GROWTH
The captive space continues to demonstrate significant growth on the island

STRUCTURE
Why insurance-linked securities and PCCs are proving to be popular captive structures

LOCATION
How Guernsey offers an alternative location to other European domiciles
High-flying

CORPORATE & COMMERCIAL / TRUST & FIDUCIARY / FUNDS
INSURANCE / PROPERTY / DISPUTE RESOLUTION / INSOLVENCY

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The Guernsey Financial Services Commission (GFSC) licensed 89 new international insurers during 2013. This means there were 758 international insurers licensed in the island at the end of December 2013.

A significant proportion of the licences issued were associated with structures related to insurance linked securities (ILS). This included a Shariah-compliant ILS structure that was judged as the top innovative deal in Europe and one of the Islamic finance Deals of the Year 2013 by Islamic Finance News.

However success on this scale doesn’t simply happen. The groundwork for ILS was laid in Guernsey from 2005 and the number of transactions steadily built year on year. The surge in deal flow in 2013 derives from a fundamental shift in the markets as investors from the capital markets have sought returns on capital from the insurance market. Convergence gathered momentum in 2013 and Guernsey was ready to react.

The Guernsey International Insurance Association (GIIA) established a new Market Development Committee and an ILS sub-committee in 2013, with the aim to continue to develop Guernsey as an innovative and attractive environment for establishing a wide variety of international insurance entities.

Of particular importance is our regulatory regime which continues to respond to innovative proposals and this was reinforced by the GFSC’s decision to form an Innovation Unit within the regulator.

Guernsey also offers proportionality through meeting the insurance core principles of the International Association of Insurance Supervisors (IAIS). The decision taken in January 2011 not to seek equivalence with Solvency II looks prescient in the light of the recent announcement from the European Captive Insurance and Reinsurance Owners’ Association (ECIROA) that as Solvency II stands, “eight out of 10 European captives will fail to qualify for simplified solvency capital treatment in 2016”.

Guernsey stands strategically well positioned to provide the natural alternative jurisdiction for those captives.

Guernsey was named ‘European captive domicile of the year’ at the UK Captive Services Awards 2013 and independent research carried out by trade publication Business Insurance (March 2013) ranked Guernsey as the largest captive insurance domicile in Europe.
The latest figures from the Guernsey Financial Services Commission (GFSC) show that Guernsey continues to grow its insurance industry. At the end of December 2013, there were 758 licensed international insurers in Guernsey – a net growth of 21 international insurers over the previous 12 months. Much of this growth relates to the use of protected cell companies (PCCs), incorporated cell companies (ICCs) and associated cells within the increasingly popular concept of insurance linked securities (ILS).

The reasons for the attractiveness of ILS as a structure and an alternative asset class for insurers and investors are two-fold:

1. ILS permits an insurer to purchase additional protection for low frequency, high severity losses, including natural and non-natural perils, operating in the traditional insurance market, typically in the form of catastrophe ‘cat’ bonds or collateralised reinsurance.

2. Investors like ILS because returns are non-correlated with the general financial markets.

Guernsey’s great strength is that it has a long and strong heritage in both the investment funds and insurance sectors, making it the optimum location for ILS. Remember, Guernsey pioneered the cell company concept back in 1997 with the introduction of the PCC for use in the captive insurance sector. The subsequent success of this innovation is illustrated by the fact that we’re ranked as the number one captive insurance domicile in Europe and the fourth largest globally, while the cell company is now used across the financial services world as an alternative application for the structuring of many different types of products. As well as adopting the similarly innovative ICC, the island has, through legislative advancements, developed a regulatory infrastructure that enables them to be widely employed.

PCC and ICC structures provide a low cost, low administration vehicle to access returns from the reinsurance market and some ILS funds avail themselves of both within their growth strategies.

**Guernsey pedigree**

At the time of writing there are in excess of 50 protected cells established in Guernsey across four different PCC platforms having written fully collateralised reinsurance primarily covering property catastrophe risks, marine, crop and other classes such as premium rein-

“Guernsey’s great strength is that it has a long and strong heritage in both the investment funds and insurance sectors, making it the optimum location for ILS”
statement or prize indemnity. Protected cells in Guernsey are also being used to conclude International Swaps and Derivatives Association (ISDA) arrangements as an alternative to a reinsurance contract.

In 2012, the Channel Islands Securities Exchange (CISE), formerly known as the Channel Islands Stock Exchange (CISX), became home to the first private catastrophe bond listed on any exchange worldwide when Aon Insurance Managers in Guernsey – which has been involved with more than 80 ILS transactions since 2006 – worked with Swiss ILS manager Solidum Partners AG to establish

Soldium Re Eiger IC Limited. It is an insurance vehicle which listed bonds with a value of $52.5m on the CISE and was the first CISE listing where natural catastrophe perils are the underlying exposure for 'principal at risk' notes. It also incorporated a dual listing with the Vienna Stock Exchange.

Cedric Edmonds, partner at Solidum Partners and director of Solidum Re Eiger IC Limited, said Solidum Partners selected Guernsey as its jurisdiction of choice for its incorporated cell reinsurance company and private catastrophe bond platform due to the "incorporated cell company legislation and incorporated cell reinsurance company and private catastrophe bond platform due to the incorporator's desire to have the full range of services on the island. Indeed, a significant majority of the international insurers licensed in Guernsey have their parent company located in the UK, was not designed for captives as they have parent companies as their policyholders.

