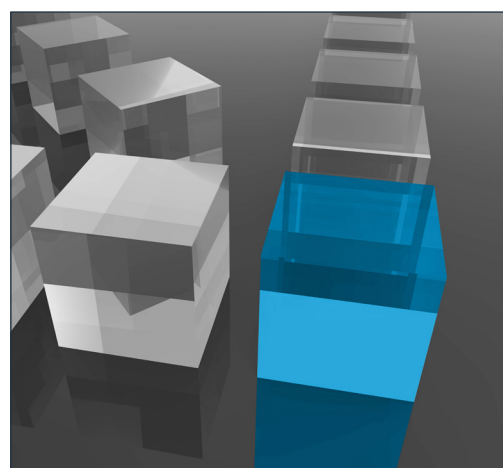


## MARSH INSIGHTS: CAPTIVES

# WHERE INSURANCE AND CAPITAL MARKETS INTERSECT: INSURANCE LINKED SECURITIES

Organizations that indemnify others are always looking for new ways to ensure that if a pay-out event occurs, there are sufficient funds available to cover all claims. Traditionally, the reinsurance market was where companies went to try to diversify their risks. However, there developed a market that combined traditional reinsurance with the funds available through the more traditional capital markets of the banking organizations, and through the use of bankruptcy remote special purpose vehicles (SPVs).



The first of these insurance-linked-securities (ILS) structures was George Town Re Limited, created in 1996. This structure allowed the cedent to access readily available cash in the event of certain triggers occurring. The investors in George Town Re Limited received a modest return on their capital and took a portion of the overall risk, should the triggers occur. From an investment point of view, the returns did not correlate with normal market conditions and therefore allowed some diversity of investment.

Traditional structures since the George Town Re Limited deal have used derivatives to transfer the risk from the cedent to the SPV, and ultimately, the investors in the SPV. There are now several different risk transfer arrangements, including reinsurance contracts and quota share arrangements. Several risks are being placed through these structures.

It is currently estimated that there are approximately US\$20.5 billion in outstanding deals in the market; in fact, US\$7.2 billion was issued in 2013 alone. It is expected that this market will continue to grow in 2014 as more investors look to it as a way to diversify risk.

### MARSH AND ILS

Marsh's Captives Solutions Group (MCSG) has been involved in the ILS market since its inception, when our Cayman office was appointed as manager to George Town Re. We are actively involved in the general securitization space, with experience in managing a large number of SPV structures over the last several years. We currently manage more than 70 such structures across various offices.

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These structures include aircraft leasing vehicles, CDO portfolios, asset-backed (ABS) and mortgage-backed (MBS) securitization transactions, synthetic securitizations, life settlement transactions, asset backed commercial paper, and trade receivable programs, as well as ILS transactions. We have also been involved in the management of over 25 ILS-style transactions, primarily in Dublin, Bermuda, and Cayman. Similar legislation has now been enacted in Malta (for more details see the domicile update section).

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## TERRORISM RISK INSURANCE ACT SET TO EXPIRE AT END OF YEAR

The Terrorism Risk Insurance Act (TRIA), which has helped ensure availability and competitive pricing of terrorism insurance since the Act's inception in 2002, has been extended twice, but will sunset effective December 31, 2014, if not extended again.

Marsh has formally advocated in multiple forums in support of TRIA's continuance and expressed the belief that a complete sunset of TRIA would have a significant impact on the pricing and availability of terrorism insurance in at least some areas of the United States.

There is significant support for continuing TRIA, but there is also strong advocacy for letting the program expire, particularly within congressional ranks. The current debates, advocacy, and public comments are very similar to those that occurred just prior to the 2005 and 2007 extensions. In each of those extensions the government share of a terrorism loss was reduced over time. Announcements accompanying prior extensions expressed that TRIA was meant to be temporary and that the insurance marketplace should be better able to absorb a larger share of a terrorism loss over time.

The insurance marketplace did, in fact, successfully accommodate slightly more of the conventional terrorism risk as provided for by the extensions. Given this history and current posturing in Congress, it is likely that any proposal to extend TRIA will need to further reduce the government share of a terrorism loss, which currently stands at 85% excess of a prescribed insurer deductible.

