MARSH INSIGHTS: CAPTIVES

TEXAS PASSES LEGISLATION AUTHORIZING FORMATION OF CAPTIVES

On June 14, 2013, Texas passed bill 734 which, for the first time, authorized the formation of captive insurance companies in the state. This legislation will provide a domestic option for Texas companies, and is anticipated to promote business development and job growth.

According to the bill, the captives' affiliates would be required to have "significant operations" in Texas in order for the captive to be licensed. The measure, which took effect on September 1, 2013, provides that licensed Texas captives may insure the operational risks of the parent company and its affiliates, as well as the risks of controlled unaffiliated businesses, in addition to employee benefits.

It is expected many Texas-based parent companies will strongly consider forming their captives in Texas, or moving their captives to Texas to take advantage of the competitive statutory provisions surrounding minimum capital requirements, the ability for the captive to loan funds to its parent, and minimal captive premium taxes.

In addition, insureds whose "home state" (as defined under Texas statute) is deemed to be Texas may benefit from procuring coverage from a captive that is admitted and licensed in Texas, as they would not be obligated to remit self-procurement premium tax in Texas.

Insureds who procure coverage through out-of-state captives that are not admitted in Texas are currently obligated to pay Texas a 4.85% self-procurement premium tax.

Under the new captive law, the captive (not the insured) would only be liable for premium taxes assessed at a rate of 0.5% on the captive's total premium receipts (subject to a US$200,000 annual cap and annual minimum of US$7,500).

The Texas commissioner of insurance is required to adopt reasonable rules, as necessary, to implement the purposes and provisions of the bill governing the formation and operation of captive insurance companies on, or before, January 1, 2014. The organization or redomestication of a captive insurer will be delayed until this time.

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FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA) AND CAPTIVES

The Foreign Account Tax Compliance Act (FATCA) is a US law aimed at foreign financial institutions (FFIs) and other financial intermediaries to prevent tax evasion by US citizens and residents through the use of offshore accounts. FATCA targets tax non-compliance by US taxpayers with foreign accounts and focuses on reporting:

- By US taxpayers about certain foreign financial accounts and offshore assets.
- By FFIs about financial accounts held by US taxpayers or foreign entities in which US taxpayers hold a substantial ownership interest.

HOW DOES FATCA AFFECT CAPTIVES?

A captive would be considered to be in scope for FATCA where it is in receipt of US-sourced fixed or determinable annual or periodic income (FDAP) e.g., dividends, interest, insurance premiums, pensions and annuities, and sales proceeds. Most captives writing only traditional property/casualty lines would therefore be expected to be characterized as a non-financial foreign entity (NFFE). However, where the captive may be involved in life/cash annuity products, a further review should be undertaken to determine if it should be characterized as an FFI.

NFFEs, which are insurance companies, must provide form W8-BEN-E (W8) to payors of US–sourced FDAP. US captives would be obliged to provide a W9 to the relevant payor. Where a captive is making payment of US FDAP, it would be required to obtain a valid W8 or W9 from the payee, before making such a payment. Where a valid W8/W9 is not received, withholding of 30% should be retained from the payment.

The captive would also be required to report annually to the IRS detailing to whom payments were made and if payments were subject to withholding. Any withholding amounts would also be remitted to the IRS, or locally though an inter governmental agreement (IGA).

FATCA IMPACT FOR FFIS

FFIs will be required to register and enter into an agreement with the IRS in order to obtain a global intermediary identification number (GIIN), which confirms the FFIs' FATCA-compliant status. An FFI will need to determine the FATCA status of each of its account holders and obtain a valid W8; otherwise, it would be obliged to withhold 30% of any payments to that account. The FFI will also need to appoint a responsible officer, who will provide overall sign-off on the FATCA status of the FFI. Details of the responsible officer will need to be registered with the IRS.

Where an FFI is in receipt of US FDAP, it will be required to provide the payor with a valid W8. The FFI is obliged to report to the IRS detailing to whom FDAP payments were made and if the payments were subject to withholding. Any withholding amounts would also be remitted to the IRS.

