

Market Review

July 27, 2009

Sector

Property/Casualty

Related Reports

2009 Special Report:

U.S. Captive Insurance – 2008 Market Review

Methodology:

A.M. Best's Rating Methodology
For Captive Insurance Companies

Rating Protected Cell Companies

Rating Analyst

Yvette Essen, Head of Market Analysis

+44 207 397 0322

Yvette.Essen@ambest.com

BestWeek subscribers have full access to all statistical studies and special reports at www.ambest.com/research. Spreadsheet files also are available.

European Captives – a Growth Market During a Challenging Time?

Stricter solvency standards and the ongoing economic crisis pose long-term and immediate challenges to the European captive insurance market. The introduction of the Solvency II Directive is clearly the biggest hurdle in both the medium and the long term, while the economic conditions faced by parent companies are the most urgent immediate issue for captives. A.M. Best believes:

- Some captives will be forced to close as they fail to comply with the new directive by the Oct. 31, 2012 deadline.
- The growing financial and administrative burdens of compliance will drive some captives out of the European Union (EU), possibly to domiciles such as the Isle of Man and Guernsey, which are exempt from EU directives.
- Solvency II will affect the global captive market as it pressures other domiciles around the world to implement tougher standards, increase oversight and promote transparency.
- The credit crisis has led some parent companies to tap their captives for cash.
- Seeking to reduce uncertainty and unlock capital, companies may pass all or part of their captives to third parties, providing the catalyst for a latent captive buyout market.
- Companies based in Latin America and the Middle East, which have previously formed few captives, are now looking at alternative risk models in Europe.
- The captive market will continue to develop in the face of its current challenges, although the growth will shift toward the formation of cells rather than the creation of pure captives.

European Captives by Domicile



Sources: Dublin International Insurance & Management Association; Guernsey Financial Services Commission; Malta Financial Services Authority; Insurance and Pensions Authority (Isle of Man); Commissariat aux Assurances

European Captives Juggle Multiple Challenges

The European captive market faces numerous challenges, although the introduction of the Solvency II Directive undoubtedly represents the biggest hurdle in both the medium and the long term.

The economic conditions faced by its parent company are the most pressing immediate issue for a captive in the wake of the ongoing economic crisis, but it will be the compulsory adoption of Solvency II that dramatically transforms the captive market. A.M. Best believes:

- Some captives will be forced to close as they fail to comply with the new directive by the Oct. 31, 2012 deadline. Considering the regulatory and compliance burdens on captives to be disproportionately large, parent companies may choose to shut

down the captive in light of the size and relatively straightforward risks it insures.

- The prospect of setting aside considerably more money and the inevitable need to spend more time on regulatory compliance will lead companies to consider setting up their insurance vehicles outside of the European Union (EU). This could benefit domiciles such as the Isle of Man and Guernsey, which are exempt from EU directives.

- While Solvency II is compulsory for just EU states, it will have profound implications for the rest of the captive market. Other domiciles around the world will have to implement tougher standards, as the economic crisis has helped fuel a need for increased regulatory supervision and transparency.

A.M. Best Company Special Report

July 27, 2009

CHAIRMAN EMERITUS
Arthur Snyder

CHAIRMAN AND PRESIDENT
Arthur Snyder III

EXECUTIVE VICE PRESIDENT/CHIEF RATING OFFICER
Larry G. Mayewski

EXECUTIVE VICE PRESIDENT/CHIEF INFORMATION OFFICER
Paul C. Tinnirello

SENIOR VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty
Rita L. Tedesco, Information Services

ANALYTICAL SERVICES
Carole Ann King, Managing Senior Business Analyst
Brendan Noonan, Managing Senior Business Analyst
Stephen Brown Klinger, Senior Business Analyst
Carol Demyanovich, Senior Business Analyst
Joe Niedzielski, Senior Business Analyst
Laura McArdle, Business Analyst
Thomas Dawson IV, Associate Editor

PRODUCTION
Angel M. Negron, Senior Designer

Copyright © 2009 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site www.ambest.com.