US-domiciled captives are subject to TRIA and many captive owners use captive insurers to provide terrorism insurance supported by TRIA. Until the future of TRIA is clarified, captives must continue to comply with the "make-available" and other provisions of TRIA.

Captive owners and their agents should review captive policy documents and ensure they factor TRIA's scheduled sunset. One suggested action is to ensure policies include a provision to enable efficient cancellation of the terrorism policy in the event of any material change to TRIA. Also, if captive owners have not done so already, they should open a dialogue with brokers, insurers, and reinsurers to maximize the chance of being able to replace any lost TRIA capacity with a commercial alternative.

#### FURTHER READING:

**TRIA information, including regulations, US Department of Treasury:**

<http://www.treasury.gov/resource-center/fin-mkts/Pages/program.aspx>

**National Association of Insurance Commissioner guidance:**

[http://www.naic.org/cipr\\_topics/topic\\_tria.htm](http://www.naic.org/cipr_topics/topic_tria.htm)

**Marsh Update on Terrorism Risk Insurance Program Reauthorization:**

<http://usa.marsh.com/NewsInsights/ThoughtLeadership/Articles/ID/33558.aspx>

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## UPDATE ON SOLVENCY II

On March 11, 2014, the European Parliament voted to approve the Omnibus II directive, which gives the EU Commission the power to finalize the draft rules of Solvency II. This move is seen as a major step to ensuring that the implementation of Solvency II will take place at the beginning of 2016 as scheduled.

Meanwhile, the European Insurance & Occupational Pensions Authority (EIOPA) "Guidelines for Preparation for Solvency II" went into effect on January 1, 2014. These are applicable across all EU states and essentially see certain key Solvency II requirements being introduced on a phased basis during 2014 and 2015.

The two guidelines of most concern for captives are:

- System of Governance.
- Forward Looking Assessment of Own Risk (FLAOR).

Implementation of the guidelines may vary slightly in the various captive domiciles but we can comment on three of them as follows:

### IRELAND

The Central Bank of Ireland outlined its implementation plans at an insurance industry briefing held in late November 2013. Captives are required to conduct a FLAOR during 2014 and submit the report to the Central Bank before December 31, 2014. Regarding the system-of-governance guideline, the general requirements apply from 2014, but captives will have until January 1, 2015, to establish the four key functions, which are:

- Actuarial.
- Risk management.
- Internal audit.
- Compliance.

They are using their risk impact system (PRISM) to determine the extent to which companies must comply. Captives fall into the "low" impact category and therefore may take a phased approach to full compliance. This approach is a positive sign for the captive industry as a key concern about Solvency II since its passage has been proportionality.

### MALTA

The Malta Financial Services Authority (MFSA) is asking companies to submit their first attempt at the FLAOR during 2014, and several have already worked with their Marsh team to produce and submit an initial version.

A key advantage of completing the FLAOR process is that captive owners can then review their captive programs in light of the Solvency II capital requirements and FLAOR results to maximize the management of their group risks, while being aware of the capital implications. Maltese companies are also implementing the Pillar II governance functions in line with the proportionality principles as appropriate.

### LUXEMBOURG

Luxembourg's regulator has required a progressive calculation of the solvency capital requirements (SCR) by a certified actuary over the past three years to gradually sensitize the Luxembourg market to the future needs and constraints of Solvency II. It is expected that regulated entities will also be required to submit a FLAOR in 2014.

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# INNOVATIVE USES OF CAPTIVES

## USING CAPTIVES TO MANAGE CYBER RISK

Cyber risk has become a major issue for businesses of every size. According to Verizon's 2013 "Data Breach Investigation" report, more than three-fifths (62%) of companies that suffered data and privacy breaches were businesses with fewer than 1,000 employees. Data privacy and network security are not just internet issues. Any entity that transacts business using a computer network or confidential information is at risk.

### GAPS IN TRADITIONAL POLICIES

Most traditional insurance products do not address internet exposures, and in some cases, carriers have begun specifically excluding data and technology-related risk from their policies.

