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2009 Captive Update—A Market in Transition

The reduction in surplus experienced by the commercial property & casualty industry in the second half of 2008 has led many to believe that the insurance market will flatten out and even harden. What does this

mean for the captive industry? In our first newsletter of 2009 we take a look at developments in the industry during 2008 and where we may be heading in 2009. This article draws on information presented by Brady Young in our January 2009 webinar.

2008—A Year of Consolidation

The captive insurance industry showed modest growth in 2008. Formations were down from previous years due to:

- The continued effect of the soft commercial insurance market. 2008 was the fourth consecutive year in which commercial premium rates fell.
- Uncertainty at the start of the year over the consolidated tax proposal
- The impact of the economic crisis at the end of the year on the willingness of companies to invest in captive insurance subsidiaries.

2008 also saw a shake-out among mature captives with captives shutting down due to merger and several re-domiciliations. The tail end of the year saw some closures due to economic pressures from parents to return capital. This was strongest in industries most affected by the slow-down in the economy, such as homebuilders. Other areas particularly affected by the slow-down were triple X life captives and mortgage guarantee captives.

Domicile Activity

Exhibit A shows the captive licensing and closure activity by domicile for 2008. We have focused on those domiciles in which SRS is active. There is a clear distinction in activity between the larger mature domiciles and the emerging domiciles. Captive numbers in the mature domiciles were largely flat. Vermont experienced a net lose in active captives for the first time in many years and we suspect that Bermuda had a similar decline. Bermuda's numbers include Class 1, 2 & 3 companies. The class category includes commercial reinsurers as well as captives writing third party business. Only 3 Class 1 and 2 captives were licensed in the first 6 months of the year. Bermuda does not publish the number of captive licenses turned in.

In contrast the emerging domiciles showed higher levels of growth both in percentage terms and by absolute numbers. All of the domiciles listed in Exhibit A had very strong years with Utah and Kentucky having the most growth by number of captives.

- Utah added 31 new captives, although this is half of what was expected after a very strong year in 2007. Utah has attracted a lot of 831B captives and estate planning captives, but it has also started to attract some large Fortune 1000 captive owners as well.
- Kentucky also added 31 captives and doubled in size in 2008. The domicile has a reputation of being very responsive to new captive applications.
- Delaware also doubled in size in 2008. Captive owners have become comfortable with Delaware because of its reputation for flexible corporate law and the fact that many corporations incorporated in the state.

Why are some domiciles growing while others stagnate? From our experience and discussions with captive owners and domicile regulators we have identified six factors driving domicile growth

1. Differences in minimum capital and surplus requirements
2. Differences in fees and tax structures
3. Regulatory staff dedicated to captive business

Exhibit A: Domicile Growth (Active Captives at Year End)

Major Domiciles

Domicile	2008	2007	New	Lost	% Change
Bermuda*	1,393	1,377	16	n/a	1.2%
Cayman	777	765	32	20	1.6%
Vermont	557	567	16	26	-1.8%
Hawaii	165	163	8	6	1.2%
South Carolina	163	158	11	6	3.2%

Emerging Domiciles

Nevada	123	108	19	4	13.9%
Utah	122	92	31	1	32.6%
Arizona	106	94	17	5	12.8%
Washington DC	88	74	19	5	18.9%
Kentucky	62	31	31	0	100.0%
Delaware	36	18	18	0	100.0%
Montana	35	29	8	2	20.1%

* As at 6/30/2008

4. Regulator responsiveness and attitude
5. Specific types of captives associated with domiciles
6. Service provider activity

