ATLAS INSURANCE
MANAGEMENT

SEGREGATED PORTFOLIO COMPANIES – GLORIFIED RENT-A-CAPTIVES?

The invention of the Segregated Portfolio (or Protected Cell) Company may have come about through a demand for statutory segregation of risk for rent-a-captives or it may have been that the original proponents of cell company legislation were creating a demand rather than responding to it. Whichever it may be, Segregated Portfolio Companies (SPC's) are now a well-established though still largely untested form of corporate entity in most offshore domiciles and are gradually making an appearance onshore as well.

Those jurisdictions that permit the formation of SPC's anticipate their use in different types of financial services and have mostly, until recently, restricted their use to activities that fall within the ambit of licensed financial services such as insurance and mutual funds. However, there is an emerging realization that the creative thinkers in the private sector will always find ways to use new types of entity that were unimagined at the time legislation was passed. This realization and a desire to encourage such creativity are leading legislators to be less restrictive so, for example, allowing SPC's to be used for specified purposes and in some domiciles "for such other purpose as the minister responsible shall allow".

In the British Virgin Islands, newly enacted companies legislation will allow the use of SPC's in a context other than insurance. This is a welcome new departure for the domicile, whose existing SPC laws form part of the Territory's insurance legislation. Bringing the governance of SPC's within the realm of company law, not only provides a means to broaden the use of such entities within the Territory, it also affords regulators an opportunity to review the application of insurance law to SPC's. This opportunity is being taken and it will be very interesting to see what changes may result.

Now, then, seems a good time to examine whether an insurance SPC is merely a rent-a-captive with knobs on or whether it can be something more.

A rent-a-captive is an insurer that provides access to captive facilities for users who do not wish to form their own captive insurance company. The rent-a-captive and its users share one paramount common objective, namely that the rent-a-captive shall not be liable for the risks of the user and that the users shall not be liable for the risks of the other users or of the rent-a-captive itself. This objective is met by segregated portfolio company legislation, which, in every jurisdiction, protects cells from each other and from the core of the company and, with some variation from jurisdiction to jurisdiction, protects the core from the liabilities of the cells.

However, the use of SPC's is not confined to conventional rent-a-captives. Indeed SPC legislation generally provides a whole host of structuring possibilities for alternative risk transfer. As we shall see, there are two crucial elements of SPC legislation, which allow flexible and creative use of these vehicles. They are, first, the segregation of risks and, secondly, the ability of cells to contract not only with outside entities but also between themselves.

An often-cited reason for the formation of a captive insurance company is that it provides a corporation with a focus for its risk management efforts and allows a global insurance programme to be structured in such a way as to achieve group objectives whilst providing enough flexibility to accommodate the needs of different operating entities within the group. For example, at the group level, it may be decided that a company can sensibly retain $1m of its own risk whereas an acceptable level of risk retention at local level may only be a quarter of that and a newly acquired subsidiary might only have the ability to retain even less until such time as it has been fully integrated into the group. A conventional (i.e. non-cell) captive works in these circumstances, generally by issuing policies with different deductible levels and purchasing reinsurance in excess of the chosen group retention.

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This is fine as far as it goes and has been a very useful tool to many corporate risk managers. Local operations can be encouraged to control risk by receiving "rewards" from the captive in the way of profit commissions or reduced premiums but overall control rests firmly in the centre or at group level from where the captive is run. In order to devolve greater power to local operations or different divisions, it is quite possible to allow them to establish their own stand-alone captives. This will be too cumbersome for most. It requires multiple insurance licences, multiple audits and multiple capital contributions. It may also result in far greater devolution than was ever intended or, to avoid that, may necessitate the group risk manager attending serial board meetings.

