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UTILIZATION OF CAPTIVES TODAY

The Oklahoma Captive Conference
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Utilization of Captives Today
Objectives of Discussion

1. The Process of Evaluating a Captive
2. Trends in Captive Utilization
3. Why Insure Various Types of Risk through a Captive?
4. Cost Considerations
5. Tax Considerations
6. Considerations in Selecting the Optimal Captive Domicile

THE PROCESS OF EVALUATING A CAPTIVE

Evaluating a Captive Program
The Process

STEPS	1 Educational Discussion to Identify Captive Opportunities	2 Objectives Defined	3 Feasibility and Modeling	4 Feasibility Report	5 Implementation of Strategic Objectives
KEY ACTIVITIES	• Conduct a basic company diagnostic • Provide a general overview on captives • Identify potential opportunities	• Define captive feasibility study objectives/scope including potential opportunities	• Review potential opportunities and coverages • Analyze operational and financial advantages • Outline captive structures • Review domiciles • Address key cost, tax, and operational considerations • Hold additional discussions with client as needed	• Summarize conclusions of feasibility study and provide recommendations • Outline implementation plan of recommended strategies	• Revise implementation plan • Meet with captive regulators • Draft business plan and pro formas • Prepare and submit regulatory application
DELIVERABLES	• Relevant brochures and educational information	• Engagement letter outlining key objectives	• Data request • Timeline and action plan	• Feasibility report • Implementation plan	• Business plan and pro formas • Regulatory application

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TRENDS IN CAPTIVE UTILIZATION

(Per Benchmarking Statistics for Captives Managed by Marsh)

Traditional Insurance Coverage Written by Captives

%	Coverage	%	Coverage	%	Coverage
36%	General Public Third Party Liability	8%	Medical Malpractice Liability	3%	Aviation Liability
32%	Property All-Risk	8%	US TRIA/NBCR	3%	Umbrella Liability
25%	Workers' Comp/Employers' Liability	7%	Property Cargo	2%	Employment Practices Liability
20%	Casualty Auto Liability	7%	Property Marine	2%	Fidelity
20%	Professional Liability	6%	Property Terrorism Non-US TRIA	2%	Fiduciary
16%	Other Financial Lines	5%	Environmental Liability	2%	Marine Liability
11%	Product Liability	5%	Errors and Omissions		
9%	Excess Liability	4%	Directors and Officers Liability		

Source: Marsh

This figure shows the full range of traditional insurance lines and the percentage of captives insuring each one.

Captive Size Based on Net Written Premium

SIZE OF CAPTIVE	PERCENTAGE
Small	21%
Medium	23%
Large	15%
Extra Large	27%
Captives in Run-off	14%

The number of captives in "run-off" represents captives that may have been in run-off for many years. As a result of the economic downturn in 2008, many captives have been "put on a shelf" so that the company can quickly start up operations again in a hard economy or when needed. In addition, some captives have been merged or liquidated. Captives in the EU cannot simply merge or liquidate, so owners will often place an EU direct-writing captive into run-off until they determine the risk management needs of the company.

Source: Marsh

- Forty-four percent of captives had premium volume of less than US$5 million, suggesting there is no "one-size-fits-all" captives.

- This finding also suggests, however, that the premium spend required to support a captive is attainable by small, midsize, and large organizations.

Captive Use by Industry

RANK	INDUSTRY	PERCENTAGE
1	Financial Institutions	18.6%
2	Health Care	17.2%
3	Retails and Consumer Products	9.1%
4	Manufacturing	8.9%
5	Power and Utilities	6.9%
6	Construction	6.4%
7	Transportation	6.2%
8	Technology and Telecom	3.7%
9	Chemicals	3.3%
10	Mining, Metals, Minerals	3.2%
11	Automotive	2.6%
12	Entertainment, Media, Sports	2.3%
13	Life Sciences	2.1%
14	Real Estate	2.1%
15	Aviation and Aerospace	1.4%
16	Education	1.0%
17	Public Entity	1.0%
18	Marine	0.9%
19	Hospitality and Gaming	0.6%
20	Forest Products	0.3%
21	Other	2.0%

