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



Strategic Risk Solutions

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Managing Collateral Requirements

In our first newsletter last year we highlighted the capital demands placed upon captives, including the need for collateral. With most captives acting in a reinsurance capacity, this continues to be a major issue and a potential impediment to the establishment of many captive programs. In this quarter's newsletter we look at strategies for managing the collateral requirement and compare a couple of different forms of collateral used: letters of credit and Regulation 114 trusts.

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Background - Collateral is usually required in captive programs by the fronting company to ensure that the captive can meet its obligations under the reinsurance contract. Indeed to claim credit for the reinsurance, the fronting company will need to collateralize the reinsurance. Collateral is usually required to the full aggregate of the captive's participation. This creates a risk gap between the funds held in the captive's loss fund and the aggregate to be collateralized. This risk gap will need to be collateralized from funds outside of the premium paid to the captive. With the risk gap typically in the range of 30-50% of the gross premium, this can be a significant additional requirement.

Handling the stacking issue - Collateral is also required under every policy the captive underwrites, which can create a stacking problem with collateral required for the risk gap under the new policy as well as the expiring policy. Assuming that the captive can not avoid the need for collateral, the stacking situation is best handled by negotiating that collateral under the expiring policies is adjusted to projected ultimate losses at the same level as that used to set reserves in the captive's loss fund. If this can be achieved then the collateral for these old years can be met out of the loss fund held by the captive without the need for additional collateral. It may also be possible to negotiate a step-up in the collateral during the current policy year. This can help with initial collateral demands and help avoid stacking in subsequent years. A quarterly step-up in collateral may be offered by insurers in recognition of the slow claims development process which means that there is minimal risk of actual losses reaching the risk gap early in a policy year.

Letters of Credit - The most typical form of collateral is a letter of credit ("LOC"). In this situation, the captive provides a LOC from its bank for the amount of the required collateral for the benefit of the fronting company. The LOC is usually issued on an annual basis with an evergreen clause. The captive provides cash and certain allowable securities to the financial institution, which issues the LOC with the fronting company as the beneficiary. The fronting company can draw the LOC at any time and will receive the funds in cash. Typically the size of the LOC will be reviewed annually with

the fronting company considering a reduction of the LOC under the expiring policy year based on actual loss experience. For programs that renew with the same fronting company, LOC requirements for the expiring and new policy years are usually combined.

LOCs are acceptable forms of collateral for most if not all fronting companies and have long been used for this purpose. However, the costs of LOCs have been increasing and availability tightening. Consolidation in the US banking industry has reduced the number of institutions providing LOCs and the imposition of risk-weighted capital allocations on banks has increased the cost of LOCs. Captives can expect to pay 25 to 100 basis points for LOCs with additional costs payable for drawing down the LOC.

Regulation 114 Trusts - A less expensive alternative to LOCs may be the use of a Regulation 114 trust. This term refers to Regulation 114 of the Insurance Department of the State of New York which details standards for the use of trust funds for reinsurance. Under this arrangement, a trust agreement is entered into between the captive, the fronting company and a bank, which acts as the trustee for the fund. The captive deposits cash and/or allowable securities into the trust. The fronting company, as the beneficiary of the trust, must approve the assets in the trust. The fronting company can demand, at any time, assets from the trust to meet the captive's obligations under the reinsurance agreement. The assets are delivered as securities which are converted to cash by the fronting company.

A Regulation 114 trust can be used to collateralize both the loss fund and the risk gap, or used in combination with a letter of credit. One advantage of using the trust for the loss fund is that the trust and hence collateral requirement will automatically adjust with loss payments. If a captive can negotiate that collateral under expiring years is adjusted to projected ultimate losses, it may be wise to separate the form of collateral used to support the loss fund and the risk gap. A Regulation 114 trust can be used to manage the loss fund, while the risk gap is handled through a letter of credit, which would be re-applied to each subsequent policy year.

Criteria	Letter of Credit	Regulation 114 Trust
Cost	25 – 100 basis points, plus transaction or drawdown charges	Typically flat fee: \$10,000 - \$15,000
Availability	Decreasing with consolidation and capital charges	Readily available
Risk-weighted capital charge	Yes	No
Investment restrictions	No restrictions, but banks will apply margin or discount based on the risk profile of securities	Assets must be approved by beneficiary. Trust can not hold equities.
Duration	Annual with an evergreen clause	Unlimited
Acceptability	Widely used and accepted	Becoming more prevalent. Beneficiaries may have concerns about receiving securities rather than cash

Conclusion – The choice of instrument to use for collateral will depend on each captive’s specific situation. LOCs and Regulation 114 trusts are the most common, but not the only options available. A funds withheld arrangement may also be used although these are not popular due to the loss of investment flexibility/control and low return on the funds.

A key consideration in deciding between a LOC and a trust is the expected market return on investment. In times of low returns, the trust may be more attractive due to its lower costs. However as returns increase, it may be beneficial to incur the extra costs of the LOC and remove the investment restrictions associated with the Regulation 114 trust.

Domicile Update: District of Columbia (DC)

In the light of the recent overhaul of its captive legislation, our domicile update this quarter looks at DC, one of today’s most progressive new captive domiciles.

DC entered the captive industry through the enactment of its Captive Insurance Company Act of 2000. Since that time it has grown quite rapidly and now boasts over 40 captives. Yet despite this growth, it felt compelled to replace its captive legislation with the Captive Insurance Company Act 2004. This law contains several important new provisions aimed at establishing DC as a leading captive domicile worldwide.

