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Property Insurance and Captives

After the loss of surplus in the insurance industry in late 2008 and the pending hurricane season, property premiums and coverage may be entering a period of instability. Could captives provide an anti-dote to a hardening market offering coverage to support commercial market programs?

The Nature of Property Risk

The conventional wisdom is that captives aren't appropriate for property insurance due to the nature of the risk:

- Large concentrations of risk, both by location and accumulations of properties exposed to a single catastrophic event means that there is little spread of risk. High severity and low frequency losses of this nature are typically not well suited to captives as they require a lot of capital to cover the volatility.
- Short-tail: unlike casualty risk, there is no delay in knowing about losses incurred during the year. Captives can not benefit from holding IBNR reserves taking away one of the major advantages of captives over deductible programs.

So where can a captive provide solutions for property risk? It won't be in all cases, but in certain situations the captive can be a valuable risk financing tool. In this newsletter we present four such situations in case studies.

Deductible Buy-Down

This case study involves a property manager with coastal real estate in Florida. The company is organized into several different operating companies. Key risk characteristics are:

- \$300 million in property values exposed to Florida windstorm.
- 5% per event per location windstorm deductible.
- A loss limit of \$50 million.

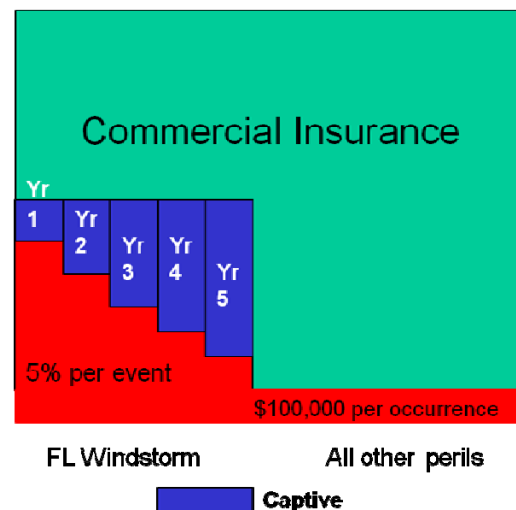
The company is concerned about the potential accumulation of retained losses within the windstorm deductible.

Captive Program — The captive was used to buy-down the windstorm deductible. With no losses in the early year, the fund to pay for losses within the deductible increases (Exhibit 1).

With the property owner's diverse organizational structure it is able to demonstrate risk distribution and shifting qualifying as an insurance company for tax purposes. Annual premiums are less than \$1.2 million, allowing the captive to take a 831(b) election.

Under the 831(b) election, the captive does not have to pay income tax on underwriting income. This structure means that all of the captive's underwriting income is added to surplus increasing the windstorm fund in a tax efficient manner.

Exhibit 1



One enhancement to this structure is to add some aggregate reinsurance into the buy-down layer to protect against an accumulation of events in a year. This reinsurance protection may be structured as a third and/or fourth event reinsurance. The captive or the insured would only be responsible for the first and second event. As the captive's windstorm fund builds up with good loss experience, the reinsurance can be pushed further out.

Shared and Layered Programs

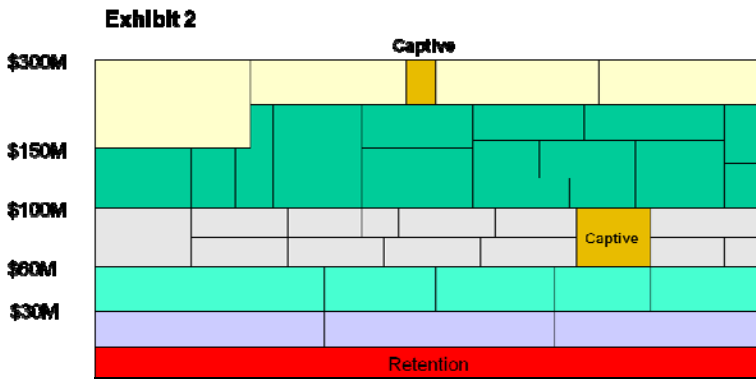
The second case study involves the strategic use of a captive in a shared and layered program. The insured is a large utility with the following risk characteristics:

- A concentration of assets in a small number of locations.
- \$300 million MFL.
- Significant earthquake and windstorm exposure.

