

# Captive INSURANCE

## A BETTER MOUSETRAP

### Alternative Risk Transfer takes over the world.

Alternative Risk Transfer (ART) is the name given to forms of insurance not so long ago considered alternative to the traditional model. The ART label has stuck, even though more than half of U.S. domestic insurance last year was structured using "alternative" techniques. The dominant vehicle in the arsenal of ART is the captive insurance company.

Less sexy than, say, hedge funds, the flowering of captive insurance in the past 40 years was nonetheless critical to the forward motion of the financial markets. With its benefits now attracting worldwide interest, the use of captive insurance is very much on the agenda in the C-suite.

Captive insurance is self-insurance. In its purest form, a captive insures only the risks of its parent, but variations have flourished that insure risks of associated parties, such as hospitals or attorneys. Other types of captive are used for particular, closely defined risks. A range of vehicles has been created, with curious names like "rent-a-captive" and "cell companies" (segregated cells, not cell phones), to allow access to the captive market to an ever-broader range of economic interests.

Captive insurance is a by-product of our dependence on oil and the structure and scale of the energy industry. Insurance historians date the earliest captive company to no later than 1922. It was founded in Guernsey, one of the Channel Islands near the U.K. In the 10 years following, a handful of mutual or co-insurance companies was formed by European-based, transnational oil and petrochemical companies, which were considerably larger financial enterprises than were the major insurers of the day. Then, too, the big energy companies, comfortable with the notion of trans-border business, understood their complicated risks better than insurers could. The net result, initially, was lower insurance premiums for the captives' owners.

Many other advantages have since

emerged. Captives can offer lower insurance costs, cash flow advantages, risk management control, and access to reinsurance. The larger captives act as independent insurance companies, writing third-party business. Tax may be minimized, but is no longer the driver in captive formation; the sheer efficiency of the model plays that role. As early as 1952, Youngstown (Ohio) insurance manager

Fred Reiss set up what would now be called a captive insurance company, for a client. In 1963, not long after Kennedy was assassinated and risk was more acutely on people's minds, Reiss set up the first modern-day captive, in Bermuda.

Curiously, Reiss's brainwave, of marrying lower insurance premiums to a tax-free environment in which to nurture earnings, took a while to catch on. Catch on it did,

though: more than 5,000 captive insurance companies now do business around the world. Almost 3,000 are domiciled in the Caribbean, 1,200 or so in Europe and Asia, and more than 1,000 in the U.S.

#### FILLING A NEED

Captives are formed almost daily somewhere around the globe, but formations peak when insurance coverage becomes unavailable or too expensive. That can happen after major events buffet the commercial insurers, such as Hurricane Andrew, 9/11, or Hurricane Katrina.

Most captive insurance is general liability or workers' compensation insurance. Medical malpractice and professional liability are also mainstays. Newer risks being transferred include construction defect liability and worker disability. Since few companies are in the business of insurance themselves, all but the largest use the services of external managers to handle the day-to-day demands of running an in-house insurance company. Many jurisdictions demand it.

The managers, prominent among them the

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**MORE THAN 5,000 CAPTIVE  
INSURANCE COMPANIES  
NOW DO BUSINESS  
AROUND THE WORLD.**

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largest commercial insurance brokers, are represented in all the jurisdictions. That used to mean a choice of four or five places in which to domicile a captive. Now, thanks to tremendous growth in the field, there are nearer 60.

### THE COMPETITION INTENSIFIES

Indeed, today captive business is keenly sought and contested by domiciles around the world. Bermuda remains the largest single jurisdiction by number of captives. The Cayman Islands are hot on Bermuda's heels, however. "The high level of advisory services that contributed to the growth of Cayman's banking and mutual fund sectors were instrumental in driving the steady growth of our captive insurance business," says Kenneth Jefferson, financial secretary of the Cayman Islands. "Progressive legislation, a sound legal system, and a balanced regulatory regime are the other significant factors that have helped Cayman secure a leadership position in captive insurance."

The British Virgin Islands and Barbados, neither far away, each has hundreds of captives and have both earned an excellent reputation. "What is proving so attractive about Barbados as a jurisdiction is a combination of its cost-effective, pro-business, yet well-regulated and stable environment," says Anthony Sobers, chief executive officer, Barbados Investments and Development Corp. "Additionally, an expanding network of tax treaties, modern legislation, developed infrastructure, and professional expertise drives Barbados' success as a leading captive domicile."

In Europe, Guernsey, Luxembourg, and Ireland are the market leaders. Places as far apart as Vanuatu, Malta, and Panama are all open for captive business, and Dubai and Bahrain have joined the market as well.

