

Captives and the middle market

Ron Clark of Abacus Risk Management Services PCC explains that the European middle-market sector hasn't quite embraced the idea of captives as of yet

THE WIDER OPPORTUNITIES presented by captives and alternative risk transfer (ART) solutions have been well understood generally by the risk and insurance managers of large global corporations ever since captives hit the scene in the 1950s. Given the risk complexity and the magnitude of assets at stake within this segment, it is hardly surprising that today close to 50% of such companies have created at least one captive vehicle with which to optimise insurance coverage and maximise their underwriting profits beyond the levels afforded by traditional insurance programmes.

However, captives do not have the same level of notoriety within the "middle market" in Europe despite the introduction in certain domiciles, of protected cell company (PCC) or similar legislation ideally suited to these smaller entities. By comparison, the interest in captives within the middle market in the US appears much greater, although a direct comparison is difficult given the different definitions of corporate segmentation on each side of the Atlantic. The greater level of interest in the US may also be due to specific legislation such as the 831(b) Captive Insurance Companies legislation which permits certain tax breaks favouring the creation of so-called "Mini Captives".

The proponents of a wider use of captives by the middle market would probably agree that the take-up rate for captives within this segment in Europe is not yet at the level it should be given the obvious benefits to be derived. The seemingly complex nature of ART solutions and a general lack of awareness of the advantages of captive ownership resulting from certain inertia on the part of some professional advisors are certainly contributory factors.

THE GLOBAL BROKERS: Marsh, Aon and Willis have secured podium positions when it comes to the conception and placement of traditional risk-transfer (TRT) programmes for national flag carriers and other large corporations. Concurrently with their "traditional" broking service, a substantial ART consultancy business (including the creation and management of captive insurance companies) has been developed. This has created a win/win situation for such brokers in advising their clients in TRT and/or ART solutions. However, the middle-market segment has not traditionally been the global brokers' target market as they are better geared to service larger corporations through their extensive networks.

THE INDEPENDENT BROKER: By comparison, independent brokers are traditionally well positioned in the middle market but tend to be less familiar with and therefore less comfortable than their larger competitors in proposing ART solutions to their clients. As a result, competition between the "independents" in most areas for middle-market business tends to centre on lowest price/broadest coverage, which do not typically encourage dialogue with prospects on ART solutions despite the potential advantages. However, these brokers ignore at their peril the advantages of captive solutions for suitable clients and especially for those rapidly expanding businesses that could be lost to the larger brokers given their more proactive approach in this regard.

Many independent brokers are unconvinced of their added value in the domain of ART solutions and are concerned that their commission income will reduce should their clients become captive owners. However, these concerns can be mitigated by entering into a

strategic alliance with experienced insurance managers such as Abacus to provide the ART skills, which may be lacking and by adopting a fee-based consulting approach to the provision of integrated ART/TRT services.

Independent brokers and indeed other professional advisors (accountants, auditors, banks, lawyers etc) who create such partnerships with insurance managers could trigger additional growth in ART solutions for the middle market. The potential for such collaboration can be seen in the recent signing of an important agreement between Abacus and a leading French automotive equipment manufacturer for the creation and management of a PCC in Malta. In this particular case, the "intermediary" was a non-broking firm.

DOMICILE CAN ALSO PLAY a major role in determining the feasibility or otherwise of creating a captive especially for middle-market entities given their more acute capital and expense constraints compared to those of most large corporations, the Belgian market's traditional preference for Luxembourg as a domicile given the geographical proximity and language and legal system affinities are positive elements, for example, which could be outweighed by the lack of PCC legislation.

Accordingly, potential captive owners with modest premium volume may well consider other domiciles with PCC or similar legislation and other advantages more suited to smaller entities (see below) to be more appropriate.

KEY CONSIDERATIONS: Irrespective of size, any organisation contemplating captive creation should take into account the presence or otherwise of the following with regards to choosing a domicile:

- A sound political and regulatory envi-

ronment with an accessible and flexible Regulator;

- An OECD/EU-compliant fiscal environment untainted by reputational issues;
- A highly qualified financial services workforce including experienced captive managers;
- A convenient geographical location with relatively easy access;
- A sustainable and effective low-tax environment rather than a “deferred tax” system;
- Double-taxation treaties with countries relevant to the captive’s parent organisation.

Additionally, middle-market entities should be particularly attentive to following as they could have a direct impact on the profitability of the new venture:

- A low-cost operating environment with regards to salaries, rents, and other overheads;
- Captive legislation permitting direct captives rather than only reinsurance captives so as to benefit from EU “passporting” rights enabling the issuance of their own policies throughout the EU. This avoids costly “fronting” arrangements and the issuance of collateral security in favour of “fronters”;
- Protected cell or similar legislation is particularly advantageous to middle-market captives;
- Lower initial capital requirements for the creation of a cell compared to a standalone captive (the required “Minimum Guaranteed Fund” normally required within the EU for a standalone captive is met at the “core” by the PCC owner);
- Simplified administration results in lower administration costs and economies in senior management’s time.

MALTA – THE IDEAL EU DOMICILE for middle-market captives :

Being the only full EU (and Eurozone) member state with PCC legislation (part of its advanced “Affiliated Insurance Company” legislation) and benefiting from other important advantages, Malta could be considered the domicile of choice for the middle-market segment given:

- A highly qualified financial services workforce;
- An extremely approachable and flexible regulator (the Malta Financial Services Authority);
- Maltese direct-writing captives are able to issue their own policies throughout the EU (see “Choice of Domicile: Key Considerations “above);
- An OECD-compliant tax environment: Malta has implemented the internationally agreed tax standards endorsed by the G20 finance ministers and by the UN Committee of experts on international co-operation on tax matters;
- A low-cost environment compared to many other EU captive domiciles with regards to salaries, rent and other overheads;
- A refundable tax credit system on dividends paid to non-resident shareholders of captives which can essentially reduce the impact of corporate tax payable by the captive from 35% to 5%;
- An extensive and growing network of double-tax treaties with over 50 countries together with the refundable tax credit system make Malta a particularly attractive tax environment.

Although the Abacus experience of strategic alliances with various professional firms

is encouraging, the most interest has been shown by non-brokers in exploring opportunities within their client base. This is somewhat ironical given the obvious interest expressed by clients of these other firms when we engage them in joint discussions. It would therefore appear that much more could be done by independent brokers to promote ART solutions within such a seemingly receptive audience.

Other areas worthy of consideration within the ART domain by those better capitalised independent brokers are:

- The creation of a direct writing PCC or insurance cell(s) on their own behalf in which to place suitable profitable client business and generate an additional revenue stream and tax-efficient reserves and/or;
- The establishment of a management cell in Malta at a modest cost through which to manage their clients’ captives via a service agreement with Abacus (as the only insurance manager in Malta incorporated as a PCC, Abacus is able to create management cells and administer them on behalf of other service providers).



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