

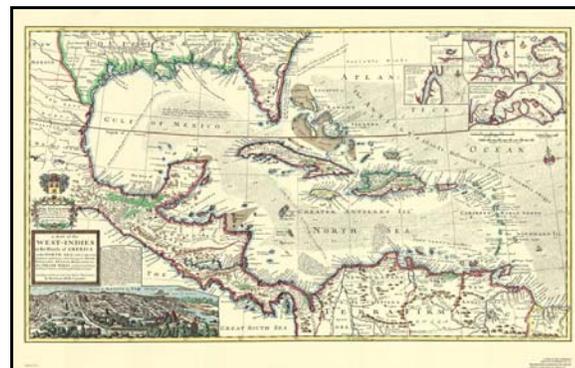
Offshore or Onshore?

Taxes, regulations, infrastructure and perception all need to be considered when choosing a domicile.

It is clear from many sources that the interest in onshore captive domiciles has risen. At last, it seems that the various states have worked out what they need to do to compete with offshore and particularly with each other. These changes are reflected in more experienced regulators, more efficient processes and more competitive set-up and operational fees.

The main beneficiaries of these changes have been the small price-driven 831 (b) captives with annual premiums of less than US\$1.2m, which now have a great choice of domiciles. A number of years ago it was considerably easier and less expensive to go offshore to any one of the very competitive Caribbean countries than to stay onshore. However, the cost differential is now less, and with political pressure to stay stateside, the tide is decidedly onshore.

In addition to the improvements mentioned above, in order to get the business through the doors to help pay for the cost of the new legislation, onshore states have become far more professional and marketing driven. This sudden spate of self-promotion is definitely working and has raised the profile of onshore facilities.



However, this cannot explain why an offshore jurisdiction such as the Cayman Islands managed to achieve record-breaking statistics in 2012 and 2013.

In Cayman there are over 750 captive insurance companies. 2012 was a year of tremendous growth for the Cayman Islands, with 53 licences granted. To put this in perspective, in 2012 Cayman received the highest number of captive applications since the hard market of 2004. 2013 continues to show steady growth for the Cayman Islands with a combined total of 28 licences granted during the first three quarters of 2013. As of 30 September 2013 total premiums reported are at an all-time high of US\$13.8 billion and total assets reported are at US\$85.8 billion, compared to US\$11.8 billion (17% increase) and US\$88 billion (3% decrease), respectively, as at 30 September 2012.

The Cayman Islands international insurance industry is composed mainly of companies insuring risks in North America (90.19%). The next most important geographical source is the Caribbean and Latin American region.



The Four-Way Test.

Why choose one captive domicile ahead of another?

Captive insurance domiciles and jurisdictions have to continually check that they are keeping up to date with global developments and are still competitive. At the same time shareholders of existing captives and possible new ones have to carry out a similar exercise to see if their chosen domicile is still right for them.

The most reliable, tried and tested way of checking whether or not a domicile is suitable for your company is to carry out “The four-way test” (apologies to Rotary International for stealing this slogan). Most captive feasibility studies will include a section on choice of domicile, usually after the basic insurance program and tax implications have been explored. This section examines the best choice of domicile based on four broad categories: taxes, regulations, infrastructure and perception, or “The four-way test”.

Let’s see how Cayman matches up to the “test” keeping in mind that every organization has different requirements, and what is attractive to one may not be so attractive to another.

1. Tax environment

Although we generally place taxes at the bottom of our list of captive advantages, they are still critical in selecting your domicile. It’s for this reason that in feasibility studies there is often a separate section on taxes. Once the basic insurance or reinsurance program has been determined within the study, the consultant then needs to assess carefully the tax structure best suited to meet the needs of

the captive parent company and possible third party participants. With respect to US parent companies in particular, the first question has to be whether to have the captive onshore or offshore. Each will have its merits and each its drawbacks, and this needs to be investigated before exploring individual jurisdictions in detail. Some jurisdictions onshore or offshore may have special tax agreements with the parent organization’s home country which will make them more suitable than others. Interestingly, many Cayman based captives are ‘not for profit’ companies, which have their own tax issues.

This part of the test needs to involve external insurance tax experts as well as the shareholders’ internal tax advisor. Shareholders of existing captives need to ensure that they keep up to date with tax changes to be able to review their position regularly.

