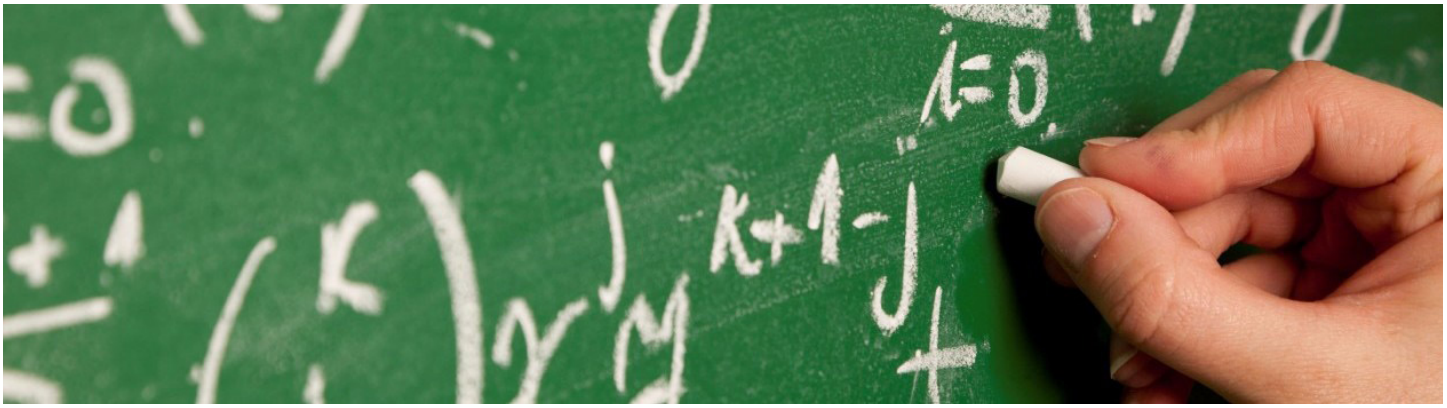

The Basics of Captives

What's Inside?

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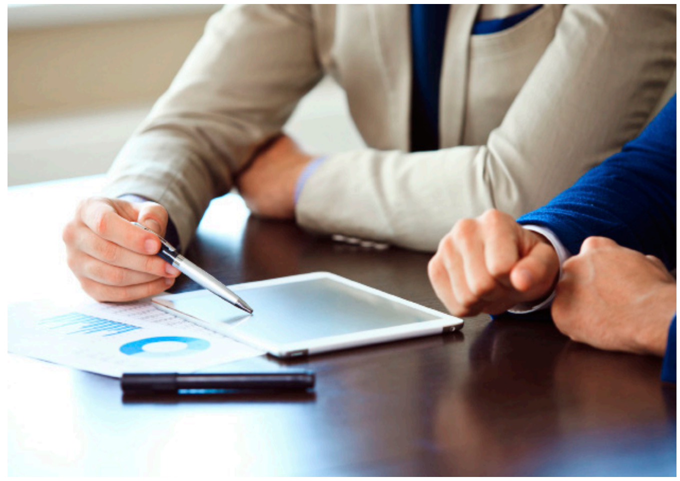
Why a Captive?



Regardless of the insurance market cycle, the use of captive insurance companies has increased year after year over the past two decades.

Traditionally, captives were wholly-owned insurance subsidiaries that provide funding vehicles for their parents' risks.

Today, captives can be sponsored by a third party and underwrite third party risks. There are now over 6,000 captive insurers worldwide. Over 90% of Fortune 500 companies employ some type of captive insurance company arrangement.[1]

The advantages of captives are multiple and can be significant:

- Potential short and long-term cost savings
- Customized employee benefits designs and property & casualty programs
- Enterprise risk financing applications
- Potential financial efficiencies like cash flow and insurance

Those are just a few of the benefits of captives. The bottomline with captives is that they offer significantly more efficiency, flexibility and control than a typical fully-funded solution. If this sounds even slightly appealing, you owe it to your company and your employees to read on. This quick book should give you all the information you will need in deciding if you should be exploring a captive further and if so, what the next steps are for you.

1 "Captive Insurance." Wikipedia: The Free Encyclopedia. Wikimedia Foundation, Inc. Web. 29 March 2016. < http://en.wikipedia.org/wiki/Captive_insurance>

What is a Captive?

A captive is an insurance or reinsurance company, established specifically to insure or reinsure the risks of its owner, or parent company.

In some cases, captives are also used to insure the risks of third parties, similar to commercial insurers.

History and Growth of Captives

Captives developed in the late 1800s when a group of New England textile manufacturers were looking for a way to help mitigate rising fire insurance rates. Then in the 1900s, companies began looking for better tax advantages and fewer restrictions, leading to the first offshore captives.

