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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE PAPER ON THE REGULATION AND SUPERVISION OF CAPTIVE INSURERS

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Guidance Paper on the regulation and supervision of captive insurers

Contents

1. Introduction 4
2. Scope of paper 4
   Ownership and structure 5
   Business underwritten 5
   Policyholders or beneficiaries 5
3. Structure of paper 6
4. Application of the ICPs and Standards 6
   4.1 Regulatory system 7
      Supervisory cooperation and information sharing 7
      Licensing 8
      Suitability of persons 9
      Changes in control and portfolio transfer 10
      Market analysis 11
      Reporting to supervisors and off-site monitoring 11
      On-site inspections 11
      Group-wide supervision 12
      Insurance activity 12
      Consumer protection 12
   4.2 Corporate governance 13
   4.3 Risk and internal control 15
      Types of risk 15
      Internal controls 17
   4.4 Liabilities 18
   4.5 Investment strategy 19
   4.6 Types of capital 20
   4.7 Capital adequacy and solvency 21
   4.8 Confidentiality and disclosure 23
   4.9 Fraud, anti-money laundering and combating the financing of terrorism (“CFT”) 25
      Fraud 25
      Anti-money laundering and CFT 25
5. Protected Cell Companies 26
6. Insurance managers 27
   6.1 Supervision 27
      Licensing 27
      Suitability 28
      Reporting requirements 28
      On-site inspections 28
   6.2 Corporate governance 29
      Internal control 29
   6.3 Fraud, anti-money laundering and CFT 30
      Fraud 30
      Anti-money laundering and CFT 30
Appendix – Captive types 31

1. Introduction

1. This paper is intended to provide guidance to insurance supervisors on the aspects of regulation and supervision that are specifically relevant to captive insurers or reinsurers ("captives"). For background information about captive insurance, reference can be made to the IAIS Issues paper on the regulation and supervision of captives[1].

2. Supervisors should develop an appropriate supervisory approach to captives and the guidance provided in this paper is designed to assist supervisors in doing this. The guidance follows the IAIS Insurance Core Principles ("ICPs") and highlights those matters specifically relevant to captive supervision.

2. Scope of paper

3. There are a number of existing "definitions" of captive insurance used in the insurance market place; this paper is not based on any particular definition. The IAIS has defined a captive insurer as "*an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties.*"[2]

4. In practice, supervisors of captive insurers tend to use the following classifications[3]:

- Pure captives: "*single parent companies writing only the risks of their owner and/or affiliates*";
- Group and/or association captives: "*multi-owned insurance companies writing only the risks of their owners and/or affiliates, usually within a specific trade or activity*";
- Rental captives: "*insurers specifically formed to provide captive facilities to unrelated bodies for a fee. They are used by entities that prefer not to form their own dedicated captive*";
- Diversified captives: "*captives writing a limited proportion of unrelated business in addition to the risks of their owner and/or affiliates*" and
- Producer owned reinsurance companies (PORCs): are captives *"that are beneficially owned by the producers of the business that is ultimately reinsured into the company through an independent fronting insurer".*

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[1] October 2006.

[2] IAIS *Standard on disclosures concerning technical risks and performance for non-life insurers and reinsurers, October 2004, (footnote 1). This definition was provided for the purpose of the disclosure standards.*

[3] IAIS *Issues paper on the regulation and supervision of captive insurance companies, October 2006*

5. The above list is not exhaustive; a more extensive list of the types of captive is given in the appendix[4].

6. Supervisors should recognise that the regulatory risk inherent in a captive insurer can vary substantially. A pure captive represents the lowest regulatory risk because there are no unrelated party policyholders or potential third party beneficiaries. Those representing the highest regulatory risk are captives underwriting risks for unrelated party policyholders or underwriting compulsory third party liability risks. Such insurers may effectively be commercial insurers and supervisors should consider applying regulatory requirements similar to those for commercial insurers.

7. In order to determine an appropriate supervisory approach, the following factors should be taken into account.

Ownership and structure

8. There are a number of different captive structures. The simplest structure is represented by single owner captives. Other captives can have more than one owner such as association captives or risk retention groups (see appendix).

9. Some captives maintain a legal separation between the assets and liabilities relating to each policyholder, but in other captives, such as rental captives, these are not kept legally separate.

Business underwritten

10. There are captives that only underwrite non-compulsory classes of business such as property damage or business interruption. Other captives write liability business where there may be third parties with an indirect interest in the proceeds of the policy.

11. In some cases, captives are permitted to underwrite compulsory classes of business directly under the legislation of the jurisdiction where the risk is situated such as employers' liability or motor third party liability.

12. The business may be directly written or assumed as reinsurance.

Policyholders or beneficiaries

13. Many captives only underwrite risks for their owner or owners, either directly or through fronting insurers. In other cases, captives write business for connected parties such as other companies in the same industry or for commercial customers or suppliers of the owner. Some captives also underwrite risks for individual consumers or for employees of the owner. The ways in which supervisors should treat these different types of captive are covered later in this Guidance Paper. However supervisors should bear in mind that captives underwriting risks for individual consumers or for employees of the owner on a direct basis or that are significant to the captive's activities should normally not be treated as captives at all.

14. Producer owned reinsurance companies (PORCs) reinsure a fronting insurer which underwrites risks for individual consumers generated by the captive owner. Supervisors should treat PORCs in the same way as commercial insurers when considering consumer protection issues because the sale of the product could be influenced by the owners of the PORC.

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[4] A. M. Best

3. Structure of paper

15. This paper considers the application of the ICPs and IAIS standards to captives and where appropriate provides additional guidance and elaboration. The ICPs and the associated Criteria apply to captives just as they do to commercial insurers although the emphasis may vary. There are separate sections on issues relating to protected cell companies and insurance managers.

4. Application of the ICPs and Standards

16. The following ICPs have been considered in respect of their specific application to the supervision of captives:

- Principle 5: Supervisory cooperation and information sharing
- Principle 6: Licensing
- Principle 7: Suitability of persons
- Principle 8: Changes in control and portfolio transfers
- Principle 9: Corporate governance
- Principle 10: Internal control
- Principle 11: Market analysis
- Principle 12: Reporting to supervisors and off-site monitoring
- Principle 13: On-site inspection
- Principle 17: Group-wide supervision
- Principle 18: Risk assessment and management
- Principle 19: Insurance activity
- Principle 20: Liabilities
- Principle 21: Investments
- Principle 23: Capital adequacy and solvency
- Principle 25: Consumer protection
- Principle 26: Information, disclosure & transparency towards the market
- Principle 27: Fraud
- Principle 28: Anti-money laundering, combating the financing of terrorism

17. Related IAIS supervisory papers are:

- Supervisory standard on Licensing, October 1998
- Supervisory standard on On-site inspections, October 1998
- Supervisory standard on Asset management by insurance companies, December 1999
- Supervisory standard on Group coordination, October 2000
- Supervisory standard on the Exchange of information, January 2002
- Supervisory standard on the Evaluation of the reinsurance cover of primary insurers and the security of their reinsurers, January 2002
- Standard on supervision of Reinsurers, October 2003

- Standard on Disclosures concerning technical performance and risks for non-life insurers and reinsurers, October 2004
- Supervisory standard on Fit and proper requirements and assessment for insurers, October 2005
- Standard on Disclosures concerning investment risks and performance for insurers and reinsurers, October 2005
- Standard on Asset-liability management, October 2006
- Guidance paper on Investment risk management, October 2004
- Guidance paper on Combating the misuse of insurers for illicit purposes, October 2005
- Guidance paper on the Structure of the regulatory capital requirements, October 2007
- Guidance paper on Enterprise risk management for capital and solvency purposes, October 2007
- Guidance paper on the Use of internal models for risks and capital management purposes by insurers, October 2007.

