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Bright ideas for insurance.

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Introduction

Plante Moran's insurance industry team is pleased to present our Bright Ideas for Insurance. This publication explores a number of opportunities the insurance industry can leverage for continued growth and success, and includes summaries of the insightful presentations from the fifth annual Plante Moran Insurance Conference. The conference brought together CEOs, CFOs, and other top executives from insurance organizations for thought-provoking sessions and conversation on evolving insurance industry issues and trends, growth strategies, cybersecurity strategies, the benefits of a captive insurance company structure, and tax and accounting updates.

While there is significant opportunity for growth in the insurance sector, it is increasingly important to prepare for regulatory changes and embrace new ideas to stay ahead of the curve. We invite you to review this summary to help you prepare for the opportunities and challenges ahead. We hope you take away new information and practical solutions to help lead and grow your business.

ABOUT US

Plante Moran currently serves more than 100 insurance companies and is nationally recognized as one of the top firms serving the insurance industry by A.M. Best Company.

Our insurance industry specialists include accountants, tax specialists, and business advisors who have the experience and industry knowledge to help insurance companies plan for growth and respond to the evolving regulatory environment.

Insurance Trends and Growth

Strategies

With more than $3.8 trillion, the global insurance market reached an all-time high in terms of capital in the first quarter of 2014, creating challenges for growth for insurers. "We've nearly doubled insurance capital since 2008 ($2.4 trillion)," said Kathleen Monaghan, a consultant on Aon Benfield's Inpoint strategy team, "and there's a need to innovate to continue to help policyholders." Doing so requires an understanding of immediate and evolving risks and opportunities that are impacting industry trends and growth strategies, both here and abroad.

"We think of markets (geographies) and risk as evolving together, with events that are constantly developing," said Monaghan, who plots markets and risks along a Cartesian plane assigning ratings from emerging to developed to better understand opportunities. The results are then grouped among four quadrants:

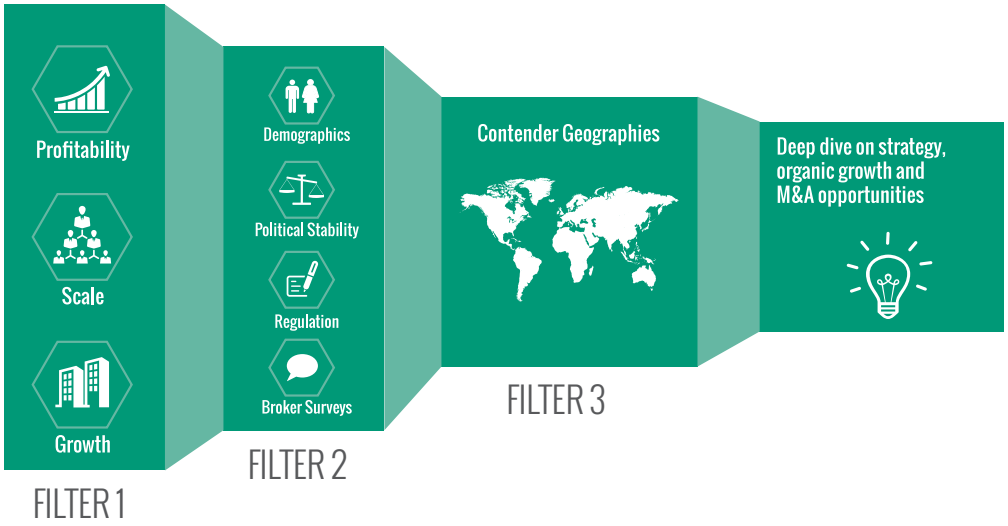
- **Developed markets/developed risk:** U.S. healthcare, U.S. small commercial, and UK auto. Monaghan states "These opportunities are evolving but for the most part understood from a coverage and pricing standpoint."
- **Emerging markets/emerging risk:** Chinese cybersecurity and African mining "These are on the frontier but should still be under consideration for future coverage," said Monaghan.)
- **Developed markets/emerging risks:** U.S. cyber insurance
- **Emerging markets/developed risks:** International motor, Brazil SME, and Brazil crop

Discovering opportunities requires assessing data through a structured, three-filter framework: profitability, scale, and growth (filter one); demographics, political stability, and regulatory environment (filter two); and distribution channels and competitive landscape (filter three). Monaghan states "From there, an insurer will have thoughtfully filtered its opportunities to those that it can execute on organically or through M&As or partnerships."

U.S. GROWTH OPPORTUNITIES

"Current growth opportunities in standard products in the U.S. are more limited," said Monaghan, noting the competitiveness of the U.S. insurance landscape.

Monaghan illustrates the use of these filters in the U.S. starting with the 14 P&C minor statutory lines of business in 50 U.S. states and the District of Columbia (714 total opportunities). Applying filter one (profitability, scale, and growth) leads to 59 opportunities. Of those, 15 opportunities exceed $500 million and outpace average growth and loss ratio, which are then filtered for regulatory considerations and demographics (filter two), resulting in eight opportunities. Finally, those eight are analyzed based on the competitive landscape and other risk factors (filter three), yielding just three high value growth opportunities in the United States: TX-Liability, VA-Liability, and IL-Liability. "This does not mean that there are only three opportunities in the entire U.S., but rather, this is a framework for

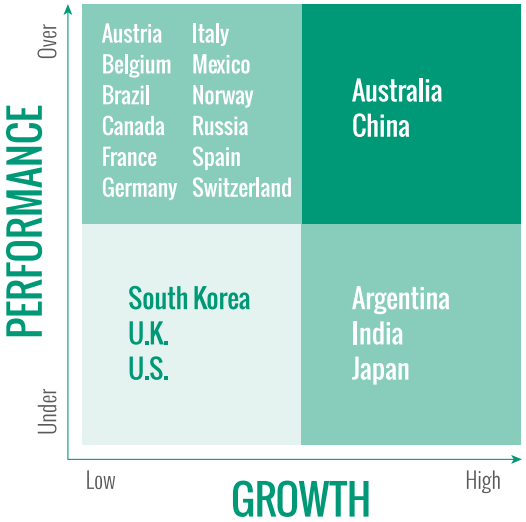


making decisions about where to grow," Monaghan said. A final investment decision must consider product differentiation, channel dynamics, changing legislation, and individual capabilities. According to Monaghan, "There are certain areas where you might be better suited for growth. You need to consider your expertise, which can impact your ability to outperform."

