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INTRODUCTION TO CAPTIVES

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MARSH & McLENNAN COMPANIES

What is a Captive?

- An insurance vehicle formed by an organisation, not otherwise generally involved in insurance, to participate in its insurance arrangements
- Ultimately a self-funding mechanism for retained risk
- Not a quick fix and should be part of a long term risk financing strategy

"*a captive insurance company is a bona fide insurance or reinsurance company owned by a non-insurance company and which insurers or reinsures the risks of its parent or affiliated companies*"

Why Do Companies Establish Captives?

- To reduce the parent's cost of risk
- To formalize pre-funding for retained risk
- To gain a strategic advantage by accessing the reinsurance markets
- To capture profits from 'unrelated' activities

What Advantages Do Captives Offer?
Financial Benefits

- May offer certain tax benefits
- May improve the parent's negotiating position with the insurance and reinsurance markets – therefore lowering the TCOR
- Can access the reinsurance market
- Can generate underwriting & investment profits
- Can match revenue and expense - by reserving from current funds for future claim payments
- Can provide a source of additional revenue - by offering insurance to third parties

Insurance Taxation
Tax Position of Captives

Insurance Company for Federal Income Tax Purposes

- Premium payments are tax deductible
- Captive recognizes income
- Captive recognizes deduction for loss reserves on discounted basis
- Position supported through precedent setting case law

Self Insurance Model – Deposit Accounting

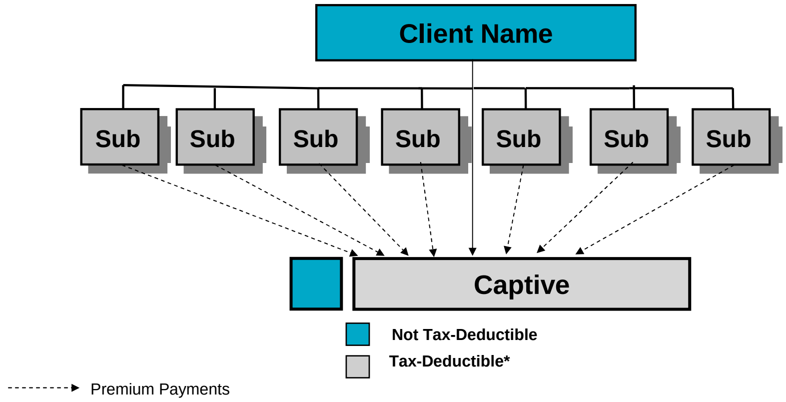
- Payments are non-tax deductible
- No tax deduction for loss reserves
- Claims are tax deductible when paid

Tax Considerations
Attaining Favourable Tax Treatment (U.S.) - requirements

1. **Captive must be a bona fide 'insurance company'**
   - issue arms-length insurance or reinsurance contracts with premiums established in accordance with industry standards;
   - be regulated in its chosen domicile as an insurance company;
   - establish reasonable loss reserves;
2. **Need to demonstrate "Risk Transfer"**
3. **Need to demonstrate "Risk Distribution"**
   - A minimum 30% to 50% unrelated business **or**
   - A brother/sister ("Humana" structure);
     - The subsidiaries of the parent should not own any stock in the captive; the stock should be owned by the parent company;
     - The captive must insure corporate affiliates that are incorporated subsidiaries, rather than branches of the parent;
     - Risks should be pooled or distributed within the captive; that is, there should not be separate accounts for each subsidiary contributing business to the captive.

Supporting Favorable Tax Treatment: Risk Distribution
Brother-Sister Approach (Humana)

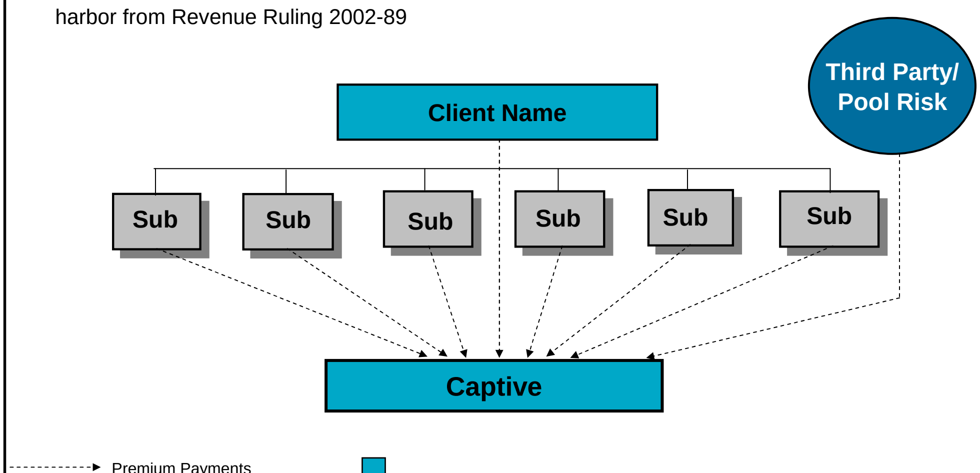
Seven subsidiaries inferred from Revenue Ruling 2002-90



*Note: Subsidiaries must be legal C corporations or other qualifying "associations" but NOT disregarded entities for tax purposes

Supporting Favorable Tax Treatment: Risk Distribution
Traditional Captive Structure: Third Party Risk

50% unrelated risk stated as a safe harbor from Revenue Ruling 2002-89



What Advantages Do Captives Offer?
Insurance/Strategic Benefits

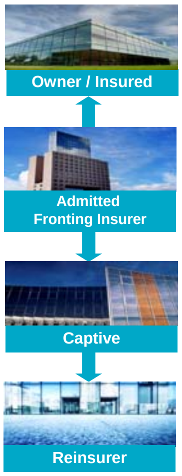
- Can provide coverage for risks not usually insurable
- Can reduce the dependence for commercial insurance
- Can create flexibility in program design and broader, more simpler insurance contracts
- Can create a more effective and efficient risk management program, through
  - designing cost allocation and claims handling systems
  - generating actuarial information
  - coordinating risk management activity
- Can offer divisions a ‘buy-down’ option
- Can reward divisions for good loss behavior

What Disadvantages May Come With Captives?