Source: Marsh

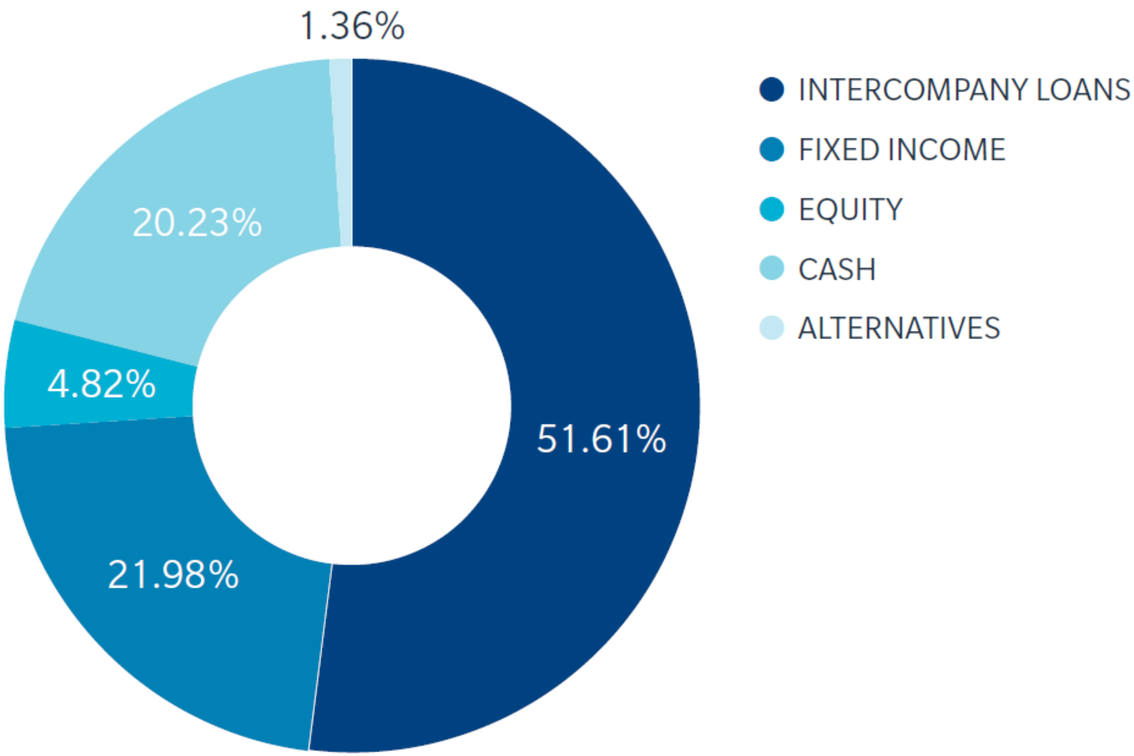
Global Captive Domicile Rank By Number of Captive Licenses

RANK	DOMICILE	2012	2011
1	Bermuda	856	862
2	Cayman Islands	741	739
3	Vermont	586	590
4	Guernsey	333	343
5	Anguilla	291	268
6	Utah	287	239
7	Barbados	261	270
8	Luxembourg	238	242
9	Nevis	203	150
10	Delaware	190	150
11	Hawaii	179	172
12	District of Columbia	170	157
13	British Virgin Islands	157	174
14	South Carolina	149	159
15	Dublin/Ireland	141	147

RANK	DOMICILE	2012	2011
16	Kentucky	139	137
17	Nevada	133	127
18	Isle of Man	125	133
19	Montana	114	85
20	Arizona	101	97
21	Turks and Caicos	83	84
22	Singapore	66	60
23	New York	50	50
24	Sweden	49	49
25	Labuan	41	34
26	Switzerland	34	35
27	British Columbia	31	31
28	Puerto Rico	29	21
29	Missouri	28	19
30	Alabama	23	18

Source: Business Insurance, "Counting Captives," 11 March 2013

Aggregate Investment Type for All Captives



Source: Marsh

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WHY INSURE VARIOUS TYPES OF RISK THROUGH A CAPTIVE?

