Captives in Paradise

Regulators in the Aloha State are touting Hawaii's ultimate destination package: insurance haven.

by Bonnie Brewer Cavanaugh

BENT ON WORLD DOMINATION: Hawaii regulators Craig M. Watanabe, deputy commissioner, left, and J.P. Schmidt, commissioner, want their state to rival the likes of Bermuda as a worldwide insurance destination.

Lucy Pemoni/Getty Images for *Best's Review*

> ▶ **The Situation:** Hawaii is the second-largest captive domicile in the United States, and it wants to grow even larger.
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> ▶ **The Issue:** In the soft market, Hawaii will see its biggest growth through foreign countries who want to take advantage of the U.S. market.
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> ▶ **The Solution:** The state's insurance commissioner sees Hawaii's regulatory environment and culture as big draws for Asian companies.

Hawaii always has had a reputation as a tourist destination, with its sandy beaches, exotic flora and enviable climate. All it needs now is a heavier concentration on insurance.

At least, that's how regulators see the future of the Aloha State: a captive paradise within an international insurance hub. Hawaii Insurance Commissioner J.P. Schmidt would like his state to surpass Bermuda as the world's leading offshore insurance market.

Bermuda is "a country with very similar challenges in the economic arena as Hawaii, being an island with limited resources," Schmidt said. "They do us a tremendous benefit in promoting the insurance industry."

Hawaii is no slouch. It's the second-largest U.S.captive domicile, with 164 captives as of January, according to the state's department of insurance. Vermont, with 800-plus captive companies, is first.

"We're second in the U.S. and 10th in the world, I believe, based on the number of captives," he said. "But another way of measuring it that's equally important is by the amount of capital assets. We're about fifth in the world."

In 2007, Hawaii's captives reported some $6.5 billion in combined capital assets, he said. The state began courting captives when it became a captive domicile in 1987.

Yet the state's reputation as a tropical getaway can somewhat hinder business growth. "We've done such a good job in promoting Hawaii as a tourist destination, there is some skepticism that people do serious business here," Schmidt said.

There's no such doubt among the Aon Captive Services Group, which views Hawaii as a "stable, well-regarded, well-regulated domicile" with the same standards as Vermont, said Nancy Gray, executive director–North America. Aon has 19 captive companies in Hawaii and has been placing captive clients in Hawaii for more than 12 years.

Parent company Aon Re Global is the world's leading broker, based on 2006 revenues of some $922 million, according to the *Best's Review* listing of Top Global Brokers for 2007.

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Globally, Aon also leads the captive industry with some 1,300 captive companies; it has 250 captives in the United States alone, with the majority in Vermont, Gray said.

Aon's Hawaiian captives include "a good diversity" of several risk-retention groups, medical liability captives, and a few builder/contractor captives, Gray said.

The first employee-benefits captive in Hawaii is an Aon client, and Aon also is looking at several client filings with the Hawaii State Department of Labor in 2008.

"We're seeing a lot of interest in employee benefits right now. We're expecting to see a lot more activity in 2008," Gray said.

Yet today's soft market is curbing captive development, to a degree, in Hawaii and elsewhere.

"You won't see the same number of new formations," Gray said. "With existing captives, you'll see clients adjust the amount of retention in their captives, declare a deductible or take less retention and buy more insurance. Then during the next hard market, they'll be able to use it as a risk management tool to fill the gaps or increase retentions and take on more risk."

Still, Aon was able to add two new captives in Hawaii in 2007. But it also lost two. One dissolved, and the other redomesticated from Hawaii to Vermont, she said.

"It was a distance thing for them. They already had an existing Vermont captive. Getting to Hawaii was problematic," Gray said.

And that's the other big challenge to Hawaii's captive domination—its remote setting.

"They're faced with the perception and the distance," Gray said. "It's an exotic location. It's still a five-hour flight from the West Coast."

Friendly Competition

Hawaii's reputation for its even-handed regulation of captives is the primary benefit of setting up a captive company there, Schmidt said. Yet Hawaii's captive industry has been seeing rivalry from mainland states in the past few years.

"What they're facing now is competition from some of the West Coast captive domiciles that have come up in the last several years," Gray said. "West Coast companies might now

Hawaiian Classes

Hawaii's captive insurance law, passed in 1987, allows for five classes of captive insurance companies—casualty, auto, marine, property and surety—with minimum statutory capital amounts as noted. Other lines, such as employee benefits and health, can be permitted by the commissioner.