2. Regulations and controls

This heading is not limited to the regulations peculiar to a particular domicile, but to all regulations whether onshore or offshore. For example, is the underlying insurance business admitted or non-admitted, can it be written direct or do you need a fronting insurer, does one domicile have stricter compliance regulations than others, and how do the regulators in each domicile treat their assessment of risk? This last point can end up being very important as the company matures and becomes larger. Some domiciles, due to their experience and in-depth knowledge of insurance and risk management, regulate in a hands-off manner trusting the directors, managers and auditors to make sure that the company is run professionally. In these cases the regulator would not necessarily insist on





annual inspections, or prior approval of every little thing. As long as the company follows its initial business plan, and meets its minimum required margins of solvency, then the regulator will not interfere. However, in other, perhaps newer, domiciles where the regulator doesn't have the staff or experience or access to professional managers and auditors, then the regulations can be far more prescriptive and rigid. In other words, in more established, older domiciles you'll tend to find the regulators more flexible and more willing to work with clients to overcome difficulties.

Clearly, as international pressure to tighten up already rigorous anti-money laundering laws continues, there will be more and more pressure on regulators to be seen to be doing the right thing. This pressure comes from the likes of the International Monetary Fund, the various Financial Action Task Forces which have sprung up, and the International Association of Insurance Supervisors. Ideally, a number of these parties want one set of rules for everyone, but as anyone familiar with the captive concept knows, one size does not fit everybody. The reason most captives exist in the first place is dissatisfaction with the traditional insurance market which was unwilling to recognize that one company's risk profile differs from another's.

Individual jurisdictions are trying to address this in different ways. Cayman, in order to remain attractive to clients but still comply with international regulations, has revised its insurance laws and regulations. This included a reclassification of its various types of insurance companies into: Class B (i) pure captives that write solely the risks of their owner(s) and up to 5% of unrelated party risks Class B (ii) captives that write between 6% and 50% of unrelated party business and Class B (iii) "open market

captives" that write unrelated party risks above this threshold, based on the percentage of net written premiums or loss and loss expense provisions.

The benefit of this system is that pure captives are subject to less strict regulatory requirements than open market captives, particularly in the area of capital and solvency.

3. Infrastructure

Besides the obvious things like travel distance and the quality of hotels and restaurants, other infrastructure points which need to be considered are the quality of the regulator, captive managers, lawyers, auditors, bankers, investment managers, actuaries and reinsurers.

All these factors contribute significantly to domicile growth rates. Visit any of the major international captive territories and you'll see which domiciles have a cohesive working relationship among the various captive services providers.

A spirit of co-operation within a captive industry sector can be a very telling factor. If nothing else, it indicates that the managers and regulators get on well together, and that everybody at the conference has the common goal of promoting the domicile rather than themselves.

A major issue for many clients is the time and expense of getting from home to the meetings. Some of the advantages that Cayman has to offer are that it has its own airline, and the island is serviced by a number of international carriers such as American, United and British Airways. The Cayman Islands are only an hour away from Miami, and are in a similar time zone to



much of the US. Although Cayman is in the hurricane belt, there are long range forecasts available to ensure safe travel.

Finally, one of the recognized benefits of having a captive in Cayman is the open-door policy adopted by the regulators, The Cayman Islands Monetary Authority (CIMA). CIMA actively encourage board directors to visit them when on island. This all helps to add to the team spirit among client, manager and regulator.

4. Perception & Reputation

Definition of Perception: *That which is detected by the five senses; not necessarily understood.*

Why are some places more popular than others? Besides all the above tangible reasons for choosing one particular domicile ahead of another, there is a host of others which are not so easily explained. I recently asked a client why he would recommend setting up a captive in Cayman, and his simple answer was, "The weather". Fair enough, but what else? I didn't even bother asking him about the golf, scuba diving, top class hotels and restaurants. However, he did give me one more reason, and that was the enormous comfort he and his company get from doing business in a jurisdiction where many, many other companies just like his own are based.

Since the 1970s when captives first started coming to Cayman, the number of captives has now grown to over 750, making Cayman one of the top three leading captive centres in the world.



Conclusion

The good old days when the risk manager and his directors selected a domicile based primarily on social activities are long gone.

Domiciles change as regulators retire, as new rules are introduced, or as service providers have to leave the jurisdiction due to the non-renewal of work permits. Change is the seedbed of risk, so make sure your decisions are based on current data.

Shareholders are unlikely to accept somebody's word for choosing one particular domicile especially when there are so many fine alternatives onshore and offshore. The only objective way of assessing one domicile ahead of another is to carry out the four-way test, or get an independent outside consultant to do it for you.

All in all, I think that Cayman will continue to pass the four-way test, but don't take my word for it; ask your consultant.

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