

THE EVOLUTION OF CAPTIVES: 50 YEARS LATER

MAY 2014

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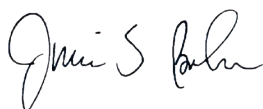
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■ FOREWORD

For the seventh consecutive year, Marsh's Captive Solutions Practice is pleased to present our *Annual Captive Benchmarking Report*. As the world's largest captive manager, we have a vast and privileged perspective of the captive industry that we are pleased to share with our clients, the captive industry, and our colleagues.

This report reflects the status of 1,148 captive insurance companies managed by Marsh globally. We have presented captive insights in a simple and efficient way, so newcomers, midsize organizations, and those seasoned in our industry can all gain an understanding of where we currently are in the captive landscape and what trends may influence captives in the future.

We welcome you — both first-time readers as well as those who have provided useful feedback to prior versions — to this year's report. We hope you enjoy this snapshot of the captive industry and our analysis. We are confident that you will find the information in the following pages both interesting and useful, and we invite you to discuss it further with your Marsh Captive Solutions contact, client executive, or members of our global Marsh team.



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EXECUTIVE SUMMARY AND DEVELOPMENTS

As the world's leading captive manager, we have benchmarked a total of 1,148 captives in our report, which includes a vast array of all types of captives, risk retention groups (RRGs), non-traditional captives (such as special purpose vehicles), and life insurance company captives. This broad sample gives us unprecedented benchmarking data and metrics to compare and contrast the industry and allows us to identify current and future trends.

The following executive summary provides our key insights and findings from Marsh's 2014 *Captive Benchmarking Report*.

CAPTIVE TYPES

Representing 66% of the total captive count, single parent captives continue to be the preferred structure of captive owners. We expect this pattern to continue, given the advantages afforded to owners, such as control and autonomy in multiple aspects of the captive.

Although this report focuses primarily on single parent captives, we have benchmarked special purpose vehicles (SPVs) and life insurance captives, and analyzed small captives (as per Section 831(b) of the Internal Revenue Code).

SPVs accounted for 9% of the benchmarked captives. Most SPVs are owned by financial institutions as part of their risk-mitigation strategy. One type of SPV, which has created a new opportunity for real estate investment trust (REIT) clients, has been growing at a rapid rate since the summer of 2013. We are working with REIT clients to create captives for the purpose of accessing funding at favorable rates via the Federal Home Loan Bank system (FHLB). A captive domiciled in the FHLB territory can access funding at favorable rates, since only banks and insurance companies can apply for membership to the FHLB.

CAPTIVE INVESTMENT PORTFOLIOS

Since the credit crisis, a large proportion of captives have entered into intercompany investments with their parent company and affiliates. Thanks to increased flexibility from the regulators with this type of investment, it is now the most common among captives, with 34% of the aggregate portfolio. These intercompany investments are securitized by 18% of captives for added regulatory comfort. We expect to see intercompany investments to grow in the near future.

Fixed-income assets come in a close second with 32%, reflecting the preference of captive owners for investments with low volatility to preserve capital.

FRONTING AND REINSURANCE

Thirty percent of captives use a fronting company, which then reinsures a portion of risk to the captive. The most common reasons to use a front with a captive are the writing of third party risks, compliance with contractual terms where "admitted" coverage is required, and parent country admitted and non-admitted regulations. Captive owners based in the US tend to access reinsurance more than their counterparts in Europe or other regions.

THIRD PARTY BUSINESS

Third party risks are insured in 18% of the benchmarked captives. These coverages include customer risk, employee benefits, and pooling arrangements. Pooling facilities for larger traditional captives, such as The Green Island Reinsurance Treaty for casualty coverages, have been in existence for more than 17 years. The success of some larger captive pools has precipitated the rapid growth and development of small pooling facilities for high-severity/low-frequency risks, especially as small captives continue to grow.

TYPES OF COVERAGE

Common non-traditional coverages in captives, such as trade credit, crime, and cyber liability, are gaining momentum. Voluntary employee benefits (VEB), such as critical illness, ID theft, pet insurance, group home, group auto, and group umbrella, are also becoming more common; it is a trend expected to continue, as the market is becoming aware of the advantages of underwriting VEB in a captive insurance company.

Among the most popular risks included in captives, general liability has the lead, with 30.8% of benchmarked captives writing this line of coverage, closely followed by property risk, with 29.4% of captives including this coverage.

CAPTIVE RATINGS

Only 3% of captives obtain a rating. A.M. Best is the leading agency with 52% of all rated captives. A.M. Best reported that it rated 18 captives and three risk retention groups in 2013. A.M. Best is followed by Standard & Poor's with 30%, and Moody's with 18%. Benefits of a rating include improved leverage with fronting carriers and reinsurers, and compliance with contractual terms.

CAPTIVE TAXATION

There were significant developments in the UK in 2013 with controlled foreign corporation (CFC) laws, making

captives more attractive to owners in the UK. Captives are formed for business and risk management reasons, and we have found that only 37% of US companies with captives actually achieve insurance company tax status and deduct premiums paid to the captive. In January 2014, *the Rent-A-Center, Inc. and Affiliated Subsidiaries vs. Commissioner of Internal Revenue* case represented the first significant decision on captive insurance company arrangements in more than 13 years. Although it did not change the captive tax landscape, this decision allows captive owners to review certain issues such as risk distribution, capitalization, and intercompany investments with some fresh and recent guidance.

There was also a favorable case (*Validus Reinsurance, Ltd. vs. United States of America*) in 2014 that affects the payment of federal excise tax (FET) and makes the rules clearer for captive owners.

SMALL CAPTIVE TAX ELECTION

There has been a tremendous amount of growth and interest in small captives that elect to be taxed on investment income, not underwriting income, in the US. Most of Utah's captive formations in the last two years have been small captives, and other domiciles, such as Delaware, Montana, and Nevada, are starting to increase their small-captive share as well. Common coverages include high catastrophic lines such as excess liability and terrorism.

In the UK, there is a similar concept to the US small captives as a result of the 2013 UK CFC laws.

CAPTIVE OWNER INSIGHTS

US companies own 58% of all captives, European parents own 28%, and companies from the rest of world (such as Latin America, Asia, and Africa) own 14%. Despite the increased activity in emerging captive markets like Latin America, the dominance of US parent companies owning captives is a trend that will continue, with small captives remaining an area for growth.

PUBLIC VS. PRIVATE AND PROFIT VS. NOT-FOR-PROFIT OWNERS

There is a growing trend for private companies to own captives, mostly attributable to the growth of small captives. Currently, 52% of captives are owned by private entities, dispelling the myth that captives are only for large public Fortune 1000 companies. Not-for-profit entities account for 19% of all captives and represent health care organizations, churches, educational institutions, public-transportation entities, and municipalities.

DOMICILES

The largest three domiciles — Bermuda, the Cayman Islands, and Vermont — represent 36% of all captives. As more global and US domiciles are created, however, there is a trend toward emerging domiciles.

Global onshore versus offshore single parent captives remained flat in 2013 with 56% of captives being onshore and 44% being located in offshore domiciles.

With Solvency II set for full implementation in 2016, the insurance industry can, at last, proceed with final preparations for the introduction of the new regime and, as such, some new growth is expected in captive formations in EU domiciles. EU domiciles currently account for 28% of all benchmarked captives.

Emerging domiciles continue to grow, attract new business, and react to making their domiciles unique and marketable to new and old captives. Texas, New Jersey, Connecticut, and Tennessee are looking to position themselves strategically and have developed regulatory infrastructure for large-scale growth.

RE-DOMESTICATIONS

We observed 11 re-domestications in 2013, down from 16 in 2012. This figure demonstrates that there is no large-scale movement of captives to onshore jurisdictions, as some had anticipated as a result of the enactment of the US Dodd-Frank Act. Texas, a new US domicile, is the only state we have seen to respond with enforcement measures, and it has enacted legislation relative to self-procurement taxes, so some movement to Texas is expected.

TERRORISM PROTECTION

On the terrorism protection front, 11.5% of captives participate in a terrorism program. Of this group, 71% are accessing the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA, but commonly referred to as TRIA) in the US. Although TRIA is set to expire on December 31, 2014, most industry experts believe it will be renewed in some fashion, although with potentially higher trigger, deductible, and quota share.

REGULATORY DEVELOPMENTS

The Foreign Account Tax Compliance Act (FATCA) is a US Regulation — enacted in 2010 and taking effect in 2014 — aimed at foreign financial institutions (FFIs), which can include captives. Administrative reporting (IRS Form W8/W9) by foreign captive insurance companies may be required in certain scenarios. Foreign captives that make a 953(d) tax election to be considered a US corporation for tax purposes may not be required to file Form W8/W9 in certain cases.

Implementation of Solvency II takes effect on January 1, 2016, and the insurance industry can now proceed with final preparations for the introduction of the new regime. With these developments, we expect to see growth in captive formations in the EU domiciles. It is also encouraging to see some EU regulators applying the principle of proportionality to captives in their approach to the interim guidelines; hopefully, this can be taken as an indication of how they will regulate captives under the new regime.

I CAPTIVE INSIGHTS

CAPTIVE TYPES

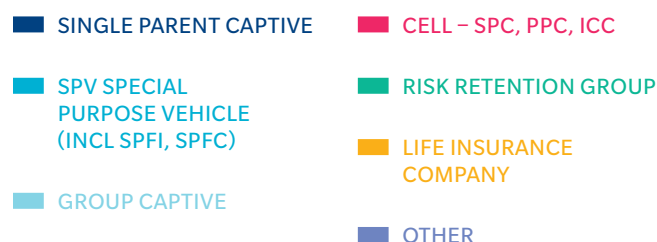
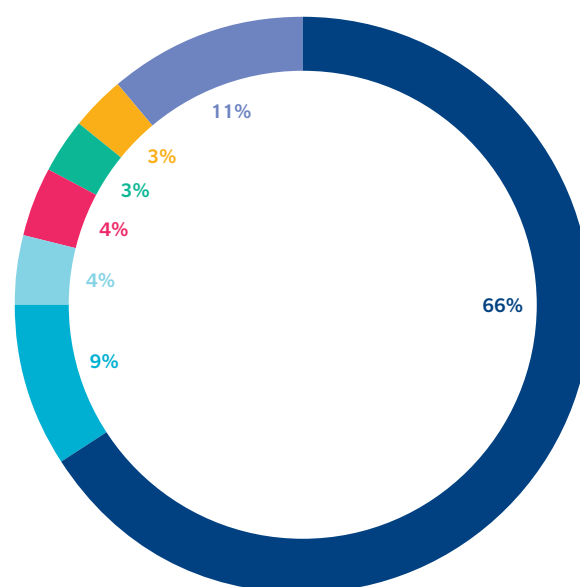
A single parent captive continues to be the preferred structure for all captive owners. This structure is practical because it allows companies to have greater influence over the vehicle and claims process, participation on and some control of the board of directors, in many cases, and the ability to make ultimate decisions regarding service providers, lines of insurance included in the captive, number of insureds (subsidiaries), investment policy, and management of surplus, among other decisions that are not encountered in other captive arrangements. Included in the single parent captive category are small-captive companies.

This year, we analyzed other categories of captives, namely, special purpose vehicles (SPVs), which represent 9% of the entities benchmarked (see **FIGURE 1**). The majority of SPVs are owned by financial institutions, which use these vehicles to protect the company from financial risk and to control capital and surplus with efficient mechanisms popular among commercial insurers.

SPVs, both traditional and insurance linked, saw an increase in activity in 2013. Traditional securitization vehicles (such as collateralized debt obligations, credit linked notes, and asset-backed) are used by financial institutions as they try to increase liquidity by pooling assets and financing their purchases through bond issuances from these vehicles. There was also a global increase in the use of insurance-linked securities (ILS) as risk-transfer vehicles, with a large increase in new issuance in the market (US\$ 7.2 billion), bringing the total outstanding to US\$20.5 billion at year's end. For this reason, we have included these vehicles in our benchmarking statistics, many of which are domiciled in the EU, Bermuda, and the US.