IGAS

Some countries have agreed to enter into IGAs with the US, which facilitates the sharing of revenue information between both countries. The IGA will allow the local reporting of FATCA-related information, rather than directly to the IRS. It will also remove the obligation for an FFI to appoint a responsible officer.

NEXT STEPS

Marsh's Captive Solutions Practice has been working closely with our sister organizations across Marsh & McLennan Companies to fully assess the impact of FATCA on our clients. Although the FATCA legislation has been finalized, there are still some groups, including Marsh, that are working with the IRS to determine what (including insurance premiums) will be considered "in-scope" for FATCA. A final determination should be made before year end.

Captive Solutions colleagues will be able to assist with reviewing captives to understand the impact of FATCA and, within affected captives, whether compliance systems will need to be developed.

KEY DATES FOR FATCA:

2010

March 18, 2010
- FATCA provisions are signed into law as part of the Hiring Incentives to Restore Employment (HIRE) Act.

2013

January 17, 2013
- Final FATCA regulations are published.

August 19, 2013
- FATCA registration portal opened.

2014

April 25, 2014
- Final date for registration as an FFI, in order to be included on the first published list.

June 2, 2014
- First list of registered FFIs published. Monthly updates to follow thereafter.

July 1, 2014
- FATCA withholding effective. Also the start of the first reporting period for FATCA.

2015

March 15, 2015
- Reporting of US FDAP payments to foreign entity recipients begins for US withholding agents.

March 31, 2015
- FFIs begin annual reporting of account balances and identifying information for year-end 2014.

2016

February 29, 2016
- Responsible officer makes certifications related to due diligence and FATCA anti-avoidance.

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LOCAL DOMICILE CHANGES/FORMATIONS

GUERNSEY

- Marsh Management Services Guernsey is working closely with the Guernsey Financial Services Commission to develop a risk-based solvency regime that will comply with insurance core principles, as promoted by the International Association of Insurance Supervisors.
- For the majority of clients, it is expected that there will be no major change to margin of solvency requirements.

LUXEMBOURG

In order to facilitate the outsourcing process under Solvency II, on July 10, 2013, Luxembourg implemented a new law defining the concept of Professionals of the Insurance Sector (PSA). According to this law, a PSA will automatically be allowed to undertake specified functions or activities on behalf of insurance and reinsurance undertakings, when asking for authorization. The new legislation provides nine categories of PSA:

- Management companies for captive insurance undertakings.
- Management companies for run-off insurance undertakings.
- Management companies for reinsurance undertakings.
- Management companies for pension funds.
- Licensed providers of actuarial services.
- Management companies for insurance portfolios.
- Licensed providers of governance-related services for insurance and reinsurance undertakings.
- Claims handlers.
- Insurance and reinsurance brokers.

In order to obtain a PSA license, the company has to fulfill minimum conditions specified by the July 2013 law, such as central administration based in Luxembourg, accounting records and documents related to its professional activities stored in Luxembourg, audited accounts, and implementation of an efficient internal audit process. PSAs will be subject to ongoing control by the Luxembourg insurance regulator. Non-Luxembourg-based PSAs, intending to form a Luxembourg branch, will be subject to the same controls and conditions.

MALTA

Malta will soon join other jurisdictions in offering facilities and expertise on catastrophe bonds and collateralized reinsurance. In May 2013, the Malta Financial Services Authority (MFSA), published draft regulations for the authorization and use of reinsurance special-purpose vehicles (RSPVs), including:

- Implementation of the provisions of the Reinsurance European Directive.
- Adherence to Solvency II requirements.
- A provision for Malta's RSPVs requiring licensing by the MFSA.
- A provision by which a Malta-domiciled RSPV will not be required to hold a minimum guarantee fund, or a margin of solvency.
- A requirement that the potential exposure of a Malta-domiciled RSPV is to be fully funded at all times by the paid-in proceeds of a debt issue, or any other financing mechanism.

The rules are expected to be put into effect by the end of 2013.