Related IAIS supporting papers are:

- A new framework for insurance supervision: Towards a common structure and common standards for the assessment of insurer solvency, October 2005
- Towards a common structure and common standards for the assessment of insurer solvency: Cornerstones for the formulation of regulatory financial requirements, October 2005
- Roadmap for a common structure and common standards for the assessment of insurer solvency, February 2006
- The IAIS common structure for the assessment of insurer solvency, February 2007.

4.1 Regulatory system

18. This section covers ICP 5 (Supervisory cooperation and information sharing), ICP 6 (Licensing), ICP 7 (Suitability of persons), ICP 8 (Changes in control and portfolio transfers), ICP 11 (Market Analysis), ICP 12 (Reporting to supervisors and off-site monitoring), ICP 13 (On-site inspection), ICP 17 (Group-wide supervision), ICP 19 (Insurance activity) and ICP 25 (Consumer protection).

Supervisory cooperation and information sharing

19. ICP 5 states: *The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.*

20. Supervisors of captives should cooperate fully in sharing information with other supervisors where captives transfer risks between jurisdictions through reinsurance or portfolio transfers. Information should be shared where a director or controller of a captive or insurance manager located in one jurisdiction applies to be a director or controller of an entity located in another jurisdiction. The requirement for supervisors of captives that are part of financial groups to cooperate with supervisors in other jurisdictions is covered in paragraph 55.

21. It is also possible for captives to migrate to other jurisdictions. This is more likely to occur for captives than conventional insurers since captives normally only insure risks based outside their own jurisdiction and there are therefore fewer impediments to a move which may be undertaken, for example, for legislative reasons or because of a change in ownership of the parent. Supervisors in the respective jurisdictions should communicate with each other in these circumstances to confirm that there are no regulatory reasons why such a transfer should not take place.

Licensing

22. ICP 6 states: *An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing should be clear, objective and public*.

23. A captive is usually an integral part of its owner's risk management programme. Supervisors should have a clear understanding of why the captive is being formed and its particular goals and objectives. Supervisors should ensure that they fully understand the scope, nature and source of the business.

24. The captive's owners may not be familiar with the operational and prudential requirements of an insurer. Supervisors should therefore satisfy themselves that the captive will be managed by experienced professionals. The day-to-day management is often carried out by an insurance manager. This is covered further in section 6.

25. Licence applications should be accompanied by relevant licensing information, which should include, at a minimum, details of proposed significant owners, directors, key functionaries, service providers such as insurance managers, auditors and actuaries, and a comprehensive business plan.

26. The business plan should include the following details:

- the capital structure, including how the captive would meet future solvency requirements
- a projected balance sheet
- a profit forecast
- cash flows projection
- intended classes of business and cover
- limits of liability
- details of reinsurers and fronting insurers
- an organisational chart
- details of any outsourcing arrangements
- an outline of the proposed investment and dividend strategies
- confirmation that it will have access to adequate financial and other resources
- actuarial reports where appropriate, depending on the nature of the business, for example if the captive is to write life insurance, pensions or long-tail non-life insurance risks
- confirmation that the legislation of the jurisdictions where the insurance risks are located does not prohibit the transfer of those risks to the captive's jurisdiction and does not impose requirements such as fronting arrangements that are not part of the captive's business plan

27. Supervisors should be satisfied that the operations of captives, domiciled in their jurisdiction, are sufficient to demonstrate that they are carrying on insurance business in or from within their jurisdiction.

28. Supervisors should assess the proposed reinsurance strategy, both assumed and ceded/retroceded, to confirm that it provides adequate protection and consider the financial standing of both fronting insurers and reinsurers. Full details should be provided of the structure of the reinsurance programme together with percentage shares placed with individual reinsurers and their financial strength ratings.

29. Where captives do underwrite risks through fronting insurers, supervisors of the fronting insurers may have concerns that such arrangements may prejudice the fronting insurers' integrity. While this matter is primarily a regulatory issue for the supervisor of the fronting insurer, supervisors of captives should also ensure that prudent underwriting procedures and adequate security arrangements are in place. Both supervisors should closely cooperate.

30. Prior to issuing a licence, supervisors should be satisfied with proof of the captive's incorporation, copies of its memorandum and articles of association (or equivalent), key agreements, evidence of the source of capital funds and confirmation of capital received and shares issued, including any relevant legal, audit or other opinions which supervisors consider necessary. Where the captive and its owner are based in different jurisdictions, performing due diligence on the owners may involve the exchange of information between supervisors in those jurisdictions, where the parent is a regulated entity.

31. Essential criterion ("EC") 6h requires that supervisors should have the ability to impose additional conditions or restrictions on an applicant. This is important in the supervision of captives since supervisors should have the flexibility to deal with a wide range of types and structures of captive. Examples of restrictions are limiting business strictly to related-party risks, permission to conduct business only through a fronting insurer, requirements to have stop-loss reinsurance in place, or limiting the captive to writing certain lines of business.

32. EC 6b requires the suitability of significant owners and key functionaries, as specified in ICP 7 (Suitability of persons), to be assessed prior to licensing.

33. The owner's location should also be considered in the licensing decision because transparency and reliability of financial information can vary between jurisdictions and differences in accounting practices can complicate assessment of ongoing financial strength. Further, some jurisdictions may restrict outward investment through exchange and other controls, potentially inhibiting cash flows or financial support to the captive.

Suitability of persons

34. ICP 7 states: *The significant owners, board members, senior management, auditors and actuaries of an insurer should be fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.*

35. Owners of proposed captives must be fit and proper for that role, therefore investigations should be undertaken to satisfy supervisors of an applicant's suitability. Where a captive is part of a complex organisational structure, the ultimate parent company and major shareholders, together with any intermediate structure should be identified and assessed to the extent judged necessary by the supervisor.

36. Supervisors should require captives to have a representative and/or manager in the jurisdiction in which the captive is licensed. To meet this requirement, many captives use the services of insurance managers, which should have the necessary insurance knowledge, skills and resources. In the case of a captive that does not employ the services of an insurance manager, supervisors should require the board members and senior management of the captive to

demonstrate that they have the required skills and experience to effectively carry out their roles, including appropriate underwriting and accounting skills.

37. In accordance with ICP 7, consideration should be given to ensuring that the significant owners and key functionaries involved are fit and proper and have the commensurate experience, skills and capacity to fulfil the responsibilities of their roles. Supervisors do not need to assess the fitness and propriety of captive owners on the basis of whether the owner has sufficient experience in insurance. Supervisors should still, however, assess the fitness and propriety of captive owners on other matters, including their financial standing, honesty and integrity.

38. Supervisors should require that the captive's board of directors collectively possesses the skills, experience and knowledge to oversee effectively the insurance managers and any other outsourced service providers. The board should also demonstrate that it has a broad knowledge of the business being written and that the directors can individually properly exercise their responsibilities.

39. Captives sometimes use service providers located outside their jurisdiction. In such cases, supervisors should require the board to be satisfied that the service providers have an appropriate level of knowledge of the legislation applicable to the captive's location.

Changes in control and portfolio transfer

40. ICP 8 states: *The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer. The supervisory authority also approves the portfolio transfer or merger of insurance business.*

41. Changes in control may occur when the captive, and/or its parent, is purchased by, or merged with another entity, thus changing the direct or ultimate owner of the captive. In these circumstances, if they have concerns over the new owner, supervisors should be able to take appropriate action such as preventing the captive from accepting further new business.

42. The purchase or merger of a captive's parent is sometimes the precursor to a change of domicile of the captive in order to allow for it to be consolidated with other risk management operations of the enlarged group (see paragraph 21). Supervisors should have the power to prevent an outward transfer of a captive or a portfolio transfer to another jurisdiction if it is not considered to be in the policyholders' interest for the transfer to take place. Inward migrations should be subject to the normal licensing application criteria.

