

CAPTIVES UNDERPIN BERMUDA MARKET

Leading Bermuda captive market players believe the sector is well placed despite current economic challenges.



From left to right:

Shelby Weldon, director of insurance compliance, *Bermuda Monetary Authority*

Philip Barnes, managing director, *Aon Insurance Managers (Bermuda) Ltd.*

Renee Lewis, head of captive insurance team, *Bank of Bermuda*

Philip Burrill, financial services partner, *Ernst & Young*

Carl Daly, president and chief underwriting officer, *Ace/Paget Re*

David Lines, partner, *Appleby*

Scott Gemmell, vice president, *Marsh*

Bermuda's illustrious history as the birthplace of the captive industry has seen it lead the world in innovative ways to manage risks. As signs of a hard insurance market appear on the horizon, views are mixed as to whether the Bermuda captive sector will see a post-credit crunch surge in formations—as has been the case in previous downturns.

In a bid to canvas the views of those closest to the action, we gathered several of the Bermuda captive sector's leading players. During the roundtable, we asked them to discuss the future and give an insight into what we can expect going forward.

How has Bermuda regulation helped captives weather the current economic downturn?

**Shelby Weldon, director of insurance compliance,
Bermuda Monetary Authority**

Bermuda's current insurance legislation has been in existence since 1978. The Insurance Act 1978 (the Act) has stood the test of time, and whilst we have continued to amend and enhance this legislation, where appropriate, over this time period, most of this has been geared towards the commercial

sector. Bermuda has not significantly changed its regulatory and supervisory approach to the captive market since the enactment of this legislation.

Bermuda continues to enjoy a robust reinsurance marketplace and is still seen as one of the premier captive domiciles. Our supervisory approach continues to be risk-based, applying the appropriate level of supervisory and regulatory oversight to insurance companies, based on their risk profile.

A number of international bodies and regulatory associations are continuing to review global regulatory approaches, and Bermuda is an active participant in these discussions. How such reviews with respect to the captive market will play out remains to be seen. However, our market and our legislation remain flexible enough to adjust accordingly. We are committed to international best practice for our insurance marketplace, but also recognise that any regulation or supervision of captives must be in line with their risk profile.

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**Philip Barnes, managing director,
Aon Insurance Managers (Bermuda) Ltd.**

Bermuda has spent the last 20 years developing regulations for prudent management of insurance companies, and these have held sound throughout this crisis. For example, there are very stringent capital requirements and restrictions on returning capital to parent companies. This has really helped companies maintain a sound base here and survive the current situation well.

**Renee Lewis, head of captive insurance team,
Bank of Bermuda**

From the banking and service provider perspective, what we're seeing is just a reaffirmation of different aspects of banking when it comes to things such as investment guidelines and policies. Captives are typically very conservative, and that's become the norm. Guidelines are expected in these economic times to be even more stringent.

We are not seeing any capital flight out of Bermuda—rather, more funds coming in. The jurisdiction is sound and has weathered

most storms well. It is a primary jurisdiction for stability and a one-stop shop. You have everything here: the financial sector, the expertise in the captive market, the re/insurance market, and from the management perspective, the accountants and the lawyers. That speaks for itself. Not many other jurisdictions have that type of infrastructure to support the good times and the bad.

Philip Burrill, financial services partner, Ernst & Young

Yes, captives are inherently conservative, that is how they are set up. The downturn has not had a big direct impact so far. That's how it should be, in good times or bad times, for existing captives, if they're well managed—which most are now. There is a lot of maturity here in terms of years of experience. And a lot of the investing done by captives is very conservative. So, there's been a downturn, but certainly nothing that has thrown the average captives offside in terms of meeting the local regulatory requirements.

In terms of regulation, the BMA's approach is flexible and reasonable. It is not only willing, but also proactive if a captive, for whatever reason, is starting to struggle. It will work with the captive to discuss ways the captive owners can bring the captive back on board if, for example, a downturn in fortune has them not meeting their solvency requirements.