The European Captive Insurance and Reinsurance Owners’ Association (ECIROA) has similarly found issues with the way Solvency II has been drawn up. The Directive may have had its implementation date pushed back to 2016, but as it currently stands eight out of 10 European captives would fail to qualify for solvency capital treatment because they carry liabilities underwritten for disposed entities, according to ECIROA. If the rules go unchanged then ECIROA believes many captives will be forced to close or move outside of the EU to escape the onerous capital and reporting requirements required under Solvency II.

We certainly feel the early clarity we gave in relation to Solvency II has played a part in the continued growth of our captive sector over the past couple of years. Indeed, a number of Guernsey practitioners have already reported receiving instructions to migrate captives from jurisdictions such as Bermuda to Guernsey, due to the uncertainty created by the delays associated with Solvency II and the requirements for equivalence within the Directive itself.

This clearly demonstrates that captive owners recognise Guernsey’s expertise in the sector. They like our close proximity to London, our speedy and proportionate regulation and that our decision not to seek equivalence with Solvency II had the backing of owners with captives already in the island.

Conclusion

The insurance industry in Guernsey has its origins dating back to the 18th century and the island’s first captive insurance company was incorporated in 1922. Since that time we have continually evolved our offering, with ILS becoming just the latest concept that can capitalise on the expertise we have honed in the captive insurance markets and which, in turn, further enhances our attractiveness as a location of choice.
FROM TINY ACORNS...

The rise of the PCC has given Guernsey a huge advantage in the captive space, a trend set to continue in the years to come. This tiny island is set for big things.
“There are many advantages of being in Guernsey, such as the strong regulatory regime, the excellent infrastructure and experienced professional community.”

The current success of PCCs is due to Guernsey being a trailblazer with the initial legislation and having a strong understanding of how it can operate.”

A pragmatic regulatory regime, the excellent proximity to the UK and other European jurisdictions and the favourable tax regime.

Guernsey’s regulatory system is raised by a number of industry professionals as a key factor to the island’s success. Le Conte adds that the GFSC is an “excellent and approachable” regulator with “flexible and commercial” regulations. The jurisdiction’s decision not to adopt the requirements of Solvency II has also received a favourable response from international insurers and therefore attracted business.

“There are many captives coming to the end of their lives due to commutations and non-renewal of policies. The GFSC states that there were 242 ‘traditional’ captives as at 31 December 2013, strikingly lower than the number of PCC cells. However, this figure remained stable throughout 2013 which is encouraging considering 17 traditional captives surrendered in 2012.

Sticking to the rules

Guernsey has grown to become the leading captive insurance domicile in Europe, recognised as the pioneer of the PCC and the incorporated cell company (ICC). But what makes the island so attractive?

Becker says: “There are many advantages of being in Guernsey, such as the strong but pragmatic regulatory regime, the excellent infrastructure and experienced professional community, the proximity to the UK and other European jurisdictions and the favourable tax regime.”

David Riley, head of office at Marsh Guernsey, says: “Regulation has been integral to the growth of the insurance industry in Guernsey. The current success of protected cell licences is due to Guernsey being a trailblazer with the initial legislation and having a strong understanding of how it can and should operate in practice.”

A challenge

It has not all been plain sailing for the industry in Guernsey, however. The jurisdiction may not have the burden of Solvency II like many other captive domiciles in the European Union, but it does share with them the issue of cost and soft markets.

Riley explains that soft markets driven by over capacity, coupled with low interest rates, continue to pose challenges for the industry by increasing the cost of self-insuring through a captive structure. Le Conte adds that the reinsurance market has been soft for some time which impacts on the effectiveness of captives against placing risk in the market, in turn making captives for some owners less viable.

The cost of running captive vehicles is a permanent issue in the sector and efforts to reduce these costs are paramount. Indeed, the PCC structure was created as a means to do this and is proving successful in making the captive solution more accessible. Becker also highlights the work of the Risk Purpose Trust – a Guernsey based mechanism which offers a solution to budgeting and providing for business risks and expenses, thereby helping to curb business costs and demonstrating Guernsey’s innovative approach at overcoming challenges.

Captive owners have also been obliged to spend more time meeting the increasing corporate governance requirements that are occurring in the sector. Becker explains that the need for corporate governance disciplines can sometimes be a challenge for captive owners, but points out that the “Own Solvency Capital Assessment” (OSCA) introduced as a requirement by the GFSC in 2008, provides a framework for a better understanding of the risks associated with a captive to help directors assess and overcome these risks.

The future

On the whole, the future remains bright for the captive insurance industry in Guernsey. Evidence of the growth in cells over recent years suggests that it is highly likely for this trend to continue. Vincent Barrett, managing director of Aon-owned cell operator White Rock Group says: “We’re seeing a lot of insurance-linked securities growth within the PCC and ICC structures and all projected indicators are that the ILS sector will continue to grow.”

Barrett reiterates Aon’s predictions that the composition of reinsurance capital will change. There will be an influx of significant amounts of capital into the reinsurance sector which will primarily focus on ILS type risk, and this will continue to be the major growth area. Aon estimates that the ILS sector currently accounts for $44bn of reinsurance industry capital.
Once the legislation for Solvency II has passed, more attention will be focused on where risk managers strategically want to bring their captives, which could, according to Barrett, encourage managers to set up in Guernsey. Ian Morris, a partner of the BWCI Group, also reflects that the burden of compliance with Solvency II is becoming a significant factor for EU-based managers on their decision of where to domicile, which could again continue to work in Guernsey’s favour.

Alongside this, Le Conte expects the regulatory regime for pure captives to become even more pragmatic with a greater focus on commercial insurers.