Insuring Retained Casualty Risk through a Captive

- **Workers' Compensation (WC)**
- **General Liability**
- **Products Liability**
- **Auto Liability**

Why Consider

- Ability to issue first dollar policies for rate reimbursement purposes
- Federal tax benefits:
  - *Accelerated* tax deduction when reserve is established versus when paid
  - Typically worth 3 to 5 percent of projected losses for one underwriting year (discounted after tax basis)
  - Contingent upon the captive operating as an insurance company for U.S. federal tax purposes
- U.S. state tax benefits:
  - Captives are not subject to state income tax
  - Ability to build income exempt from state taxes

Insuring Retained Casualty Risks through a Captive
Case Study: Financial Value with Captive Program

Financial Savings Summary
Deductible Program vs. Captive Program (USD)

2014 POLICY YEAR			
	Loss Payments	**Tax Deduction Deductible Program**	**Tax Deduction Captive Program**
2014	$ 6,000,000	$ (2,280,000)	$ (7,600,000)
2015	5,000,000	(1,900,000)	-
2016	4,000,000	(1,520,000)	-
2017	3,000,000	(1,140,000)	-
2018	2,000,000	(760,000)	-
Total	20,000,000	(7,600,000)	(7,600,000)
Total After Tax Cost		12,400,000	12,450,238
Present Value Total After Tax Cost		11,674,985	11,448,436
Advantage of Captive			226,549

Lower cost due to additional investment income earned as a result of recognizing tax deduction sooner.

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Insuring Traditional High Severity Retained Risk through a Captive

- **Property Risk, including wind and quake**
- **Builders Risk**
- **Professional Liability**
- **Pollution**
- **Employment Practices Liability**
- **Weather Risk**
- **Cyber Risk**

Why Consider

- Ability to segregate funds over time to stabilize the annual cost
- Means to obtain formal evidence of coverage
  - Reimbursement purposes
  - Meet contractual requirements with third parties or regulators
- Ability to build up captive income exempt from <u>state</u> income taxes
- Potential to build up underwriting profits of the captive <u>exempt</u> from <u>federal</u> income tax per Section 831(b) of the U.S. Tax Code:
  - Premiums cannot exceed $1.2 million annually
  - Captive must operate as an insurance company for U.S. federal tax purposes
  - The captive must reside onshore, or if offshore, take the 953(d) Election to be treated as a U.S. taxpayer

