The Heritage Group (‘Heritage’) is a multi-faceted financial services group with representation in Guernsey, Malta and Gibraltar. We provide a wide range of offshore financial services including insurance management, underwriting agency management, fiduciary & wealth expertise, fund administration and insurance broking.

Heritage Insurance Management, part of the Group, is the largest independent insurance management company in Europe and manages a diverse client portfolio with in excess of 160 facilities ranging from PCC cells to large and mature insurance companies.

This paper is designed to offer an introduction to captive insurance companies, which will be referred to as captives, and consists of 2 sections. Section 1 covers the rationale and mechanics of captives and will run through the basic concept, and Section 2 considers the current key issues for users of captives.

Many of those working in, or with connections to the insurance industry have or will come into contact with captives and often there seems to be some mystery about what they are, how they work and why they are being used. The purpose of this paper is to unravel any mystery by offering some knowledge to help develop an understanding of the basic principles.

The information contained in this paper is also available in video, in the form of a Chartered Insurance Institute CPD seminar, and can be found with the following link:

http://www.cii.co.uk/knowledge/underwriting/articles/captives-explained/26685

Section 1: The Basic Concept

In this first section we will consider what a captive is, how they can be used for self-insurance and risk financing, why clients use captives, different types of captive entity including protected cells and how, on a practical level, captives participate in insurance programs.

Captives have been used for many years by organisations as one means of helping them manage their retained risk exposures, typically that part of their insurance programme which they want to self-insure, often a large excess or deductible. A good definition of a captive is:

‘A captive is a special purpose insurance or reinsurance company established primarily to finance risks arising from its parent group or groups and thereby contributing to a reduction in the parent’s total cost of risk’.

Therefore a captive is an insurance, or sometimes a reinsurance company, which has been formed by a parent company to underwrite a proportion of that parent’s insurance program. It is important to appreciate that a captive is a bone fide insurance company, which accepts real insurable risk from its parent or sponsor.

Captives are used extensively throughout the world by both major and medium sized corporations to cover risks situated at home and abroad. As trade barriers throughout the world have been lowered and companies have become more internationally orientated, insurance buyers are taking a more global approach to risk financing and captives can play an integral role in the successful implementation of a global risk financing strategy.

All captives are licensed and regulated as insurance or reinsurance companies and, in terms of location, the majority are domiciled in offshore financial centres like Guernsey or Bermuda. Captives require the parent to subscribe capital into the company in order to meet the solvency required by the insurance law, and they are regulated accordingly by the financial services commission in the domicile where the company is incorporated. The level of capital required can vary between domiciles and this is something that is covered in more detail by Section 2.
Captives are formed for many reasons, including:

- **Greater Control over the insurance purchase:** A means of escaping from some of the unpredictability of the commercial insurance market which has historically been cyclical. It is well known that pricing, cover, deductibles and capacity can change through the market cycle from being in plentiful supply when the market is ‘soft’ to being in short supply when the market is ‘hard’. By establishing a captive to underwrite those risks which the parent has chosen to retain, there is an opportunity for that parent to change its relationship with the traditional insurance market and move to a position where only larger and less frequent losses are covered. This brings a number of benefits:
  
a. The opportunity to price those risks retained based solely upon the performance of the parent’s business and, since this is now self-insured risk, the subsequent opportunity to improve that performance using risk management controls;
  
b. The process of pound swapping with insurers, where underwriters ‘gross up’ within their quoted annual premium for predictable claims, is avoided;
  
c. The relationship with the commercial insurance market has the opportunity to be improved as there is less adversarial discussion around small claims and the focus shifts to risk management. This helps to foster longer term relationships and produces more stable pricing, cover and capacity;
  
d. The parent can develop much more control over the insurance purchase, as the captive can be used to vary their self-insured retention depending on the commercial market position. Typically captives are often used to best effect by their parents as part of the negotiating process with underwriters at renewal time and can be used to counteract, for instance, the effect of a rating increase.

- **Opportunity for Revenue:** The desire to capture a share of the underwriting profits and investment income that would otherwise be earned by the commercial underwriter;

- **Other Insurance Markets:** As a means to access the reinsurance market or, in certain circumstances, as a means of diversifying into insurance services.

Captives are usually designed to participate in self-insurance structures. These tend to be referred to as pure captives, and most of these companies are used to provide benefit and value to the parent by helping to stabilise and minimise the long-term cost of risk.