From an auditor’s perspective, Becker explains that changes in accounting rules under both UK and international accounting standards will require significant changes in the way in which insurance contracts are accounted for. This could in turn lead to a substantial increase in costs associated with preparing and auditing this information which could impact on the viability of certain structures. He says: “The way in which Guernsey responds to this challenge will be key and I am glad to say that the industry has already started to engage with the regulator to ensure that a pragmatic and innovative solution is found and that the impact of such changes are minimised.”

The bottom line:
As Riley explains: “The last 12 months have demonstrated that Guernsey has a core of highly qualified captive professionals who are able to identify niche opportunities and implement these effectively. Undoubtedly there are other opportunities out there, so the challenge will be to identify these. There is certainly momentum building around insurance-linked securities which is expected, by the industry and regulator alike, to grow.”

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<td>Captives have been present in Guernsey since 1922</td>
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<td>Guernsey is the leading captive insurance domicile in Europe…</td>
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<td>…and number four in the world</td>
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<td>Guernsey was the first jurisdiction to implement the PCC</td>
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<td>Around 40% of the UK FTSE100 companies with captives have them domiciled in Guernsey</td>
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Source: Guernsey Financial Services Commission
We act for captive insurance companies who provide cover across a wide range of insurance sectors, providing a partner-led bespoke audit solution. This enables us to provide a prompt and efficient audit, which ensures that our clients meet their regulatory deadlines.

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Guernsey’s heritage as an international insurance centre has helped build an infrastructure and expertise that is ideally suited to providing a range of alternative risk management solutions.

The following selection of facts and figures highlights Guernsey’s position as one of the leading captive domiciles globally.

Vital statistics
Guernsey continues to retain its position as the leading captive domicile in Europe and number four in the world.

Approximately 40% of the leading 100 companies on the London stock exchange with captives have them domiciled in Guernsey.

Guernsey pioneered the cell company concept when, in 1997, it introduced the protected cell company (PCC). It has since also introduced the incorporated cell company (ICC).

Numbers of entities
There were 89 international insurance licences issued during 2013. This helped push the net total number of international insurers licensed in Guernsey up by 21, from 737 at the end of 2012 to 758 at the close of 2013 – a 2.8% increase.

Value of business
There has been steady and sustained growth in the value of international insurance business in Guernsey.

The value of gross assets has increased markedly in recent years, reaching £22.9bn (US$37.4bn) in 2012. The net worth of insurance business in Guernsey reached £9.3bn (US$15.2bn) in 2012 – up 37% compared to 2008. In 2012, premiums written were £4.6bn (US$7.5bn), which was a rise of £0.5bn (US$0.8bn) on 2010.

Location of parents
New captives, PCCs, ICCs and cells licensed in Guernsey during 2013 were predominately established by UK and Cayman parent companies – 38.63% and 31.82% respectively.

For the UK this represented a fall from 2012 where it was the home to 80% of the new additions, while Cayman was only responsible for 9% in 2012.

The island still boasts a truly international insurance sector, illustrated by the fact that the spread of new business includes Europe (Ireland, Luxembourg and Switzerland), the US-Caribbean (US and Cayman), the Middle East (Abu Dhabi) and Asia/Pacific (Singapore and Abu Dhabi).

This is all in addition to existing business that is spread across these regions and beyond.

2013 NEW LICENCES BY PARENT LOCATION

- UK: 38.63%
- Cayman: 31.82%
- Ireland: 6.82%
- US: 5.68%
- Guernsey: 3.41%
- Bermuda: 3.41%
- Switzerland: 3.41%
- Australia: 2.27%
- Singapore: 2.27%
- Luxembourg: 1.14%
- Abu Dhabi: 1.14%
Guernsey remains a leading international financial centre, with strong expertise in the fiduciary, funds, investment and banking sectors, in addition to being Europe’s largest captive insurance centre and the fourth largest globally. A key part of Guernsey’s success has been its proactivity in promoting the capabilities of the island and establishing strong long-term relationships with key business partners and introducers.

This theme of exploring and deepening relationships is no different in the captive sector. Increasingly we are seeing captives being established in the island where the establishing parent is interested in maintaining existing relationships and maximising efficiency in the way its insurance structure will be run.

This can be achieved where the captive is established in the island with partners that are also connected with the parent company, for example the captive might be established with a local bank, like Barclays, that also provides banking services to the captive’s parent company.

Primarily the benefits centre around a greater familiarity between the parties responsible for establishing the captive which grants flexibility in terms of establishing the structure, choosing investments and speeding up processes including the establishing of basic banking accounts through to the provision of collateral arrangements, whether this is through letters of credit (LoC) or trust arrangements.

For example, an arrangement for a captive entity where the parent is also known to the bank, allows the captive to be established with the balance sheet and investment objectives of the parent company being taken into account. This in turn allows a banking partner, with the enhanced knowledge of the parent company as well as the needs of the captive, to look at a broader range of solutions. The result is that the bank will often be able to increase yield through the captive, while still meeting the parent company’s asset diversification programme. This could be achieved by shifting an asset class from the parent balance sheet, gilts, bonds, equities to the captive balance sheet and not holding it on the balance sheet of the parent.

Further, this can have benefits for the financial status of the captive as it makes the captive more cost-efficient in its own right and it ensures that the captive is not just viewed as a cost centre but an income generator for the parent.

Outside of asset use within the captive, these synergies can also lead to the introduction of more economically and operationally efficient structures for captives. As an example, historically, the most common way for a captive to secure its fronting insurance arrangements was by a cash backed LoC. While this may still be a valid option, we are increasingly seeing captive boards using alternative options that are more flexible and cost effective, such as the Security Trust Agreement (STA), and also looking at ways in which the assets of the captive can generate increased yield, within defined risk parameters.