New Provisions – In addition to lowering the premium tax rate, there were two unique innovations contained in the law:

- *Best practices*: this provision allows the Commissioner the flexibility to approve any captive arrangement which would be acceptable in any other captive jurisdiction worldwide.
- *Segregated cell companies*: These vehicles can now be set-up by any individual or entity without the need for a specific traditional insurance company sponsor. This provision within the DC law potentially allows risk retention groups (RRGs) to operate as segregated cell companies and has been highly touted as a major benefit of DC as a domicile. However, caution should be exercised as it is uncertain how this structure will be accommodated with the provisions of the Risk Retention Act itself.

The effects of the above are to give DC the most flexibility of the onshore domiciles. Combining this with a commitment to the regulatory infrastructure, puts DC in a strong position to continue growing as a captive domicile.

Infrastructure - DC's trade association, the Captive Insurance Council (CIC), is comprised of experienced legal and captive professionals that are working closely with the DC Department of Insurance, Securities and Banking to both promote the domicile and regulate the captives. 100% of revenues collected from premium taxes are credited to regulation and supervision of captive insurers.

Why DC? The principal reasons we see captive owners expressing interest in DC as a domicile are:

- *Location*: The nation’s capital is readily accessible and close to other regulatory bodies, including the Department of Labor, which needs to approve the insurance of ERISA programs in captives. DC is home to nearly 6,000 associations, a ready source of group and RRG business.
- *Reinsurer and investment flexibility*: The Commissioner may allow credit for reinsurance and approve investments outside of the NAIC Model Act Provisions.
- *Regulatory flexibility*: The best practices provision and several other aspects of the new captive law provide considerable flexibility for the Commissioner to consider different forms of captives on their own individual merits without being overly restricted by the legislation.
- *Associations and Groups*: A high proportion of DC’s captives are RRGs. With the proximity to so many Associations this is a natural focus for DC and the revisions to its segregated cell provisions enhance that.

Outlook – The new captive law provides DC with tremendous flexibility with many individual regulatory decisions at the discretion of the Commissioner. This will attract a lot of activity in the domicile and could result in rapid growth. The Commissioner will need to maintain a strong

hand over the District's flexible captive regulation to ensure that DC's reputation is protected. This will be particularly important with the emphasis that DC has placed on RRGs and the resultant scrutiny of other states' Insurance Commissioners as these RRGs look to write direct in their states. If DC can maintain a reputation for strong regulation within its flexible law, it will be well positioned to grow and become a leading onshore domicile in the US.

Washington D.C. Captive Fact Sheet

Applicable Legislation. Captive Insurance Company Act of 2004

Number of Captives

41 licensed as of 3/31/05 . Current breakdown:

- 18 RRGs (2 set up as Non Profits);
- 9 Associations;
- 7 Pure (1 set up as a segregated cell);
- 4 Agency (1 set up as a segregated cell);
- 2 Sponsored; and
- 1 Branch

Capitalization & Solvency Requirements

	Minimum Capital & Surplus
Pure Captive	\$250,000
Rental or Agency Captives	\$400,000
Association (Stock)	\$400,000
Association (Mutual)	\$500,000
Reciprocal	\$500,000
Segregated Cell	As determined by Commissioner

Premium Taxes

Premium	Direct	Reinsurance
First \$25 million	0.25%	0.225%
Next \$25 million	0.15%	0.150%
Each add'l \$1	0.05%	0.025%

Subject to a minimum of \$7,500 (RRGs \$10,000) and a maximum of \$100,000

Fees

Application Fee	\$500
External application review fee	Pure captive < \$5,000 Others < \$7,500
Annual License Fee	\$300
Examination Fee	Varies by captive

Local Representation Requirements

- Maintain office in District
- Use Bank chartered in DC or with a branch located in DC
- Employ or contract with attorney licensed to practice in DC

SRS News

Client News – SRS is pleased to welcome the following new captive clients:

- **BB&T Assurance Company Ltd**, SRS was selected as the new captive manager for this Class III insurance company in Bermuda. The appointment was effective January 1, 2005
- **NFI International Ltd**, a Bermuda domiciled captive selected SRS as its new manager effective January 1, 2005. NFI is a single parent captive owned by NFI International, a leading US logistics firm.
- **Watch Hill Insurance Company**, FM Global selected SRS to manage its newly formed sponsored captive, Watch Hill Insurance Limited domiciled in Vermont.
- **Pental Insurance Co Ltd**, SRS was selected as the new captive manager of Pental, a single parent captive domiciled in Bermuda. Pental is owned by Tidewater Inc, a provider of offshore marine services.
- **Insurance Services (Bermuda), Ltd**, Johnston Enterprises selected SRS to manage its newly formed single parent captive domiciled in Bermuda. Johnston Enterprises is a provider of grain storage, processing and transportation services.

Our People – SRS is pleased to announce the addition of Carla Fiske as an Account Manager in Vermont. Carla was most recently an accountant in the Finance Department of Swiss Re. Previously she was an Account Executive for seven years at SINSER Management Services in Vermont. She has extensive experience working with single parent captives, associations and risk retention groups.

Educational Program – In May, SRS initiated a series of web based seminars on issues affecting captives. Seminars will be offered monthly. The next scheduled seminar is "Employee Benefits in Captives" to be presented by Michael O'Malley at 1pm EDT on June 8th.

SRS web seminars are hosted at our Webex site (<http://srs.webex.com>). Check out and register for upcoming seminars within the **Event Center** section of the site. You may also view recordings of previous seminars in this site.

Events – Look for SRS at the upcoming **ICAP International Captives conference** at the Ritz-Carlton Orlando Florida, June 13-15.

SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate. SRS is an approved manager of captive insurance companies in Arizona, Bermuda, Cayman Islands, D.C., South Carolina & Vermont. Through a wholly owned subsidiary SRS is also licensed as an insurance broker in Bermuda.

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