43. Although it is rare for a captive to undergo a change in control through a direct sale to an unrelated party, supervisors need to take appropriate action if this takes place as the captive could then be writing unrelated party risks. Similarly, action should be required when a related entity insured by the captive is sold to an unrelated entity or group; the captive could then be exposed to unrelated party risks. Actions could include imposing conditions requiring the captive to cease accepting new business or to transfer out existing business, or to review its level of capital and/or restrict the making of distributions to shareholders. Supervisors should consider whether it remains appropriate to designate the entity as a captive insurer and hence whether it is necessary to amend its supervisory approach accordingly.

44. Where a captive proposes to carry out a portfolio transfer of its business to another insurer, supervisors should ascertain in advance that the receiving or transferring insurer is of suitable standing to enter into the transaction. In practice, such transfers may involve some or all of the risk factors detailed above, i.e. a change in control (of the business rather than the entity), a change in jurisdiction of the business and a change in the nature of the business from insuring related parties to insuring unrelated parties. Where this is the case, supervisors should take appropriate steps as

previously detailed in relation to those risk factors. In considering a proposed portfolio transfer, supervisors should be mindful of the need to ensure that policyholders' security is not materially diminished by the transfer. Inward transfers should be subject to the normal licensing criteria.

Market analysis

45. ICP 11 states: *Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and insurance markets. It draws conclusions and takes action as appropriate.*

46. Supervisors should undertake quantitative and qualitative analysis of the factors that may have an impact on the financial soundness of captives that, in turn, to some extent contribute to the financial stability of the overall insurance market. In undertaking this analysis, supervisors should recognise that the general and market developments that may have a significant impact on captives could originate in the jurisdiction where the captive's parent is located, which normally is a different jurisdiction to where the captive is located. Similarly, supervisors should be aware of significant legislative, regulatory, economic or other market developments in locations where there are large concentrations of risks written, or ceded, by captives.

Reporting to supervisors and off-site monitoring

47. ICP 12 states: *The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.*

48. Reports to supervisors are as important in relation to captives as for any other insurer. Whilst captives frequently pose reduced risk to external stakeholders or to the financial stability of the insurance market, supervisors should nevertheless receive sufficient reporting to monitor solvency, assess compliance with the applicable legislation and to identify potential problems. ICP 12 ECa requires supervisors to set the requirements for the submission of information. In defining the scope and nature of the information to be provided, supervisors should take into account the captive's particular risks, size and the amount of third party and/or unrelated party insurance exposures, if any.

49. Supervisors should regularly monitor a captive's adherence to its agreed business plan, particularly as regards dividend policy and the extent of any unrelated party business, and require adequate information on an on-going basis regarding its insurance and reinsurance arrangements.

On-site inspections

50. ICP 13 states: *The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.*

51. It is important that the risk profile of a captive, including the amount of any potential liabilities to third parties and/or unrelated party business, be considered in establishing the extent and focus of the inspection, and especially when considering the frequency of inspections. Supervisors should recognise that captives frequently pose less risk to external stakeholders and to markets than do commercial insurers or reinsurers, so supervisors should have the ability to tailor inspections, where appropriate.

52. All the criteria listed in paragraph 13.5 of the explanatory note to ICP 15 regarding the principal areas of focus for a full-scale inspection are applicable to captives. Account should be

taken of the specific risks applicable to captives. This is covered in paragraph 75. Supervisors should specifically focus on:

- connected party transactions
- the amount of unrelated party business
- third party liabilities

53. Where an insurance manager has been appointed, on-site inspections of captives are normally carried out in conjunction with an inspection of the insurance manager. This is covered further in section 6.

Group-wide supervision[5]

54. ICP 17 states: *The supervisory authority supervises its insurers on a solo and a group-wide basis.*

55. ICP 17 ECa requires supervisors to define an insurance group or financial conglomerate and determine the scope of supervision necessary. Most captives are not part of such groups. Although supervisors usually find that no other financial services supervisors are involved in the supervision of the corporate group, it may sometimes be necessary to communicate with other supervisors. This can also be relevant where multiple captives, in different jurisdictions, are involved in a group's risk finance programme.

56. Supervisors should consider the overall structure of a group and use risk-assessment techniques to determine whether further supervision is necessary, for example if the captive holds significant related-party assets (see paragraph 92).

Insurance activity

57. ICP 19 states: *Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums.*

58. Premiums charged by a captive to related parties are not driven solely by market rates and are normally determined by the captive's board of directors, often through a recommendation from the insurance manager. Pricing may be based on the parent's experience in the line of business being insured by the captive, the insurance manager's experience of the insurance market, the rates charged by fronting insurers or the reinsurance market, or may be a combination of these factors. Premiums may reflect the lower operational and/or capital costs inherent in a captive. Supervisors should have the power to require the insurance manager, where applicable, and the captive's board to report the basis and if necessary justify it.

Consumer protection

59. ICP 25 states: *The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers beginning when a contract is entered into through to the point at which all obligations under a contract have been satisfied.*

[5] The IAIS are currently developing a paper on the Principles of group wide supervision.

60. The criteria of ICP 25 have limited applicability to captives, since requirements for fair treatment of customers, assessing insurance needs before advising customers and dealing with complaints are less pertinent to a captive because a captive's customer is normally its owner. Captives do not generally directly write unrelated party business for individual consumers[6]. Where they do, supervisors should treat the captive as a commercial insurer for regulatory purposes. In the case of a group or rental captive, supervisors should require that, if applicable, the captive's business plan explains its marketing programme and the information to be provided to prospective owners or users.

61. In accordance with paragraph 25.5 of the explanatory note to ICP 25, supervisory requirements should distinguish between particular types of customers. In particular, since policyholders of most captives will fall into the category of professional customers, detailed conduct of business rules may not be appropriate[7].

62. The risk characteristics and services arising from the different captive types are varied. In the case of group captives, a major feature may be risk sharing or one captive member's account being charged for the losses of another captive member. Supervisors should be satisfied that policyholders receive comprehensive and meaningful ongoing disclosure of technical performance and risks on a timely basis[8]. Supervisors should also review the appropriateness of such disclosures when assessing the business plan. The same principle would apply in other cases where unrelated parties are involved, particularly where the practice is not subject to consumer protection schemes. Supervisors should be satisfied that the board of the captive is aware of any consumer protection requirements applying in the jurisdiction concerned if the captive writes any unrelated party business.

63. When a captive underwrites liability risk, in particular compulsory liability, supervisors should recognise and take account of the fact that claims may arise from unconnected third parties and that these claims may be made against the parent or, in certain cases, directly against the captive. If a captive, under the applicable legislation, is permitted to insure compulsory classes of business in its own or in another jurisdiction, supervisors should be satisfied that there are no supervisory impediments to the rights of any third parties with a legitimate claim against the captive.

4.2 Corporate governance

64. This section covers ICP 9 (Corporate governance).

65. ICP 9 states: *The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.*

66. The principles of corporate governance, as outlined in this ICP, apply to captives, bearing in mind that ICP 9 ECb states that the corporate governance regulations should take account of the size, nature and complexity of the insurer. Corporate governance issues specifically relevant to

[6] Individual consumers can be defined as "individuals, including suppliers and customers of the captive, who are acting for purposes which are outside their trade, business or profession".

[7] Professional customers can be defined as knowledgeable, 'sophisticated', customers, as in the case of a major enterprise, who would have in-depth knowledge concerning all major aspects of the transaction, including associated risks.

[8] IAIS *Standard on disclosures concerning technical risks and performance for non-life insurers and reinsurers, October 2004*

captives may include unrelated party issues, related party transactions or perceived or actual conflicts of interest.

67. Where a captive is managed by an insurance manager, a distinction should be made between corporate governance as it applies to the captive and its board of directors and corporate governance as it applies to the insurance manager. The board remains responsible for the corporate governance of the captive despite outsourcing the management. Corporate governance issues specifically relating to insurance managers are dealt with later in section 6.