MISSOURI

- On July 8, 2013, the Missouri Department of Insurance named Maria Sheffield as its new captive program manager. She replaces John Rehagen, who was promoted to deputy director of the Division of Company Regulation.
- On August 28, 2013, Senate Bill 287 took effect, allowing for the formation of sponsored captive insurance companies in Missouri, which may establish and maintain one or more incorporated cells. The bill also lowers the minimum of capital and surplus requirements for an association captive insurance company from US$750,000 to US$500,000.
- Missouri now has 28 captives operating in the state with $6.6 billion in premium volume (2012).

NORTH CAROLINA

- On July 1, 2013, the North Carolina captive law went into effect, allowing the formation of captive insurance companies in the state for the first time.
- All types of captives can be formed, including special-purpose financial captives formed to facilitate risk securitizations.
- Minimum capital and surplus requirements are set at:
    - US$250,000 for pure captives and protected-cell captives.
    - US$500,000 for association captives and industrial-insured captives.
    - US$1,000,000 for risk-retention groups.
- Taxes have been set at:

	PREMIUM TAX ON DIRECT PREMIUMS	TAX ON REINSURANCE PREMIUMS
Up to US$20 million	0.4%	0.225%
US$20 to $40 million	0.3%	0.15%
US$40 to $60 million	0.3%	0.05%
US$60 million or more	0.3%	0.025%

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CAPTIVE AND INSURANCE INDUSTRY UPDATES

CAPTIVES AND REINSURANCE

Volatility in claims, particularly in the first few years of a captive's formation, can endanger the health of a captive. The use of reinsurance can provide stability to a program as it grows and enters into new lines of business. Benefits can include:

- Surplus and capital protection by reducing the threat posed by large losses.
- Cost efficiency and capacity over the traditional insurance market.
- Establishing and building a strong relationship with reinsurers – including access to underwriting expertise, market intelligence, and benchmarking data.

When selecting a reinsurer, captive companies should consider the health and financial stability of the company, as well as its ability and willingness to pay claims. A trusted reinsurer can help support a captive's current goals and grow with the captive, as new lines are added.

POWER AND UTILITIES

Power and utilities companies are the fifth-largest users of captives. While many of these companies are conservative, primarily using their captives for traditional property and casualty coverages, some are including new lines such as employee benefits and cyber risk.

Environmental insurance has also become of interest, as the overall market for environmental insurance products was fluid and highly competitive entering 2013. Many environmental insurers focused on rate increases or coverage restrictions on a client-by-client basis. Claims frequency continued to rise, with leading markets reporting increases in first-party claims. Power and utilities companies may be able to significantly reduce their premiums by placing the first layer of environmental risk into a captive, and then securing excess environmental impairment liability limits in the traditional insurance marketplace.

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INNOVATIVE USES OF CAPTIVES

MIDSIZE COMPANIES MAY LOWER RISK MANAGEMENT COSTS WITH GROUP CAPTIVES

Captives continue to attract midsize firms that are seeking alternatives to traditional insurance. Captive programs offer an efficient mechanism to retain risk, coupled with a group risk-share component. Rounding out the insurance plan is a risk-transfer program from an A-rated insurer. These arrangements have been available for casualty programs for more than 20 years. A summary of both options is provided below.

Marsh's Group Captive Practice was formed to help businesses obtain adequate insurance coverage at a more affordable and stable cost. Two of our largest captives, Columbus, a heterogeneous group captive servicing any industry type and Fleet Solutions, a homogeneous group captive servicing the transportation industry, seek to provide the highest-quality insurance protection for their non-related shareholders.

While members do share some risks with other members of the captive, premiums are based largely on the individual member company's success at exercising loss control, minimizing losses, and the cost of a loss. Companies can realize several key benefits by joining a group captive:

- **Cost control and cost efficiency**: Members often see more stable prices over time because the captive limits the company's exposure to its losses, not insurance company market conditions.
- **Superior loss control and claims handling**: The premise is to reduce insurance costs through effective pre- and post-loss management.
- **Premiums are paid to the insurance entity that members own**: Since each member company holds a seat on the captive board, they participate fully in all decisions regarding claims, risk control, finances, and other important matters.
- **Opportunity to share investment income and underwriting profit**: Profits and losses from the captive are shared by the member companies.
- **Opportunity to share best practices**: Member companies share their experiences relating to loss control or business issues to build and strengthen other member companies.

