State of the Captive Insurance Market

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Presentation Outline

1. 2015 Captive Industry Review
2. Domicile Review
3. Captive Uses
4. Groups and RRGs
5. Regulatory and Infrastructure
6. SRS Recent Experience
7. Outlook for the next 12 months

Captive Industry Review

- There was strong growth in the captive industry in 2014 with an increase in active captives of 8.6%. Over 500 new captives were reported
  - Growth driven by small captives and new cells
  - More new cell or series formations reported than stand alone captives
  - Continued trends from prior 2-3 years
- Emerging domiciles saw a disproportionate share of the growth. Two “new” domiciles, Tennessee and North Carolina, added more captives and cells/series than any domicile other than Delaware.
- Traditional property & casualty captives remained strong despite flattening commercial insurance premiums.
- In 2015, all the above trends have continued despite the “storm clouds” gathering over the small captive market

Captive Industry Review

- Medical Stop Loss interest continues to be high and activity is increasing both in the group area as well as for individual captive owners
- Favorable rulings for large captives in 2014 but attacks by the IRS on small captive owners and so called “captive promoters” are increasing
- Competition between domiciles continues to grow resulting in more law changes with more to come. Pressure on captive owners to bring captives “home”.

Selecting a Captive Domicile

- The options for captive owners continue to grow
- The **material** differences between domiciles continues to shrink
- Choices often come down to:
  - Accessibility and Experience of the regulators
  - What is the business focus of the captive/fit with the domicile (healthcare, benefits, 3rd party risk, etc.)
  - Domicile Taxes and Fees
  - Quality of Infrastruture
  - Convenience

Domicile Review

- The total number of active captives in the established domiciles we track increased 4.5% over 2013. This is down from the 2013 growth rate of 6%, but consistent with the prior five years (2007-2012).
- Growth among emerging domiciles was strong. Including these domiciles, the industry grew by 8.6% in 2014.
- ***New formations in established domiciles fell by 9.2% compared to 2013. The first decline in six years (2009-2014).***
- Closures were down 6.5% in established domiciles compared to 2013.

Total Active Captives

	2014	2013	% change		2014	2013	% change
Bermuda	841*	841	0.0%	Nevada	159	148	7.4%
Cayman	759	758	0.0%	South Carolina	158	145	9.0%
Vermont	581	588	-1.2%	DC	125	126	-0.1%
Utah	417	337	23.7%	Kentucky	122	128	-3.9%
Delaware	333	266	11.7%	Arizona	114	106	7.5%
Hawaii	194	184	5.4%	Emerging Domiciles*	269	102	163.7%
Montana	177	150	18.0%				

	2014	2013	% Change
Combined Total – ex Emerging Domiciles	3,980	3,810	4.5%
Combined Total – inc Emerging Domiciles	4,249	3,912	8.6%

*** Alabama had 40 licensed captives on 12/31/2014 up from 20 the previous year**

New Captive Formations*

	2014	2013	% change		2014	2013	% change
Bermuda	16	24	-33.3%	Montana	34	47	-27.7%
Cayman	22	39	-43.6%	Nevada	26	31	-16.1%
Vermont	16	29	-44.8%	South Carolina	20	3	566.7%
Utah	106	86	23.3%	DC	5	5	0.0%
Delaware	87	88	-1.1%	Kentucky	0	1	-100.0%
Hawaii	15	17	-11.8%	Arizona	13	9	44.4%

	2014	2013	% Change
Combined Total	344	379	-9.2%

* Including re-domestications

Captive Closures

	2014	2013	% change		2014	2013	% change
Bermuda	16*	18*	-11.1%	Montana	7	11	-36.4%
Cayman	21	19	10.5%	Nevada	9	11	-18.2%
Vermont	17	27	-37.0%	South Carolina	5	5	-0.0%
Utah	26	29	-10.3%	DC	6	5	20.0%
Delaware	20	2	1000.0%	Kentucky	6	12	-50.0%
Hawaii	5	11	-54.5%	Arizona	5	3	66.7%

	2014	2013	% Change
Combined Total	143	153	-6.5%

* SRS estimate

Emerging Domiciles

- The newer emerging domiciles grew rapidly compared to most of the established domiciles.
- North Carolina, Tennessee and Oklahoma all gained traction and have quickly reached critical mass as captive domiciles. Texas has experienced solid growth with some big companies moving “home”.
- More interest in home state re-domestications with the choice of domiciles available and the threat of self-procurement tax.
- The emerging domiciles have also benefited from the continued growth of the small captive market, and the latest captive legislation including series LLC and cell structures.
- Others domiciles continue to enter the market including Ohio which passed captive legislation in 2014.

Cells and Series Captives

- The growth in cells and series captives continued to be strong in 2014 with participants taking advantage of new domicile's cell and series legislation
  - Tennessee licensed 194 new protected cells in 2014 for a total of 206.
  - Delaware's series activity was below 2013, but it still added 141 SBUs. The domicile now has 688 active SBUs and 12 active cells.
  - North Carolina reported 120 new protected cells in addition to the new captives licensed in 2014.
  - Cayman reported 606 active segregated portfolios across 139 segregated portfolio companies, at 12/31/2014
  - Utah reported 19 cell formations and 5 closures for a total of 71 active cells.
  - Montana licensed 19 new SBUs and 29 new captive cells during 2014.
  - DC reported strong growth in protected cells in 2014
- There continues to be an updating of captive legislation to allow new cell or series structures and at least match that available in competing domiciles.

