



## **Riding the insurance cycle—a BVI perspective**

*For a number of years now, the British Virgin Islands' have been firmly established as one of the world's largest captive domiciles. Simon Owen of Hyperion Risk Solutions gives us an industry update and explains why the jurisdiction is looking forward to further growth in 2008 despite the uncertainties associated with the current economic climate.*

With the global credit crisis still in full flow, 2008 may yet be remembered by many as the year that a major financial institution collapsed. Analysts have advised that around \$1 trillion of permanent capital will be required to maintain the current pricing of mortgage assets. The US Federal Reserve has already had to make \$200 billion of emergency financing available. Hedge funds have seen their entire value disappear almost overnight due to the superfluous overleveraging of their assets. So with the majority of economists citing these events as further catalysts of the imminent recession, what does the future hold for the captive industry?

Firstly, it is important to remember that there a number of factors that dictate if and when it is the right time to form a captive. The state of the economy is certainly one of those factors. However, this is really only because of the bearing it may have on a prospective captive owners' balance sheet, and the effect on the commercial insurance and reinsurance markets.

For example, at present, rates for most commercial insurance lines are still relatively soft. Given the new start-ups and the potentially underutilised capacity in Lloyd's and other key marketplaces, premiums are unlikely to show signs of hardening until the losses resulting from sub-prime mortgages are unravelled. It may take some time to ascertain the true exposures attributable to the associated collateralised debt obligations. But, with 137,000 bonds downgraded purely as a result of Ambac's reduced credit rating and an estimated \$6 billion exposure to the E&O and D&O insurers, premium rates will eventually begin to rise.

Even with signs of market hardening on the horizon, many industry experts have commented that the current conditions will dissuade the formation of group and single-parent captives. In reality, that is simply not the case. Most captives are simply long-term strategic instruments, designed to protect the parent's balance sheet against the fluctuation and volatility of the commercial markets. In fact, a soft insurance market can often be a precursory sign that the time is right to form a captive.

Fronting and reinsurance are often the most vital components of a captive's viability. The fronting market has, for a lengthy period, been relatively stagnant and uncompetitive. However, we are finally seeing an increase in the number of carriers offering fronting capacity.

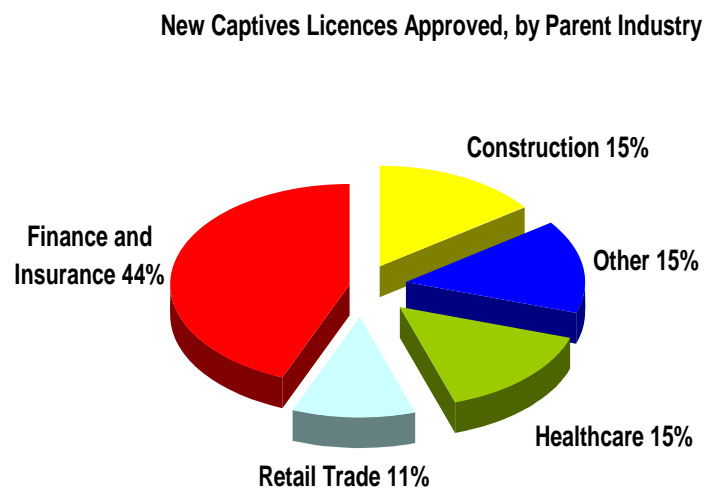
With regard to reinsurance, a common misconception is that reinsurance markets soften at the same time as the insurance markets. While they are, of course, inextricably linked, reinsurance rates generally only tend to soften after a period of rate reduction in the insurance markets. Only now are we seeing reinsurance rates fall significantly, with reductions being estimated at 9 percent across all lines.

It is therefore fair to say that, even when insurance rates are low, the combination of notably reduced reinsurance premiums and the increased availability of affordable fronting can offer a sufficient incentive to a company to consider captive formation.

### **New business**

Since the introduction of our Insurance Act in 1994, we have seen consistent growth in the British Virgin Islands (BVI). So at a time when a number of other domiciles are reporting a slowing of new captive formations, we have been particularly encouraged by the vast number of new formation enquiries already received in the first quarter of 2008.

Unlike other domiciles, which tend to concentrate on niche classes, the business we see in the BVI is still incredibly diverse and related to a number of different industries. To highlight this, the chart below shows the percentage split by industry of new formations in the BVI in 2007.