68. The areas in which the application of good corporate governance, as it applies to captives, would differ from those applicable to commercial insurers and reinsurers include requirements that vary because:

- many of the functions of the captive may be outsourced, either to the insurance manager or, for example, to investment managers or specialist claims administrators.
- the captive is often domiciled in a different jurisdiction from its owners. In these cases, supervisors should be satisfied that supervision is not impeded in any way by cross-border issues. Supervisors should take account of any known potential conflicts between corporate governance requirements applying in the home jurisdiction and the parent company's jurisdiction.
- there is a need to strengthen the trust between captive owners, directors and insurance managers and to avoid any disproportionate influence from any single party.
- confidence needs to be provided to potential claimants under policies issued by the captive and to third parties with potential claims against the captive owner.

69. The following are specific guidelines relating to corporate governance of captives. Supervisors should:

- satisfy themselves that operational control of the captive and access to its books and records are within the jurisdiction of supervision. Considerations include the location of senior management and clerical/administrative processes.
- when approving non-executive directors, seek confirmation that, if the supervisory framework requires it, they are independent and able to challenge sensibly the views of the directors who are appointed by the parent group.
- be satisfied with the composition of the board of directors, including any requirement for locally resident directors and the balance between executive and non-executive directors.

70. Supervisors should be satisfied that the board of directors:

- has sufficient balance to prevent any undue influence by the captive's owner, insurance manager or any other interested party.
- has the proper balance to ensure that the legitimate business interests of the owner are aligned with the proper management of the captive.
- have put in place transparent, effective ways to identify any conflicts of interest and ensure that they are managed and satisfactorily dealt with.
- takes into account the interests of stakeholders, for example possible claimants on the parent policyholder who rely upon the fact there is a captive that has covered a particular liability, e.g. employer's liability or motor third party liability.
- have the skills and experience necessary to manage effectively any outsourced operations including outsourced insurance management functions.

- do not accede to transactions, payments or charges on assets initiated by the owner (dividends, reinsurance agreements with related entities, loans, expenses or guarantees) that may financially impair the captive's ability to meet its liabilities.

71. In the case of captives established as association captives, multi-owner captives or rental captives, the board should consider their responsibilities to both the owner of the captive and to the other owners, if different. They also need to be aware of the challenge posed by the need to understand the possibly diverse nature of the business transacted.

4.3 Risk and internal control

72. This section covers ICP 18 (Risk assessment and management) and ICP 10 (Internal control).

73. ICP 10 states: *The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board of directors and management to monitor and control the operations*.

74. ICP 18 states: *The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively*.

Types of risk

75. The nature of the risks to which captives are exposed is similar to that of commercial insurers but the degree and diversity of exposure may differ. The following risks may apply to a greater extent to captives than to commercial insurers (this list is not exhaustive nor in any particular order of priority):

- Control of outsourced insurance management function
  - Supervisors should confirm that the captive's board of directors has sufficient skills and experience to effectively control the outsourcing arrangements and that a suitable management agreement is in place. The directors should be aware of the potential for additional operational risks arising from the outsourcing arrangements.

- Management risk
  - Supervisors should take account of the risks posed to a captive by poor management, whether or not the management is outsourced to an insurance manager. A lack of technical knowledge is particularly significant as it can pose a threat to the solvency of the captive through inadequate premiums levels or insufficient technical provisions or solvency.

- Location of owners and captives in different jurisdictions
  - Supervisors should be aware of the additional risks arising if a captive is located in a different location from its parent. For example, the impact of the applicable legislation to be used for settling disputes and there may also be exposure of the captive to claims from third parties that may not arise under its local legislation.

- Legislative developments affecting captives
  - Supervisors should be aware that legislative developments, particularly in the jurisdiction of the parent of a captive, can adversely impact captives; for example,

by imposing a requirement for fronting insurers or restricting the payment of premiums or claims.

- Concentration of assets
  - Where captives hold relatively low levels of assets, technical provisions and have low solvency capital requirements, it is not always appropriate to hold a widely diversified portfolio of investments. In view of this, supervisors should assess the credit standing of the counterparties and consider the need to impose minimum standards or additional capital requirements.

- Failure of a fronting insurer
  - The failure of a fronting insurer could adversely impact a captive if, for example, it had been required to provide security to the fronting insurer. Supervisors should take account of this when considering a captive's fronting arrangements.

- Lack of risk diversification
  - Supervisors should take account of the lack of risk diversification inherent in many captives when setting capital requirements. Supervisors should have the power to require the captive to hold sufficient funds to meet the maximum potential claim level in a given period.

- High claims volatility
  - Supervisors should take account of the potential for a captive, particularly one writing a single line of business, to experience high claims volatility. This should be reflected in the methods employed for setting technical provisions and solvency requirements.

- High liquidity risk
  - Since captives can potentially have high liquidity requirements resulting from a high level of claims volatility or high collateral requirements, for example from fronting insurers, supervisors should take account of the liquidity of the assets held by the captive.

- Exposure to related parties
  - Captives sometimes provide loans to their parent companies. Supervisors of captive insurers should consider whether, and under what circumstances, it is appropriate to include these as admissible assets. If loans are to be acceptable, supervisors should assess the financial position of the parent company and require that the loans are repayable if required, are made at arms length and consider whether the loans should be secured.

- Potential risk of money laundering, terrorist financing and fraudulent activities
  - Supervisors should be aware of the risks of captives being utilised for money laundering, terrorism financing or fraudulent purposes. The payment of excessive levels of premium can be an indicator of the possibility of this type of activity.

- Dependency on the financial strength of the parent
  - Even if no loans are made from a captive to its parent, supervisors should be aware of the risks posed by the insolvency of the parent, particularly if there are outstanding premiums. Supervisors should be aware of the need for the rights of third party claimants or unrelated policyholders to be protected in the event of a liquidation of a captive following the insolvency of its parent.

- Reinsurance risk
  - Since there is often significant reliance on reinsurance, supervisors should require that the terms of reinsurance contracts are promptly documented and clearly expressed and that the credit standings of reinsurers have been prudently assessed.

- Taxation issues
  - Supervisors should take account of the risks arising from potential tax changes, both in the home jurisdiction and in the parent's jurisdiction.

- Counterparty risk resulting from reliance on contingent capital
  - Supervisors should be aware of the risks involved if a captive relies on support from contingent capital such as letters of credit or unpaid share capital. Supervisors should be satisfied that additional capital will be available if required.

- Currency risk
  - Currency risk – Since captives often underwrite risks in multiple jurisdictions and hold assets in a different currency to their liabilities, supervisors should be aware of the potential impact of changes in exchange rates.

76. Many risks normally associated with a commercial insurer are mitigated or are of less impact in a captive. For example:

- Legal risk: the risk of being sued by a policyholder is generally quite low since the captive frequently insures just its owner although there remains a risk of being sued by a third party claimant. If necessary, confirmation should be sought that legal advice has been obtained in this regard.

- Operational risk: such risk may be low if the captive has few transactions or a limited number of policies; this is common in many captives.

Internal controls

77. ICP 10 ECa notes that supervisors should take into account the nature and scale of the company's business when assessing internal controls. ICP 10 ECh states: "The supervisory authority requires oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the normal standards of internal controls".

78. The purposes of internal control listed in explanatory note 10.1 of ICP 10 all apply to captives. In common with other insurers, the board of directors of a captive should exercise its judgment in determining the nature and scope of the risk management and internal control systems and practices that are necessary including internal controls operated by the insurance manager which should be documented. Supervisors should require captives to have an effective compliance mechanism in place. In practice this is often provided by the insurance manager. Most captives are not complex operations, which require extensive internal audit functions, or sophisticated internal risk management functions. Some captives nevertheless, are subject to the internal audit disciplines and/or risk management functions of the parent company. This should be taken into account when supervisors assess the internal control requirements for captives.

4.4 Liabilities

79. This section covers ICP 20 (Liabilities)

80. ICP 20 states: *The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities and making allowance for reinsurance recoverables. The supervisory authority should have both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary*.

81. Cornerstone 5 of the IAIS Cornerstones Paper[9] states: *The solvency regime includes the definition of technical provisions. Technical provisions have to be prudent, reliable, and objective and allow comparison across insurers worldwide. Technical provisions include an explicit risk margin*.