The company insures its property risk to the \$300 million MFL using capacity from the global insurance market. The structure of the program varies considerably with market cycles. In the soft market when there is plenty of capacity, the program has a simple layered program with limited syndication and consistent terms.

In a hard market, the price and availability of capacity means that the program is more complicated with:

- Smaller and inconsistent layers
- More syndications
- The potential for inconsistent terms and pricing with follow markets having greater influence over terms than previously.
- Gaps in layers and shortage of capacity.



Captive Program — In this structure, the captive serves two purposes:

1. To fill holes and provide capacity where there is a shortage
2. To maintain consistency in pricing and terms. The insured is able to use the captive as an alternative to commercial insurers improving its negotiating position

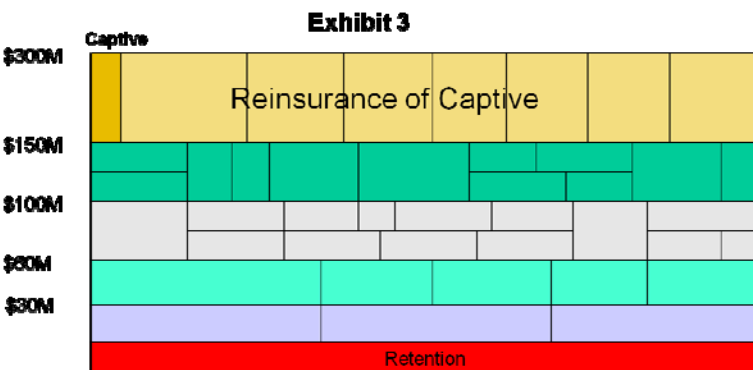
The benefit of the captive is both the returns in the layer it participates and the savings in pricing across the program.

%	Layer	Retention	Premium	Savings
5%	\$100M xs \$200M	\$5 Million	\$100,000	\$200,000
10%	\$40M xs \$60M	<u>\$4 Million</u>	<u>\$250,000</u>	<u>\$250,000</u>
Total		\$9 Million	\$350,000	\$450,000

The captive participates in two layers taking a total retention of \$9 million in exchange for a premium of \$350,000. This is a fairly high retention to premium for typical captive involvement. However, by using the captive, the utility is able to reduce premium by 10% in those layers generating an additional \$450,000 benefit.

Accessing Reinsurance

In a variation to the previous case study the utility uses its captive to front for the top layer of its property program (Exhibit 3).



The captive retains a small layer of risk (5%) and cedes the rest to reinsurers. This approach has two principal benefits:

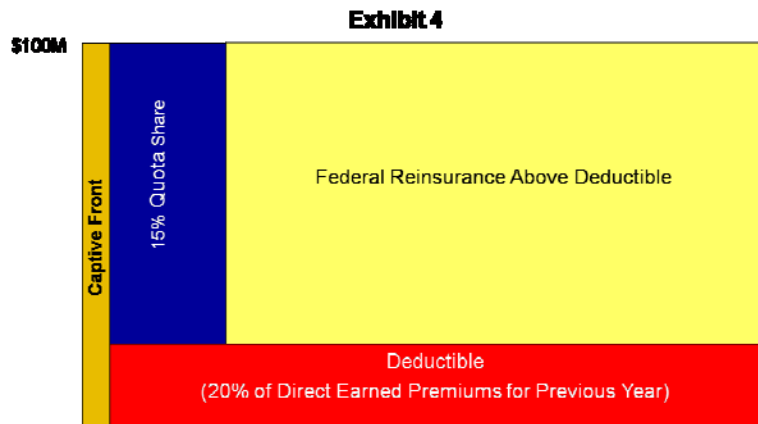
1. It can provide access to additional capacity available only in the reinsurance market.
2. It can reduce frictional costs. For example, FET on reinsurance premiums is 1% compared to 4% on primary insurance premiums.

Terrorism Coverage

The use of captives for terrorism coverage has evolved since the initial introduction of TRIA, but captives remain a valuable tool in effectively insuring terrorism risk. The fourth case study involves a hotel chain with exposures in high profile cities including New York and Las Vegas. The company has a \$100 million MFL and is concerned about traditional terrorism and Nuclear, Biological, Chemical and Radiation risks (NBCR).

Captive Program — Under a conventional insurance program terrorism coverage would be provided but NBCR risks would be excluded. The company uses a captive to provide the coverage.

