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Optimizing Your Captive's Capital

Difficult economic conditions have led many captive owners to look to access the capital in their captives. This can present conflicts in providing sufficient funds to support the captive, while also providing much needed capital with the owner's core business. In this newsletter we discuss how to assess whether there is

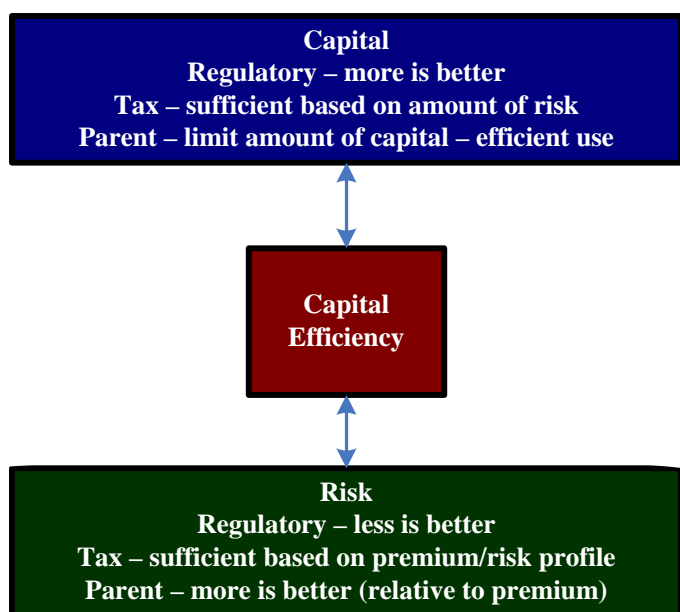
capital available and different ways to access the capital. It draws on information presented by Michael O'Malley of Strategic Risk Solutions and Amy Angell of Milliman from our March 2009 webinar.

Capital Adequacy

The first question to address is whether there is surplus capital in the captive that may be used for other purposes. In assessing the level of capital adequacy it is important to recognize the different interests of the parties involved. These can lead to a range of potential answers to the capital adequacy question.

- Owners: as little as possible to maximize the efficiency of the capital being used.
- Regulators: fully funded programs to minimize the risk of failure.
- Tax: appropriate levels of capital given the risk being underwritten

As shown in the diagram below, these conflicting interests all serve to determine where capital efficiency is for any particular captive.



Risk Assessment

The capital adequacy of a captive is dependent on the programs that

it is underwriting. A captive is an insurance company and it needs appropriate levels of premium, capital and reinsurance to meet its obligations. There are four principal factors in considering whether that is true and whether additional capital is available for use by the captive owners.

The Nature of the Risk Underwritten—generally the greater the volatility or uncertainty in the portfolio of risks underwritten, the more capital will be needed to cover that volatility. With greater volatility it is more difficult to obtain agreement for release of capital from a captive or it may require underwriting years to more developed before regulators are comfortable with the release of capital. Factors that increase volatility in a portfolio include:

- Low frequency/high severity exposures, which make losses more difficult to predict with certainty.
- Longer tail liability where the true liability will not be known for many years.
- Low premiums and/or high limits which require more of the risk exposure to be covered by capital than premiums. Smaller portfolios of risk also tend to be rated on industry experience and the captive program may vary materially from the industry.
- Changes in law can affect the potential exposure and introduce volatility into a portfolio. It may require some years of claim development before the impact of the change is known with any accuracy.
- Concentrations and correlations of risk: even though there may be a large volume of risk in the portfolio, any concentrations or factors which would impact all the risk exposures will increase volatility.

Loss and Expense Reserves—the more conservatism built into the captive's loss and expense reserves the lower the probability of capital being impaired. Key issues to consider are:

- The confidence level chosen for the reserves and if actual reserves are at the actuary's projections.
- Whether the reserves have been discounted, i.e. we are relying on investment performance to pay for claims.
- Acquisitions and divestitures which may alter the risk profile of the run-off of old policy years.
- The run-off history: does the captive have a history of reserve deterioration? If so, regulators may be more conservative in agreeing capital releases.

Premium Funding—the more conservatively you fund the captive the easier it is to take capital out as it is created, as adverse experience will be covered by the premiums not capital. Similar to loss reserves, issues to consider are the confidence level at which premiums are set and the level of discounting used in setting the premiums.

Reinsurance Program—reinsurance is a form of rented capital, with the captive relying on someone else's capital (the reinsurer) rather than putting up its own. However, there are issues to consider in the reinsurance program most notably whether it is adequate or could the captive be exposed in the reinsurance layers. This could be through coverage or limit deficiencies or adjustable premium provisions.

Assets and Investment Income—the asset portfolio is important from two perspectives:

- Is it generating the returns used in loss and premium discounting calculations? If not, there may be a shortfall in funding.
- Are the assets sufficiently liquid to pay claims as they arise. A portion of illiquid assets may be excluded from capital adequacy calculations as they are not available to pay claims.

Accessing Capital

Once it has been determined that excess capital exists there are three main options for captive owners to consider in accessing that capital: dividends, premium reductions and restructuring capital. This assumes that they wish to use the capital outside the captive rather than expanding the use of the captive through additional lines of coverage or increased limits.

