



# 180°

A guide to what's hot in the world of captives and ART



Issue 2, Q2 2004

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## The Fronting Market

In the previous issue of 180° we looked at the collateral requirements associated with captive and retained risk programs. This collateral requirement is primarily imposed to mitigate the credit risk of a fronting company and can be restrictive to the development of captive programs. In this issue we look at the need for fronting and trends in the fronting market.

**The Need for Fronting.** A fronting arrangement exists where an insurer issues policies to an insured and then reinsures a layer of the risk to the insured's captive. It is typically used to satisfy two requirements about procuring insurance:

- *State licensing regulations*, which require insurers to be licensed to operate in their state, either as admitted insurers or approved surplus lines insurers.
- *Insurance provisions in loan covenants and other contractual agreements.* These provisions aim to protect a contracting party's interest by requiring the other party to maintain insurance with an insurer of a certain financial strength rating, typically A- or better from AM Best.

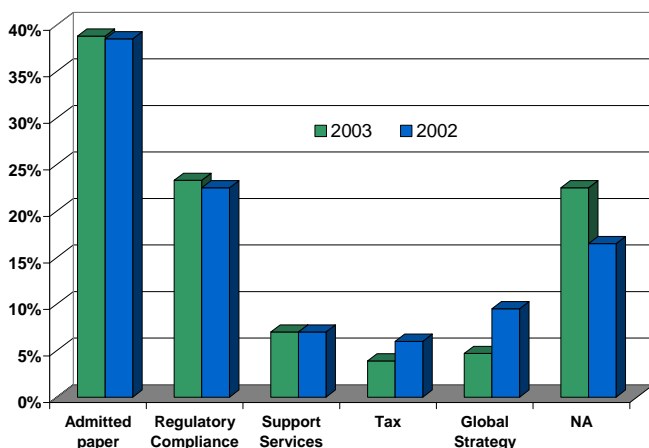
The 2004 CICA Fronting Survey shows that these are the predominant reasons for using a fronting insurer with the need for admitted paper to satisfy insurance provisions outweighing regulatory compliance. This can be explained by the use of RRGs and the structuring of programs for captives to underwrite direct, reducing the need to use fronting insurers for regulatory compliance.

reduced the number of players providing fronting services and led to more restrictive fronting programs. Today most fronting arrangements will be coupled with specific and aggregate reinsurance for the captive. There are few insurers who will provide standalone fronting. In addition, many fronting insurers require that they manage the claims rather than use TPAs. Collateral is usually required to 100% of the captive's aggregate retention.

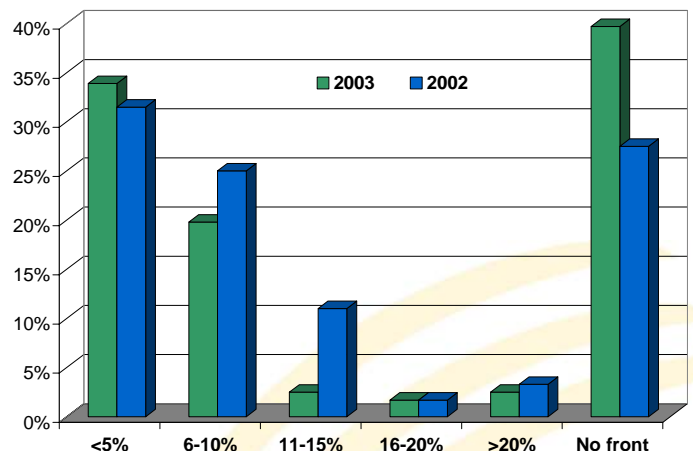
**Signs of Improvement.** With most of the withdrawals from the fronting market occurring in 2002, there are some signs that the fronting market is stabilizing. The analysis of fronting costs in the CICA Fronting Survey shows three favorable trends:

- A smaller percentage of respondents reporting fronting costs above 10% in 2003 compared to 2002. Fronting costs above 10% are generally seen as making captive programs unworkable.
- A higher percentage of respondents reporting fronting costs of 5% or less in 2003 compared to 2002.
- A higher percentage of respondents not using fronts. A reduction in the demand for fronting may translate to a reduction in the cost.

