Tony Weller of Citadel Risk explains why being able to fully fund your cell captive is the most important thing for owners to consider when setting up

There is so much information available via the web or from alternative risk insurance experts extolling the virtues of segregated cell insurance mechanisms, that one more article on the subject might seem like overkill. This article does not set out to replicate something you can read on a regulator or lawyer's website. They have already outlined the technical issues very well but at the practical application level, there is still a lot of misunderstanding about segregated cells, how they can be used efficiently and their place in the transition of insurance programmes from incubator to full-fledged insurance.

A segregated cell is a very simple and relatively inexpensive way of setting up your own insurance or reinsurance company. There is a great deal of flexibility as to what it can do including a direct insurer providing coverages to its owner participants, as a reinsurance mechanism assuming risk from a commercial insurer or, as an insurance conduit allowing access to the commercial reinsurance market. As long as you (or a fronting insurer if necessary) are abiding by the laws of the jurisdiction that the insurance is being written, then the segregated cell can participate in the risk of choice under most circumstances.

Without too much difficulty or capital, you have your own de facto insurance or reinsurance company.

A captive cell is a 'company within a company'. The cell is associated with a 'core' company that arranges the affairs of the cell in a way that is economical and efficient. The core also provides the required expertise for holding the insurance license and has provided the basic capital necessary for the operations of insurance programmes within its cells. In every jurisdiction, the important thing to recognise is that the assets and liabilities of your cell are quarantined from the other cells. Bermuda in particular has created a legislative environment that has a balanced approach to regulation for cells, and a strong body of law surrounding segregated accounts that has withstood legal challenges unscathed.

An example of the Bermuda's balanced approach to segregated cells is the approval of cell structures within the core company management. Bermuda offers guidance on best practices for determining the quality of a cell's participant, however, leaves that decision to the core company. Some jurisdictions need to have business plans submitted outlining each different class of business and each geographic segment. The plans then gather dust on a regulator's in tray and this, frankly, is a very frustrating process, which is unknown to Bermuda segregated account participants.

Bermuda is a stringently regulated insurance domicile. It is a well-respected, regulated and mature jurisdiction. Solvency II equivalency, the robust reinsurance marketplace and the huge amount of capital based on the island has ensured that. The Bermuda Monetary Authority (BMA) has a thoroughly pragmatic side, and the administration of segregated cells is a good example of that.

Setting up a cell

When considering a cell for insurance or reinsurance business there is one key issue, and it is a critical one. The BMA want to know that, even in the worst possible case, the cell can honour all of its insurance obligations. Can it pay all its claims and creditors? That is what they really want to know. If you think about it, that should be the main function of regulators. Their great fear (and it should be) is an insolvency. They're messy, time-consuming and interminable. They are a fact of life, but one of those facts best avoided. It should also be the most pressing issue for the owners of cells. This is called 'fully funding' the cell and it means that the cell can pay or reinsure away every loss contingency that it may be faced with.

Setting up a cell in Bermuda is relatively simple, but the first question any responsible captive manager will ask you is how you intend to keep the cell fully funded. If you don't know the answer, then a proactive captive manager will advise you how it is done. If there is only one thing you take away from this article, it's that the cell must be fully-funded.

The most obvious answer is to ensure there is enough capital in the cell. That may be axiomatic, but it is also in many, if not most, instances completely impractical. There are programmes where the theoretical risk is huge, but the practical risk is miniscule, so nobody wants to over capitalise a cell like that. Other standard responses are letters of credit and bank guarantees. Again, a great theoretical answer, but for very large potential loss exposure impractical. The days of banks issuing letters of credit that are partially collateralised are over. Letters of credit normally need to be collateralised in full with cash, so you may as well put the cash in the cell and call it capital. There is an option, however, which will significantly reduce capital obligations; the purchase of aggregate stop-loss reinsurance.