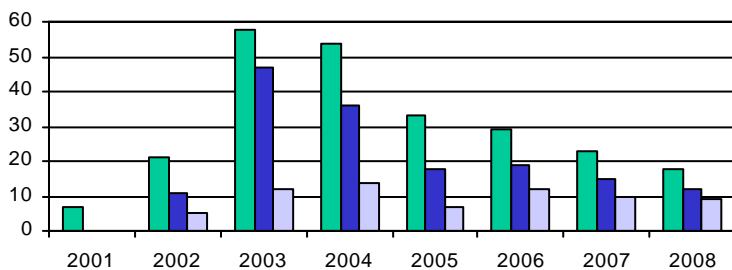
Areas of Captive Growth

The slowdown hasn't been consistent across the board. While some sectors, such as the construction industry, have been adversely affected, others have continued to see strong growth among captives. Those sectors include

- **Healthcare, both professional and general liability:** the insurance market for healthcare liability is localized and independent of market cycles. There continue to be sectors that are not well served by the commercial market. Risk retention groups continued to be formed in this sector, particularly for physicians.
- **Employee Benefits:** the use of captives by large employers to insure ERISA benefits continued to expand in 2008 as the costs savings and advantages for this approach have become clearer and the fronting and reinsurance market is more defined. Activity was not limited to large employers and ERISA benefits. Increasingly group and agency captive programs are being created to insure employee benefits with health insurance a focus. The costs of health insurance continue to increase for employers and captives are increasingly becoming involved.
- **Entrepreneurial Captives:** these ventures are created not purely to control the insurance costs of the owners. Heterogeneous group captives grew in 2008 providing access to a pool of risk supported by group purchase of reinsurance and excess insurance. Agency captives increased as MGAs were encouraged to take some underwriting risk in the programs they are managing. We did not see as much activity in the formation of cell captives as in previous years.
- **831B and estate planning captives:** a number of captives were formed under the 831B section of the IRS code for small insurance companies allowing them to be taxed only on investment income. Several captives including 831B captives were formed for estate planning purposes.

Risk Retention Groups (RRGs)

Exhibit B: RRG Formations



■ All Formations ■ Healthcare □ Physicians

Source: Risk Retention Reporter

RRG formations were lower in 2008 than in the prior five years, but activity was still well above the levels of the late 1990s. (Exhibit B) Formations were concentrated in the healthcare industry accounting for 12 of the 18 formations. Of the 12 healthcare formations, nine were for physician groups. By the year of 2008, there were a record number of active RRGs (262) of which 161 were healthcare RRGs.

Captive Trends

The captive market was impacted by several major trends in 2008

- **Re-domiciliations:** there continued to be interest in re-evaluating domiciles. This was driven partly by the increase in the number and choice of onshore domiciles, with some owners re-domiciling onshore. Conversely we saw some captives moving offshore to domiciles such as Cayman attracted by the healthcare focus and lower minimum capital requirements.
- **Change in captive managers:** 2008 saw an unprecedented number of RFPs and turnover in captive managers. This was primarily driven by service issues, with service being rated as captive owners highest concerns in the 2008 CICA survey. Consolidation among managers also led to turnover in captive managers
- **Financial crisis:** the second half of the year was dominated by the financial crisis with captive owners focusing more closely on their investment portfolios. Financial pressures at parent companies led to a noticeable slow-down in formations towards the end of the year, as well as pressure for the release of capital from some captives. Closures were largely limited to sectors most affected by the economic slow-down, such as construction.

Outlook for 2009

Heading into 2009, we see offsetting trends affecting the captive market. Premium rates in the commercial market are showing signs of firming following the significant loss of surplus experienced by the industry in 2008. The financial crisis means that there is an absence of readily available capital to replace this surplus. With less surplus in the industry, supply and demand logic suggest rates will increase. In addition, several years of declining premiums have removed any cushion in the rating structure. Rates are at or near pre 9/11 rates, which subsequently proved to be inadequate with those underwriting years requiring reserve strengthening.

Increasing premium rates and restrictions in coverage in the commercial market will increase demand for captives. This increased demand will be offset by the lack of available capital to create new captives. Existing captives will face stricter collateral requirements at a time when parents are pressing for release of surplus. The 2009 CICA survey showed collateral to be captive owners biggest concern, replaced the service concerns expressed last year.

