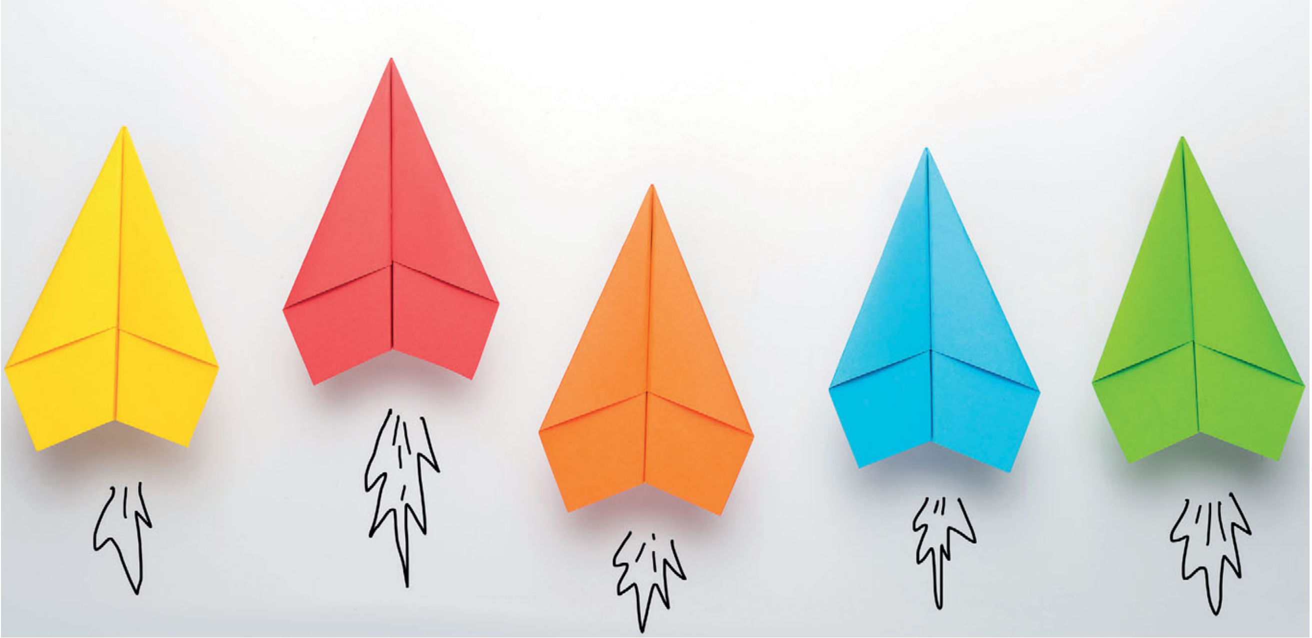
THE EVOLUTION OF GROUP CAPTIVES

Alanna Trundle, of Global Captive Management, reflects on the evolution of the group captive



The group captive industry has seen significant growth in the past few years, not just in the number of group captives but also in the number of members insured. In the Cayman Islands alone, total premiums have doubled in the last five years and assets have increased from $5.2bn to $8bn in the same period. Group captives now make up 17.19% of the captives licensed in the Cayman Islands. However, it hasn't always been smooth sailing for this industry. Group captives have faced many challenges in the past 10 years, but by facing these challenges head on and learning from them, they have positioned themselves well for continued growth and success into the future.

Group captives became popular with mid-size companies between 1985 and 2005 as a result of the hardening of the market in the late 1980s and early 2000s. By 2008, when the financial crisis happened, many group captives were well-established and had seen significant growth year-over-year in membership. The impact of the crisis on mid-size companies was significant and this was reflected in the group captive industry, which saw member numbers stagnate or even fall, as companies were forced to close. Construction group captives fared the worst as capital projects slowed down and the housing market took several years to rebound. It wasn't just a fall in member numbers that affected the industry; the creation of new captives also stagnated.

Recent challenges for group captives

The financial crisis also impacted the value of the investments held by group captives. Established group captives that had equity allocations of up to 50% were hardest hit and in some cases, were forced into capital calls to avoid going into a shareholders' deficit position. Other group captives faced collateral restraints impacting what they could invest in, further reducing investment returns. Limited excess collateral led to an inability to move fronting carriers even if renewal terms weren't favourable and dividends were limited at a time when member companies needed additional capital. A reduction in dividends also impacted the marketability of the captive,

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making it less attractive to new members.