When evaluating new members for a group captive, we look at the following criteria:

- They must be committed to safety and claims management.
- They must be motivated to improve safety and claims management.
- Their financial standing must be sound.
- They must possess an entrepreneurial spirit.
- Their business philosophies must be compatible with current members.

USING CAPTIVES FOR EMPLOYER HEALTH PROGRAMS

Similar concepts are now being applied to employer health programs. With January 1 renewals fast approaching, many companies are reviewing their medical plans. Marsh recently introduced a new option for small and midsize companies called RightPath Reinsurance, LTD. RightPath is a Cayman Island-based captive that provides medical stop-loss insurance. Ideal candidates have stop-loss retentions in the US$50,000 to US$150,000 range, between 200 to 1,000 employees, and are committed to reducing annual plan rate renewal increases.

The program works as a traditional stop-loss arrangement with sharing of premium surplus. Each employer is an owner of the captive and participates in its financial results. This integrated, full-service product gives midsize employers significant control of their health care costs.

The solution includes:

- Client choice of underlying self-funded plan administration/network provider.
- Comprehensive stop-loss protection through RightPath Reinsurance, LTD captive.
- Best-practice health management program.
- Prescription and employee communication aggregate purchasing arrangements.
- Integrated financial/clinical data analytics.
- Annual budgeting and renewal services.
- Compliance reporting/disclosure support.

An additional benefit to participants is that the captive is not subject to the health insurance industry fee that is set to go into effect in 2014.

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CAT BONDS PROVIDE ATTRACTIVE WAY TO REINSURE AGAINST NATURAL CATASTROPHES

Dating back to the mid-1990s, CAT bond special purpose vehicles (SPVs) have been used as an alternative way of reinsuring against major natural catastrophes. CAT bond SPVs enable bankruptcy remote SPVs to issue debt instruments to the capital markets. The purchasers of the notes assume a portion of the risk, should a specific natural catastrophe event occur, in return for a return on their investment. Typically, an insurance company acts as the risk counterparty to the SPV through a derivative agreement (ISDA Master Agreement), which will detail the relevant "trigger" events for the underlying risk.

Traditionally, CAT bond SPVs have been domiciled in the Cayman Islands, with Ireland becoming a more popular venue since the late 1990s. Ireland has also issued bonds through vehicles that are subject to regulator supervision (SPRVs). Other jurisdictions are looking at this area now, including Malta, which is in the process of updating legislation that will facilitate the registration of such vehicles.

There has been considerable growth in the CAT bond market in recent years (the level of outstanding CAT bond issuances is estimated to be around US$20 billion, and of this, some US$3.3 billion was issued in the second quarter of 2013), as insurers look to alternative methods of spreading risk and investors look at ways of seeking improved returns and uncorrelated risks to those available in traditional investment markets.

From a structuring point of view, this market growth in CAT bond issuance has had a positive benefit in terms of the pricing of deals for capital markets. According to David Flandro, global head of business intelligence at Guy Carpenter: "At July 1, we saw continued significant decreases in US property catastrophe program pricing. Although the impact of convergence was less dramatic elsewhere, general downward pressure on rates was observed for property business in several other regions and across some casualty lines. Without further significant catastrophe losses in the remainder of 2013, we expect that this downward pricing trend will likely continue through the remainder of the year and into the January 1, 2014, renewals."

It is expected that general downward trend in pricing will have a positive effect on CAT bond deals also. Marsh Management Services Cayman provided administrative services to the first rated CAT bond deal, Georgetown Re, launched in 1996. Currently, Marsh manages 60 SPVs comprising aircraft, collateralized debt obligations (CDOs), life securitizations, synthetics, accounting, company secretary, registered office, provision of director services, Intralinks administration for the deal, and other general administration services.

As CAT bond issuances generally pay interest at rates above capital market base rates, the potential returns for investors is still good and this uncorrelated asset class offers good options for those investors looking to diversify their portfolios.