Small Captives

- For the past five or more years small (< $1.2 million in annual premium) captives were the major driver of captive growth.
- Factors driving the growth continued from prior years:
  - Middle market clients realizing the benefits of a captive arrangement.
  - The economy is better and more companies have the ability to consider a captive
  - Forming as wholly-owned single parent captives and as cells is easier in more places and less expensive
  - The growth is attracting new entrants into the captive production space (supply/sales driven).

Small Captives – IRS Scrutiny

- The IRS has stepped up their efforts with particular emphasis on small captive owners and “promoters” out selling captives for the tax savings as opposed to the risk management and insurance benefits
- Small captives recently named to the IRS dirty dozen of tax scams which are the focus of the Service’s attention in 2015.

Captive Uses - Traditional

2014 Predictions	2014 and YTD Activity
Group captives will continue to add members – not many new group P&C captives will be formed given current market conditions	While overall feasibility remained strong, group captive feasibility was limited by commercial market conditions. Existing groups are reporting solid growth due to a variety of factors (improved economic conditions, industry rate increases).
More captive owners will expand 3rd party business activities to grow and diversify	Activity was largely limited to group medical stop loss. Many single parents are considering insuring this risk in their captives and/or adding this coverage.

Captive Uses – Employee Benefits

- Medical Stop Loss (MSL) – Group Captives
  - Existing established programs continue to see growth, benefits for employers formerly fully-insured moving to a self-funded arrangement
  - Growing interest from both brokers and employers
  - The employer mandate regulation in effect for plans starting 2015 may drive more small/mid-size employers to look at self-funding/captive
  - State Regulation/Proposed state regulation (and NAIC) regarding minimum stop-loss attachments and other items still a key factor for the future of some of these programs

Captive Uses – Employee Benefits

Medical Stop Loss – Single parent (individual companies)

- A significant uptick in employers placing Medical Stop Loss in their captives for two primary reasons:
  - More companies seeing the benefit of retaining more risk in the captive and buying reinsurance directly at a lower cost.
  - The "potential" to have medical stop loss treated as unrelated third party business.
- ERISA Benefits (LTD, Group Life, etc):
  - Over 35 major companies and the momentum and interest is accelerating
  - Obtaining DOL approval for employee benefits is moving back to the fast track (90-120 days) after a temporary suspension in 2012.

RRG Activity

- RRG premiums are relatively flat:
  - Larger mature RRGs remain strong
  - Newer RRGs are struggling to reach critical mass under competition from the commercial market
- The actual number of RRGs continued their decline from 2013. Active RRG numbers decreased to 238, the lowest level since 2006.
- Retirements were lower than 2013 at 19, although new formations were lower at seven, the lowest level since the hard market after 9/11.
- Five formations were in transportation where rates are hardening.
- 11 retirements were in healthcare where commercial rates were soft.
- Sponsored (by insurers) RRGs are solving specific issues/needs

Healthcare Provider Owned Captives

- Continued merger/acquisition activity in healthcare in general, resulting in the merger of healthcare captives.
- Increasing trend toward former 3rd-party physicians now becoming employed physicians and part of the health system’s insurance program, both for captive coverage and commercial coverage.
  - More discussion around prior acts and tail coverage for these now employed physicians
- Main coverage line in healthcare captives remains medical professional liability but captives looking at other lines, particularly medical stop loss.
- Claim severity still trending up approx. 2-3%, although claim frequency seems flat and therefore underwriting results are generally positive, creating healthy surplus. This has led to more focus on getting more performance from investable surplus and/or dividends back to parent.

Captive Taxation

- In the past 12 months we have seen several notable wins for the taxpayer
  - Rent-a-Center case, which included concentration of risk (60%) in one subsidiary and a guarantee
  - Securitas
  - Validus: trial court determined retrocession was not subject to cascading FET.
- Revenue Ruling 2014-15 which treated retirees as individual risks for retiree medical. Implications for medical stop loss and argument for treatment as third party business.
- Self procurement tax – some states are very aggressive which is leading many captives to move to their “home state”.
- Increased IRS scrutiny on small captives perhaps less interest in large traditional captives

Market Trends/Predictions

- We expect current captive trends to continue:
  - Continued captive growth to be driven by small captives and cells…… **unless** material negative changes are passed on 831(b) qualifications
  - RRG premiums to be flat. We have not seen the end of the closures as the class of 2002-2005 struggle to reach critical mass.
  - Heterogeneous group captives will continue to gain market share both on the p&c side and especially for group medical stop loss as the reality of ACA kicks in
  - Homogeneous group captive will experience some growth especially in higher risk industries (construction, transportation, etc.)
  - Home states with captive laws and receptive regulators will continue to grow – established domiciles will hold their own
- We anticipate a more restrictive environment in the small captive playing field or at least clearer picture on anticipated changes.

Questions?

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