Webcast Transcript: State of the Captive Market

In a July 30, 2009 webcast, Steven Chirico, Yvette Essen, John Andre, Tina Bukow-Truman and Clive Thursby were joined by Christina Mancini of captive.com to review what’s been a surprising year, and look at some of the possible twists ahead for the captive insurance industry.

LEE McDONALD: I’m Lee McDonald with the A.M. Best Company. We’re here to discuss two new reports on the captive insurance industry from the A.M. Best Company. We have a nice turnout today, so thank you to everyone for registering. This is an interactive session. We have advance comments, questions and we plan to integrate them. If anything occurs to you please send your thoughts to news@ambest.com and we’ll do our best to recognize them. Before we go further I need to note that we plan to refer to financial strength ratings. We are a regulated rating agency.

The financial strength rating opinion addresses the relative ability of an insurer to meet its ongoing insurance obligations. They’re not assigned to specific policies or contracts or address any other risk. They’re not limited to claims paying ability and the ability of the insurer to dispute or deny claims payment on grounds of any misrepresentation of fraud or any specific liability contractually borne by the policy or contract holder. A financial strength rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. In arriving at a rating decision A.M. Best relies on third party audited financial data and or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information. For more information or details on this, see A.M. Best terms of use. That’s www.ambest.com/terms.html.
We're going to get to a very interesting and active conversation today. What I'd like to do is start out by asking our panelists to tell a little bit about themselves and their role. We'll start with our non-A.M. Best guest today, who is Chris Mancini. Welcome, Chris.

CHRISTINA MANCINI: Well, thank you, Lee. It's a pleasure to be here. I'm certainly excited to be with you folks. Captive.com, as those of you listening probably already know, is a content and networking website that devoted strictly to the alternative insurance market. So my role today, as I understand it, is to answer whatever questions I can and respond to some of what we're hearing at Captive.com in terms of the types of captives that are being formed. What's hot and what's not? Some new uses for existing captives, regulatory issues that we're hearing about and anything else that we can be of assistance with. Those of you who did send me emails, we're certainly happy that you did so; I'm never going to get to all of what you gave to me yesterday. I think we'll do something with that down the road at the website. Thank to everybody who did offer some input for this teleconference.

McDONALD: Thank you, Chris. Thank you for participating. We enjoy your website and your scope of knowledge about this industry, which is why we invited you.

STEVEN CHIRICO: My name's Steve Chirico. I'm an assistant vice president in charge of five analysts that cover captives for A.M. Best.

JOHN ANDRE: John Andre, Group Vice President of responsibilities for global reinsurance and captives and I'm housed here in the Oldwick office.

TINA BUKOW-TRUMAN: I'm Tina BUKOW-Truman. I am the senior manager for business development covering U.S., Canada, Caribbean and Latin America.

ESSEN: Yvette Essen here, calling from London. I'm head of market analysis for A.M. Best, responsible for in-depth research, comment and analysis for issues facing the insurance industry outside America, Bermuda and Canada.

McDONALD: We'll be speaking with Yvette quite a bit. Just to let everybody know at this point, on your player page as you're watching you'll see the names of participants. Below that you'll also see a link to a report that was published on Thursday, which is about the state of captives in the U.S. A link to that report will be there as well. Just to let everybody know at this point, on your player page as you're watching you'll seem the names of participants.

In a word, great. I'd like to bifurcate my comments into two broad categories. The first are broad comments of basically how the captive market did compare to the commercial insurance market. Then we'll go over some statistics of exactly how good the captive market was compared to the commercial market. Broadly speaking, the captive insurance market did very well.

The anchor that acted on a negative basis to the commercial insurance market was basically divided into three main categories. The first is the continuing soft insurance underwriting cycle; secondly, the adverse investment market; thirdly, the lack of financial flexibility caused by the credit crisis. So why did the captives do better than the commercial markets? Let's address each topic as regards to captives.

First of all, captives are subject to an underwriting cycle. However, that cycle is softer than you find in the general commercial market so the peaks aren't as high and the troughs aren't as low. We have a situation where we have a much more stable pricing environment in captives. As far as a philosophical difference between how captives invest versus how the commercial insurance market invests, captives' investment portfolios point toward principle preservation. Then whatever money they can make by doing that adds to the bottom line. The commercial market generally looks to their investments as a revenue and income source. With increased risk comes increased reward and that equation has born true throughout 2008. The last topic is the financial flexibility caused by the credit crisis; very few captives use the credit markets as capital. We do find some captives having trust-preferred securities or surplus notes or bank debt or things like that, but it ends up being a minority. The majority of captives' capital generally turns out to be hard equity. The captive market has been able to outperform the commercial market on all of those points.

