

## COLLATERAL OPTIONS

*Regulation 114 Trusts offer a cost-effective alternative to LOCs*

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The growth of the alternative risk transfer (ART) market has been one of the major trends in risk management over the past 15 to 20 years. This growth has occurred in the property/casualty insurance sector as well as employee benefit sector. In particular, the continued development of the captive insurance company movement has benefited from greater acceptance by middle market accounts. Today, it's the middle market corporations that are largely responsible for this sustained growth as many of these firms are beginning to see the strategic value of forming a captive insurance company.

### Not always easy

Despite the growing interest in captives, most organizations have come to realize that several potential roadblocks can sidetrack formation plans. One of the bigger potential potholes historically has been the availability of an acceptable fronting carrier and/or reinsurer. However, the current softening insurance market has lessened this issue to a large extent.

Another potential problem area has been the collateral requirements that are usually imposed by the fronting carrier/reinsurer. The collateral requirement is a critical issue for most captive formations, not only for the captive owner, but also for the fronter/reinsurer. This is also a major concern for insurance regulators and, to a lesser extent, the various rating agencies, since it directly affects the ongoing financial viability of the captive.

For years, the standard approach to resolving the collateral requirement issue has been the Letter of Credit (LOC). LOCs have a long history of use within the insurance industry, so it was only natural that their utilization be expanded into the captive area. However, at various times in the recent past, the availability of the LOC has been an issue for some captives. Additionally, the annual renewal process for LOCs and the potential problems presented by the "evergreen features" have caused some concern for both the captive and the fronter/reinsurer. Costs have also been a concern, and have frequently left captive owners searching for a better approach to the collateral requirement issue.

### An alternative approach

However, LOCs are not the only alternative to fulfill the captive's



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—Robert G. Quinn  
Vice President/Collateral Trust Division  
Wells Fargo Bank

collateral requirements. Over the past few years, one option that has gained a significant following is the Reg. 114 Insurance Trust. The details of these Trusts are spelled out in Regulation 114 of the Official Compilation of Codes, Rules and Regulations (11NYCRR4) of the New York State Insurance Department (Reg. 114). It provides an overview of the relationship of the three parties to the Trust transaction. The three parties to the 114 Trust are the Beneficiary (fronter/reinsurer), the Grantor (the captive) and the Trustee (usually a bank).

The New York Insurance Department has always been a strong advocate for improved financial security. For example, it was one of the first state insurance departments to take note when many captives began going off shore to Bermuda. One of the issues that concerned the department was the financial security of the captive, but it realized it had no jurisdiction in Bermuda, so it would have little control over the captive's financial affairs. The department did, however, have jurisdiction over the fronters/reinsurers that were headquartered in the United States. As a result, the department passed regulations that stated that in order for the fronter/reinsurer to take Schedule F credits on its financials, the front or reinsurer must obtain acceptable collateral from the captive they were insuring/reinsuring.

From an operational standpoint, the 114 Trust is structured to assume eligible assets of the captive by placing them in the Trust. The Trust is held by the Trustee (i.e., the bank) and established to guarantee payment of its obligation to the fronting carrier/reinsurer. According to Robert G. Quinn, vice president of the Collateral Trust Division of Wells Fargo Bank, "The assets that go into the Trust must be U.S. debt-based financial assets rated 'A' or better." Quinn's Collateral Trust Division has been at the forefront of the 114 Trust utilization for the past six years. During that time, the division has established more than 600 trusts, which amounted to over \$60 billion. He points out that there are several key advantages to the use of 114 Trusts.

### **Numerous financial advantages**

Quinn notes that one of the most important advantages of 114 Trusts is cost. He says, "LOCs are expensive." Frequently, he points out, the cost of the LOC will be in the 25 to 60 basis point range. "This can be a significant cost to any captive," he says. Today, most LOCs require the captive to use cash to collateralize the LOC. This translates into some significant costs each year for the captive. The trust, on the other hand, frequently charges only a fixed fee (in the \$2,000 to \$5,000 range) and possibly a smaller variable fee in the five basis point range. This can provide a meaningful cost reduction for the captive. This cost savings can be in the 80% to 90% range.

Another major financial advantage of the 114 Trust has to do with credit availability issues. According to Quinn, when a corporation secures an LOC, it often has to dip into its available credit. As a result, the LOC actually increases the amount of borrowing against the corporation's lines of credit. He says: "This takes away from a corporation's ability to borrow, since their credit is usually encumbered by the amount of the LOC." The Trust does not have the same effect on a company's lines of credit, he says. Further, he says the 114 Trust also has a more favorable effect

on the corporate balance sheet. Quinn points out that the Trust will typically be categorized as a restricted asset, while the LOC will be shown as a contingent liability on the balance sheet or in the footnotes to the financials.

An additional major financial consequence of the collateral requirements associated with the LOC is called “stacking.” Stacking occurs when the captive has to increase the amount of the LOC annually due to the addition of the previous year’s unpaid claims. As a result, captives frequently have to obtain another LOC each subsequent year to support the unpaid claims amount. Not so for the 114 Trust, says Quinn.

“The effect of the Trust is considerably different. You establish the Trust in Year One, but the Trust document does not contemplate the dollar value of the collateral requirements. It’s the underlying insurance agreement that deals with the value of the collateral,” Quinn points out. So, he says, “If the amount of the collateral changes, you simply wire the additional money into the Trust.” And since the Trust agreement is silent on the dollar amount, the captive does not even have to amend the agreement.

### **Conclusion**

While Regulation 114 Insurance Trusts have been used within the insurance/reinsurance community for a number of years, their use within the captive arena is more recent. Quinn says that the 114 Trust is one of the three acceptable forms of collateral—the other two forms being LOCs and funds withheld. As a result, the Trust has become more viable with fronting carriers. Wells Fargo has spent considerable time and intellectual capital to develop standardized trust documents with most fronting carriers. As a result, while in prior years, the Trust would require a little more time to implement, now the time commitment for LOCs and the Trust are similar.

While LOCs have been the primary method of meeting a captive’s collateral requirements, Reg. 114 Trusts have been receiving a lot of attention of late. And there is just cause for this interest today, according to Wells Fargo’s Quinn. Many regulators are concerned about the quality of the captive’s investments. As a result, most state insurance departments and the NAIC have set certain requirements to assure that assets will be available, if needed. Quinn says they must “be safe, liquid, and predictable in value,” and he notes that the 114 Trust fits the bill perfectly.

Additionally, the 114 Trusts are gaining favor with the fronters/reinsurers and can certainly provide a cost-effective alternative to the LOC. Quinn says a comparison of total cost shows that the Trust can frequently provide an 80% to 90% cost savings over the LOC. The cost savings and the lack of reduction on the captive’s line of credit have led to the increased use of the 114 Trust for collateral requirements. Accordingly, he says, this trend will continue as captive owners and captive managers begin to realize the many benefits associated with the 114 Trust. \*

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