Reasons for using a fronting insurer  
(2004 CICA Fronting Survey)



Fronting Costs as % of premium  
(2004 CICA Fronting Survey)



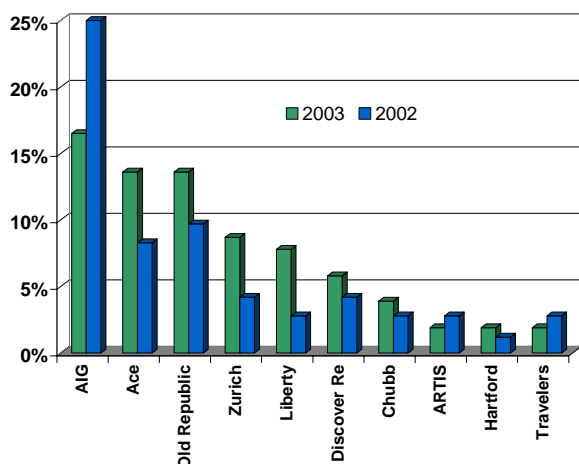
**The market for fronting.** The past couple of years have seen the downgrading and withdrawal of several insurers from the market (Legion, Kemper, ARTIS). This has

**Fronting Insurers.** The market for fronting services is dominated by the major commercial property casualty insurers with a few specialist ART carriers such as Old

Republic and Discover Re. AIG was the leading fronting insurer among respondents to the 2004 CICA Fronting Survey. 16.5% of respondents reported AIG as their fronting insurer. However, the market is showing signs of becoming less concentrated. Among respondents to the CICA survey, Ace, Old Republic, Zurich, Liberty, Discover Re, Chubb and The Hartford all made ground on AIG. All of these insurers have dedicated captive units pursuing fronting contracts.

### Leading Fronting Insurers

(% of respondents from 2004 CICA Fronting Survey)



**Managing Fronting Costs.** Facing a fairly restrictive fronting market, captives have been actively pursuing strategies to manage their fronting costs. These include:

- **Renegotiating loan covenants and contracts.** The financial strength standard can be counter-productive to managing the default risk under the loan, as it restricts borrowers' operations by increasing costs and collateral demands. Lenders will often be flexible in insurance provisions for this reason. A lower standard expands the pool of available fronting insurers and may allow a captive to underwrite directly.
- **Using Risk Retention Groups:** RRGs operate under a Federal license and can underwrite directly without the state regulatory burden of admitted insurers. For coverages that are not subject to insurance provisions, RRGs can avoid the need for fronting. The RRG option is only available for liability lines of coverage.
- **Structuring captive programs to go direct:** non-RRG captives programs need to satisfy state licensing requirements. This can be achieved through appropriate structuring of the program, for example as a deductible reimbursement policy, or through the method and location in which the insurance is procured.
- **Rating of captive insurers:** In recent years, AM Best has become actively involved in the captive industry. Many established captives have been rated. While few achieve A ratings, a captive with a strong AM Best rating has more flexibility in structuring favorable fronting terms, including collateral requirements, and will be more acceptable in a direct program than an unrated captive.

## Domicile Update: Arizona

Arizona is one of the newest captive domiciles having put its captive law into effect on July 1, 2002. Since that time, the state has licensed over 20 captives. The Arizona Captive Insurance Association has been formed to represent the captive industry in the state and it recently held its inaugural conference. This update looks at the unique features of Arizona as a captive domicile and its prospects for growth.

**Regulatory Environment** Arizona's captive law and capitalization requirements broadly follow those in place in Vermont, South Carolina and other onshore domiciles. The one major exception being the absence of premium taxes. However, what makes Arizona a domicile to watch is its commitment to the regulatory infrastructure and promotion of its captive law. Similar to the approach taken by South Carolina & Vermont, Arizona has created a standalone Captive Insurance Division within the State Insurance Department and staffed it with experienced captive professionals.

**Why Arizona?** We see four principal reasons why captive owners should look to Arizona as a domicile:

- **Location:** for companies based in the Western United States, Arizona is an attractive alternative to Hawaii and many of the other onshore domiciles.
- **Premium Tax:** Arizona does not charge a premium tax; instead it imposes a flat \$5,500 annual registration fee. For large captive insurers this fee compares favorably to the premium caps in Vermont (\$200,000) and South Carolina (\$100,000). The fee applies to each cell of a protected cell captive.
- **Agency captives:** Arizona is one of the few onshore domiciles that accommodate agency captives. Its \$500,000 minimum capitalization requirement compares favorably with the \$1 million minimum required for a class III Bermuda captive.
- **Flexibility:** as a young domicile, Arizona is looking to gain critical mass and may be more flexible than mature domiciles in bringing captives to the state.

