Captive Collateral Options and Solutions

Bermuda Captive Owners Association

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Why is Collateral Required?

- Regulators mandate that if a captive or corporation will not/cannot pay its retentions/deductibles/obligations, the carrier must
- For reinsurance, programs not properly collateralized (per the NAIC) create a Schedule F Credit charge
- Therefore, insureds present a certain credit risk
- Collateral is both credit risk and accounting driven
- Each form of collateral requires expertise
- Each has its pros and cons

Types of Collateral

- Letters of Credit (LOC)
  - Standby
  - "Carved-out" of a revolving line of credit

- Funds Withheld
  - Pre-funded deductible programs
    - May be static amounts or depleting or "working" trusts

- Collateral Trusts
  - Insurance Trust
  - Reg. 114 Trust
  - Security Escrow
    - May be static amounts or depleting or "working" trusts

Letters of Credit

Client obtains, for a fee, a bank line of credit posted to the insurance carrier in the amount required.

- Pros:
  - Relatively little legal work
  - Universal carrier acceptance
  - Universal understanding
  - Relatively easy to establish

- Cons:
  - Most expensive option (50 + BPS in annual fees)
  - Often must be cash collateralized
  - "Stacking" effect over multiple years
  - Create credit encumbrance
  - Create "contingent liability" on balance sheet
  - Limited investment possibilities (where collateral is posted)
  - Must be re-renegotiated each year (even evergreen)

Funds Withheld (Pre-Funded Deductible Programs)

- Pros:
  - Easy to execute
  - Low “out-of-pocket” costs (often $0 fees)

- Cons:
  - Must be “cash”
  - Collateral may disappear from depositor’s balance sheet
  - Collateral may become asset of insurance company
  - Low rate of return on cash (high opportunity cost)
  - Fixed rate of return
  - Subject to solvency of carrier (not “bankruptcy-proof”)
  - Some carriers “moving away” from this option

Pledge qualified investments to satisfy collateral obligation

- Pros:
  - Inexpensive
  - Assets in trust remain on client's balance sheet
  - A "Restricted asset" not "contingent liability"
  - One trust covers all years (no "stacking, no renewals")

- Cons:
  - Longer legal document
  - Must be funded with financial assets
  - Limits on investment options (similar to LOC collateral accounts)
  - Most (but not all) carriers accept the trust
  - Some clients don't qualify

Collateral problems?

- Is credit expensive?
- Are letters of credit (LOC) harder to obtain?
- Is the client's credit availability restricted by insurance related LOCs?
- Are carriers increasing their collateral requirements more and more each year?
- Is it often difficult to manage all of the LOCs posted from multiple banks?
- Is it difficult to get an LOC released?
- In short, is there a better collateral alternative to LOCs?

The solution ~ The Wells Fargo Collateral Trust

- Replace insurance and surety related LOCs
  - Place “investment grade financial assets” into trust
  - “A” rated debt-related securities including corporate debt, CP, CD, U.S. Treasuries, Treasury Funds (see next slide for specifics)
- The client (grantor), Wells Fargo (trustee), and the insurance carrier, fronting carrier, or surety provider (beneficiaries) sign “tri-party” trust agreement
- Pledge the trust directly to the insurance carrier, fronting carrier, or surety provider
- This satisfies the regulators and (most) carriers

What can go in a trust?

These are guidelines set forth by NY State Reg. 114 and are subject to carrier acceptance

- Cash
- Deposits in NAIC approved money market funds
- U.S. Government or agency obligations
- U.S. corporate debt rated “A” or better
- Shares of registered investment companies
- Deposits on a United States bank

Wells Fargo

Why use the Wells Fargo Collateral Trust in lieu of Lines of Credit?

- Significantly less expensive
  - Depending on the size, the trust could save over 80% of LOC fees
- Increase credit availability
- Convert “contingent liabilities” to “restricted assets” on the balance sheet
- Combine multiple LOCs into one trust

Applications of the Wells Fargo Collateral Trust

Replace LOCs used as collateral for insurance and surety requirements

- The Wells Fargo **Captive** Trust
- The Wells Fargo **Deductible** Trust
- The Wells Fargo **Reinsurance** Trust
- The Wells Fargo **Surety** Trust
  - Secure a surety bond or replace it outright

Answers to treasurer's questions

- Income from the trust is the property of the depositor
- Assets in the trust remain on the depositor's balance sheet
- The trust is easy to set up
- The trust is easy to dissolve
- Usually need only one trust per carrier
- The trust does not need to be re-negotiated each year

Check with the individual carrier and address requirements per your specific client

- The carrier decides the following:
- Whom they allow to use the trust
- What they allow for investments (within the limits set forth by the regulators)
- What % of the collateral can be a trust
- The trust must be funded with financial assets
- No real property, treasury stock, accounts receivable, etc.
- The funding level is usually at least 100%

The limitations

- Client does not have the money (financial assets)
- Carrier does not take the trust
- Client is in severe financial trouble and carrier says no
- Some carriers reluctant if the client is no longer their client
- Carrier might require client to go back to LOC upon termination of relationship

Why use Wells Fargo?

- Dedicated group of administrators who work exclusively on insurance related trusts
  - Our staff has established and administered over 1,000 trusts with a market value of over USD $100 billion
- Clear understanding of the carriers' general requirements
- Pre-negotiated trust agreements with most carriers
- Robust and easy-to-use on-line reporting
- Single "administrative" point-of-contact for each deal
- Our team can deliver:
  - Extensive information on carrier requirements
  - Technical and specific information on trust set-up
  - Detailed cost/benefit analysis
  - Thorough (yet easy to understand) explanations for the clients
  - Named "Global Best Bank for Insurance Trusts" by Intelligent insurer

Pricing

You Save
$95,000
(95%) with a
Wells Fargo
Trust

- The difference in fee structure is as follows:
  - Wells Fargo Trust
    - **On average** $5,000 (depending on structure)
  - Letter of credit
    - 25 – 200+ basis points annually
- For example: $10,000,000 collateral requirement, 100 BPS LOC:
  - Wells Fargo Trust = $5,000
  - Letter of credit = $100,000

Wells Fargo requirements

In accordance with the USA Patriot Act, all financial institutions must fulfill certain government regulations prior to engaging a transaction. This includes:

- Due diligence to be performed on each new client
- Know your customer ("KYC") information
- We need background information, financials, etc.

Summary

- Save Money (often over 80% of LOC fees)
- Free up credit availability
- Remove contingent liabilities from the balance sheet
- Potentially enhance credit relationships
  - www.wellsfargo.com/collateral-trust

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