MARSH

Captive Basics and Trends for the Casualty Actuaries

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Michael Serricchio, Senior Vice President
Norwalk, CT

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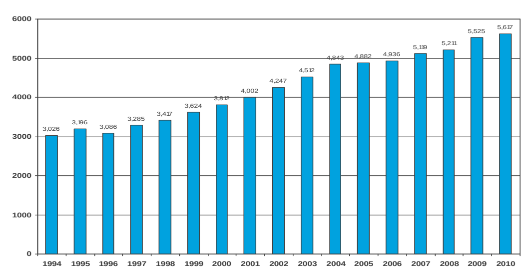
Agenda

- Defining Captives
- Captive Trends
- Domicile
- Captive Structures
- The Role of the Actuary
- Tax Status
- Captive Formation

Total Number of Captives Worldwide at Year End 2010



Source: Business Insurance

Definition of a Captive

- Licensed insurer
- May insure or reinsure the risks of its owner, affiliated parties, or chosen unrelated parties
  - Usually controlled unrelated parties such as employees or customers, vendors, etc.
  - Not generally un-controlled, unrelated or unaffiliated risk
- Located onshore or offshore
- Regulated under special captive legislation
  - Regulated by domicile regulators only
  - Not regulated by other state insurance department
- Non-admitted insurer
  - Not permitted to direct write lines requiring local licensing (e.g., WC, AL)
  - Buy downs of primary casualty deductibles are permitted

Types of Captives

- Single-Parent Captive (largest sector)
  - Wholly owned by one parent company
  - Insures or reinsures the risks of its parent, affiliated entities, or chosen unrelated parties
- Group/Association
  - Owned by multiple companies or an association, and insures or reinsures the risks of the group
- Rent-a-Captive
  - Insures or reinsures the risks of unrelated parties, whereby insureds are “renting” capacity
  - Typically structured as Protected Cell Captives (PCCs)
    - AKA – Segregated Cell Captives – (I.e. VT’s new law)
- Risk Retention Group
  - Regulated under federal legislation, licensed in one state, and able to operate in all 50 states on a registered basis
  - Can only write liability lines of risk (not WC)
    - Pending legislation may permit for RRGs to directly insure property coverage

Captive Trends – 2011

- Domicile Trends
  - Emerging jurisdictions
  - US states – New Jersey, Connecticut, others
  - EU direct writing captives (Slow with uncertainty of Solvency II)
- The Dodd-Frank Act of 2010
- Intercompany Investments – Access to captive’s cash
- Unrelated risks in captives
  - Employee Benefits
    - US companies: 28
    - Postretirement benefits
    - Multinational pooling of global benefits
    - Voluntary benefits – payroll deduct
  - Customers, Vendors, Independent Contractors
  - Profit Center
    - Extended warranty
    - Financial institution lines of coverage
- Review of tax deductibility issues and recent IRS developments/guidance
- AM Best Ratings and other ratings

Domicile Selection

There are a number of factors which organizations should consider when selecting a captive domicile:

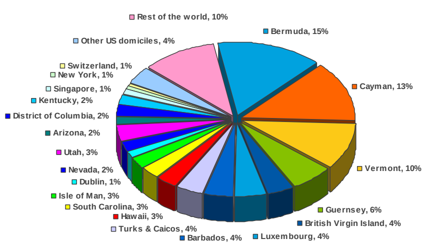
- **Regulation** – Captive domiciles should have firm but flexible regulation.
- **Infrastructure** – Ensuring that your domicile has captive managers, lawyers, banks, and auditors who understand the captive industry is an extremely important factor.
- **Permitted Business** – Access TRIA and US employee benefits can only be done using a US domiciled captive or a branch of an off shore captive.
- **Convenience** – Factors such as the requirement to visit a domicile to have board meetings, frequency of board meetings, and travel time are often taken into consideration when selecting a domicile.

Other factors to consider when selecting a domicile include:

- Capitalization
- Premium Taxes
- Industry Expertise
- Ability to enter into intercompany investments
- Operating Costs
- Time frame for licensing

Global Captives at Year End 2010

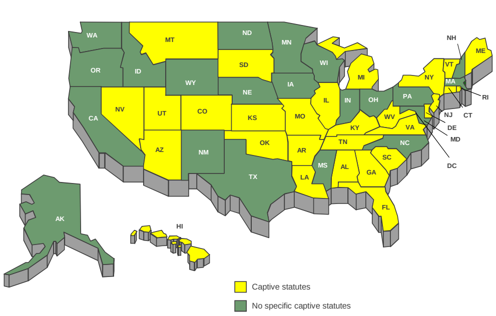
Active Captives by Domicile for Year-End 2010



Total Active Captives: 5,617

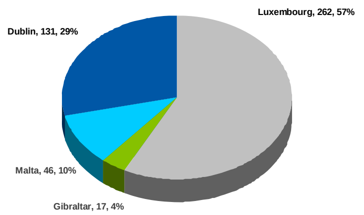
Source: Business Insurance Magazine, March 2011

U.S. Domestic Captive Domiciles as of May 2011



Alabama
Arizona
Arkansas
Colorado
Connecticut
Delaware
District of Columbia
Florida
Georgia
Hawaii
Illinois
Kansas
Kentucky
Louisiana
Maine
Michigan
Missouri
Montana
Nevada
New Jersey
New York
Oklahoma
Rhode Island
South Carolina
South Dakota
Tennessee
USVI
Utah
Vermont
Virginia
West Virginia