INTERNATIONAL GROWTH – AN OVERVIEW

While the U.S. currently commands the largest share of the global P&C market, followed by Japan, China, Germany, the UK, and France, Monaghan foresees an imminent shakeup at the top, with China displacing Japan as the second largest market by 2017 and (perhaps) the U.S. in the not-too-distant future. "We wouldn't be surprised if China is the largest market within 10-15 years … China is growing so quickly."

Among the top 20 global markets, China and Australia skew high for both performance and growth metrics, while the U.K. and the U.S. lag behind in both of those measurements.



INTERNATIONAL GROWTH – ASSESSING OPPORTUNITIES

To identify the markets with the most growth opportunities, carriers must look beyond premiums and losses to barriers of entry and the regulatory environment, assessing each by how it can differentiate (a reflection of accessibility/distribution and product innovation, among other factors).

Any growth estimate must be balanced by a look at the trends that can impact global direct written premiums (product innovation, government support) as well as global ceded written premiums (alternative capital writing reinsurance directly, evolving government support for reinsurance.).

Monaghan works through each of these considerations before offering an assessment of high value, international opportunities. "Over the next five years, motor will continue to dominate the P&C market, followed by property." While property is currently driving the

most growth in developed economies, motor (followed by property) is driving the most growth in developing economies.

SPECIFIC OPPORTUNITIES

Returning to a market/risk analysis, Monaghan identified a number of specific growth opportunities, breaking down her assessment by grouping:

Developed markets/developed risks

- **U.S. healthcare:** "We believe that with the individual mandate, an expansion of Medicare, and the employer mandate, there will be $350+ billion from private exchanges entering the market." However, she cautioned: "There is a lot of uncertainty still, the share [of private exchanges] is small but this could grow."
- **U.S. small and middle commercial:** Carriers can differentiate here by adapting to new buying trends (online shopping) and emerging risks (cyber and employer liability)
- **U.S. and UK auto:** Monaghan quoted the NAIC, which believes in the next five years 20 percent of all vehicles may have usage-based insurance, which offers more control and transparency for customers and more accurate loss and cost estimates for carriers.

Emerging markets/developed risks

- **International motor:** China will achieve the most rapid growth and will remain the second largest motor market in the world, while Brazil and Norway are also skewing high for both growth and performance.
- **Brazil P&C:** Brazil has realized 5 percent average annual growth over the past several years, led by property (26 percent), liability (22 percent), and crop (20 percent).

Developed markets/emerging risks

- **U.S. cyberinsurance:** Monaghan said to look closely at whether there's a gap between property and cybercoverage, a distinct opportunity. "The majority of small businesses are not covered but at risk," she said, estimating the cyber market size at roughly $1.5 billion.

The reinsurance sector is also sitting on record capital and capacity, with growth opportunities coming with terrorism, crop, mortgage, and casualty. "Industry trends here require reinsurers to innovate and differentiate," Monaghan said, with reinsurers needing to assess new business "beyond traditional reinsured risks."

LOOKING FORWARD

"There is a large amount of capital to deploy," Monaghan concluded, summing up the state of the industry and what's at stake for insurers. "Creativity and an expansive appetite will help the industry grow."

Kathleen Monaghan is a consultant on the Inpoint strategy team based in Chicago. Inpoint is the consulting division of Aon Benfield and works with reinsurance and insurance carriers to develop actionable strategies for growth as well as to increase operational efficiency by reducing claims leakage and improving recoverable payments, etc. Kathleen has worked with several insurers to analyze U.S. and Latin America small commercial, surplus lines, and property & casualty, and life & health reinsurance markets. kathleen.monaghan@aonbenfield.com.

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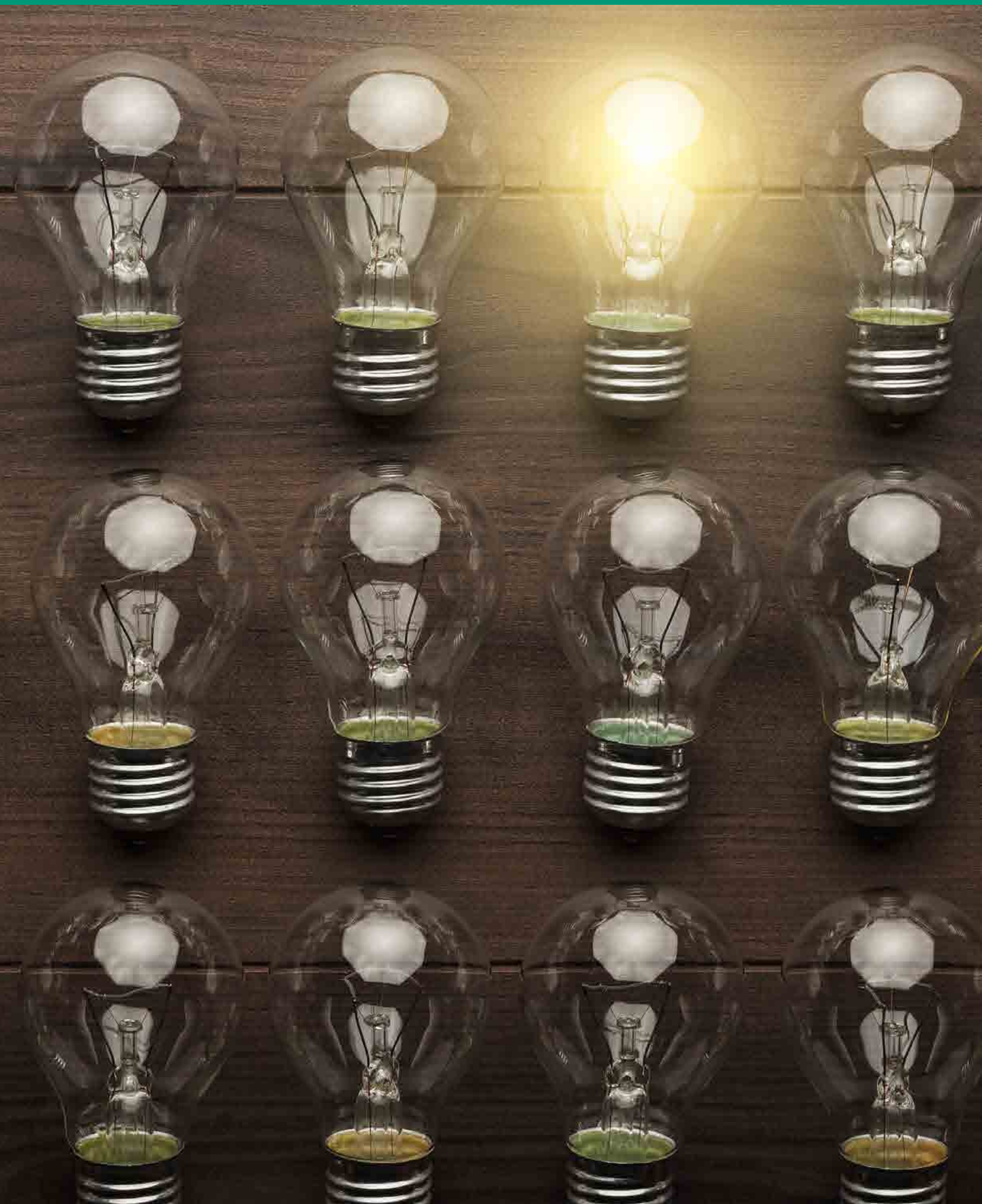

