benefits of hedging are evident as you compare the unhedged and hedged intermediate portfolio; the hedged portfolio produces a total return that, while still negative, is seven percentage points better than the unhedged portfolio and four percentage points better than the one to five year strategy. The potential advantages of actively managing interest rate exposure and yield curve positioning are clearly demonstrated in these examples and should be evaluated for inclusion in actively managed fixed income portfolios as investors navigate a more volatile interest rate environment in the coming quarters and years.

While it is important for each captive insurance company to consult their service providers and regulators as to the applicability of the investment strategies highlighted above, we believe it is important for captive mangers and boards to know there are options. There is no better time than the present to have these discussions with their investment managers and begin to plan for the eventuality of higher interest rates. Each captive will have differing needs and constraints, yet it is incumbent upon their investment manager to make them aware of the options available for managing interest rate risk, because as we all know in the captive insurance world, it's not a one size fits all business.

TABLE 1 | Migrate to a shorter duration composite

Portfoliotype	Composite duration	Composite yield	Duration change	Duration change (%)	Yield change
Intermediate duration portfolio	4.07	1.96	-		-
1-5 short duration portfolio	2.53	1.10	1.54	38%	0.86
1-3 short duration portfolio	1.75	0.87	2.32	57%	1.09
Intermediate portfolio w/ futures overlay	0.90	1.04	3.17	78%	0.92

Source: Factset, Munder Capital Management

Example is for illustrative purposes only and should not be relied upon as an indicator of future results.

TABLE 2 | Scenario analysis: 12 month total return

	Rates down 100 bps	No change	Rates up 100 bps	Rates up 250 bps
Intermediate duration portfolio	6.03%	1.96%	-2.11%	-8.22%
1-5 short duration portfolio	3.63%	1.10%	-1.43%	-5.23%
1-3 short duration portfolio	2.62%	0.87%	-0.88%	-3.51%
Option (Intermediate portfolio w/ futures overlay)	1.94%	1.04%	0.13%	-1.22%

Source: Factset, Munder Capital Management

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Past performance does not guarantee future results.

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