THE BENEFITS OF CELL CAPTIVES

Bob Gagliardi and Scot Reynolds of AIG highlight the advantages of "rent-a-captive" structures

Today's complex risk environment requires businesses to continuously look for solutions that can support effective risk management. Large companies have long relied on captives to support such risk management needs. Now, smaller and mid-sized companies are also seeking to capitalise on the advantages that alternative risk management solutions can offer – but due to the resources required for formation and management, a standalone captive may not be the right first step for all companies. The answer may be to form a cell in a rent-a-captive facility where the risk is retained in an account that is segregated from the risks and creditors of other companies, often times with capital requirements that are significantly lower than for a standalone captive. The industry often refers to these types of facilities collectively as "rent-a-captive" structures.

In 2000, Bermuda was one of the first captive domiciles to enact legislation that enabled the cell captive concept, permitting a segregated accounts company (SAC) to rent separate accounts to third parties. Other jurisdictions followed Bermuda's example by implementing similar structures, including Vermont in 2001 with its sponsored captive insurance company.

Subsequent legislation has kept Vermont at the forefront of the industry as the domicile's rent-a-captive regulations have continued to evolve with market trends. While originally only a US-based insurer could form a sponsored captive, today any entity approved by the insurance commissioner may do so, based on its experience in financial operations, financial stability and strength, and business reputation. Vermont also offers the option of establishing separate accounts (SA) within an existing Vermont standalone captive, thereby eliminating much of the time and expense involved with relicensing as a sponsored captive.

Bob Gagliardi

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Scot Reynolds

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Vermont is one of the most active rent-a-captive domiciles with 35 sponsored captives and over 220 cells operating as of 1 June 2019. In May 2019 the Vermont Department of Financial Regulation issued a new application form along with guidance for the formation of any new protected cell within its domicile. This new form provides more clarity on several issues regarding requirements for cell formation approval as well as best practices for ongoing cell governance. The new guidance is expected to provide for a more streamlined process for captive cell formations going forward.

What is a rent-a-captive cell facility?

A rent-a-captive cell facility has a core in which the owner/sponsor of the facility holds the regulatory capital and the insurance licence, and manages day-to-day operations. The cell facility then contracts with third-parties to rent and form individual cells. Each cell is segregated from the others so that insurance risk, liabilities, assets and other pertinent information are not shared or commingled. The creditors of one cell are not able to access the assets of other cells in the facility.

Capital or collateral funding levels may vary depending on the facility or domicile requirements. Some cell facilities are just one legal entity with multiple cells whereas other facilities allow for the incorporation of individual cells and thus have multiple separate legal entities. There can be other differences too, such as how the cell facility allocates and charges operating expenses to each cell.

What is a captive cell and how does it work?

A captive cell is flexible risk management solution that provides many of the benefits of a standalone captive insurance company, including features that allow the insured to retain a certain proportion of its risks and better manage the associated expenses, without the full operating costs of a standalone captive. The key features include:

Formation and capital

- Formation can be quick with minimal startup costs
- A participation agreement signed by

each member defines the rights and obligations of the cell

- Assets and liabilities of each cell are legally segregated from the others
- The facility owner generally maintains the minimum core capital as required by the local regulator.
- Participants have no ownership interest in the cell facility and may need to post collateral to a fronting company and/or contribute funds to its cell.

Underwriting

- Similar to a standalone captive, premiums from the insured are written by or ceded to the participant's cell, thereby providing the potential for underwriting and investment profits.
- Annual operating expenses can be significantly less for a cell than for a standalone captive.
- As with a standalone captive, there is potential for enhanced management and control over losses.
- Cells are available for most lines of business, such as general liability, professional liability, workers' compensation, property, warranty, trade credit, cyber risk and medical stop-loss.
- Depending on the line of coverage, a traditionally licensed insurance company may be needed to provide fronted policies on rated and/or admitted paper as well as programme coordination, claims handling and reinsurance services.

Reporting and regulations

- The owner of the cell facility is responsible for the cell's compliance with local regulatory requirements and for administrative tasks
- Unlike a standalone captive, a rented cell does not require a separate board of directors which can mean less management time.
- Separate reporting is available to the participant that accounts for income statement activity such as premiums, losses and expenses as well as the balance sheet position of the cell including assets, liabilities and surplus.