There are also commercial or third-party captives which are formed to underwrite associated business of the parent, typically profitable insurance lines, with the objective of creating underwriting profits. In this paper we will focus on pure captives, but it is important to recognise the trend of captives underwriting either a mix of self-insurance and commercial insurance, or exclusively commercial insurance. These types of captives are formed to generate underwriting profits which can increase the parent’s revenue or which can be used to help subsidise self-insurance premiums. Heritage has extensive expertise with both of these types of captive and can provide more detailed information if required.

The main advantages of using a captive are:

- Allowing the Parent the ability to price risks appropriately and reflecting the loss record of the company in question

- Helping to achieve more stable premium rates in comparison to the unpredictable swings typical of the conventional market

- Promoting awareness & control of risk management strategy
- Providing the potential for bespoke cover/wordings and provision of cover for risks unavailable or inappropriately priced in the conventional market
- Providing extra negotiating power with the commercial insurance market
- Gaining access to the reinsurance market, which can open new avenues
- Retaining investment income and cash flow benefits

Whilst there are many potential benefits in forming a captive, there are some potential disadvantages which need to be considered before a decision to establish a captive is taken. The main considerations are:

- Capital: The parent must contribute the requisite capital to support the captive’s underwriting;
- Risk of Adverse Results: The captive’s capital could be eroded by adverse underwriting results, although most captives tend to adopt a fairly cautious approach and limit the underwriting downside by the use of aggregate limits and reinsurance.
- Operating Costs: the expenses incurred to run the captive.

Before considering an example it is worth briefly considering where captives can best participate in their parent’s insurance programme to add most value. This will vary between companies, so it makes sense to consider this in terms of the classic risk frequency and severity model.

### Captive Risk Participation

**Total Cost of Risk = Insurance Premium Plus Cost of the retained losses**

**Need to strike the optimum balance**

- **Should Insure:** Low Frequency & High Severity
- **Can Insure:** Moderate frequency and severity
- **Should Retain:** High frequency & low severity

- **In this layer Insurance is sometimes more expensive than retaining risk but depends on the client’s risk appetite and the cost of insurance**
- **In this layer insurance is the most efficient solution as Clients earning and capital cannot withstand losses of this severity**
- **In this layer insurers won’t insure or will charge an excessive premium, therefore more efficient to self insure these losses**

Losses in the red area are both infrequent and large, and for most captives it does not make sense for a participation in this risk area, as substantial capital is needed and usually the commercial insurance market has good appetite for this type of risk.

Losses in the green area are those that happen regularly but are very small. A good example would be accidental damage to goods in a retailer. It makes sense that these losses which are very predictable and small in value are retained by the company, usually by way of a policy excess. Captives can be used to cover losses in this area but often the high-frequency combined with the cost of the insurance premium tax can make this unattractive.
Those risks in the middle amber area are those which happen with moderate frequency and also moderate severity. This is the area of risk which is most commonly insured by a captive, as often the commercial insurance market is more expensive compared to retaining the risk, and this affords the opportunity for the parent to self-insure and to risk finance this retention into their captive.

It was previously mentioned that captives can either act as insurers or reinsurers. Often this is determined by the structure of the insurance programme that the captive needs to fit into and there need to be consideration of a number of factors, for instance from a regulatory and legal perspective is the captive able to underwrite insurance directly in the territories required?

By way of example a Guernsey domiciled captive can underwrite policies directly into the UK, apart from compulsory covers, but could not underwrite policies directly into France or Germany. However, a Malta or Gibraltar domiciled captive can underwrite directly into any of the European states.

Additionally factors such as whether local service is necessary require consideration. Some insurance programmes require that operating companies have locally issued policies, premium collection and local claims management.

Typical Captive Structures

In the structure above the insurance programme is being underwritten by one or a number of local insurers who are providing fronting services to the captive. The captive is acting as a reinsurer to these local insurers and may be either accepting all of the insurance risk, or just the proportion that it is comfortable to retain. Most captives do not have the capacity nor appetite to cover the entire insurance programme, and therefore if this captive was being ceded 100% of the original risk then it would probably use reinsurance to reduce the risk exposure to a level at which it is comfortable.

Whilst this type of programme has the advantage of local insurers and service, it is likely that the insurers will charge a fee to the captive for the insurance risk they are fronting on its behalf.
In the second structure below the captive is being used to directly issue insurance policies into Australia, Belgium and the UK. Again, this captive is using reinsurance to reduce the risk exposure.