Class 1:	Pure captive that writes business only as a reinsurer; $100,000*
Class 2:	A pure captive that can be a reinsurer and/or a direct writer; $250,000
Class 3:	An association or risk retention group captive; $500,000 (RRG), $750,000 (Assoc.)
Class 4:	A leased capital facility (protected cell); $1,000,000
Class 5:	A reinsurance captive; at the discretion of the insurance commissioner

*Minimum statutory capital amounts
Source: State of Hawaii Insurance Division

Captive Tax Laws: Good News, Bad News

Two new captive tax laws—one enacted, one pending—could change the face of Hawaii's captive culture and affect its standing as a major captive player.

A state law enacted in mid-2007 puts a $200,000 cap on premium taxes to be paid by Hawaii captives, regardless of how much business is generated. That includes several Fortune 500 firms, said Hawaii Insurance Commissioner J.P. Schmidt.

"The cap on the tax will allow companies that we have here to do even more business through their captives, and avoid having to pay additional taxes," he said.

The law also allows captives the flexibility to form limited liability companies, giving them protection from liability similar to a corporation, Schmidt said.

> The IRS proposal, if passed, "would have a very negative impact" on the captive industry.
>
> — J.P. Schmidt, Hawaii Insurance Commissioner

"They avoid the double taxation of a corporation, where the income is taxed and the dividends are taxed," he said. "It provides more flexibility in the distribution of income and tax benefits among the LLC members. And we have had a number of our captive owners already restructuring as LLC companies and taking advantage of the law."

This new tax law put Hawaii's captive industry on the same level as some of the other captive domiciles, said Nancy Gray, executive director—North America for Aon.

However, a proposed change to the federal tax rules that govern captives, initiated by the Internal Revenue Service in 2007, could change the way captives are taxed and hurt the captive industry, Schmidt said.

The IRS proposal would create a tax deduction for captive companies that could be taken only at the time a loss is actually paid. Under Hawaii's tax law, captives can take an immediate tax deduction for reserves established to pay for future losses of affiliated companies, similar to commercial insurers, he said.

Captive domiciles, owners and associations nationwide have been contacting Congress and providing comment to the IRS and the U.S. Treasury "on the importance of the industry and the need to have appropriate treatment in the tax code," Schmidt said. The IRS proposal, if passed, "would have a very negative impact" on the captive industry and the alternate risk transfer industry in general, he said.

"The insurance companies have different requirements than a standard company, and that needs to be recognized in the manner in which they're taxed, and that's particularly true of the captive insurance industry," Schmidt said.

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consider Arizona, Utah or Nevada as an alternative. It is closer to home."

Schmidt is not worried. While Hawaii's captive structure remains stable, some competing captive domiciles have seen "instability" with the turnover of captive leaders, he said. But what captives need is that consistency and expertise, he said.

Gray agreed that Hawaii's solid captive foundation remains a huge plus for the tropical domicile.