Marsh saw its overall portfolio of SPV companies grow during 2013, and now manages more than 108 of such entities. Twenty-five of these are ILS transactions, nine of which were new issuances in the past year. The more traditional securitization vehicles under our management also increased, with a divergence into trade receivable and non-performing loan vehicles. It is expected that this market will continue to grow during 2014, especially in relation to ILS, as the capital markets are developing a

FIGURE 1 | TYPE OF RISK-FINANCING VEHICLE
Source: Marsh's Benchmarking Survey Analysis 2014



keen interest in this asset class and insurers are looking for alternatives to the traditional reinsurance markets.

Captive membership in the Federal Home Loan Bank (FHLB) is a significant new opportunity for real estate investment trust (REIT) clients, and has been growing at a rapid rate since the summer of 2013. We are working with REIT clients to create captives for the purpose of accessing funding with the FHLB system. When the FHLB was chartered by Congress in 1932, it restricted membership to only companies that engaged in lending activities. Since only banks and insurance companies can become members of the FHLB, today's captive insurance company can be an eligible applicant.

CAPTIVE INVESTMENT PORTFOLIOS

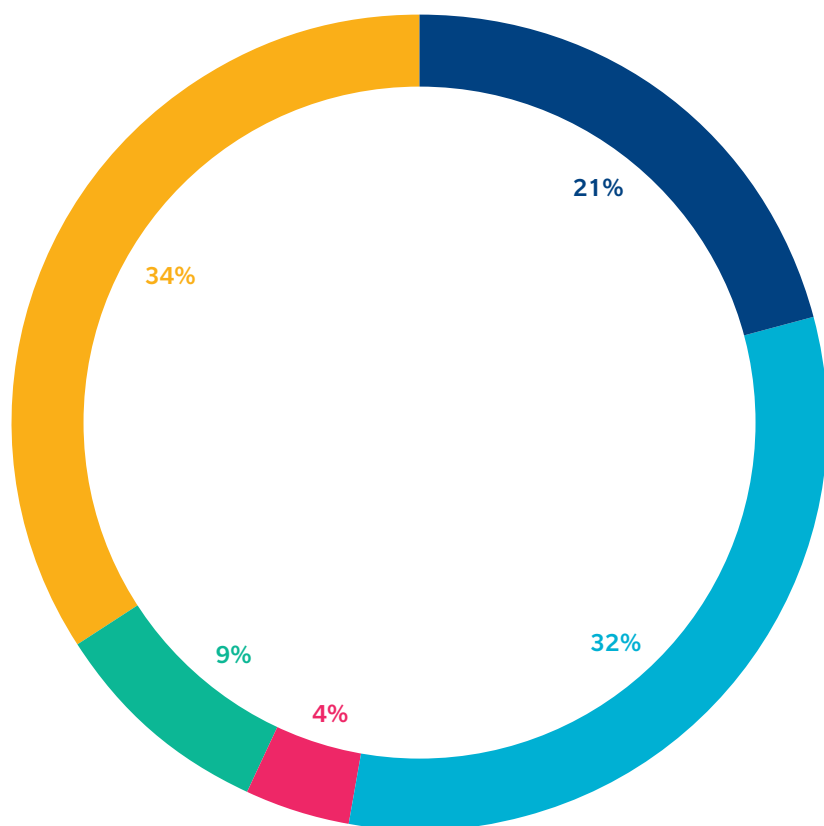


FIGURE 2 AGGREGATE INVESTMENT TYPE FOR ALL CAPTIVES
Source: Marsh's Benchmarking Survey Analysis 2014

- CASH AND CASH EQUIVALENTS
- FIXED INCOME/BONDS/DEBT SECURITIES
- EQUITIES/SHARES
- ALTERNATIVE INVESTMENTS/HEDGE FUNDS
- INTERCOMPANY LOANS/OTHER INTERCOMPANY INVESTMENTS

Intercompany loans are the most common type of investment for captive insurance companies (see **FIGURE 2**). The reinjection of resources to the operations of the parent company reduces the opportunity cost of having those assets in the captive earning little or no investment income, and is the main driver for companies to structure intercompany investments. A low-interest-rate environment, existing since 2008, accounts for this trend to access a captive's assets via these mechanisms.

As with traditional insurance companies' portfolios, fixed-income assets — which are viewed as very conservative — are the leading investment type following intercompany

investments. Fixed income investments are the most likely investment to tie to the captive's long-tail liabilities. Cash and cash equivalents, with 21% of the portfolio, shows how captives maintain a healthy level of liquidity in order to pay losses to their insureds.

Only 4% of captives are investing in equities, evidence of the extremely conservative nature of captives in general. However, it is important to note that 9% of the portfolios are alternative investments, other portfolios, and even some hedge fund investments, which reflects the flexibility that captives have in the management of their portfolios.

We expect a steady increase of intercompany loans since regulators worldwide are becoming more flexible with this practice, especially when the loan is securitized in some way (see **FIGURE 3**). Globally, and from a US federal income tax perspective, as well as regulatory comfort, loan securitization is preferred since it demonstrates an arm's-length, reasonable, and prudent mechanism,

similar to how traditional insurers operate. Currently, 18% of captives are securitizing their loans, a practice that is expected to grow in the near future, in light of recent case law and best practices in the industry. Examples of secured loans are mortgages/notes on real property and accounts receivables.

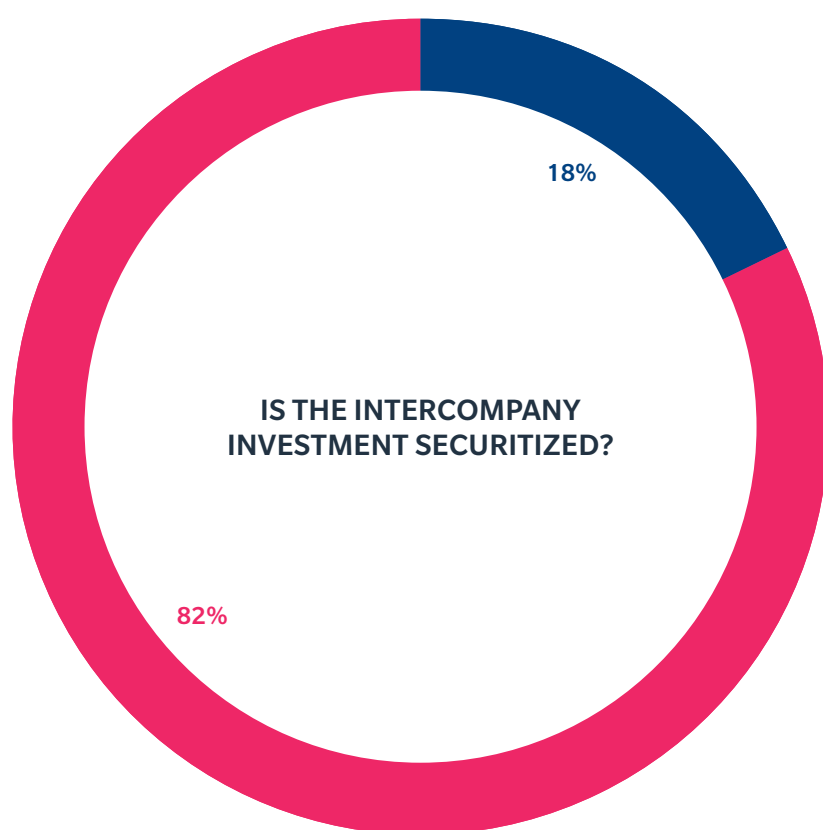


FIGURE 3 SECURITIZED VS. UNSECURITIZED CAPTIVE INTERCOMPANY INVESTMENTS
Source: Marsh's Benchmarking Survey Analysis 2014

■ YES
■ NO

FRONTING

There are two ways to transact business with a captive. The first is via “fronted captives,” where the insurance policy is issued to the insured by an admitted “fronting” insurer, which then reinsures all or a portion of the risk to the captive. This approach provides the insured with:

- ▶ The ability to retain risks via a captive.
- ▶ “Admitted” coverage in countries where it is required.
- ▶ The ability to transact business with third parties and lenders, complying with contractual terms where “rated” or “admitted” coverage is required.

Most third party risks within captives (such as employee benefits) need to be fronted since a captive generally cannot transact business with third parties directly.

Nearly one-third of the benchmarked captives are operating with a fronting arrangement. Some countries, such as Brazil and Argentina, only allow captive formations if the captive is fronted by a local carrier. However, we see that this restriction is easing in other countries such as Colombia, where legislation allowing local companies to procure insurance from foreign carriers without the use of a local fronting company passed last year, opening new opportunities for the captive industry in the region.

The second way to operate a captive is to have the captive write the insurance directly with its owners and affiliates where permitted by law. This approach is common in domiciles such as the UK, Australia, and the US. Under the European Union Freedom of Services Act (FOS), direct-writing captives also have the flexibility to provide direct coverage in the 28 EU countries, as well as Norway, Iceland, and Liechtenstein in the European Economic Area (EEA).

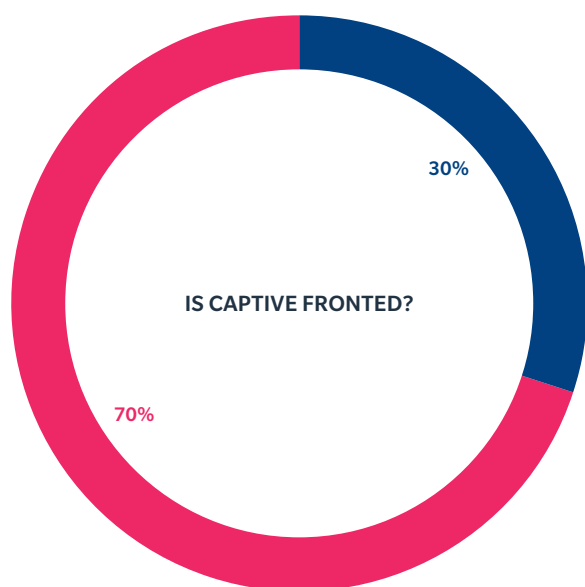


FIGURE 4 | CAPTIVES THAT ACT AS A REINSURER FOR A FRONTING CARRIER

Source: Marsh's Benchmarking Survey Analysis 2014

- YES
- NO

FIGURE 5 CAPTIVES THAT PURCHASE REINSURANCE PROTECTION
Source: Marsh's Benchmarking Survey Analysis 2014

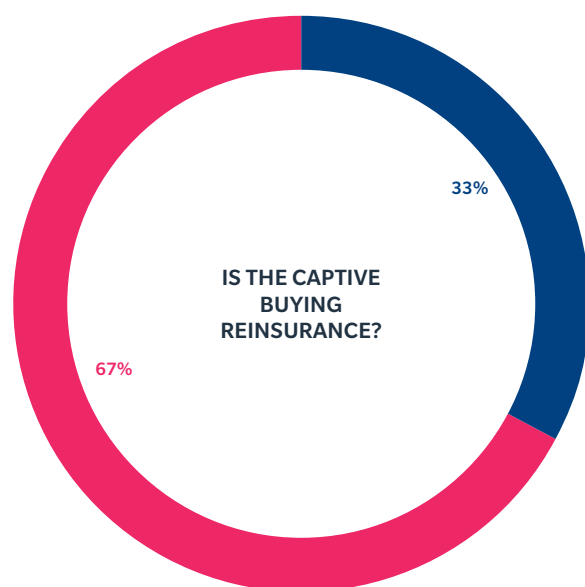
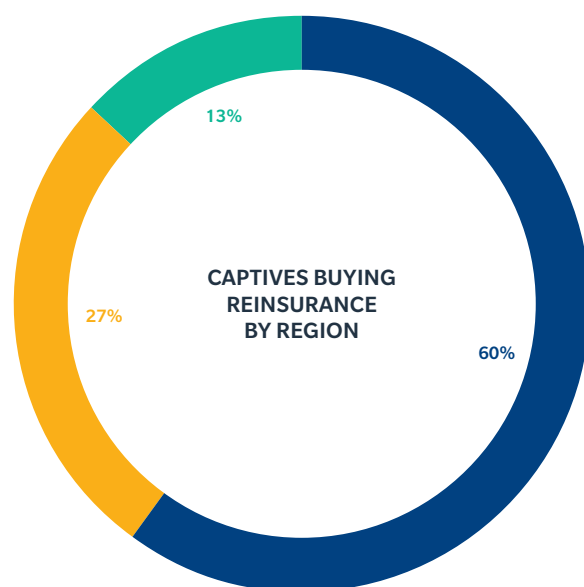


FIGURE 6 REINSURANCE ACCESSED BY OWNER REGION
Source: Marsh's Benchmarking Survey Analysis 2014



REINSURANCE PROTECTION

One-third of the benchmarked captives are buying some level of reinsurance as protection. The use of captives as a front to access the reinsurance market, where terms and conditions may be more preferable than in the traditional market, is an excellent example of how a captive arrangement can help a company to reduce its total cost of risk. In recent years, however, the prices in the reinsurance market tend to mirror the primary market, thus making it less advantageous than in the early 1980s, when the reinsurance market was much more favorable.