Through seeking to implement new strategies of asset holding into captives, such as the STA, a historical hurdle has been the lack of understanding of these products and their use. With the increasing access to the parent as well as the captive, we have now started to find these ideas are being better received. Principally this is because these products are not far removed from what many larger corporates will use in their day-to-day activities and this knowledge is now being brought closer to the captive structures. The representative(s) from the parent company that sit on the
board of the captive can be helpful in shaping discussions and decisions taken, while recognising the separate governance structure around the captive.

As the ties between parent company and a captive are reinforced at respective board levels, this has changed the emphasis for captive service providers who now have to view the process of establishing captives more holistically. Previously, decisions were principally made based on what was best for the captive. We are experiencing an increasing trend in captive managers informing us that they have to bear in mind that what is good for the captive may not be good for the parent. We are also witnessing that the representation on the captive board is increasing in seniority from the parent company e.g. a finance director currently where previously a finance controller would have been present. This is a response to parents wanting the captive to work harder for them as they are no longer guaranteed to be self-sustaining through interest rate return on cash held alone.

This evolution of captive boards has meant that increasingly they are looking at a broader range of potential solutions for the captive that drive efficiency and return. Shared banking providers also means that the representatives of the parent company that sit on the captive board will typically already know the capabilities and individuals within the bank the captive is dealing with, they can therefore be more demanding and insistent on what they expect and wish from their banking partner.

Having closer ties between the two, and indeed between the advisors and relationship managers of each party, means that these decisions can be made more easily and that all parties can be kept informed of why certain actions are being taken. To illustrate the benefit of this approach, one of Guernsey’s leading independent captive managers gave us their view: “The client appreciated the ‘joined-up’ approach used by Barclays in bringing the client’s UK relationship manager into the discussions with the captive board in Guernsey. The parent company and the captive were already both using Barclays’ banking services, and the UK relationship manager’s knowledge of the potential expansion into the captive’s investment management activities enabled her to link in with the parent company’s treasury team and ensure that their reporting and other requirements were being met from a group perspective.”

Guernsey is particularly active in promoting this part of the captive management space because it demonstrates the importance of ongoing management to the successful use of captives. Rather than just a handy jurisdiction for establishing an insurance perspective, Solvency II has created challenges and opportunities. In this particular case this has provided benefits for Guernsey as it is not part of the European Union. The banking industry also continues to go through change, with Basel III affecting the treatment, and therefore the potential cost, of letters of credit. We continue to see Guernsey captive managers being proactive to change, as they work with their clients not only on their day-to-day requirements of the captive, but planning for the future to make sure captives in Guernsey are equipped to deal with future changes in a positive way.

Above all, working with existing contacts gives great comfort to companies looking to establish a captive. In an era when ‘know your customer’ is increasingly important it is perhaps not surprising that ‘know your service provider’ is becoming more critical to business decisions. Using the same banking partners for both corporate and captive structures makes business sense and reflects Guernsey’s resolve to provide a more holistic approach in the initial establishment of a captive, while also aligning service providers that will be able to support the captive as its needs change over its lifecycle.

“Part of any successful relationship includes having an eye to the future”
CORPORATE GOVERNANCE: AN AUDITOR’S VIEW

Jeremy Ellis of Saffery Champness discusses the importance of corporate governance from the perspective of an auditor

Jeremy Ellis is responsible for developing the growth of the Guernsey Audit and Tax Partnership. He is also at the helm of the Audit Engagement Quality Control Review process. He has 20 years’ industry experience. Initially an external advisor, Jeremy joined the partnership in early 2010 and was appointed audit partner in 2012. He is a chartered certified accountant and was admitted as a fellow in 2003.

Captive Review (CR): Do you think the demands of recent regulations will lead to better corporate governance for captives? Why or why not?
Jeremy Ellis (JE): There is a consultation paper circulating in Guernsey which aims to follow the core principles of the International Association of Insurance Supervisors (IAIS). Guernsey needs to keep pace with emerging international standards in insurance regulations and these could potentially have an impact on captives. Most people will understand the link between operating in a highly-regulated environment and the need to observe corporate governance standards. However, captives are not quite the same as other entities so not everything will apply across the board. Regulators need to look at captives slightly differently – it’s not a one size fits all approach.

In general, companies need to be aware of corporate governance and certainly from an audit perspective, good corporate governance will provide us with greater comforts as
far as internal controls are concerned. During the course of an audit we’re required to highlight to those charged with governance any weaknesses in internal controls. Robust corporate governance will certainly help to reduce the number of issues that might need to be discussed for all sorts of entities, captives included. The right type of corporate governance, amended for specific entities, needs to be there for the protection of the shareholder, but this is somewhat different for a captive because the shareholder is nearly always the parent and will be well-informed; the parent company will have some sort of representation on the board. A lot of the captive parents will be listed entities themselves and their subsidiaries will fit within the framework of the group as a whole and be governed accordingly, probably tailored to fit the needs of the captive. This helps us from an audit perspective because good strong corporate governance enables us to place better reliance on controls and rely less on substantive testing. If you’ve got a good control environment then it mitigates the risk of things going wrong.

CR: Are there any upcoming regulations in 2014 that will put increasing demands for corporate governance on captive managers?  
JE: The outcome of the current consultation and any draft rules and guidance will not be known until sometime in the first quarter of 2014. There may not be huge changes to what is currently undertaken under the existing rules, but in general people are getting used to having to jump through more hoops as far as corporate governance is concerned. As far as captives are concerned, the consultation paper mentions that governance issues will continue to have up to date systems in place and any draft rules and guidance will not be included. The right type of corporate governance, amended for specific entities, needs to be there for the protection of the shareholder, but this is somewhat different for a captive.