European Union Domiciles for Year Ending 2010



Total: 456

Source: *Business Insurance*. March, 2009, and Malta Governmental Website

Note – These 4 domiciles all allow for Direct Writing Captives, however, these statistics represent Direct Writing Captives and Non-Direct Writers

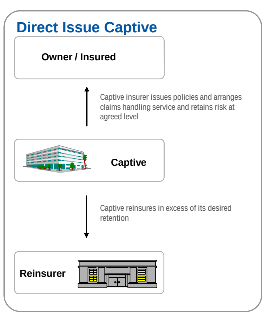
When Does a Captive "Fit"

- Company wants more formalized and disciplined Enterprise Risk management (ERM) approach to risk management and insurance
- High casualty retentions and loss projections
- Parent company is a tax-paying entity
  - Brother-sister corporate structure; or
  - Unrelated risk – 30 % to 50 %
- International tax rate arbitrage
- When subsidiaries need lower retentions than parent assumes
- Uninsurable or costly insurance program
- Top-line growth from customer insurance programs
- Access to reinsurance markets directly
  - Terrorism Pool in the US – TRIA access
- Not for profit companies
  - Mechanism for taking on risk and buying less commercial insurance

Direct Placement

Direct write when…

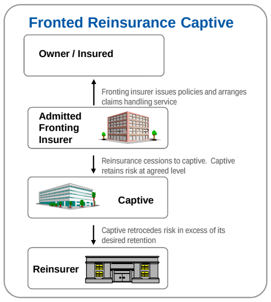
- insurance policies required;
- admitted coverage not required; and
- need formalized funding vehicle to allocate and track insurance expenses.



Reinsurance Captive

Reinsure when…

- admitted insurance policies are required;
- need to meet proof of financial responsibility requirements (property -landlords, products liability - retailers);
- security issues (A.M. Best rating); and
- providing insurance to unrelated parties.



The Role of the Actuary

- Actuary
  - Individual that prepares the actuarial certification or actuarial feasibility study
  - Individual that prepares and certifies the annual loss reserve opinion
  - Ongoing interactions with the client on a monthly, quarterly or annual basis
  - Expected case scenario vs. worst case scenario and confidence level analysis
  - Solvency II testing – adequate capitalization levels (Now – 2013)
- Most domiciles require the following:

1. Initial actuarial feasibility study to accompany the captive's application to the state or country of domicile to support the risks, assumptions, losses, and financial projections that are prepared along with the application
2. Annual ongoing actuarial reserve opinion

- Client may ask an Actuary to interact with the company, the captive manager, the auditors, etc. on a quarterly or sometimes month basis

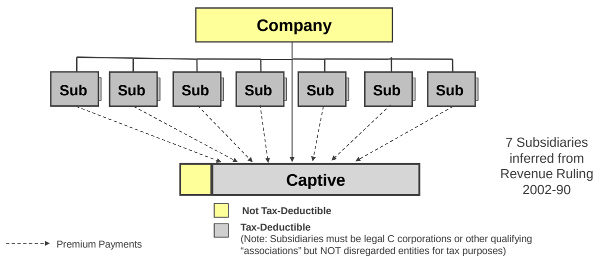
Tax Status: Perspective of "Insurance" by IRS

- **2 Paths to Obtaining Tax Deductibility**
- "Is it insurance from a federal income tax perspective"?

1. Brother sister risk distribution
2. 3rd party risk within Captive

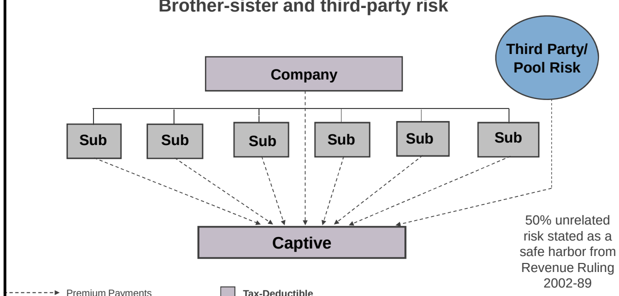
Supporting Favorable Tax Treatment

Brother-Sister Approach



Supporting Favorable Tax Treatment

Traditional Captive Structure
Brother-sister and third-party risk

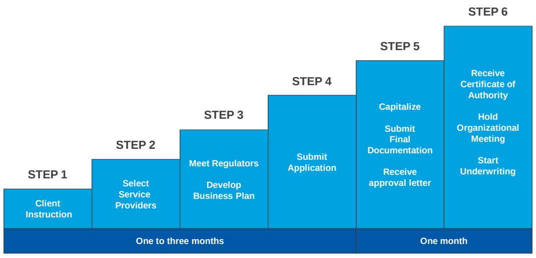


The Feasibility Process for a Captive

- Information gathering
- Review of loss data and financial information
- Captive modeling
- Business plan development
- Structure of captive
- Determination of optimal ownership structure
- Analysis of tax issues*
- Domicile analysis
- Implementation steps
- Final report issued
- Ongoing consulting

* All such matters should be reviewed with the client's own qualified tax, accounting, and legal advisors.

The Incorporation Process



Different domiciles will have slight variations on the above process