82. The ICP states that supervisors should require insurers to demonstrate that they comply with standards for establishing adequate technical provisions and other liabilities. Supervisors should also receive sufficient information to understand how technical provisions have been determined. The underlying principles behind ICP 20 are as relevant to captives as to commercial insurers. A supervisory regime should have legal provisions requiring the establishment of appropriate technical provisions and have the authority to review their sufficiency through on-site and off-site monitoring, including the use of appropriate actuarial skills and to have the powers to require an increase in those provisions if they are not deemed sufficient.

83. Captives have some unique characteristics such as having higher potential claims volatility. These characteristics should be incorporated into a review of liabilities by supervisors or when creating regulations regarding captive liabilities.

84. Captives may reinsure a portion of their risks and some captives are formed with the sole purpose of accessing the reinsurance market. Supervisors should take this into account when establishing whether to give full credit for reinsurance in the calculation of technical provisions, subject to satisfactory reinsurance creditworthiness. Captives should be asked to confirm that they have adequately considered their reinsurance requirements. Supervisors should also pay particular attention to the admissibility of reinsurance recoverables from a related reinsurer as this constitutes a “related party transaction” and should consider imposing limitations on the credit exposure to a related reinsurer.

85. It is common when a jurisdiction sets standards for technical provisions to require a reserve for incurred but not reported claims (“IBNR”). However, in some cases, pure captives may already have knowledge of all reported claims, because their owner is the only claimant. In those cases, the IBNR provision may justifiably be zero where there is a sufficiently strong reporting procedure in place such that the captive is immediately aware when an insured event occurs. Adequate provision must however be made for the potential for adverse loss development, such as a reserve for claims incurred but not enough reported (“IBNER”). The IBNR provision is often lower on average for captives as compared to commercial insurers since policies are more likely to be written on a “claims made” basis.

86. Where appropriate, supervisors should require that the board of directors of captives take actuarial advice before setting provisions for outstanding claims, IBNR or other reserves. This should apply particularly in the case of long tail classes of business such as liability insurance

[9] IAIS *Towards a common structure and common standards for the assessment of insurer solvency: Cornerstones for the formulation of regulatory financial requirements. October 2005.*

written on an “occurrence” basis or liability insurance that has a level of technical provision that is statistically significant. Actuarial advice may also be required if there is a question over whether a captive or the insurance manager has sufficient expertise to recognise that known claims are developing in a more adverse fashion than originally expected thus potentially giving rise to the need for an IBNER reserve.

4.5 Investment strategy

87. This section covers ICP 21 (Investments).

88. ICP 21 states: *The supervisory authority requires insurers to comply with standards on investment activities. These include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management*.

89. Because of the nature of their business, many captives have very straightforward investment strategies, which may be tied to the investment and risk management goals of their owner.

90. Supervisors may consider that the full range of essential criteria set out under ICP 21 may not be appropriate for every captive due to the nature of the captive's business plan and its investment portfolio. The processes and systems required in each case should be proportionate to the nature, scale and complexity of each captive's activities. Supervisors should consider the following factors as being particularly applicable to captives.

- Liquidity issues may have a higher profile than is normal for a commercial insurer or reinsurer. Supervisors should be satisfied that a captive has in place adequate internal procedures to make sure that it is able to meet its obligations as they fall due or can do so without incurring excessive cost. A captive should hold sufficient liquidity to ensure that it can be considered to be conducting its business in a prudent manner.
- Supervisors should require that the board of a captive has adequately assessed its exposure to counterparty risk including exposure to banks and to related parties and has taken steps to limit or mitigate this.
- Supervisors should ensure that a captive has taken adequate recognition of asset-liability matching and make active decisions about the extent of any mismatch in relation to its business plan including holding an appropriate amount of additional capital to cover asset-liability mismatching.
- Supervisors should consider a captive's investment policy as part of their review of its business plan. The supervisor should be advised of any change to the original investment policy.
- Often captives do not have a material exposure to investments in equities, property (or other illiquid assets) or derivatives and similar commitments. Where they do or, it appears that they have a material asset-liability mismatch, supervisors should refer to appropriate IAIS guidance[10].

91. Supervisors should require that any related party transactions by a captive, such as loans to the parent company, loans to related entities, loans to directors/owners or investments in other

[10] E.g. IAIS guidance paper No. 9: *Investment risk management.*

related entities and reinsurance agreements with related entities are approved by the captive's board of directors. Supervisors should consider, in the light of the regulations applying to solvency and liquidity in their jurisdiction, the extent to which to give credit for assets held in related party transactions. Supervisors should also consider whether it is appropriate to make any specific requirements regarding transferability of capital or protection of funds in the event of a material adverse change in financial circumstances affecting the captive and/or the parent company or other related entity.

92. Supervisors should consider whether loans to any connected parties should be subject to prior regulatory approval and when approving loans as admissible to cover technical reserves or for solvency purposes, they should consider whether the loans have adequate security, are not subordinated, pay a commercial rate of interest and have a defined repayment schedule. The written formal loan agreement should form part of the captive's books and records. (See "Exposure to related parties" in paragraph 75).

93. When the parent or related entity is a regulated financial services business, supervisors should be aware that if a captive invests in the shares of its parent or a related entity, there is the possibility of "double counting" of such investments in the solvency/capital requirement calculations of both parties. For example, an investment by a captive in the shares of its parent might be counted as an asset towards the captive's solvency coverage, while the cash receipt in the parent company might be included as part of its capital, thus counting the transaction twice and artificially inflating the apparent strength of the group. If the captive and the parent are located in different jurisdictions, there should be a dialogue between the respective supervisors to enable a coordinated regulatory approach to be followed.

94. Supervisors should be satisfied that a captive's board of directors is able to:

- set the captive's investment policy, including periodic review of its continued suitability
- implement and review the investment mandates or other instructions issued to implement that policy
- direct and oversee any investment activities of the insurance managers, including a review as to whether they possess appropriate competence in this area
- direct and oversee the activities of any outsourced investment managers

95. Supervisors should be satisfied that a captive's board of directors is able to ensure that any investment activities undertaken on behalf of a captive by its parent or other related entity treasury departments or functions are treated by the directors in the same way, and are subject to the equivalent terms and conditions, as any other outsourcing arrangement to third parties.

4.6 Types of capital

96. This section covers ICP 23 ECc (Capital adequacy and solvency).

97. ICP 23 ECc states: *Suitable forms of capital are defined.*

98. An insurer's capital consists of the financial resources it holds in excess of its technical provisions and other liabilities. Supervisors should require insurers, including captives, to hold sufficient capital to ensure that, in adversity, an insurer's obligations to policyholders will continue to be met as they fall due.

99. A number of captives meet capital requirements through alternative forms of capital, for example:

- letters of credit
- unpaid share capital
- trust funds or
- subordinated debt

100. Supervisors should consider whether a distinction should be drawn between the forms of capital permitted in respect of the minimum capital requirement as opposed to additional capital required to support the business on an ongoing basis.

101. Supervisors should be satisfied that the terms of the capital instruments confirm that funds will be made available when required. It is particularly important to ensure that funds will be available in situations of significant stress for the captive as well as for normal ongoing operations.

102. If retained earnings are used to support a captive's capital requirements, supervisors should review the permanence of this capital in the light of any legal requirements to pay dividends e.g. if a certain level of distribution is required to maintain the taxation status of the owner.

103. Depending upon the financial and legal status of the owner, they may be required to provide a greater proportion of contributed ordinary share capital in cash rather than other types of capital instrument such as a mix of ordinary shares and redeemable preference shares and subordinated debt.

104. Supervisors may also consider permitting captives to hold a portion of their capital requirement in the form of a contingent guarantee to invest further monies if required, such as a letter of credit issued by a recognised financial institution acceptable to the supervisors, provided that they are satisfied with the financial status of the owner.

