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Middle market captive growth

Lanston Connor and Stewart Feldman look at where and why middle market companies are forming captives.

In this period of financial turmoil, many of the US's largest conventional insurance companies are suffering as a result of poor investment decisions. Their stock values have declined significantly and, in some cases, insurers are now dependent on the US Government for their survival. The disasters that have befallen Hartford, AIG and others have made many insureds question how advisable it is to use conventional insurance. Many of these insurance companies have petitioned the government to become bank holding companies in order to further secure emergency government aid. While Fortune 1000 companies historically have had other insurance options available to them, only relatively recently have these alternative risk planning options become available to middle market companies.

As a result of the growing uncertainty, more and more middle market companies are looking to captives as a viable risk planning alternative. Long the bastion of the largest publicly held companies, captives have become viable for the substantial closely held business that seeks to supplant or supplement current property and catastrophe coverages. For the business owner, a captive provides the insureds with greater influence over the financial health and well-being of the insurer, rather than being at risk of having coverages effectively negated due to poor investment decisions by conventional insurers or the traditional propensity to deny commercial claims.

Funding claims

Some conventional insurers have long enjoyed a reputation for not paying claims. Yet businesses depend on these same companies for coverage when they are sued. Middle market companies are looking for more certainty from their insurance company when filing a *bona fide* claim. It is almost commonplace for some conventional insurers to deny even *bona fide* claims as part of the 'negotiation process', especially when facing a large commercial loss. As a result, businesses have to sue their insurance companies to recover unpaid claims or face declaratory judgement actions. The certainty of payment from a captive is, for many, a better alternative.

Commercial insurers often tend to rely on policy exclusions, which create uncertainty among the insureds regarding what is actually a 'covered risk'. In contrast, policies issued by captive insurers can be custom-designed to supplement 'holes' in existing commercial policies, or to provide cost-effective coverage not offered or unacceptably priced by conventional insurers. In some cases, the captive's policies specifically take over when the conventional carrier denies coverage on the underlying policy.

Controlling claims payments

Captive insurance claims payments mean no more red tape and no more coverage litigation when it comes to claims-handling. Due to the special relationship between the captive insurer and its insureds, claims-handling is no longer the adversarial relationship that many businesses have come to expect from their conventional liability carrier. Claims investigations, verifications, adjustments and payments can all be done expeditiously and efficiently through a captive.

Selecting a domicile

Capstone is one of the country's oldest and largest sponsors of small and intermediate-sized captive insurance companies (property and casualty premiums of less than $1.2 million per year) that in turn insure middle market businesses. Having formed more than 80 captive insurance companies in multiple domiciles over the last 12 years, Capstone understands the importance of choosing the right domicile. Owners of small businesses prefer the lower cost of capitalisation and the less restrictive on-site meeting requirements, coupled with a high level of insurance expertise and reasonable regulation, based on Capstone's experience.

However, not all domiciles—whether onshore or offshore—are the same. For a captive to be the most economically feasible, it must operate in a jurisdiction with an efficient and accessible regulatory environment. Therefore, high on Capstone's criteria in recommending a jurisdiction is a licensing and regulatory regime that is responsive, efficient, well respected and capable of providing cost-effective services to its regulated entities. Expertise in regulating these smaller captives is paramount. A jurisdiction skilled in handling larger companies, which have a legal staff able to deal with changing regulatory requirements, may not be appropriate for a regional general contractor.

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From formation and licensing to responsive regulatory oversight, Anguilla has met Capstone’s expectations. Evidence that the market has also reached similar conclusions is its growth over the last few years as the domicile of choice for smaller captives.

The cornerstone of the jurisdiction’s streamlined formation procedures is Anguilla’s Commercial Online Registration Network (ACORN), which is an innovative system that allows companies to be formed online. The ACORN system, coupled with the electronic transmission of insurance licence application materials, with the later receipt of original documents, accelerates the licensing process. In cases where there are time-sensitive filings, there is a willingness on the part of the Registrar and Financial Services Commission (FSC) to recognise reasonable deadlines and to put in the extra work necessary to meet those deadlines. The availability of the jurisdiction’s staff is not limited to banking hours.

The Anguilla Insurance Act and the Insurance Regulations also provide a sound regulatory framework for the operation of captives. Anguilla excels in fairly and consistently enforcing its captive framework. The FSC’s focus has been on providing a secure, practical regulatory framework for the safe and sound operation of captive insurance companies, and not on creating and maintaining a regulatory minefield strewn with bureaucracy.

This is in contrast to other captive jurisdictions that have installed staff who continue to promulgate rules—often without industry consultation—that regularly change the regulatory landscape, providing for little certainty, while needlessly reworking the captive’s operations. Some domestic jurisdictions have an underlying theme to their regulatory structure, which is to promote tourism, requiring in-person meetings with the regulatory staff and in-person directors’ meetings annually. While this might work well in the context of a publicly held company whose employees are looking forward to a vacation in an attractive domicile, the owners of privately held businesses often find it difficult to travel out of the state, or out of the country, on a given schedule to hold a *pro forma* meeting. Similarly, some domestic jurisdictions have as a theme the creation of in-state jobs, by requiring service providers (e.g. auditors or directors) to be resident of the state. This often opposes the primary objective of the captive, which is to provide cost-efficient, alternative risk coverages to the related insureds.

In contrast, Anguilla’s FSC has shown impressive accessibility and responsiveness. Its rules are a balance between good regulation and a recognition that coverages are being written to affiliates of the captive’s owners. The Commission has responded in a timely manner to requests for interpretations and rulings on technical insurance issues. This is a sharp difference to other jurisdictions, which either do not seek industry input on proposed regulations or otherwise seek limited input.

A case in point was the dialogue with the Commission director concerning the calculation of ‘allowable assets’ contained in a new set of Anguilla Guidance Notes. The proposed guidance notes were distributed in advance of (not after) their implementation and there was opportunity to comment ahead of time. The definition of allowable assets is important for insurance companies, especially Capstone’s sponsored captives. An exchange of emails and telephone calls followed, culminating in a face-to-face meeting in Anguilla. In each instance, we were encouraged to present the business, accounting and insurance reasons for the requested revisions. Through this enhanced communication process, we were able to come up with a workable solution.

During Capstone’s dealings with the FSC, it was at least assured of a timely, well-reasoned response and a genuine attempt at understanding the perspective of the middle market client.

Before forming its first captives in Anguilla, and before beginning the migration of existing captives to Anguilla from other increasingly unresponsive domiciles, Capstone did its homework and Anguilla’s commitment to the small captive industry has continued on.

Middle market growth

Captive insurance enables small business owners to better manage insurance needs, including cost, coverage, service and capacity. More than 900 captives worldwide were incorporated during 2008, and more than half of those were formed by middle market businesses. In 2009, the middle market will continue to be a valuable source of captive formations. The option remains an attractive one as companies focus on the overriding need to reduce costs and manage their risks effectively.

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