CR: What steps should captive managers take to improve their corporate governance?  
JE: Most captive managers have got good systems in place regarding corporate governance for the captives they manage. As part of our audit we have to look at adherence with laws and regulations and we generally find that managers are ensuring that the captives are meeting their obligations. It forms part of annual and ongoing reviews that they are complying with all of those regulations. It’s probably largely a matter of keeping abreast of any changes and making sure that their systems are updated as and when necessary. Captive managers have representation on the relevant industry committees that helped to mould the regulations which resulted in the consultation and therefore should be well informed as to any potential changes. From an audit side we need to make sure that they continue to have up to date systems in place for the captives that they manage. Any deficiencies in these systems and controls, which are effectively the systems and controls of the captive, will need to be discussed with those charged with governance.

CR: How important is it for a captive to have an independent director on the board?  
JE: It’s very important to have an independent director on the board. As with anything, a lot of people can get involved very heavily in the day-to-day side of things so it is very good to have someone who has no link to the parent company or the manager and can look at things in the cold light of day and raise questions. They perform a similar function to us as an auditor: to examine things. We’re required to challenge management and those charged with governance on estimates and decisions they’ve made in preparing financial statements and that’s where an independent director can help.

“We’re required to challenge management and those charged with governance on estimates and decisions they’ve made in preparing financial statements and that’s where an independent director can help”

CR: How would the introduction of a cap on directorships affect the industry? Would this lead to better corporate governance?  
JE: It’s probably six of one and half a dozen of the other. There are people who would argue that if there was a cap on directorships it could limit the number of boards the most appropriately qualified candidates could sit on. The captive may end up having to appoint people who were not best qualified for the job. On the other hand it could be argued that a cap would enable captives to broaden their base of candidates, who may be able to provide a fresh perspective on corporate governance. Not having a cap may result in a small pool of people getting the majority of the directorships which might lead to a better service because of their depth of knowledge and experience. Whether there is a cap in place or not, the most important point for captives is to ensure that they appoint the candidate that best suits their needs. As far as Guernsey is concerned, I do not think that a cap would have an impact on the quality of corporate governance as there are a large number of individuals with the appropriate qualifications to serve as an independent director.
In late 2012 many City of London analysts were predicting a ‘triple dip’ recession, voicing fears that 2013 would be another grim year for UK PLC. While economic activity in 2013 didn’t shoot out the lights, estimated consecutive quarterly growth of 0.3%, 0.6% and 0.8% for the first three quarters illustrates that the UK economy fared a lot better than many predicted and that activity accelerated as the year progressed. The Bank of England predicts that Q4 GDP growth will be 0.9% and, while the finalised total 2013 GDP figure will not be known for another 18 months or so, if the current estimates had been offered to the Chancellor a year ago I think that most bookmakers would have offered short odds that would have been gratefully accepted.

2014 appears to start from a much better position, although the problem is of course that the starting point a year ago was so low that almost any positive news was treated as a surprise. Perhaps the issue now will be that, while the recovery will continue to gather pace, the momentum may cool as quarterly GDP figures in 2014 do not match those of late 2013, although the overall growth rate for 2014 should exceed 2013. Assuming that the Bank of England is correct and the recovery has “finally taken hold”, the other issue to be grappled with in the coming year or two will be how Central Banks can “normalise” their monetary operations, which will obviously mean higher interest rates at some point or other and will involve balancing the threat of stifling the recovery with preventing another build up of cheap credit.

First of all, let’s continue the positive theme with some more upbeat economic statistics. Aside from the continuing encouraging economic indicators, there have been several recent positive surveys which are worth highlighting. 122 CFOs were recently asked about prospects for 2014, and nine out of 10 reported that they expected revenues to improve and also anticipated increasing investment and hiring in the year ahead. Separately, another survey reported that the willingness of companies to invest is currently at a 19-year high with higher optimism than at any other point
since 2007. The main reasons given for this optimism are improved access to funding and greater confidence in the Bank of England’s policies.

Our internal base forecast (i.e. the scenario to which we attach the highest probability) for UK GDP growth for 2014 is 2.7%, which is very slightly ahead of the 2.5% forecast by the MPC. Our base case continues to assume no disorderly euro break up and is cautious on global growth relative to pre-crisis conditions. Our base forecast for inflation has been reduced slightly over the last few months to 2.0%; the reason for this is due in part to the likely impact of the recent rise in sterling. We expect oil prices over the next year to remain broadly stable with the potential increase in demand caused by growth in the world’s largest economies being matched by an increase in supply.

Inflation has been trending downward over the last few quarters and, while it is still above the 2.0% target, the margin of overshoot has reduced dramatically since the days in 2011 when CPI stood at over 5.0%. This reduction in inflation together with a more robust economic outlook might offer the beginnings of an answer to the “cost of living crisis” – the fact that wage increases have not kept pace with inflation. While the Office of National Statistics’ monthly figures are reporting that pay increases were on average 1.1% over the last year, there is some hope that the gap with inflation will narrow further and may even close completely assuming inflation remains closer to target and the confidence of the various CFOs reported above is not completely misplaced. Of course, although this development would be welcomed, the actual improvement in real wages (i.e. inflation adjusted) is not likely to be anywhere close to the 2% per annum which used to be considered normal and so households are not likely to feel very much better off in the near term, and then of course the cost of servicing debt will rise at some point.

Looking further ahead into 2014 there is growing optimism that another milestone in the UK’s economic recovery will be reached. In December 2013 the British Chambers of Commerce announced its latest forecasts, which suggested that in the third quarter of 2014 the overall size of the UK economy will finally return to positive territory. In other words the economy will surpass its previous peak which was reached in the first quarter of 2008. While much has changed in the intervening period, the resumption of fresh growth will be welcomed by all.