Dividends—The treatment of dividends depends on the legal structure of the captive.

- Stock companies: dividends are an after tax distribution and will face double taxation as the dividend itself will attract capital gains tax for the captive owner as well. Dividends must also be paid in proportion to the stock, ruling out experience based distributions.
- Mutual companies: dividends are a much more tax efficient distribution for a mutual. Policyholder dividends are treated as a pre-tax expense. They must also be paid to the policyholders creating the surplus, so they are experience based and provide an incentive for loss control.

Premium Reduction—a tax efficient way to return capital is to provide premium credits for returning members of the captive. This can act as an incentive to retain members during competition from the commercial market. Reductions are given in proportion to premiums paid and are not directly experience based. The reduction is a one-time event and may not provide the level of capital distribution owners are looking for. There is also a danger that returning to normal premium levels is seen as a premium increase.

Restructure Capital—the third option is to restructure capital so it can be used within the parent company's business. Restructuring options include:

- Letters of Credit: replacing the cash assets of the captive with a

letter of credit secured by the parent company. There are accounting implications with this approach as LOCs are not considered capital under GAAP unless you have a qualified opinion from the captive's auditor.

- Loan: replace cash capital with a loan to the parent. This can be a secured or unsecured note, but regulators often require a demand note to provide liquidity to the captive. The loan should also have a market interest rate. In structuring loan-backs, captives and their owners should be careful not to jeopardize the tax position of the captive.
- Subsidiary Investment: this provides liquidity at the parent level, but it raises issues for regulators including how the captive will submit financial statements, the liquidity of the investment and if it is treated as a contribution to equity.
- Sale and lease back: the captive purchases assets and leases them back to an affiliate. This provides liquidity to the parent, but also gives the captive a steady stream of rental income and the security of a fixed asset behind the investment. A key issue to consider is how impairment to the asset would be treated.

Analysis and Regulatory Review

Before you can extract capital from your captive you will need approval from the regulator. We recommend that you conduct a detailed risk assessment and review to get the regulator comfortable with the capital plan. That analysis should include:

- Reasons behind the request: communication with the regulators is key. They understand the difficult economic conditions that everyone is facing and will work with captive owners to meet their requests so long as they don't impair the captive.
- Actuarial assessments including stress test of reserves and forward looking analysis. The purpose of this analysis is to detail the likelihood of insolvency for the captive under the revised capital plan.
- Five-year financial pro forma under expected and adverse scenarios. Key financial ratios are used to compare the captive to industry standards. The adverse scenarios are used to address the factors that can drive additional volatility in the captive's program. Uncertainties include the profile of risks insured, the timing of loss payments and growth in the program which will need to be supported by growth in capital.
- The financial strength of the parent.

Overall domicile regulators focus on the solvency of the captive and liquidity of its capital and assets. There are specific concerns with each type of capital release. For dividends, the reserve to surplus ratio is key. For LOCs the critical issue is whether they are pledged to the regulator or not, and for loans it will be the financial strength of the parent.

It is important to remember that captives are a risk management tool of their owners. Releasing capital from the captive is an effective way of meeting owners' need for liquidity without compromising the ability of the captive to participate on its owners' insurance programs going forward. Capital is being extracted from captives. The ability to provide liquidity to owners at a time of need is one of the strongest validations of a captive's value.

Spotlight on Hawaii

SRS recently announced its expansion into Hawaii with the hiring of Judy Nako. In this quarter's newsletter, we take a look at the latest domicile in which SRS has a physical presence.

Overview

Hawaii is a mature domicile having established its captive legislation in 1987. It has historically been the second largest US domiciles behind Vermont and it continues to hold that position despite the recent growth in newer US domiciles. Its geography has made it popular with Western US captive owners and those from the Pacific Rim.

Regulatory Environment

Hawaii has a mature and consistent regulatory environment with dedicated full time staff of captive regulators. Although there has been some recent turnover in the regulators office, the state has consistently funded and supported its captive insurance industry.

Why Hawaii?

We believe there are five key factors which make Hawaii attractive to captive owners:

- **Mature domicile:** As a mature domicile Hawaii has a stable regulatory environment with dedicated captive regulators. It also has an established infrastructure with most of the leading captive service providers present in the domicile.
- **Western US:** Hawaii's location makes it attractive for western US captive owners. Over 75% of Hawaii's captives are owners by organizations in the Western US. Despite competition from newer domiciles in the west, it remains the only mature western US domicile. For captive owners on the west coast looking for a stable regulatory environment, Hawaii is attractive.
- **Reinsurance captives:** the minimum captive requirement of \$100,000 for Class 1 captives makes Hawaii attractive for most traditional pure captives writing fronted policies. Most other onshore domiciles require a minimum capitalization of \$250,000.
- **Non-profits:** Hawaii has a specific category for non-profit captives. This has made the domicile attractive for healthcare, education and other non-profit captive owners.
- **Real estate and Construction specialty:** Hawaii is home to 47 real estate and construction owned captives or almost 30% of Hawaii's captives. Expertise in this industry may attract additional captives. However, it also makes Hawaii subject to the economic conditions which have caused many construction owned captives to close.