Typical Captive Structures

This approach has the benefit of maximum flexibility whilst keeping costs low. There are no fronting charges to pay and the captive can issue the exact scope of cover that is required. Additionally the captive has the widest possible choice of insurers or reinsurers with whom to place their reinsurance protection.
An Example

We will now consider an example that shows how a captive can be used:

The company in this example is a firm of accountants and the major insurance purchase is a Professional Indemnity ('PI') programme. This firm is a medium sized partnership and purchases total PI cover of £20mn, which is placed by its insurance broker at an annual cost of £800,000. The cover is placed in layers: a primary £5mn priced at £600,000; a £5mn excess £5mn priced at £125,000 and the top £10mn excess £10mn layer priced at £75,000.

The firm has enjoyed a good claims experience over the years but in the last period of cover had a claim paid for £1.25mn and as a result at renewal the premium on the primary layer is being quoted at £850,000, an increase of £250,000.

The firm considers this loss to have been a one off event, and believes it has good risk management in place. There is appetite to accept risk and, with a view of self-insuring the first £1mn, the firm instructs their insurance broker to investigate the potential market placement for a £4mn excess £1mn layer to replace the £5mn layer.

The insurance market is much more competitive on the revised layer and quotes a premium of £250,000, which is accepted.

The firm decides to establish a captive to underwrite and risk finance the £1mn deductible that they have decided to retain. As the firm operates only in the UK they decide that Guernsey is a suitable domicile as the policy can be issued directly to them without the need for a fronting insurer. Within 8 weeks they incorporate their captive insurance company which issues the required cover to the firm.

The captive charges a premium of £350,000 to the firm, which is based upon the expiring total price of the £5mn layer, now split between the commercial insurance market and the captive.
The captive issues share capital of £650,000 to the parent which is partly paid at £100,000 with £550,000 unpaid. The figure of £650,000 is chosen so that the captive has sufficient share capital to be able to meet its maximum liability of £1mn in the event of a loss under the policy. The shares are partly paid at £100,000 in order for the captive to meet the required solvency but whilst not overburdening the firm to pay the full £650,000 unless, of course, there is a large loss.

This provides the firm with a financially efficient solution, with the following advantages:

- The potential for underwriting profit: should the policy run claims free then the captive will produce an underwriting profit of £350,000 which can be used to
  a. pay a dividend to the firm; or
  b. to accept a greater level of risk for the following period; or
  c. it could be used to finance the underwriting of additional lines of insurance for the firm, should that be required

- There is no fronting insurer required which keeps the operating costs low;

- Over time the premium for this risk retention can be geared to actual loss experience

- Positive cash flow/investment income on premiums and reserves

- Possible greater control over claims

- Influence over policy coverage

- Potential leverage on overlying insurers at subsequent renewals
Before moving onto the Section 2 and the current key issues for captives, it is worthwhile touching briefly on Protected Cell Companies (“PCC”).

The PCC concept originated in Guernsey and was introduced under specific legislation in 1997. Similar facilities are now available in a number of other offshore insurance domiciles.

A PCC is a single legal entity made up of a core and any number of cells. The cells are separate and distinct from each other and most importantly the assets and liabilities of each cell are legally segregated from all other cells and the core of the PCC. This means that a creditor of any one cell can only access the assets of that particular cell and this allows a PCC to support the insurance underwriting activities of many clients.

Cells within a PCC offer similar advantages to those of captive insurance companies because, with respect to its underwriting activities, a cell behaves in the same way as a wholly owned captive insurance company.

Effectively a PCC Cell is a mini captive and they have become a very popular low cost alternative to captives as they can provide a number of additional benefits, such as:

- There is no minimum capital requirement as the PCC has already been capitalised by its owner to the minimum statutory level
- They are quicker to form and to terminate
- Operating expenses and start-up costs are lower
- There is less call on management time due to there being no requirement for a cell to hold board meetings
Section 2: Current Key Issues

It has already been mentioned that the decision about whether and where to have a captive is influenced by a number of factors. Once the decision to form a captive has been made, and the legal structure of the captive has been determined, there are some further key considerations including:

- Choice of jurisdiction or domicile of the captive;
- Legislative environment applicable; and
- Regulatory regime applying.

Naturally these three are inter-connected as the regulations and legislation will vary by jurisdiction.

There are jurisdictions or domiciles in the world which are more popular for captive insurance than others. The largest domiciles for captive insurance include Bermuda, the US State of Vermont, the Cayman Islands, and Guernsey, although captive insurers can be created anywhere that has insurance legislation.

The reason for these locations becoming well known captive domiciles has much more to do with their insurance laws than it does with their popularity as holiday destinations, although it is crucial that they have excellent transport links, as ease of physical access is an important factor in the decision about where to domicile a captive.