Insuring Uninsured Terrorism Risk through a Captive

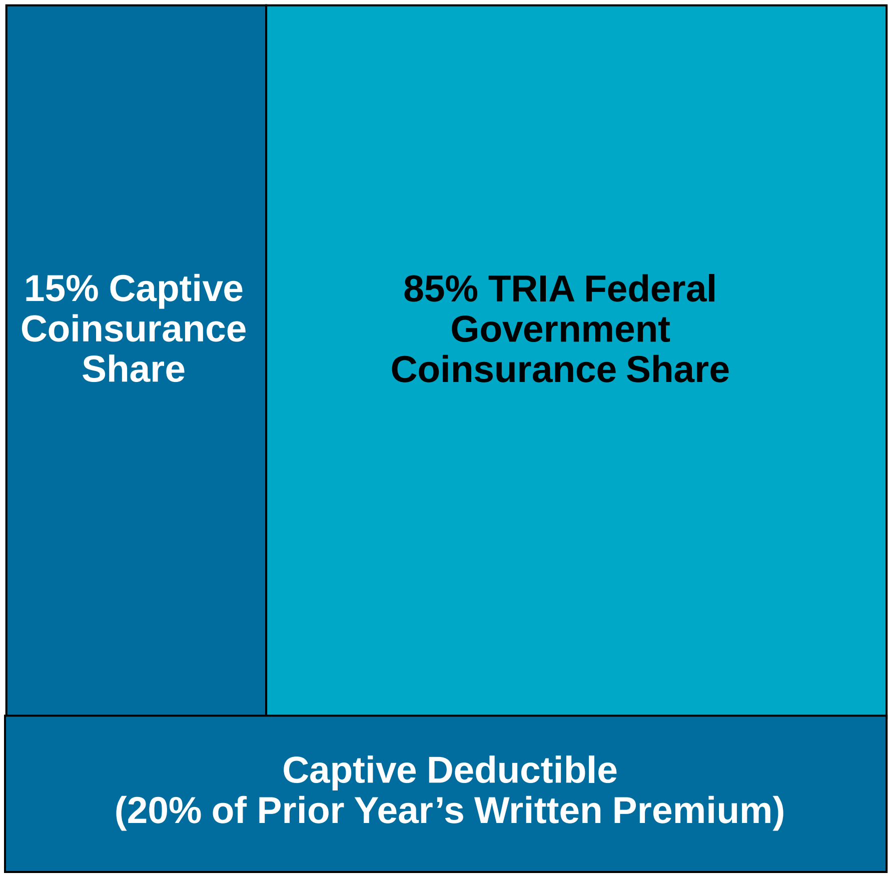
- **Terrorism Risk:**
  - **Property**
  - **Nuclear, Biological, Radiological and Chemical Risks (NBCR)**

Why Consider

- Access to the U.S. Government sponsored Terrorism Risk Insurance Act (TRIA) reinsurance pool for risk transfer protection
- The loss must *exceed* $100 million in total for <u>all</u> insurers affected for the TRIA pool to respond
- TRIA Pool provides government backed insurance for 85 percent of the loss costs excess a deductible equal to 20 percent of the captive's <u>prior</u> year written premium
- No cost to captive to access TRIA protection
- Captive must reside onshore or be a U.S. branch of an offshore captive

Illustration of TRIA Coverage – Assumes $20 Million Insured NBCR Loss

$20M Limit



Insured Loss	$	20,000,000
Captive Deductible		**2,000,000**
Subtotal	$	18,000,000
15% Quota Share		**2,700,000**
Government Share	**$**	**15,300,000**
Captive Share	**$**	**4,700,000**

Traditional Commercial Placements Fronted by Captives

	Why Consider
Placements with traditional foreign insurers (subject to U.S. federal excise tax)	• Direct placements with foreign insurers are subject to 4 percent U.S. federal excise tax • If fronted by a U.S. captive and then reinsured offshore, FET reduced to 1%
Placements with surplus lines carriers (subject to state surplus lines tax)	• Surplus lines premium tax varies by state on direct procurement of coverage from a non admitted surplus lines carrier • If fronted by a U.S. captive and then reinsured to the commercial insurer, the transaction would not be subject to surplus lines tax • However the insured may incur self procurement tax on the captive placement which may equate to the surplus lines tax

Insuring Traditional Third Party Risk through a Captive

- **Subcontractors:**
  - **WC**
  - **General Liability**
  - **Auto Liability**
  - **Subcontractor Default**
- **Clients**
- **Joint Venture Partners**

Why Consider

- Enhanced profits for company
- Source of third party risks in the captive to create risk distribution which supports the favorable tax treatment of the captive
- Wrap-up approach ensures consistent terms and conditions as well as adequate limits
- NOTE: Placements must be fronted by an admitted insurer and then reinsured to the captive to meet state insurance regulatory requirements

Insuring "Active" Employee Benefits through a Captive

- **Retained "Active" Employee Benefits Risk:**
  - **Short Term Disability**
  - **Long Term Disability**
  - **Group Life**

Why Consider

- Source of third party risks in the captive to create risk distribution for favorable tax treatment
- Ability to build up captive income exempt from state income taxes
- More disciplined approach for segregating funds for liabilities