Overall, we believe that the captive industry will see slightly increased activity in 2009. Despite the capital and collateral challenges we expect formations to be up.

Interview with an Icon: Tom Jones



In the second of our series of “interviews with an icon” 180° talks with Tom Jones, Partner at McDermott Will & Emery LLP. Tom has been active in the captive industry for 25 years. He is a leading expert on taxation, legal and regulatory issues affecting captives and their owners.

180: How did you get started in the captive industry?

TJ: I started my legal career with McDermott in 1975 as an interna-

tional tax attorney working on a wide range of corporate tax and legal matters for taxable entities.

My captive work started in 1984 with a Cayman hospital captive. From then on I started doing more and more captive work, especially for non profit and other healthcare captives. In the early 1990s I also started focusing on taxable company captive issues and from the mid 1990s I have focused almost exclusively on captives and their owners.

180: How do you view the current tax environment for captives?

TJ: The tax framework for captives and their owners is better now than has ever existed before. The key issues are pretty clear. At least the analytical framework of this positive environment exists because certain taxpayers have been willing to take on the IRS in court. Over the decades the IRS has tried to establish the law by issuing administrative orders, revenue rulings etc. that are not supported by statutes and case law. These IRS initiatives have been followed by lawsuits where one or more taxpayers challenge the IRS. For the most part the taxpayers have prevailed, thus restarting the cycle. If lawsuits such as Humana and Sears had not been heard and won, the captive market would be far smaller than it is today.

180: What changes have you seen in how the IRS approaches captives?

TJ: There is no coordinated or “standard cookbook” approach that applies anymore to captives. Every case is based on fact and circumstances with no consistent approach in the field. The result is that some field agents focus on random issues that can be somewhat “off the wall”. This is not necessarily a bad thing but it just means it’s harder to predict how the IRS will view a particular captive arrangement or set of facts.

180: What changes have you seen in the industry in general?

TJ: The level of professionalism is much greater than the “good old days”. As the industry has matured it has attracted smarter, more qualified people who have learned from the mistakes of the past.

People make the difference – the captive industry is an amazingly supportive atmosphere in which the participants are willing to share knowledge on a collaborative basis. It has attracted a lot of diligent, honest, entrepreneurial individuals over the decades who are not

only in it for the money. Loss prevention and mitigation are the overriding concerns.

180: What future changes do you see in the tax environment

TJ: The next big issue on the horizon is refining the definition of risk distribution. The IRS position that the only way to achieve insurance treatment is to pool the risks of numerous corporate legal entities or unrelated parties is bound to be challenged because fundamentally there are many other ways to achieve economic risk distribution.

The IRS is currently focusing on cell captives and appears to be leaning towards treating every cell as a separate taxpayer. It is an open question whether any changes will be prospective or retrospective. More direction and clarity will be positive for cell captives in the long term.

Captives are also likely to be impacted by future changes in tax policy. Falling corporate tax rates to match other industrial countries will make pass through (e.g. multiple LLC) structures less attractive to family businesses. This should be a helpful fact pattern for captives. Closely held businesses will be moving back to consolidated corporate groups and away from complicated families of LLCs which currently hinder brother - sister arguments. The current economic environment has already hurt several industries – auto dealers, real estate developers/managers, construction companies that have been active owners and users of §831(b) captives.

180: What changes do you see in the captive industry generally?

TJ: Captives are now mainstream. They are no longer an afterthought to most companies’ risk financing and insurance strategy. Captives will become more integral and sophisticated financial vehicles. Tax is just part of the equation and is not the main driver for most companies.

The use of captives for employee benefits is rapidly expanding and here to stay. This segment of the industry is finally achieving critical mass and demonstrates yet another reason companies are growing their captives.