Bermuda and the Cayman Islands have historically been popular jurisdictions for captive insurers owned by US companies, as their insurance laws have included specific solvency and other provisions for captives, as well as being easily accessible from the USA. More recently, a number of US States have enacted captive insurance legislation which has replicated the legislative and regulatory advantages of Bermuda and the Caymans, such that a number of captives have been moved or “migrated” from Bermuda and the Caymans to places like Vermont. Vermont was the first US State to enact captive legislation, but now over half of the States have enacted captive legislation. Of course, having your captive domiciled in your home state, or at least on the mainland US, makes accessing it even easier than Bermuda.

In Europe, Guernsey is the largest captive domicile with around 700 licensed insurers. The reason for Guernsey’s attractiveness as a captive domicile is that it also has insurance legislation and regulations which, like Bermuda, are more suited to captive insurance than other parts of Europe. Also, Guernsey is less than an hour’s flight from London, one of the world’s most important insurance centres.

When selecting a domicile, another important consideration, alongside the ease of access and the insurance legislation is the receptiveness of the regulator. In Guernsey, just as in other key captive domiciles, the regulator is geared up to licence captive insurers in a matter of weeks rather than months, as would be the case in some other jurisdictions. This is important as captives usually take a proportion of their parent’s risk alongside other insurers, so they must be up and running in good time to fit in with the parent company’s insurance renewal period.

Just as Bermuda and the Caymans are independent of the USA, so too, in Europe are jurisdictions like Guernsey and the Isle of Man independent and outside of the European Union, which means that they do not need to adopt EU directives governing insurance companies. This gives them a certain competitive advantages in relation to captives, as unlike certain US States, EU Member states cannot implement captive legislation which does not conform with EU insurance laws.
On the other hand, Guernsey and the Isle of Man are restricted in their ability to directly insure some European risks. This is because they cannot take advantage of the EU Freedom of Services legislation. For this reason, some captives chose to be located in EU domiciles such as Luxembourg, Malta and Gibraltar.

For EU domiciles, the freedom of services legislation means that captive insurers can directly insure into all other EU member states, although they will be subject to all the EU directives, including those relating to capital and regulatory requirements for insurers.

Another advantage of locations like Guernsey, Luxembourg, Malta and the Isle of Man, as captive jurisdictions, is that there are many specialist insurance management firms located in these jurisdictions who have the knowledge and experience of setting-up and managing captive insurers. Their presence helps to ensure that the cost of setting-up a captive remains competitively priced, as well as providing the captive owner with a choice of service provider, to enable them to choose an insurance manager which is best able to provide the tailored service they require.

New and emerging domiciles for captive insurance would include some Middle Eastern jurisdictions such as Dubai, Bahrain and Qatar, all of which have developed excellent international transport links, and are looking to diversify their economy and attract both Western and Asian businesses wishing to form captives. Whilst these domiciles have enacted captive legislation, their markets are still very much developing and perhaps lack some of the expertise of the mature domiciles like Bermuda and Guernsey.

In respect of the legislation governing captive insurance, one main area of focus is in relation to the capital and solvency requirements for captives. As captives are risk-retention tools for their parent companies, the risk profile of a captive is different to an insurer writing third-party risks, in that the policyholder is the owner of the company, and should have a good knowledge of the risk profile of the business being written by the captive. For this reason some captive jurisdictions like Guernsey, Bermuda and the Isle of Man, impose a lower capital requirement on captive insurers than would be the case for commercial insurers. However the legislation in place in the jurisdiction must be explicit as to the capital and solvency requirements.

For instance, in both Guernsey and the Isle of Man, the minimum capital requirement for a captive insurance company is £100,000, and the minimum solvency requirement is 18% of the net earned premiums (being net of reinsurance and commissions) which will be underwritten in the first twelve months. This means that an insurer which is expecting to write £5mn of net premiums must hold at least £900,000 of capital in order to meet the legislative requirements. The legislation will also govern how this capital is to be held. It may not necessarily be required to be held in cash, as certain other assets, such as Government Bonds or Letters of Credit will also qualify as “approved assets”.

In comparison the EU capital requirements for insurers require a minimum capital of €2.5mn (increasing to €3.7mn if underwriting liability business). The minimum solvency requirement in the EU is 18% of the gross earned premium in the first twelve months (increasing to 27% for liability business). Additionally most EU regulators apply a “buffer” to these requirements, meaning that the solvency requirement for a new insurer can be between 27% and 36% of gross premium. These capital requirements apply to all general insurers, regardless of whether they are captives or not.