As previously mentioned, the challenge for central banks is to remove stimulus without derailing recoveries. To that extent, the Bank of England has tried to provide some clarity with the new ‘Conditional Forward Guidance’ (CFG) policy, which was unveiled in August 2013 and stated that the MPC would not even consider raising interest rates until unemployment was below 7.00%. At the time this announcement was made, the MPC was forecasting that this rate was unlikely to be reached until 2016. However, the stronger economic data has meant that unemployment has fallen far faster than was expected and when the next round of MPC forecasts were published in November 2013, the Bank of England attached a reasonable possibility of the 7.00% target being reached in the last quarter of 2014. This of course poses a problem for the MPC; it appears that the introduction of CFG was designed to delay market expectations of a UK interest rate rise in 2015 until 2016. However, the stronger than expected data threatens to do exactly the opposite and stoke expectations of an earlier rise.

MPC reaction has been to state repeatedly that the 7.00% threshold is only the point at which they will start to assess whether a rate rise is necessary and they continue to reiterate that they are unlikely to sanction a rate rise for a considerable period of time after this point has been reached. Some commentators think that the Bank may underline this message further by amending the unemployment threshold to a lower figure: 6.5% has been mentioned by some. This course of action would buy the MPC more time but it may cost them a loss of credibility. On balance then, it is likely that rates will remain on hold in 2014, although a move in 2015 is becoming more likely. Of course, this is when official interest rates will rise: we would expect longer term market rates to rise in advance of this and so are hopeful that the sterling yield curve will steepen as 2014 progresses, which should provide opportunities to begin to improve returns for actively managed cash portfolios.

Finally, lest this article should be considered too optimistic, we have to consider what may go wrong in 2014. Starting from a macro picture, the eurozone must still feature towards the top of most people’s list of potential problems. While conditions have definitely improved and there are even tentative signs of improvement in the peripheral economies, there are still problems which could yet cause further disruption. The ECB cut interest rates in late 2013 over deflationary fears and the French economy is perhaps giving the most cause for concern at present. However, given how important France is to the EU it would be assumed that should support be required it would be given quickly.

Back in the UK it is possible that economic data will start to disappoint which will cause this fragile sense of optimism to evaporate. On the other side of the coin, there is a danger that interest rates will rise more quickly than the MPC ideally want them to: if perhaps fears grew of a house price bubble coupled with an early rate rise in the U.S. In this scenario, the fear would be that the pace of interest rate rises was being dictated by forces other than the strength of the UK recovery.

In conclusion and to return to the slightly hackneyed theme of economic forecasts and bookmakers, on current estimations, the outlook for 2014 and 2015 would again have been gratefully accepted by the powers that be if offered a year ago.
Oh no, not another PCC article, I hear you cry! Well I am afraid so, and with good reason. The statistics for last year, i.e. calendar year 2013, tell us the continued strength of PCC business in Guernsey (see diagram below).

So PCCs and PCC cells were 77% of all new business in Guernsey last year. Here at Robus we followed this trend and in fact, by our reckoning had 28 cells licensed in 2013, making up almost half the 63 licensed in Guernsey in that period.

So PCCs are in our blood, and I speak both as a Guernseyman, and a Robusman.

Why the ongoing popularity?

PCCs rather than standalones – there’s no reason not to

When setting up a new vehicle, our view is that you may as well go down the PCC route, just because – why do anything else?

The costs of a PCC with no cells are exactly the same as a standalone vehicle because at its basic level a PCC is a standalone vehicle. This covers capital, regulatory fees, independent NED fees, audit fees and insurance management fees.

A business can write business through the core exactly as if it was not a PCC entity. So given that a PCC could offer future flexibility, the first question I often ask my clients is ‘why not’? Some PCCs are formed, therefore, without initially utilising cells or utilising just one cell.

Some clients, of course, still prefer a standalone; they just cannot see when they would want or need to use a cell structure and/or they are concerned at confusing counterparties by having to explain what a PCC is and how they are utilising it. These are perfectly valid reasons not to have a PCC structure. Of course, a standalone can be converted to a PCC at some point in the future too if the need arises. But in general our recommendation is to consider forming as a PCC initially ‘just in case’.

PCC cells – still a great concept

Swift to form and swift to close

PCC cells are normally faster to set up than standalone vehicles, because the information required to the Guernsey FSC and consequently their review time is reduced. The corporate structure of the PCC, the board and the auditors, these things are already known and accepted, so a cell application can focus purely on the business plan and ownership of the cell itself.

There is speed of exit too. For a standalone the insurer needs to have liabilities removed and then must go into a liquidation process. For a cell there is no liquidation; once the cell has been emptied of assets and liabilities it can be simply closed through a board resolution.

Value for money

The costs associated with cells are reduced compared to standalone vehicles; regulatory fees are materially reduced and other costs are generally shared in a PCC and again should be lower. Insurance management fees for a single cell should be lower than for a standalone because the manager generally has less work to do as there is only one corporate structure for multiple clients.
Minimum barrier to entry
We rarely see it used but as the minimum capital of £100,000 required for a Guernsey insurer applies to the PCC as a whole, the capital of a cell can be less than that.

Management time
For a client, management time expended on their insurance/reinsurance vehicle can be brought down, specifically around board meetings, because the client will not have representation on the PCC board. Periodic strategy or planning meetings can of course be held but timing is entirely within the client’s remit as opposed to the relative formality and rigour of a full board process.

Flexible
PCC structures offer flexibility; an insurance licensed PCC can also, with regulatory approval, form cells not undertaking insurance business, for example offering guaranties or indemnities or participating in ISDA swaps or similar structures.