Carl Daly, president and chief underwriting officer, Ace/Paget Re

Bermuda's infrastructure is really the reason it became pre-eminent in the first place and why it will remain pre-eminent in the years to come. The past year was tough. There are more competitors than ever—some 40 to 50 domiciles, including a growing number of onshore US domiciles—so the pressure was there for Bermuda to perform, regardless of the financial crash, in the latter part of the year. Most of the mature domiciles that compete with Bermuda are in exactly the same position.

Bermuda is well set for the current climate. A hard market is on the way. It will, as it has done in previous years, result in clients using their captives more and in buyers incorporating new vehicles to retain risk. I see Bermuda being able to benefit as it has from previous dislocations.

Scott Gemmell, vice president, Marsh

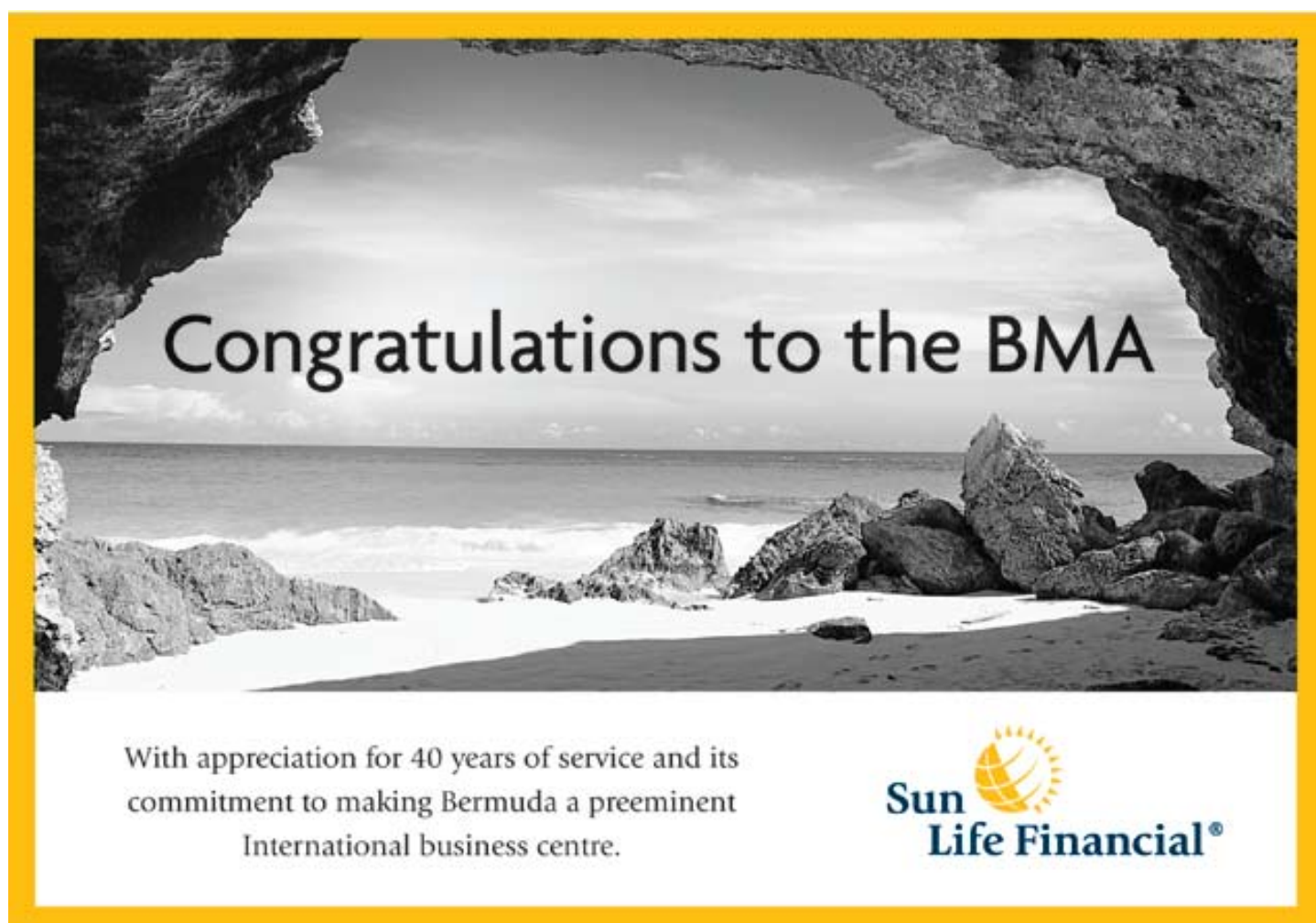
I agree. If you look at historical facts, during a hard market, there has typically been a real spike in the number of incorporations. That's what you'd expect in a normal

