

CAPTIVE | REVIEW

The essential guide to alternative risk transfer

GIBRALTAR INSURANCE MANAGER 2009

Caledonian Insurance
Management Services Ltd (CIMS)

SMEs take captives ‘Back to the Future’

Rob Martin of Mazars LLP and Penny Hudson of Caledonian Insurance Management explain why SMEs are turning to captive structures

Recently both companies have seen an increase in interest in small managed companies looking at captives and cell captives. Managing and financial directors are taking further time to consider more diverse risk management solutions and learning that alternative insurance facilities can really affect their bottom line. Self insurance can become insurance and excess layers can become protected. No longer are all European jurisdictions considered to be “offshore”, several now have agreed tax status within the European Union and well-managed companies, such as those for SMEs usually are, can benefit their parent companies with sound profitable insurance programmes.

Back to basics

The reasons that the first captives were formed by UK owners almost 100 years ago include:

- a lack of capacity in the market to underwrite a specific type of risk;
- the conventional markets did not wish to provide cover for the type of risk, and;
- the premiums from the conventional markets were too high.

These fundamental motives for utilisation of captives remain equally valid today.

Escaping from the shadow of tax evasion

There was steady growth in captives during the twentieth century, but a boom occurred from the mid-1980s to the mid-1990s. Ironically this followed the UK’s first Controlled Foreign Companies legislation in 1984. Unintentionally this highlighted how captives could be used as part of effective tax planning. A point which was not to escape the advisers to the newly privatised industries.

From this point on many owners of captives were viewed as the villains of the piece. Legal tax planning being viewed as tax avoidance and even tax evasion by their critics. No doubt some captives were established purely for tax advantage, some improperly optimising the gaps in the regulations that existed at that time. But other captives continued to be incorporated for valid reasons.

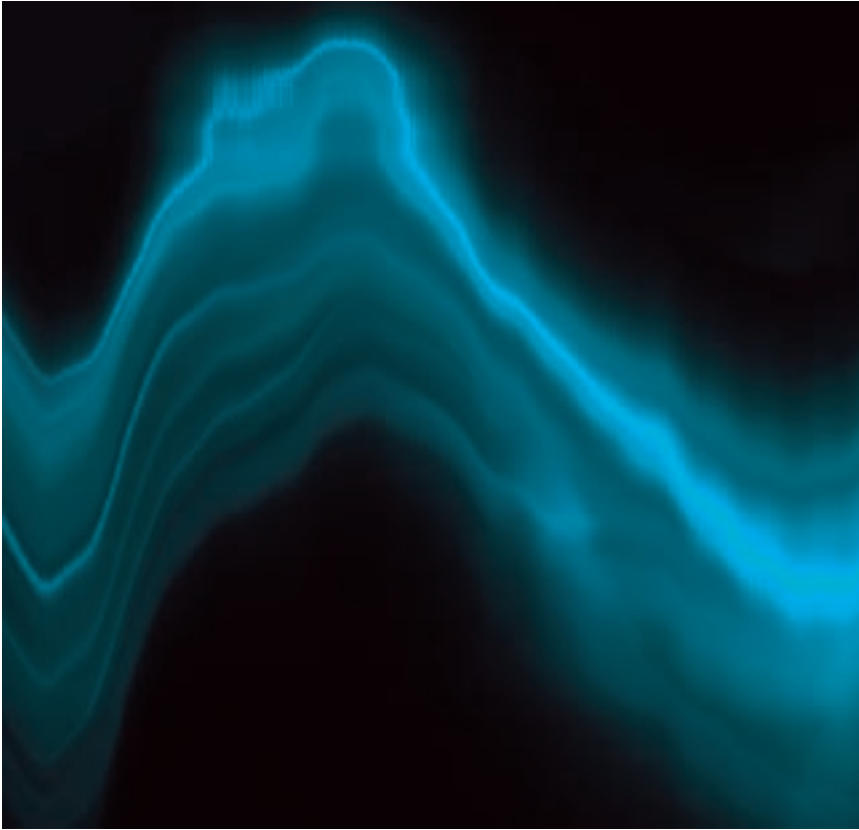
The constraints on the use of captives through tightening CFC legislation and compliance with UK accounting rules (ABI SORP) for owners reporting to the UK tax authorities, were to motivate them to take a new look at their captives. By the mid-1990s many captives had

established significant asset bases. Thus, even some that were previously established purely for tax advantage, were now reborn as valid risk retention and risk transfer vehicles for the parent and its various subsidiary companies.