To further demonstrate that level of diversity, the following examples are real cases that are in the feasibility study stage or that are currently in the process of being formed in the BVI:

*Example 1*

*A reinsurance captive for a North American-based engineering and environmental firm with operations in two other continents.*

This is a relatively straightforward transaction and, based on the proposed fronting fee and reinsurance rates obtained, this structure clearly endorses our notion that a soft market can actually create opportunities for prospective captive owners. Risk management obviously remains a key factor for any captive, but formation at a time when rates are low is an extremely effective way of ensuring that start-up costs do not adversely affect the parent's bottom line.

*Example 2*

*A fully collateralised captive for an international project management firm seeking to participate on the credit risk of a number of \$1 billion+ projects it underwrites across the globe.*

This is a sophisticated transaction that involves the capital markets and financial guaranty insurers. The structure of each project is, effectively, sovereign debt supported by an 'A' rated bank or syndication of banks. The end goal of the project underwriter is to drive down the borrowing cost of the project to the lowest rate possible by assuming the credit risk associated with the repayment of the loan.

In order to do so, we will obtain a credit 'wrap' for the transaction from an 'AAA' rated investment bank or financial guaranty insurer, depending on the best available price. If a bank is used, a special purpose vehicle (SPV) will be used to convert a credit default swap (or a collateralised debt obligation for a multi-transaction deal) into a reinsurance contract. In this particular case, our client's collateralised captive will participate on a 'first loss' percentage of the assumed credit risk, with the bank of financial guaranty insurer taking the remainder of the risk.

*Example 3*

*A single-parent captive for a rapidly expanding cable company offering television and broadband services in seven countries.*

The client is seeking a solution to costing issues and the vagaries associated with multi-jurisdictional insurance placement. Given the client's exemplary loss history and excellent risk management procedures, the insurance premiums the company is currently paying, even during soft market conditions, do not make economic sense. Having a captive will allow the client to retain a significant amount of premium. Furthermore, it will provide access to reinsurers who will be in a better position to provide the company with cost-efficient coverage for its real concern—exposure to natural catastrophes.

## **Why form offshore?**

There are a number of reasons why captives are formed offshore rather onshore. The primary advantages relate to cost and favourable legislation. Generally, offshore regulations relating to initial capital requirements and the required margin of solvency are far less stringent when compared to those of our onshore counterparts.

It is obviously important for the regulators and the insurance managers in any jurisdiction to ensure that capitalisation is sufficient to support the net written premium and exposure levels attributed to the captive, particularly when third parties are exposed. However, for small to medium-sized single parent captives, the non-discriminatory requirements of offshore domiciles can have a significant impact on a risk manager's feasibility assessment. Cost-efficient operating costs and the absence of direct corporate taxes and premium taxes gives us an immediate and distinct advantage over our competitors.

## **Why the BVI?**

Our legislative framework compares more than favourably with that of our longer-established competitors and enables us to offer our clients a wide range of products and structures. The Insurance Act has recently been enhanced and the close working relationship between the private sector and the regulators allows us to be proactive as we look to suit the future needs of our clients.

We are also unburdened by the restrictive regulations of other jurisdictions. For example, there are no requirements to appoint of local directors, to hold annual general meetings in the BVI or to establish bank accounts here.

Our service providers include the majority of the big names you would expect to see in any of the world's financial centres and, as our example transactions show, we have the ability to assist with a number of innovative and sophisticated structures.

From a regulatory standpoint, the BVI is extremely well regarded by a number of international bodies. In fact, the BVI has never been blacklisted by any organisation or regulatory body. Our regulators are active members of the Caribbean Financial Action Task Force (FATF) and played a prominent role the working group that revised the FATF's anti-money laundering recommendations.

## **Future growth**

It is also important to remember that the BVI is not just a captive domicile, it is a financial services domicile. Not content with being one of the world's largest captive jurisdictions, the British Virgin Islands is home to more than 8,000 funds. It is a leading domicile for company incorporations, with around 750,000 companies being registered here.

In the recently published 'Global Financial Centres Index', the BVI is ranked at number 27 in the world, surpassing the likes of Vancouver, Madrid, and Hamilton, Bermuda.

Not only are the size and numbers of captives continuing to grow, we are increasingly receiving enquires from existing 'A' rated international open market reinsurers that are looking to relocate their operations and are seeking an alternative to the traditional domiciles, such as Bermuda, Cayman and Switzerland.

In summary, the BVI is mature enough as a domicile to have attained credibility with the regulatory bodies around the world, yet it is young enough to embrace new ideas and solutions.

This, coupled with favourable market conditions, sets the scene for another exciting year in the captive industry. The right time to form your BVI captive is, most certainly, now.

Simon Owen is the managing director of Hyperion Risk Solutions Limited and served as the chairman of the BVI Association of Insurance Managers for a number of years. He can be contacted at [simon@hyperionbvi.com](mailto:simon@hyperionbvi.com).