Important Considerations

- Must be fronted by an admitted insurer
  - Per U.S. Department of Labor (DOL) requirements
  - Results in additional fronting fees and premium taxes
- U.S. DOL approval is required for the captive transaction:
- Local domicile approval required as well
- U.S. domicile or U.S. branch is needed
- Captive must be seasoned for one year prior to reinsuring risk

COST CONSIDERATIONS
Operating Cost, Premium Taxes, and Capital Requirements

Captive Cost Considerations

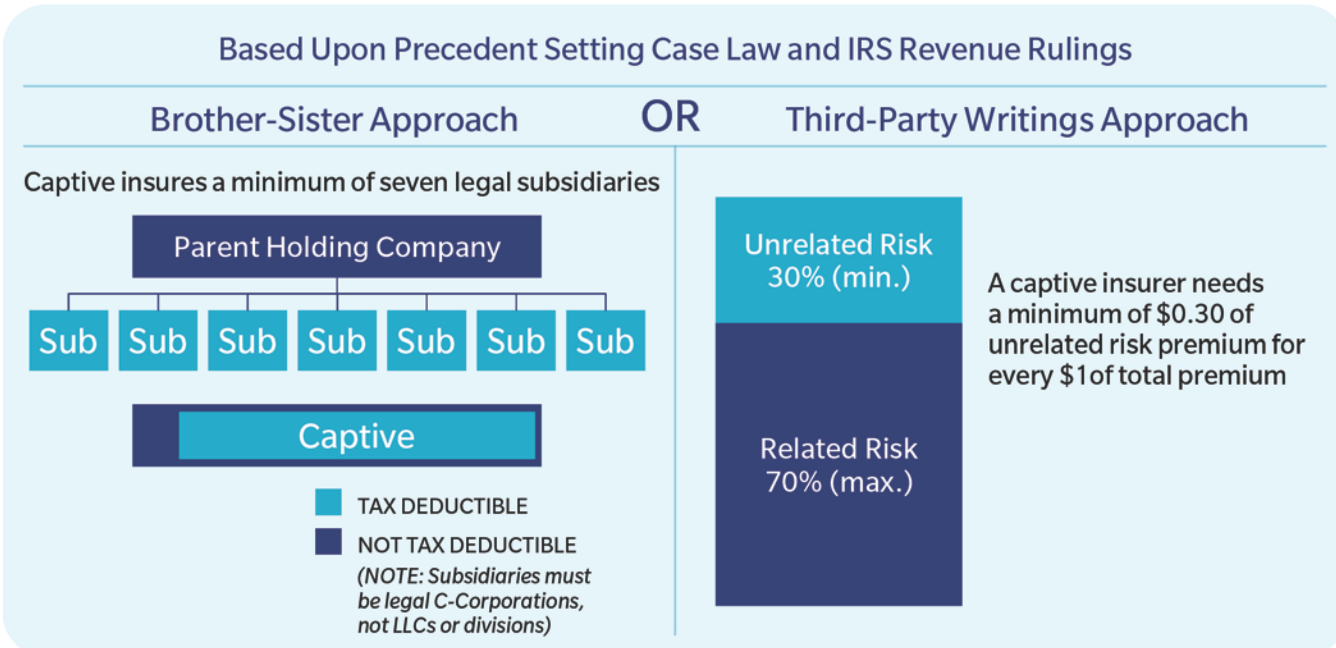
ITEM	COST
Captive Feasibility Study	Fees on average range from $25,000 to $50,000
Start Up Costs	Regulatory, legal, actuarial, and implementation fees (approximately $25,000 to $45,000 depending on domicile)
Annual Operating Costs	Regulatory, legal, actuarial, audit, and captive management fees (approximately $100,000 to $125,000 per year for wholly owned captives)
Captive Domicile Premium Tax	Only imposed by select onshore captive domiciles (typically 0.38 percent on direct captive placements and 0.225 percent on reinsurance captive placements)
Self Procurement Tax	• U.S. state premium tax imposed on an insured by its “home state” when procuring insurance from a non-admitted insurer such as a captive • Tax due by state ranges from 0 to 6 percent, which may be imposed on the total U.S. premium at the “home state” rate or assessed on allocated premium by state at the individual state tax rates (home state would collect and allocate the tax out)
Capitalization	Typical premium to capital ratio required ranges from 3:1 (more severity type risks such as Property) to 5:1 (more predictable risks such as Casualty) and may be met through cash or a letter of credit depending on domicile
Opportunity Cost on Funding Captive Premium	Driven by the ability for captive to mirror investment returns on cash flow used to support premiums versus if cash had remained with parent company

