INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

APPLICATION PAPER ON THE REGULATION AND SUPERVISION OF CAPTIVE INSURERS

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This document was prepared by the Captive Insurance Task Force (formerly the Captive Insurance Drafting Group within the Reinsurance Subcommittee).

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1. Introduction

1. This paper is intended to provide guidance to insurance supervisors on the application of 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 Captive insurance companies – October 2006.

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, 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.*"

4. In practice, supervisors of captive insurers tend to use the following classifications[1]:

- 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*". [2]

5. The use of internal reinsurance vehicles by insurance groups, to reinsure the insurance or reinsurance risks they have underwritten, is outside the scope of this paper. Such vehicles are sometimes referred to as captives but fall outside the traditional definition of a captive. [3]

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

[2] Some jurisdictions consider that an insurance company writing unrelated party business cannot be classified as a captive.

[3] Captives may be used to insure the operational risks of an insurance or reinsurance group in the same way as they are used by any other industrial, commercial or financial entity, e.g. to cover risks of group owned property. In that case they may be treated in the same way as any other captive.

6. Supervisors should recognise that the regulatory risk inherent in a captive insurer can vary substantially and therefore the level of supervision that is necessary will vary accordingly. 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 where the third party has direct recourse to the insurer. Such insurers may pose risks similar to those of commercial insurers and, to that extent, supervisors should consider applying regulatory requirements similar to those for commercial insurers.

7. Supervisors should determine an appropriate and proportionate supervisory approach, depending upon the type of captive and the following factors may 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.

9. Some captives may be structured as protected cell companies (PCCs)[4] which maintain a legal separation between the assets and liabilities relating to each policyholder, but in other captives, such as rental captives, these may not be kept legally separate.

Business underwritten

10. There are captives that only underwrite classes of business such as property damage or business interruption for which it is clear that only the parent company has an interest in the policy. Other captives write liability business or employee benefit risks where there may be third parties or employees with an indirect interest in the proceeds of the policy. It is important to establish who the obligation to the third party rests with; in many cases it remains with the captive owner.

11. In some cases, captives are permitted to underwrite compulsory classes of business, such as employers' liability or motor third party liability, directly under the legislation of the jurisdiction where the risk is situated. In other cases the captive will require the use of a fronting insurer who will bear the responsibility to third parties.

12. The business may be directly written or assumed as reinsurance which involves the use of a fronting insurer.

Policyholders and 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. However supervisors should bear in mind that captives underwriting such risks on a direct basis may require heightened regulation or supervision.

14. Producer owned reinsurance companies (PORCs) reinsure a fronting insurer which underwrites risks for individual consumers generated by the captive owner. Supervisors should

[4] See section 5

have heightened awareness of consumer protection issues, because the sale of the insurance product could be influenced by the owners of the PORC, and consider carefully whether such entities should be treated as captives.

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 Standards apply to captives subject to the nature, scale and complexity of various forms of captives. There are separate sections on issues relating to cell company structures and insurance managers although, for the avoidance of doubt, the ICPs do not apply to insurance managers but to the insurers for which they act.

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:

- ICP 3: Information Exchange and Confidentiality Requirements
- ICP 4: Licensing
- ICP 5: Suitability of Persons
- ICP 6: Changes in Control and Portfolio Transfers
- ICP 7: Corporate Governance
- ICP 8: Risk Management and Internal Controls
- ICP 9: Supervisory Review and Reporting
- ICP 13: Reinsurance and Other Forms of Risk Transfer
- ICP 14: Valuation
- ICP 15: Investment
- ICP 16: Enterprise Risk Management for Solvency Purposes
- ICP 17: Capital Adequacy
- ICP 19: Conduct of Business
- ICP 20: Public Disclosure
- ICP 21: Countering Fraud in Insurance
- ICP 22: Anti-Money Laundering and Combating the Financing of Terrorism
- ICP 23: Group-wide Supervision
- ICP 24: Macroprudential Surveillance and Insurance Supervision

4.1 Regulatory system

17. This section covers ICP 3 (Information Exchange and Confidentiality Requirements), ICP 4 (Licensing), ICP 5 (Suitability of Persons), ICP 6 (Changes in Control and Portfolio Transfers), ICP

24 (Macroprudential surveillance and insurance supervision), ICP 9 (Supervisory Review and Reporting), ICP 19 (Conduct of Business) and ICP 23 (Group-wide Supervision).

Supervisory cooperation and information exchange

18. ICP 3 requires the exchange of information amongst relevant supervisors and authorities subject to confidentiality, purpose and use requirements.