Collateral Reform for Reinsurers

UPDATE ON U.S. COLLATERAL REFORM

In November 2011, the National Association of Insurance Commissioners (NAIC) revised its Credit for Reinsurance Model Law and Regulation, which governed, among other things, the collateral requirements for reinsurers.

"It's been a while since any new major reinsurers appeared in the United States," said Michael McClane, managing director and head of market analysis for Aon Benfield, in explaining the rationale for the significant industry move. "We need regulations to see that insurance claims get paid. About 250 reinsurers hold the vast majority of U.S. property and casualty premiums, but many are offshore."

It's been a while since any new major reinsurers appeared in the United States.

While the end result is relaxed collateral requirements – previously, a 100 percent rule was applied to all non-U.S. reinsurers that were not authorized (e.g., licensed, accredited, or equivalent) in the ceding company's state of domicile – reform measures have impacted reinsurance reporting for U.S. ceding companies as well as the potential credit risk associated with some of the off-shore reinsurers.

McClane and his team continually evaluate the implications of the law and regulation as they review collateralized reinsurance transactions, and it is from that vantage point that he offered a view of the current status of U.S. collateral reform as well as an outlook for where the industry is headed.

UPDATE ON U.S. COLLATERAL REFORM

Originally passed in 1984, the Credit for Reinsurance Model Law provided a balance sheet credit for cessions made to reinsurers that were licensed or accredited (or equivalent), known as authorized reinsurers. It also provided credit for unauthorized reinsurers that provided sufficient collateral (and in the case of many non-U.S. reinsurers, this meant posting 100 percent collateral). For the ceding company, if the unauthorized reinsurer did not post collateral, a penalty offsetting the value of the reinsurance recoverable asset would be assessed.

Common forms of collateral include: cash, letters of credit (LOCs), single beneficiary trusts (a trust established for the sole benefit of a single beneficiary or ceding insurer), and multi-beneficiary trusts (MBT — a trust established for the benefit of multiple beneficiaries or ceding insurers). MBTs require state approval. However, they reduce the administrative burden (compared to some other forms of collateral) on both ceding insurers and reinsurers. Furthermore, they are much more cost efficient for reinsurers. "How much can you save?" McClane asked rhetorically. "One customer put its figure at $3 million a year."

Common forms of collateral:

- Cash
- Letters of credit
- Single beneficiary trusts
- Multi-beneficiary trusts

While a line of credit allows for prompt payment from the bank providing the collateral, McClane said, "you need a court order in order to get money from an MBT. The time and expense is therefore shifted to the ceding insurer, which is a clear disadvantage [from other forms of collateral]." Many believe that the disadvantages are moot, as the reinsurers using MBTs have a strong history of paying claims on a timely basis.

Historically, non-U.S. reinsurers faced costly burdens in meeting the 100 percent collateral requirement and approached U.S. regulators and the NAIC to relax the collateral requirements. The 2011 changes were designed to assist those reinsurers that were financially capable and domiciled in jurisdictions that are considered well-regulated.

In order to post reduced collateral, the key elements of the new rules require reinsurers to:

- Apply to become a certified reinsurer within each state in which they intend to offer reinsurance,
- Maintain capital and surplus of at least $250 million (this is the minimum amount recommended),
- Be licensed and domiciled in a qualified jurisdiction,
- Maintain a secure rating from at least two rating agencies (A.M. Best, Fitch, Moody's, S&P), and
- Submit audited financial statements and reports on assumed and ceded reinsurance balances, keeping insurance commissioners abreast of ratings and licensing changes.

Each state's insurance department will assess the reinsurer's rating in arriving at a reduced collateral amount, classifying the reinsurer by a secure-level rating. For instance, those reinsurers who rate A++ (A.M. Best) and AAA (Fitch/S&P) are deemed "Secure-1" and may have their collateral requirement reduced to zero, while those who rate B++ (A.M. Best) and BBB+ (Fitch/S&P) are classified as "Secure-5" and required to post 75 percent collateral.

A certified reinsurer whose rating is downgraded is granted a three-month grace period for obtaining additional collateral, if required. For catastrophe losses (i.e., hurricanes), certified reinsurers may be eligible for a deferral in posting collateral. The grace period applies to certified reinsurers at all rating levels.

