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



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Capital Demands

Insureds who are looking to retain risk in the current hard market are finding that the problems of securing the credit risk associated with these retained risk programs are threatening the viability of many options. This article, drawn from a speech made by Michael O'Malley, Director – Consulting Services, at the World Captive Forum in November examines the capital demands on captive programs and techniques to manage the problem

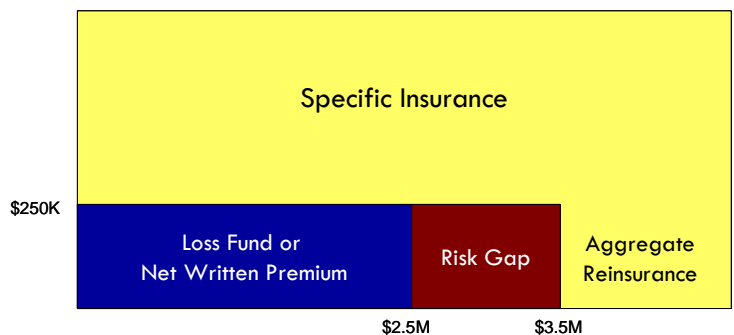
Capital - The Need for Collateral. When an insured retains risk, it may create a structure where it is required to reimburse another party for the losses it incurs. While the insured itself retains the risk of loss, the other party assumes the credit risk that the insured will be unable to meet its obligations to pay losses. For a captive this situation typically arises with a fronted program where an admitted insurer (the front) cedes a portion of risk to a captive. The front will require collateral to secure the credit risk associated with the captive's participation and to avoid Schedule F penalties. These penalties relate to NAIC filings and arise where reinsurance is placed with a unrated insurer. In essence, without collateral, the reinsurance is not recognized on the fronting company's books.

Collateral may be provided in several forms including cash, letters of credit, regulation 114 trusts, bonds and marketable securities. While the forms of collateral vary the impact is the same. Money is taken out of the insured's business to secure its retained risk position. The posting of collateral has a significant cash-flow impact on the business and can have high opportunity costs associated with it. Direct costs are typically in the range of 25-50 bps.

How Much is Needed? Most captive programs are put together with an aggregate limit at some multiple of expected losses, e.g. 150%. The captive is responsible for payment of losses up to the aggregate and is typically required to post collateral to its full aggregate participation. What this means is that an insured considering a captive program will be required to set aside funds above and beyond the expected losses for the year. This excess is referred to as the "risk gap". The need to provide funds for this risk gap is often what determines the level of capital needed to support a captive program, not the requirements of the regulators in the captive's domicile. In the example, collateral of \$3.5 million will be required to match the captive's aggregate position. \$2.5 million is provided by the loss fund, but an additional \$1 million (the Risk Gap) must be provided from other funds

The nature of insurance contracts also creates a stacking problem over time. Claims will not be fully paid out for many years after the end of the underwriting period. Collateral will need to be held to secure the captive's position for earlier underwriting years, while posting additional collateral for the current underwriting year. At its extreme, this stacking problem can prevent the captive from participating in the program in future years

Exhibit A: Fronted Workers Compensation Program

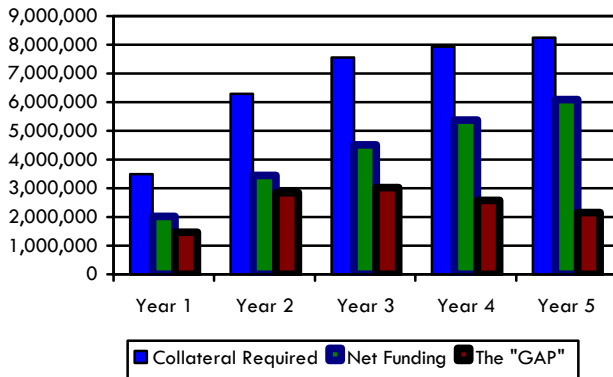


Managing the Collateral Problem. There are several techniques that can be used to manage the collateral problem:

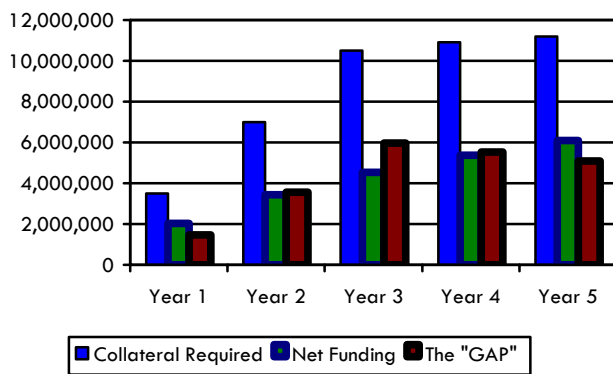
- *Go direct:* for lines not requiring admitted, rated paper, companies can go direct to their captives and avoid the restrictions and costs related to fronting. (look for more on fronting versus direct in future newsletters).
- *Lay-off some of the risk:* this may be done through a stop-loss reinsurance program to meet the gap between expected losses and the captive's aggregate limit, or through a quota share reinsurance. The costs of these programs will usually exceed the direct costs of the collateral. They are best used where the captive is unable to post further collateral or there is a significant opportunity cost to posting collateral
- *Structure long-term relationships* that allow for flexibility in reducing collateral requirements in subsequent years. Fronting insurers will often limit on-going collateral requirements to expected losses at the end of the underwriting period. With good loss experience this will release collateral for use in the current underwriting year. In the exhibit, total collateral is held to approximately \$8M with a gradual release compared to \$11M+ under a program that holds each underwriting year's collateral for three years
- *Manage losses:* improving loss experience during the year will free up more capital under a program with a gradual release of collateral according to loss experience. Claims reviews to close outstanding claims and reduce paid loss development patterns can also help free up collateral



Collateral – Gradual Release



Collateral – Three Year Hold



The need for collateral can be a high hurdle for many prospective captive owners. Companies in a weak financial position or with high levels of debt may find other financing alternatives more attractive. However, the need for collateral exists in most retained risk programs. Establishing a captive as the formalized, regulated risk financing vehicle for the program can have benefits in obtaining collateral to secure the insured's risk taking position.

Domicile Update: South Carolina

Since South Carolina passed its captive legislation in June 2000, the state has grown rapidly as a captive domicile. At its current growth rate, South Carolina is on track to pass Hawaii as the second leading onshore US domicile this year. This update looks at some of the reasons for South Carolina's growth and recent changes in the domicile.

Regulatory Environment: South Carolina's captive legislation is broadly similar to that of Vermont and other onshore domiciles. It includes provision for captives, RRGs and protected cells. What is different about South Carolina and has promoted its rapid growth is the State's commitment to build the regulatory infrastructure and promote its captive legislation. South Carolina created a separate division within the Department of Insurance specifically focused on captives: the Alternative Risk Transfer Services. This division sits alongside divisions regulating commercial insurers in the State and reports directly to the Insurance Commissioner, Ernest Csiszar. The division actively promotes South Carolina

as a captive domicile through a full-time Business Development position. Regulatory resources have been added in the division in response to captive applications. There are currently five full-time regulators dedicated to captives in South Carolina.

Why South Carolina? South Carolina offers a couple of major advantages for captive owners:

- **Location:** for companies based in the SE United States, South Carolina is an attractive alternative to Vermont or other onshore domiciles, simply by its proximity to the parent companies. The ability to easily involve senior management in a captive subsidiary can bring greater attention to the captive and the risk management program of the organization(s).
- **Flexibility:** in keeping with its growth goals, SC has been more flexible in bringing captives to the State. This flexibility has seen a higher proportion of RRGs formed in South Carolina compared to Vermont. We believe that SC's flexible approach is likely to continue in the short term, but will inevitably tighten up as the domicile matures.