In the 1960s, mutual associations developed, allowing organizations to fund risks by pooling with similar companies. Captive insurance growth surged in the 1970s and 1980s, when the property & casualty market hardened, leading to increased costs. The total number of captive insurance companies grew from 100 in the 1960s to 1,000 in the 1980s.

The number of captive insurance companies continues to rise. In 2014, there are roughly 6,300 captives globally, up from 5,525 in 2009. About 90% of the Fortune 500 companies[1] own one or more captive insurance companies and many captives house more than one company with the development of cell captives. Cell companies are a captive program sponsored by one entity for the use of other entities.

Throughout the United States, and globally, captive domiciles are revising and modifying their legislation to better accommodate employers' evolving needs. For example, many domiciles are refining their requirements for establishing cell captives, and many include opening up to new lines of coverage, such as employee benefits. Today, over 30 states allow the establishment of captive insurance companies.

1 "Captive Insurance." Wikipedia: The Free Encyclopedia. Wikimedia Foundation, Inc. Web. 29 March 2016. < http://en.wikipedia.org/wiki/Captive_insurance>

Requirements for Captives

No matter where you are looking to domicile, there is a great deal of statutory and regulatory standards that need to be followed in order to establish and maintain a captive insurance company. Captives are licensed and regulated by regulatory insurance agencies.

Captives in the United States are licensed under state law with some federal regulatory oversight. Certain types of captives can be licensed across state lines. Non-US captives are licensed by national governmental bodies. It is important to become very familiar with the specific rules and regulations in whichever domicile you are looking to establish your captive.

A Few Important Captive Benefits:

Save and Manage Costs

- Accelerate cash flow through premiums, claims and reserves
- Reduce costs (commissions, taxes, risk charges, administration, underwriting)
- Capture investment return
- Improve cash flow and centralize investment of reserves

Increase Control

- Design coverage and provisions of benefits
- Improve data management and claim cost management
- Remove insurer's profit loading
- Improve management reporting and understanding of risks

Improve Risk Management

- Operate and manage a central risk pool
- Implement appropriate stop loss reinsurance to manage peak risks
- Reduce overall cost of risk

What Can Captives Cover?

Property & Casualty

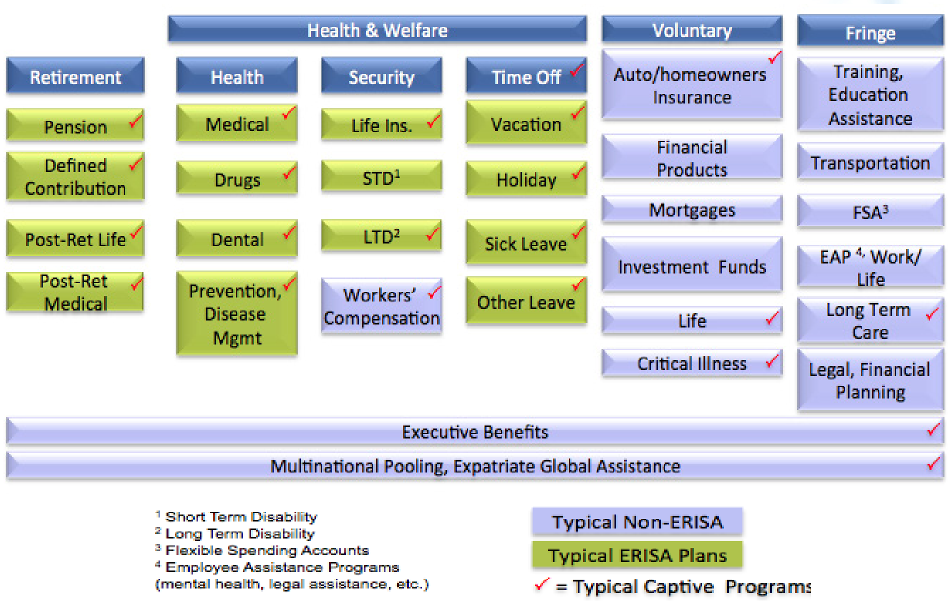
Companies underwrite a wide array of property & casualty programs through captives. An estimated 65%[1] of P&C premiums are insured through captives. Some of the most common P&C risks covered include:

- Professional E&O Liability
- Cyber Risk
- Products Liability
- Workers Comp./Employers Liability
- Property Damage / Business Interruption
- Auto Physical Damage / Liability
- General Liability
- TRIA / TRIPRA
- Certain or Limited Liability Employee Benefits
- Pollution / Environmental
- Extended Warranty
- Other Uninsurable risks

Employee Benefits

A wide range of employee benefits may be funded through a captive. Benefits that pay out over multiple years (e.g. long-term disability and retiree medical), provide cash flow stability and loss predictability. Lines such as group life insurance, which can be very profitable for commercial insurers, offer the captive the same profit potential.