The captive issues a broad form terrorism policy for \$100 million including NBCR. The majority of the risk is reinsured by the TRIA pool with terms following the primary insurance, i.e. including NBCR. The premium for the policy is \$600,000. Under the TRIA structure, the captive retains a deductible of 20% of the prior year's premium (\$120,000) and a 15% quota share or \$15 million. The captive retains this risk, although it could seek to reinsure it with the commercial market.



The captive also provides deductible buy-down coverage on the property program with the terrorism program being ancillary to that. TRIA has clamped down on captives set up purely to access the TRIA pool.

Conclusion

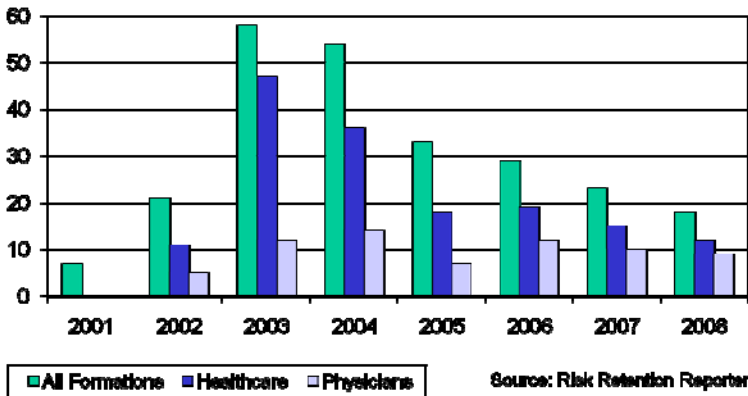
The nature of property risk makes it difficult for captives to handle property programs on their own. They are unlikely to be a stand-alone alternative to commercial insurance if and when the market hardens. As shown in these case studies, captives can be a valuable tool in supporting and structuring property programs in certain situations.

RRG Trends

In a follow-up to last quarter's look at the captive market, we focus on recent developments with Risk Retention Groups. 2008 saw a net growth in RRGs but at a slower rate than in the past five years. Several trends emerged both among new formations and in the slow-down or closure of some RRGs.

Trend 1: Physician Groups Gain Ground

Physician groups continue to dominate new formations as shown below. Premium has also been growing at a rate of 10% per annum



among physician owned RRGs as reported by the Risk Retention Reporter. New formations were concentrated in states experiencing a distressed commercial market. New York, which has had seen difficulties with its assigned risk program (MMIP), saw the most new physician RRG formations in 2008 with four new RRGs.

The risk retention group structure presents a couple of key advantages to hospitals and their affiliated physicians:

- The ability to write direct avoiding fronting costs and developing a direct link between the RRG and the physicians.
- A formalized funding structure whose premiums are acceptable for cost reimbursement.

Trend 2: Nursing Home RRGs are Re-emerging

Competition in the soft market had seen a slow-down among nursing home RRGs. 2008 showed signs of this trend reversing with the formation of a couple of new RRGs:

- Sigma RRG insuring a group of nursing homes in PA; and
- Select providers Reciprocal RRG insuring nursing homes in Arkansas.

At the same time some existing RRGs are struggling, including Connecticut Health RRG which closed in 2008.

Trend 3: Captives Convert to RRGs

Captives continue to use the structural benefits of a risk retention group in their development strategy. There are several ways in which a RRG can complement or replace an existing captive:

- Direct writing of liability risks as a companion to a property or workers compensation captive.
- Conversion of an existing captive to write direct as a RRG.

- Fronting of a captive through a RRG to manage regulatory risk.

Recent formations in this area include:

- ICI Mutual RRG: VT domiciled RRG owned by mutual fund investment companies. Converted from group captive structure.
- Public Utilities RRG: VT domiciled RRG owned by non-profit and publicly owned utilities. Converted from a group captive structure.
- Church of God of FL: NV domiciled RRG owned by 450 Church of God churches in FL. Formed as the liability insurer to accompany a segregated cell company insuring property exposures.

Trend 4: Contractor RRGs are Struggling

Contractor RRGs have been affected both by competition from the commercial market and a down-turn in the economy which has reduced the volume of premium written in this industry sector. Premiums declined by 34% in 2007 and by a further 32% in 2008 (Risk Retention Reporter). Closures of RRGs have been concentrated among residential contractors in states most affected by the economic slowdown.