Seven jurisdictions have been approved as "qualified jurisdictions" effective January 1, 2015. Reinsurers domiciled in the following jurisdictions are eligible to become certified reinsurers: Bermuda, France, Germany, Ireland, Japan, Switzerland, and the United Kingdom.

Since the Act was passed in 2011, 23 states have enacted a reduced collateral law while 13 states have approved reinsurers for posting reduced collateral.

Since the Act was passed in 2011,

23 states have enacted a reduced collateral law

13 states have approved reinsurers for posting reduced collateral

COMPLEXITIES IN REINSURANCE REPORTING

The Credit for Reinsurance Model Law and Regulation was well intentioned. Unfortunately the debate and compromise over some of the issues resulted in increased reporting complexity for U.S. ceding insurers. Some of the reporting issues that will complicate the reporting of recoverables from certified reinsurers include rating upgrades, downgrades, and tracking recoverables from catastrophes that may be eligible for a one-year deferral of collateral. Combined with the increased use of MBTs and the lack of adequate information on reinsurers at the state level, accurate reinsurance reporting may be a very labor-intensive exercise.

COLLATERAL MANAGEMENT

Some of the larger ceding insurers are swimming against the tide.

As a result of the reform, "some of the larger ceding insurers are swimming against the tide," McClane said, "trying to maintain existing collateral levels to avoid any potential increase in credit risk.

While the reduced collateral is a regulatory minimum, ceding insurers may choose to negotiate for higher levels of collateral at the time of the reinsurance placement, incorporating amount, type, and deferral into the reinsurance contract.

LOOKING AHEAD

While 23 states have passed legislation, representing over 60 percent of the direct written premium across all lines, reduced collateral has yet to significantly impact the U.S. market. Florida, New York, and Pennsylvania are the only states to have certified more than four reinsurers. As such, the collective industry impact has been modest.

McClane stated that, "most of the reinsurers who have been approved for a reduced level of collateral are highly rated entities and pay their claims on a timely basis. However, some of the larger and more sophisticated ceding insurers are beginning to proactively manage their collateral requirements. As a result, a few reinsurers have elected to let their certifications lapse."

Additionally, reinsurers and ceding insurers are increasingly trying to leverage control, often at the expense of the other. For instance, reinsurers that have realized relaxed collateral requirements have not discounted their rates to ceding insurers. And as ceding insurers look to negotiate a higher level of collateral, some reinsurers are allowing their certification to lapse.

"More states will adopt the collateral reforms." In addition, recent developments such as NAIC led efforts to qualify jurisdictions and analyze and approve reinsurers will facilitate the implementation of these reforms. "Over time, it will be more beneficial and cost effective for reinsurers to provide reduced collateral."

Over time, it will be more beneficial and cost effective for reinsurers to provide reduced collateral.

Michael McClane, CPCU, is managing director, head of market analysis for Aon Benfield Analytics. With more than 25 years of experience in the property/casualty insurance industry, Mike is currently the head of Aon Benfield Market Analytics' Team in the Americas. Mike leads a team of financial and credit analysts responsible for analyzing the financial strength of traditional reinsurers as well as identifying and monitoring trends in the reinsurance industry. More recently, Market Analysis has taken a lead role in the review of collateralized reinsurance transactions and markets. michael.mcclane@aonbenfield.com

Employing Reinsurance in Acquisition Transactions

With their myriad parts and stakeholder interests, acquisition transactions present structuring complexities for both buyers and sellers. To address that concern, companies are turning to reinsurance as a tool that adds flexibility in the structuring of mergers and acquisition transactions.

Whether it's excluding an unwanted class of business from a target company's portfolio or, conversely, including a line of business that is not written on a target company's paper, reinsurance is becoming increasingly prominent.

It is in this context that Sidley Austin Partner Jeremy Watson explained its key concepts and strategic applications.

REINSURANCE BASICS

"Reinsurance involves the cession of insurance from the ceding company to a reinsurer," Watson began, as he laid out the basics of a relationship that "is typically structured on an indemnity basis, whereby the reinsurer indemnifies the ceding company."

There are a number of types of reinsurance, including:

- **Indemnity reinsurance:** The reinsurer indemnifies the seller (ceding company) for its policyholder liabilities, with the seller (ceding company) remaining directly liable to policyholders.
- **Assumption reinsurance:** As contrasted with indemnity reinsurance, policyholder liabilities of the seller (ceding company) are assumed

Reinsurance involves the cession of insurance from the ceding company to a reinsurer.

by the reinsurer, thus extinguishing the ceding company's obligations to its policyholders. This requires policyholder (and, in certain cases, regulatory) consent.

- **Funds withheld transactions:** The ceding company transfers reserves associated with the reinsured business to the reinsurer, with the ceding company retaining on its books the assets supporting the reserves.
- **Modified coinsurance:** The ceding company retains on its books the reserves associated with the reinsured business as well as the assets supporting the reserves.

REINSURANCE IN ACQUISITION TRANSACTIONS

Reinsurance can be used to provide tremendous flexibility in the structuring of stock acquisition by:

- Removing a line or class of business from the target company that the parties want to exclude from the transaction. In this scenario, reinsurance is used to transfer a target company's unwanted business before the stock acquisition is consummated.
- Transferring a line or class of business into a target company that the parties want to include in a transaction. In this scenario, reinsurance is used to transfer the desired business to the target company prior to the stock acquisition.

Reinsurance can also be used as a primary acquisition vehicle when the transaction does not involve a stock sale or merger. "This is similar to an asset sale," Watson explained, "and provides the parties flexibility to specifically define the insurance business that is to be transferred."

CONSIDERATIONS IN THE STRUCTURING OF TRANSACTIONS

To fully leverage the financial value of using reinsurance in an acquisition transaction, "the parties must ensure that the ceding company receives credit on its statutory financial statements for the reinsurance," Watson said.