Sixty percent of the captives buying reinsurance are owned by US parents but include captives in Bermuda, the Cayman Islands, and other global domiciles (see **FIGURE 6**), a statistic that includes traditional commercial reinsurance access such as property, excess liability, professional liability, and medical malpractice liability. Of the remaining captives, 27% are in Europe and 13% in the rest of the world.

From the perspective of a captive accessing reinsurance, there was a favorable case recently that affects the payment of US federal excise tax (FET) and made the rules clearer for captive owners. In February 2014, the US District Court for the District of Columbia released its opinion in *Validus Reinsurance, Ltd. vs. United States*, on the validity of the cascading FET. Prior to this case, cascading FET would apply to reinsurance placements, and could continue to be assessed every time there was a retrocession (at a 1% FET). Importantly, the court's ruling was broader than taxpayers had hoped. The prevailing thought within the industry was that the court would strike down the cascading tax on the basis that it was an inappropriate extraterritorial application of US law. Instead, the court held that the statute itself did not allow for the FET to be assessed on any retrocession (that is, reinsurance of risk that had been assumed by the ceding company in a reinsurance transaction).

THIRD PARTY BUSINESS

Writing third party risk generally requires a fronting carrier and is one of the alternatives that captive insurance companies offer to diversify the captive's risk profile, provide for profitable business, and allow for participation in certain businesses such as joint venture, customer, or vendor business relationships. Some amount of third party risk is written by 18% of the captives worldwide (see **FIGURE 7**).

The inclusion of third party risks in a captive could be motivated by several reasons. One of the most common drivers for this decision is the possibility of converting the captive into a profit center for the parent, increasing the economic value of the captive arrangement.

In Europe, these third-party risks include warranty business and joint venture business. Bermuda third party business tends to be life insurance, warranty, title insurance, forced place insurance, and personal accident. Cayman Islands tends to be employee health and other third party benefits.

In the US, the number of captives writing third party risks has been increasing — we believe this is due to the increased interest of captive owners in meeting certain risk-distribution fact patterns that support tax deductibility of captive premiums for the parent company.

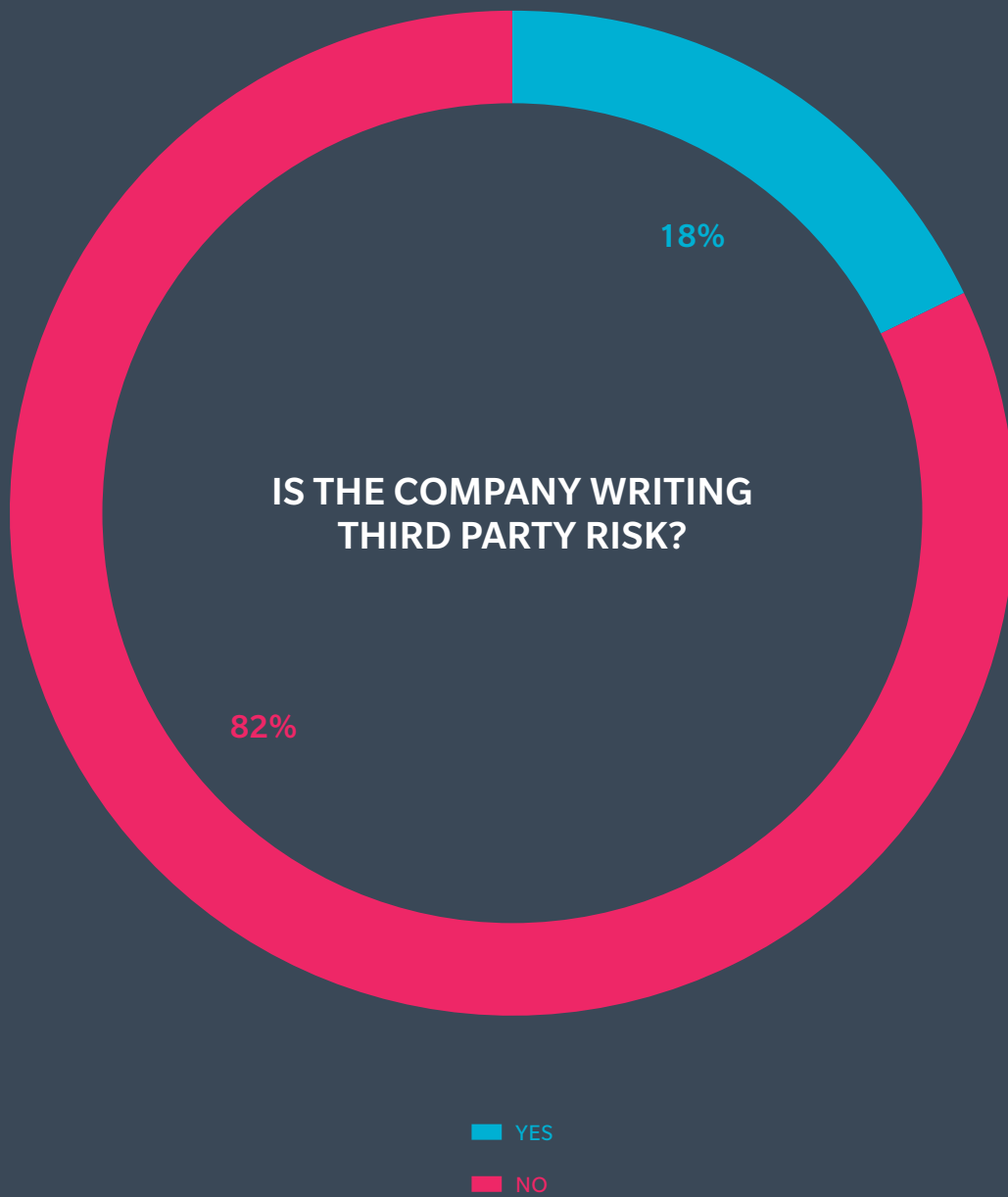
One way to include third party risk in a captive is through participation in risk pools. Through a pooling mechanism, participating captives share their loss experience by

transferring a portion of their risk in exchange for assuming a percentage share of the risks of other treaty participants. By accepting other participants' risks, captives can diversify their underwriting portfolios by assuming third party premium. Pooling may result in a reduction in the variability of expected losses for individual members as each member will be writing a smaller portion of a large pool of losses. The reduction in loss variability produced by the pool is designed to stabilize cash expenditures on losses assumed by participants. Pooling also provides a source of third party risk, which can assist with US federal income tax treatment. To contrast this, the captive also assumes other participants' risk, which it does not control or have risk management oversight of.

The most common lines of coverage found in these pools are workers' compensation, general liability, and auto liability. Marsh's Green Island Reinsurance Treaty (GIRT) is an example of this. With GIRT, participating captives' premium volume has grown over the last 17 years from US\$59 million of premium in 1997 to US\$670 million of premium in 2014.

With the growth of pooling over the years and the increasing number of small captives, there are also numerous small-captive pools that, in some cases, may allow for proper risk shifting and risk distribution. These small pools typically are not for very predictable primary casualty losses; rather, they are catastrophic coverage pools, with lines such as excess liability, product liability, product recall, environmental, cyber liability, supply chain, and terrorism, among others.

FIGURE 7 | CAPTIVES THAT WRITE SOME AMOUNT
OF THIRD PARTY RISK
Source: Marsh's Benchmarking Survey Analysis 2014



TYPES OF COVERAGE

The top five coverages included in captives are no surprise, with general/public/third party liability leading the way with 30.8%, closely followed by property with

29.4%. Deductible buy-down programs for workers' compensation and auto liability are the most common arrangements in captives writing these lines of coverage, representing 21.2% and 17.4%, respectively.

FIGURE 8 | TRADITIONAL INSURANCE COVERAGE WRITTEN BY CAPTIVES
Source: Marsh's Benchmarking Survey Analysis 2014