Any and all ratings, opinions and information contained herein are provided "as is," without any expressed or implied warranty. A rating may be changed, suspended or withdrawn at any time for any reason at the sole discretion of A.M. Best.

A Best's Financial Strength Rating is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any

other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

A Best's Debt/Issuer Credit Rating is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

A Best's Bank Deposit Rating is an opinion of the relative ability of a bank to meet its ongoing financial obligations to depositors. It is based on a comprehensive quantitative and qualitative evaluation of a company's capitalization, asset quality, management, earnings, liquidity and sensitivity to market risk. The ratings are not assigned to specific deposit accounts or contracts and do not address the ability of the bank to repay any other financial obligation issued by the bank. A Bank Deposit Rating is not a recommendation to buy, sell or hold financial obligations of a bank, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

A.M. Best does not offer consulting or advisory services. A.M. Best is not an Investment Adviser and does not offer investment advice of any kind, nor does the company or its Rating Analysts offer any form of structuring or financial advice. A.M. Best does not sell securities. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

Price: BestWeek subscribers BestWeek subscribers can download a PDF copy of all full special reports at no additional cost or a combination of the PDF copies plus all related spreadsheet files of the report data at no additional cost from our Web site at www.ambest.com/research.

Nonsubscribers can access an excerpt of each special report and purchase individual reports and spreadsheet data from our Web site at www.ambest.com/research. Call customer service for more information, (908) 439-2200, ext. 5742.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.



SR-2009-180

- The credit crisis has resulted in companies turning to their captives as a potential source of cash. A growing number of parent companies are asking their captives for increasing amounts of money during these turbulent times.
- The growing desire for certainty and the need to unlock capital could result in companies looking to pass on their entire captive, or part of it, to a third party. This captive buyout market is just bubbling under the surface, but this is set to escalate and could later attract the interest of private equity and venture capitalists.
- Despite the challenges of the credit crisis and Solvency II, the captive market will continue to develop. It is far from the saturation point, although the growth will be fuelled largely by the formation of cells rather than through the creation of pure captives.
- Companies based in Latin America and the Middle East, which have previously formed few captives, are now looking at alternative risk models in Europe.

The Threat to Europe

The insurance industry generally accepts the need for Solvency II to replace 14 existing directives on capital adequacy and risk management. The old directives are viewed as “outdated,” and a new, strengthened, EU-wide requirement is partially welcomed as it will help create confidence in the insurance market.

The European Parliament approved the directive to implement Solvency II in April, and there has been some progress in alleviating the impact of Solvency II on captives. While they will be judged under a “Proportionality Principle,” reflecting their less risky nature, the exact impact of this is one of many factors that will emerge in the coming months and years. Likewise, captives writing not just parent company but third-party risks (e.g., those in the retail sector that are effectively selling to the public) are awaiting further details to determine whether they will be regulated and treated like insurance companies or still fall under the captive category.

As insurance entities must have gross premium income exceeding EUR5m or gross

technical provisions in excess of EUR25m to fall under the scope of Solvency II, many captives will not be subject to the directive. It is not absolutely clear how Solvency II will impact bigger captives, but it is certain there will be implications. The exact nature of those implications will depend on the size and type of business underwritten, plus the location of the captive and its parent company.

While the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) works with the EU to outline the industry’s opinions, a range of concerns are mounting for captives domiciled within its jurisdiction.

The primary fear is that captives will have to increase their capital significantly, despite any flexibility brought about by proportionality. CEIOPS’ latest Quantitative Impact Study (QIS 4) helped illustrate this concern (see **Exhibit 1**). Of the 99 captives that took part in the survey, 28.3% did not meet the Solvency Capital Requirement (SCR).

However, CEIOPS has emphasized that for a number of reasons, a captive not meeting this requirement will not necessarily have to raise capital upon the introduction of Solvency II. CEIOPS says companies should be able to anticipate the introduction of Solvency II, and the possibility of reallocating funds between entities.