The chart below shows all employee benefit options, and gives an example of those that a typical employer may wish to fund through a captive.



1 Vermont regulator estimate

What Types of Captives Are There?

Types of Captives

There are a number of different ways in which a captive insurance company can be setup. How a captive is formed depends on a number of factors related to the company's objectives and requirements. Here are a few of the most common captive formats along with descriptions to illustrate the basic structure of each.

- Single Parent (Pure)
- Group
  - Risk Retention Groups
  - Association
- Protected cell facilities

Pure Captive

- Owned and controlled by one owner
- Insures the risks of the parent only
- Most common structure
- Some captives write unrelated business

Group Captives

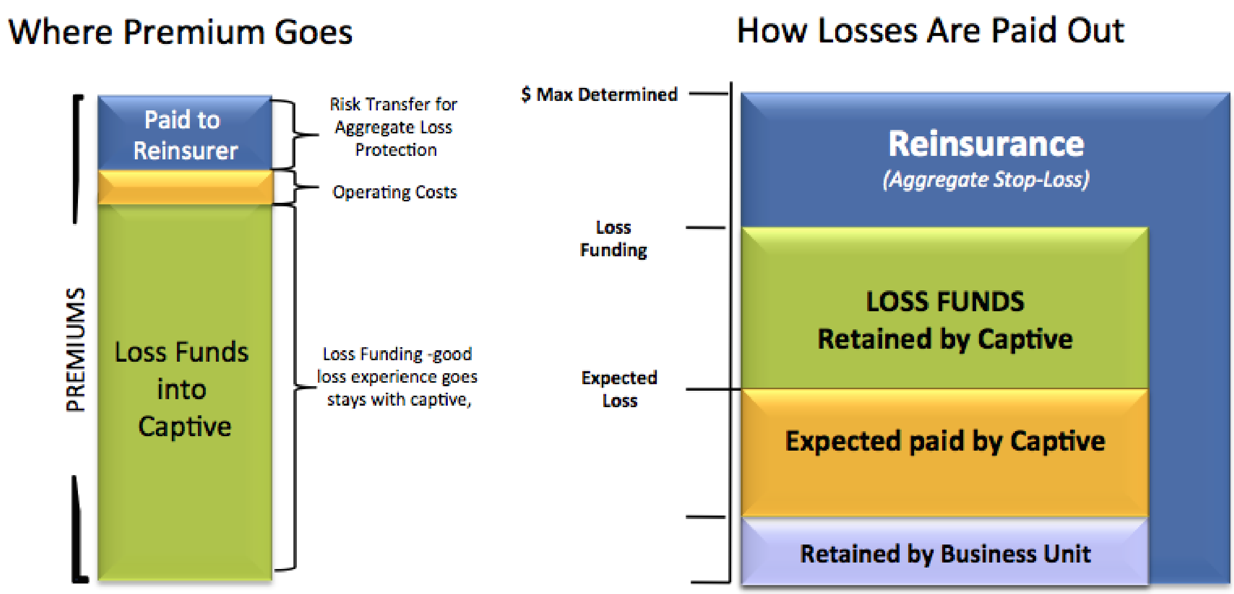
- Owned by a group of companies
- Can be related/homogeneous (i.e. trade groups) or unrelated/ heterogeneous (i.e. same size)
- Insures the risks of the group (members / policyholders)
- Can be subject to joint and several liability

Cell Captives

- Owned or operated by a third party sponsor (i.e., insurance company, etc.) that sets up accounts, holds premiums and capital
- Insures the risks of multiple insureds
- Affords the benefits of a pure captive by allowing the insureds to "rent"a cell, and lessen ownership and management responsibilities
- May or may not require a capital commitment
- Participants covered under a participation agreement rather than a shareholder or member agreement

How Do Captives Work?

Where there are a number of different captive structures, which will be discussed later on in this brochure, the graphic below illustrates the basic premise of a captive setup.