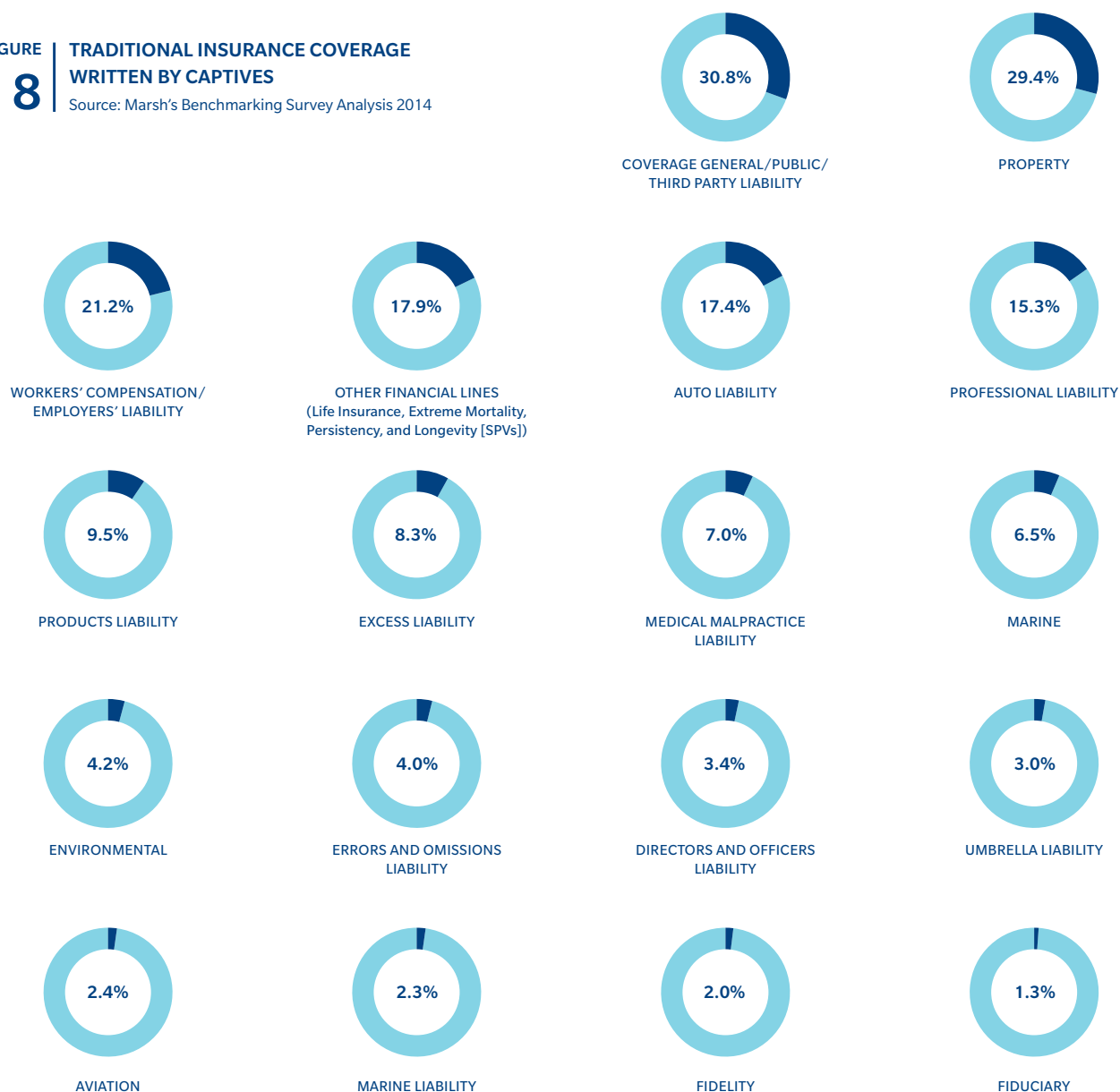
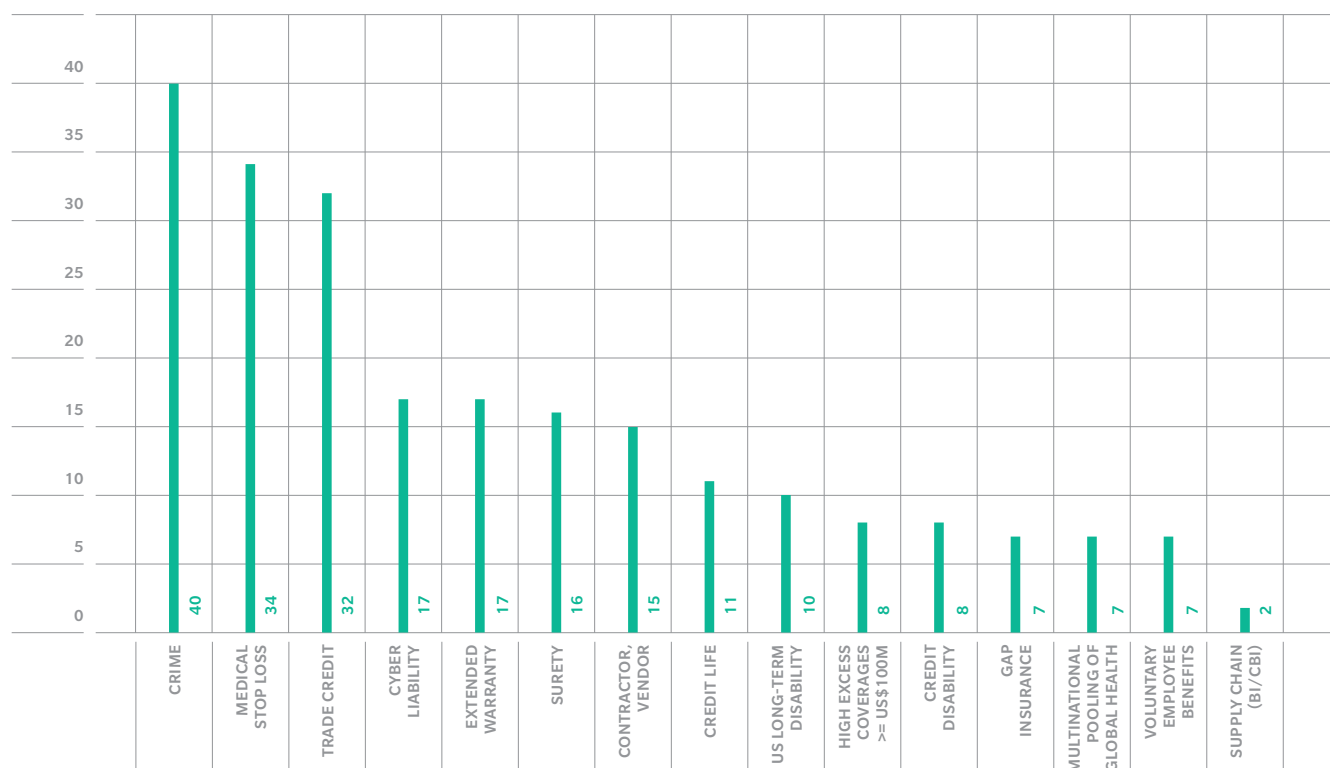


FIGURE 9 | NON-TRADITIONAL INSURANCE
COVERAGE WRITTEN BY CAPTIVES

Source: Marsh's Benchmarking Survey Analysis 2014

NUMBER OF CAPTIVES



Non-traditional coverages historically may not have been prevalent in captives, but have been growing in popularity in the last several years. Examples of non-traditional or core captive coverages include crime insurance/crime deductibles, which leads the ranking. However, the penetration of this coverage is still very low, with only approximately 3.5% of captives underwriting this risk. A number of companies use their captives to write medical stop loss coverage, placing certain layers of self-insured coverage into the captive, allowing the employer to control and minimize health insurance costs. This coverage will be an exposure to watch as the health insurance industry works to implement the remaining portions of the Affordable Care Act in the US.

Cyber-attacks are becoming more frequent and more damaging. Incidents like the data breach involving a large retailer in 2013, which led to the theft of approximately

40 million credit card numbers and 70 million personal records, have raised the awareness of this risk in the corporate world — and captives are a true reflection of these recent developments. The percentage of companies running cyber liability through their captive is gradually increasing and is a trend expected to continue in the near future for captive arrangements.

Other risks such as supply chain, which is linked to property damage (business interruption and contingent business interruption), have been discussed often within the captive world, but with only two captives in our sample writing this coverage, it has not grown as much as anticipated. On the other hand, voluntary coverages, which can include employee benefit programs such as critical illness, identity theft, and pet insurance, are growing along with purely property and casualty voluntary benefits such as home, auto, and umbrella.

CAPTIVE RATINGS

Obtaining a rating is an excellent way to demonstrate the financial strength of the captive, similar to virtually all commercial insurance carriers globally. This can potentially provide more flexibility with fronting carriers (when a front is needed); it may facilitate the inclusion of third party business, since some business partners require a rating to satisfy their requirements; and, in the light of corporate governance, a positive rating is indicative of the highest standards.

Yet having a captive rated is not a small task, which may help explain why only 3% of the captives are rated (see **FIGURE 10**). To start, there are costs associated with the

rating process. Captives must pay an application fee and, after obtaining the rating, there is an annual fee in order to keep the captive rated. The incentives for obtaining and maintaining a rating for a captive or an RRG are that it facilitates improved access to reinsurers and also allows for compliance with contractual terms and conditions (such as leases), where a certain contract may require rated insurance company “paper.”

Rating agencies such as A.M. Best, Moody’s, S&P, and Demotech provide ratings to captives and RRGs. A.M. Best leads the ranking with 52% of the rated captives (see **FIGURE 11**), and it reported that it rated 18 captives and three RRGs in 2013. A.M. Best is followed by S&P with 30%, and Moody’s with 18%.

FIGURE 10 | **CAPTIVES RATED BY A RATING AGENCY**
 Source: Marsh’s Benchmarking Survey Analysis 2014

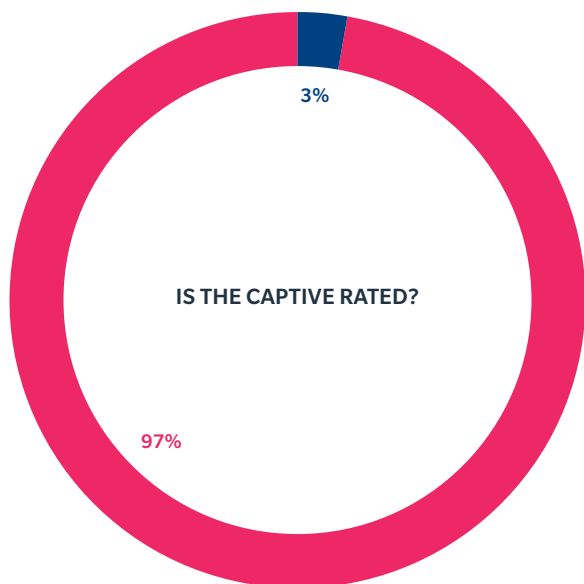
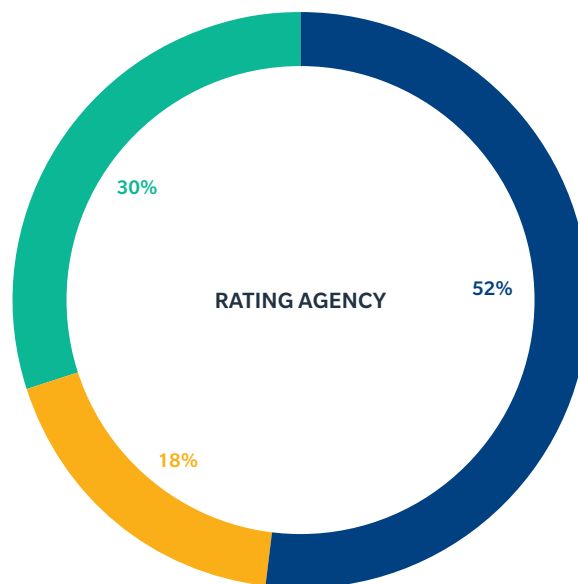


FIGURE 11 | **CAPTIVE RATING AGENCIES USED BY CAPTIVES**
 Source: Marsh’s Benchmarking Survey Analysis 2014



I CAPTIVE TAXATION

A significant development impacting captive taxation, effective January 2013 in the UK, controlled foreign corporation (CFC) legislation is more focused on the artificial diversion of profits from the UK. These rules introduce a principles-based approach designed to exclude many non-UK foreign resident companies from the CFC rules. Therefore, if the risk-retention vehicle (such as a captive insurance company) is structured properly, it may provide certain opportunities for multinational companies. In addition, the new rules have also introduced a low profit threshold, which may provide opportunities for UK companies with lower premium spends to participate in retention strategies centered around single parent or cell captives.

In recent years, multinational companies have been keen to ensure that informal group pooling arrangements, such as intercompany contributions to a central fund, are not challenged by tax authorities under any applicable tax avoidance legislation. Consequently, they have increasingly expressed an interest to formalize such arrangements by establishing a captive that would enable them to achieve the group risk management strategy while reducing the risk of any potential tax challenges.

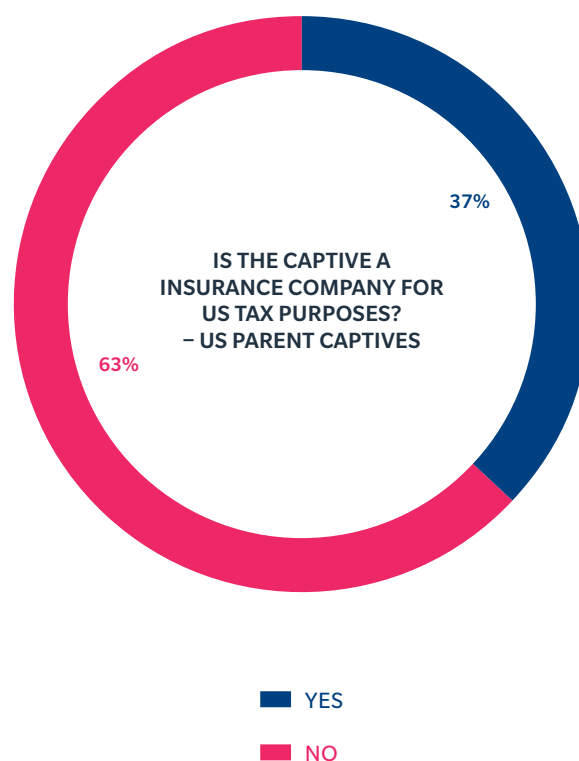
From a US perspective, smaller and midsize companies are investigating captive options and account for the growth in most US domiciles. Whether or not a US captive is an insurer from a federal income tax perspective continues to be a hot topic in the industry. Tax status is commonly referred to as meeting “risk shifting” (transferring economic risk) and “risk distribution” (spreading that risk appropriately).