economic climate, but in the current climate, people might not want to spend money or might not be able to afford to invest in the first place. You are going to see a number of organisations merging or acquiring each other. When companies merge, they often look at the number of captive vehicles they have and consider a consolidation of vehicles. That is the only thing that will stop us from seeing an increase in the number of captives worldwide.

David Lines, partner, Appleby

From a legal perspective, the BMA is always updating its regulation, legislation and its compliance requirements, but there's little that is captive-specific.

The BMA and the Government have been quite good at leaving things alone if they work. For example, whilst the BMA has introduced risk-based capital for Class 4 reinsurers, it has not increased captive regulation.



We have been able to maintain a productive working relationship with the BMA and the Registrar of Companies. This has always been an integral aspect of our business success. We don't want to lose this. Once we move away from this working relationship, we will have challenges.

What are the priorities going forward for the captive space?

Carl Daly, president and chief underwriting officer, Ace/Paget Re

My focus is on rent-a-captives. Bermuda needs to continue to modify its legislation, when necessary, to remain competitive. That is part of the BMA's responsibility—to ensure we have all the bells and whistles that others have instigated, and

that have proved popular and workable. An example might be the introduction of incorporated cell legislation. Segregated accounts legislation is working fine and is the structure of choice at the moment, but incorporated cells may prove popular with certain buyers.

Scott Gemmell, vice president, Marsh

Differentiation from other domiciles is critical. It's something that is becoming harder and harder to demonstrate. More domiciles are replicating the legislation that is successful in other jurisdictions.

The advantage Bermuda has is that it has always been at the forefront of market innovation, and there is more insurance expertise on this tiny Island than there is in any other domicile. Everyone knows each other, and we get together and discuss ideas. Organisations looking to do something new, or looking for alternative uses of their captives, know they can come here and get experience from all the service providers on the Island. That'll be the one thing that continues to keep Bermuda at the forefront.

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In an era that will be marked by increased regulation, economic constraint and an unprecedented aversion to risk, our view is clear. Look past the problem to the possible. We applied the same vision when we launched a new insurance holding company in Bermuda, two years ago, with more than \$1 billion of fresh capital that today is supporting the needs of insurance brokers and their clients no matter where the risks are located. By focusing on what can be done instead of what cannot, we are distinguishing ourselves in a sea of challenges and providing both our brokers and their clients the surety to meet new horizons.


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Philip Barnes, managing director, *Aon Insurance Managers (Bermuda) Ltd.*

The other challenge on the regulatory front is to demonstrate that regulation is not there for regulation's sake. A good example of that is the recent Class 3 company reclassification exercise. The BMA applied its risk-based approach to this very wide category of insurers by creating three distinct classes: 3, 3A and 3B. There was consultation with the industry, which resulted in each category having the appropriate level of regulation (and fees). If there is going to be legislation, it needs to be done properly. I think the BMA has a good track record on that.

David Lines, partner, *Appleby*

That's a good example of the BMA listening and speaking to the industry.

Shelby Weldon, director of insurance compliance, *Bermuda Monetary Authority*

The Authority has no immediate plans to significantly change our regulatory approach with respect to our captive sector. When there are proposed enhancements to our regime in this respect, we will continue our established consultative process and seek the input of industry prior to implementing any changes.

Currently, one of our key initiatives is to ensure that Bermuda achieves equivalency under Solvency II. The Authority together with our key industry stakeholders are currently reviewing the regime with a view to implementing the necessary enhancements in accordance with the timeframe established by the EU Directive. We are also monitoring developments in the US to ensure that our supervisory approach is deemed mutually equivalent and is operating in accordance with international standards.