4.7 Capital adequacy and solvency

105. This section covers ICP 23 (Capital adequacy and solvency) apart from ICP 23 ECc, which is covered under the "Types of capital" section above. ICP 23 states: *The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurers to absorb significant unforeseen losses.*

106. Supervisors should consider basing minimum capital adequacy and solvency requirements for captives on the overall level of risk retained by the captive. This may be measured in terms of the risk exposure or by the size of premium income or technical provisions. Where this method is adopted, supervisors should base the minimum level required on the size, nature and complexity of the captive. Where third party or unrelated party business is written by a captive, the risk profile is significantly altered and this should be reflected in the capital adequacy and solvency requirements.

107. Supervisors should establish a minimum solvency margin requirement, which adequately reflects the risks that are inherent in captives. Significant factors to evaluate may include:

- The risk portfolio may be unbalanced; consequently, a formulaic approach may not be appropriate.
- Although the policyholder is generally the parent, there may be third party interests to consider or protect, especially if liability business is written.
- Solvency requirements need to be appropriate to the risk evaluation and should not be used to distort the market, one way or another, either by inhibiting the formation of captives or promoting the formation of inadequately capitalised captives.

108. The admissibility of reinsurance recoverables for the purpose of covering technical provisions and minimum solvency requirements can be a significant issue when examining captives because captives with a high percentage of reinsured risk may have reinsurance recoverables as their largest asset. ICP 20 ECf requires that general limits for the admissibility of the amounts recoverable under reinsurance arrangements with a given reinsurer are established for solvency purposes, taking into account the ultimate collectability and the real transfer of risk. Where appropriate, supervisors should consider whether these general limits should be commensurate with the size and risk profile of the captive.

109. In assessing solvency levels for captives, supervisors should take account of any relevant information concerning the risk management processes established between the captive and its parent.[11]

110. Supervisors should consider setting "solvency control levels" for captives which would trigger regulatory intervention if the level of solvency fell below that level.[12] The determination of these solvency control levels should make allowance for the amount of unrelated party or compulsory liability business written by the captive.

111. In addition to considering capital, supervisors should consider the scope and quality of a captive's reinsurance programme. This is because a captive may retain only limited risk and may be exposed to a single event. If a major disaster affected the parent and also created large liability claims, it is not inconceivable that both captive and parent could fail. In these circumstances reinsurance may be a more effective risk mitigant than capital.

112. Structure Element 1 of the IAIS Structure Paper[13] states: The supervisor must have adequate powers to:

- *require an insurer to assess and manage the risks to which it is exposed;*
- *set regulatory financial requirements for individual insurers to protect policyholders' interests; and*
- *require that, if necessary, an insurer holds additional capital or takes action to reduce its risks so that the assets it holds are sufficient and appropriate.*

113. Structure Element 8 of the same paper states: *From a regulatory perspective, the purpose of capital is to ensure that despite adverse conditions, policy claims will still be met as they fall due and the required technical provisions remain covered.*

114. Structure Element 8 applies equally to captives as to commercial insurers. In setting capital requirements, supervisors should take into account the nature of the policyholder. In particular, there should be a recognition that the policyholders' interests differ between a normal commercial

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[11] IAIS *Guidance paper on enterprise risk management for capital adequacy and solvency purposes*
[12] IAIS *Guidance paper on capital requirements*
[13] IAIS *Common structure for the assessment of insurer solvency*

insurer providing cover to individuals in the retail market, a multi-owner captive and a pure captive. Allowance should be made for the potential for some captives to write an element of unrelated party business or to have potential third party liabilities.

115. The second part of Structure Element 11 of the IAIS Structure Paper states: *Capital requirements should be calibrated such that, in adversity, assets will exceed technical provisions with a specified level of safety over a defined time horizon*.

116. Paragraph 79 of the same paper notes that capital requirements should be set to reflect the overall actual risk exposure of the insurer. In the case of captives, supervisors should recognise that the required "level of safety" may justifiably be different to that applicable to a commercial insurer, depending upon the nature of the policyholders and the types of business written.

117. Paragraph 79 of the above paper also notes that capital requirements should take account of diversification between risk factors. In the case of many captives, given the limited exposure, supervisors should recognise that there may be little or no risk diversification.

118. Structure Element 6 of the IAIS Structure Paper states: *A market consistent valuation of technical provisions should be based on the risk characteristics of the portfolio rather than the characteristics of the specific insurer holding the portfolio. However, it may be appropriate to use assumptions that reflect aspects of the insurer's specific business model and practices where they can be sufficiently substantiated*.

119. For some classes of business, e.g. liability, the determination of loss reserves in a captive can be based on the loss experience of the owner alone, if adequate information is available. This occurs where, for example, ultimate net loss reserves are established by actuarial calculation and reference is made principally to the owners' past experience as opposed to market experience in general. On the other hand, a commercial insurer with thousands of customers and where market information is available would probably adjust reserves in light of actuarial evaluation of market experience and any other relevant information such as its own experience, in order to arrive at an accurate estimate of its ultimate net loss reserves. Supervisors should take account of this when establishing solvency requirements applicable to captives.

120. Many captives will determine their capital requirements using a simple deterministic approach such as stress testing. A minority of larger or more complex captives may use internal models to set capital requirements. If supervisors permit the use of internal models to set capital requirements, they should approve the model used and should ensure that both they and the captive have access to the necessary skills to carry out this work.[14]

121. A sound and well-developed solvency regime that takes account of risk is vital and should be a component of any captive insurance supervisory regime. Key components of a solvency regime are rules on the valuation of assets and liabilities, asset/liability management and the suitability of different forms of capital.

4.8 Confidentiality and disclosure

122. This section covers ICP 26 (Information, disclosure and transparency towards the market).

[14] IAIS *Guidance paper on the use of internal models by insurers*

123. ICP 26 states: *The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial positions and to facilitate the understanding of the risks to which they are exposed*.

124. IAIS disclosure standards[15] includes the wording:

> *Supervisors can decide not to apply this standard to "captives" that are considered non-life insurers or reinsurers in the legislation in the jurisdiction, provided there is no potential threat to the financial system, no public interest need for disclosure* <u>*and no legitimately interested party is prevented from receiving information.*</u>

125. "Legitimately interested parties" includes, for example, related policyholders, third party claimants, fronting insurers, reinsurers, unrelated party policyholders, owners, and parent companies.

126. In certain instances, public availability would be detrimental to the parent group and to the captive, for example if a parent had to disclose that it had liability insurance in force. Public availability would also be detrimental in the case of kidnap and ransom insurance. This disclosure would not be required if the risk was insured directly with a commercial insurer rather than placed through a captive. Information should however be made available to supervisors.

127. ICP 26 is concerned with providing reliable and timely information to stakeholders including policyholders. In establishing disclosure requirements applicable to captives, supervisors should consider who the users or stakeholders of the captives are and might be, whether the captive's results are consolidated into the parent's figures, whether the parent is quoted and the financial statements are publicly available, as well as the company law disclosure requirements applicable in the captive's jurisdiction of incorporation.

128. ICP 26 ECa lists various criteria to determine the type of information that an insurer should disclose. Some of those items are not applicable or have limited applicability to captives, notably:

- Relevant to decisions made by market participants - as noted above the participants in a captive already have means of ensuring that the captive discloses information adequate to their needs.
- Comparable between different insurers - captives write specific lines of business for their owners. Loss histories are specific to the owner and are not necessarily reflective of trends in the insurance sector. Pricing, retention levels and investment strategies are also in the control of the owner, limiting the usefulness of comparing captives with one another.

129. Fronting companies or reinsurers have their own requirements for disclosure, in order to make business decisions, before they conduct business with a captive. Consequently, supervisors should not need to take steps to monitor the information disclosed to the other parties as outlined in ICP 26 ECd.

130. Supervisors should consider the need to ensure that third party claimants under compulsory classes of liability insurance are not put in a worse position through different disclosure requirements applying where the insurer is a captive rather than a commercial insurer.