To compete, individual U.S. states began granting captive insurance companies the same benefits they could derive offshore. Colorado was the first, in 1972. Vermont, Hawaii, and South Carolina now lead the way, with Nevada and Arizona growing fast. Together, the U.S. was in front with new captive formations in 2005.

"In South Carolina, we view the captive insurance business as part of our state's overall economic development plan," says Jim Kinder, president, South Carolina Captive Insurance Assn. Inc., Simpsonville, S.C. "Alternative risk transfer programs enable organizations to directly manage their risk through a solid regulatory system which provides greater flexibility both in contractual form and rating, thus enabling business to more effectively compete in our global economy." Kinder expects more states to enter the fray.

### A CONTINUING EVOLUTION

Captive insurance began as an alternative, offshore technique; now it is not necessarily either. Like the personal computer, captive insurance is an answer to which questions are still being found. Captives are more and more in use, for example, in developing strategic risk financing programs. Captive insurance can only expand as it broadens its focus to meet the needs of middle-market corporations and small businesses.

Captive insurance was crowned king, one might say, late in 2005, when Lloyd's of London, where the modern practice of insurance started hundreds of years ago, lent its imprimatur: Lloyd's announced that it, too, would facilitate captive insurance.

In the 1960s, for a year or two, Fred Reiss couldn't persuade anyone to back his idea of self-insurance, and was warned off it by at least one traditional insurance giant. He would have had the last laugh, though. In insurance circles, what were once considered vices are now habits.

**Web directory:** Barbados Investment and Development Corporation [www.bidc.com](http://www.bidc.com)  
Cayman Islands Government [www.caymanfinance.gov.ky](http://www.caymanfinance.gov.ky)  
Insurance Managers Association of Cayman [www.imac.ky](http://www.imac.ky)  
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# Cayman Islands Continue to Captivate



THE CAYMAN ISLANDS' captive insurance industry understands that captive owners have a choice when it comes to selecting or maintaining operations in a particular jurisdiction. Fortunately, many of those captive owners choose Cayman.

A British overseas territory located in the Western Caribbean, the Cayman Islands have become a leading jurisdiction for captive insurance over the past 35 years. At the end of 2005, 733 captive insurance companies were domiciled in Cayman, with assets of \$26.7 billion and annual premiums of \$6.7 billion. By number of companies domiciled, Cayman ranks as the second largest captive insurance center in the world. Healthcare and workers' compensation are two of the largest lines of business for these companies, but Cayman captives bring advantages to a wide array of insurance programs.

## Great minds think alike

An experienced cadre of managers, regulators, auditors, legal advisors and other professionals, combined with progressive legislation, a balanced regulatory regime and a highly entrepreneurial business climate, all contribute to one common goal: to maintain Cayman's reputation as not only the best home in the world for captive insurers, but as a gateway for international capital and economic growth.

Cayman insurance managers play the central role in the day-to-day operations of captive companies. With all the world's largest managers represented in Cayman, as well as many local firms who are smaller but equally adept, captive owners repeatedly speak of the high degree of professionalism that is the hallmark of Cayman's insurance business.

Captive insurance offers advantages in risk and cost minimization, as well as access to the global reinsurance markets, but it is not a financial panacea. Captive insurance works best in Cayman when it solves specific problems or supports specific corporate needs.



Many captive insurers do business in George Town, capital of the Cayman Islands.

Larry Smith, vice president of risk management for MedStar Health, a nonprofit, community-based organization serving the Washington/Baltimore area,



The Cayman Islands Legislative Assembly.

says his company moved its healthcare captive from another jurisdiction to the Cayman Islands in 2004. The reason behind MedStar Health's decision, says Smith: "We found more of what we expected with Cayman. We needed regulators who understood our kind of business. Even more important, they [Cayman] understood the captive insurance company as a strategic part of that business."

## A win-win situation

The Cayman Islands have demonstrated leadership in global financial services regulation. The Cayman Islands Monetary Authority (CIMA) supervises and monitors such activity in strict accordance with the highest international standards. The process by which Cayman captives are formed is a consultative one. The potential owner prepares a business plan, which a potential manager reviews to ensure that it meets Cayman's standards and reports all necessary information. CIMA then considers the plan from every angle, including the background of the proposed company's sponsors, before issuing a license that will enable the captive owner to execute the plan.

Cayman believes, and its captive owners are happy to confirm, that the goal of regulation – protection of the insured, the shareholder, and every other stakeholder, including the public – should never be overlooked in a welter of red tape. The success of Cayman's captive owners, in accordance with the dictates of international standards and law, becomes in turn the success of Cayman's population.