- **Commercial general liability's (CGL)** primary purpose is to provide coverage for claims alleging bodily injury or property damage. Most cyber claims don't involve physical injury to either people or tangible property. Electronic data is not considered tangible under a typical liability policy.
- **Property policies** focus on the physical damage, theft, or destruction of tangible assets (buildings, machinery, equipment, inventory, etc.). With computer claims, information is often copied without authorization, with no loss or damage to the original information. As a result, property policies may not cover cyber claims or provide inadequate coverage.
- **Crime policies** may cover losses resulting from the theft of money or securities using the internet, but will not cover the loss or unauthorized copying of data.
- **Kidnap, ransom, and extortion:** In the past such threats primarily affected people or physical property. With the use of computers, extortion now often involves the threat of breaching network security, interfering with system access, or releasing confidential information if certain demands aren't met.



### UNDERWRITING CYBER RISKS

Initial underwriting data needed:

- Self-assessment of current data protection and network security practices.
- Revenues.
- Data stored, including protected health information, confidential financial information, and personally identifiable information.
- Relationship with security vendors, cloud providers, and other essential relationships.

Recent regulation, both in the US and EMEA, requires better notification around breaches, and the penalty for mishandling personal data is expected to be substantial. When commercial insurance coverage for cyber risk is unavailable or prohibitively expensive, a captive can be used to build a statistical base, which can make securing coverage at acceptable terms and pricing easier.

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## USING CAPTIVES TO ACCESS FEDERAL HOME LOAN BANK SYSTEM FUNDING

A new opportunity for real estate investment trust (REIT) clients has been growing rapidly since the summer of 2013. We have been working with REIT clients to create captives for the purpose of accessing funding with the Federal Home Loan Bank system (FHLB).

When the FHLB was chartered by Congress in 1932, it restricted membership to companies that engaged in lending activities. At that time, insurance companies were investing in lending, and thus, today's captive insurance companies can be eligible applicants.

Clients have formed FHLB captives that not only help insure the risks of the mortgage originator or REIT parent, but also help the company gain access to low-cost funding through the FHLB, allowing them to increase leverage and improve liquidity at attractive rates.

Lines of coverage have mostly included mortgage impairment and terrorism coverage. Captives are being formed in Michigan in order to access the Indianapolis FHLB, and in Missouri to access the Des Moines FHLB. As the opportunity grows, Marsh's Captive Advisory team is likely to begin forming captives in other domiciles to access additional branches of the FHLB.



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# LOCAL DOMICILE CHANGES/FORMATIONS

## BERMUDA

### AFFIRMATION ON TAX POSITION OF PREMIUM PAYMENTS TO BERMUDA CAPTIVES

A recent court ruling in the US has affirmed the tax deductibility position of a parent company's premium payments to a Bermuda captive. The company in question is a large US entity in the home furnishings rent-to-own industry and has a group of subsidiaries. The Internal Revenue Services (IRS) claimed that premium payments paid to the company's captive based in Bermuda were not tax deductible as they were not in line with the tax code's provisions on insurance payments. Based on this, the IRS had alleged that the parent owed more than US\$43 million in back taxes. The parent took this issue to the courts.

The court found in favor of the parent company, ruling that the captive was a bona-fide insurance company and so premiums were tax deductible. They found the captive had not been established for tax reasons, premiums paid to the captive had been priced appropriately on policies that involved insurance risk, and there was genuine risk distribution. This judgment supports the precedent set in the Humana Inc. case of 1989.

## DUBLIN/IRELAND

The principle of proportionality is a cornerstone of the proposed new EU Solvency II regime. This underlying principle has been put into practice by the Irish Regulator, Central Bank of Ireland (CBI), with the adoption of the new PRISM system for regulating entities (including captives), and through the introduction of a specific corporate governance code for captives.

### PRISM

PRISM is how the CBI has been implementing its risk-based supervision since its introduction in November 2011. The PRISM system ensures regulatory supervision will focus on the firms with the highest impact rating. All captives have been designated as "low risk" institutions under this new rating system — the lowest of five distinct categories of risk rating. As a result, the regulation and supervision of captives is targeted to avoid sector-wide issues and uses a combination of reactive and thematic reviews primarily through the requirement for a submission, on a periodic basis, of financial returns and other management information.

### CORPORATE GOVERNANCE CODE

The Corporate Governance Code for captives was implemented in June 2012. This captive-specific code mirrors the spirit of the code that was implemented for all other regulated entities except in a number of key prescriptive areas. For instance, under the captive code:

- A minimum of three directors (versus five under the main code) is required.
- No requirement for independent directors (versus two under the main code).
- No requirement for subcommittees (versus a requirement for a separate risk and audit subcommittee under the main code).
- Only requires a minimum of two board meetings a year (versus a requirement for four under the main code).