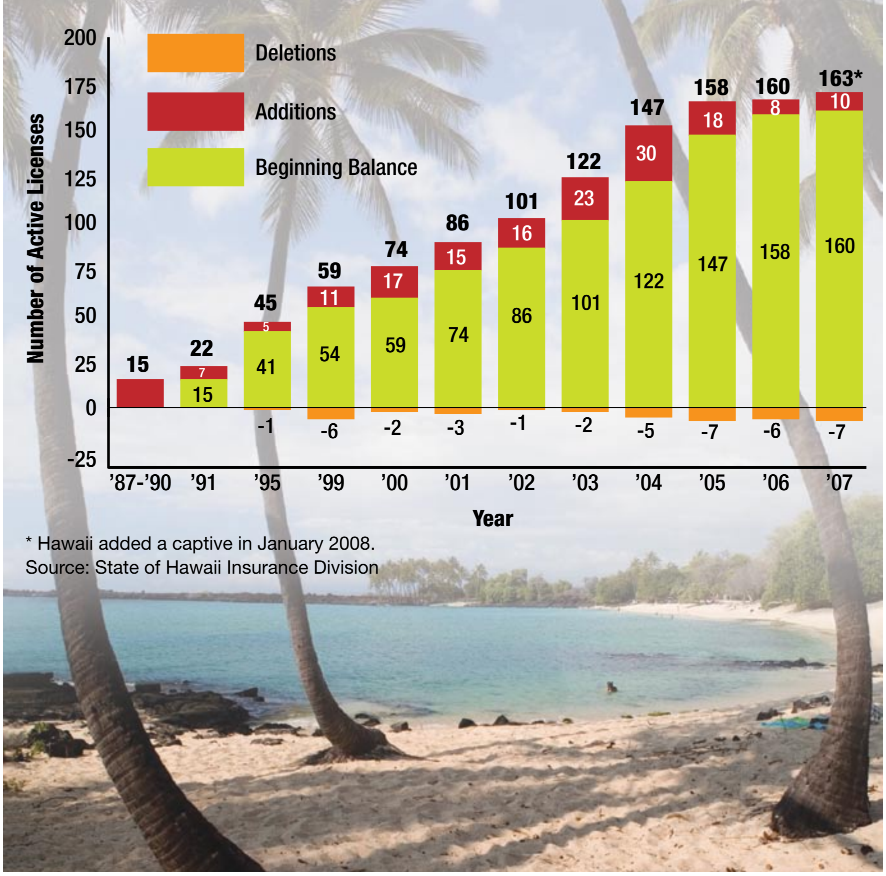
"What we've seen under Sarbanes-Oxley and post-Enron is [that] companies now go through a much more detailed review and approval process to set up a captive, and the perception is a lot more important than previously," she said.

Additionally, Hawaii has some "very approachable regulators," Gray said.

Deputy Insurance Commissioner Craig M. Watanabe, who heads up the captive insurance branch of the Hawaii Insurance Division, won the 2006 national award for "Outstanding CPA in State Government" from the American Institute of Certified Public Accountants.

Hawaii's Captive Insurance Activity

The number of Hawaii's captive companies has steadily increased since the island state became a domicile in 1987.



* Hawaii added a captive in January 2008.
Source: State of Hawaii Insurance Division

Asian Inspiration

Aon hopes to see more development in the Hawaii captive industry through foreign captives, Gray said. "We think for Hawaii, it will be the Asian marketplace that will see some of their captive growth," she said.

Japanese companies are attracted to Hawaii's captive industry over other Pacific Rim captive domiciles, such as Singapore, because of Hawaii's regulatory reputation, Schmidt said.

The first Japanese-owned captive came to Hawaii around 2000, said deputy commissioner Watanabe. The state now has 15 Japanese captives. Seven are owned by a U.S.-based Japanese company, and eight are owned directly by Japanese companies, and thus are non-U.S. taxpayers.

"For the directly-owned Japanese companies, we need to work more closely with the Japanese insurance regulators," Watanabe said.

Hawaiian regulators participate in trade talks with Japan's regulatory body, the Financial Services Agency, and run a yearly insurance seminar in Japan. They also meet regularly with Japanese captive owners, prospective captive owners, traditional Japanese insurance companies and with the U.S. Embassy in Japan.

The Hawaii insurance department also works closely with the China Insurance Regulatory Commission, and each year hosts CIRC insurance regulators as part of the internship program of the National Association of Insurance Commissioners. Some South Korean companies have also expressed interest in Hawaii's captive culture, Watanabe said.

"The other reason the Japanese like us in Hawaii is because we take the time to understand the domestic Japanese insurance market," Watanabe said. "There are certain things that you have to do there that you can't do in the United States, so we take the time to try to understand that."

Japanese companies must pay a tax penalty if they do business in a country that is considered a tax haven—and some offshore domiciles with very low tax rates meet the criteria of a tax haven under Japanese law, he said.

"In the U.S., the highest tax rate is what is used as the standard, and that is above the level where the country would be considered a tax haven," Watanabe said.

Japanese companies also want to set up captives in Hawaii to access the U.S. investment market, "which has provided significantly better returns than the Japanese market in the past few years," Schmidt said.

And Hawaii shares a common history with Japan and China due to immigration and similar cultural standards, Watanabe said.

"They feel pretty comfortable coming here," he said. "I'm Japanese—third generation in Hawaii—and I don't speak much Japanese. Some of the hotel workers who aren't Japanese [speak] better Japanese than I do." BR

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