19. Where appropriate, and subject to confidentiality and use considerations, supervisors of captives should cooperate fully in sharing information with other supervisors. Examples include; where captives transfer risks between jurisdictions through reinsurance or portfolio transfers, or where a director or controller of a captive or insurance manager located in one jurisdiction applies to be a director or controller of a regulated 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 51.

20. It is also possible for captives to migrate to other jurisdictions. Supervisors in the respective jurisdictions should review the cooperation and confidentiality arrangements and communicate with each other in these circumstances to confirm that there are no regulatory reasons why such a transfer should not take place.

Licensing

21. In accordance with ICP 4: A legal entity that engages in insurance activities must be licensed before it can operate within a jurisdiction.[5] It is further required that procedures for licensing must be clear, objective and public, and be consistently applied and therefore this would apply to the licensing requirements for captive insurers.

22. 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.

23. 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.

24. Licence applications should be accompanied by relevant licensing information, which should include, at a minimum, details of proposed significant owners, board members, key persons in control functions, service providers such as insurance managers, auditors and actuaries, and a business plan.

25. Most supervisors of captives require that the business plan also addresses matters, some of which may be obtained from the feasibility study, such as:

- the capital structure, including how the captive would meet future solvency requirements
- a projected balance sheet

[5] See ICP 4 for further information on the exclusion of limited insurance activities from licensing requirements.

- a profit forecast
- cash flow projection
- intended classes of business and cover
- limits of liability
- use of reinsurers and fronting insurers
- an organisational chart
- any outsourcing arrangements
- an outline of the proposed investment and dividend strategies
- financial and other resources
- rating and pricing methodologies
- claims management process
- prior loss experience
- information on the actuarial function 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 supports and is consistent with the captive's business plan

26. Supervisors should be satisfied that the operations of captives, domiciled in their jurisdiction, are sufficient to demonstrate that management and control resides within their jurisdiction.

27. Prior to issuing a licence, supervisors should be satisfied with proof of the captive’s incorporation and capitalisation. Where the captive and its owner are based in different jurisdictions, performing due diligence on the owners may involve the exchange of information between authorities in those jurisdictions.

28. Standards within ICP 4 require supervisors to have the authority to impose additional requirements, conditions or restrictions on an applicant where appropriate. This is important in the supervision of captives since supervisors need to 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.

29. The Standard requiring the suitability of board members, senior management, significant owners and key persons in control functions, as specified in ICP 5 (Suitability of Persons), to be assessed prior to licensing is equally applicable for captives even though the owner and the policyholder may be one and the same.

30. The owner’s location may 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 on-going 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

31. ICP 5 addresses the suitability of board members, senior management, key persons in control functions and significant owners of an insurer.

32. Owners of captives must have financial soundness and integrity, therefore inquiries 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.

33. Supervisors usually require captives to have a representative and/or manager in the jurisdiction (or country) 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.

34. 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.

35. When assessing the suitability of captive owners the supervisor may take into account that the insurance expertise is often provided by other parties such as the insurance manager or the insurance/reinsurance broker as well as by the owner's risk management or insurance functions. Therefore it is not necessary for the captive owner to be an expert in all aspects of running a captive insurer.

36. 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 transfers

37. ICP 6 requires that proposals to acquire significant ownership or an interest in an insurer, portfolio transfers and merger of insurers should all be subject to supervisory approval.

38. 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 need to be able to take appropriate action such as preventing the captive from accepting further new business. Changes in control often take place within the group so that the ultimate owner of the captive is unchanged and the supervisor will need to be notified of it, and if necessary, the supervisor will inquire further to, for example, satisfy themselves of the reason for the change.

39. The purchase or merger of a captive's parent is sometimes the precursor to a change of domicile (migration) of the captive in order to allow for it to be amalgamated with other risk management operations of the enlarged group. Supervisors may have the power to restrict or impose conditions relating to an outward transfer of a captive or a portfolio transfer to protect the policyholders' interests. Inward migrations will usually be subject to the normal licensing application criteria.

40. When a captive undergoes a change in control through a direct sale to an unrelated party, supervisors need to take appropriate action as the captive could then be writing unrelated party

risks. There is a market for the purchase of captives that are in run-off. This may be attractive for a parent that has no further use for its captive since it removes potential liabilities from the group. The supervisor should consider the type of business that was written by the captive when assessing the prospective purchaser and should assess whether the purchaser has the financial resources to deal with any future deterioration in long-tailed claims reserves prior to approving the change in control.

41. Similarly, 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. In this respect, supervisory 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.

42. 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, and should evaluate the risks of the transaction to the policyholders and to unrelated parties.