I will say that captives have been affected by something you generally don’t find in the commercial market, which I like to call risk isolation. We can see that manifesting itself in a number of ways, because captives tend to be more specific in what they underwrite, more myopic in scope. For instance, if you look at the single parent captives of the U.S. auto makers, those captives are amongst the best-run captives that we rate. However, current companies have been compromised by the economic environment. We also see this in the group captives scenario regarding residential home construction companies. A number of group captives that we rate underwrite liability insurance for residential homebuilders. Some of them are to the point where the premium has dried up because of the decrease in homebuilders that are still solvent, to the point where the premium has dried up because of the decrease in homebuilders that are still solvent, to the point where they are struggling to cover their fixed costs. Moving to some more-specific financial highlights, we have a composite we've built of 186 captives. Most are rated. We're using this as an indication, combined with discussions that we've had out in the marketplace.

Bear with me as a run through a few numbers. Policyholder surplus for the captive composite declined by 5.1%, or $1.1 billion, from 20.4 billion at year-end 2007, to $19.3 billion at year-end 2008. To put it into perspective, the commercial insurance composite decreased surplus by 10%, approximately double. Assets declined 5.5%, or $3 billion, from $53.7
We saw shifts in the investment portfolios of the captives toward safety and liquidity. For instance, equity holdings went from 13.3% of invested assets at year-end 2007 to 8.2% of invested assets at year-end 2008. We saw movement toward cash and liquid short-term securities and also an increase in bond holdings. Net income decreased a whopping 66%, or $1.7 billion, in 2008 for the captives. We went from $2.5 billion of net profit for this composite in 2007 to $838 million at the end of 2008. A substantial portion of the decrease, I want to highlight, was the responsibility of one company, a very large group captive that had an adversarial year both on the investment front and on the underwriting front because of storms. Having said all that, we end up having one of the 186 companies that we follow have an impairment in their financial strength rating based on the environment. In fact, what we saw was the opposite situation. There have been a number of upgrades of captives directly reflecting the strength during the crisis. These impairments will be summarized in an A.M. Best report that will be forthcoming in the next year or two. Every few years A.M. Best does an insolvency study that incorporates not just rated companies but all companies that they can gather information on. But as far as rated captives go, there has been very little impairment activity.

**McDonald:** We saw in this year's annual insolvency and impairment study an uptick in both sides, P/C and life, so it's been a tough year overall. What do we see in terms of captive strategy that may reflect the time we're in?

**Chirico:** I'd like to bifurcate my comments here between broadly grouped captives and single-parent captives. From an underwriting strategy perspective, group captives compete more generally in the marketplace with commercial insurers than do single-parent captives, so we have been rate decreases of 5% to 10% in 2008. Captives as a general rule don't chase rate. When rates go down below reasonable amounts they have the ability to let business go because they are generally not rated on production goals. They can shrunk comfortably and keep an eye more toward the profit end of the equation versus the production end. In underwriting from single parent captives, we've see no change whatsoever. They're not subject to the market, really, at all.

What we have noticed is some placement of some of the more volatile coverages that would normally be put into a single-parent captive. The parent companies made the decision to access low rates sometimes in the commercial market, fully with the anticipation that when rates harden they'll bring those coverages back into the captive.

**Andre:** That's probably the distinction this time through, Steve, than in years past as the cycle's been moving. In years past they might have put captives on the shelf, whereas now they stay, but in public forums or utilized differently than they might have been ten years ago.

**McDonald:** And just in terms of strategy, Tina, are we seeing anything different or emerging in why companies may be either seeking or inquiring about ratings at this point?

**Bukow-Truman:** Most of what we're hearing from companies that come through are things like, they come through for collateral relief, savings on fronting charges, transparency, partner confidence. Overall, the theme really is economic savings. It really is financially based. That would even show more once leave my group and move on to the ratings side.

**McDonald:** One of the things that's always been interesting in the past 20 years is that captives have basically been a growth industry in different parts of the world for different reasons. What are we seeing these days? Is it still a growing area and how so?

**Chirico:** From our perspective it is. We talk to captive regulators. They tell us that they are continuing to grow. Some domiciles are growing faster than others. A few Western domiciles don't seem to be growing at all, that don't seem to be getting their platform up and running. But the established captive domiciles have been doing very well. From a rating perspective we have been seeing quite a number of new rating requests come to us. We believe we're seeing the captive formations continue and then rating activity based on the economic uncertainty that we see in the marketplace. There are a lot of questions out there about coverage and what's being provided, what the pricing environment is. General questions regarding the economic environment have led companies to re-evaluate their risk-management programs. That, combined with the general enterprise risk management focus that companies are giving themselves, captives are being discussed more and more. What we are observing is the cost-benefit analysis that is normally done, which is much more of a tactile analysis of tangible benefits versus costs, is taking more time. In talking to some of the risk managers of companies that have come to us that are not quite yet rated, they mention that the risk manager is on board for all the reasons that we've been talking about. However they have to convince the CFO or treasurer of a company that the laying out of frictional cost to either establish a company or to buy into a group captive makes sense for them. Those arguments of how to spend frictional costs today are challenging across the board, not just with the captive formation. You notice that those frictional-cost discussions are taking a little bit more time, the cost benefit analyses are taking a little bit more time. At the end of the day, when the captive makes sense there seems to be that resolution of establishing the captive and then the ones that need a rating, coming to us for a rating.

