



180°

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



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Selecting a Domicile

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The past few years has seen a proliferation of US states passing captive insurance laws. With more than half of US states having captive insurance laws and new offshore domiciles developing, the selection of a domicile has become increasing difficult. In this quarter's newsletter we examine the critical factors that should drive the selection of a domicile. Some of these factors restrict options to either onshore or offshore, while others are a matter of choice between individual domiciles.

US Federal Regulations: certain classes of US business can only be underwritten onshore. These restrictions typically apply to lines of coverage or captive structures that require Federal approval or utilize a Federal regulation. The government is limited in jurisdiction and hence will only grant the rights under the regulation to US domiciled insurers. Examples of programs subject to Federal regulation include:

- Risk Retention Groups: the Federal Risk Retention Act only applies to group captives which are domiciled in the US.
- Employee Benefits: captives insuring ERISA benefits must obtain or qualify for an exemption to the prohibited transactions rules of ERISA. This requires approval by the US Department of Labor. In its guidelines for approval under the EXPRO process, the Department of Labor requires that the captive or a branch of the captive be domiciled in the US. This situation only applies to benefits which fall under the US ERISA regulations. Non-ERISA benefits can be insured both onshore and offshore and captives have been insuring non-ERISA benefits for many years.
- TRIA: as the deductibles under this program are based on the insurer's total premium, captives have been able to access the TRIA pool at a lower attachment level than commercial insurers. Access to TRIA is limited to US domiciled insurers requiring a captive to be domiciled onshore.

If a prospective captive is considering using one of these regulations, either now or at some time in the future, it would favor selecting an onshore domicile. An onshore branch can also be used to allow offshore captives access to some of these Federal programs.

Third Party Business: US states have created specific regulations for captive insurance companies, distinct from commercial insurers operating in their states. To create this separation between captives and commercial insurers, the states have had to limit the activities of the captive principally to the risks of its owners. A limited amount of third party business is allowed, but regulators will want it to be incidental and controlled by the owners of the captive. Captives in offshore

domiciles operate under the general insurance laws of those territories, not necessarily specific captive laws. While there may be different classifications and capital requirements for captives underwriting the risks of its owners to third party business, the same insurance laws will accommodate both. Any captive writing a significant amount (>20%) of third party business will probably be limited to an offshore domicile.

Local Captive Regulations: while the differences between captive regulations, particularly onshore, have reduced over the past few years, there are still some significant differences between the local regulations and their application. Capital requirements are a key issue. While most domiciles (other than Bermuda) use judgment in assessing the amount of capital that is required versus a formula approach, there is wide disparity from one domicile to another on what is considered reasonable. Capital requirements can be driven by other considerations, such as the need to post collateral to a fronting company. However the regulator is likely to require "free and clear" capital at least to the minimum capitalization levels applying in the domicile. Generally minimum capital requirements offshore are slightly lower than those applying onshore.

Investment restrictions in the local regulations can also be important. This will include the willingness of the local regulator to allow loan-backs to the captive's parent(s). This issue is not exclusively a local regulatory issue. The tax implications of using loan-backs will also factor into this decision. One other aspect of local regulations that should not be overlooked is the requirement for local Directors' meetings. Most onshore domiciles require an annual meeting of the Board in the state. Some offshore domiciles, such as Bermuda, have waived this requirement, although meetings may still need to take place outside the US if the captive does not want to be subject to US taxation. Consideration should be given to the willingness of Directors to travel to the domicile annually for these meetings. This can be an issue for some groups which are used to periodic meetings in different locations.

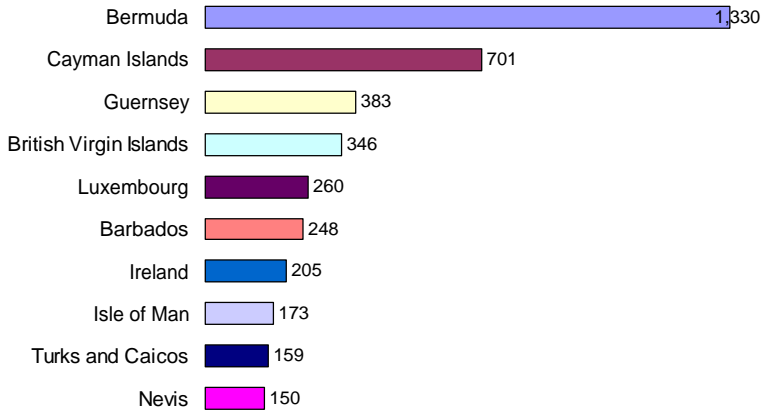
Taxation: there is often a misconception that captives domiciled offshore will not be subject to US income tax. Income from offshore operations will be consolidated into the parent company's taxable income either directly as part of an affiliate

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Domicile Overview

In the past issues of 180° we have reviewed various leading captive domiciles and identified the attributes that make the particular domicile attractive to captive owners. This quarter we look at the overall domicile picture, both onshore and offshore.