[15] IAIS *Standard on disclosures concerning technical performance and risks for non-life insurers and reinsurers, (footnote 1)*

4.9 Fraud, anti-money laundering and combating the financing of terrorism ("CFT")

131. This section covers ICPs 27 (Fraud) and 28 (Anti-money laundering, combating the financing of terrorism).

Fraud

132. ICP 27 states: *The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.*

133. Despite the nature of their risks, supervisors of any type of captive, especially those underwriting unrelated party risks such as multi-owner captives or risk retention groups should be aware of possible fraudulent activity. Even in the case of a pure captive, it is possible that outsourced third party service providers, including insurance managers, could become involved in fraud, or a single director could commit a fraud.

134. Supervisors should take into account the nature of the captive when implementing regulations regarding fraud, as some regulations applicable to commercial insurers may be inappropriate for captives. In particular, the risk of claims fraud by policyholders is lower. Supervisors should also be aware of the risks posed by the payment of an excessive level of premiums relative to the actual risk as the excess premiums could potentially be used to fund fraudulent claims or commission payments.[16]

Anti-money laundering and CFT

135. ICP 28 states: *The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter and report money laundering and the financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).*

136. The criteria listed under ICP 28 deal primarily with ensuring that a jurisdiction has adequate and appropriate anti-money laundering ("AML") regulations in place and that the supervisory authority has adequate powers and resources to enforce those regulations. At a minimum, such regulations should apply to insurers and intermediaries offering life insurance products or other investment-related insurance (ICP 28 ECe) although there is also a risk of money laundering in non-life insurance companies. Supervisors should take these regulations into account when assessing the overall acceptability of any licence application and the ongoing adequacy of corporate governance and other risk management systems put in place within a captive.

137. Supervisors should be aware that it is possible that an owner could attempt to use the captive for money laundering purposes and should consider the legitimacy of the source of funds used to capitalise or pay premiums to the captive. Supervisors should require that there are controls on monies paid out, such as appropriate seniority levels on bank mandates.

138. The FATF has increased its focus on the insurance sector but to date have not discussed specifically the possible use of captives for money laundering schemes. Similarly, IAIS guidance only mentions captives as a potential money-laundering risk if a fictitious captive is established to try to launder funds. In such an instance, enforcing due diligence procedures from within the

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[16] IAIS *Guidance paper on combating the misuse of insurers for illicit purposes*

captive or by the directors and employees of the captive would be ineffective. Supervisors should require that any potential money laundering risks posed by captives will be mitigated by robust "customer due diligence" procedures, including checks carried out by insurance managers at the authorisation/licensing stage. Supervisors should keep in mind the importance of having a clear understanding of the objectives of any proposed captive and of the nature and reasonableness of the risks being transferred. Supervisors should also be satisfied that the ownership and management structure is appropriate and reasonable for what is proposed.

139. Supervisors should require captives or their managers to maintain an anti-money laundering function and if necessary, depending on the type of business, appoint a suitably experienced person as a Money Laundering Reporting Officer ("MLRO"). This person will have responsibility of reporting identified or suspected instances of money laundering or terrorism financing activity to the relevant authorities in the jurisdiction. The role of the MLRO is normally carried out by the insurance manager or other outsourced service provider. Supervisors should be satisfied that the appointed person is competent to carry out this role and that adequate procedures are in place.

140. It is important that supervisors in different jurisdictions cooperate with each other to prevent the use of captives for illicit purposes, such as fraud, money laundering or terrorist financing activities.

5. Protected Cell Companies

141. Since a significant proportion of captives are established using Protected Cell Companies, it is important to consider the specific supervisory issues that arise from the use of this company structure.

142. A Protected Cell Company (PCC)[17] is a single company incorporated under company legislation consisting of a core and an indefinite number of cells. The structure enables different risks to be written in separate cells. Each cell has assets and liabilities attributed to it and under the PCC legislation, its assets cannot be used to meet the liabilities of any other cell. The company will also have non-cellular (core) assets, which may be available to meet liabilities of the PCC as a whole. A PCC can create and issue shares ("cell shares") in respect of any of its cells but the company has a single board of directors. The board of directors of a PCC has a duty under the PCC legislation to ensure that assets and liabilities of individual cells are strictly segregated.

143. In the event of the insolvency of a cell, the creditors only have recourse to the assets of that cell and not to those of other cells. In some circumstances, there may be access to assets held in the core.

144. The licensed entity is the PCC which should be subject to formal supervisory approval. The creation by the PCC of a new cell will not create a separate legal entity. Supervisors should nevertheless consider whether the addition of new cells to a PCC should be subject to formal supervisory approval because in many respects a cell may have similar characteristics to a stand-alone captive. PCCs can be used as rental captives with the core typically being owned by an insurance manager and the cells owned by or rented to individual companies.

145. A consolidated solvency calculation may mask problems in certain cells if the deficit in one or more cells is less than the combined surplus in others. When assessing the solvency position of a PCC, supervisors should consider both the consolidated position and the solvency of

[17] Also known as a Segregated Account Company (SAC) or a Segregated Portfolio Company (SPC)

individual cells. Supervisors should require that sufficient information is provided to identify if there are any cells in deficit.

146. Supervisors should consider the adequacy of the capital within a PCC in both the core and the individual cells. If a PCC is established with individual cells being created and offered to clients to operate as captives, supervisors should consider the funding of each cell separately as well as the PCC as a whole. If individual cells rely on capital in the core for solvency support, supervisors should seek confirmation that appropriate contractual agreements exist to permit the core capital to be used for this purpose.

147. In addition to the risks set out in the earlier section on types of risk, supervisors should consider certain risks that apply specifically to PCCs. PCC legislation does not exist in every jurisdiction and accordingly there remains potential uncertainty whether the courts outside the PCC's home jurisdiction would support the segregation provisions of that jurisdiction's PCC legislation. The PCC may mitigate this risk by, inter alia, retaining some or all of its assets within its home jurisdiction or other jurisdictions having equivalent PCC legislation. Supervisors should be satisfied that the board of the PCC has adequate measures in place to assess and manage this risk, and should require that the legal status of the PCC and cells is clearly explained to any contracting party.

148. The board of a PCC has overall responsibility for all aspects of its business, including actions taken by the owners and management of cells. There can potentially be a large number of cells that are unrelated to the core, a wide geographical spread of cell owners and a diverse range of business written across different cells, all of which may lead to an increased risk that the board may be unable to adequately monitor and control all of the business activities of the PCC. Supervisors should be satisfied that the board has sufficient skills and experience, and has put in place appropriate systems and controls, to allow it to exercise proper control over all aspects of the business. Supervisors should also be satisfied that the board has put in place suitable corporate governance procedures to ensure that potential conflicts of interest that may exist between the owners/management of the PCC and that of its cells can be identified and managed.

149. A variation of the PCC structure is an Incorporated Cell Company (ICC) where individual cells are distinct legal entities. This may provide a further degree of legal separation of assets and liabilities.

6. Insurance managers

6.1 Supervision

150. Insurance managers play a critical role in the management of many captives. This section considers the specific application of the ICPs to insurance managers. A captive will usually be managed in the captive jurisdiction by an insurance manager that is often a regulated entity. This section is based on the assumption that the manager is regulated; additional considerations that apply if the manager is not regulated are given in paragraphs 160 and 173.

Licensing

151. Before licensing an insurance manager, supervisors should ensure that the insurance manager is fit and proper, with sufficient financial and skilled human resources and the necessary insurance protection in cases of negligence and fraud, e.g. the captive manager must be very

familiar with local regulations and practices and must have sufficient human resources in relation to the captives it manages.

152. The regulatory regime should address, inter alia, licensing, suitability of persons, reporting requirements, on-site inspections, corporate governance, internal controls, fraud, anti-money laundering and combating the financing of terrorism.

153. Licence applications from managers should be accompanied by relevant information including a business plan showing the sources of business and details of the owners, directors, officers and other functionaries and resources, including underwriting and accounting skills. Applications should also include details of the applicable professional indemnity, fidelity and directors and officers insurance covers.