Supervisory review and reporting

43. ICP 9 describes a risk based approach to supervision, requiring the supervisor to use both off-site monitoring and on-site inspections to examine the business of each insurer, evaluate its condition, risk profile and conduct, the quality and effectiveness of its corporate governance and its compliance with relevant legislation and supervisory requirements.

Off-site monitoring

44. Reports to supervisors are as important in relation to captives as for any other insurer. Whilst captives typically pose reduced risk to external stakeholders or to the financial stability of the insurance market, supervisors should nevertheless receive sufficient and timely reporting to monitor solvency, assess compliance with the applicable legislation and to identify potential problems.

45. Standard ICP 9 requires supervisors to set the requirements for supervisory reporting. In defining the scope, content and frequency of the information to be provided, supervisors may take into account the captive's particular risks, size and the amount of third party and/or unrelated party insurance exposures, if any.

46. Taking a risk based approach, supervisors should regularly monitor a captive's adherence to its agreed business plan, particularly as regards dividend policy, the extent of any unrelated party business and risk management strategies.

On-site inspections

47. 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.

48. Supervisors may specifically focus on:

- connected party transactions
- the amount of unrelated party business
- third party liabilities
- capital and solvency
- corporate governance and control, including board oversight

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

Group-wide supervision

50. ICP 23 requires supervisors to identify the scope of the group to be subject to group-wide supervision.

51. Supervisors should consider the need to communicate with other financial sector supervisors responsible for other companies in the group. For example, a global group may have multiple captives, in different jurisdictions, involved in the group's risk finance programme.

52. 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 or relies upon unpaid share capital for solvency purposes. The group structure should be explained in sufficiently transparent terms such that the supervisor can assess the risks involved in such related party assets.

53. Many captives, being owned by industrial or commercial organisations, will be the only legal entity within their group that is subject to financial regulation. Supervisors may not find it practical or have the authority to undertake group supervision in those circumstances. The focus should be on the legal entity but with appropriate analysis of the potential for the activities of group entities to impact on the captive and on the controls in place to prevent the group from removing assets from the captive without the approval of the board and the supervisor.

Reinsurance

54. In accordance with ICP 13 supervisors should require that cedants are transparent in their reinsurance arrangements and the associated risks, allowing the supervisor to understand the economic impact of reinsurance and other forms of risk transfer arrangements in place.

55. Supervisors should require that the board has assessed the proposed reinsurance strategy, both assumed and ceded/retroceded, to confirm that it provides adequate protection and has considered the financial standing of both fronting insurers and reinsurers as well as the domicile in which they are located. The supervisor should consider the level of supervisory review of the reinsurance programme based on the type of captive and the extent of reliance upon the reinsurer.

56. Captives are often reliant upon one reinsurer and the supervisor should require that the board has adequate procedures, which may involve some delegation to the captive manager, to monitor this significant counterparty exposure.

Conduct of business

57. ICP 19 deals with requirements for the conduct of the business of insurance in order to ensure that customers are treated fairly throughout the duration of the contract.

58. The criteria of ICP 19 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.

59. 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.

60. Guidance notes to ICP 19 allow for supervisory requirements to distinguish between particular types of customers. Therefore, since policyholders of most captives will fall into the category of sophisticated customers, detailed conduct of business rules may not be appropriate[6]. In the event that a captive has retail customers the supervisor may consider whether to apply conduct of business rules in the same way they would be applied to commercial insurers.

61. 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. Where unrelated parties are involved, supervisors should be satisfied that the board of the captive and, where relevant, the captive manager is aware of any consumer protection requirements applying in the jurisdiction.

62. When a captive underwrites liability risk, in particular compulsory liability, supervisors may 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 the rights of third parties are appropriately recognised.

4.2 Corporate governance

63. This section covers ICP 7 (Corporate Governance).

64. The aim of the corporate governance framework is to provide for sound and prudent management and oversight of the insurer's business and it should adequately recognise and protects the interests of policyholders.

65. The principles of corporate governance, as outlined in this ICP, apply to captives, bearing in mind that the application of corporate governance standards should take account of the size, nature and complexity of the business of the insurer. Corporate governance issues specifically relevant to captives may include unrelated party issues, related party transactions or perceived or actual conflicts of interest.

66. Where a captive is managed by an insurance manager, a distinction can be made between corporate governance as it applies to the captive and its board of directors and corporate

[6] Sophisticated customers can be defined as knowledgeable, 'professional', 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.

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.

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

- Separation of the oversight function from the management responsibilities may become blurred.
- Many of the functions of the captive may be outsourced, either to the insurance manager or, for example, to investment managers, specialist claims administrators or firms of actuaries.
- 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 formalise the arrangements between captive owners, directors and insurance managers to ensure effective governance.
- There are different conduct of business considerations for owners, related parties and unrelated third parties.
- Any remuneration policy is likely to be limited solely to the directors since the majority of captives do not employ their own staff.
- A captive may be required to adopt policies or procedures developed at group level but it should still ensure that these are appropriate and meet the requirements of the insurance supervisor.