Exhibit 1 European Captives – QIS4 Participation by Country

| Country | Number of Captives |
|--|--------------------|
| Finland | 1 |
| Germany | 7 |
| Ireland | 10 |
| Luxembourg | 65 |
| Malta | 3 |
| Norway | 7 |
| Sweden | 6 |
| Total | 99 |
| Captives not meeting the Solvency Capital Requirement (SCR) | 28.3% |
| Captives not meeting the Minimum Capital Requirement (MCR) | 7.1% |

Source: CEIOPS’ Report on its fourth Quantitative Impact Study (QIS4) for Solvency II, November 2008.

Furthermore, almost three quarters of the captives that took part in QIS 4 were resident in Luxembourg, which is not seen as a typical cross-section of the captive industry because it is heavily skewed toward reinsurance captives.

It is possible that some captives may have to put up less capital, but this is thought to be the exception, rather than the rule.

Solvency II will make captives look at the way they spread risk and at their diversification, both in terms of the lines of business underwritten and the pool of invested assets. This could create a challenge for captives, as they tend toward liquid investments, such as tracker funds. Captive managers are also increasingly complaining there has been a reduction in suitable investments due to the credit crisis. Captives are having problems finding counterparties with adequate ratings and liquidity, and the list of counterparties they can invest in has shrunk. Parent companies meanwhile are expressing greater interest in the nature of their captives' investments.

Currently, the industry has been very much focused on the quantitative burdens imposed by meeting the first pillar of the Solvency II requirements. Attention is now turning toward the burden of meeting the second pillar. This test focuses on effective risk management and the supervision process, and the overriding worry is that much more management time will be needed to comply with the requirements of Pillar II.

A.M. Best believes this will make businesses think more carefully about where they need to domicile their captives, and they may deem the capital and solvency requirements to be potentially out of proportion to the nature of the risk and the scope of the business. There will be some businesses that think they may be required to hold onto an excessive amount of capital, and they may look at establishing themselves outside the EU.

This will be more of a consideration for start-ups, and there is some anecdotal evidence that Guernsey and the Isle of Man have already seen an increase in inquiries

about captive formations as a result of the pending directive. It is inevitable that domiciles outside the EU will see a pick up in interest, as Solvency II represents an enormous change to the framework for insurance business in general.

Raising the Bar

While countries that fall outside the remit of the European Parliament could pick up more captive business, they too are coming under pressure to impose tougher capital requirements. There is a feeling that a benchmark has now been established and that other domiciles will have to show increased transparency, leading to a shake-up of current global regulation.

The captive industry in general is speculating that unless changes are made to toughen up regulatory structures outside the EU, captives in non-EU domiciles will be perceived to be less well regulated. There is also the prospect that fronting insurers may increase fees or ask for higher letters of credit (LOCs) and collateral from non-EU domiciled captives for greater security. Solvency II could also lead to an insurer demanding higher charges if it is ceding risks to a non-rated entity.

To address these concerns, other domiciles are focusing on demonstrating they have "equivalent" standards. Guernsey is creating its Own Solvency Capital Assessment (OSCA), and the Isle of Man is also developing further its risk-based capital regulatory approach. Meanwhile, the Bermuda Monetary Authority is well under way with its road map to modernize its regulatory structure. Jurisdictions that take no action may be considered as "second-class domiciles."

Although complying with Solvency II brings increased costs and management burdens, European domiciles are likely to cite it as a distinguishing mark – as proof that they have a superior standard of regulation, at a time when there is a heightened need for clarity and security. Official figures from European domiciles do not distinguish how many captives are actively writing business, and how many are dormant (see **Exhibit 2**). However, the data does show that European domiciles have successfully

established themselves over the years, and this trend will continue.

Captives are in theory able to move, and some parent companies may look into redomiciling their captives. However, this is likely to be limited, as European captives enjoy the advantage of being able to insure cross-border business in 30 countries through the passporting scheme. There is some evidence that captives are moving into the EU to take advantage of this cross-border arrangement.