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COMMITMENT TO CAPTIVES

Our Captive Solutions Practice has always been focused on our clients' growth. We can only succeed if we are providing world-class support and anticipating new areas where our clients may wish to expand. We have made the following enhancements to our team, as we move together into new regions of the world:

- Lorraine Stack has assumed the role of Captive Solutions business development leader for EMEA Asia-Pac. In this role, Lorraine will coordinate growth and business development activities, working closely with our office heads. Based in Dublin, Ireland, her role will be domicile–neutral, with a solitary focus on driving growth for the practice as a whole.

- Maria Escobar is the leader of Marsh Latin America Captive Solutions and is based in Bogota, Colombia. Maria is dedicated to assessments, feasibility, proposals, and management services. With the full support of the Global Captive Solutions team, she will add to the depth of capabilities we offer for our clients' risk management strategies.

- Daniel Gomez is a consultant in the Captive Advisory Group and currently spends approximately 75% of his time on US and international advisory projects, and 25% on Latin American work with Maria. Ultimately, he will take on a more substantial role in Latin America and will lead projects in both regions. He previously worked for the investment group of a large Colombian insurance company.

- Luis Delgado is a finance manager with Marsh IAS Management Services (Bermuda) Ltd. He is from Colombia and specializes in coordinating the incorporation and ongoing captive management services for Latin American companies that establish captives in Bermuda.

RELATED CONTENT AND CONFERENCES

- **September 23-24, 2013** — Captive Prospect Summit, Phoenix, Arizona
  Marsh is proud to sponsor this invitation-only summit — an exclusive educational and networking event for US-based companies considering their first captive. Arthur Koritzinsky, Captive Advisory leader for North America, will present on feasibility studies and Ellen Charnley, our Captive Solutions growth leader for the US, will lead a roundtable on captive management.
- **September 29 to October 2, 2013** — FERMA Risk Management Forum, Maastricht, Netherlands
  Once again, Marsh will have a large presence at FERMA and will be represented at booths 21-10-11. Claude Weber and Brian Collins from Marsh Management Services (MMS) Luxembourg, and William Thomas-Ferrand from MMS Malta, will be in attendance.
- **October 2, 2013** — The 2013 Symposium on Captive Insurance in Connecticut, Stamford, Connecticut
  The focus of this year's symposium will center on sophisticated methods for risk financing, intersecting the capital markets and captive insurance. Michael Serricchio from Marsh's Captive Advisory team will take part in a panel discussing the growth of captives for midsize businesses.
- **October 9, 2013** — Risk Management 301 Webinar, United States
  The ways that companies use captive insurers are continuing to evolve. What is driving the formation of new captives and domiciles? Join Marsh for Risk Management 301, where our Captive Solutions experts, including Michael Serricchio, Ellyn Casazza, and Ellen Charnley, will provide a global captive perspective on the industry.
- **November 5-8, 2013** — Hawaii Captive Insurance Council Forum, Waimea, Hawaii
  Marsh Management Services Hawaii will once again be a gold-level sponsor of the forum. Ellen Charnley will speak about using analytics to enhance captive performance, and Scot Sterenberg will address how senior management involvement is key to a captive's success. Please stop by our booth to see us.
- **November 14, 2013** — Broker Expo, Coventry, United Kingdom
  Marsh will have a booth at the expo, and Stephen Casey from Marsh Management Services Guernsey will be in attendance.
- **December 3-5, 2013** — Cayman Captive Forum, Grand Cayman
  Marsh Captive Solutions will once again be an exhibitor. We hope to see you at Booth #8! We have many speakers this

year, including Marsh's US HealthCare Practice Leader Holly Meidl, Jeffrey Devron, Mark Karlson, and from Marsh Management Services Cayman, John Ramsey.

- **January 29-31, 2014** – World Captive Forum, Aventura, Florida
  Arthur Koritzinsky will be moderating a session at the 2014 conference. Maria Escobar, our leader for Marsh Latin America, Captive Solutions, will also be a presenter.

Marsh is one of the Marsh & McLennan Companies, together with Guy Carpenter, Mercer, and Oliver Wyman.

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