**McDonald:** Chris, you have a pretty broad scope of observation here. Where are you seeing the action these days? Where do the most new captives seem to be coming from? What are the areas that appear to be most active?

**Mancini:** That's a huge question. What we're hearing at Captive.com is everybody who replied to that email request that I sent out talked about cell captives that are being formed, both onshore as well as offshore. From a U.S. domicile representative we're hearing about a fairly significant decline in risk-retention group formations and that most of the new captives are pure captives. We're seeing a lot of interest starting to emerge in terms of benefits. We're seeing some TRIA and NBCR formations. Some of those cells are being used for NBCR as well. E&O has been hot, D&O, DPLI, 831-Bs are hot...
but a captive manager that we work with fairly extensively seems to think that they may be being abused and will be scrutinized as the 501(c)15s were a few years back.

We’re hearing also that existing captives are getting creative about using cells or using existing captives for some of those same coverages that the new captives are actually being formed to cover. We’re seeing some movement from within the domiciles, from domicile to domicile. A little bit of movement from offshore to onshore – in some instances to avoid regulatory scrutiny. They don’t want to be under the microscope, not knowing what’s going to shake out of potential regulation. We’re seeing a little bit of movement.

Another interesting development was that several people who responded to my request mentioned Malta as having some international movement going on over there. I thought that interesting as well. Doctor groups, of course, that’s another relatively hot sector. Again, everyone is kind of sitting on pins and needles because all you can see is the camel’s nose under the tent but you’re not quite sure whether the whole camel’s coming in yet or whether he’s going to stay outside, so I think a lot of formations are just sitting a little bit to see how all of this regulatory chaos shakes out before they make their move.

**ANDRE:** Chris, this is usually when the managers and captive sponsors get creative in order to fill a market void, as in years ago with the medical malpractice crisis back in the 80’s and the recent medical mal issues. You mentioned D&O and E&O and benefits. Captives always tend to see what the commercial market is doing and react accordingly. It’s interesting to see where these areas of growth are coming from.

**MANCINI:** Exactly. To the extent that they are actually utilizing the captive to the best interests of the parent company, everything should go well. As long as they don’t step outside that and lose track of what they were about, I think the industry is going to do extremely well. The other thing that was fascinating to me when email comments came in was an extreme sense of optimism about the industry as a whole. Given the chaos that’s going on in many other sectors of our economy, it just seemed that to the man and to the woman everybody felt that the captive industry was indeed a very healthy industry and would continue to do well.

**McDONALD:** Yvette, you’ve just completed a report on European captives. What are you seeing in terms of some of the locations and topics that seem to be drawing the most interest?

**ESSEN:** As Christine said, protected cell captives do seem to be a hot talking point at the moment. We’ve seen growth in the captive market fueled by cell formation over the last few years. That certainly seems to be the case going forward, partly due to the cost of establishing and running a cell being quite considerably lower than that of a captive and also that it needs less management time to establish and to run a cell than it does with the captive. So that’s something that we’re seeing here as well.

**McDONALD:** Clive, can you add to that in terms of the activity we’re seeing as far as outreach and inquiries? Where is the action these days?

**THURSBY:** While the growth in captive activity is being driven by cells, from my perspective, trying to get people interested in rating captives it’s the more well-established ones that are going to show interest. There is some pressure, I think, within the captive market for these vehicles to demonstrate that they are delivering value and, indeed, should be delivering more value. So making captives work harder is one of the themes I think we’ll see coming to the fore in the next year or so.

**McDONALD:** Tina, anything to add to that?

**BUKOW-TRUMAN:** Actually, Chris, your comment was interesting on risk retention groups. At the first six-month mark for 2009, of the seven new ratings we’ve had come in, more than half of them have been risk retention groups. To fuel that as well on the protective cell side, we are seeing a huge rise in inquiries in that. The interest is incredible and most of that on my side is coming from the Caymans.

**McDONALD:** In part of the report on domestic captives we address risk retention groups. We have a nice base to draw our results from. What are we seeing there, Steven?

**CHIRICO:** We currently rate 30 risk retention groups that just crested $1 billion dollars of surplus. Risk retention groups, rated risk retention groups, had a phenomenal year in 2008. They put up a combined ratio of 81. Surplus actually increased by 3% for this group; phenomenal results in any year, particularly in a year that was compromised by the financial crisis.