I am optimistic about the future. Captives have largely out maneuvered the traditional commercial insurance industry over the past 30 years. If the traditional market would have been more flexible, captives would not have been so successful.

180: What concerns if any do you have for the future?

TJ: More insurance regulation. If the entire insurance industry becomes subject to federal regulation, captives could be swept up and adversely impacted. A “one size fits all” type of regulation simply doesn’t work for captives.

Anti-tax haven legislation could adversely impact offshore captives. Not for profit healthcare captives in particular are vulnerable because they do not have a dedicated common trade association or voice to represent and protect their interests.

180: A final comment..

TJ: The great thing about captives is the fundamental fact that the owners know the underlying risks being funded better than outsiders. This is a sustainable advantage in contrast to commercial insurance companies that don’t encounter these risks on a daily basis.

SRS News

SRS Welcomes 100th Captive Client

In March SRS welcomed Advocate Insurance SPC as its 100th captive management client. Advocate Insurance SPC is a Cayman domiciled captive owned by Advocate Health Care, a health care delivery system in Northern Illinois. Advocate is the largest health care delivery system in metropolitan Chicago and one of the top 10 systems in the US.

“100 is a nice milestone and we are pleased with the steady growth we are achieving year to year”, said Brady Young, President of SRS. “More satisfying than the growth is our retention rate. Our model is about quality and making sure we serve the unique needs of each and every client. We really want to make sure our existing clients are well served and happy with the service they receive from us,” added Young.

With 100 captive management clients, SRS is among the ten largest captive managers worldwide.

SRS Expands Cayman Office

In March, SRS announced the expansion of its Cayman office with the addition of two new captive professionals, Colin Robinson and Kristine Corella. Mr. Robinson joins as an Account Executive and Ms. Corella as a Client Accountant.

The additions bring SRS’s staff compliment in Cayman to 9 experienced managers and/or CPAs providing one of the lowest client to employee ratios in the domicile.

For the second straight year SRS was the fastest growing manager in Cayman in 2008 according to figures released by the Cayman Islands Monetary Authority. SRS is now the sixth largest manager in Cayman having leap-frogged Kensington Management and Willis Management during the year.

Staff News

Andrew Hupman has joined SRS as Director of our Bermuda operations, based in Hamilton, Bermuda. He will oversee the management of the company’s clients in the domicile and will also join the healthcare industry practice. Andrew was formerly an Assistant Vice President with Aon Insurance Managers in the Cayman Islands.

Colin Robinson has joined SRS (Cayman) as an Account Executive. Colin has worked in the insurance and captive insurance industry for 7 years. He was formerly a D&O underwriter and was most recently a Senior Account Manager with Marsh Management Services Cayman

Andrew Berry has joined SRS as CFO and Managing Director. Andrew has over 20 years experience in the insurance and captive industries. He was formerly President of Newport Risk Services, a consulting firm to the insurance industry and President of GRX Technology Services a provider of collaborative software in the industry.

Events

April 20-23 RIMS: Brady Young, Seamus Tivnan and Wayne Cowan will be attending the RIMS conference in Orlando, FL.

May 6—8, Arizona Captive Insurance Assn Conference: Brady Young will be presenting on the unraveling of the financial markets and its effect on captives. Ann Wick deliver the welcoming address as the President of AZCIA. The conference will be held at the Intercontinental Montelucia Resort and Spa.

Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

SRS Webinar Series

SRS hosts monthly webinars on topical issues affecting the captive insurance industry. Upcoming webinars include:

- Property insurance captives—an antidote for a hardening market?
- Risk Retention Groups—a market update.

To receive invites to this and other webinars, contact us at info@strategicrisks.com.

Recordings

Recordings of prior webinars are available at our website (www.strategicrisks.com). Recent recordings include:

- The Continued Growth of Captives in the Middle Market
- 2009 Captive Update—A Market in Transition?
- Captive Taxation—The Latest Developments

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

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