Suitability

154. ICP 7 states: *The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications*.

155. Where an insurance manager represents the captive's senior management, notwithstanding the supervisor's oversight of the insurance manager, supervisors should be satisfied that the captive's board undertakes appropriate steps to ensure that the insurance manager is suitably qualified, has sufficient experience and resources and is able to perform its obligations in that capacity. In addition, as insurance management represents an outsourced activity, supervisors should require the captive to conduct appropriate due diligence and consider all the risks of outsourcing in selecting an insurance manager.

156. The supervisory regime for insurance managers should include an approval process for changes in directors and other key functionaries as well as the receipt of information regarding financial resources and a programme of regular on-site inspections.

Reporting requirements

157. Supervisors should ensure that the insurance manager provides information to supervisors on an annual basis which, as a minimum, includes the financial statements of the insurance manager at its year end, any material changes to its business plan or resources which have occurred during the year, changes to compliance policy and details of any complaints or pending litigation. Supervisors must be satisfied that the insurance manager has, and will continue to have, financial and human resources that are adequate for the nature and scale of the business.

On-site inspections

158. Insurance managers should be subject to on-site inspections by supervisors both in their own capacity and as managers of captives.

159. The on-site inspections should be a primary tool for supervisors as the insurance managers' systems, procedures and level of controls are often common to the captives they manage. The inspection should provide an effective means of testing the compliance of the captives under the insurance manager's control with the applicable legislation and include an overview of the corporate governance procedures that have been adopted.

160. In respect of insurance managers which are not regulated entities, supervisors should have the power to carry out on-site inspections of the insurance manager through its power to supervise outsourcing arrangements or through information gathering powers.

6.2 Corporate governance

161. ICP 9 states: *The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.*

162. When assessing a captive's corporate governance framework, supervisors should recognise that an insurance manager is an outsourced service provider. At the same time, it will form part of the captive's corporate governance framework. Supervisors should also take into account the fact that conflict of interests may arise in respect of corporate governance areas such as independence and accountability, when for example, a director or employee of the insurance manager is also a director of the captive engaging its services. Where insurance managers are part of the same groups as the producing brokers or reinsurance brokers, appropriate procedures should be in place to ensure that any conflicts of interest are managed fairly. There may be reporting requirements on the insurance manager such as a whistle blowing requirement, which create a potential conflict if the insurance manager is also acting as a director of the captive.

163. Supervisors should be satisfied that there are management agreements in place reflecting the division of responsibilities between the insurance manager and the captive's board and that these agreements clearly reflect the relative obligations of both parties.

164. Supervisors should be satisfied that the boards of insurance managers have a clear understanding of their obligations in respect of the captives that they manage. The board of a captive must however recognise that it cannot delegate its responsibilities for good corporate governance to the insurance manager and must satisfy itself of the adequacy of the governance arrangements within the insurance manager

Internal control

165. ICP 10 states: *The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.*

166. When assessing the captive's internal control procedures, supervisors should bear in mind that many of the day-to-day activities of a captive are outsourced to the insurance manager, including for example, compliance, asset management, financial reporting, premium pricing and claims handling. In such case, insurance managers may themselves undertake many of the captive's internal control activities and should be subject to oversight by the captive's board. Supervisors should also recognise that the insurance manager's internal control procedures, which should be separate from those of the captives they manage, may overlap with those of the captive.

167. Supervisors should require the appointment of a compliance officer by insurance managers.

6.3 Fraud, anti-money laundering and CFT

Fraud

168. Supervisors should be satisfied that the insurance manager has in place the necessary measures to prevent, detect and remedy insurance fraud in respect of its own business and that of the captives it manages.

Anti-money laundering and CFT

169. Supervisors should be satisfied that the insurance manager has in place appropriate procedures in respect of AML and CFT.

170. Supervisors should be satisfied that the insurance manager operates an appropriate "know your customer" procedure, which ensures it has a sound knowledge of its customer's business and pattern of financial transactions and commitments. Since the insurance manager's customer is the captive, the manager should carry out appropriate due diligence checks on the captive owner, both at the start of the relationship and on an on-going basis.

171. Supervisors should also be satisfied that the captive performs AML/CFT checks, as appropriate, on policyholders or others with whom it conducts relevant financial business. In practice, a captive may often delegate the operation of its AML/CFT procedures to the insurance manager servicing the captive.

172. As part of the AML regime, supervisors should be satisfied that the insurance manager has appointed a suitably qualified and experienced Money Laundering Reporting Officer and that the manager's staff regularly undertake appropriate AML training.

173. Where the insurance manager is not a regulated entity, supervisors should also be satisfied that the captive's board has ensured that measures are in place to prevent, detect and remedy insurance fraud and that procedures in respect of AML and CFT are in place as part of the operations of the insurance manager.

Appendix – Captive types

A. M. Best has defined a number of different types of captives:

	Captive Type	Description
1	Pure	Insurer that writes only the risks of its owners and/or affiliates.
2	Captive writing connected business	Insurer that writes the risks of unaffiliated companies doing business with the insurer's owners and/or affiliates, in addition to the risks of its owners and/or affiliates.
3	Captive writing third party business	Insurer that writes unrelated, open market risks, in addition to the risks of its owners and/or affiliates.
4	Captive of insurer	Subsidiary of a commercial insurer and/or reinsurer that writes only risks assumed from its owners and/or affiliates.
5	Association captive	Insurer that is owned by a trade association or members of a common industry or trade association for the purpose of sharing risk among its members.
6	Health care captive	Any type of captive writing coverage for hospitals, health maintenance organizations or managed care companies.
7	Multi-owner captive	Insurer that is owned by two or more unrelated parties for the purpose of writing the risks of its owners and/or affiliates.
8	Long-term (or life)	Any type of captive writing long term (life) business.
9	Composite	Any type of captive writing a combination of long term (life) business and general (non-life) business.
10	Rental captive	Insurer that contractually provides captive facilities for a fee to parties unrelated to the insurer's owners.
11	Agency captive	Insurer that is owned by one or more independent insurance agents to write high-quality risks that the agents control so the agents can participate in the profits generated by the business.
12	Finite	Any type of captive that writes related and/or unrelated risks involving: (i) clearly defined aggregate limits; and (ii) premiums that reflect the underwriter's anticipated investment income.
13	Captive not otherwise classified	Insurer that writes risks on a direct or reinsured basis that was formed to meet the insurance needs of its owner(s) whether it is

		formed under captive legislation or not.
14	Protected/Segregated cell captive	Insurer that provides captive facilities for a fee to parties unrelated to the insurer's owners. The captive is established by legislation that legally protects, or segregates, each cell's assets so that liabilities of other cells cannot attach to them.
15	Sponsored captive	Insurer that is owned by one or more insurer, reinsurer and/or captive. Each participant is unrelated to the owner(s) and insures its own risks. Each participant has its assets protected in a separate cell within the facility so that one participant never pays for the losses or expenses of any other participant.
16	Branch captive	U.S. domiciled subsidiary of an offshore captive that writes U.S. employee benefits subject to ERISA legislation for the owner of the offshore captive.
17	Risk retention group	Multi-owner captive formed under the U.S. Product Liability Risk Retention Act of 1981 or under the U.S. Federal Liability Risk Retention Act of 1986 that writes only liability risks.
18	Governmental pool	Separate, legal, non-governmental, risk-bearing entity that is formed by one or more governmental agencies and/or subdivisions for the purpose of self-insuring its risks.
19	Group self-insurance pool	Separate, legal, risk-bearing entity that is formed by a trade association, common industry or other related group for the purpose of self-insuring the risks of its members.
20	Special purpose vehicle	Any type of captive that transfers insurance and non-insurance risks into the capital markets.
21	Trust	A fiduciary relationship created by agreement in which money from individuals and/or companies is held by a trustee to satisfy the legal obligations of the individuals and/or companies to injured third party claimants.