Long-Term Strategies: **1. Grow LOSS FUNDS by retaining and managing more risk in the captive, lessen dependency on insurance over-time**
2. Accrue value in captive

Potential Frictional Savings with Captive Funding*:

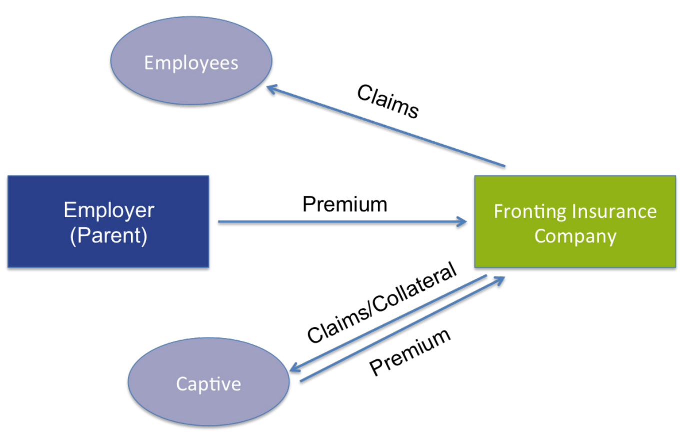
Insuring risks in a captive allows clients to gain transparent control of not only their loss exposure, but to the expense structure required to support their programs as well. This transparency allows the client to reduce, and in some cases, eliminate some of their plan expenses. Expenses such as underwriting profit, broker commissions, taxes, carrier risk charge/profit loads and plan administrative expenses are all often favorably impacted when moving into a captive. The chart below reflects the typical savings levels that can be achieved.

Program	Potential Savings - As a Percentage of Frictional Costs
Property & Casualty	5% to 40%
Life Insurance	15% to 35%
Retiree Medical	10% to 25%
Disability	15% to 35%
Multinational Benefits	15% to 25%
Medical Stop Loss	10% to 20%

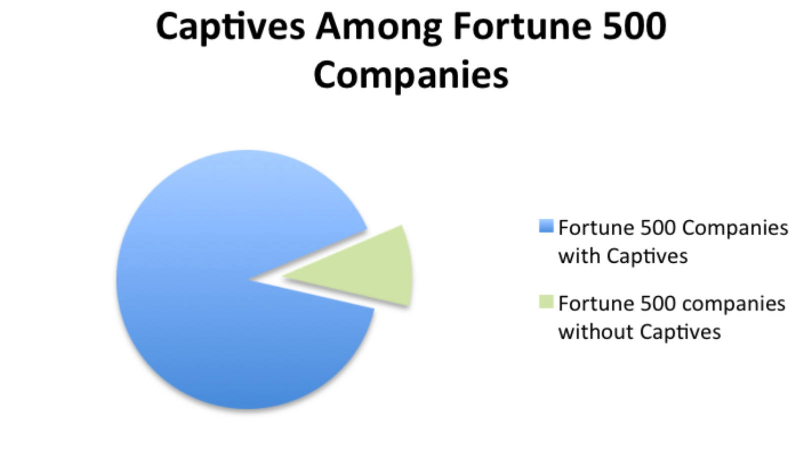
** Potential savings are represented as percentage of frictional costs of commercial insurance*
- These are typical savings that our clients have experienced in the past; actual performance may vary

Structure of the Transaction

The following chart outlines the typical structure of a single parent captive with employee benefits ceded to the captive through a fronting insurer. This illustrates the key players, and how capital (premium and claims) flow between the various parties.



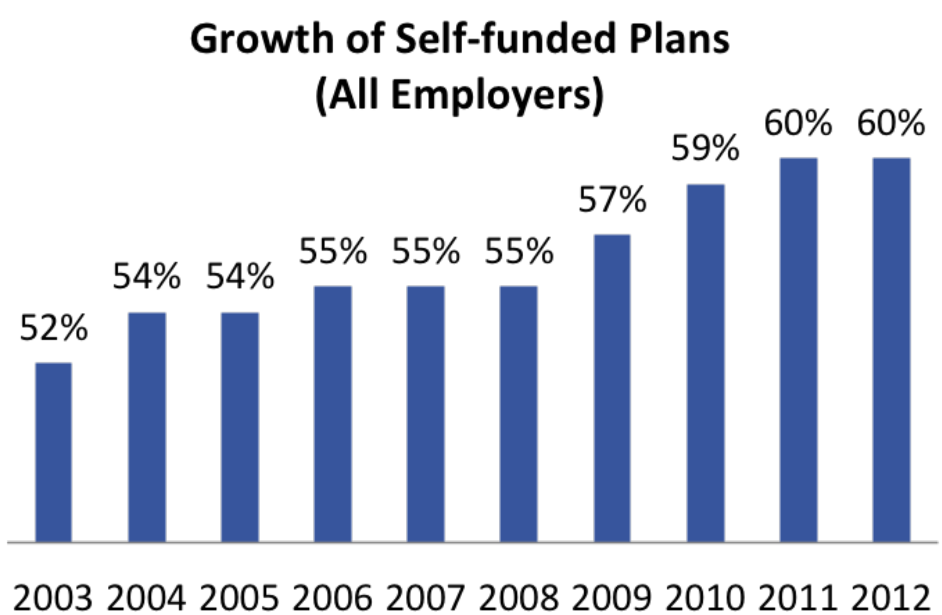
Who Uses Captives?