68. The following are specific guidelines relating to corporate governance of captives. Supervisors may wish to consider:

- Satisfying 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, seeking confirmation that they are able to exercise independent judgement and objectivity in making decisions and able to challenge sensibly the views of the directors who are appointed by the parent group.
- Be satisfying themselves with the composition of the board of directors, including any requirement for locally resident directors and the balance between executive and non-executive directors.

69. Supervisors may wish to be satisfied that the board of directors:

- Has sufficient balance such that no one individual has unfettered powers of decision.
- Has the proper balance to ensure 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, like possible claimants on the parent policyholder e.g. employer's liability or motor third party liability.
- Collectively have the skills and experience necessary to manage effectively any outsourced operations including outsourced insurance management functions.
- has clearly defined and agreed the responsibilities of the insurance manager
- have adequate controls in place so that transactions, payments or charges on assets initiated by the owner (dividends, reinsurance agreements with related entities, loans, expenses or guarantees) do not financially impair the captive's ability to meet its liabilities.

70. In the case of captives established as association captives, multi-owner captives or rental captives, the supervisor should be satisfied that the board consider their responsibilities to multiple owners of the captive.

4.3 Risk management and internal controls

71. This section covers ICP 8 (Risk Management and Internal Controls).

72. Effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit are an essential part of the overall corporate governance framework and the supervisor should require an insurer to have such functions. The systems and controls should be adequate for the nature, scale and complexity of the insurer's business and risks.

Types of risk

73. 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 differ as between captives and commercial insurers and the supervisor may take into account the resources of the parent and the nature of the captive when considering such risks (this list is not exhaustive nor in any particular order of priority):

- Control of outsourced insurance management function

  Supervisors should require 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

  Asset concentration risk and credit risk should be monitored, managed and mitigated by a captive, especially if it holds relatively low levels of assets and technical provisions and have low solvency capital requirements.

- Failure of a fronting insurer

  Supervisors should be aware that the failure of a fronting insurer could adversely impact a captive if, for example, the fronting insurer had collected premiums which had not been paid over to the captive, or, fronting was required to meet local regulatory requirements in certain jurisdictions. Supervisors may take account of this when considering a captive's fronting arrangements.

- Lack of risk diversification/retention

  Supervisors should take account of the lack of risk diversification or risk retention 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 for solvency purposes. If loans are to be acceptable, supervisors should assess the financial position of the parent company and consider the impact of the terms of the loans on the captive's solvency under stress.

- 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, sometimes total, 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. Supervisors may wish to consider whether there is an appropriate level of risk retention within the captive, whilst recognising that there may be valid reasons why no risk is retained.

- Taxation issues
  Supervisors should be aware 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
  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.

74. 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 may remain a risk of being sued by a third party claimant. If necessary, confirmation should be sought that legal advice has been obtained by the captive in this regard. Legal risk may also exist in relation to the relationship with the fronting insurer.

- Operational risk: such risk may be low if the captive has few transactions or a limited number of policies and thus does not conduct activity every day; this is common in many captives. Many captives are reliant upon an insurance manager for operational matters and can be run remotely if necessary.

Internal controls

75. Outsourced functions are addressed within the standards of ICP 8. At least the same degree of oversight of and accountability for any outsourced material activity or function (such as a control function) should be applied as to non-outsourced activities or functions and thus remains the ultimate responsibility of the captive.

76. 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. Most captives are not complex operations which require extensive control functions and some captives are subject to the internal audit disciplines and/or risk

management functions of the parent company. This may be taken into account when supervisors assess the internal control requirements for captives.

77. Supervisors should require captives to have effective control functions in place. In practice many functions are provided by the insurance manager, the parent company or outsourced to specialist firms. The following issues are of specific relevance when considering the control functions of a captive:

- Risk Management Function
  Captives are an integral part of their parent's enterprise risk management function with the head of the risk function often being appointed as a director of the captive. The captive's attitude to risk will therefore be heavily influenced by its parent but it is important that the whole board is engaged in the process and is able to challenge the parent if required.

- Compliance Function
  The compliance function is often outsourced; usually to the insurance manager since they have the expertise relevant to local legislation and will be familiar with the regulatory requirements set by the supervisor. This also provides economies of scale for the captive as the costs of the compliance function can be shared amongst all of the captive clients of the insurance manager. The parent company may also have oversight of the compliance function from a group perspective.