Restricted credit was also an issue as the requirement for members to post collateral became increasingly difficult to meet. Banks became very cautious, not just about providing credit but also on accepting credit from certain institutions. To make matters worse, letter of credit fees became increasingly expensive.

Considering all these factors, it is clear to see how many group captives struggled during this time, especially younger captives which took many years to get back on their feet. For those captives that were able to weather the storm, key lessons were learnt.

The importance of a steady stream of new members was highlighted. Losses would have a much greater impact on groups with low member numbers. The introduction of new members was no longer the job of the broker. If members wanted their captive to thrive, they needed to start introducing peers and helping to sell the product. This change in attitude has been key to the continued growth of group captives and has never been more important than it is today. As noted by Lindsay Chase of Innovative Captive Strategies: "As the baby boomers near retirement many are looking for an exit strategy to their businesses, which often result in acquisitions by larger companies or private equity firms, which don't necessarily have a desire or need for a captive."

Members have also become more conservative, especially when it comes to investments and dividends. The main focus of most group captives' investment policies today is capital preservation with limited amounts invested in equities. This has helped to establish a strong balance sheet with stable returns.

A key shift in recent years is that members are opting to reinvest dividends in the captive instead of providing a letter of credit. By doing this, members can earn a stable rate of return and avoid increasing letter of credit fees. This benefits the captive as it boosts the balance sheet position and gives the investment manager more buying power, but it also means members are less reliant on dividends for their onshore companies' cashflow needs.

Further challenges

The cyclical nature of the insurance industry is a challenge faced by all captives and the continued soft market through the 2010s has caused rates in the commercial market to be more favourable. However, this has not had a significant impact on group captives. Members are no longer focused solely on keeping rates low. Although this may have attracted them to a group captive initially, the education they receive as a member of a captive on risk control and the ability to mitigate/reduce losses for the benefit of both the employees and the employer becomes far more worthwhile.

The ability to retain members during a soft market is one thing, but group captives have managed to grow significantly over the last five years. Group captives are no longer the industry's best kept secret. Improvements in technology making information more accessible has meant that companies and insurance agencies are now thinking "outside the box" to explore other alternatives to their insurance needs. Captives have also become more accessible to smaller companies with group captives being formed with lower retentions.

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Changes in US tax rules have also posed their own challenges to the group captive Industry. Recent tax reform has forced members of group captives to reconsider the organisational and tax structure of their captive. With the reduction in tax rates, many expected captives to re-domicile onshore; however this has rarely been the case. The Cayman Islands is still considered one of the top domiciles of choice given its appropriate level of regulation, capital requirements, and the knowledge and expertise of the industry.

Many existing offshore group captives have also re-evaluated their decision not to take the Internal Revenue Code Section 953(d) election. A 953(d) election allows a Controlled Foreign Corporation (CFC) engaged in insurance business to be treated as a US corporation for US tax purposes and shifts the tax burden to the captive instead of its members. After careful consideration of all the facts, very few captives have strongly considered taking the irrevocable election. This is primarily due to the potential tax exposure on previously deferred and unearned income at the time of the election and the uncertainty around future corporate tax rates.

Although tax reform has not had a significant impact on group captives, it has given members of group captives the opportunity to gather information and reaffirm decisions previously made to ensure the captive is still structured adequately to move forward successfully in to the future.

One of the most significant challenges faced by group captives is the burden of increased regulation. Compliance with anti-money laundering and terrorist risk financing regulations, increased due diligence requirements for shareholders, directors and officers and keeping up to date with new guidance implemented by local regulators is a full-time job. Although this does incur additional time and effort upfront, captives that have embraced changing legislation and implemented sound policies and procedures have seen the benefits. Appropriate regulation helps offshore jurisdictions with perception issues, which is not just beneficial to the domicile but also the group captives domiciled there. The burden of new member paperwork may not be attractive to prospective members, but joining a captive that is transparent and compliant with regulation is.

Conclusion

So, as group captive numbers continue to rise, what will be the next challenge? Whether it be regulatory, tax, industry or market changes, group captives have shown that they are resilient and adaptable much like the members who comprise them. The success of group captives can largely be attributed to their members. Their ability to think outside the box for their insurance needs, invest both physically and mentally in the concept, work with their peers to help improve each other's businesses and use their skills and expertise from running their own companies to help make their shared company a success. As one long-standing group captive member said: "Being in a group captive was not only one of the best business decisions I made but also a great personal decision. We continue to be committed to the group and to our partners through good times and bad and we are excited about the future for our company and our fellow members."