Fact: There are more than 6,000 captives globally

Fact: 90% of Fortune 500 companies own at least one captive

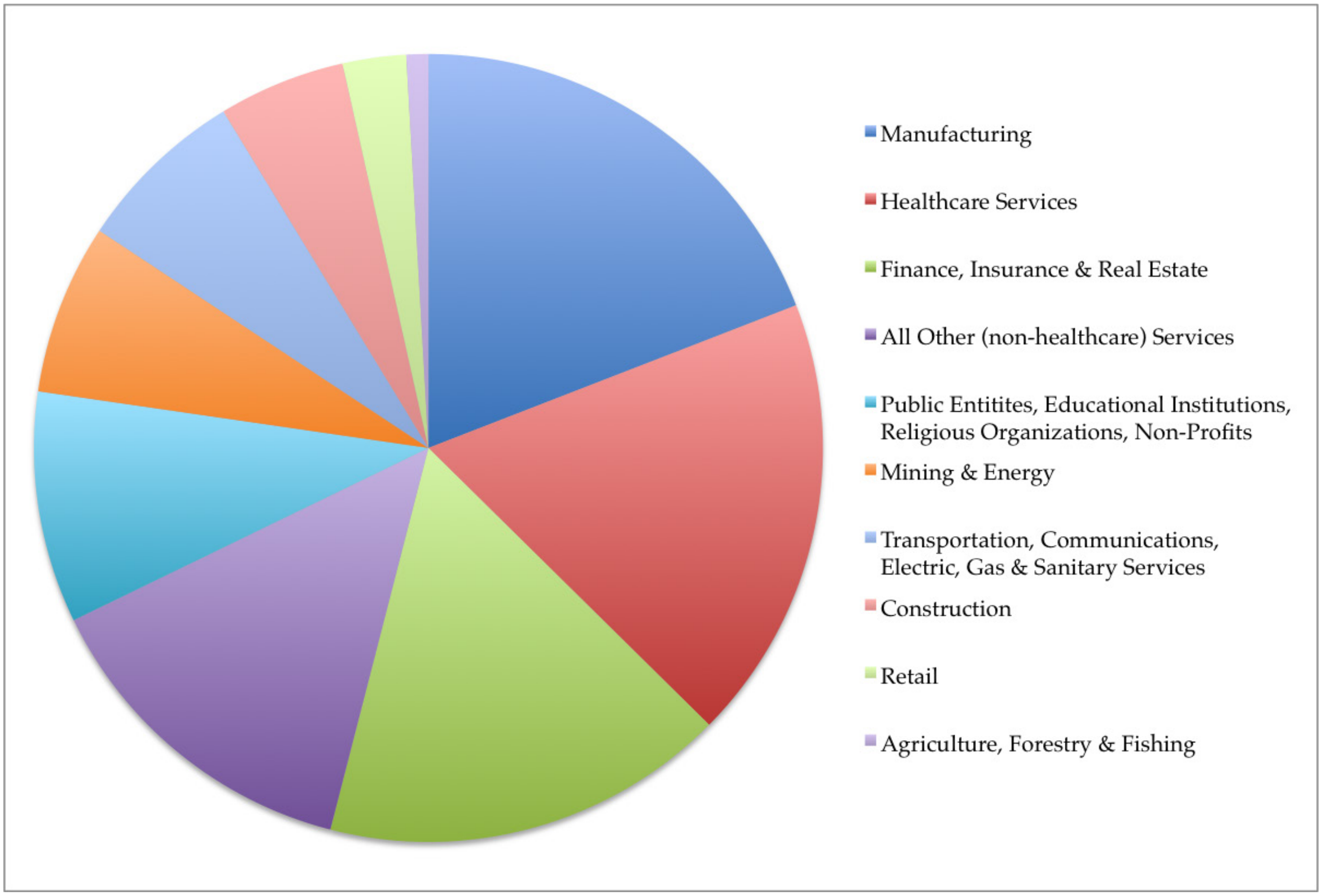
Captive insurance. In Wikipedia. Retrieved March 29, 2016, from http://en.wikipedia.org/wiki/Captive_insurance



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2012.

Industries Served by Captives (major SIC divisions)

There are a number of industries that have found captive to be an effective and efficient means to managing costs and improving control. Traditionally, industries that tend to have high property & casualty risk were inclined to use captive funding solutions, but with the growing trend of funding employee benefits in captives, the pie chart below is likely to be more evenly distributed in the future.