If we take an insurer writing a £25 million gross premium with a £20m outwards reinsurance, giving a net premium of £5m, it can be seen that the legislative requirements within the EU of £6.75m are much more demanding than the £900,000 required by non-EU domiciles, however it may be the case that certain captives which are large enough are happy to hold more capital in order to be able to insure EU-based risks directly through the freedom of services legislation.
Insurer writing £25m gross premium with £20m outwards reinsurance. Net premium = £5m

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The EU capital requirements are being amended currently to make them more risk-based. This EU directive known as “Solvency II” is amending the EU legislation to require insurers to carry a capital requirement which is linked to its risk profile.

As captives have a lower risk profile, this would logically seem to be advantageous for captives, however the factors within the computation do not adequately cater for the lower risks carried by captives, and the absolute minimum capital requirement of €2.5mn will remain. Certain trade associations, such as the European Captive Insurers and Reinsurers Owners Association (ECIROA) are lobbying the European Commission to try to ensure that captives are treated fairly under this regime. Since Guernsey and the Isle of Man are not in the EU, they will not be subject to Solvency II, but they will need to implement some form of risk-based capital requirement in order to comply with international best practice. Nevertheless, these jurisdictions are much better placed to implement a “captive appropriate” risk-based solvency regime, which will mean that they will remain attractive as captive domiciles.

In addition to the solvency requirements, other legislation which will impact on captives includes the availability of Protected Cell Company legislation. Both Guernsey and the Isle of Man have PCC legislation, enabling the creation of cells as captives, and providing for the statutory segregation of assets and liabilities between cells.

Within the European Union both Malta and Gibraltar have PCC legislation. However no other EU jurisdictions have PCC legislation, which means that all captive insurers in, for instance, Luxembourg or Ireland, must be traditional companies. The advantage of a cell over a company is that it can be more cost-effective to run, and it can be easier to establish, as the cell will form part of a pre-existing licensed insurer.
Other important legislation in relation to captive insurance is the availability of migration provisions within the law, to enable the efficient movement of captive insurance companies from one jurisdiction to another. Most captive domiciles have migration provisions in their law, making it relatively straightforward to move a captive insurer from one jurisdiction to the other. Captives can be moved for a variety of reasons, including moving them closer to their parent company domicile, moving them into or out of the EU, or else moving them to take advantage of specific capital or regulatory provisions in a particular domicile.

Most captive domiciles will also have provisions in their law for the conversion of companies into PCC companies or cells, amalgamation provisions, to allow the easy consolidation or merging of captives.

Whilst a low tax environment is helpful, it is not usually a deciding factor for the location of a captive, as higher-tax jurisdictions like the UK have controlled foreign company legislation which means that it is not possible for the parent companies of captives to avoid tax on profits generated by foreign subsidiaries or cells including their captives. In any case, the use of captives to specifically avoid tax is at best morally questionable and at worst illegal, such that it would be unlikely to obtain regulatory approval.

Turning now to the regulatory environment, this is a very important factor which companies examine when considering the location of their captive. Most companies which are large enough to have a captive will be successful, highly reputable international companies which have a well developed and sensitive risk management function. As such they are mindful of the importance of locating subsidiaries in jurisdictions which have a track record for being reputable and with a high-quality regulatory regime.

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By way of an example we can consider Guernsey’s regulator, the Guernsey Financial Services Commission (GFSC).

The GFSC has been the regulator for insurance business since its formation in 1987. The GFSC is an active and founder member of the International Association of Insurance Supervisors (IAIS), which is the international standard setting body for insurance. Furthermore, the Guernsey insurance regulations have been continuously updated to ensure that they remain fully compliant with the IAIS Core Principals.

It is these principals which are used by organisations such as the OECD and the IMF in their assessments of the financial stability and robustness of finance centres. As a consequence, being fully compliant with the IAIS Core Principals means that Guernsey is able to receive a favourable report from all such international bodies who review it.

However, an effective regulator must do more than just meet international best practice. They must be responsive to industry and facilitate the introduction of new business, which in the case of captive insurance, can be quite time-sensitive. In other words, a successful captive domicile will be able to review an application for, and licence, a new captive insurance company or cell in a matter of weeks rather than months, but the speed at which they operate should not compromise the quality and robustness of their supervisory oversight.

One way in which captive regulators are able to licence captives more quickly than some other insurance regulators is by also regulating the insurance manager to whom the captive outsources their day to day management. By regulating the service provider, the regulator will gain a significant level of comfort in relation to new captives which are proposed to be managed by the regulated manager. Most captive domiciles do regulate insurance managers for this reason, but not all jurisdictions, for instance Ireland doesn’t. Consequently, those which do not may be at a disadvantage in terms of the speed at which captive licenses can be issued, as well as the robustness of the insurance management oversight.