Recent Changes: in June 2003, South Carolina made three changes to its captive law:

- Allowed the formation of captives by Limited Liability Companies. Previously LLCs had to receive a special category designation by the Department. They are now included in the statute. This change closed a potential gap in the captive law. Vermont passed similar legislation in 2003
- Capped premium taxes at \$100,000 annually. No SC captive has reached this level, but the cap was introduced in an effort to attract larger captives to the State. Vermont also passed legislation in 2003 imposing a cap on premium taxes at \$200,000
- Fee increases: an additional fee of \$2,500 was included in the legislation to cover the costs of examining captive applications. Most examinations are performed by the ARTS division and this fee will cover internal costs and/or the option of using external resources. Annual license renewal fees were also increased to \$500 from \$300.

Looking Ahead: the captive industry has been one of the success stories for the state and is likely to continue to receive strong support and promotion. The regulatory infrastructure is established and the service infrastructure is expanding with many of the leading captive service providers establishing operations in the state. Within the next three years we anticipate that South Carolina will see upwards of 200 licensed captives and an established position as the second leading onshore US domicile. Also expect some new regulatory initiatives. At the SCCIA annual conference in December, Ernest Csiszar outlined a vision for a free trade services zone around Charleston to service the insurance and captive industry in the state. Stay tuned!

South Carolina Captive Fact Sheet

Applicable Legislation. Captive legislation (Act 331) creating South Carolina as a captive domicile was signed June 2000. The captive industry in South Carolina is governed by South Carolina Code of Laws Title 38.

Number of Captives. 69 licensed (65 active) as 12/31/2003. Active captives break down as follows

Pure captives	29
Risk Retention Groups	31
Sponsored captives	2
Special purpose captives	3
Total	65

Capitalization & Solvency Requirements

	Capital	Surplus
Pure captive	\$100,000	\$150,000
Association stock	\$400,000	\$300,000
Association mutual	n/a	\$700,000
Industrial Insured stock	\$200,000	\$300,000
Industrial Insured mutual	n/a	\$500,000
Sponsored	\$500,000	\$500,000
Reciprocal	n/a	\$1,000,000

Premium Taxes

Premium Level	Direct	Reinsurance
\$0 - \$20 million	0.4%	0.225%
\$20M - \$40M	0.3%	0.150%
\$40M - \$60M	0.2%	0.050%
\$60M +	0.075%	0.025%

Minimum:\$5,000; maximum: \$100,000

Local Representation Requirement:

- At least one board meeting held in the state
- Maintain principal place of business in the state
- Appoint a resident registered agent in the state.
- One member of the Board must be a SC resident

Regulatory Fees

Application Fee	\$200
Examination Fee	\$2,500
Annual Insurance License Fee	\$500
Audit Fee	Subject to negotiation

SRS News

Client News - SRS has been pleased to welcome a number of new clients in the past quarter. These include:

- Salt River Project** who selected SRS to manage their newly formed Arizona captive
- Cinergy** who selected SRS to assist in the formation and management of a Vermont domiciled captive.
- Synernet**, a group of Maine hospitals, selected SRS to manage the re-domiciling of their group captive from Barbados to Vermont. SRS will also provide on-going management to the captive in Vermont

SRS expands into Arizona - In December 2003, SRS was approved as a captive manager in Arizona and established an Arizona subsidiary to manage captives in this domicile. Arizona is a growing captive domicile and an attractive west coast option. SRS is pleased to be represented in Arizona and at the forefront of the domicile's development. Watch for further information on Arizona in a future domicile update.

SRS sees strong growth in 2003 - In its first full year of independent ownership SRS saw solid growth in its captive management business with a more than 30% increase in its client base. Brady Young, President of SRS commented "2003 was a very successful year for us and saw us successfully establish SRS as an independent player in the captive market. We had strong growth in our business which has allowed us to make a number of key hires and expand our base of operations. We are excited about the prospects for 2004 and the opportunity to establish SRS as the leading independent captive manager throughout the domiciles in which we are represented."

Our People - SRS is pleased to announce the addition of **Richard Winchell** to our Bermuda office. Richard joins us from Centre Re and will be responsible for growing our captive management and wholesale brokerage operations in Bermuda. **John Green** also joined our team in Orlando as part of Choice Underwriters, a SRS joint venture with the Florida Association of Independent Agents. John will initially be responsible for underwriting workers compensation on behalf of Choice.

SRS provides underwriting, management and wholesale brokerage services to 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.

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