Source: 2012 CICA Captive Market Study, formerly the Fronting Survey

Where are Captives Domiciled?

Captives may be domiciled in a number of locations inside and outside of the United States. While off-shore domiciles have historically been the most popular choice of captive owners, recent regulatory changes in a number of U.S. states have made domestic domiciles much more appealing. Many states have taken advantage of the on-shoring trend including states like Vermont, Delaware and Utah, who now rank among the world's largest captive domiciles.

Here is a listing of the current captive domiciles separated by domestic U.S. and off-shore:

U.S. Domiciles

- Alabama
- Arizona
- Arkansas
- Colorado
- Connecticut
- Delaware
- District of Columbia
- Florida
- Georgia
- Hawaii
- Kentucky
- Maine
- Maryland
- Michigan
- Missouri
- Montana
- Nevada
- New Jersey
- New Jersey
- New York
- North Carolina
- Oklahoma
- Oregon
- Puerto Rico
- Rhode Island
- South Carolina
- Tennessee
- Texas
- U.S. Virgin Islands
- Utah
- Vermont

...and growing!

International Domiciles

- Aland
- Anguilla
- Bahamas
- Bermuda
- British Columbia, Canada
- BVI
- Cayman Islands
- Cook Islands
- Gibraltar
- Guam
- Guernsey
- Hong Kong
- Ireland
- Isle of Man
- Jersey
- Labuan
- Liechtenstein
- Luxembourg
- Malta
- Mauritius
- Nevis
- New Zealand
- Panama
- Qatar
- Singapore
- St. Kitts
- St. Lucia
- Turks & Caicos
- Vanuatu

Most Popular Captive Domiciles[1]

1 "Captive domiciles see growth as insurer formation options increase" Business Insurance. Crain Communications 16 March 2014 Web. 20 January 2015. < http://www.businessinsurance.com/article/20140316/NEWS06/303169985>

Is a Captive Right for You?

Who Should Consider a Captive?

Generally speaking, any company that is looking to achieve greater control over their risk should consider a captive. More specifically, there are a few general characteristics of companies that captives suit best.

Companies with:

- Good risk management
- Long term commitment
- Financially sound
- Driven by an interest in financing assumed risk positions
- Reasonably predictable insurance risk

Business Not Typically Suitable for a Captive:

On the flipside, there are also a few telltale warning signs that a company should not be considering a captive

- Poor risk management / high loss ratios
- Short term outlook or price driven
- Financially weak
- Highly volatile or catastrophic exposures without the support of stable lines
- Are too small to accept the risk of loss

Key Considerations When Forming a Captive

There are a wide variety of internal and external factors that need to be considered when deciding whether to form a captive or how you should do so. Here are just a few of the most critical items that should be deeply considered before greenlighting such a significant commitment.

Captive Type:

- Pure
- Group
- Cell

Legal Structure:

- Stock
- Mutual
- Reciprocal

Domicile:

- Foreign
- Domestic
- Which State?

Tax Issues:

- Deductible premiums
- Insurance accounting
- Deposit accounting

Regulatory:

- Compliance
- Financial metrics
- Record keeping

Is a captive right for your business? Take this quick quiz and find out:

- Is the cost of insuring your risks getting too expensive?
- Do you have risk that is uninsurable by traditional market means?
- Would you like more control over claims and data?
- Do you have a strong loss history?
- Would you like more predictability and stability in your risk financing?
- Would you like to earn income on your revenue rather than have that accrue to an insurer?
- Would you like more control over your insurance plan design?
- Is your competition setting up captives?
- Do you have a strong risk management team in place with effective policies?

Captive Feasibility Study

If you find yourself answering “yes” to some or many of the questions above, you will want to have a captive feasibility study conducted for your business. A captive feasibility study is will dig in deeper to your company’s specific set of circumstances and determine if a captive is your best funding solution and how your captive would be best structured.

What is addressed in a captive feasibility study? Here are a few of the basics:

- Identifying your goals and objectives
- Reviewing your current state of programs
- Collecting, organizing reviewing and analyzing your existing data
- Estimating potential captive savings for each line of coverage
- Identifying your most effective program design
- Identifying the pros and cons of captive funding of each program
- Determining implementation steps
- Determining cost and schedule of the next phase

How Do You Establish a Captive?