- Actuarial Function
  A captive board may have a number of sources of actuarial advice such as the insurance manager, the insurance or reinsurance broker, and, external actuarial consultants which are often used by larger captives writing liability risks. Depending upon the type of insurance being underwritten a fronting insurer may also be a source of actuarial information in relation to the setting of technical provisions. In practice captives mainly make use of actuarial resources to calculate technical provisions and advise on the ORSA. Captives generally do not use actuarial techniques to calculate premiums or to match assets and liabilities.

- Internal Audit Function
  Insurance Managers often work to a set of generic control procedures that are applied to all captives under their management. Individual captives will therefore modify these controls to suit their circumstances. The insurance manager's internal audit function will therefore have some oversight of each captive. The internal audit function of the parent company will often also be responsible for oversight of the captive to ensure that group controls are effectively applied.

  Whilst some self-managed captives may be of sufficient size and complexity to support their own control functions most will not and therefore the supervisor should take into account the nature, scale and complexity of a captive's business when considering the adequacy of the control functions.

4.4 Valuation

78. This section covers ICP 14 (Valuation).

79. The valuation of assets and liabilities for solvency purposes is addressed in ICP 14.

80. The underlying principles behind ICP 14 are as relevant to captives as to commercial insurers. They require the solvency regime to address the recognition, de-recognition and measurement of assets and liabilities so that they are valued on a consistent basis in a reliable, decision useful and transparent manner. This is partly to allow comparison across insurers worldwide but this is not such an important consideration for captives which do not have to comply with ICP 20 on Public Disclosure.

81. The Standards require that the valuation of assets and liabilities is an economic valuation and reflects the risk adjusted present values of future cash flows. In practice many captives are inherently conservative in their valuation of liabilities and do not take into account the time value of money. To the extent that this results in higher capital requirements this should not pose a difficulty for the supervisor, however, the supervisor should be satisfied that there is no inherent optimism in the valuation of liabilities.

82. Captives have some unique characteristics such as having higher potential claims volatility. This volatility may be managed by the imposition of annual aggregate limits or by the purchase of reinsurance. These characteristics may be incorporated into a review of liabilities by supervisors or when creating regulations regarding captive liabilities.

83. Captives may reinsure a portion of their risks and some captives are formed with the sole purpose of accessing the reinsurance market. Supervisors may take this into account when establishing whether to give full credit for reinsurance in the calculation of technical provisions, subject to satisfactory reinsurance creditworthiness.

84. In some cases, pure captives may already have knowledge of all reported claims, because their owner is the only claimant. In those cases, the incurred but not reported ("IBNR") component of the technical provisions 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").

4.5 Investment

85. This section covers ICP 15 (Investment).

86. ICP 15 deals with requirements for solvency purposes on the investment activities of insurers.

87. 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.

88. The processes and systems required in each case should be proportionate to the nature, scale and complexity of each captive's activities. Supervisors could, for example, consider the following factors when establishing requirements for solvency purposes on the investment activities of 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.

- Some captive's investment portfolios are less well diversified than that of larger commercial insurers since they will have a smaller portfolio. Diversification is often achieved by the use of collective investment schemes.
- A captive's investment portfolio may reflect a lower risk profile, as often captives do not have a material exposure to investments in equities, property (or other illiquid assets) or derivatives and similar commitments.
- 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 assess whether a captive has taken adequate account of asset-liability matching and that the captive has made 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 may consider a captive's investment policy as part of their review of its business plan. The supervisor should consider whether it wishes to be advised of any change to the original investment policy.

89. 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 related entities and reinsurance agreements with related entities are approved by the captive's board of directors. Supervisors may consider, in the context 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 may 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.

90. Supervisors should consider whether loans to any connected parties should be admissible to cover technical reserves or for solvency purposes depending upon the terms and conditions of the loan. The written formal loan agreement should form part of the captive's books and records.

91. 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

92. 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/finance departments or functions are scrutinised by the directors in the same way as any other outsourcing arrangement to third parties.

4.6 Enterprise risk management for solvency purposes

93. This section covers ICP 16 (Enterprise Risk Management for Solvency Purposes).

94. There is a requirement for the supervisor to establish enterprise risk management (ERM) requirements for solvency purposes that require insurers to address all relevant and material risks.

95. The IAIS recognises, within the guidance, that this ICP may not be fully achievable by some insurers and some markets in the near future. Further, it emphasises that this ICP does not prescribe a specific aspect of solvency requirements which is to be applied compulsorily by IAIS Members. The supervisor may take this into account when setting the requirements for captives.

96. A captive is an integral part of its parent company's ERM framework. It is not necessary for a captive to duplicate work that has already been carried out at a group level. The board of the captive should focus on risks that are specific to the captive.

