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



Strategic Risk Solutions

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Soft Market – Impact on Captives

In a recent webinar, Brady Young discussed the impact of the softening insurance market on the formation and use of captives. This newsletter outlines some of the main conclusions from the webinar.

Premiums in the commercial insurance market have been declining since they peaked in late 2001 following the terrorist attacks of 9/11. The Counsel of Insurance Agents and Brokers market survey (2nd quarter, 2007) indicates that premiums are falling at a rate of 11% per annum and are at their lowest level since the survey was started at the end of 1999.

It is a commonly held belief that the rate of captive formations and their use declines in a soft market. So is the current soft market negatively impacting captives? **The evidence shows that activity is still strong, although some areas such as group captive formations are down.** This is less to do with anomalies with the current soft market than misperceptions about captives in a soft market.

Captives have been steadily increasing in numbers over the past twenty five years. Since the late 1980s the number of captives worldwide has increased at a rate of approximately 4% per annum. The rate of increase has been consistent and unaffected by hard or soft markets. There are now roughly 5,000 captives worldwide and the moderate growth rate is more reflective of a mature captive market than the effects of commercial market cycles.

Exhibit 1: Captive Growth Rates

	<u>2005</u>	<u>2006</u>	<u>#s</u>
Bermuda	(1%)	3%	894
Cayman	6%	1%	740
Vermont	5%	5%	563
Hawaii	7%	1%	160
S. Carolina	18%	21%	140
Arizona	48%	43%	85
DC	48%	19%	70
Nevada	<u>49%</u>	<u>62%</u>	<u>99</u>
Combined	6%	6%	2751

In addition to the long-term trend, the recent growth in formations remains strong. In the eight domiciles in which SRS operates, the number of captives has increased at a rate of 6% per annum over the past two years (Exhibit 1).

This is slightly down from the prior couple of years, but still strong. **Growth has been strongest onshore** where there has been considerable competition among the domiciles themselves to attract captives. Offshore domiciles have seen some slow down in captive growth. The shift between onshore and offshore is due to:

- Increased competition from domestic domiciles.
- Liquidations in mature domiciles.
- Re-domestications.
- Some unique advantages of domestic domiciles: ERISA benefits, RRGs, and access to TRIA.

Single Parent Captives

The soft market is exerting minimal pressure on single parent captives. These vehicles are typically formed as an alternative to self-insurance, either qualified self insurance or self insurance through large deductible programs. They are rarely formed as an alternative to conventional insurance. **As a result, changes in the commercial insurance market have little impact on the decision to form or use a single parent captive.**

As captives are still reliant on the commercial insurance and reinsurance markets to provide support to their programs, the softening of the commercial market is having a beneficial effect on single parent captives.

- Fronting is becoming more available with some competition on price.
- Collateral requirements are easing.
- Attachment points are being lowered both on per loss and aggregate basis. Adjusting attachment points is the most significant area in which single parent captives are adjusting to the softening commercial insurance market.
- Insurers are more willing to unbundle services supporting the captive program (fronting, reinsurance, claims handling, loss control).

Single parent captives continue to be formed as part of the risk financing strategy of their parents. The perceived benefits vary on a case by case basis but include:

- The ability to achieve tax deductibility on funds accrued to pay for self insured losses. The current tax situation is more favorable to captives and more clearly defined than in previous years.
- The need for a more formalized funding mechanism than self insurance
- For unique program structures such as ERISA benefits or TRIA.

We continue to see a strong rate of formation of single parent captives. There is interest in all industries and risk areas, although those which are still relatively distressed are seeing the highest rates of formation. These include construction defects, mold and fungi exposures, windstorm risks, real estate and healthcare.

Group Captives

Group captives face the greatest pressure from the commercial market. Their members are typically middle market accounts who lack the size to retain significant amounts of risk on their own. Group captives are one of the few options to commercial insurance.

Reductions in the cost of commercial insurance make group captives a less attractive option. As a result we are seeing a drop-off in the rate of new formations.

Group captives are particularly difficult to put together requiring a group which is comfortable in sharing risk and cohesive enough to stay together for the long-haul. With commercial rates dropping, the challenges of putting the group together are exacerbated.

One area where formations are still strong is risk retention groups (RRGs). Numbers had been declining through the soft market of the 1990s, but there has been a significant increase in numbers post 9/11. The increase co-incident with the hardening of the insurance market post 9/11 and RRGs proved to be an attractive option for liability risks in many industry sectors. The growth also co-incident with an increase in the number of domestic domiciles. Many of the new RRG formations have been domiciled in less mature domestic domiciles.

