Portfolio Insurance Companies (PICs)

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Portfolio Insurance Companies

Jim Bulkowski and Kevin Poczatek discuss Portfolio Insurance Companies, their benefits and strategic uses with Captive Review.

Captive Review (CR): As a refresher, can you give us general background on Portfolio Insurance Companies and tell us what need they fill?

Kevin Poczatek (KP): Portfolio Insurance Companies (PICs) were introduced in the Cayman Islands via legislation in 2013 and 2015 to provide additional risk management opportunity within segregated portfolio companies (SPCs). Specifically, segregated portfolios (or "cells") within SPCs sought to contract within their respective SPC for reinsurance, risk pooling, and quota sharing and also to reduce uncertainty around their tax status as unincorporated cells. PIC legislation allowed for an SPC to incorporate one or more of its cells. The PIC then operates under the SPC's insurance license but is seen as its own separate legal entity where a related cell holds its voting shares. PICs have their own business plan and register with and are regulated by the Cayman Islands Monetary Authority, (CIMA) but do not require a license separate from that of the SPC.

CR: Why have PICs become so popular since their recent introduction?

KP: Simply put, they are easy to establish and further enhance risk management if you are already part of an SPC or looking to become part of one as an alternative to a traditional pure captive. PICs continue to make up a significant portion of the new captives created in Cayman since the legislation was enacted.

A PIC can be set up quickly and provide the following benefits:

- Ability to contract with another cell of its SPC
- Can mitigate and reduce the risk of inadvertent comingling of assets among other cells
- Option to have a different board of directors to that of its SPC, allowing for more flexibility in governance
- Greater recognition from counterparties that are unfamiliar with unincorporated cells
- Allows for easy transition to a standalone captive or insurer or merger with another captive
- Will be recognized as a separate legal entity for US tax purposes, allows tax elections to be made under its own federal tax identification number, like 953(d)
- Can issue non-voting shares to another person or entity
- Will reduce concerns as to whether courts outside Cayman would recognize the segregation principles inherent in an SPC
- Can be wound up without affecting its controlling SPC or other cells

CR: Surely it can't all be positive. What are the drawbacks or barriers to entry?

Jim Bulkowski (JB): PICs are relatively new and add a level of complexity to the traditional SPC structure, so there is a level of education and diligence needed. PICs need to register with CIMA, which requires some additional administrative time; however, this is not overly burdensome. There is also a cost of incorporating and a minimum capital requirement. Lastly, a cell can only have one PIC, so there is a limit to the strategic options for each cell.

CR: What are strategic ways you are seeing PICs used or that they could be used?

JB: Good question! Let's walk through a few scenarios we have encountered and other potential solutions that exist.

Splitting and segregating of risk

PICs allow the segregation of risk from the owning cell to the incorporated PIC. While this splitting of risk can be accomplished traditionally between the cells within an SPC, the PIC structure allows an incorporation structure to provide legal certainty that may be lacking in some other jurisdictions, or other jurisdictions may not view traditional cells as being legally separated. This is then enhanced by the PICs ability to contract within an SPC, or between PICs.

For example, a hospital group that is a cell owner could have its hospital professional liability insurance in a cell, but leverage a PIC for medical malpractice for the hospital's physicians. This ring fences the physicians' insurance along with its inherent volatility.

Taking this one step further, the PIC could be used to separate low-, medium- and high-risk medical specialties (e.g., neonatal and neurosurgeon vs. general practitioner). While a cell can only incorporate one PIC, multiple cells and corresponding PICs could be used to divide those risks into tranches. PIC A could contain one type of specialty, PIC B another and PIC C left for those remaining specialties that are known to produce higher volume and/or severity of claims. This tiered system would allow specific underwriting by class along with corresponding premium charges and loss aggregation.

Loss Portfolio Transfer (LPT)

Using a PIC, historic books of business or other certain blocks of risks can be transferred to a PIC in the form of an LPT, or novation, from another PIC or wholly owned captive. This would allow books of business, with either favorable, adverse or moderate claims experience to be segregated in a PIC and allow a rigorous focus on management and focus on reduction in claims severity.

A cell or cells may have a segment of claims that has negative and worse-than-expected loss experience. An option is to carve this out of the current cell (or parent self-insured retention), and transfer to a PIC. Capital would need to be dedicated, with approvals from CIMA, but this enhanced capital requirement in anticipation of claims payments and adverse IBNR naturally garners greater senior management attention. Greater attention demands more resources to increase the return on capital, causing a reduction in claims volume and reduction in reserves.

Risk pooling

A captive insuring physicians is a natural pool of risk, if there are enough doctors. Pooling allows greater certainty in loss expectation through the law of large numbers, as well as reducing the negative effects on one adverse claim in a small pool, which negatively impacts the average. This concept can be expanded to pool risks with other physician groups external to the hospital group. There may be various hospital groups in an SPC owned and managed by a third party and each group sets up a PIC. These PICs could enter into a pool managed by the third-party SPC owner or enter into a reinsurance or sharing arrangement with the other hospital groups. These other groups could even be PICs in the same SPC.

Non-voting shares

As mentioned above, voting shares are maintained by the sponsor cell. However, a PIC can issue non-voting shares. This may be useful to issue to certain groups, say individual physicians whose medical malpractice is insured in a PIC. Non-voting shares will let the individual doctor benefit from issued dividends, given profitable underwriting and loss results. This would potentially provide the physicians an added incentive to focus on additional quality measures and design safeguards to reduce the overall number, and perhaps severity of claims.

Similar structures could be arranged with groups using a PIC. That is, group members in a PIC would have non-voting shares in relation to the amount of their premium.

CR: So, it seems like the opportunities are endless?

KP: They are certainly abundant. The combination of the benefits of a traditional SPC, combined with the structure more typically found in a pure captive, is truly unique and provides additional flexibility to doing business in Cayman. We believe this is the primary reason so many PICs have been incorporated the past couple years.

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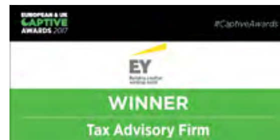

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