97. Risk tolerance limits for a captive will, to a large extent, be guided by the willingness of the parent company to provide capital and by the risks that are offered to the captive; a captive does not generally seek out risk but rather waits until it is offered a risk by its parent.

98. Asset-liability matching (ALM) is not always practised by captives since their investment priorities are often simplicity and capital preservation and this prevents them from taking longer term investment risk to match with their potentially long tail liabilities. Of course some more complex captives may practice ALM.

99. ICP 16 requires supervisors to ensure that insurers have a risk management policy which includes explicit policies in relation to underwriting risk. For captives it is particularly important that the underwriting policy addresses the levels of risk retention that the board is willing to accept given the relative lack of diversification within a captive portfolio. The captive's board should consider setting a retention policy which incorporates caps, such as an aggregate limit on its exposure, or the use of reinsurance.

100. The simplicity of a captive's operational and reporting structure means that it can readily respond to changes in its risk profile and it is likely to be a part of a wider group feedback loop since one rationale for operating a captive is to enable better reporting on insured risks and claims.

101. An insurer is required to perform its own risk and solvency assessment (ORSA) in order to determine the economic capital requirement. The ORSA output should proportionally account for the nature, scale and complexity of the insurer and may be a concise, simple high level assessment given the characteristics of a captive

102. The ORSA process for a captive may focus on those areas which may not be adequately captured in the standardised approach determined by the supervisor. A basic qualitative and quantitative assessment of the risks, without analysing sophisticated modelling, may be sufficient for a captive. Supervisors may wish to consider the following points which are of specific relevance to a captive's ORSA:

- Underwriting risk – the aggregate limits applicable to a captive's insurance programme should be considered when setting economic capital requirements.

- Credit risk – the level of reliance upon reinsurers is likely to be the most significant risk for many captives.

- Market risk – Given the low risk approach to investments this is unlikely to be a significant risk for most captives.
- Operational risk – this is best dealt with on a qualitative basis since the captive is reliant upon the insurance manager who will be obliged to provide a service regardless of operational risk events. The board should satisfy itself with the business continuity arrangements of the insurance manager.
- Liquidity risk – this can pose an issue for captives if they have been required to tie up significant assets in collateral arrangements for fronting insurers.
- Group risk – the extent to which the captive is reliant upon the parent for recapitalisation or repayment of group loans should be addressed.

103. The ORSA time horizon for a captive may be much shorter than that of a commercial insurer and will be influenced by the parent company. Most captive parent companies prefer to recapitalise on a regular basis rather than maintain capital in the captive for a long-term time horizon. Given that the risks offered to a captive may vary from year to year, depending on the terms offered by the insurance market, the captive cannot look beyond a fairly short time horizon – often not beyond the next renewal cycle.

4.8 Capital adequacy

104. This section covers ICP 17 (Capital Adequacy).

105. The capital adequacy requirements for solvency purposes, set by the supervisor, are intended to ensure that insurers can absorb significant unforeseen losses whilst also providing for varying degrees of supervisory intervention.

106. The supervisor should ensure that the standardised approach to solvency is appropriate to the nature, scale and complexity of the risks that captives face and feasible in practice for captives taking into account the technical capacity required to manage their business effectively.

107. The supervisor is required to set solvency control levels that trigger different degrees of intervention. The level at which these control levels are set, and the intervention actions that are triggered will be influenced by the risk tolerance of the supervisor. The risk tolerance of the supervisor may be different for a captive insurer compared with a commercial insurer and therefore the solvency control levels and the intervention actions that are triggered will reflect this. The supervisor may consider that triggers are not necessary for some types of captive.

108. The standards on regulatory capital requirements require the supervisor to establish a Prescribed Capital Requirement (PCR) and a Minimum Capital Requirement (MCR). The supervisor should consider whether, in the interests of simplicity, the MCR for captives may be set by means of a simple formula or an absolute monetary amount. The underlying calibration of the PCR for the standardised approach will reflect the risk tolerance of the supervisor and therefore the PCR may be lower for captives than for other types of insurer.

109. For the sake of transparency the supervisor should make public the solvency framework which applies to captives including where they differ from the requirements applicable to commercial insurers in the jurisdiction.

110. Group-wide capital adequacy assessment is also addressed in the standards but it would be unlikely that a captive supervisor would wish to apply solvency controls on a group-wide basis, particularly where the group is undertaking business of which the supervisor has no relevant experience or expertise.

111. The supervisor is required to address all relevant and material categories of risk within technical provisions and/or regulatory capital requirements. These include, at a minimum, underwriting risk, credit risk, market risk and operational risk.