**McDONALD:** Overall, the combined was over 105.

**CHIRICO:** If you could compare it and contrast it to the commercial market, it blew it away. One of the things that we noticed and we’ve touched on it a little bit here, was this onshore/offshore strategy. What we see going on is offshore insurance solutions that have been offered through the alternative risk market have been populating onshore for a host of reasons. We mentioned the ease of doing business, as well as some of the regulatory constraints that captives believe are coming. The response has been to come onshore with some of these alternative risk programs and what better way to do that than form a risk retention group so you can avoid the licensing requirements, time and cost in all the states. If you used the measure of $200,000 per license in 50 states, that’s $10 million dollars of frictional cost just to establish yourself in the regular market, whereas the risk retention group formation avoids a lot of those frictional costs. It’s definitely an efficient, quick way of getting yourself established and pitching your tent onshore to provide continuing coverages to your insureds and having the bifurcated ability to be onshore and offshore with your solution. Of course, the Risk Retention Act limits the lines of coverage you can write but certainly they’re being used to write liability coverages.

**McDONALD:** Chris, you mentioned risk groups. Where do you think that’s headed this year and what are you seeing in terms of their performance at this point?

**MANCINI:** Risk retention groups specifically? All I can convey to you is what people have said to us. Regulators that are the onshore regulators have suggested that new growth seems to be slowing. I haven’t heard anything that would cause my antennae to go up in terms of risk retention groups
getting themselves into any sorts of financial dilemmas. The only thing that I do hear on a fairly consistent basis is the concern that's shaking out of the potential for a systemic regulator at the federal level and potentially worse in terms of the amount of government control that's going to be exerted over our industry. That would be a potential problem that would cause some slowdown of growth. If people don't know what to expect yet from an administration, certainly they're not going to be prepared to jump in with both feet.

**ANDRE:** The point about the RRGs, is what helps is that it's a 'speed to market' issue with these formations.

**MANCINI:** Yes. The risk retention groups are actually very supportive of federal regulation. One group representative said not long ago that they would rather deal with "one gorilla than with 50 monkeys," in terms of regulation. I laughed about that and I said, "Well, you could find yourself working with 50 monkeys plus a gorilla. The gorilla could either be not a very smart one or downright hostile to your best interest. So, be careful." You might get what you wish for and I think that we need to be very closely involved in terms of just exactly what the federal government is doing relative to the way states are being regulated and take a long hard look at the issue that Representative Kanjorski continually raises, that insurance is a systemic risk to the economy. I haven't found anybody who actually believes that. What is it that you're trying to accomplish with this federal regulator? I'm ambivalent about it myself. We need to be very involved in watching this whole situation unfold.

**CHIRICO:** It's going to be hard for the regulator, whoever he or she may be, going forward to look the other way at the results these organizations are putting up. How many doctors and warranty writers and contractors are served by these companies? Our composite puts up an 89; I'd imagine the total composite is probably doing pretty darn well. It's hard to look the other way at those results.

**McDONALD:** Steve, there's that broader issue of possible changes in taxation. The Obama administration has targeted some of this offshore activity. How's that going to affect captives and risk retention groups?

**CHIRICO:** There are two main points of view out there. Not to get political, but just to give a backdrop, the negative view is that it is unfair to have some companies being able to operate offshore in different types of business environments with different tax structures. The positive view is that by allowing companies to operate offshore, you decrease the cost of goods and services. I call that kind of the Wal-Mart theory where it's good to keep costs down because it helps keep inflation down. Having said all that, I don't think it's going to affect the captive community much at all. For instance, most of the rated, single-parent captives already select the 953D tax election, so they're already taxed as U.S. taxpayers. When asked a direct question of these companies, why are you in Cayman then, or Barbados and Bermuda, the direct response generally is it is a very friendly business environment and that the domiciles work with companies to solve issues and are very responsive. I have also heard that a majority of the domestic captive domiciles are also very responsive. Having said all this, I don't think it's going to come down to a tax issue. It's going to come down to an ease of doing business issue, a responsiveness issue from the domiciles. There's more variation within domestic domiciles than there is between onshore and offshore domiciles as far as service level and timeliness and response go. One thing that is on our radar screen is some of the captives that are in Bermuda, and Cayman in particular, are registered as reinsurers. They're licensed as reinsurers in those domiciles. What the federal government could do is increase the federal excise tax, which would have a detrimental effect to those companies that are licensed as reinsurers.

**McDONALD:** Chris, any other major legislative or regulatory changes that you think could impact the captive industry dramatically?