These structures can also be facilitated in standalone vehicles but we are of the view that the regulatory oversight of PCCs is a good thing and gives comfort to third parties that business is occurring in a well-regulated environment.

PCCs rather than ICCs – almost always
Guernsey, of course, provides an incorporated cell company (ICC) framework as well as a PCC framework.

Incorporated cells (ICs) are actually very different to PCC cells, given that they are legal entities in their own right. One advantage this brings is that ICs can contract with each other while PCC cells within the same PCC cannot.

Historically ICs had the potential advantage of being ‘floated off’ from their umbrella ICC to become true standalones. However, under revised Guernsey legislation this is now available to PCC cells also.

Against this, costs of ICs are somewhat higher than PCC cells and administration is certainly more burdensome.

So, all in all here at Robus we most often favour a PCC structure over an ICC, although there are specific occasions when an ICC format may be of value.

The rise of ILS
As has been well documented by Guernsey Finance and others, the insurance-linked securities (ILS) market has driven a lot of the growth of PCCs and ICCs in Guernsey, particularly in 2013. Certainly here at Robus our Hexagon PCC Group, led by one of the world’s leading PCC experts, Justin Wallen, has been very active in that sphere and we already see that continuing in 2014.

It’s not all just ILS though
ILS may have led the way in terms of number of transactions, but that is not to say there isn’t other business activity also; we have seen a variety of cells formed in 2013.

PCCs and/or cells are ideal for MGAs and brokers looking to participate in capacity provision and we expect further activity in that sector in 2014.

Conclusion
Looking deeper into the Guernsey statistics as set out on the Guernsey FSC website, tells us that PCCs and ICCs are driving all insurance growth in Guernsey, certainly in terms of number of licensed entities. In the case of standalones, while 10 new licences were issued in 2013, 10 were also surrendered, so that market continues to appear quite flat.

I have no doubt that Guernsey’s love affair with PCCs and cells will continue in 2014, and our view at Robus is that that is quite right. While they are by no means new, having been around now for almost 17 years, PCCs remain a fantastic tool that will stand the test of time and continue to be valued by those interested in Guernsey insurance and reinsurance structures.
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Guernsey as a domicile offers a full range of captive solutions. It was the innovator of the PCC structure and the more recent ICC structure. The benefits of domiciling in Guernsey are clear; however, as the global captive space develops increasing standards as a result of regulation, changes to Guernsey’s regime will become necessary to remain a world leader in this space.

Recently the Guernsey Financial Services Commission (GFSC) has sought to make a number of changes to the Guernsey solvency regime, which is a good example of regulatory consultation with the industry. The process started in early 2012 with a GFSC discussion document concerning a move toward risk-based solvency. This recognised the fact that Guernsey has previously announced intentions not to apply for Solvency II equivalence, a decision which has been fully supported by the industry.

However, Guernsey has made it clear that the island would continue to comply with the Insurance Core Principles issued by the International Association of Insurance Supervisors (IAIS). For Guernsey to continue to comply with its commitments to the IAIS, it was necessary to re-look at its current regulations. In addition, the IMF conducts regular reviews of the island and if Guernsey didn’t operate under a risk-based solvency regime, particularly given that the IMF will be looking at other onshore jurisdictions which are subject to Solvency II, then it could be argued that it is non-compliant.

The initial discussion document asked the industry to look at a variety of matters, including the definition of captives and non-captives, a confidence interval akin to that seen within Solvency II, and what is appropriate in a jurisdiction like Guernsey. Another point that came through the IAIS was called the
ladder of intervention, which effectively asks ‘what are the trigger points of regulatory interaction with licensees, captives, insurers, etc. and how does that escalate?’

Once the industry had responded to the GFSC on the discussion document, they issued the first version of the risk-based solvency spreadsheet, which was then put to various clients, amended, and sent out again in new versions. From this, the need for a trade-off was brought to light. If the regulator was to allow the industry to drill down deeply into the data on individual policies and types of peril countries with the level of regularity that you have in Solvency II, you can build up a more accurate solvency picture. However, the trade-off is the amount of time and effort involved in this, therefore simplification was brought in. For example, if we have one level of solvency required for property – whether that represents an office block in London or an offshore drilling rig in the Gulf of Mexico – the solvency requirement is the same for those two property perils. This may seem intuitively wrong, however the alternative is to have considerable work involved for the captive manager and potential cost involved for the client, that they don’t find of benefit. There is also a lot of debate about calibration for the solvency factors and the general consensus was to base these on Solvency II as it has been looked at across a wide pool of licensees and is well understood and recognised.

In Q1 2013, the GFSC requested a number of licensee test spreadsheets as a means of establishing the impact of solvency, and published the results in September. This looked at 116 non-life insurers, of which 84 were captives, with the balance being what is now categorised as commercial insurers. Risk-based solvency was found not to have a huge impact on the ability of licensees to meet their solvency requirements. That’s not to say solvency requirements didn’t change, but because of the way the risk-based solvency spreadsheet was calculated in terms of assets and liabilities, it wasn’t a major issue. This positive result is a sign proper consultation took place. In addition to the impact assessment, in September 2013 the GFSC also released a document involving insurance regulation, A Consultation Paper on the Revisions of Regulations, Rules and Codes for Licensed Insurers, looking at risk-based solvency, categorisation, corporate governance and public disclosure.