Even if a collateral mechanism is not required for credit for reinsurance purposes, the ceding company may insist on a collateral mechanism, such as a collateral trust, to protect against the credit risk associated with the reinsurer. While these collateral mechanisms are often undesirable from the buyer's perspective, they can be structured so as to be minimally burdensome.

Other considerations that may be relevant in acquisition transactions include:

- Renewal rights: The ceding company grants to the reinsurer a right to renew any expiring policies comprising the acquired business. These may be structured irrespective of whether a reinsurance arrangement is used.
- Front arrangements: The ceding company can grant the reinsurer the authority to quote, underwrite, and issue policies on the ceding company's paper if the buyer lacks the authority to write the type of business being acquired or the seller cannot directly write the type of business that comprises the excluded business. In such an arrangement, the ceding company retains full liability to the policyholders if the reinsurer becomes insolvent.
- Inuring reinsurance: Whenever reinsurance is used in an acquisition transaction, due diligence is critical, Watson said. "For instance, retention provisions may require third-party consents."
- Extra-contractual obligations (ECO): "These are fairly heavily negotiated in reinsurance contracts," Watson said, "with the reinsurer often being asked to accept responsibility for the ECO risk."

REGULATORY CONSIDERATIONS

When using reinsurance in an acquisition transaction, there are a number of regulatory considerations that dictate structure and procedure:

Risk Transfer

"Risk transfer is a key [consideration]," Watson said, introducing SSAP 62R requirements (which apply in connection with property and casualty reinsurance transactions). In order to receive reinsurance

accounting treatment, a reinsurance agreement must transfer risk from the ceding company to the reinsurer. To satisfy the risk transfer requirements, agreements must, among other things, include an insolvency clause, require at least quarterly reporting, and transfer insurance risk (underwriting and timing).

Credit for Reinsurance

Receiving proper accounting treatment is an integral consideration of a reinsurance transaction. Reinsurance credit is governed by the ceding company's state of domicile. Each state has its own "credit for reinsurance" statute, which is often modeled after the NAIC Model Credit for Reinsurance Act. Typically, reinsurance credit is provided as a result of the reinsurer being licensed or accredited in the state of domicile of the ceding company or the reinsurer posting collateral to the ceding company. Some states now allow certified reinsurers to post less than 100 percent collateral.

Withdrawal Requirements

Regulations also govern a ceding company's withdrawal from a line of business. While these vary by state, many require the insurance regulator to receive prior notice of the withdrawal. A few states require the posting of collateral in a trust for a withdrawal from the state in its entirety, while others require prior approval

of the insurance regulator and may require the withdrawal to take effect over time.

LOOKING AHEAD

Reinsurance transactions are gaining an increasing foothold in the structuring of acquisition transactions, "especially as private equity firms become more involved," Watson concluded. "They're constantly looking at ways of becoming more creative. And as they continue to look to these new structures, traditional buyers – insurance companies – are following."

Jeremy Watson is a partner with Sidley Austin LLP. His practice is focused on a variety of corporate, securities, and regulatory matters relating to the insurance and financial services industry, including the representation of both acquirers and sellers in connection with mergers, acquisitions, and private equity transactions; underwriters and issuers in connection with public and private securities offerings, including initial public offerings and other equity offerings; and insurance companies and investment banks in connection with the structuring and regulation of investment vehicles. jwatson@sidley.com.

Reinsurance transactions are gaining an increasing foothold in the structuring of acquisition transactions.

Are Captive Insurance Companies Part of Your Strategy?

Companies are turning to captive insurance in greater numbers in an effort to better manage risk and take advantage of tax benefits.

WHAT IS A CAPTIVE AND WHAT DOES IT DO?

As a means of managing their insurance risks and even retaining underwriting profits, large companies have been using captive insurance for nearly 50 years. Created in the 1950s by Ohio insurance broker Frederic Reiss, the concept is simple: a parent company forms an insurance company subsidiary — the "captive" — that insures the parent.

The industry received tepid support until the 1980s, when it began to gain momentum. While there were roughly 1,000 captives in 1980, the number has swelled to more than 6,000 worldwide today.

"Captive insurance companies have taken on a sexy appeal over the past few years," explained Michael Mead, president of M.R. Mead & Company, Inc., a captive consulting and management company. As such, companies are increasingly looking at forming a captive. But while the industry is certainly trending, there are significant consequences — tax and actuarial, for instance — that

While there were roughly 1,000 captives in 1980, the number has swelled to more than 6,000 worldwide today.

must be considered before moving forward. Indeed, "A captive is not for everybody and won't solve everybody's problems," Mead said. It is in this context that Mead, along with actuarial consultant Kyrle Mrotek, of The Actuarial Advantage, and Doug Youngren, a Plante Moran insurance tax partner, addressed key captive insurance trends and considerations.

Background

A captive was originally created for tax purposes – reserves converted to premiums were tax deductible — to allow companies to better control their claims and reserves. "It's about control, control, control," said Mead.

A captive was originally created for tax purposes to allow companies to better control their claims and reserves.

While captives can write any type of policy, about 70 percent focus on workers' compensation ("they want their own claims people," Mead explained), along with general liability, auto liability, crop, property, and loss of income. Emerging captive coverage includes cyberliability, which is becoming increasingly popular because of the proliferation of cyberliability lawsuits. "Actuaries can't give you a rate, there is no standard cyberliability wording, and all have exclusions," Mead said.

There are several types of captives, though not every domicile licenses each type:

- Single parent or "pure": The most popular type; these are when the captive writes the risks only of its parent or its affiliates.
- Group/association: Established by a group or association to write the risks only of its owners or affiliates.
- Cell: A captive that is owned by a non-parent company and available for others to use for a fee. "These are very popular today," Mead said, as they reduce the costs associated with a company forming its own captive.
- Risk retention group: A group or association captive whose purpose is to assume and spread the risk for commercial liability exposure.

Today, more than 50 percent of the commercial property/casualty market is in some form of self-insurance, and captives have gained popularity with estate planners and wealth management advisers, too.

Costs are a significant barrier to entry in the captive market. A company must have at least $250,000 in capital, and startup costs range from $50,000, with at least $75,000 in ongoing fees (actuary, manager, accountant, taxes).