US TAX CONSIDERATIONS

The Importance of Treating the Captive as an Insurance Company for US Federal Tax Purposes

U.S. Tax Considerations
Qualifying As An Insurance Company for U.S. Federal Tax Purposes

- No bright line test to support the existence of "insurance" for federal tax purposes
- However favorable precedent setting case law and revenue rulings for captive owners have emerged since the mid 1980's
- Two main approaches support the existence of risk distribution



Captive US Federal Tax Treatment
Steps to Realize Federal Tax Benefits

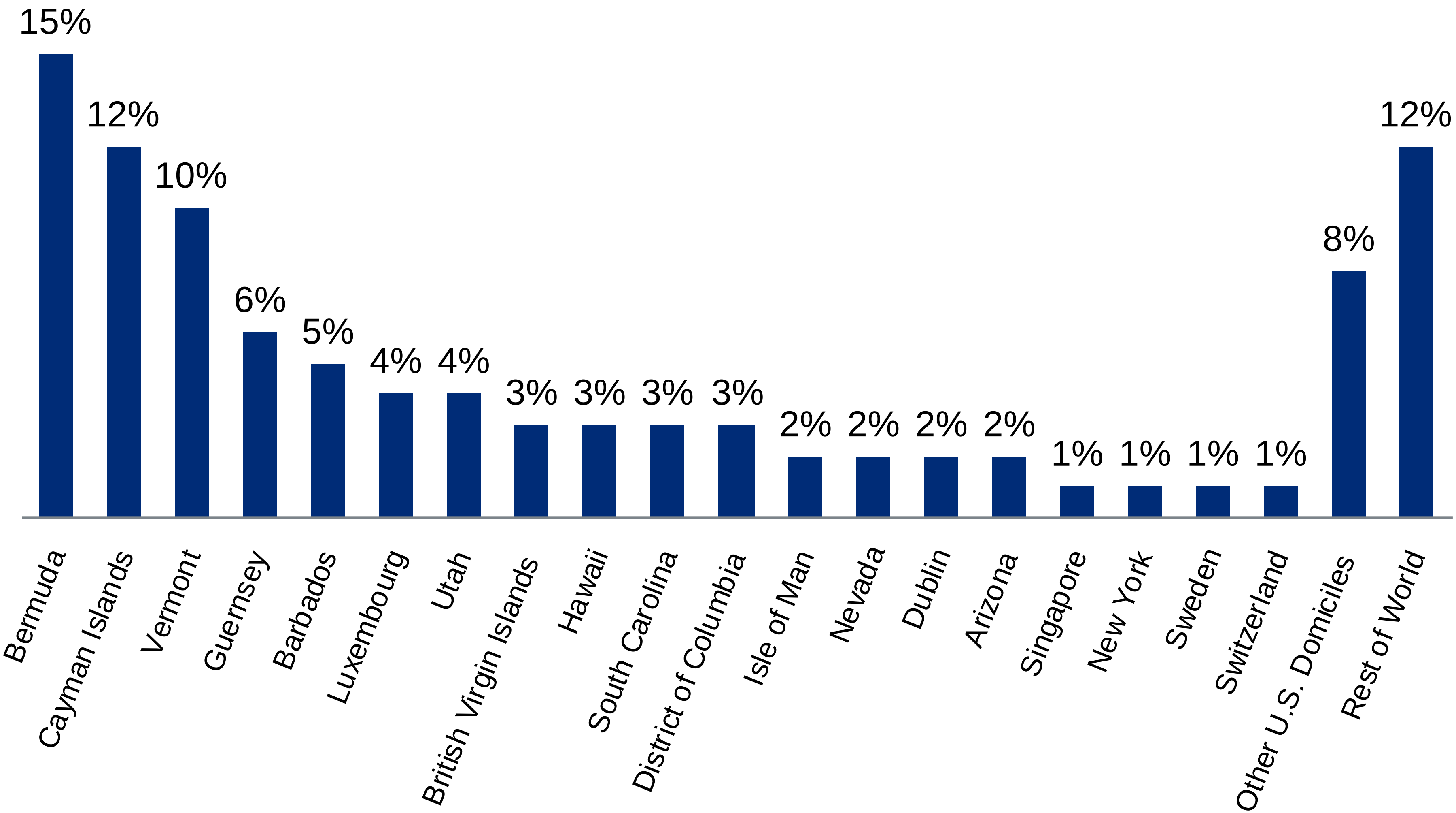
STEP 1: Qualify as an Insurance Company for US Federal Income Tax Purposes	**STEP 2:** Meet Risk Distribution Requirements	**STEP 3:** Realize the Tax Benefits
• Existence of insurance risks (not investment or business risks) • Shift financial risk to the captive ("risk shifting") • Appropriately distribute the risks among a sufficient number of insureds ("risk distribution") • Regulated insurance company • Clear business reasons • Adequately capitalized • No parental guarantees – arms length	**Two Options:** 1. Insure brother/sister companies (Must be legal C-Corps not LLCs or divisions) Case law— Insure minimum of six sister entities Revenue Ruling – Insure minimum of twelve sister entities **or** 2. Insure unrelated third parties Case law— Minimum 30 percent premium from unrelated risk Revenue Ruling – Minimum 50 percent premium from unrelated risk	1. 831(b) or the "Small Insurance Company" Election – If premiums < $1.2 million annually, ability to earn *underwriting* profit on a tax exempt basis – Beneficial when insuring risk high in severity with no expected claims such as Property 2. Accelerated tax deduction when reserve established versus when loss is paid due to special rules afforded to insurance companies (beneficial when insuring long tail risk such as Casualty)