- Conduct a feasibility study
  - Loss history
  - Risk/reward discussion (potential benefits)
  - Minimums: solvency, capital requirements, premiums
  - Ownership options
  - Financial analysis
  - Legal requirements
  - Actuarial review
  - Reinsurance / insurance contracts
- Select service partners
- Incorporate
- Captive licensure
- Capitalize
- Service provider agreements

The Development Process

Phase One: Initial Analysis (High Level)	
■ Data Collection	Captive Consultant
■ Data Initial Analysis	Actuary
■ Program Parameter Development	
■ Initial Indications	

Phase Two: Formal Feasibility Analysis	
■ Develop Optimal Program Parameters	Captive Consultant
■ Fronting and Reinsurance Options	Actuary
■ Actuarial Analysis	Legal
■ Tax and Legal Analysis	
■ Pro Forma Financial Statements	

Phase Three: Captive Program Implementation	
■ Incorporating / Licensing & Setting up the Captive	Captive Consultant
■ Binding Insurance Program(s)	Legal
■ Securing Capital Commitments	Regulator

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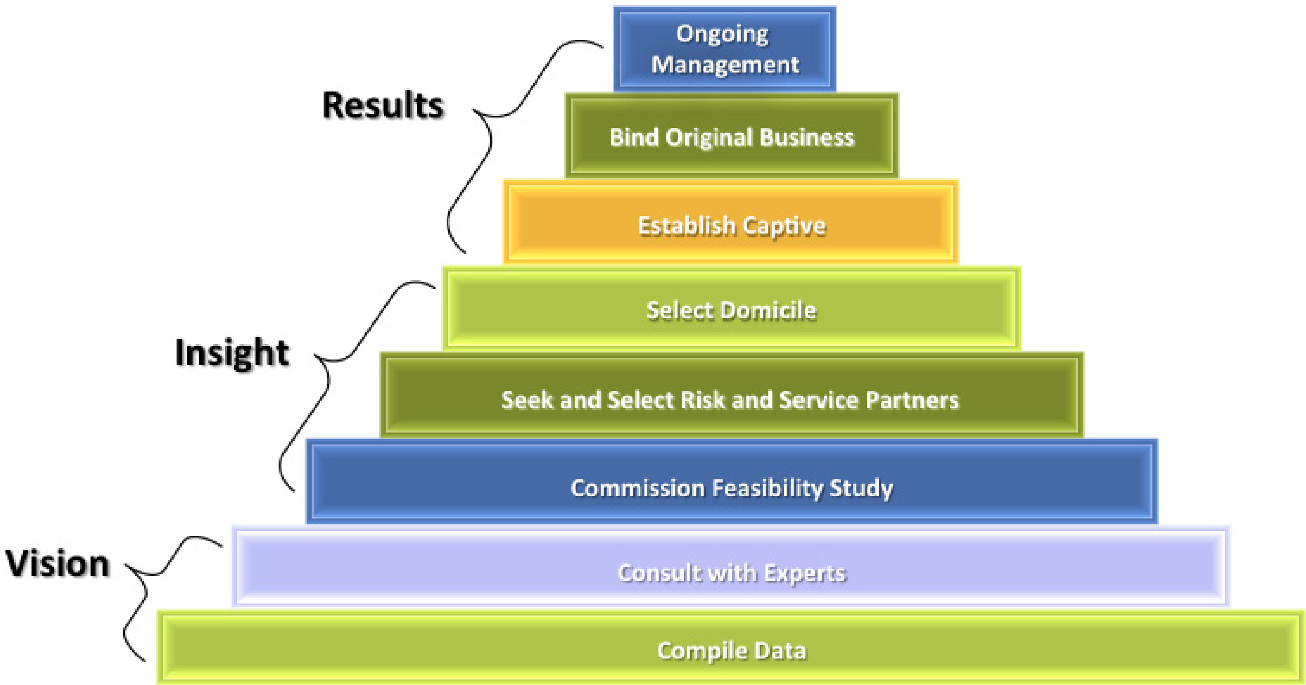
Key Steps to Exploring, Forming and Maintaining a Captive



Case Study

Evaluating Alternative Funding Method

A non-profit, multi-state health system with 35,000 employees, wanted to conduct a feasibility study to determine if captive funding could:

- Generate employee benefit cost savings
- Improve operational performance
- Increase cash flow
- Enhance benefits
- Improve employee participation

PROCESS

Spring assessed basic life, supplemental life (including spouse and dependent child coverage) and long-term disability with identifying fully insured basic life and supplemental life as potential candidates for captive funding (estimated $1m in savings). Long-term disability was eliminated as a candidate due to current funding and the non-profit status of the company.

SPRING'S SOLUTION

Spring proposed using a fronting company arrangement and to re-insure benefits through a single parent captive. Our experts assisted with qualifying and selecting a fronting insurance company, one who is recognized for outstanding plan implementation and administration. Spring also worked to establish a captive branch on-shore, as required by the Department of Labor (DOL) and completed the application to submit for approval by the DOL.