CAPTIVE INSURANCE TAX PLANNING

Background

Over the years, the IRS has struggled to clarify tax consequences for parent companies and their captives, considering distinctions between risk shifting (the insurer assumes risk that was formerly with the insured) and risk distribution (the insurer pools a number of independent risks). In many instances, it has ruled that premiums paid to captives are a form of self-insurance and thus not deductible (unless the captive also wrote coverage to non-parent companies) under Section 162.

The IRS has struggled to clarify tax consequences for parent companies and their captives, considering distinctions between risk shifting and risk distribution.

Its ruling was based on its determination that there was real risk shifting, as the same "economic family" was responsible for any loss. However, in a later ruling, it concluded that a captive owned by multiple unrelated shareholders could legitimately achieve risk shifting and distribution, as the captive retained a level of unrelated risk. Generally, to meet a risk-shifting requirement, the parent must demonstrate that it has transferred specific risks to the captive by paying a reasonable premium.

Smaller captives enjoy significant tax benefits under IRC 831(b): Those whose gross premiums fall under $1.2 million do not have to pay tax on premium income, paying taxes only on investment income. However, losses cannot be deducted.

Family attribution rules

As an estate planning vehicle, captive insurance is also gaining acceptance, as it helps shield family members from incurring substantial tax liabilities. For instance, if the shareholders of a captive are family members of the owner(s) of the parent, they are entitled to the income of the captive without having to pay gift or estate tax, as it is considered an intra-familial transfer of wealth.

Protected cell companies

Several states have established the creation of a protected cell company (PCC), which allows companies to take advantage of the benefits of a captive without creating their own. A protected cell company includes a "master cell" that holds the capital for the entire entity, and individual "cell companies" whose assets and liabilities are shielded from the remainder of the PCC.

The IRS allows for individual cells to be treated as separate captive insurance companies as long as it would be considered as such within the jurisdiction where it operates. Such an arrangement essentially allows the cell to operate a captive insurance company at a lower cost and with a smaller level of risk.

ACTUARIAL PERSPECTIVE

With so many potential risk and tax-savings benefits, forming a captive would seem a logical pursuit, but Mrotek advises a more deliberate approach. "Actuaries are critical to the healthy function of insurance and captive insurance," he said, adding rhetorically, "But the question remains, is a captive right for your company?"

Actuaries are critical to the healthy function of insurance and captive insurance.

Mrotek views the feasibility of captives from an actuarial lens, performing financial and operational evaluations as well as a thorough actuarial analysis.

The key elements he considers include:

- Risk management objectives
- Proposed coverages and policy provisions
- Historical losses (minimum five policy periods)
- Historical and prospective exposures (minimum five years)

A FINAL ANALYSIS

After preparing a number of reports including loss and loss expense payout reports, pro forma financials, and a capitalization analysis, business owners/managers make a determination. And lately as to whether a captive makes sense for a company, business owners' conclusions are leaning more often toward "yes."

Citing recent comments from a risk management consultant, Mrotek stated, "There are roughly 600,000 business in the U.S. that can justify the cost of a captive. At least one-sixth of those have a business reason to pursue this, which is 100,000 companies.

"That means you're going to keep hearing about captives. They're here to stay. They're poised to continue growing. And they can be done with insurance companies."

You're going to keep hearing about captives. They're here to stay and they're poised to continue growing.

Michael Mead, CPCU, M.R. Mead & Co., Inc., is a veteran of the insurance industry having served as an underwriter, broker, manager, and consultant. He is currently the editor of Captive Insurance Company Reports and the president of M.R. Mead & Company, Inc., a captive consulting and management company. Previously he served as president of Lionheart Insurance Group, Advantage Life and Annuity Company, National Insurance Partners, Inc., and Crusader International Management, all captive insurance related firms. In 2011 he received the CICA Distinguished Person Award for his years of service to the captive industry. In his career he has formed and managed numerous captives and risk retention groups covering manufacturing, professional liability, nursing homes, public housing, convenience stores, auto warranties, home warranties, construction firms, and trucking companies. mmead@mrmeadandco.com

Kyle Mrotek, with The Actuarial Advantage, Inc., is an actuarial consultant specializing in property/casualty insurance. For 15 years he has provided actuarial services to insurance companies and self-insured entities including captive insurance companies, lenders, and government agencies. He is a fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries. kmrotek@taa-inc.com

Doug Youngren, CPA, Plante Moran, is an insurance tax partner who oversees all aspects of the firm's insurance company tax services area. He has more than 30 years of combined legal and accounting experience, the last 24 of which have been spent specializing in insurance company and agency taxation. He's known for his proactive ideas and extensive legal background, which is invaluable when clients need assistance with issues related to offshore captive insurance companies, what constitutes sufficient risk to be called "insurance," tax-free mergers and acquisitions, and relevant tax statues and laws. doug.youngren@plantemoran.com.

Cybersecurity Demystified

"It's not who you are but what you're not doing that makes you a victim to cybercrime," said Joe Oleksak, leader with Plante Moran's information technology consulting team, in laying out the importance of developing a proactive cybersecurity plan.

As a recognized national expert dealing with highly technical subject matter – among other responsibilities, Oleksak is a Qualified Security Assessor (QSA) for companies seeking PCI compliance – he has the unique ability to make such material highly accessible to those less tech-savvy, all the while underscoring the operational imperative of protecting customer data.

Make no mistake, despite our best intentions, our data is at risk. Everything from our personal information seemingly locked behind a smartphone's four-digit passcode (which is not nearly as secure as we are led to believe, requiring a simple voice command to bypass the lock screen) to a company's massive database of customer information (the headlines continue to reveal breaches of escalating magnitude), we are continually playing catch up to a growing number of predatory hackers who seek to capitalize on our lack of security vigilance.

It's not who you are but what you're not doing that makes you a victim to cybercrime.