This will include a commitment to the training and development of our people to ensure that we are well placed to continue the success we have enjoyed as an international insurance marketplace. In the current environment, this has become

even more critical to our goal to be recognised as a leading risk-based financial regulator.

We are very aware of the need to continue to give timely and efficient service whilst ensuring that we continue to honour two of our key responsibilities—protection of policyholder rights and protection of the jurisdiction's reputation. Bermuda has always been a jurisdiction known for its flexibility, fostering a creative and innovative marketplace. We want to continue to react quickly, not only to changes in our market but also to developments taking place from an international regulatory perspective.

Philip Barnes, managing director, *Aon Insurance Managers (Bermuda) Ltd.*

The risk-based approach being used by the BMA is definitely the way to go, and we constantly use that as a selling point when marketing the domicile to prospective captive owners. Other locations don't necessarily have that flexibility. The BMA now has way more staff than it used to and they are well positioned to fulfil their ongoing regulatory duties—which has impacted positively on the industry as a whole.

Are captives more attractive given the current market conditions?

Carl Daly, president and chief underwriting officer, *Ace/Paget Re*

The misconception is that somehow there's a tax break here, whereas, in reality, on the captive side, the majority of US entities have elected to pay income tax. In the 30 years that I've been working in Bermuda, almost every other year, there has been talk of legislation coming out that will be the death knell of Bermuda, but it has not happened. Captives have weathered a number of storms, and I see that continuing. Obviously, I wouldn't want the reinsurance market to be impacted, because it will have an impact on the captive market. Hopefully, the US legislature has other things on its plate and bigger fish to fry than offshore domiciles.

Philip Burrill, financial services partner, *Ernst & Young*

Captives are not a short-term decision, it is always a long-term decision to set one up. It might not be this year, in terms of capital constraints, but they are always a viable option worth exploring for the long term. The attraction of captives should

always be viewed from a long-term perspective, regardless of current market conditions.

**Philip Barnes, managing director,
Aon Insurance Managers (Bermuda) Ltd.**

When you're negotiating a global reinsurance programme, if you have a captive, you are demonstrating that you have some "skin in the game", and that really helps to buy into the programme. Working with the markets and brokers really helps build a partnership. So if you have capital and assets invested in Bermuda, you're here for the long haul.

David Lines, partner, Appleby

Captives are not particularly sexy or beautiful work, or particularly high-end work, but they are great solid work, which is important to a lot of companies. That's always the


message you try and put out when you meet these clients.

Renee Lewis, head of captive insurance team, Bank of Bermuda

The conservative approach is going to be here for a while and we're going to see some change in terms of what risk managers require from us, i.e. a more stringent scorecard for those working with captives.

What we've seen is an increase in the number of dialogues from risk managers in an attempt to better understand our philosophy on how we do investing and looking at our internal controls within the bank. They want to understand our process and our risk management approach to the industry. I'd suggest increased transparency and dialogue with your clients. Pick up the phone and say, 'I know you've had concerns, come in and talk to our investment managers', to ensure that the confidence that has been there all this time remains there.

One of the things we want to do in terms of making sure we're on the edge is to talk to our clients, and if they are looking at products that maybe we don't



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normally have or don't have right now, to develop these in tandem with them, to expand their business. So, we're looking more for partnerships and not just relationships, and that's the long-term goal.

**Shelby Weldon, director of insurance compliance,
Bermuda Monetary Authority**

Captives remain a core element of the Bermuda insurance market. Our regulatory framework continues to recognise this and we are committed to regulating this sector appropriately.

Historically, we have seen an increase in captive formations as insurance markets harden, or when there has been significant market dislocations. However, the current economic environment has had a negative impact on the development of new insurance vehicles in both the captive and commercial sectors, not only in Bermuda but globally. Despite the global financial crisis, we continue to see interest in the jurisdiction from a captive standpoint.