- Underwriting risk – special considerations for captives include relatively unsophisticated premium setting methods and a lack of diversification compared with commercial insurers. However, captives can have an advantage in the accuracy of their claims reporting because they will be alerted to any significant incidents quickly by their parent company.

- Credit risk – the main risk for a captive is often its exposure to reinsurers but there is often a concentration on a small number of significant counterparties.

- Market risk – captives vary in their exposure to market risk but there is often a lack of diversification in the asset base.

- Operational risk is best addressed for captives on a qualitative rather than quantitative basis. Captives rarely have their own staff or premises but are reliant upon the business continuity arrangements of the insurance manager.

- All of these risks can be addressed in a relatively simple manner within a standardised approach that is suitable for the nature, scale and complexity of captives.

112. It is unlikely that a captive would seek to utilise an internal model due to the cost involved and the limited nature of the data available to captives. The Supervisor should carefully consider whether to permit internal models for captives and should only do so if it is confident that is has the resources to review and assess those models.

4.9 Capital Resources

113. This section covers Standard 17.11.

114. The standard addresses the establishment of criteria for assessing the quality and suitability of capital resources, having regard to their ability to absorb losses on both a going concern and wind-up basis.

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

- letters of credit
- partly paid share capital
- trust funds or
- subordinated debt.

116. Supervisors should consider whether a distinction should be drawn between the forms of capital permitted in respect of the Minimum Capital Requirement (MCR) as opposed to additional capital required to support the Prescribed Capital Requirement (PCR) or the economic capital requirement established in the ORSA.

117. 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. This is particularly important in relation to unpaid share capital and the supervisor should consider whether events which adversely impact the captive could also impact the parent such that it will be unable to pay up the unpaid capital.

118. 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. The captive owner often considers these taxation issues when selecting a domicile, as prior approval of any dividend may be required by the supervisor.

119. 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.

120. 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.

4.10 Confidentiality and disclosure

121. This section covers ICP 20 (Public Disclosure).

122. ICP 20 addresses the comprehensive, timely and relevant disclosure of information to policyholders and market participants.

123. According to the guidance supervisors can decide not to apply public disclosure standards to captives provided there is no potential threat to the financial system, no public interest need for disclosure and no legitimately interested party is prevented from receiving information.

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

125. 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 or its loss reserves could be identified by claimants or third parties. Public availability would also be detrimental in the case of kidnap and ransom insurance. The detail of risks underwritten and the pricing methodology would not be disclosed if the risk was insured directly with a commercial insurer rather than placed through a captive. Supervisors should consider the protection of

proprietary or confidential information, information should however be made available to supervisors.

126. ICP 20 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.

127. Standard ICP 20 provides various criteria to determine the type of information that an insurer should disclose which is not otherwise required to disclose by law. Some of those items are not applicable or have limited applicability to captives, notably:

- Decision useful 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.

128. 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.

129. Supervisors should appropriately consider the needs of third party claimants under compulsory classes of liability insurance when establishment is through different disclosure requirements.

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

130. This section covers ICPs 21 (Countering Fraud in Insurance) and 22 (Anti-money Laundering and Combating the Financing of Terrorism).

Fraud

131. ICP 21 is concerned with deterring, preventing, detecting, reporting and remedying fraud in insurance.

132. Despite the nature of their risks, supervisors of captives, especially those underwriting unrelated party risks should be aware of possible fraudulent activity. Supervisors should be concerned about intrinsic illegal activity a captive or captive owner may conduct, which may be monitored by a variety of means such as examination powers, audited and unaudited annual statement filings, and pre-approval of any parental loan activity. However, pure captives will not tend to write unrelated, uncontrolled risk and therefore intrinsic fraud is unlikely.

133. 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.

Anti-money laundering and CFT

134. ICP 22 is concerned with effective measures to combat money laundering and the financing of terrorism.

135. The criteria listed under ICP 22 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 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 on-going adequacy of corporate governance and other risk management systems put in place within a captive.

136. Supervisors should consider the legitimacy of the source of funds used to capitalise or pay premiums to the captive. Supervisors should require that there are appropriate controls to prevent the use of a captive for money laundering or other illicit activities.

137. 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.

138. Supervisors should consider whether the business conducted by a captive warrants the captive or its manager maintaining an anti-money laundering function.

139. 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.

4.12 Macroprudential surveillance

140. This section covers ICP 24 (Macroprudential Surveillance and Insurance Supervision).

141. ICP 24 covers the use of macroprudential surveillance by supervisors in order to inform the supervision of individual insurers.

