

# Time to take it on trust

Doug Lavelle and Tom Mackay of Wilmington Trust explain how Regulation 114 Trusts work, who can benefit from them and why they are not all the same

As corporations and other entities that buy commercial insurance have increasingly discovered over the past decade and a half, captive insurance products can be a cost-effective solution for many types of insurance needs. The captive market has grown steadily and continues to grow, fuelled in particular by the availability of captive choices, which have made captives a potential alternative for companies of all sizes.

Today there are more than 5,000 captives around the world, many of which serve multiple insureds. The top three captive domiciles – Bermuda, the Cayman Islands and Vermont – account for 45% of all captives, although there are at least 25 active domiciles.

## The role of collateral

In the most common scenario for a captive, the insured entity establishes a captive reinsurer to participate in the risk being underwritten by a fronting carrier. The insured entity pays a premium to the fronting carrier, which then passes (reinsures) some or often the bulk of the premium to the captive in exchange for the captive's assumption of insurance risks.

While US insurers are free to reinsure risk with any reinsurance company, regulatory guidelines require that the reinsurance be obtained from an admitted carrier in order for the insurer to be able to take credit for the reinsurance purchased and avoid seeing a statutory

reduction to its surplus balance. This statutory accounting adjustment is commonly known as the Schedule F penalty, referring to the reinsurance schedules in the National Association of Insurance Commissioners (NAIC) Annual Statement.

Under current rules, in order for an insurer to take credit for reinsurance ceded to a non-admitted carrier, the insurer must be provided an approved form of collateral from the reinsurer in an amount equal to at least the amount of reinsurance reserves the insurer is recording in its financial statements. In the current era of credit difficulties and pressure on capital needs, no carrier can afford taking a Schedule F penalty.

This is especially important in captive transactions because captives are almost always considered non-admitted carriers, therefore captive reinsurance transactions will almost always result in captives needing to pledge collateral to the fronting carrier.

## Three collateral options

A captive that needs to post collateral has three main options:

- 1) Cash: this option consists of an actual cash deposit with the fronting insurer either via an informal cash transfer or under a more formal funds withheld arrangement (FWA).
- 2) Letter of Credit (LOC): if selected, the LOC would need to be clean, irrevocable, unconditional, and drawn on an NAIC/Domicile approved bank.
- 3) Establish a Regulation 114 Trust.

Setting aside the collateral from current assets definitely solves the collateral problem, but in almost any financial climate it is a very poor option. The captive that chooses to go this route will have very limited flexibility in how it is permitted to invest those assets – it will have relinquished control of the assets, and will no longer have any say as to the investment of the funds. With a pure cash collateral situation, the captive will get no credit for investment income at

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all, and with an FWA, the captive will typically be given credit for a small fixed rate of return tied to some index.

For many years, an LOC was the collateral option of choice. Prior to the recent financial crisis, many firms found LOCs readily available and the costs were not prohibitive.

However, in today's tight-liquidity climate, it can often be very difficult to obtain an LOC. Even if an LOC is available, current costs are likely to make it an unattractive option.

So-called Reg 114 Trusts have become increasingly attractive in recent years, and have evolved to the point where they can offer a potent combination of low cost, easy set-up, minimal ongoing maintenance, and widespread acceptance and flexibility.

#### How a Reg 114 Trust works

In the most common configuration for a Reg 114 Trust, the captive places assets in a trust with the fronting insurer named as the beneficiary. The trust is established and administered by the trustee (typically a bank), and the trustee also holds the collateral assets. In the event that the captive is unable to meet its insurance liabilities, the trustee may direct that some or all of the collateral assets be transferred to the fronting insurer.

While the captive in this arrangement may be onshore or offshore, the Reg 114 Trust must be onshore. The collateral remains in the trust and can only be removed with the consent of the beneficiary. The value of the collateral in the trust is the initial collateral amount minus allowable debits (commissions and claims) plus investment income earned on the collateral.

#### Setting up a Reg 114 Trust

Like captives themselves, the first Reg 114 Trusts were somewhat costly to set up, limiting their appeal. However, just as the cost and difficulty of setting up or accessing a captive programme has fallen over the years, so has setting up a Reg 114 Trust. An experienced Reg 114 trustee will be able to work from existing model documents that have been approved by regulators.

Assets can remain in a static pool of investments chosen at trust inception and left unchanged, or they can be actively managed.

In this second case, the manager can be the insurer or the trustee, or another third party investment manager. Whether the captive chooses a static approach or an active one, all funds

### REPRESENTATIVE COST COMPARISON: LOC VS REG 114 TRUST

Type	Value	Set-up fee	Annual fee	Total cost year 1	Total cost year 2 and on	Accounting treatment
LOC	\$10,000,000	–	0.50%	\$50,000	\$50,000	Contingent liability
114	\$10,000,000	\$5,000	0.05%	\$10,000	\$5,000	Restricted asset

must be denominated in US dollars and invested in eligible instruments.

#### Financial advantages of Reg 114 Trust

Anyone looking for a driving factor behind the surge in acceptance of Reg 114 Trusts need look no further than a comparison with the cost of an LOC: in a typical case, the overall annual cost of a trust can be 80% less than the cost of an LOC. While the difference will not be as dramatic for insured entities with immaculate credit, there will still likely be a difference in favour of the trust. And for

“The cost of a trust can be 80% less than an LOC”

entities with weaker credit, the difference may be even greater: LOC costs of 150 basis points are not unheard of.

A Reg 114 Trust can also offer financial advantages on the earnings side. Though the range of investment vehicles for collateral is limited, a capable trustee will still be able to identify approved investment vehicles that offer incrementally higher yields. As most Reg 114 Trust agreements allow any increase in the value of the invested assets beyond the amount that must be pledged as collateral to be returned to the insured, incremental yield differences can have direct ongoing financial benefits to the captive and, by extension, to the insured entity.

#### Service providers

The coming of age of Reg 114 Trusts has been the product of numerous factors and has benefited from the experience of many service providers and insureds.

Numerous providers exist to help you or your clients establish a trust with many basic benefits such as:

- Acceptance in virtually all domiciles;
- The freeing up of scarce credit resources for more productive uses;
- The ability to earn a return on investment;
- Minimal ongoing maintenance required (other than actively managed portfolios);
- One-time implementation – no need for annual renewal;
- Significantly lower cost;
- Ability to increase the amount of collateral without obtaining a new LOC;
- Ability to set up multiple trusts all of which are segregated and can be easily monitored.

Additional benefits are currently available from a small number of service providers. These include:

- Availability of skilled portfolio management capable of earning incremental yields;
- Access to in-house and third-party investment vehicles, including vehicles ideally structured for Reg 114 use;
- Availability of separately managed accounts.

Most significantly, working with a trustee who is not only well-proven in the world of captives and in Reg 114 Trusts but also has no conflict of interest in offering Reg 114 Trusts over LOCs is beneficial. Regardless of which service provider you choose, in the current environment one fact is clear: Reg 114 Trusts can benefit most entities that use an insurance captive, and they are here to stay in the captive insurance world. **CR**

Doug Lavelle and Tom Mackay are both senior vice presidents for Wilmington Trust, responsible for leading global capital markets sales, marketing and product development efforts. Tom and Doug each have more than 20 years of experience and a broad background in the corporate trust industry.