Already, U.S. captives have been moving from “offshore” to “onshore” in recent years, and the debate about light regulatory touches and the benefits of these different types of domicile is likely to heighten. This will lead to greater focus on the Organisation for Economic Co-operation and Development’s (OECD) list of jurisdictions implementing its internationally agreed tax standard. Offshore centres have in recent years had to prove that they are transparent, with tight money laundering rules, but reputation is set to become even more important with the introduction of Solvency II.

A Period of Transformation ...

Solvency II will add pressure onto captives, just when the market is already being tested.

The fallout of the credit crisis has made companies seek greater certainty, and this could fuel the emergence of a captive buyout market. A.M. Best believes that companies will consider passing on older insurance liabilities contained within the captive to run-off specialists.

This would give the parent company some increased security by removing long-tail risks, such as liability risks. There are other reasons why a parent might look to examine a buyout transaction; perhaps it has decided to close the captive or has found itself the owner of a number of captives through mergers and acquisitions.

Each captive buyout deal will be transacted according to how well funded the insurance vehicle is. In some cases, if the captive is deemed to be overcapitalized, a buyout deal

may allow a company to liquidate some of its captive’s assets.

As it is increasingly challenging to raise money in the market, cash-constrained companies looking for alternative access to funds may be tempted to explore this route to release capital. A number of insurance run-off specialists are consequently establishing themselves in the captive takeover space. Aim-listed Randall & Quilter recently purchased Woolworths Insurance (Guernsey) Ltd., the captive of Woolworths Group plc (in administration), from its administrators, Deloitte.

A.M. Best has learned that in addition to insurance industry specialists, private equity and venture capital firms have been investigating the possibility of purchasing long-tail risks associated with captives. They are examining the captive market as other commercial deals have dried up, and so they will view the development of the captive buyout market with interest.

Captives in run-off, in particular, can tie up valuable capital. Based on the reduction in the number of new registrations of single-parent captives over the past few years, KPMG estimates that in some domiciles, up to 30% of captives may not be actively underwriting. The key drivers behind run-off are numerous, ranging from companies setting up new captives (or cells) in onshore domiciles, to parent companies engaging in takeover activity or becoming insolvent.

There are further incentives for companies to look closely at whether value can be unlocked from their captives. It may no longer be financially beneficial to use a

Exhibit 2 European Captives by Domicile

| EU Domicile | Number of Captives | Number of Cells |
|--------------|--------------------|-----------------|
| Dublin | 125 | 0 |
| Guernsey | 365 | 336 |
| Malta | 8 | 3 |
| Isle of Man | 155 | 7 |
| Luxembourg | 138 | 0 |
| Total | 792 | 345 |

Sources: Dublin International Insurance & Management Association; Guernsey Financial Services Commission; Malta Financial Services Authority; Insurance and Pensions Authority (Isle of Man); Commissariat aux Assurances

captive. In some cases, running a captive has become more expensive over the past year, as fronting insurers are demanding increased collateral for higher amounts of money as they become more cautious and seek further security. Banks in turn are demanding higher rates for providing LOCs, especially for certain industries such as transportation companies. The costs of LOCs are rising by significant amounts if an unsecured level of credit is being used, and more marginally if it is cash-backed.

Companies have identified their captives as potential streams of money in other ways. A growing number of parent companies are asking for money from their captives through loans or dividends, and the amounts being requested are increasing, too.

Passing money to the parent company could be perceived as bad news for some captives, reducing their investment opportunities. However, the solvency of the captive is unlikely to come under threat, as various regulatory standards in each jurisdiction will help to ensure that the insurance vehicle is sufficiently funded.

There are other factors that will cause companies to act cautiously before they “raid” the money within their captives, or sell off parts of their insurance vehicles. These include the growing need for transparency, and companies could come under pressure to be more open about their dealings with their captives. Captives are by nature guarded, perhaps as some were originally created partly for tax relief,

although most captives today are formed not for tax advantages but largely to enhance risk management and save costs related to risk mitigation.