There was considerable discussion from this around risk-based solvency and the distinguishing line between a captive and a commercial insurer. Some companies are clearly captives, writing first-party risk, while others are clearly commercial insurers writing, insuring or reinsuring third-party risk. However, if you have, for example, a retailer that insures its own property damage in its captive but also provides some warranty business, then how does that fit in the scheme of things? The GFSC released further guidance to answer this question in that a captive can still be called such even if it is writing warranty-based risk, as long as the contract is going to another part of the same group (which is a pure captive), a member of association (therefore mutual), but also if the insurance policy is incidental to the transaction with customer, it can still be deemed a captive and enjoy the proportionate benefits therein. This has caused people to look at their client base in a different manner and make sure clients fully understand the differences between captives and commercial insurers. Another positive from this process is an approved asset regime which categorises assets that are held by captives and commercial insurers. Under the proposed regime, there will be no approved asset protocol, meaning every asset will rank towards solvency but the amount it ranks and efficient manner and allow us to bring new business to the island. The changes may require further data to be included than is in place at present and captive managers will need to assist clients with the preparation of that data and bringing it into spreadsheets once the final version has been released. At Marsh, we are certainly looking to be able to work with our clients in an efficient manner to assist and comply with the requirements going forward.

As far as the continued growth of Guernsey over the next few years, I see no reason that the trends that have been demonstrated by Guernsey over the last couple of years in respect to licences should cease
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Captive Review (CR): How has London & Capital’s specialist captive investment management division evolved since its inception?

William Dalziel (WD): London & Capital was established in 1986. The company has always focused on capital preservation and risk management in relation to portfolio construction, aspects which are particularly important for the investment needs of captive insurers. Our captive investment management division, established in 2006, now has around $850m in assets under management (AUM), representing roughly one third of the company’s total AUM.

Over the past seven years this division has become a very important and strategic part of London & Capital’s offering. We place significant emphasis on providing high levels of client service, a testament to our wealth management heritage, which differentiates us from competitors.

Many clients have previously avoided the investment market. There was a perception that risk had to be taken on an ‘all or nothing’ basis which understandably made them uncomfortable. London & Capital controls the risk content of its client portfolios accordingly, ensuring a client isn’t exposed to the market’s full downside.

CR: The current environment is characterised by low returns. What is London & Capital’s market outlook and how should captives navigate this kind of market?

WD: Although our captive clients are concerned about the lower returns on the horizon, it is important for them to remember that investments in high quality bonds (which are common captive investments) have seen assets appreciate significantly as yields have compressed.

Interest rates will stay where they are for a little while longer, and in light of that, captives need to think about the real risks their portfolios are running. Highly rated bonds can still hide substantial liquidity problems. Clients should also be aware of the sub-asset classes they may be exposed to, such as mortgage-backed securities, asset-backed securities and municipal bonds.

It’s important to have a disciplined methodology for assessing the risks and rewards of each asset (and sub-asset) class. Even in the current market there are investment opportunities to be had – with the right asset mix it’s possible to match or outperform inflation, but there’s no doubt that bond investments are running with a much higher level of volatility than investors are traditionally used to and clients that don’t recognise that are in for some unpleasant surprises. We think that globally diversified bond portfolios can generate good returns, particularly with some equity allocations to provide for risk diversification.

CR: How do active and passive investment strategies differ?

Written by William Dalziel

William Dalziel is a partner at London & Capital with more than 30 years’ insurance industry experience. Dalziel set up the firm’s captive’s investment management division in 2006 and has led its growth to $850m assets under management. He is a faculty member of the International Centre for Captive Insurance Education (ICCIE) and was recommended in Citywealth’s Leaders List 2013.
“The needs of cell captives have been ignored, largely because they have been seen as too small to generate a profit for investment managers. Very few managers will deal with portfolios of less than $10m”

CR: Can you tell us more about this solution?
WD: The cell captive investment solution was developed in response to a client request – we were approached by an organisation managing 180 cells and were asked to find a solution to address their investment needs.

Cell Portfolios allow captive cells to invest in a segregated portfolio and benefit from full cost and asset transparency. We, as investment managers, actively adjust the portfolio to ensure it only takes the level of risk that is appropriate for that particular client. Effectively, our solution treats small cells in the same way as large, standalone or group captives.

The establishment of the segregated portfolio follows the same process that we would undertake with any other client such as asset allocation as a risk diversifier, then portfolio construction discipline to mitigate unrewarded risk and finally appropriate stock selection to give clients a good balance between capital preservation, liquidity and reasonable rates of return.

With this solution, cell captives also benefit from the management discipline applied to all portfolios. We provide monthly performance reviews and link every investment decision to our prospective macro-economic outlook for each asset class. Cell portfolios provide clients with economies of scale, reducing the aggregate costs of trading and ensuring this is viable for captives of all sizes, but particularly those cells with relatively small portfolios.

Our solution is flexible and simple, key requirements for cell captives. Our clients can access and download all the material they need in a full, auditable format at their convenience, ensuring smooth communication between all parties regardless of time zone or geography.

CR: What do the next 12 months hold for the cell captive industry?
WD: We see the future for cell captives as being extremely strong – this is one of the key growth drivers in the overall captive market. We expect to see the formation of a greater number of cell captives where traditionally standalone captives have been used, simply because the regulatory burdens being placed on captives are increasing.

We are the first investment manager to offer such a targeted approach to the investment needs of cell captives, but we would welcome the entry of additional managers to this space, to ensure that the diverse needs of clients are met.
BABBÉ

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Guernsey Finance is the joint government/industry body responsible for promoting the island as a leading international finance centre, including its internationally renowned risk-management industry. Guernsey is the largest captive insurance domicile in Europe and number four in the world. The island has grown a reputation for having a (re)insurance industry with significant experience and expertise and pioneering the innovative and hugely successful cell company concept.

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