While such vulnerabilities appear daunting to address, Oleksak maintains otherwise, citing the latest research:

- The majority of data breaches – 78 percent – are not the result of highly sophisticated attacks but those ranking low (68 percent) or very low (10 percent) on the complexity scale. According to a recent report by Verizon, 97 percent of recent breaches were avoidable.
- Most attacks occur indirectly, through social media. "Hackers know this, and have developed social scams by the thousands, hoping but one will fall victim," he said. Indeed, since 2010, the number of annual phishing attacks have escalated exponentially, jumping from 187,000 in 2010 to 445,000 just two years later.

No industry is immune from cybercrime, including insurance firms.

Meanwhile, the increase in data breaches has brought with it a commensurate rise in the percentage of breaches that have gone undetected for one month or longer. As a result, the corporate focus must extend beyond initial network design into monitoring, as today's data breach will not present itself as an alarms-blaring intrusion. "Detection and response represent an extremely critical line of defense," Oleksak said. "What you don't know can hurt you."

No industry is immune from cybercrime, including insurance firms, which have been victim to several recent, sizable data breaches:

- A Texas life insurance firm suffered a data breach that compromised the medical records of its members, which were selling in bulk on the black market for under $7 apiece.
- Nationwide Insurance incurred a breach that affected more than one million of its customers across the country.
- Triple-S Management mistakenly exposed personal data of more than 13,000 of its Dual Eligible Medicare beneficiaries, incurring a fine of $6.8 million by the Puerto Rico Health Insurance Administration.

The Triple-S Management breach should be particularly worrisome, for it attached a cost component to data breaches. "You must be thinking about this for your organization," Oleksak said, before ticking off the steps organizations should take to protect their networks.

A FRAMEWORK FOR SUCCESS

"First, this is not an IT problem but an organizationwide problem," he said. "To be successful in data security, you must have representation from key business units."

To begin, there must be a distinct information security budget, along with a security officer who reports to the CFO or CIO independently of the IT department. "Remember, security is an organizational issue, not just an IT issue" Oleksak said. "IT historically has played a major role in security, but until the business embraces all aspects of security, avoidable breaches will continue to plague organizations."

Security is an organizational issue, not just an IT issue.

Once that initial framework is established, companies must undertake a complete risk assessment, understanding where their data resides and what controls are in place to protect them. "Once you understand the types of data you have, where it's stored, and its impact, you can then evaluate the threats."

Securing the network comes next, which is accomplished across multiple layers — perimeter security, wireless security, remote access — and with a number of tools, including firewalls, encryption, and anti-virus software. Network monitoring and testing are critical here, to ensure existing controls are effective.

While securing the physical elements of one's network is essential, so too is securing those who access your network. Target Corp. suffered one of the most extensive data breaches in U.S. history, with hackers stealing tens of millions of customer records. They did so not by penetrating Target's network directly, but through an access point for one of its vendors. As a result, it's essential to carefully screen and secure those who use your network, which may include employees, consultants, vendors, customers, and temporary visitors. Additionally, you must understand how access is granted and removed for each user, along with the type of access you are granting, and implement a real-time monitoring program that is capable of uncovering unauthorized access or use of information systems.

It's essential to carefully screen and secure those who use your network.

SPACES COUNT

Oleksak said there is nearly universal confusion about what it means to create a secure password, which isn't a reflection of obscure symbols and alternating letter cases. Because software today can generate several billion attempts per second to guess a password, even the most random sequence of letters and symbols can be hacked relatively quickly, as long as it is an uninterrupted string of characters. "On the other hand, it would take much longer to guess a password that's a phrase, such as 'I love my dog Fido!,' and likely the phrase would be rotated before a hacker would be able to crack it." he said.

Of course, the most well-intended security measures must contain an equal measure of common sense. While we are familiar with those emails that solicit our bank account information "for verification purposes" or a money transfer to a stranded relative overseas, those campaigns are evolving into more sophisticated schemes that seek to defraud, requiring both vigilance and prudence.

Of course, the most well-intended security measures must contain an equal measure of common sense.

As a result, in order for our sensitive data to remain protected, a collective shift in attitudes must take place, one where we educate ourselves as well as those who use our networks, to ensure that our data is as safe as it can be.

Successfully combating cybercrime will take a multi-layered, enterprisewide approach, Oleksak concluded, one that is ongoing, deliberate and strategic. "It takes people, processes, and technology," he said. "That's how you're going to do it."

Joe Oleksak, CISSP, CRISC, QSA, is a partner with Plante Moran. Joe has more than 16 years of information systems security and information technology audit experience in the service industry, health care, government, and financial institutions including banks, credit unions, mortgage companies, family offices, and insurance companies. Joe's experience includes: IT strategic planning, IT risk assessments, IT audit, global/local network security projects, web application security, PCI compliance, SSAE16 & SOC reviews, incident response, and business continuity and disaster recovery management. joe.oleksak@plantemoran.com

A.M. Best Trends in Life Insurers' Portfolios

"The state of the industry for life and health insurance companies is strong," says Ken Frino, group vice president, life health department for A.M. Best. "Strong earning results. And strong capital levels."

With nearly two decades of experience as a financial analyst and ratings expert, Frino should know. It's a bottom-line assessment, such as upgrade, downgrade, or affirmation, which consumers look for when choosing a life insurance company. While for some, an A.M. Best letter grade (-B to AAA) offers sufficient purchasing guidance, there is much that goes into an A.M. Best rating, including an exhaustive annual review of a company's investment portfolio that, when viewed collectively with industry competitors, offers valuable financial insights into industry-specific and macroeconomic trends.

"The state of the industry for life and health insurance companies is strong."

With that, Frino offered a candid analysis of recent A.M. Best data and research, revealing the ratings process, the financial strength of life and health insurance companies today, and notable trends in its investment portfolios.

THE RATINGS PROCESS

A ratings decision is comprised of three pillars: balance sheet strength, operating performance, and business profile. Included in

that analysis is a consideration of risk (ERM), along with country risk for multi-nationals.

For the first half of 2014, upgrades rose from 5.5 to 9.9 percent, the majority of which were attributed to increased parent consideration, while downgrades were trimmed nearly in half (1.7 to 0.9 percent), the result of reduced parent consideration or earnings. "Normally, ratings don't change too often," Frino said. "And we try to signal that in advance through our outlooks."