A recent court case, *Rent-A-Center, Inc. and Affiliated Subsidiaries vs. Commissioner of Internal Revenue*, is the first significant case in more than 13 years since the IRS discussed captive taxation in revenue rulings to examine this concept. The case is considered a pro-taxpayer victory and addresses many captive taxation elements, but the sharply divided court seems to have disagreed on many issues, and it is likely to be appealed in the US Court of Appeals for the Fifth Circuit.

Of the 664 captives benchmarked with a US parent, only 37% are being treated as an insurance company for US

FIGURE 12 | US CAPTIVE OWNERS THAT TREAT CAPTIVES AS AN INSURANCE COMPANY FOR TAX PURPOSES

Source: Marsh's Benchmarking Survey Analysis 2014



federal income tax purposes (see **FIGURE 12**), meaning that captive premiums are tax deductible and that the captive sets up tax-deductible reserves in most instances. This finding suggests that a large majority of captive owners in the US see their captive not as a vehicle for certain tax efficiencies, but as a tool that generates operational and risk management value to the organization in different ways, such as funding retained risk, providing more discipline and control to retained financed losses, accessing the reinsurance market, injecting more oversight and corporate governance to insurance and, in some cases, turning the captive into a profit center by writing third party risks.

Of the captives treated as insurance companies, an almost symmetrical distribution can be seen between the two different positions to qualify for insurance tax accounting. There are two predominant ways to qualify for insurance tax status: “brother/sister,” or with risk distribution based on corporate entity; or third party risk to support risk distribution. The brother/sister approach is used to qualify 47% of the captives (see **FIGURE 13**), where the captive insures seven to twelve legal subsidiaries (subsidiaries must be legal C-corporations or S-corporations, not disregarded single-member LLCs or disregarded divisions). The third party writings approach,

where the insurer needs a minimum of 30% to 50% third party risk, is used by 42% of the captives; the remaining 11% of the captives qualify as insurance companies for tax purposes with a combination of the two positions.

In addition to meeting the risk-shifting and risk-distribution requirements, there are other substantial elements to be met to justify a captive’s tax position, including a solid and sound capitalization, arm’s-length premium parameters, strong investment policies, and no parental guarantees that “prop up” a captive.

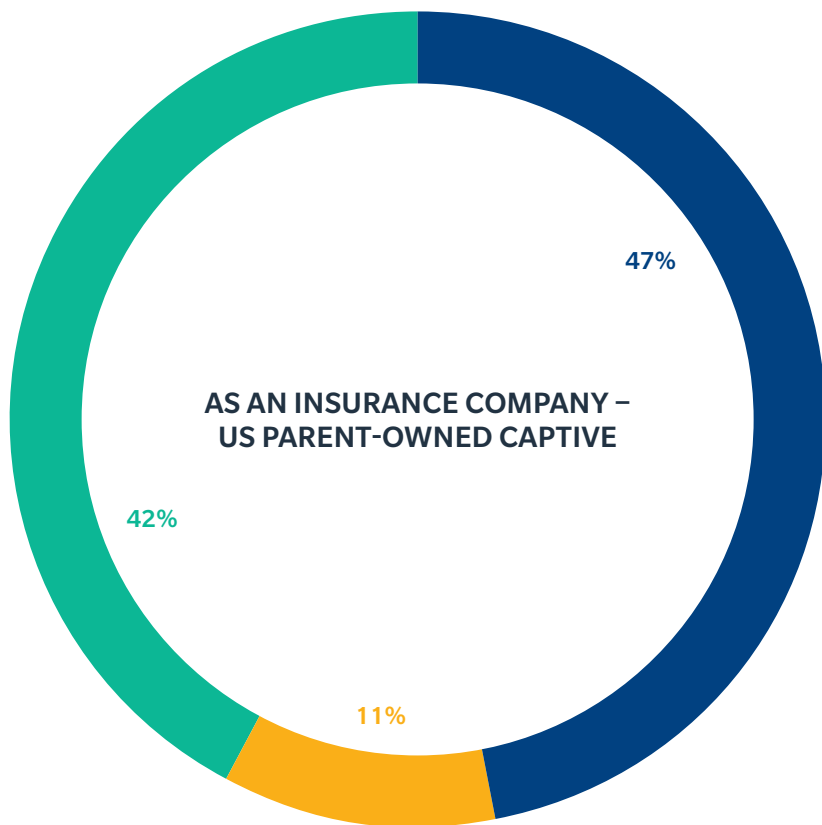


FIGURE 13 US PARENT-OWNED CAPTIVE: APPROACH USED TO QUALIFY AS AN INSURANCE COMPANY

Source: Marsh’s Benchmarking Survey Analysis 2014

- BROTHER/SISTER APPROACH
- HYBRID BROTHER/SISTER AND THIRD PARTY
- THIRD PARTY RISK

I SMALL CAPTIVE TAX ELECTION

The term “small captive” refers to a captive insurance company typically created by midsize companies writing less than US\$1.2 million in premium. Should the captive meet certain risk-shifting and risk-distribution elements and qualify as an insurance company for US federal income tax purposes, it can then elect to be taxed only on investment income, as per section 831(b) of the Internal Revenue Code.

This type of captive represents the most common new captive formations in the US over the last five years and has led to the significant growth of domiciles like Utah, Kentucky, Montana, and Delaware. Offshore, there are also small captives that choose to make the election of being treated as an insurance company for US tax purposes.

Contrary to traditional captives, the small-captive landscape is led by parent companies from many different industries, including manufacturing, real estate, transportation, media and technology, and professional services companies.

Companies often look at small captives as a first step into the captive world for the organization and are less reluctant to set up a new company, in part because normally these small captives demand less capital than a traditional captive. Small captives also provide advantages, such as not having the underwriting profit subject to federal income tax if the captive is properly structured (investment income is subject to federal income tax). Of the small captives, approximately 80% are owned by private companies (see **FIGURE 14**), which supports the idea that they are midsize companies.

Small captives are increasing their participation in the US federal government’s TRIA program, providing an 85% backstop protection (excess a deductible equal to 20% of the prior year written premium, and a 15% quota share participation) for terrorism and nuclear, biological, chemical, and radiological (NBCR) exposures for which parents are, in most cases, self-insured.

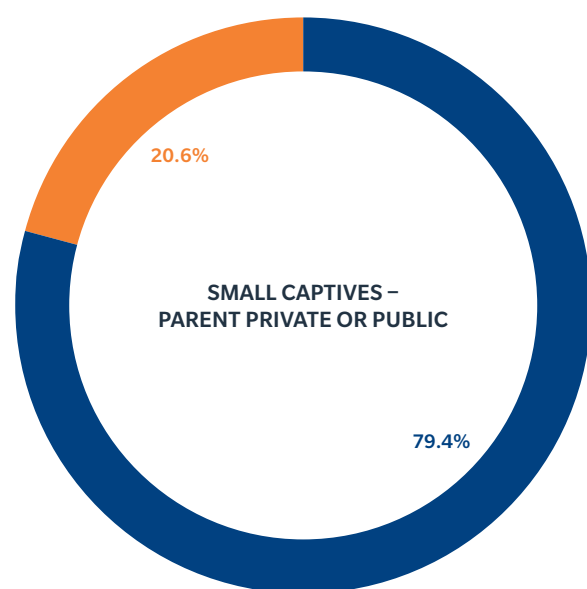


FIGURE 14 | SMALL CAPTIVES: PRIVATE COMPANY OR PUBLIC COMPANY OWNERSHIP

Source: Marsh’s Benchmarking Survey Analysis 2014v

■ PRIVATE
■ PUBLIC

Captives that make the small-captive election often insure risks that are characterized with historically high-severity and low-frequency losses. Terrorism fits this description of an appropriate risk for a captive since it allows the captive to benefit from the business advantages afforded by the TRIA program, as seen by the 17.6% of small captives that are writing terrorism risk (see **FIGURE 15**). This is partly because NBCR terrorism risk is a real and expensive exposure for virtually all companies with real estate in the US, and TRIA provides a mechanism to reduce this risk from a business and risk-management perspective.

The majority of the small captives (68%) are opting for the brother/sister approach in order to qualify as insurance companies for tax purposes (see **FIGURE 16**). The hybrid approach (brother/sister and third party writings) is used by 22% of the captives to qualify, and only 10% are achieving it with the third party risk approach. With the emergence of pooling facilities, we expect the third party pooling approach to grow significantly in the future.

All captives need an appropriate level of capital and surplus. The minimum capital in most domiciles is US\$120,000 to US\$250,000. However, additional risk-based capital is required depending on a captive's business plan. The average capital base for Marsh-managed small captives is US\$5.4 million, which demonstrates that these captives have a strong surplus position to pay claims and are taking the notion of being an insurance company seriously.

In the UK, there is a similar opportunity. Based on the UK CFC legislation that was passed, if a foreign subsidiary earns a profit of £500,000 or less, it is deemed de minimis and is exempt from UK tax. It is similar to small captives, but the trigger is annual profit rather than annual premium with a small captive in the US.

FIGURE 15 | **SMALL CAPTIVES: WRITING TERRORISM INSURANCE (TRIA)**
 Source: Marsh's Benchmarking Survey Analysis 2014