In light of the current downturn, there is a greater desire for more disclosure and for proof that captives are fit for purpose. This trend has become more prevalent during the financial turmoil, and U.S. President Barack Obama has also pledged to crack down on tax havens.

The U.K. Treasury has also been looking closely at the issue of taxation of controlled foreign companies (CFCs) for some time. Until July 1, 2009, 90% of a captive’s profits as calculated under U.K. tax principles were taxable. They were able to receive tax breaks on the 10% of profits retained, but now 100% of their profits are taxable in the United Kingdom.

The Treasury is clearly scrutinizing CFCs closely and has also set up a liaison committee of business member representatives to examine options to reform and modernize the current rules in the long term. Michael Foot, who has had an extensive career in the Bank of England and the Financial Services Authority (FSA), is also conducting an independent review of British offshore financial centres for the Treasury. He is looking at not just taxation but other issues such as financial supervision and transparency.

Growth Still on the Agenda

The captive market is changing dramatically through the regulatory changes of Solvency II and as a result of the credit crisis, but it is well placed to thrive.

Although growth has slowed in the past year as companies have been more focused on surviving the recession than on creating new insurance vehicles, captives are still deemed important. Figures collated by the U.S.-based Insurance Information Institute showed that despite last year’s market turbulence, there was growth in the global captive market (see **Exhibit 3**).

Premium increases are not as high as many industry figures had initially predicted, partly as a result of reduced demand for insurance during the recession as companies cut costs.

Exhibit 3 Global Captive Growth (1989-2008)

| Year | Number of Captives |
|-------------|---------------------------|
| 1989 | 2,535 |
| 1992 | 2,896 |
| 1995 | 3,199 |
| 1997 | 3,361 |
| 1998 | 3,418 |
| 2004 | 4,688 |
| 2005 | 4,772 |
| 2006 | 4,951 |
| 2007 | 5,119 |
| 2008 | 5,211 |

Source: Insurance Information Institute, based on Business Insurance and Conning Research data.

There is also too much insurance capacity in the market.

However, despite a rather subdued start to the year, there are now signs of a pick-up in captive formation as certain lines of business are seeing a jump in premiums, leading to companies seeking alternative insurance arrangements. Many of these companies had looked at creating captives in the past and are now revisiting those plans.

Regulators and captive managers are seeing an increase in inquiries across the board, but certain lines of businesses are attracting the most attention. These are notably liability risks, such as professional indemnity for the financial services industry, and property/casualty (P/C) risks.

Directors and officers (D&O) cover has traditionally been written in the direct insurance market, as there is a debate over whether writing D&O in a captive could raise a conflict of interest. Nevertheless, with D&O premiums surging as companies brace themselves for a wave of claims stemming from the credit crisis, there has been some interest in D&O captive formation.

The struggle for businesses to obtain affordable credit insurance cover has also been a feature of the recession, as retailers and manufacturers in the building and construction industries face sharp rises in premium, and sometimes withdrawal of cover. Businesses in these sectors are consequently exploring the use of captives, although there are service constraints as a captive is unlikely to be in a position to assess the creditworthiness of its parent company's customers. There are also increased discussions about captive formation for catastrophe, property and terrorism risks.

Rate rises are not the sole reason why companies are investigating the possibility of using a captive. The economic slowdown has also resulted in a need to cut back on expenditures, and self-insuring often reduces the cost of cover, while also bringing about longer term savings through greater awareness of risk.

Although the insurance industry has weathered the economic storm better

than other financial sectors, companies need to look more closely at mitigating future counterparty risk. AIG showed that even the world's largest insurer can find itself in difficulties and emphasized the importance of avoiding the concentration of risk with a sole supplier.

Fronting insurers are attempting to protect themselves against too much risk by asking for increased collateral and LOCs. Captives, too, are examining the risk of their fronting insurers running into difficulties, and as no major captives have collapsed, they are in theory in a stronger position to demand security from the insurer.