The implementation of a separate and distinct code for captives translates into lesser burdens on management time for the owners of captive entities based in Ireland. These are just two examples of recent positive developments for captives operating in Ireland.

## MALTA

Malta's Reinsurance Special Purposes Vehicles (RSPV) legislation went into effect on December 27, 2013. The legislation defines an RSPV as:

- An undertaking, other than an existing insurance or reinsurance undertaking, that assumes risks from a ceding undertaking and that fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment right of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such a vehicle.

It is expected that this legislation will support the continued trend for Malta to position itself as the onshore domicile for insurance linked securities and catastrophe bond issuance that will be fully compliant with the Solvency II Directive and can provide maximum benefit for capital relief under Solvency II.



## NORTH CAROLINA

The North Carolina Captive Insurance Association hosted its first educational event on December 10, 2013, in Raleigh. More than 60 registrants attended the one-day event, which focused on the rollout of the new North Carolina Captive Insurance Act. Insurance Commissioner Wayne Goodwin was the keynote speaker for the conference. Raymond Martinez, senior deputy commissioner, and Jeffrey Trendel, deputy commissioner, reviewed the key advantages of the act, namely:

- There are no annual fees.
- There are no application fees.
- There are no mandatory Department of Insurance examinations.
- There is the possible exemption from the annual audit requirement for captives writing less than US\$1.2 million in premium.
- The insurance commissioner has the authority to approve that a captive has less capital than the minimum amount stated in the act.

Marsh is an approved captive manager in North Carolina. We will keep our clients informed of any developments in the domicile.

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## CAPTIVE AND INSURANCE INDUSTRY UPDATES



### MESOTHELIOMA SUPPORT SCHEME

It is expected that by midyear 2014, the Association of British Insurers and the Department for Work and Pensions will have a mesothelioma support scheme in operation.

The scheme will:

- Make payments to mesothelioma sufferers who were negligently exposed to asbestos at work but cannot find a solvent employer or insurer to file a claim against.
- Be compulsory for all employers liability insurers.
- Be open to mesothelioma claimants diagnosed after July 25, 2012.

Until the scheme is in operation, mesothelioma sufferers and their representatives are encouraged to continue searching for an employer or insurer to file a claim against. Further details, including how to register a claim, will be announced on <http://mesosupport.org.uk/>.

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# COMMITMENT TO CAPTIVES

## INDUSTRY ASSOCIATIONS

Marsh is proud to support each of the domiciles in which we do business. One way in which we ensure our clients have strong regulatory updates and representation is through our participation in local industry associations. We are proud to be part of the leadership team for the following industry and trade groups:

- **Lawrence Bird** is the immediate past president of the Bermuda Insurance Management Association (BIMA).
- **Derek Maddison** is treasurer for the Guernsey International Insurance Association (GIIA) and also sits on the executive committee.
- **Louise Jackson** is about to become president of the Insurance Institute of Guernsey.
- **David Riley** is the past chairman of GIIA, current chairman of GIIA's Regulatory & Technical Committee, and is the insurance industry representative for the Guernsey International Business Association Technical Committee.
- **Stephen Hodgins** is the current director of the Dublin Insurance Managers Association (DIMA), a role that has been held in the past by Ian Clancy, Brian McDonagh, and John Magee. John is also the past chairman of DIMA's Captive Subcommittee.
- **Derek Patience** is the past chairman and a current member of the executive committee of the Isle of Man Captive Association.
- **Clayton Price** is on the executive committee of the Insurance Managers Association of Cayman (IMAC) and is also chair of the Legislative & Regulatory Subcommittee. Other IMAC roles held by our team members include: Kieran Mehigan on the Forum Committee, Alissa Matthews on the Research & Development Committee, and Joanna Barnes on the Marketing & Social Committee.

## CAPTIVE ADVISORY – NEW TEAM MEMBER



**Kathryn Anderson** recently joined the EMEA Pacific Captive Advisory team from the Marsh Business Analytics practice (MRC). Her new role will include conducting captive feasibility and strategic reviews and developing and enhancing our captive reserving and loss modeling capabilities. Kathryn has been with

Marsh since 1997 and has extensive experience in loss modeling, insurance program optimization (risk finance optimization), funding, and reserving analysis. Kathryn is based in London.