Use of an SPC in these circumstances would make much better sense. The group can provide core capital to the captive and can be responsible for all domicile regulatory issues. Each different operating division can insure with its own cell and be responsible for the profits of that cell. The cell structure makes it simple to cater for different regional needs such as different currencies, different statutory insurance requirements, different languages etc. Particularly interesting though is the scope for allocating risk that the ability to segregate risk allows. It is easy to imagine that the group would establish a cell to reinsure the excess risks of the other cells and that this reinsurance cell would itself buy reinsurance from the commercial market. A little more imagination leads to the possibility of the cells of some operating divisions sharing risks with each other, perhaps because of some operational overlap or perhaps because one division is clearly not exposed to a risk that another division has.

Segregation of risk need not be by insured. It can be by class of business underwritten. This type of segregation may have an application for both captive and commercial insurers. For example, a company that has successfully insured its general liability risks with its captive for several years may hesitate to begin insuring a different class with the captive for fear of the possible adverse consequences to the captive as a whole, if the new class proves less successful. By converting the captive to an SPC and segregating the two lines of business, the parent avoids any need to form a second captive. This saves time, cost and the ongoing administrative and regulatory burden. It also allows the one captive to benefit from the success of the new line of business so that retained earnings can strengthen the overall balance sheet. Segregating risks in cells also makes it easier to cease writing business in the captive, perhaps in the event of a change in market conditions. If multiple captives are used to write different classes, withdrawal from one class leads to the dormancy or liquidation of the captive. There is no such problem with a cell arrangement.

For commercial insurers and reinsurers too, segregation by class and also segregation along geographical lines may be attractive in certain cases as it allows management closely to control the allocation of capital to risk. Of course, there are potential problems with this as well, such as how the rating agencies would react but a reinsurer wanting to enter a new market cautiously or even to assist existing reinsureds by providing cover outside its usual range might take advantage of a cell structure.

Groups or associations seeking to form a captive have often stumbled because members cannot agree how and to what extent to share risk with each other or how to structure ownership. SPC's may not eliminate all the problems of forming group and association captives. However, the ability easily to segregate risk or to determine at what level risk should be shared and to do so within an insurance entity rather than through the imposition of self-insured retentions or deductibles affords the sponsors considerably enhanced structuring flexibility. There are a number of cases, for example, of SPC's in which the larger association members have their own cells to achieve greater segregation while smaller members pool more risk in shared cells.

The ability to form a limitless number of cells, with little or no additional expense of either formation or administration, provides a chance for insurers, programme managers and agents to offer insured's participation in underwriting profits. An agency captive has traditionally allowed insurance agents to participate in the profitability of their book of business. A cell structure allows the agent to continue to do so while rewarding customer loyalty and cementing long-term client relationships. The agent sponsoring the SPC can either allocate a percentage of risk to a client's cell while retaining the balance in his own cell or the core of the company or he can participate as co-owner of the client cell. As is so often the case, the SPC offers choice and flexibility.

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An increasingly popular form of captive in the USA is the Risk Retention Group ("RRG"). An RRG issues policies to its members as an admitted insurer so that there is no need for a commercial fronting carrier. However, all policyholders must be shareholders and retained risk (and profit) is necessarily shared amongst all members. As with group and association captives, proponents of RRG's are often faced with the problem of potential members being put off by the thought that they will be insuring the risk of their fellow members. However, if the RRG reinsures a proportion of its risks to a number of cells in an SPC, the sharing of risks can be much reduced because of segregation within the cells. A cell can be established for each small homogenous group and it is even possible to establish cells for individual insured's thus achieving almost complete segregation of risk.

This combination of RRG and SPC allows insured's to benefit from the admitted insurer status of the RRG, while segregating risk in an offshore captive. Reinsurance can be arranged for the programme as a whole. The offshore situ's of the SPC and its likely status as a non-controlled foreign corporation may provide considerable tax benefits.

SPC's have applications for commercial insures, for the largest corporate captive users, for smaller corporate captive users, for groups, associations and agencies and even for individuals. Very large cells are feasible and extremely small cells are feasible. SPC's offer choices about risk sharing and risk segregation. They allow differing investments from cell to cell. They permit various methods of profit participation. They provide tax planning possibilities. They give marketing opportunities. All in all, the SPC is a powerful and flexible risk and financial planning tool; much, much more than a glorified rent-a-captive!

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