**Recent Changes:** Arizona made several changes to its captive law which became effective September 18, 2003. These included:

- Expanding the law to include the formation of agency, group (including Risk Retention Groups) and protected cell captives.
- Permitting captives to form as reciprocal insurers with \$500,000 in free surplus.

In addition, Arizona is in the process of passing a bill that would allow Non-profits to form captives in the state.

**Looking Ahead.** The captive law is relatively young in Arizona but the state is committed to the industry and is promoting its flexible regulation, experienced regulators and its wide variety of recreational activities. An infrastructure of qualified captive service providers, including Strategic Risk Solutions, is forming on the heels of the regulatory infrastructure. With the infrastructure in place and the active promotion by the state, the prospects are good for Arizona to become a significant captive domicile, particularly for owners based in the Western United States.

## Arizona Captive Fact Sheet

**Applicable Legislation.** The Arizona Captive Insurance Act creating Arizona as a captive domicile went into effect July 1, 2002. The captive industry in Arizona is governed by Title 20, Chapter 4, Article 14 of Arizona's Revised Statutes.

**Number of Captives.** 21 licensed as 3/17/2004. 8 pending applications as of that date

### Capitalization & Solvency Requirements

	Capital	& Surplus
Pure captive - direct		\$250,000
Pure captive - reinsurance		\$125,000
Group captive - direct		\$500,000
Group captive - reinsurance		\$250,000
Agency		\$500,000
Protected cell	\$1,000,000	
Reciprocal		\$500,000

### Premium Taxes

Premiums paid to captive insurance companies are not subject to premium tax in Arizona

### Local Representation Requirement:

- Captive manager must be a resident of Arizona
- Maintain principal place of business in the state
- Appoint a resident incorporator in the state
- One member of the Board must be a Arizona resident

### Regulatory Fees

Application Fee		\$75
Annual License Fee		\$5,500
	(\$1,000 first year)	
Examination Fee		Varies by captive
Examiners Revolving Fund		\$100

## SRS News

**Client News** - SRS is pleased to welcome **Mears Transportation** as a new captive client. Mears has selected SRS to manage its South Carolina captive which was licensed and started business April 1, 2004.

**Partner News** – SRS added two important partners to our network in the first quarter 2004:

- **Arthur J Gallagher**, the world's fourth largest insurance broker, selected SRS as its partner to provide captive management services in Vermont, South Carolina and Arizona. SRS will provide services to Gallagher and its clients in these domiciles complementing the consulting and offshore management services provided in-house by Gallagher.
- **MarketScout** selected SRS as its "Best of Class" provider for captive services. MarketScout is an ecommerce company providing independent agents access to property casualty insurers and services. SRS has developed a captives' vertical on the MarketScout web-site and will provide captive consulting and management services to MarketScout's 50,000 subscribing agents.

We are pleased to welcome both Arthur J Gallagher and MarketScout as partners and look forward to working with them and their clients.

**SRS on the Web** – In March, SRS unveiled its new web-site. The site includes a new section, the **Learning Center**, providing educational material on captives and the alternative market, including published articles by SRS staff. It also contains past issues of 180°.

Check it out at [www.strategicrisks.com](http://www.strategicrisks.com).

**Our People** - SRS is pleased to announce the addition of **Allison Hazen**, as Senior Account Manager, in our Vermont office. Allison joins us from Aon Insurance Managers and brings over 12 years of captive insurance company accounting experience.

SRS provides underwriting, management and wholesale brokerage services in the alternative insurance market. We design, implement, manage and grow captive and ART programs on behalf of corporations, groups and insurance companies. SRS is an approved manager of captive insurance companies in Arizona, Bermuda, Cayman Islands, South Carolina & Vermont. Through a wholly owned subsidiary SRS is also licensed as an insurance broker in Bermuda.

For more information on SRS, visit us at [www.strategicrisks.com](http://www.strategicrisks.com).

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