**MANCINI:** Well, the onshore domiciles as well as the offshore domiciles are continually in a state of flux. One offshore manager/broker had said that United States domiciles appear to have a flavor of the month in terms of, everybody's running to this domicile this year and then off to another domicile another year. They come and they go. I listen to that and say well, I guess one could make the same argument about many of the offshore domiciles as well. Perhaps one was very "hot" a couple of years ago, regulatory/legislative changes come in where businesses are more constrained. I guess I'm thinking mostly of Dublin at this point. People say I'm not going to deal with that environment anymore, so they'll take their captive elsewhere, whether it be to Guernsey or Gibraltar or whatever it is that they think would be more beneficial to them. We see the same thing going on here. Here we have an issue where every couple of years you have an election that may change the insurance commissioner, who then brings in a whole new group of regulatory folks. So you have an issue that just by virtue of our election system things change a little more rapidly than perhaps some of might like to see happening. That impacts our onshore domiciles as well.

At this stage of the game we've got Kentucky being the flavor of the month, Missouri is trying to do some things to lure captives in and then a host of new domiciles are coming onboard. For any of these new legislative domiciles to be successful and reach a critical mass there's going to have to be a hook of a lot of new captives; I just don't see it. I don't see it happening. That's the individual domicile's framework, but from a more global perspective, that in order for a capitalistic system to work, one thing that we need to have, above all else, if predictability. We need to have this legislation, whatever it's going to be, get passed so the captive industry, which is probably the fastest moving and most innovative industry in the insurance world, can say okay. This is what we have to work with. Then we'll see where it takes us. I have every confidence that these guys are going to figure out what they need to do once they know what the legislation is going to be.

**McDONALD:** Steve, your report and Yvette's report both cite protected cell captives as a development to watch. How so?

**CHIRICO:** We do rate protected cell companies. I'll add that the ratings of those companies are extremely customized
and specific and we don’t look at any one cell captive exactly like another one. We distill their risks down and we rate them that way, almost as you would rate an individual security, because the risks are very different between different cell captives. Having said that, we do see a preponderance of activity. Everywhere I speak I get asked: do we rate protected cell companies? How do we rate them? There seems to be an interest in it. I could weigh that down into probably two main categories. The first category is that it is a good way for a company to establish an alternative risk solution without going through some of the uncertainty and the extra frictional costs of forming your own captive. It also lends a comfort level because it is more of a homogenized program. A lot of the protected cell companies establish negotiations and relationships with a reinsurer and they renegotiate together. It takes some of the management time and the risk for management out of the equation. They buy some of the products and goods and services that a captive requires together. You negotiate with actuaries together, reinsurance in front, if need be. Those are the distinct advantages. Also a smaller company where the frictional cost doesn’t make sense to have their own captive can rent a cell within a protected cell corporation and that may make sense for them whereas forming their own captive would not.

McDONALD: Yvette, your report devotes an entire section to protected cells. What’s the significance of that in the European marketplace?

ESSEN: As we’ve been discussing there is definitely an interest in cell formation. It’s worth looking at just how quickly the cell market has grown. The first cell-specific legislation wasn’t introduced until 1997. Now there are an estimated 3,000 cells within protected companies. That is quite remarkable growth. Previously we saw a degree of caution attached towards cells. They are a relatively new segment of the captive market and there have been some question marks as to whether the regulations surround them stand up. We are seeing more interest, partly because bigger companies already have a captive so it’s the smaller companies that are likely to look at self insuring and with the various benefits; cell formation is certainly one of the options.

McDONALD: We do have a methodology on rating protected cell captives. I’ll update the page that you’re watching after the broadcast, but if you just go to one of the search engines and type in “A.M. Best protected cell captive,” it will take you to that methodology link. It’s freely accessible. Yvette, what are we seeing in terms of the impact of Solvency II on the captive industry?

ESSEN: Solvency II won’t be introduced until October the 31st, 2012. That might seem like a very long time away but it’s already having a very profound effect on the captive market. Yes, there is a lot of concern about the credit crisis now, but it’s Solvency II that people are addressing and talking about as the biggest challenge for the market in the medium to the long term. Simply, some captives will close if they fail to comply with the directive. We last year had the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) publish the results of its fourth quantitative impact study. That study showed that 99 captives took part; 28.3% didn’t meet the minimum solvency capital requirement, which implies that some others will not as well. There’s also a fear that the growing financial administration burdens of Solvency II could lead to captives being set up outside of the European Union.

McDONALD: Are there any particular domiciles that will have any decided impact here?

ESSEN: We’ve seen there could be a potential for growth for domiciles such as the Isle of Man and Guernsey, which don’t have to comply with the Solvency II requirements. Then again they are having to adjust their regulatory status as well. Solvency II, we’re finding, is setting a benchmark standard. It’s raising the bar of domiciles, not just the ones in Europe, but the ones outside as well.

McDONALD: When I read your report I thought that was one of the more interesting things was that outside the EU the whole Solvency II climate would affect Latin America and Middle Eastern markets as well. Can you just go into that a little bit?