Exhibit A: 10 Leading Offshore Captive Domiciles



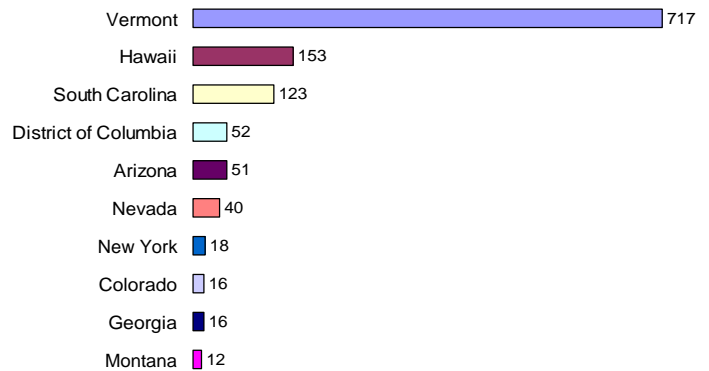
Exhibits A and B show the leading captive domiciles by the number of captive licenses issued as at September 1, 2005. This picture shows that while there have been a number of new captive domiciles formed, the market is heavily dominated by a few major domiciles. Offshore Bermuda and Cayman dominate particularly for US parents. These two domiciles have also been at the forefront of the growth in protected cell captives. The figures reported for licensed captives do not include the individual cells set up within these captives. Barbados has traditionally been an important domicile for Canadian owned captives on the back a tax treaty between those countries. The other Caribbean domiciles have benefited for some favorable tax treatment for smaller captives and have attracted several captives taking the 501(c)(15) or 831(b) elections. With the changes in eligibility for the 501(c)(15) election it will be interesting to see if these domiciles can maintain their growth and attract the larger captives. Guernsey remains the leading European domicile, supported mainly by UK owned captives. Dublin provides attractions of being able to underwrite directly into the EU. This combined with the growth of the commercial market in Dublin has led to tight regulation of captives in the domicile. Owners are still struggling with finding the right domicile for writing directly into the EU. There has been considerable interest in Malta, a recent entrant into the EU, as a possible solution.

Onshore domiciles have benefited from a growing trend of US owners preferring to stay onshore. Unless there is a compelling reason to go offshore, such as unrelated business of a capital advantage of the offshore domicile, US owners are likely to domicile their captives onshore. The onshore domiciles are heavily dominated by Vermont. There are currently 26 US states with captive regulation, but Vermont has more

licensed captives than all the others combined. Spurred on by the competition from the new entrants, Vermont continues to grow, while maintaining its strong regulatory reputation. Behind Vermont, the choices for captive domicile have improved considerably. All of the next five domiciles have gained critical mass and with dedicated captive regulators are well positioned to grow. Only Hawaii among the secondary group is a mature captive domicile. The other domiciles have grown to their present positions quite quickly. Whether they continue will depend on the returns that the states can see from their investment in the captive industry and their willingness to continue the funding. Other states, such as Colorado and Georgia, have reduced their commitment to the industry after initial investments and now account for a relatively small portion of the onshore captive market.

SRS is domicile neutral and looks to provide captive management services in the domiciles favored by our clients. At the present this includes the leading offshore domiciles for US

Exhibit B: 10 Leading Onshore Captive Domiciles



owned captives (Bermuda and Cayman) and the leading onshore domiciles with the exception of Hawaii. We will continue support the growth of these domiciles and monitor develop-

SRS News

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

- New Pembroke Ins. (Bermuda) Company Ltd selected SRS as the captive manager for this newly formed class 3 Bermuda insurer. SRS Underwriters was also selected as the underwriting manager for this facility.
- Ojai Indemnity Ltd, a Cayman based insurer specializing in 'bed and breakfast' property and liability covers, recently transferred the management to SRS (Cayman) Limited.
- Medical University of Ohio selected SRS as the captive manager for its recently formed captive domiciled in Cayman Islands.