In 1997 the Protected Cell Companies for Insurance Purposes (PCCs) emerged. The benefits being quickly recognised at one end of the scale by parent groups with international operations and/or diversified activities, and at the other end by SMEs who did not have the resources nor the risk appetite to fund the capital needed, or the running costs, for a stand-alone captive.

Captives, and hybrids thereof, emerged from the shadow of classification as merely being tax structures to take on an integrated, bona fide role within the enterprise-wide risk management and risk finance programmes of their parent groups.

The continued need for captive insurance companies is evidenced by further countries establishing laws to allow for their formation. In addition, we have seen PCC legislation, albeit it under different names, being incorporated into the laws of most domiciles as well as the use of redomiciliation legislation to move captives from one domicile to another in order to reap new advantages, such as:



“The continued need for captive insurance companies is evidenced by further countries establishing laws to allow for their formation”

- the ability to write policies direct into the EU Member States;
- the ability to reformat into a PCC structure;
- the rationalisation of several captives owned by one parent group into a single entity;
- a better understanding of the parent group's needs by the local regulatory supervisor;
- a better infrastructure support and reputation of the new domicile;
- lower travelling costs;
- better telecommunications;
- a move into the same or similar time zone as the parent group, and so on and so forth.

So what of the future?

The UK's current proposals for further changes to their CFC legislation including abolishing the Acceptable Distribution Test and Exempt Activities Test will no doubt be trumpeted by some as (yet again) the end for captives. The authors of this article do not believe this will be the case. The tax advantages to be achieved through captives have not been the drivers for their existence for

some time. Indeed this additional step could result in the owners of captives not requiring their captive to make any distribution of profit in the form of dividend (the parent picking up the resultant tax imposed on them by the Customs and Revenue), thereby allowing the captive to build its balance sheet and provide it with the capacity to write even more of the parent group's insurance programme.

The credit crunch has created concerns about the counterparty credit risk that may be posed by the conventional insurance markets, together with fears that premium rates will harden, scope of coverage afforded by policies reduce, and conventional markets will become even slower to react to new and emerging risks.

So we have gone 'Back to the Future'. The reasons for the formation of captives that were evident at the start of the twentieth century have re-emerged as the motivation for their use once more at the start of the twenty-first century. However, this time around the issues are valid concerns for SMEs not just the large companies. SMEs are turning to captive structures and in particular PCC structures for solutions.

Rob Martin of Mazars LLP UK is a chartered accountant and chartered insurance practitioner, who has over 30 years' business experience in commerce and industry, including managing major captives. Mazars provides audit and assurance, tax and a range of advisory services to support owner-managed and entrepreneurial businesses at every stage of development, including risk management solutions like captives and cell captive facilities. They work with businesses of varying size across a range of sectors, including some of the UK's fastest growing entrepreneurial businesses according to *The Sunday Times* Fast Track league table.

Penny Hudson is a Fellow of the Chartered Insurance Institute with over 20 years' in the insurance industry, and is managing director of Caledonian Insurance Management Services Ltd based in Gibraltar who manage a number of small and large diversified life and general insurance facilities, including open market insurers, captives and cell facilities.



If you could see into the future
you would already know
Caledonian is the
right choice



Managing Insurance Companies in Gibraltar
successfully and Independently since 1996

Contact our Insurance Management Expert
Penny Hudson FCII

CALEDONIAN
INSURANCE MANAGEMENT SERVICES LTD



PO Box 371
2nd Floor
85 Main Street
Gibraltar

Tel: +350 200 45578
Fax: +350 200 45579
E-mail: info@caledonian.gi
www.caledonian.gi

FSC Licence No 000493B