In the past few months, captives have looked to deal with higher rated fronting insurers. Furthermore, they may be considering spreading their exposure to more than one insurer, especially for long-term risks.

A.M. Best understands that companies in countries that have previously shown little interest in captives are now looking at alternative risk models. Emerging markets, such as Latin America and the Gulf region, seem to be embracing a different type of risk-financing technology, and companies in these markets are considering establishing captives in European domiciles.

A.M. Best would expect companies in other less developed markets, such as Africa and the Middle East, to look to establish captives in Europe. It is still early days, but a shift in risk management in developing regions is being driven by increasingly sophisticated knowledge and better advice from insurance brokers. The insurance industry is also adapting models to cater to the demand from new customers. For example, Heritage has developed a new type of Shariah-compliant captive takaful structure.

Competition among captive domiciles continues to be rife, with the Middle East region – notably Dubai, Qatar and Bahrain – attempting to build a captive presence. Growth is unlikely to be explosive in these newer domiciles, as the established markets, such as Luxembourg, Guernsey, the Isle of Man, Dublin and Malta, will continue to be

(continued on page 9)

The Case for Protected Cells

In recent years, the growth in the captive market has been fuelled by the formation of protected cell companies (PCCs). At the recent European Captive Rendezvous in Luxembourg, Aon Global noted that cells are the fastest growing segment of the captive sector. In 1997, cell-specific legislation was introduced for the first time in Guernsey. Aon notes that last year there were 3,000 cells within companies.

There are numerous reasons for the rapid emergence of cells, with the fact they are easier to set up than a captive being among the key incentives (see **Exhibit 4**). The cost of establishing and running a cell is significantly lower than that of a full captive when taking into account regulatory and auditors' fees, although this of course varies by domicile.

Besides the cost element, these structures have a number of other advantages. They provide greater flexibility to the parent company but deliver the same type of benefits as a wholly owned captive.

A cell also requires less time from management to run. A company finance director or risk manager often needs to attend captive meetings, but this is not a requirement for a cell, as the company's management are not on the board of a cell company. This is a benefit for cell shareholders, as they do not have to take time out for meetings, but it can also be seen as a slight disadvantage, as they do not have as much control as they would with a captive.

As is the case with the captive market, tax breaks have always been an advantage of having a cell, although increasingly tax issues are regarded as just an advantage but not one of the main reasons to self-insure.

It is worth noting that cells do not appear to fall under the same rules as a CFC, provided they are diverse in number and nature, where U.K. parties could not be deemed to have control.

The captive and cell community is awaiting further clarity, but it seems that the U.K. Treasury's recent rules to tax 100% of a captive's profits will not apply to cells. This could be partly as cells do tend to be considerably smaller than captives, so profits from a cell are usually much lower than those of a captive and the tax changes will have a fairly limited impact on cells. It will be interesting to see whether the British government turns its attention to cells at a later date.

In the past, there has been a slight degree of caution attached to cells. This is unsurprising, considering they are a relatively new arm to the captive market and a small question mark has hovered over whether PCC regulation would stand up. There has, to date, not been any major test of whether each cell owner is completely separated, with the assets, liabilities and financial performance of every cell being totally isolated from those of all other cells. Nevertheless, there is a good level of confidence in this structure, and an estimated 40 domiciles now play host to cells.

According to estimates, 81% of the FTSE 100 operates a captive, and 55% of the FTSE 250 also has its own insurance vehicle. As most of the biggest companies in the FTSE 100 and FTSE 250 have already created captives, it is the next tier down – i.e. the medium to smaller businesses – that will look to self-insure. Rather than form full captives, A.M. Best expects them to seek smaller and cheaper structures, namely through cells.

The industry is clearly braced for further heightened activity in this space. For example, in April, Marsh set up "Mangrove Insurance Solutions," providing protected cell facilities in Washington, D.C. and the Isle of Man. Aon is already well established in this space, with its White Rock cell facility host to more than 60 cells/clients.