ESSEN: Yes. Despite the prospect of tougher worldwide regulations, the captive market is indeed showing signs of increased activity. Lee pointed out Latin America and the Middle East and we’ve seen interest from companies in those countries looking at forming a European captive. There appears to be a change of risk management patterns going on in those regions, in developing regions where there’s an increasingly sophisticated knowledge about alternative risk management. We can presume also that perhaps these areas are getting better advice from their brokers as well.

McDONALD: You raise the point that some firms may consider selling their captives to third parties. Why so?

ESSEN: The credit crisis has resulted in an increased demand for security. Companies are also looking to free up capital now. It’s very difficult to get access to money and people are being very innovative nowadays. The captive market is also maturing. I’ve seen estimates where 30% of captives are estimated to be in dormant areas, not really writing any new business as such. So you’ve got these captives that are sitting there, not really doing very much and people are looking to free up capital. So, companies are therefore, looking at the options. They’re looking at the buyer market. Perhaps selling their captive or part of the risk associated with captives to a third party provider, perhaps a run-off specialist.

McDONALD: Steven, do we see anything similar in the North American market or is that pretty much a European exercise?

CHIRICO: I think it’s predominantly a European exercise. We do have some single parents selling their captives. There was one in 2008 that we’re familiar with. However, it is not as much of a problem because it is easier with the U.S. GAAP standards to move money in and out of a captive. You can avail yourself of some of the capital that’s in a captive, say it was in a dormant stage, whether it was domiciled offshore, U.S. or onshore. In Europe they have the equalization reserve methodology where one of the ways to get your money out is to sell the captive and then you get to have the buyer get
McDONALD: Clive, just to circle back to Solvency II, is that driving any increased activity among captives as far as your interactions, anything that captives are particularly concerned about that would cause them to change the inquiries or increase activities there?

THURSBY: I think there is interest in new captive formation. The driver behind that is greater risk financing efficiency and creating a new captive, wherever it would be, is a way of solving that. It’s worth saying, as well, that once we talk about emerging markets as a source of new captive business, Europe itself is very uneven in the extent to which captives have penetrated. While the U.K. may have too many captives, some might say, places like Germany have very few. Therefore there is potential for tremendous growth in Western Europe itself. I think we’ll see more effort to try and harness that potential.

McDONALD: Yvette, what is our outlook for the likelihood of activity in Europe as far as captive growth and some of the major changes?

ESSEN: Well, we started to notice that there is more interest. It’s been quite quiet for the last year Companies have been looking after themselves, trying to cope with the credit crisis, trying to survive really. But now we’re looking at potentially new formations, not just cells but also captives as well. This may be related to the market. The market in some certain lines of business, mainly liability, has seen increases. Companies are looking at their options, which could be captive formation. Now companies are also likely to be focused on an increased need to save costs during the credit crisis, so that also could fuel growth going forward. Our research does show increased interest but it’s worth pointing out whether this does translate into actual growth remains to be seen.

McDONALD: Steve, what are our expectations for U.S. market?

CHIRICO: Our expectations for the market going forward are about average growth in captive formations and rating activity. We started out the first six months of 2009 with a robust activity level. If we look back at September 15th, 2008, the global economic system came as close to failing as it ever has. It took several months for companies to become comfortable with implementing the plans that they had on the table. That’s what I attribute to a lot of activity that we saw in the first quarter or second quarter of 2009. Going forward, we do see it slowing somewhat as we already stated about the cost-benefit analysis being looked at a little closer. CFOs and treasurers of companies are taking a much closer look at all frictional costs. We also see, counterbalancing that, a perception that certain coverages are going to come under duress from the commercial market. There is a significant lack of capacity providing small contractors with liability coverage, so we’ve seen the formation and rating activity of a lot of those small risk retention groups to address that marketplace void. If we distill that in, we expect an average year. We can see reasons for increased captive formation and rating activity and we can see that slowing on some fronts as well. If you had to ask, we’d see more activity in the group captive scenario and a little bit less activity in the single parent captive but we’re predicting average growth. Our outlook for the captive industry from a financial perspective is at least stable.

McDONALD: Yvette, do we have any expectations for any other parts of the world in terms of unusual captive activity?

ESSEN: We talked very briefly about Latin America and the Middle East looking at creating captives themselves. We also expect companies in other regions such as Africa to look in this direction, to look to captive formation in Europe.

McDONALD: Tina, I we’re fairly consistent in how we go through the rating process.

BUKOW-TRUMAN: Absolutely. The rating process remains the same no matter where you come through – domestic, nondomestic. It’s a two-part process. There’s business development and there is the technical rating side and you can get to either party just by entering our website, calling any one of us and we can further explain that. I don’t want to get into the rating process here because that’s not what this webcast is about.