RESULTS

The first-year projected savings were $500,000. Life insurance claim payments improved from 1 month to 4 days, and the company was able to be more responsive to clients' requests. Additionally, employee participation increased by 8.5%.

Benefit enhancements included:

- Doubled life coverage for spouses and children
- Enhanced accelerated health benefits
- Added beneficiary counseling, legal services and travel assistance for emergency medical needs

Spring's Captive Services

The Spring Captive Team

- Focuses on captives as a core business
- Industry experts that have set many new precedents in the design of benefits captives
- Spring has 8 patents on its unique approach to funding benefits through a captive
- Ability to deliver a full spectrum of services:
  - Feasibility, consulting, implementation, administration and program management
- Objective and independent
- Flexibility to partner with other client preferred advisors
  - Tax specialists, attorneys, captive managers, etc.

Captive Specific Services

- Determine appropriate coverages for consideration
- Identify preferred domiciles
- Define structure, including financial arrangements and service requirements
- Develop loss projections and financial pro formas
- Facilitate go, no-go decision

Captive Program Modeling

- Confirm preferred domicile, coverages and parameters
- Develop program structure, including financial arrangements and service requirements
- Access/coordinate tax opinions
- Complete loss projections including scenario modeling and pro forma financials

Implementation

- Meet with domicile insurance commissioner to discuss filing
- Develop program submission to captive domicile insurance commissioner
- Submit captive application
- Draft policies and procedures
- Arrange for excess coverage through RFP process (access commercial market)
- Finalize partnership arrangements
- Confirm transition plan

Ongoing Administration and Actuarial Support

- Develop policy forms, necessary filings, service standards and procedures
- Issue policies and provide ongoing administration
- Conduct actuarial reviews of reserves and liabilities and perform certifications
- Develop premium, loss and expense allocation
- Review existing programs and identify areas for expansion - create business plans and financial models to support expansion
- Continually monitor the program success against the initial and changing objectives

About Spring

Spring, provides a full range of strategic consulting services to institutions in the insurance and financial services industry; broad consulting and brokerage capabilities to employers; and funding solutions for benefit programs, including the use of captive insurance facilities and the day-to-day management thereof.

Spring was formed in March 2004, through a management buyout of the US insurance and financial services strategy consulting practice of Watson Wyatt, LLP.

Spring has been focused on the funding of employee benefits and use of captives across property and casualty programs for years and has specific expertise in the area of captive insurance.

OUR UNIQUE EXPERTISE

In addition to designing the first employee benefit captive in the U.S., Spring has worked with many large size employers and financial organizations to design both insured and self-insured programs and implement innovative captive insurance company programs. The Spring team believes that as the costs of benefits are rising, a captive, if managed correctly, can reduce benefit costs and provide budgetary stability. Moreover, recent legislative developments in the U.S. are changing the market dynamics and are rapidly evolving towards more effective funding of employee benefits in captives. Spring brings our clients unmatched expertise in the area of employee benefits design, alternative funding and captive management. The Spring team has been providing a full range of employee benefit and captive program administration services, including underwriting, pricing, reserving, claims processing, financial management and administrative services to employee benefits captives for more than 10 years.

To help ensure the success of our consulting engagements, Spring has under its roof a full arsenal of resources, tools and strengths to benefit our clients. These include:

- Captive Specialists. We have expertise in developing captive insurance strategies in employee benefits for our clients that seek cutting edge alternative risk financing solutions. With our precedent-setting captive strategies, we have helped shape the employee benefits captive world in the United States as we know it today

- Recognized Experts. You want the best in the business — people who have worked with FORTUNE 500 to small business clients to solve problems creatively. Our consultants are recognized leaders in the design and funding of captive insurance solutions, and can bring to bear their collective knowledge, insight and industry connections for this project
- Strategic Solutions. You need answers that will be long-term solutions — ones that take into account not just the problem of today, but to anticipate and plan for the challenges your organization will face tomorrow
- Effective Teamwork. You need a committed, proactive team with the ability and resources to deliver service. You want experts who can transfer their knowledge of complex issues to the your team easily and effectively
- Predictability. You need straightforward advice tailored to your specific business issues. You want no surprises in both our working relationship and the results we provide you
- Focus on Business Objectives. You need a team who understands your business well and is dedicated to delivering services that add value to your business — a firm that understands the complexities of issues ranging from financial forecasting to actuarial funding and its impact on short- and long-term budget and financial plans

What's Next?

Spring is a recognized leader in risk funding strategy. There is no other firm out there that is as dedicated and flexible in determining if a captive is the right fit for you and then providing you with the right solution from development through implementation.

If a captive seems like something that may benefit your company, the next step is discussing a captive feasibility study contact our team of captive professionals for additional information about how to begin the process.

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