In the last couple of years, the commercial market has softened and the regulation of RRGs has tightened, fueled in part by a report by the Government Administration Office. Despite these changes, the growth rate for RRGs remains strong and in line with the growth post 9/11.

Group captives remain an attractive option in the right situations. These typically involve a cohesive group, which probably exists outside the captive, and an industry sector which is still fairly under-served by the commercial market

Conclusion

Captives are a long-term risk financing solution. They provide consistency in the availability and cost of insurance.

Short-term changes in premium rates in the commercial market have been shown to have a minimal and isolated impact on the captive industry. The signs are that the same is true of the current soft market. There may be some tactical changes in the use of captives such as the lowering of attachment points. There may also be some weeding out of marginal captives.

Those with solid reasons for forming and a long-term commitment will continue to be formed and will continue to deliver value to their owners.

Western Domiciles Round-Up

With SRS's recent expansion into the western United States, this article provides an overview of the leading captive domiciles in the region.

Arizona

Arizona officially became a captive insurance domicile after enacting legislation in 2001. Arizona has been in the business of licensing and regulating insurance companies for many years. When counting both traditional and captive insurers Arizona regulates more insurance companies than any other major captive domicile and is positioned to handle all of the analysis functions required for regulation in-house.

As a result of this in-house expertise, the application and examination costs are kept lower than other domiciles. Recently the Captive Administrator announced that pure captive insurance companies will only be examined if the Department deems it necessary. Unlike most other domestic domiciles, Arizona does not charge a premium tax.

Arizona has a broad network of experienced and capable service providers doing business in the domicile with a vibrant captive insurance association. The regulators and association work together to review legislative developments to ensure Arizona maintains a competitive domicile with sound regulation. During the 2007 legislative session the captive laws were amended to allow formation of Branch captives; enable pure captives to form as an LLC; enable group captives to cover controlled unaffiliated business; reduce the minimum capital for cell captives to \$500,000; allow a pure captive to have only 1 Director and a Group only 3; give the Director the authority to expend monies in the captive insurance regulatory and supervision fund to pay costs of administering the captive insurance law and to promote Arizona's captive insurance industry; and other clarifying laws.

At December 31, 2007 Arizona regulators are projecting to have licensed 100 captive insurance companies. Pure captives represent 68%; RRG's 24%; Agency 3%; Other Group 3% with 1 Protected Cell company.

Hawaii

Hawaii has been the premier captive insurance domicile of the Pacific since passing legislation in 1987. Despite the slow down in captive formations and the proliferation of new captive domiciles in the U.S., Hawaii licensed 8 new captives in 2006 for several large and prominent national and international companies ending the year with 160 captive insurance companies.

For several years now, the Hawaii regulators and service provider representatives have annually traveled to Japan to meet with the local insurance professionals and provide education regarding the Hawaii captive insurance industry. The sophistication of the Asian/Japanese risk managers and their use of captives continues to evolve.

Hawaii regulators and industry professionals keep abreast of legislative developments to ensure Hawaii maintains a competitive domicile with sound regulation. During the 2007 legislative session the captive laws were amended to allow captives to organize as LLC's; simplify and consolidate minimum capital and surplus requirements; enhance captive investment opportunities; remove the requirement for a local resident director and incorporator; establish a \$200,000 cap on premium taxes and designate the Captive Insurance Administrator as a Deputy Insurance Commissioner.

The outlook for Hawaii is to continue to attract and retain captive organizers looking for prudent, consistent and responsive regulatory environments complimented by a network of experienced professional services providers.

Montana

Montana passed captive legislation in 2001. Growth has been slow but steady since that time. As of August 2007, 26 captive licenses have been issued and the Department projects they will exceed 30 by year end.

During the legislative session in 2007 the captive laws were amended to allow pure captives to insure controlled non-affiliated business; reduce minimum capital and surplus requirements for protected cell companies to \$500,000, reduce minimum capital and surplus requirements for reinsurance captives and clarify the law related to risk retention groups. The captive law had overwhelming support in the state legislature.

Montana now has a vibrant captive association which held its annual meeting in July with about 90 people in attendance.

The Insurance Department has committed resources to add staff to keep pace with the captive formations. The regulators are open to new ideas and as reported in the Risk Retention Reporter, Montana was the first domicile to allow the formation of a captive to provide stop loss for health insurance.

Nevada

Nevada became a captive insurance domicile after enacting legislation in 1999. The Nevada Insurance Department and local Association has taken an active role in promoting Nevada with involvement from the Commissioner, Chief Administrator, and more recently the Economic Development Commission.

March 20, 2007 Nevada announced the licensing of their 100th captive. As of December 31, 2006 Nevada had 90 active captives.