INVESTMENT OBJECTIVES

In order to effectively evaluate the holdings of life and health insurance companies, it's important to understand their numerous investment objectives, many of which vary by product. For life insurers, those objectives include:

New money yields are falling "well short of returns offered by maturing assets"

- Long-term liability duration profile
- Minimal exposure to inflation
- Risk-based capital constraints
- Liquidity (critical for paying claims)
- Longer investment horizons (for long-term care)
- Spread management (various products)

A DEEP DIVE INTO THE NUMBERS

For nearly nine years, life insurers have been facing a battle of falling portfolio yield. While net investment income has been supported by a growing asset base (from roughly $152 billion in 2004 to $172 billion in 2013), new money yields are falling "well short of returns offered by maturing assets." As a result of these declines, many insurers have altered their product offerings, eliminating interest-sensitive liabilities. Companies rated BBB+ have realized the largest falloff in yield, from roughly 5.1 percent in 2009 to 4.0 percent in 2013.

Compared to pre-crisis levels in 2006, asset allocations of life and health insurers have remained relatively unchanged – "maybe more so on the margin," Frino said — though shifts are more pronounced when looking at just the past three years, which has resulted in the following:

- Bonds have remained constant (74.8 percent in 2013), though "within that class there has been some shifting around from mortgage-related structured debt, foreign debt, and below invest-

ment grade (BIG) holdings to pure investment grade (IG) corporates and other asset-backed securities. "We see a general trading of liquidity for yield," Frino said, as companies have reduced their BIG exposure (6.9 percent in 2010 to 5.8 percent in 2013) while assuming it elsewhere.

- Commercial mortgage loans (10.1 percent) have risen slightly.
- Schedule BA assets have risen substantially, from 2.6 percent (2006) to 4.1 percent (2013).

Significantly, "We've passed the $2 trillion threshold in [investment grade] corporates," Frino noted, "while there has been a run-off in commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) … this is more supply-driven than risk management at work."

Municipal bonds allocations have remained relatively stable

Municipal bonds allocations have remained relatively stable, though Frino said A.M. Best reviews individual holdings when issues arise in specific municipalities or regions, such as Detroit (bankruptcy). Municipal bond investments primarily consist of Build America Bonds and Qualified School Construction Bonds.

A.M. Best looks carefully at combined mortgage exposure, combining direct loans with structured paper. As a percentage of total capital, combined mortgage exposure since 2009 for CMBS and RMBS has been "relatively stable," Frino said, with a slight overall drop. "When it comes to mortgage loans, we're interested in loan to value, the size of the mortgage, and expertise … We don't like companies to be overly exposed here."

In 2009, "We had companies with more than 100 percent mortgage loan exposure," Frino said, "though those companies have scaled back, with problem loans leveling off, too … Most companies have demonstrated good diversification characteristics [here]."

The volume of non-mortgage related asset-backed activity has increased appreciably since 2009

The volume of non-mortgage related asset-backed activity has increased appreciably since 2009, from roughly $150 billion to $205 billion (2013). "Most companies like this asset class … it generally is well-diversified" and includes collateralized loan obligations (CLOs), transportation, credit card, student loans, and commercial receivables, among other investments.

BA asset exposure "has been ramping up," Frino said, standing at just below 40 percent. "The concern here is that as rates start to rise,

this is an asset class that can bring a lot of pain to companies." The increase in allocation is enhancing yields and producing results that are boosting returns — as well as risk. "Make sure controls are in place with management here," he instructed.

Higher-rated companies are buying more BAs, Frino said, "which manages spread as for what they're guaranteeing … As part of the rating process, we try to make a determination that the company has the capital and demonstrated expertise to manage these assets, whether management is internal or through outside asset managers." Comparatively, lower rated companies tend to "invest in everything, and that's why they're on the low end of the rating."

Lower rated companies tend to "invest in everything, and that's why they're on the low end of the rating.

The industry trend is toward shifting assets on the margin (high-risk assets), with some companies having up to 90 percent exposure. "Although improved capital levels have helped high risk assets as a percentage of capital to trend slowly down, on an absolute level, the exposure continues to increase and bears watching," Frino said.

A.M. Best's highly detailed Quantitative Analysis Reports (QAR) include an exhaustive set of metrics that yield considerable financial strength insights. "We do this by company and compare it to the industry to see where the company stacks up, it shows the net industry yield, too."

Benchmarking is a relatively new report that A.M. Best rolled out last year, which looks at 30 different metrics in calculating five-year company trends. The report can also be tailored to competitors, which offers a helpful benchmark comparison.

"We have a stable outlook on life and health," Frino concluded, with the biggest concern targeting a spike in interest. But overall, "We don't see much ratings movement in the next 12 months.

"Your concerns are still on the investment side."

Ken Frino, is group vice president, life health department, A.M. Best Company. Ken has been with A.M. Best since December 1996 and assumed his current role in 2008, where he oversees A.M. Best's North America life, annuity and health ratings. Founded in 1899, A.M. Best Company is the oldest and most widely recognized rating agency dedicated to the insurance industry. A.M. Best is also a well-known and highly regarded source of information and commentary on global insurance trends and issues through a host of other products and services. kenneth.frino@ambest.com

Meet our team

Please reach out to one of the leaders on our insurance team to discuss how to develop new ideas, how to implement them, and how to introduce them to your stakeholders.

MARGARETE CHALKER
margarete.chalker@plantemoran.com

MICHELLE GOSS
michelle.goss@plantemoran.com

JERRY HUFTON
jerry.hufton@plantemoran.com

KEVIN KRAUSE
kevin.krause@plantemoran.com

TERRY OLEJNIK
terry.olejnik@plantemoran.com

TERRI POLLOCK
teresa.pollock@plantemoran.com

JOAN WAGGONER
joan.waggoner@plantemoran.com

DOUG YOUNGREN
doug.youngren@plantemoran.com

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