Exhibit 4 European Captives – Cell Costs*

Low costs have helped drive the success of cells.
(GBP)

| Cost Category | Captive | Cell |
|--------------------------------|---------------|---------------|
| Formation "once only" | | |
| Formation assistance fee | 10,000 | 5,000 |
| Incorporation | 1,500 | 0 |
| GFSC application | 3,900 | 1,100 |
| Total (minimum) | 15,400 | 6,100 |
| Operation "annual" | | |
| GFSC annual return | 3,900 | 1,280 |
| Filing fee | 510 | 110 |
| Auditors | 4,000 | 1,500 |
| Non-executive directors (each) | 4,000 | 0 |
| Management fee | 30,000 | 25,000 |
| Total | 42,410 | 27,890 |

* Based on Guernsey minimum costs.

Source: Aon Global presentation slide from the 12th European Captive Rendezvous, 16th June 2009.

the main domiciles. They have more experience, and the infrastructure is already in place.

There have been more queries across the entire captive market about formation of captives or cells as a risk-financing alternative for companies. However, whether this translates into a steep rise in the number of captives and cells established remains to be seen.

Outlook for the Captive Market

Captives have so far remained resilient during the current economic turmoil, although the impact of the downturn will remain a pressing concern.

The credit crisis has created an increased need to demonstrate good governance and further highlighted the importance of replacing old regulation. Although it is viewed as necessary, Solvency II represents the main challenge in the future, and other domiciles must make gestures to

demonstrate they have an equivalent risk-based capital approach.

Although Solvency II will be more onerous than the current directives, it will not dampen activity in the market. In recent months, there has been a mounting increase in captive inquiries and feasibility studies. It is not yet clear how this will translate into new business, but it is most likely that PCCs rather than pure captives will continue to represent the main entry into the market, especially for midsize companies. Growth is expected not just in the number of cell and captive formations but in captive buyouts.

Captives have not been completely immune from the credit crisis, as companies have spent the past 18 months focusing on their core business as they try to survive the storm, leading to a sluggish but stable captive market. However, the industry is in good health, and as the clouds start to lift, despite the challenges of Solvency II, the European captive community should thrive.

A. M. Best would like to thank the following for their help with publishing this report:

- Darryl Ashbourne, KPMG
- Steve Bauman, Zurich
- Paul Corver, Randall & Quilter
- Malcolm Cutts-Watson, Willis International Captive Practice
- Bill Dodwell, Deloitte
- Alan Fleming, Association of Insurance and Risk Managers (AIRMIC) Captive Interest Group
- Sarah Goddard, Dublin International Insurance & Management Association (DIMA)
- Jonathan Groves, Marsh
- Clive James, Aon
- Erik Johnson, Deloitte
- Matthew Latham, AIG
- Richard Le Tocq, Aon Insurance Managers (Guernsey)
- Peter Niven, Guernsey Finance
- Derek Patience, Isle of Man Captive Association (IOMCA)
- Jeanette Rödbro, European Captive Insurance and Reinsurance Owners' Association (ECIROA)
- Michael Tagg, KPMG
- John Tortell, Heath Lambert
- David Vick, Insurance and Pensions Authority (IPA) for the Isle of Man Government
- Merise Wheatley, Heath Lambert
- Dr. Paul Woehrmann, Zurich



Founded in 1899, A.M. Best Company is a global full-service credit rating organization dedicated to serving the financial and health care service industries, including insurance companies, banks, hospitals and health care system providers. For more information, visit www.ambest.com or contact one of our offices.

A.M. Best Company

Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
www.ambest.com

A.M. Best Europe Ltd.

12 Arthur Street, 6th Floor
London, UK EC4R 9AB
Phone: (44) 20 7626 6264
Fax: (44) 20 7626 6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.

Unit 4004 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852) 2827-3400
Fax: (852) 2824-1833
www.ambest.com.hk