142. A captive sector may be material to a small jurisdiction in providing employment and in introducing business to service providers such as banks, lawyers, investment advisers etc. Where the captive sector is material to the jurisdiction, supervisors should undertake quantitative and qualitative analysis of factors that may impact the financial soundness of captives and, in turn, contribute to the stability of the insurance market in the jurisdiction.

143. 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.

144. The captive sector is unlikely to pose any systemic risk to the financial sector in a jurisdiction for a number of reasons, including the following:

- The risks insured are not located in that jurisdiction
- The shareholders are not located in that jurisdiction
- Captive risks are unlikely to be correlated with each other so they are not collectively vulnerable to the same risks
- Shareholders come from a wide variety of industries and are therefore not collectively vulnerable to the same risks.

145. The supervisor should take steps to be aware of any concentration in the use of a small number of fronting insurers or reinsurers such that the failure of one could impact on a significant proportion of captives in the jurisdiction.

5. Protected Cell Companies and other cell company structures

146. A proportion of captives are established using Protected Cell Companies (PCCs)[7]. In jurisdictions where PCCs are allowed it is important to consider the specific supervisory issues that arise from the use of this company structure.

147. A Protected Cell Company 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.

148. 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.

149. 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 or authorisation 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.

150. 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

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

of a PCC, supervisors should consider both the consolidated position and the solvency of individual cells. Supervisors should require that sufficient information is provided to identify if there are any cells in deficit.

151. 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.

152. 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.

153. 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.

154. There are variations to the PCC structure, with each domicile having developed legislation in which the degree of legal separation of cells and the level of licensing/authorisation and supervision of the individual cells varies. Examples include; the Incorporated Cell Company ("ICC"), the Portfolio Insurance Company ("PIC"), the Series Captive Insurance Company, the Segregated Accounts Company, the Segregated Portfolio Company. In some structures, individual cells are distinct legal entities. In others, a separate company is established underlying the relevant cell, rather than a cell itself taking the incorporated status. The benefits of incorporation are then granted to each cell including the ability to enter contracts and appoint their own directors. This provides a further degree of legal separation of assets and liabilities and flexibility as to the activities undertaken.

6. Insurance Managers

6.1 Supervision

155. Insurance managers play a critical role in the management of many captives. This section considers how the role of the insurance manager may impact upon the specific application of the

ICPs to captives which utilise insurance managers. A captive will often be managed in the captive jurisdiction by an insurance manager that may be a regulated entity or an approved entity. This section is based on the assumption that the manager is regulated although the ICPs contain no reference to insurance managers and there is no requirement that they be licensed; additional considerations that apply if the manager is not regulated are given in paragraph 165.

Licensing

156. If licensing an insurance manager, supervisors should assess whether the insurance manager is fit and proper to carry out functions on behalf of a licensed insurer. An insurance manager should have sufficient financial and skilled human resources in relation to the number and complexity of the captives it manages and the necessary insurance protection in cases of negligence and fraud. The captive manager must be very familiar with local regulations and supervisory practices.

157. A regulatory regime for insurance managers could 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.

158. Licence applications from insurance 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 covers.

Suitability

159. ICP 5 addresses the suitability of Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer.

160. Where an insurance manager represents the captive's Senior Management and Key Persons in Control Functions, 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.

161. A supervisory regime for insurance managers should include an approval process for changes in Board Members, Senior Management, Key Persons in Control Functions and Significant Owners as well as the receipt of information regarding financial resources and a programme of regular on-site inspections.

Reporting requirements

162. Supervisors should require 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. Notwithstanding the involvement of the insurance manager the ultimate responsibility for supervisory reporting remains with the captive undertaking. 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

163. Insurance managers may be subject to on-site inspections by supervisors both in their own capacity and as managers of captives, however, the captive remains responsible for any issues identified during an inspection.

164. The on-site inspections are 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.

165. 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 and internal control

Corporate governance

166. The aim of the corporate governance framework is to provide for sound and prudent management and oversight of the insurer's business and to protect the interests of policyholders.

167. 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 recognise 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.

168. 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 management, and that these agreements clearly reflect the relative obligations of both parties.

169. 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 its governance arrangements as well as the governance arrangements within the insurance manager.

Internal control

170. Effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit are an essential part of the

overall corporate governance framework and the supervisor should require a captive to have such functions.

171. 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, certain underwriting functions 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.

172. Supervisors may require the appointment of a compliance officer function by insurance managers which will oversee the provision of the outsourced compliance function to the captives.

6.3 Fraud, AML and CFT

Fraud

173. 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.

AML and CFT

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

175. Supervisors should be satisfied that the insurance manager operates an appropriate "customer due diligence" 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.

176. 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.

177. 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.

178. 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.