Section #7

SELECTING THE OPTIMAL CAPTIVE DOMICILE

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

Domicile Selection: What is Important?
Factors Organizations Should Consider When Selecting a Domicile

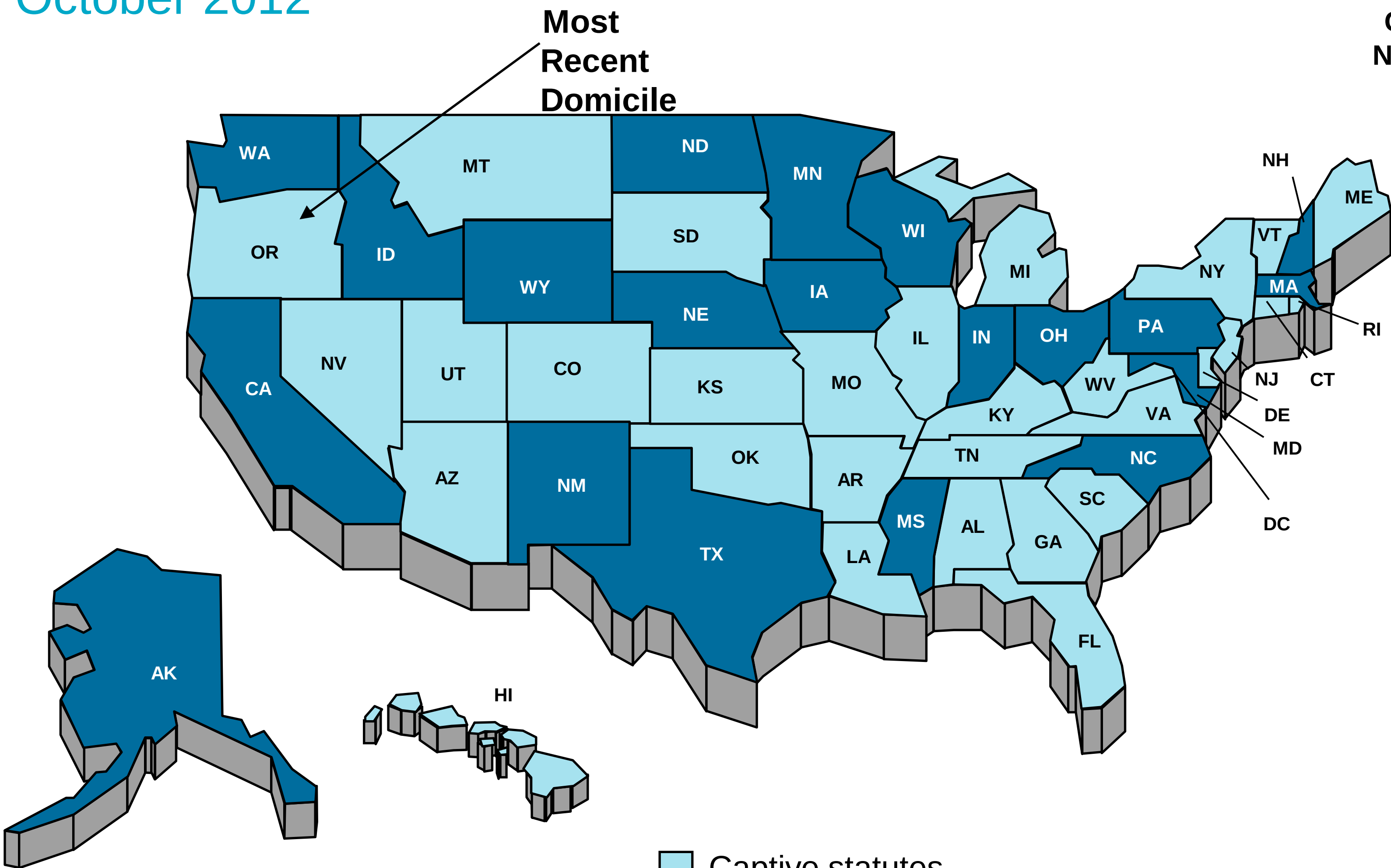
Some Key Factors to Consider:

- **Capitalization**
- **Operating Cost**
- **Regulation**
- **Infrastructure** – ensuring that your domicile has captive managers, lawyers, banks, and auditors who understand the captive industry is an extremely important factor
- **Ability to direct write in the E.U.**
- **Permitted business** – access to TRIA and U.S. employee benefits can only be done using a U.S. domiciled captive or a branch of an offshore captive; access to Pool Re
- **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

Other Factors to Consider Include:

- Premium taxes
- Industry expertise
- Ability to enter into intercompany investments
- Time frame for licensing
- Access to Regulators
- Diversity of captives regulated/makeup and depth of captives managed
- Need for the captive to reside in the insured's home state where the captive is admitted and licensed (placement therefore may not be subject to Self Procurement Tax)

U.S. Domestic Captive Domiciles
October 2012



Captive statutes

No specific captive statutes

Captive Domicile / Number of Captives

Alabama	18
Arizona	97
Arkansas	1
Colorado	5
Connecticut	2
Delaware	150
District of Columbia	157
Florida	0
Georgia	13
Hawaii	172
Illinois	1
Kansas	1
Kentucky	137
Louisiana	0
Maine	2
Michigan	5
Missouri	19
Montana	83
Nevada	127
New Jersey	4
New York	50
Oklahoma	1
Rhode Island	0
South Carolina	159
South Dakota	4
Tennessee	4
USVI	8
Utah	239
Vermont	590
Virginia	0
West Virginia	1

Why Oklahoma

- Updated competitive captive statute
  - Low premium taxes
  - Reporting requirements
- Flexible and supportive regulatory environment
- No self procurement premium tax imposed on captive premium for Oklahoma based insureds
- Pro business
- Knowledgeable experienced regulatory team

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