McDONALD: It’s probably important to let people know that it goes through basically the same channel.

ANDRE: Analytically, too, to complement what Tina is saying, we basically have the same tools. There’s some differences in the capital model when it’s not on a U.S. statutory accounting basis, but it’s basically the same capital model that we run all companies. We have transatlantic video-conference-based rating committees. For example, I spent most of this morning on some rating committees for some reinsurers that are followed by our colleagues in London for that. This goes on all the time. There may be some times when we’re not consistent but they’re few and far between these days. We strive for consistency. Certainly you should get the same analysis whether from our Hong Kong team, in London or here in New Jersey.

McDONALD: There’s the opportunity to get a start-up rating, if appropriate. Can you just address that?

BUKOW-TRUMAN: That’s correct. Start-up ratings, we get quite a few inquiries on that. Since 2004 we have the capability and we have the methodology out there for rating start-up companies and that does include captives. We rate them and we have rated them. That goes for U.S. and non-U.S. as well.

ANDRE: That’s what’s helped in that regard, again, from the analytical side, is not only our colleagues in London and Hong Kong but the breadth of the analytical group here in New Jersey. Steve’s group includes banking experience, credit experience and insurance experience. They have a niche they can follow pretty well, whether it be banking, or pharmaceutical or auto. They get engrossed inside of that niche and helps
us attack any kind of rating that comes our way. There's been some very interesting ones. We had one recently that does scuba diving risk that we released a couple of weeks ago, so now we have a scuba diver expert of sorts on staff. It's a neat side of the business and one that we're willing to attack and our analysts – and Steve can speak to this better than I can – enjoy the challenge.

McDONALD: That explains the flippers in the cafeteria. Chris, what are people asking you?

MANCINI: One thing that did come up was from a U.S.-based accounting firm. This individual mentioned that the potential migration to a new national accounting standard, IFRS, in the coming years is going to result in a huge change in the regulatory and financial reporting with captives. There's going to be a session on that at VCIA this year. I don't know whether that has an impact on your rating methodology. I'm kind of curious about that.

CHIRICO: Well, we can certainly say that we can handle any basis of accounting. We deal with IFRS currently. We deal with U.S. NAIC-based statutory reporting. We rate several self-insurers – funds that report in through the department of labor of their particular state. It's a quasi-GAAP, quasi-statutory basis. We deal with Luxembourg statutory, FSA, SEC, we can handle basically any basis of accounting. When we run across something new, we analyze it and we make changes to the model to wrap around the risks that are apparent in those underlying financial reporting schemes.

MANCINI: So the impact of that would rest more with the captives themselves than with A.M. Best?

CHIRICO: Absolutely. It's really just paraphrasing it, a different way of looking at it and to address the risks that occur. What we do in the captive unit pretty much daily is we provide customized ways of looking at risk and then customized ways of addressing those risks in the capital model. That's different than our colleagues that are in commercial lines and personal lines that where 90 or 95% of their work is in the NAIC U.S. statutory-based reporting. They have other things to deal with that result from competing out in a broader marketplace that captives generally don't have.

McDONALD: I'm integrating some of the real-time questions and comments that are coming in. Steve, is there an impact of the credit crunch on rated captives? Have we seen anything noteworthy in that regard?

CHIRICO: Yes and no. Let me explain that. Of the captives themselves, as we stated there was only one captive that had one financial strength level (FSL) downgrade based on being in the marketplace during 2007. Having said that, unfortunately there have been some impairments of single parent captives' captives because the parent company's situation has become adversarial. There are certain industries, we all know what they are, that have become extremely compromised because of the crisis. They tend to be manufacturers of hard assets that require financing to purchase. We've stated in some of the rating reports of those captives that the captives are very well run, they're very well capitalized but there's this ominous tether to the parent company. I'm unaware of any captives in any industries where we have a question mark of continuity of the parent company. But there are certainly some very large speed bumps in the way of some of these companies that they have to get through for us to bring the captives' ratings back up to where they should be, if we're looking at the captive in isolation. So there is a tethering in the single parent captive situation of the captives' rating with the finances of the parent company. In a group captive situation we don't find that very much. There are some group captives that are in some industries where we have questions of just general shrinkage and the ability to meet fixed costs, but those are reflected in the ratings of those companies.

ANDRE: To play off of Steve's point, we are going to spend a load of time this year getting behind the issue of U.S. auto writers in that we rate of number of those captives and we rate international auto writers as well. It goes beyond just the insurance company part of our analysis. If the credit crunch impacted them, it was not really at the insurance company level it's because of what might or what might not have been going on at the parent. To the listener's question, too, Lee, I think that the lack of movement, credit crunch related, in this sector is emblematic of what's gone on in P/C side in general. With some notable exceptions, including one that was in the paper every day for probably a year, there were not a lot of rating changes as a result of the credit crunch. There might have been some changes in outlooks or a nick here or there but, generally speaking, the P/C side held up pretty well with the credit crunch. The life side – that was different. It's a different kind of business. Captives as a microcosm of that bigger P/C sector did even better in terms of the credit crunch impact, certainly the ones we observed from the outside.