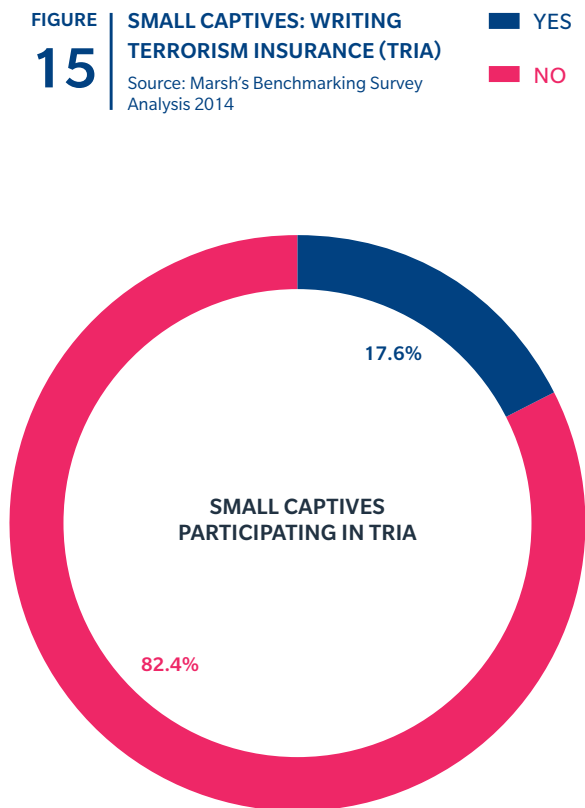
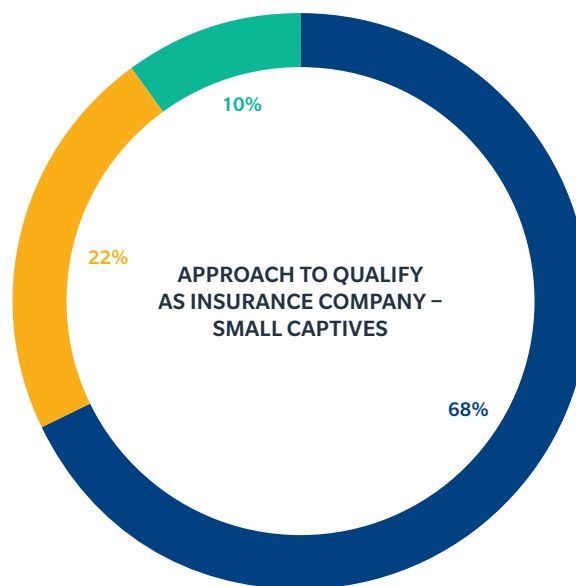
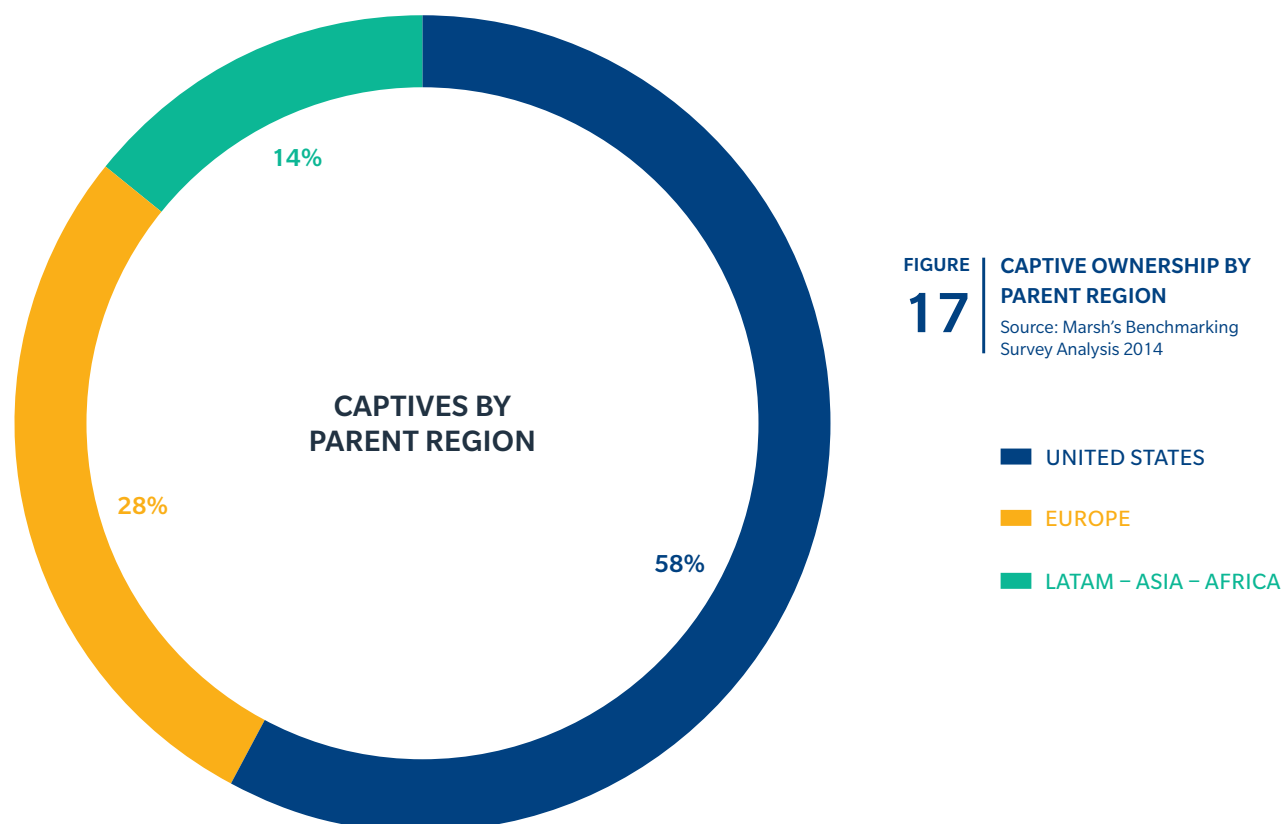


FIGURE 16 | **SMALL CAPTIVES: APPROACH USED TO TREAT CAPTIVE AS AN INSURANCE COMPANY FOR TAX PURPOSES**
 Source: Marsh's Benchmarking Survey Analysis 2014



I CAPTIVE OWNERS INSIGHTS

PARENT REGION



The US and Europe together represent 86% of the global captive ownership count (see **FIGURE 17**), a trend that is expected to continue. Small-captive growth will likely continue and play an important role in the growth of the captive industry for US parents, since this type of captive is encouraging midsize companies to venture into an industry that traditionally has been defined by large companies.

It is important to note that emerging captive markets such as Latin America are experiencing growth, which is likely to continue in the coming years as many Latin American companies are reaching a position where a captive makes

sense in their risk management strategy. However, regulatory requirements, such as requiring a front in some countries like Argentina and Brazil, can slow down the growth of the captive industry in Latin America. There will likely be an increase in captive use in countries like Colombia, Chile, and Peru.

Asia-Pacific, as observed in previous years, did not present much in the way of growth on the captive front. Companies in this region are more likely to transfer their risk to traditional insurance companies instead of retaining it in a separate facility due to higher aversion to risk and a more traditional approach to risk management.

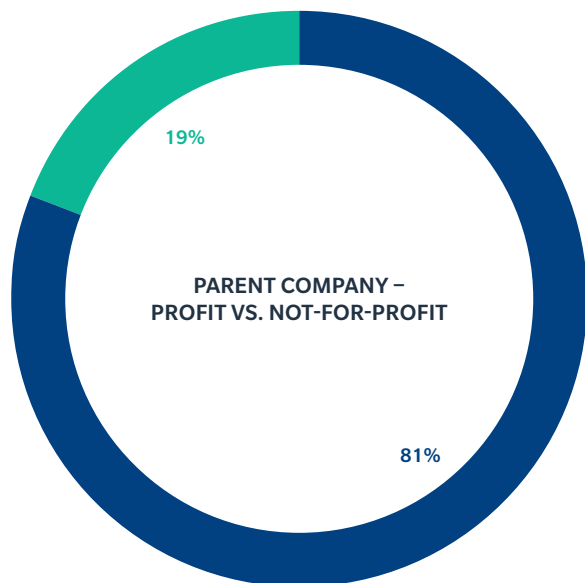
CAPTIVE OWNERS: PROFIT VS. NOT-FOR-PROFIT

Not-for-profit organizations such as universities, municipalities, and health care entities are long-time users of captive insurance companies (see **FIGURE 18**). The insurance advantages that a captive can provide to a non-profit organization include coverage for risks that are uninsurable in the market, lower premiums, improved risk management, and reduced dependency on the commercial market.

CAPTIVE OWNERS: PUBLIC VS. PRIVATE

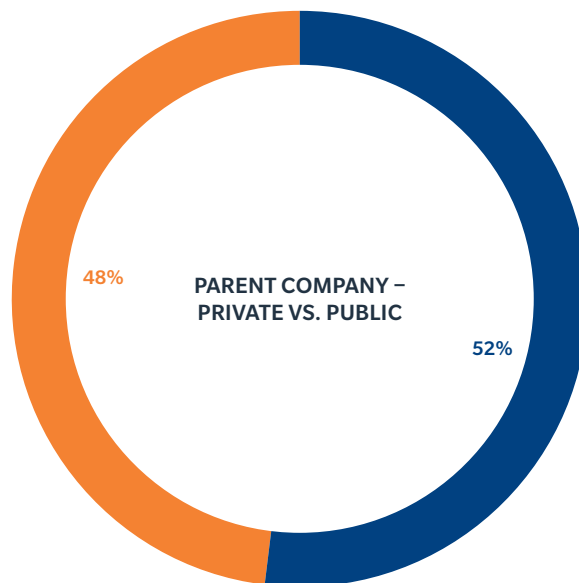
There are slightly more private companies that own captives versus public companies (see **FIGURE 19**), with the growing number of private companies likely attributable to small captives.

FIGURE 18 | PROFIT VS. NOT-FOR-PROFIT
CAPTIVE OWNERSHIP
Source: Marsh's Benchmarking Survey Analysis 2014



■ PROFIT
■ NOT-FOR-PROFIT

FIGURE 19 | PUBLIC COMPANY VS. PRIVATE COMPANY
CAPTIVE OWNERSHIP
Source: Marsh's Benchmarking Survey Analysis 2014



■ PRIVATE
■ PUBLIC

CAPTIVE PARENT INDUSTRY

Approximately one quarter of the global captives benchmarked are owned by companies in the financial institutions (FI) industry (see **FIGURE 20**), such as insurance companies (48%) and banks (28%), with the remaining 24% owned by holding companies, asset managers, and investment companies.

There are several reasons that explain the predominance of FIs in the captive landscape. Because of their nature, FIs are more familiar with the insurance and captive industry and are more likely to use innovative financial vehicles such as captives as part of their long-term strategy. FIs are also more prone to increase their risk retention in areas such as errors and omissions (E&O) and directors and officers (D&O) liability risks, as long as it is managed in a disciplined manner — which is exactly what a captive insurance company provides to its parent. Further, FIs have many divergent customers and can offer these customers insurance products such as homeowner, auto, umbrella liability, credit disability, and other personal lines.

From a domicile position, most FI captives (31.8%) choose Bermuda as the preferred domicile.

Health care companies are in a solid second position with 13.6% of the captives. Health care captives write medical and professional liability coverage for insurance premium services, discipline, coverage, and the ability to pool risk, among other reasons.

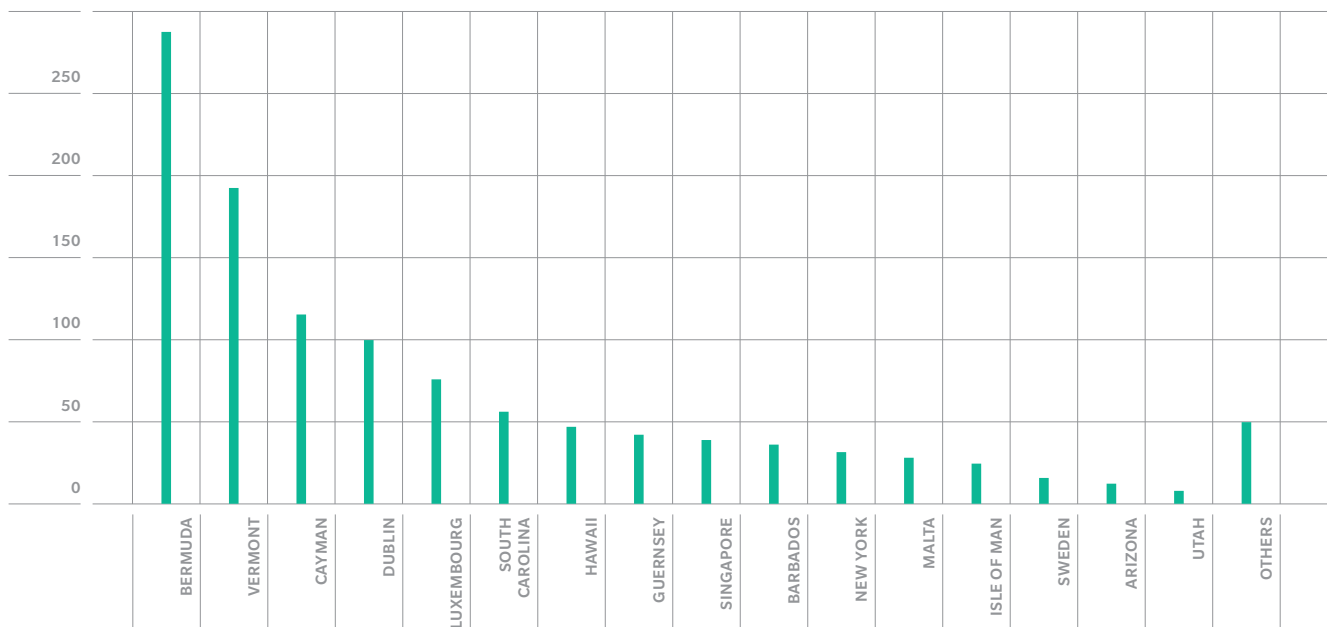
FIGURE 20 | CAPTIVE USE
BY INDUSTRY

Source: Marsh's Benchmarking Survey Analysis 2014

MARSH INDUSTRY PRACTICE	PERCENTAGE
FINANCIAL INSTITUTIONS	24.8%
HEALTH CARE	13.6%
MANUFACTURING	6.8%
RETAIL/WHOLESALE	5.8%
CONSTRUCTION	4.9%
POWER AND UTILITIES	4.5%
TRANSPORTATION	4.4%
COMMUNICATIONS, MEDIA, AND TECHNOLOGY	3.8%
MISC. OTHER	3.4%
CHEMICAL	3.1%
OTHER SERVICES	3.1%
MINING, METALS, AND MINERALS	2.9%
AUTOMOTIVE	2.4%
ENERGY	2.3%
REAL ESTATE	2.1%
MARINE	1.9%
LIFE SCIENCES	1.7%
FOOD AND BEVERAGE	1.7%
AVIATION AND AEROSPACE	1.3%
EDUCATION	1.1%
SPORTS, ENTERTAINMENT, AND EVENTS	1.1%
PROFESSIONAL SERVICES	1.0%
PUBLIC ENTITY AND NOT-FOR-PROFIT	1.0%
AGRICULTURE AND FISHERIES	0.5%
FORESTRY AND INTEGRATED WOOD PRODUCTS	0.5%
HOSPITALITY AND GAMING	0.5%

I DOMICILES

FIGURE 21 GLOBAL CAPTIVE DOMICILES BY NUMBER OF CAPTIVE LICENSES
Source: Marsh's Benchmarking Survey Analysis 2014



Traditional domiciles, including Bermuda, Vermont, and the Cayman Islands, continue as the undisputed leaders chosen by captive owners (see **FIGURE 21**). Their developed legislation, maturity, long-time experience, and captive-friendly institutional infrastructure have positioned them as the preferred domiciles in the captive industry. The dominant position of the traditional captive domiciles is being challenged by upcoming captive domiciles that have become more popular thanks to their efforts to attract captives through flexible but very complete regulations.