Individual cells may or may not receive their own audit report; this depends on the domicile, the cell facility and/or the needs of the participant. Typically, the entire facility is audited annually by an independent firm.

For income tax purposes, each cell is typically treated as a separate entity from the cell facility. Depending upon the facility, its domicile, the location of the participant or the insured risk, the participant may be responsible for filing applicable federal tax returns and paying any taxes resulting from the operations and assets of its cell.

AIG owns and manages two rent-a-captive facilities, domiciled in Vermont and Bermuda, for which we execute all administrative tasks, including regulatory compliance, corporate administration, financial accounting and reporting. Services that AIG provides directly to each cell participant include:

- Submitting formation application and obtaining regulatory approval for each new cell
- Obtaining and maintaining legal contracts, such as participant and reinsurance agreements
- Collecting capital and collateral as required
- Providing financial statements to participants on a periodic basis
- Preparing and submitting annual regulatory filings
- Liaising with service providers, e.g., auditing, legal, actuarial, and claims management services

> "A captive cell is flexible risk management solution that provides many of the benefits of a standalone captive insurance company"

Who might be interested?

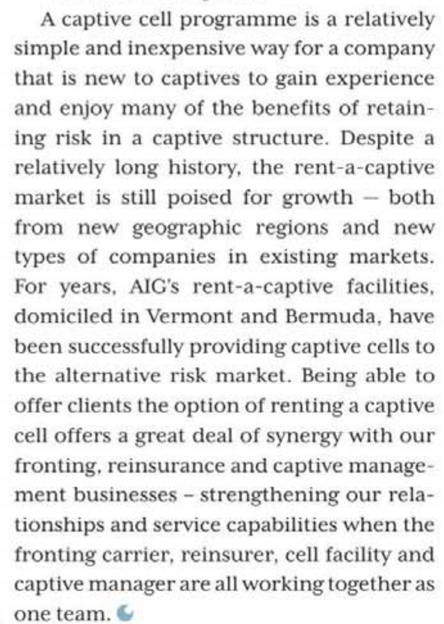
Characteristics of companies that would benefit from retaining risk in a captive cell include those seeking an alternative risk management solution without the costs or commitment associated with a standalone captive, as well as those with loss histories are better than their industry's average. Similarly, if pricing in the traditional risk transfer market does not yet reflect a company's improvements in loss control, a captive cell may be a more cost effective solution to managing that risk. Ultimately, any company will benefit when premiums charged by the traditional insurance market are higher than the fees and losses the company would pay when retaining risk in the captive cell.

Other good rent-a-captive candidates include companies seeking a short-term risk management solution (e.g. a transition for captives in run-off or a loss portfolio transfer), and clients with difficult-to-address risks and an appetite to share in those risks in order to achieve additional capacity and programme flexibility.

Is there opportunity for continued growth in the rent-a-captive market?

There has been plenty of discussion about the saturation of the captive market and how most large companies already have one or more captives. Despite that sentiment, there are still growth opportunities in several areas:

- Small- and mid-sized employers in the US grouping together with like-minded employers to share in a portion of risk as part of an overall self-insurance strategy.-Large- and mid-sized European and US companies looking to retain more of their P&C risks such as their workers compensation, general liability and property deductible layers.
- Large companies in new emerging markets, e.g., Latin America and Asia Pacific, where captives are gaining in popularity due to the advantages captives can offer and the existing sophistication of large companies in those regions.



A captive cell programme is a relatively simple and inexpensive way for a company that is new to captives to gain experience and enjoy many of the benefits of retaining risk in a captive structure. Despite a relatively long history, the rent-a-captive market is still poised for growth — both from new geographic regions and new types of companies in existing markets. For years, AIG's rent-a-captive facilities, domiciled in Vermont and Bermuda, have been successfully providing captive cells to the alternative risk market. Being able to offer clients the option of renting a captive cell offers a great deal of synergy with our fronting, reinsurance and captive management businesses – strengthening our relationships and service capabilities when the fronting carrier, reinsurer, cell facility and captive manager are all working together as one team.