## POWER 50 – CAPTIVE REVIEW

**Julie Boucher**, Captive Solutions Practice leader (Americas), and **Arthur Koritzinsky**, Captive Advisory leader (North America), were recently named to Captive Review's "Power 50 List," which honors the most influential people in the captive industry globally — key figures who have not only helped shape, but also continue to be the most influential in the industry. Julie came in at number 13 on the list due to her role in growing and developing US captive domicile operations for Marsh and her efforts in maintaining "solid relationships with regulators."

Art, number 30, was cited for being "one of the main drivers for Vermont's early growth and remains one of the most influential captive professionals at Marsh. He brings a wealth of expertise to the industry and has extensive experience in the formation stage of captives." Please join us in congratulating Julie and Art for this honor.



# CONTENT/CONFERENCES

Our team will take part in the following events/conferences this year. Hope to see you there!

March 4-5, 2014	<b><a href="#">SIFMA Insurance and Risk Linked Securities Conference 2014, New York, New York</a></b> Several members of the Captive Solutions ILS team attended the SIFMA IRLS conference and will be available to answer your questions on our service offering.
March 9-11, 2014	<b><a href="#">Captive Insurance Companies Association (CICA), Scottsdale, Arizona</a></b> Marsh's Captive Solutions Group hosted a booth at CICA's 2014 conference. Our speakers included Ellen Charnley, national growth leader for Captive Solutions, who covered newer and emerging captive coverages to consider, Rae Brown, Marsh Management Service Arizona, discussed how to survive financial audits, and Dawne Davenport, actuarial consultant and Scot Sterenberg, office head for Hawaii, explored ensuring captive capital adequacy.
April 10, 2014	<b><a href="#">Setting up a Reinsurance SPV &amp; Listing of Insurance-Linked Securities in Malta, London</a></b> The use of special purpose vehicles and insurance-linked securities to manage and transfer high-value, low-frequency catastrophe risks has exploded in recent times and is now a fundamental part of the international risk transfer market. Several members of our Marsh Management Services team will be available to discuss the rollout of new SPV legislation in the domicile.
April 24-25, 2014	<b><a href="#">American Conference Institute's National Forum on Captive Insurance, New York, New York</a></b> Arthur Koritzinsky will moderate a panel discussing the best strategies for choosing a domicile that is right for your company. The panel will also cover the implications of the proliferation of new captive jurisdictions.
April 27-30, 2014	<b><a href="#">RIMS, Denver, Colorado</a></b> Several members of the Captive Solutions team will be at RIMS to answer your captive questions. In addition, we will be releasing our "2014 Captive Benchmarking Report" during the conference.
May 19-21, 2014	<b><a href="#">Western Region Captive Insurance Conference 2014, Salt Lake City, Utah</a></b> The Arizona, Utah, and Missouri Captive Insurance Associations will host the fourth annual western region event. Derek Martisus, our small captives leader, and Rae Brown, from our Arizona office, will review traditional captive coverages and how these risks can efficiently be placed within a small captive that makes the 831(b) election. Please visit us at booth number two!

Please save the date for these conferences later in the year. More details to follow as we get closer to these conferences:

June 2-4, 2014	<b><a href="#">Bermuda Captive Conference, Southampton, Bermuda</a></b>
June 12-14, 2014	<b><a href="#">Malta International Risk and Insurance Conference, St. Julian's, Malta</a></b>
August 12-14, 2014	<b><a href="#">Vermont Captive Insurance Association's 29th Annual Conference, Burlington, Vermont</a></b>
September 22-24, 2014	<b><a href="#">South Carolina: A Captivating View, Isle of Palms, South Carolina</a></b>
November 11-12, 2014	<b><a href="#">European Captive Forum, Luxembourg Congress, Luxembourg</a></b>



For further information, please contact your local Marsh office or visit our web site at: [www.marshcaptivesolutions.com](http://www.marshcaptivesolutions.com)

Marsh is one of the Marsh & McLennan Companies, together with Guy Carpenter, Mercer, and Oliver Wyman.

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