Captive managers can be one-stop shops for setting up a captive, and a good one will be able to organise stop loss and excess of loss protection for the cell, by far the most capital-efficient method to keep a cell fully funded. If the risk is small, finding stop loss protection incepting at a loss ratio of 100 percent should be practical and relatively inexpensive. One method is for the reinsurer to charge a relatively high premium (to protect the reinsurer should unlikely events occur) but to pay back substantial profit commissions and commute the protection depending upon 'the tail' of the risk. The captive manager should have connections or access to carriers who are prepared to write this type of risk. He or she will then calculate the amount of capital required—normally the running costs of the cell.

The administrative process of setting up the cell is relatively simple and can be completed very quickly. The ownership agreement is fairly standard and the question of whether you prefer a profit-share agreement, where profits are shared in proportion to the agreed 'ownership' of the cell, or, a preferred-share agreement, where preferred shares are issued to the 'owners' of the cell can be discussed with the captive manager. Normally it is just a matter of personal preference. Sometimes it is just a question of what method the client can more readily understand. The length of time that it takes to set up is largely the responsibility of the 'owner' of the cell or the client. Like a broker who presents a complete, comprehensive, well set up and accurate presentation of a risk to an underwriter from the outset, a client who understands the risk and—importantly—can back it up, will give the captive manager confidence and result in a quick and efficient start to the life of a cell. Ownership agreements can be completed in a matter of days, but bank accounts typically take longer, and that is often the function that delays effective trading.

Setting up a bank account and the surrounding know-your-client (KYC) issues, can be challenging. The captive manager and the bank will want to know who the ultimate beneficiary of the programme is. Captive managers and banks are very sensitive about these issues, some of whom have had their fingers badly burnt. If you are not laundering money or doing anything illegal then, you should have nothing to fear, other than the fear of completing forms. Sometimes this proves the most challenging task if the ownership structure does not fit easily into the presentation of the forms that need to be completed. The most frustrating part is that there are normally a number of follow up questions as the captive manager or the bank really need to know that they cannot be accused of aiding or abetting anything illegal.

Other issues are the same as any insurance or reinsurance programme. Managing risk, underwriting, claims management, underlying documentation and all the usual administrative challenges that are part of commercial life. Given that a cell is like a real insurance or reinsurance company, a good captive manager will be proactive in managing commercial challenges. Most firms do the first bit well, which is completing accounts on a timely basis. The really interesting task is whether they can advise you adequately and proactively on investment management and any regulatory scrutiny. A good manager identifies a potential problem before a regulator does.

In my experience with the BMA, our queries have all been pretty well on the same issue—is the cell fully funded, and their questions have been good ones. So a good captive manager will consider, once he has posted all the journal entries, whether he can conclude that the cell is fully funded. If not, he needs to urgently bring this to the attention of the client. Once you have suffered from a regulatory bloody nose, it is hard to retrieve your reputation, so it is better not to get into the fight in the first place.

If you address that sole issue, it is an amazingly inexpensive way to participate in insurance risk. We have found a lot of brokers and agents who like a risk and want to make more than commission in life. It also gives 'external' reinsurers a great deal of confidence to see a broker or agent participating in a programme they are trying to sell to outsiders.

We don't often think about how something will come to an end when we are creating it, but this is another advantage to segregated cell structures. Segregated cells come apart almost as easily as they go together.

On one hand the segregated cell could be a very successful venture and the owner decides to move the programme to an owned captive company instead of a cell. On the other hand the programme may have outlived its usefulness and needs to be wrapped up.

Again, a good captive manager will have access and connections with carriers who will assume the risk of a cell once its active life is complete. It is really in nobody's interest for a client to incur unnecessary administrative costs while he waits for a couple of claims to be settled. It is important that this issue is discussed as forward planning in reinsurance also means considering what to do when the risk being underwritten is no long warranted.

As in the rest of life there are positives and negatives associated with the use of a segregated cell structure. Balancing the reduced cost and improved operational efficiencies are the need for the core company owner to purchase services on a bundled basis for all cells within the core.

This can eliminate some of the control that the cell owner can exercise in choosing their own service providers. Likewise, because the cell is an extension of the core, legal matters must be executed by the core's directors rather than at the cell level. Overall the advantages outweigh the disadvantages for many cell participants and that is why there are so many active cell programmes in the captive industry and in particular in Bermuda. **CIT**

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Tony Weller, CEO, Citadel Risk