Recent Developments

Hawaii has experienced some recent turnover in its regulators office with the departure of both Craig Watanabe and Judy Nako. In October 2009, George Sumner was appointed as the new Captive Administrator and Deputy Insurance Commissioner. George was formerly the leader of the captive insurance team at the Bank of Hawaii. Two new captive examiners also joined the Captive Branch in January 2010. These appointments are indicative of Hawaii's commitment to the industry. Going forward we expect Hawaii to remain a strong, stable domicile.

Hawaii Fact Sheet

Applicable Legislation. Hawaii Revises Statutes, Title 24, Chapter 431, Article 19 (1986)

Number of Captives. At 12/31/2009 Hawaii had 162 active captive having issued 224 captive licenses.

Capital and Solvency Requirements

Hawaii licenses five classes of captive insurance company with minimum capital requirements as shown below:

Class 1: Single parent captive - reinsurance only	\$100,000
Class 2: Single parent captive - other	\$250,000
Class 3: Association captive or Risk Retention Group	\$500,000
Class 4: Sponsored captive	\$500,000
Class 5: Reinsurance or excess captive	case by case

Premium Taxes (Maximum Tax: \$200,000)

<u>Gross Premiums</u>	<u>%</u>
\$0 — \$25,000,000	0.25%
\$25,000,000 — \$50,000,000	0.15%
\$50,000,000 — \$250,000,000	0.05%
> \$250,000,000	0.00%

Regulatory Fees

Initial incorporation fee	\$50
Annual business registration fee	\$15
Captive application fee	\$1,000

Captive Annual License Fees

Classes 1 and 2	\$300
Class 3	\$500
Classes 4 and 5	\$1,000

SRS News

SRS Ranked 8th Largest Captive Manager in Business Insurance Survey.

In its annual survey of captive managers, Business Insurance ranked SRS as the eighth largest manager worldwide by number of captives managed.

SRS had a total of 116 captives under management at the end of December 2009. This is the first year that the company has been in the top ten largest managers.

“We are pleased to be included in the top ten. Our goal is to provide high quality captive management services and develop strong client relationships, rather than build a large volume of clients”, said Brady Young, President of Strategic Risk Solutions. “It is a testament to our operating model that so many new clients have chosen to have their captives managed by our firm.”

SRS Expands to Hawaii. Hires Judy Nako.

On March 1, SRS announced its expansion into Hawaii with the hiring of Judy Nako. Ms. Nako was formerly the Acting Deputy Commissioner and Captive Insurance Administrator for the State of Hawaii. She worked for the State’s Captive Insurance Branch for eight years and has 17 years experience working with insurance companies in Hawaii.

SRS’s activities in Hawaii will be overseen by Ann Wick, President Strategic Risk Solutions, Western Division. The company currently manages its Hawaii domiciled captives from its Arizona office. This expansion provides SRS with local representation in Hawaii.

Hawaii is the second largest captive domicile in the US and one of the oldest. It first introduced its captive insurance legislation in 1987. At the end of 2009, Hawaii had 162 active captives.

“We are pleased to welcome Strategic Risk Solutions to Hawaii. This expansion shows the strength of Hawaii as a captive domicile, said George Sumner, Captive Insurance Administrator & Deputy Commissioner, State of Hawaii. “Judy Nako has been a tremendous supporter of the Hawaii captive community and we wish her every success at Strategic Risk Solutions,” added Sumner.

SRS to Manage World’s First Serial Captive.

In January, Amplitude Reinsurance SPC became the world’s first serial entity captive. The captive was licensed and will be domiciled in Delaware. SRS will manage the captive and provided feasibility and implementation services in its creation.

Amplitude Re will provide reinsurance to a sister company, Practitioners Assurance RRG which will underwrite physicians professional liability. Organized as a serial LLC, each physician’s program will be held in a separate series or cell with Amplitude Re. The serial LLC structure can provide tax and organizational advantages over traditional protected cell captives.

Delaware was chosen as the domicile due to the state’s serial LLC law, captive regulation and long and well respected history of corporate law. “This is a break-through in the captive insurance world with the first captive of this type. I am proud that the First State is once again blazing a new trail in the world of commerce”, said Delaware Insurance Commissioner Karen Weldin-Stewart.

Staff News

Asad Masood has joined SRS (Cayman) as a Client Accountant. Asad was formerly a Senior Accountant at KPMG in the Cayman Islands. He holds a Chartered Accountant designation.

Andrew Marson has joined SRS (Arizona) as an Account Manager. Andrew was formerly with Marsh Management Services in the Cayman Islands. He is a member of the Association of Chartered Certified Accountants.

Industry Events

SRS will be participating in the following upcoming industry events. Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

April 5-8, 2010, Western Region Captive Insurance Conference. Brady Young and Derick White are speaking and Ann Wick is attending this conference to be held at the Arizona Biltmore Resort in Phoenix, AZ.

April 25-29, RIMS 2010 Annual Conference & Exhibition, Boston, MA. Representatives from Vermont, Cayman and SRS Advisers will be attending the conference.

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

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

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