- Capital commitment (cash or LOC) - the captive’s capital may not be available for use in the parent’s business
- Adverse results - the captive’s capital can be eroded by adverse results under the insurance program
- Operating costs - a captive does incur operating costs and may demand some time commitment from senior management

Potential Structures
Fronted Structure Vs. Direct

Fronted Reinsurance Captive

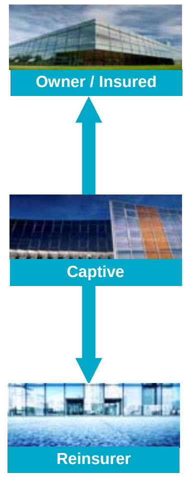


Fronting insurer issues policies and arranges claims handling service

Reinsurance cessions to captive; captive retains risk at agreed level

Captive retrocedes risk in excess of its desired retention

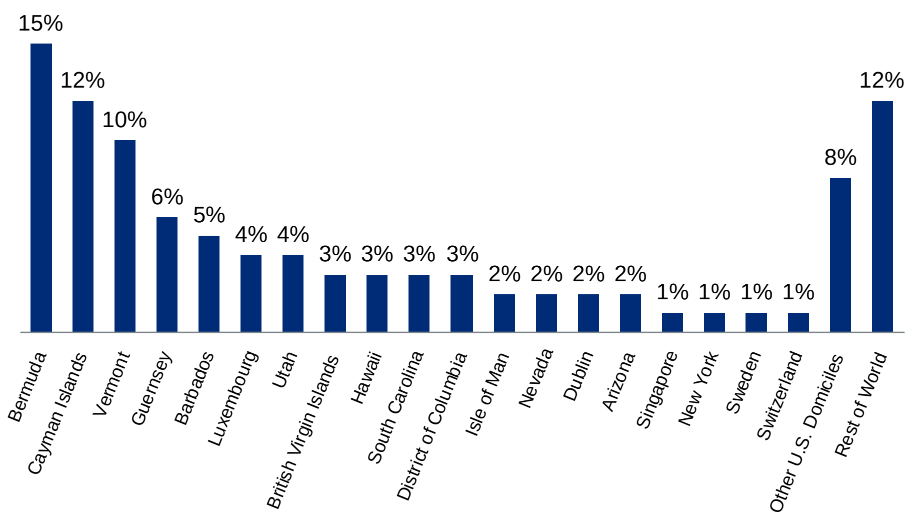
Direct Issue Captive



Captive insurer issues policies and arranges claims handling service and retains risk at agreed level

Captive reinsures in excess of its desired retention

Active Captives by Domicile – Year End 2011
Total Active Captives – 5,745



Source: BI Survey, "Counting Captives," Business Insurance, March 5, 2012: 9
Source: BI Survey, "Total Captives Worldwide," Business Insurance, March 5, 2012: 12

What Are Other Companies Doing With Their Captives?

Casualty/Liability

- Employers liability/WC
- Public/General liability
- Auto liability
- Professional liability
- Products liability, Product recall
- Environmental liability
- Excess liability/umbrella
- Banker's blanket bond
- Credit
- Medical malpractice
- Crime
- Employment practices
- Cyber risk

Property

- Terrorism insurance:
  - U.S. TRIA policy with NBCR
  - Pool Re
- Quota share reinsurance
- Shipping, cargo, and transit insurance
- Marine cargo
- Motor
- Aviation
- Residual value

Third Party Insurance

- Customer related insurance
- Customer, vendor, and joint-venture business
- Extended warranty
- Service contracts
- Employee benefits:
  - global, voluntary, and ERISA benefits
- Pooling facilities
  - Green Island Reinsurance Treaty (GIRT)

The Road To A Captive
Phase One-Feasibility Study

Scope

- Education, Advantages and disadvantages
- Identification / analysis of exposures and covers
- Analysis and forecast of losses
- Program costs and premium determination
- Program Structure - analysis of options
- Tax discussion and analysis
- Comparison of different structures
- Financial Proformas
- Domicile analysis
- Future uses
- Recommendations

The Road To A Captive
Phase Two-Implementation

- Preparation of Articles of Association
- Select local professionals as directors for the captive
- Appoint auditors, lawyers, bankers etc
- Prepare an application to the authorities for Authorisation of Trade
- Incorporate the captive
- Establish a registered office and comply with legal and regulatory requirements

The Road To A Captive
Phase Three-Ongoing Management

- Company administration, including: maintenance of detailed and comprehensive files of legal and general administration functions of the company
- Insurance, including: administration of insurance and reinsurance programs, policy issuance
- Accounting, including: bookkeeping, payment and receipt of premiums, audit and actuarial coordination