Emerging global domiciles, such as those that have developed in the last 10 years, are expected to grow in the future. Overall, the trend for captives to be based onshore (onshore is defined as EU, Dubai, Singapore, Australia, and the US; offshore is defined as “all other”) has only increased by one percentage point from 2012 (see **FIGURE 22**).

For US companies in particular, more captive formations are expected to be seen in onshore domiciles such as

Utah, Vermont, Texas, Tennessee, Connecticut, and New Jersey. Currently, the top offshore domiciles continue to dominate the captive landscape, since domiciles such as Bermuda, the Cayman Islands, and Guernsey, among many others, have long-standing history and expansive, pragmatic regulation, a robust infrastructure, and many other compelling reasons for new formations and re-domestications. With the Solvency II implementation set for January 2016, the EU domiciles will also experience growth in the short term.

FIGURE 22 GLOBAL CAPTIVE ONSHORE AND OFFSHORE DOMICILE COMPARISON
Source: Marsh's Benchmarking Survey Analysis 2014

	2013	2012	2011
ONSHORE	56%	55%	52%
OFFSHORE	44%	45%	48%

EMERGING DOMICILES

In the last few years, some onshore domiciles have implemented captive legislation or resurrected prior captive laws. This phenomenon has led to an increased activity in domiciles, and the emergence of new domiciles is expected in the near future. Globally, there are more than 65 domiciles, but in recent years, there has been a major increase in the number of domiciles. For example, in 2013, Texas and North Carolina enacted captive legislation. There are now more than 34 US states, plus the District of Columbia, Puerto Rico, and the US Virgin Islands, with captive laws — and more on the horizon. Further, states like Ohio are close to creating captive-enabling legislation, which will make the US captive domicile even more competitive.

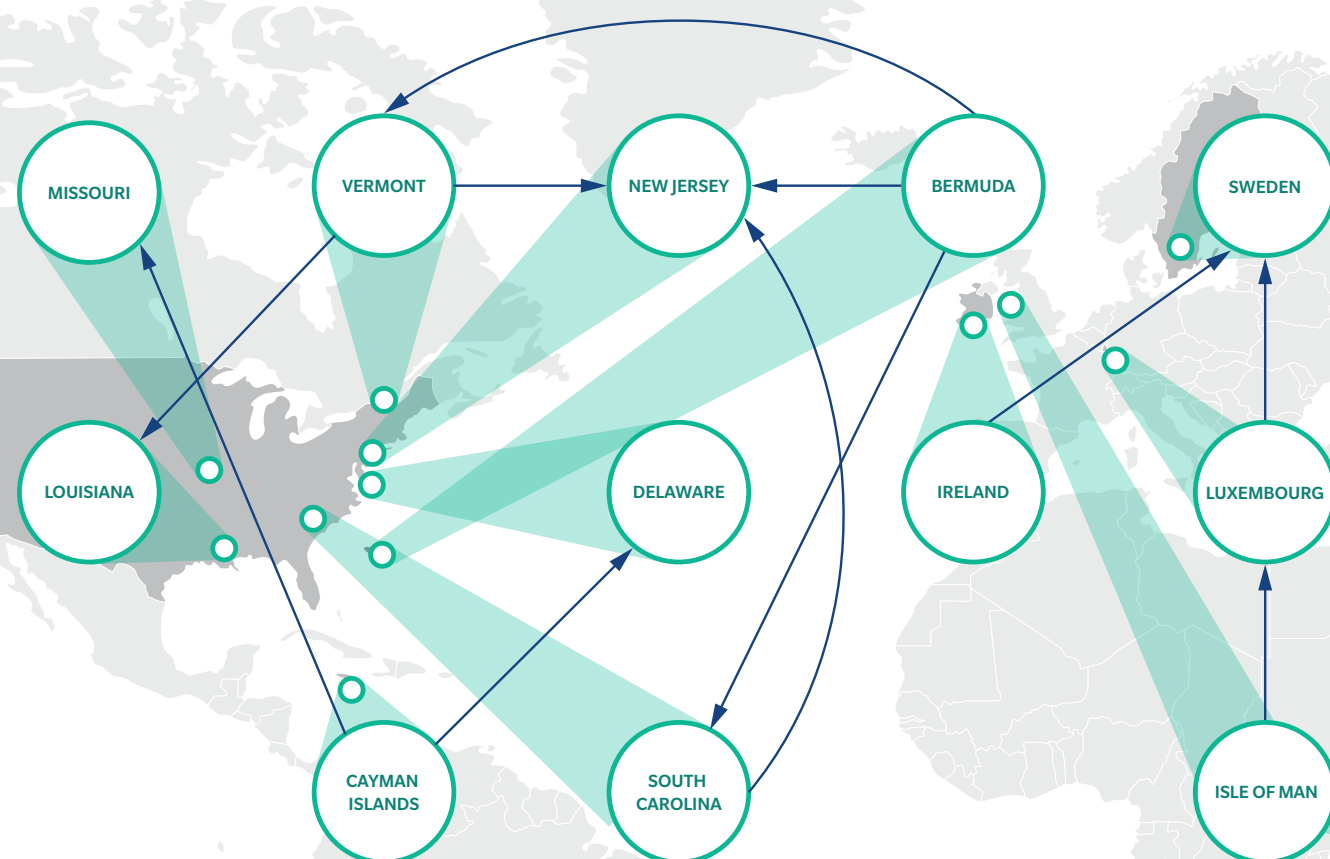
Companies in Latin America have several options when considering a domicile, including popular offshore domiciles such as Bermuda, and also locations like Luxembourg in the EU.

RE-DOMESTICATIONS

We have not seen a surge in captive re-domestications in the last two years, nor do we expect it as a major trend in the captive arena, even though US onshore domiciles are emerging and gaining new captives and continue to gain expertise. In 2013, only 11 of the benchmarked captives re-domesticated. Eight of the re-domesticated captives moved to or within domiciles in the US, two to Sweden, and one to Luxembourg (see **FIGURE 23**).

FIGURE 23 DOMICILES SEEING RE-DOMESTICATIONS (INBOUND OR OUTBOUND)

Source: Marsh's Benchmarking Survey Analysis 2014



I TERRORISM PROTECTION

GLOBAL TERRORISM POOLS

The events of 9/11 changed the market for terrorism protection worldwide and triggered the creation of terrorism pools around the world. These events demonstrated the potentially devastating effects and catastrophic impact a terrorism event can represent for insureds, insurers, and reinsurers.

The majority of the terrorism pools that our clients are accessing were created after 9/11. The Gestion de L'Assurance et de la Reassurance Contre les Attentats et Actes de Terrorisme (GAREAT) was created in France in January 2002; the Terrorism Risk Insurance Act (TRIA, and extension acts) was created in the US in November 2002; the Australian Re-insurance Pool Corporation (ARPC) in June 2003; and the Terrorism Re-insurance and Insurance Pool (TRIP) in Belgium in 2007. Other existing pools, such as Pool Re (UK, 1993) and Consorcio de Compensación de Seguros (CCS – Spain, 1941) were subject to reviews and changes in terms and conditions after the 9/11 attacks.

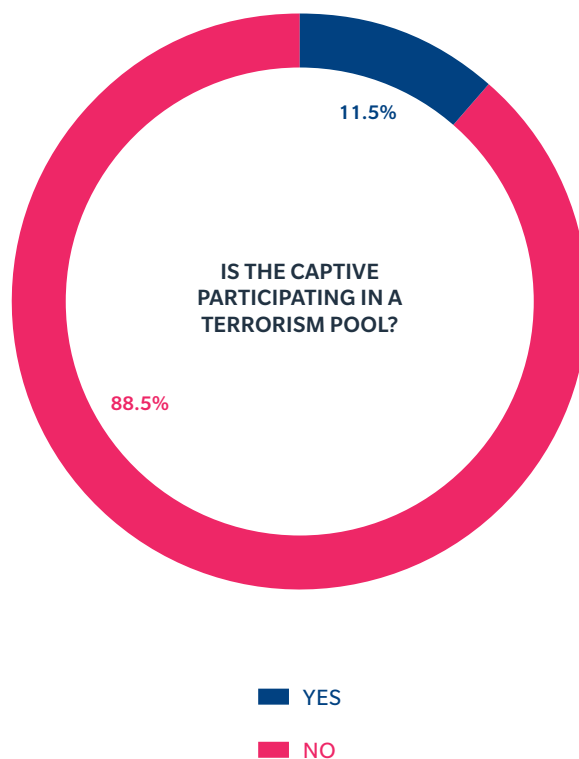
Despite the fact that each program has different terms and conditions, the terrorism pools accessed by Marsh clients share two elements: 1) They are generally a cost-effective method to cover the company for terrorism losses, since the 9/11 attacks caused a spike in the cost of terrorism coverage in the commercial market (however, there could be a situation where the coverage, which is mandatory in some pools, is more expensive than the pools); and 2) All of the benchmarked pools are backed by the government of each country. In the UK, Pool Re is the only terrorism underwriter in the UK that can provide full-value insurance. Terrorism insurers provide cover with defined limits, subject to available market capacity to manage their exposure. Insureds that require, or desire, full-value terrorism insurance to comply with financial covenants often choose to insure with Pool Re.

Becoming a Pool Re captive member can be more cost-effective than accessing its insurance via a commercial insurance company, which typically adds a margin or administration charge to Pool Re's premium rates and usually has to retain a larger share of the

Pool Re member retention due to the amount of premium they place with the pool.

Companies access these pools based on their perception of exposure to a terrorism act, typically by the nature of its business, country, and location of production plants and/or commercial facilities, among other factors. However, the number of captives accessing these pools could be considered low, since only 11.5% of the 1,148 benchmarked captives are participating in terrorism programs (see **FIGURE 24**).

FIGURE 24 | CAPTIVES THAT PARTICIPATE IN A TERRORISM POOL OR TERRORISM PROGRAM
Source: Marsh's Benchmarking Survey Analysis 2014



US TRIA

Of the captives analyzed for this report that participate in a terrorism protection pool, 71% are accessing TRIA in the US (see **FIGURE 25**). This is not a surprise, since most of the captives included in this report have some property risk (operations or parent) in the US. In second place is ARPC with 10% of the benchmarked captives participating in the Australian pool.