Philip Burrill, financial services partner, Ernst & Young

There are also a couple of things out there from an accounting standpoint. One thing we have been talking to a lot of our captive clients about is the form of accounts produced. Bermuda captives are permitted under the Companies Act 1981 to waive audited GAAP or IFRS financial statements. Only statutory financial statements prepared in accordance with the Bermuda Insurance Act need be produced and audited on an annual basis. Statutory reporting tends to be much less onerous or nuanced, particularly from a note disclosure standpoint, than is increasingly required under both US GAAP and IFRS, which drives up the costs of both preparing these types of financial statements and having them audited. As such, a lot of Bermuda captives are opting for statutory-only reporting.

In addition, one of the silver linings of the global recession is the retention of staff. Over the last seven years in Bermuda, it has been difficult to keep staff. Now that it has hit a plateau of sorts, one of the things we've seen is a retention of good people, which, from an accounting standpoint, leads to better servicing of captive clients and the industry as a whole.

Carl Daly, president and chief underwriting officer, Ace/Paget Re

The better service also applies to the managers. If you are able to keep accountants who have embedded themselves with a client for longer than a few years, then

that's a good thing. I see the service improving across the board as a result of that retention.

What would you like to be saying about the captive space a year from now?

Scott Gemmell, vice president, Marsh

I'd like to look back and think what a big turnaround from 2008 to 2009 in terms of incorporation numbers. I'd also like to see a large number of organisations with captives in Bermuda looking to use their captives in a more strategic way. We keep coming back to this market argument. So many times, we've been looking at using the captive for other lines of insurance, but because the cost of insurance cover has been so cheap for the last few years now, there has been no reward for people taking on that extra level of risk. I think we will definitely see people using captives more innovatively to get a better overall return and be a key part of their finance strategy.

**Philip Barnes, managing director,
Aon Insurance Managers (Bermuda) Ltd.**

A number of once-protected markets are opening up for Bermuda—such as South America and the Far East. We are seeing a lot more interest from those areas now, whereas it used to be focused on localised jurisdictions. For instance, in Japan, they'd much prefer to deal with a long-established domicile with a good reputation and track record. And we see that as a big growth area. A lot of markets are beginning to open up in Latin America, and that's down to education and getting the word out about what we can do.

David Lines, partner, Appleby

With the market being in a state of flux, there is a lot of focus on captives—taking them less for granted, focusing on our key markets, and getting Bermuda's game back in order and really pushing captives once again.

**Carl Daly, president and chief underwriting officer,
Ace/Paget Re**

There is something to be said for rent-a-captives in this environment. A rent-a-captive, structured correctly, can give you all the benefits of a captive, but for a lower cost and without the hassle of the corporate governance. So, my expectation is that rent-a-captives will be a hidden growth area.

Renee Lewis, head of captive insurance team,
Bank of Bermuda

The thing for us is to be the support for wherever there is that need, for it to be consistent and strong, and to work wherever we need to. I think communication, when you consider some of the challenges some clients are seeing, is a key.

Philip Burrill, financial services partner, *Ernst & Young*

We're feeling more pressure to keep our fees competitive, not just against our competitors on the Island, but being aware of what other jurisdictions are doing and making sure we're part of the solution, not part of the problem. We're trying to be much smarter about outsourcing work that doesn't need to be done in Bermuda, using back office functions in places such as India. A lot of other service providers are also doing that, and it's something we're using to keep fees competitive.

Shelby Weldon, director of insurance compliance,
Bermuda Monetary Authority

We are committed to ensuring that Bermuda plays a significant role in any international discussions with respect to the future of captive regulations. Bermuda continues to be the captive domicile of choice. Even during a difficult 2008 year, Bermuda continued to maintain its leadership position in the captive sector. Our register demonstrates that from both the number of captives registered and the amount of underwriting activity conducted by captives, Bermuda remains at the front of the pack. The international financial community still recognises Bermuda as a premier captive domicile, and we plan to continue to do what we can to maintain this position. While we have no plans to radically change our regulatory approach when it comes to captives, any initiatives from an international perspective aimed at reforming the approach to captive supervision will include the input of the Bermuda marketplace.



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