CHIRICO: One observation you’ll notice in the captive report is that the rated captives produced an underwriting profit in 2008. That is exemplary performance by any measure. Yes, there were some asset impairments from investments and, yes, there were some bumps as far as realized and unrealized capital losses, but underwriting stuck to its knitting as far as the captive community’s concerned and in fact put up an underwriting profit in one of the most challenging years in the last 20 years.

McDONALD: Chris, any other significant comments or questions from your base?

MANCINI: A very intriguing question did come in from somebody in a large, multinational accounting firm who says, "I'm curious if any of the panel has any perspective on whether there is a role for captives to play in the changing landscape of health insurance in the United States. Perhaps from a pooling or group perspective?" Quite naturally, a hugely rhetorical question given everything going on in Washington today, but it might be worth a mention. Any thoughts on that?

CHIRICO: I generally avoid making definitive but on this one I would say no. Where we have seen some activity in the captive marketplace are non-medical employee benefits. Also there's been a lot of interest in companies talking to us about putting employee benefits that are transactional into their captives. Things like employee life insurance, things like accident, disability, death and dismemberment coverages. No one has spoken or inquired about medical benefits at all. Think it is a
very volatile cover which inures itself to being placed more in a commercial market. It is surrounded by uncertainty, politics at this point, and why would you retain that risk if you could place it in the marketplace? Those other employee benefits, though, there has been some discussion of placing them in the captive. In fact, we have one single-parent captive that currently has some employee benefits in their captive.

Mancini: My understanding also is that there is an outstanding request to fast-track retiree medical benefits – I believe it was Coca Cola – that’s being held up. They didn’t get the fast-track exemption but I think it’s still being looked at. It’s going to be interesting to see how that shakes out. Again, that’s far from what this question was speaking to. What is does reveal is that everybody is concerned about the volatility of insurance regulatory issues in general within our industry.

McDonald: Chris, I have time for about one more question or comment. Did you have anything else?

Mancini: The most important thing that I was hearing from folks is that the captive industry needs to make sure that we re-evaluate and are very clear about what we’re seeking to achieve from our captive. So, if whatever it is that we’re trying to achieve doesn’t work for risk retention purposes then it doesn’t work, period. Captives are not retail vehicles. According to a Guernsey-based captive consultant, I think this was a rather cogent statement. He said that they should never be taken as a retail vehicle. Consequently, they should always be dealing on a professional level. A professional to professional basis. So we have to pin ourselves down to what it is that the sector is trying to accomplish and make sure that we actually take ourselves in that direction and I think that you guys, from a rating perspective, would be right on board with that philosophy.

McDonald: Chris, can you tell people how to reach you and some of the places that you’ll be appearing.

Mancini: Captive.com, of course, is www.captive.com and a second, sister website which were are working on developing and populating and A.M. Best is going to be involved in that, actually, is www.captivelearning.com. You can reach us in Connecticut at 860-276-9775 or me, directly, mancini@captive.com. We’re going to VCIA. We always do that one. We’ll do World Captive Forum this year as always. We’re going to go down to SIIA. They’re becoming more involved in the art market. We’re going down to South Carolina for a couple of events. CICA we always do, but above and beyond that we just try to stick closer to home and take care of business.

Thursby: My next outing into the captive arena is to the conference arranged by FERMA, the organization which acts as an umbrella body for all of the risk management associations in Europe which is taking place in Prague at the beginning of October. A.M. Best will be having a booth and will be available to meet with risk managers there and generally I can be reached through the A.M. Best website at any time.

Esse: Obviously, we’ve published this report now, so we will be keeping an eye on developments.

Bukow-Truman: Domestically we will be making the rounds for the remainder of the year, that’s for sure. Same as Chris, we’ll be in Vermont. We’ll be in South Carolina. We, too, will be attending the Self Insurance Conference. Actually, Steve Chirico will be speaking both there and in South Carolina. We’ll also be in D.C. We’ll be at the World Captive Forum and, of course, we’ll be at the Cayman conference in December. So, we are always available to have meetings or to just sit and chat if you have any questions, either on the rating side or on the business development process side. Contact any of us and we’d be happy to meet with you.

Chirico: We will be in Vermont. I will be speaking at the South Carolina Captive Conference in September as well as the SIIA Conference in Orlando in September and the rest of the year we’ll see how it plays out.

Andre: I’ll be wearing my reinsurance hat at the Monte Carlo meeting in September.

McDonald: Thank you.

Note: This transcript has been edited for clarity.