Recent Closures—Contractor RRGs

RRG	Members
Bridgetown	Residential construction contractors in OR and WA
Cornerstone Insurance	Residential contractors in 6 western states
Builders Ins. Assoc.	Homebuilders in VA
Citadel Insurance	Residential homebuilders in CA, DE, GA, NV
Contractors Liability Ins	General contractors in CA, GA, NV
Quadriga Builders Ins	Residential contractors in MN
Texas Construction Ins	Contractors in TX

Trend 5: Extended Warranty RRGs are Declining

The appeal of RRGs for insuring service contracts of auto dealers appears to be declining. There have been some well publicized failures which have led to greater scrutiny of these programs. These arrangements also rely on a contractual liability definition which has been challenged in the past year, mainly in relation to insuring employee benefits. Recent closures among extended warranty RRGs include:

- Capital Assurance: a South Carolina domiciled RRG
- GSFI: a South Carolina domiciled RRG for Toyota auto-dealers. Merged with Sentruity Casualty Company, a sister property and casualty insurer.

Trend 6: Employee Benefits Stalled

One of the most significant developments for RRGs in the past year was the State of California's challenge of Auto Dealers RRG insuring employee benefits. Under this structure the RRG issues a contractual liability policy to reimburse an employer for payments under its benefits plan. Auto Dealers RRG backed off the structure in CA in the face of the challenge, although the case did not resolve whether this structure was within the scope of the Federal Risk Retention Act. The

willingness of States such as California to challenge the structure has served to slow down the use of RRGs for employee benefits. There remains considerable interest in this area and we anticipate that there will be further developments in the next year.

Projections

The past couple of years has seen some consolidation in the RRG market. Some have not survived while others have been successful and are well positioned to respond to any hardening in the market. New formations will continue in specialist areas such as physician groups but there will also be closures. Overall, we expect modest net growth in RRGs in 2009.

Domicile News

Vermont Governor Signs New Captive Legislation

On May 27, Governor Douglas signed into law the omnibus banking and insurance legislation, S.42. The new legislation includes two key provisions designed to enhance Vermont's leadership position among US domiciles.

- Provisions to attract non-US owned captives. The legislation allows Vermont captives owned by foreign parents to use the financial accounting methods used by their foreign parents. The legislation also streamlines the re-organization of a foreign captive company into a Vermont captive.
- Incentives for new formations: a premium tax holiday of up to \$7,500 for new captives formed after the legislation takes effect and until 12/31/2010.

Other provisions increase the amount of funding allocated to the regulation of captives in the State.

Bermuda Signs Tax Information Exchange Agreements

Bermuda recently signed two important Tax Information Exchange Agreements (TIEAs) with:

- Canada: Following the signing of the TIEA, an important benefit will extend to Bermuda that previously had been conferred only to countries with which Canada has a double tax treaty in force. Dividends, of foreign affiliates resident in Bermuda, that are paid to their Canadian parent companies out of the active business income earned in Bermuda, will be exempt from Canadian taxation. This change makes Bermuda very competitive as domicile of choice for Canadian captives.
- The Netherlands: the signing of this TIEA in early June triggered Bermuda being designated as an OECD "White List"

jurisdiction which has "substantially implemented the internationally agreed tax standard.". Bermuda's elevation to the OECD "White List" category demonstrates Bermuda's commitment to upholding the international tax standards set by the OECD and the G20 group.

Cayman Update

Ron Sulisz recently provided an update on developments in the Cayman Islands as part of his Chairman's Report for IMAC Quarterly. Read the report at <http://67.199.119.196/sites/default/files/IMAC-Newsletter-April-2009.pdf>

SRS News

Staff News

Justine Holeman has joined SRS as an Accountant in our Charleston, SC office. Justine was formerly with Johnson and Lambert where she audited captives and risk retention groups in South Carolina and other domiciles.

Kristine Corella has joined SRS (Cayman) as a Client Accountant. Kristine was formerly an Audit Associate with Deloitte. She gained her CPA designation in 2006.

Events

August 11-13, VCIA 24th Annual Conference. SRS will be exhibiting at the conference. Stop by to visit with our senior management and Vermont personnel. Brady Young, Michael O'Malley and Derick White will also be presenting.

September 14-16, SCCIA 10th Annual Conference. Derick White will be moderating the regulator panel and members of our South Carolina office will be attending the conference in Charleston, SC.

SRS Webinar Series

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

- July 15: Insuring Physician Groups
- August 5: Captives 101

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

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.

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