Our People—SRS is pleased to announce that David Littlehale in our Vermont office has been promoted to Director.

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David has been with the firm for five years having previously been an examiner with the Vermont Department. We congratulate David on his well deserved promotion.

Events—SRS has continued its series of web seminars over the past quarter. Recent seminars include:

- Employee Benefits in Captives
- Vermont domicile update with Len Crouse and Derick White
- Captive Tax update

Recordings of these seminars are available for viewing on our web-site at www.strategicrisks.com. Details of future seminars will be distributed to recipients of the newsletter as they are scheduled.

SRS consultants were recent speakers at the first annual Bermuda Captive Conference and the ICAP conference on Alternative Risk Financing Solutions for Hospitals and Physicians. SRS will be exhibiting at the upcoming ASHRM conference to be held in San Antonio, October 23-26, 2005.

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group filing a consolidated return or through the Related Party Insurance Income provision. Indeed many offshore captives choose to take a 953(d) election and be treated as a US entity for tax purposes. This avoids having to pay Federal Excise Tax on premiums paid to the captive. From an income tax perspective, offshore captives can actually be at a disadvantage to onshore captives, due to the dual consolidated loss provision. This provides that net operating losses from offshore companies can not be used to reduce the taxable income of other members of an affiliated group. This provision applies whether the captive makes a 953(d) election or not.

The other taxation issue to consider in selecting domiciles is the level of premium tax. Many domiciles will apply a tax on premiums paid to the captive. Tax levels are relatively low, usually less than 1% of premium, and often capped. However, it does provide for some cost differences between domiciles. Most offshore domiciles, and some onshore, do not apply premium taxes, but impose an annual fee instead.

Infrastructure: a key differentiator between the newer and more established domiciles is the quality of the infrastructure. This applies to both regulators and service providers. It is important that the domicile have experienced regulators who understand captives and who are available to answer a captive owner's questions. There should be a consistent track record of captive regulation in the domicile so captive owners can understand not only the regulation but how it is applied in the domicile. This can be a challenge for newer domiciles which are just getting started. High turnover of

regulatory staff should be viewed with caution as it can create inconsistencies in the application of the regulations.

The reputation of the domicile is also important. Several of the newer domiciles, in their quest to attract business, have provisions that allow owners more latitude. In many cases this leads a captive to take more risk (operating, tax, regulatory) than they would have in one of the major captive domiciles. This latitude can have negative implications for the reputation of the domicile. Offshore operations have come under scrutiny in the past couple of years and it is important for captive owners to have legitimate reasons for domiciling in these locations. The established offshore domiciles such as Bermuda have a longer history of regulating captives than other domiciles and can use this regulatory scrutiny to their advantage. Others have built up a strong reputation in particular areas such as the Cayman Islands in healthcare, which has allowed the domicile to earn a strong reputation in this niche. Onshore, the reputation of the domicile's regulators becomes extremely important for risk retention groups. These groups will need approval from individual state insurance departments to operate in those states. Domiciling in a state with a strong regulatory reputation will help with those approvals.

Coupled with the quality of the regulatory infrastructure is that of the service providers. The older, more established domiciles will have service providers experienced in managing captives. In addition, Bermuda has benefited from the presence of a strong commercial insurance market, which allows risk managers to couple captive meetings with insurer and reinsurer meetings. Some onshore domiciles such as Vermont are attempting to attract specialist captive reinsurers to their states to provide a similar one stop service environment.

Logistics: the final issue to consider in domicile selection is the logistics of the domicile. While this is often seen as the domicile's tourist appeal, there are some serious logistical issues to consider. These will include time zone differences between the insured(s) and the captive, the quality of the communication infrastructure in the domicile, and the ease of getting to and from the domicile. Will you get the input of senior management if it requires a 3 day trip to a remote location with no cell phone coverage for a single board meeting?

Conclusion

Like other aspects of captive feasibility, domicile selection is dependent on the unique characteristics of the captive and the business to be underwritten. Each captive owner must review these characteristics and make their own determination. It is also not a one-time decision as the factors behind domicile selection change over time. A re-examination of domicile should be included in periodic strategic reviews of the captives operations.

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

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