On June 15, 2007, the Commissioner Alice A. Molasky-Arman, announced the appointment of Gary Cooper as the Deputy Commissioner of Captives in response to the Commissioner's request to create a high profile and increasingly responsible position to head Nevada's captive program. Mr. Cooper has been with the Nevada Insurance Division since 2004 as the chief insurance examiner of the self-insured workers' compensation section where he was responsible for the financial and regulatory oversight of the individual and group self-insured workers' compensation programs.

During this past legislative session the captive laws were enhanced to combine the level of capital and surplus and establish the position of Deputy Commission of Captives. The annual premium tax is a minimum of \$5,000 and is capped at \$175,000.

Nevada has an active association which will hold their annual meeting on November 15 – 17th in Los Vegas at Caesars Palace.

Utah

Utah joined the western domiciles when legislation was passed in 2003. During the legislative session in 2004 Utah enhanced the captive laws to eliminate premium taxes. During both 2005 and 2006, 14 new licenses were issued bringing the total licensed captive count to 30 at December 31, 2006. Of the 30 licenses issued, 29 are pure captives and 1 is a risk retention group. An additional 10 licenses have been issued during 2007.

Currently the Department is drafting Captive Insurance Law Amendments to provide for a Special Purpose Financial Captive statute that will meet the needs of Triple X participants. The domicile has strong support from the Governor, Commissioners office and the Utah State Legislature.

For further information on the Western Domicile Options please contact Ann W. Wick, CPA, President, Strategic Risk Solutions (Arizona), Inc. 602-903-0318.

SRS News

SRS Heads West. Hires Industry Veteran Ann Wick

In July, SRS announced plans for an expansion of its operations into the western United States. A regional office in Arizona will manage captives domiciled in the state as well as overseeing SRS's operations in Nevada and Hawaii.

Ann Wick, a twenty year captive industry veteran joined SRS as President of SRS Arizona August 1, 2007. She is based in Arizona. Ms Wick was formerly with AIG Insurance Management Services, Inc, where she oversaw AIG's domestic captive operations. At SRS she will be responsible for the growth of the western region operations, including the management of captives in western US domiciles and supporting SRS's brokerage partners in the region.

SRS has been managing captives in Arizona since 2003. We are seeing continued growth in this domicile and other new domiciles in the western US. We are also increasingly working with clients and partners in the western region. Our expansion allows us to better serve those companies and domiciles.

Client News

SRS is pleased to welcome the following new captive clients:

- **VMC Indemnity Company, Ltd**, appointed SRS as Insurance Manager effective July 1, 2007. VMC Indemnity is a Bermuda domiciled captive owned by Fletcher Allen Healthcare.
- **Brayson Insurance Company**, a newly formed pure captive in South Carolina, has appointed SRS as manager. The captive is owned by Brayson Homes a privately owned homebuilding firm.
- **Dealer Management Group, Ltd**, a Cayman Islands group captive, appointed SRS as Insurance Manager effective July 1, 2007. The company is a homogenous captive serving the risk management needs of companies in the automobile dealership industry.
- **CI Ltd. SPC**, a newly formed Cayman Islands segregated portfolio company, has appointed SRS as Insurance Manager. CI Ltd is owned by one of the

largest providers of insurance and risk management services to the transportation industry in the Midwest United States.

Our People

SRS is pleased to welcome the following new hires:

Nancy Velasquez has joined SRS Arizona as an Account Manager in our Arizona office. Nancy will manage captives in Arizona and other western US domiciles. She has over 20 years experience in the captive management industry. Nancy was most recently with AIG Captive Management.

Saldea Arboladura has joined SRS as an account manager in the Bermuda office. She was formerly a senior auditor at KPMG Bermuda where she worked with captive insurance companies as well reinsurance and long-term insurance companies. Saldea is a CPA and has a Bachelors of Science degree in Accountancy (Cum Laude) from the University of Santo Tomas, Manila, Philippines.

Events

SRS will be participating in the following upcoming industry events:

- **Oct 9: CICA Fall Seminar, Dallas.** Ann Wick from SRS Arizona will be attending the conference to be held at the Hyatt Regency, DFW airport.
- **Oct 9: VCIA Road Show, Chicago.** Michael O'Malley will be attending the road show to be held at The East Bank Club.
- **Oct 10-13: ASHRM Annual Conference, Chicago.** Wayne Cowan and Ron Sulisz from SRS Cayman will be attending the conference to be held at the Hyatt Regency.

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

SRS Webinar Series

SRS hosts periodic webinars on topical issues affecting the captive insurance industry. To ensure you are included on the distribution list for webinar announcements, 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.

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

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