TRIA was first enacted on November 26, 2002, and has since been extended twice, most recently for a period of seven years; it is now in effect until December 31, 2014. At the time this report was being written, the US Congress was weighing whether to reauthorize TRIA.

The extension of the act is critical for the terrorism protection market since TRIA plays a major part in the availability and affordability of coverage. The termination of TRIA would be very disruptive for the market, and many clients that need and want terrorism coverage would be at risk of not being able to procure it without TRIA.

Marsh & McLennan Companies (MMC) is actively urging lawmakers to reauthorize TRIA. “The existence of a private terrorism insurance market, backstopped by TRIA, actually serves to protect the government and taxpayers from absorbing virtually all of the financial loss in the event of a terrorist attack,” said Peter Beshar, MMC’s executive vice president and general counsel, in his testimony to the US Senate Committee on Banking, Housing and Urban Affairs in September 2013.

FIGURE 25 | CAPTIVES ACCESSING TERRORISM PROGRAMS BY COUNTRY
Source: Marsh’s Benchmarking Survey Analysis 2014

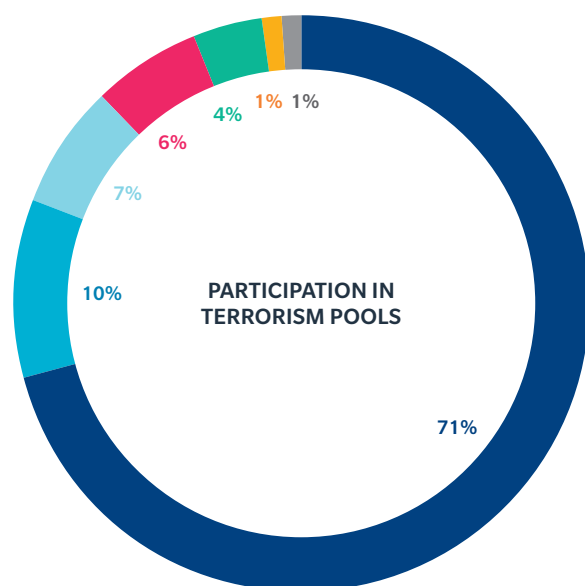
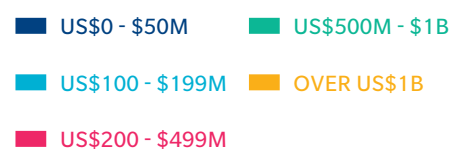
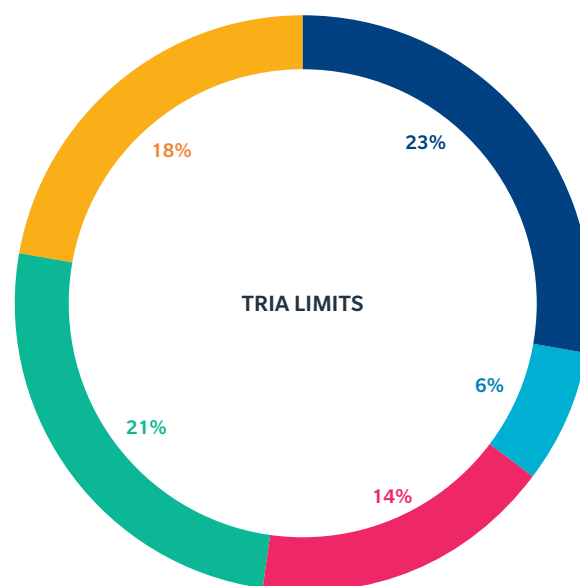


FIGURE 26 | US TRIA POLICY LIMITS WRITTEN BY CAPTIVES
Source: Marsh’s Benchmarking Survey Analysis 2014



I REGULATORY DEVELOPMENTS

SOLVENCY II

With January 1, 2016, now set as the date for full implementation of Solvency II, the insurance industry can, at last, proceed with final preparations for the introduction of the new regime. In the interim, the European Insurance and Occupational Pensions Authority (EIOPA) has introduced Guidelines on Preparing for Solvency II that apply from January 1, 2014. With these guidelines, EIOPA intends to significantly increase preparedness of both regulators and insurers for Solvency II. The guidelines aim to ensure that the regulators and insurers take active steps toward implementing key elements of Solvency II in a consistent and convergent manner. The key areas covered, with the first two of concern for captives, are:

- ▶ System of governance (including risk management systems).
- ▶ Forward-looking Assessment of Own Risks (FLAOR).
- ▶ Pre-application for internal models.
- ▶ Submission of information.

Having already completed a considerable amount of preparatory work with clients on the Solvency II, Pillar 2 requirements, we believe that our clients' captives are well on-track for compliance with the majority of the system of governance requirements. We will also be working with those companies on a number of solutions to complete the FLAOR requirement during 2014 and 2015.

With these developments, we hope to see growth in captive formations in the EU domiciles. It is also encouraging to see some EU regulators applying the principle of proportionality to captives in their approach to the interim guidelines and hopefully this can be taken as an indication of how they will regulate captives under the new regime.

FOREIGN ACCOUNT TAX COMPLIANCE AND CAPTIVES

The Foreign Account Tax Compliance Act (FATCA) is a US regulation – enacted in 2010 and taking effect in 2014 – 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 noncompliance by US taxpayers with foreign accounts and focuses on reporting and disclosures. 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), for example, dividends, interest, insurance premiums, pensions and annuities, and sales proceeds.

Administrative reporting and the first reporting period pursuant to FATCA starts in July 2014.

The scenarios listed below describe whether a W8/W9 would be needed or if no action would be required by the captive with a US-owned company pursuant to FATCA:

US direct premium paid to:

1. 953(d) captive – No action required.
2. Non 953(d) captive – Captive must provide W8/W9.

US or non-US captive ceding reinsurance payments to:

1. 953(d) captive – No action required.
2. Non 953(d) captive – Captive must provide W8/W9.
3. Reinsurance company (non-captive) – Reinsurer must provide W8/W9.

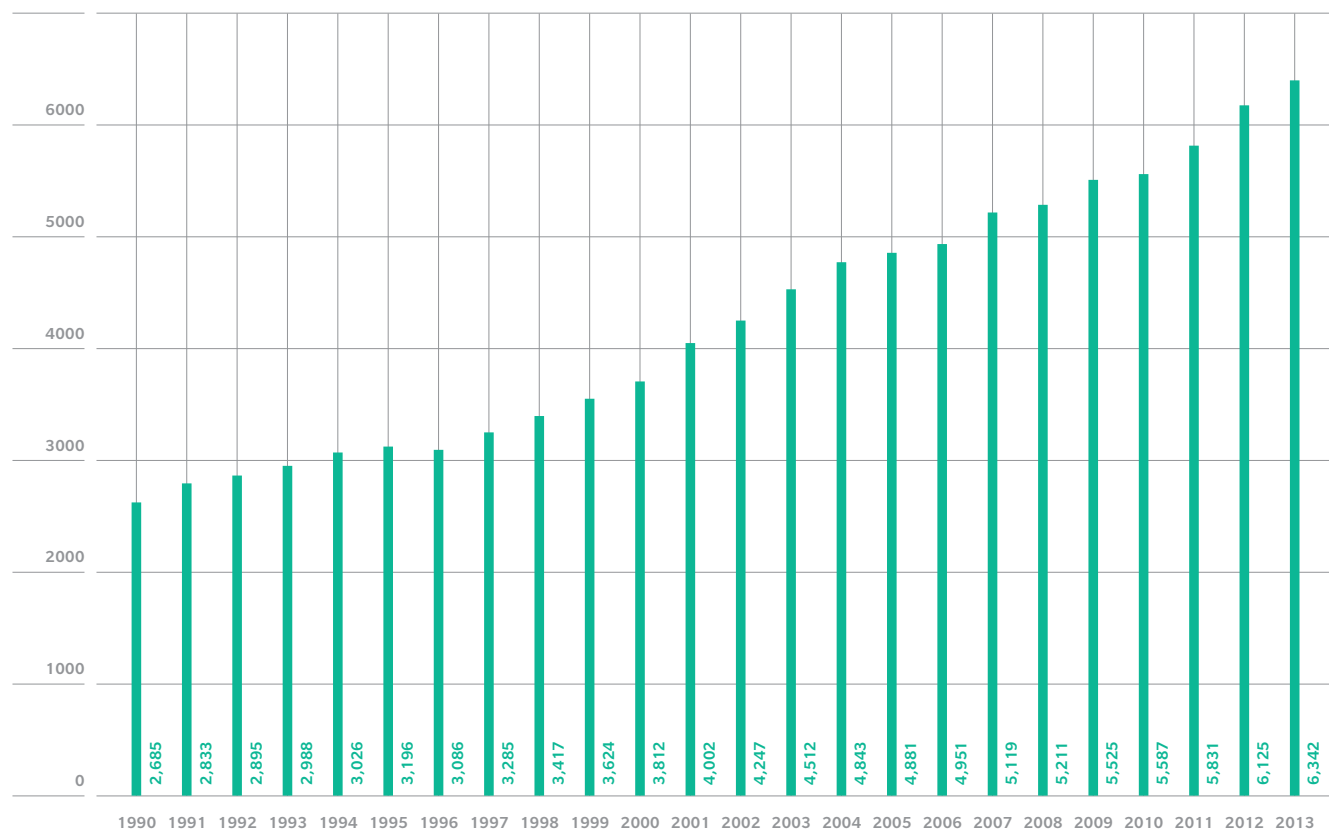
FATCA is a recent development and none of this information should be regarded as legal or tax advice. Marsh encourages you to consult your own advisors on the compliance and reporting requirements pursuant to FATCA.

THE DODD-FRANK ACT AND CAPTIVES

The Dodd-Frank Act, which went into effect in July 2011, has not had the impact on state self-procurement taxes that was originally envisioned. In 2013, however, Texas became the first state to enact unauthorized captive insurance premium taxes at a rate of 4.85% payable by an out-of-state captive. Texas is the only state where we have seen such enforcement mechanisms as a result of Dodd-Frank.

NUMBER OF CAPTIVES WORLDWIDE

Source: Business Insurance, March 17, 2014 - includes some restatements.



■ ABOUT MARSH

Marsh is a global leader in insurance broking and risk management. We help clients succeed by defining, designing, and delivering innovative industry-specific solutions that help them effectively manage risk. We have approximately 27,000 colleagues working together to serve clients in more than 100 countries. Marsh is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), a global professional services firm offering clients advice and solutions in the areas of risk, strategy, and human capital. With more than 54,000 employees worldwide and approximately \$12 billion in annual revenue, Marsh & McLennan Companies is also the parent company of Guy Carpenter, a global leader in providing risk and reinsurance intermediary services; Mercer, a global leader in talent, health, retirement, and investment consulting; and Oliver Wyman, a global leader in management consulting. Follow Marsh on Twitter [@Marsh_Inc.](#)

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Marsh's Captive Solutions Practice includes the Captive Advisory Group, Captive Management Services, and the Captive Solutions Actuarial Group. We have more than 450 colleagues managing more than 1,240 captives globally. In the industry for more than 40 years, we have management offices in 18 countries and advisory expertise in retail brokerage offices worldwide. Captive Advisory is the consulting arm of Captive Solutions. A designated team of expert captive advisors works closely with captive champions in the geographies to deliver best-in-class advice and service from feasibility studies to structuring and implementation of captives. This group is also responsible for training and developing colleagues throughout Marsh to be captive champions and practitioners. Captive Management is an industry leader in designing, implementing, and managing new captives. Once a client has decided to develop a captive, Captive Management can provide the necessary financial, accounting, treasury, and insurance services, from choosing the appropriate location to conducting regulatory filings. Our established relationships with key service providers such as auditors, lawyers, and actuaries helps ensure that each captive runs smoothly, cost-effectively, and with the strategic and financial benefits most appropriate for our clients' businesses. Our Captive Solutions Actuarial Group comprises credentialed actuaries and supporting actuarial analysts. Our actuaries consult exclusively with captive and self-insurance programs in numerous global domiciles.



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