

Making the right choice for your captive

Michael A.L. Taylor and Matt Barlow of Citi explain the key factors captives must examine when making the choice between LoCs and trusts

Industry discussions on the most appropriate form of insurance collateral ebb and flow as we move through the cycle, however in reality both LoCs and trusts are important instruments for securing a captive's obligations under a reinsurance agreement. While LoCs have long-standing and numerous merits, trusts offer significant attractions too.

For years, since their introduction in the US in the 1960s as a substitute for escrow facilities, LoCs have been the most popular solution used by captive insurers. Since then, captive insurance has undergone a revolution: there are now thousands of captives writing business worldwide using fronting companies. Although each jurisdiction has unique requirements, the principal that captives are thinly capitalised (and therefore require security for both regulatory and credit reasons) is universal and LoCs have consequently remained the dominant product.

According to Marsh's 2010 Global Captive Benchmarking Report, which

analysed 750 single parent captives in its client group, LoCs represent 59% of all collateral instruments used compared to 19% for insurance trusts, 19% for escrow facilities and 3% for parental guarantees. Citi's own experience shows that in the US, up to 80% of collateralisation uses LoCs and around 20% insurance trusts; the figures are more skewed in favour of LoCs in Europe, where the trust market is more recently established.

How LoCs and trusts differ

While LoCs are the most significant instrument used by captive insurers for collateralisation, trusts are of growing importance. Trusts perform the same role in securing a captive insurer's reinsurance obligations but work in a somewhat different way. Instead of an applicant for a LoC, the captive is called the grantor of the trust. The fronting company is the beneficiary in both products, and a bank sits in the middle. However, there are further differences between the products that need to be considered.

One of the most important differences between a LoC and a trust is the role of the bank. Under a LoC, the bank issues LoCs in favour of the beneficiary and acts as a guarantor. With a trust, the bank is a trustee rather than a guarantor. The grantor puts assets in the trust, which can fall in value, and the trustee has no responsibility to act. Instead, the beneficiary has a duty of care to monitor what is held in the trust in order to ensure it remains sufficient to meet any obligations.

One of the reasons for the growth in the use of trusts by captive insurers is that LoCs are a credit product and therefore carry regulatory capital costs – a 100% capital charge – for banks. This has prompted some banks to encourage the use of trusts, which do not carry a capital charge; a trend accelerated by the credit crisis when LoC costs rose dramatically and some banks withdrew from the market.

Closer examination of costs

From the perspective of captive insurance companies, trusts have a clear attraction: they often appear cheaper than LoCs. However, costs are not as simple as they seem at first glance.

Marsh's report shows that 55% of trusts have an associated explicit cost of between zero and 50 basis points of the facility value compared to 68% for LoCs. Trusts are often provided on a flat-fee basis: the larger the value of the trust, the more cost efficient the deal becomes. With LoCs, the basis point fee is

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constant; higher value LoCs carry more expensive charges. For this reason, to allow a simple comparison, Citi routinely offer trusts for an all-in equivalent cost of two or three basis points.

However, some trusts can cost 350 bps although this may be because of the low value of funds in the trust (where in fact a fixed fee would have been more appropriate). In addition, the assets that go into Reg. 114 trusts – the de facto standard in the US market – are restricted: cash and equivalents, US Treasury securities, and US fixed income securities rated single-A or higher; in some states only Treasuries are permitted.

It is indeed pertinent to add at this point that the collateral composition of Reg. 114 trusts is regulatory driven and consequently restrictive; however, that of LoCs is driven by the credit policy of each bank. For example, Citi in particular offers tremendous collateral flexibility including accepting Money Market Funds and other instruments. In such instances, LoCs are often cheaper than Reg. 114 Trusts because the enhanced yield available from a wider range of collateral may dwarf the additional cost of a LoC: a 50 basis point yield enhancement will not only cover the potential 35 basis point cost of a LoC but also generate 15 basis points of additional yield.

On the other hand, outside the US, insurance trusts do not have restrictive regulations regarding assets, although many often follow the Reg. 114 model and remain conservative. Nevertheless, and similar to a LoC, provided the beneficiary agrees, almost any assets can be placed into a trust, the lower cost of which could potentially offer a significant yield enhancement. Moreover, an investment fund, managed by a reputable fund manager, can be tailored for the trust to meet specific risk/return criteria.

Ease of establishment and flexibility

Another key issue is how easy it is to work with each product. LoC facilities are straightforward to establish, and can be set up in advance and LoCs then is-

sued when needed. Some banks, such as Citi, offer electronic facilities that make LoC issuance as simple as making a wire transfer.

In contrast, a Reg. 114 trust requires new documentation for every trust with new beneficiaries, and although standardised documents are used, this can take a little longer than LoCs. However, in Europe the documentary requirements for setting up an insurance trust are relatively straightforward and can be easily replicated. In addition, European trusts are simply established as a normal account that holds securities with a pledge or charge over them in favour of the beneficiary.

Once established, there are differences between LoCs and trusts' flexibility. For example, it is easier to adjust the market value of a LoC than a trust as the liabilities change: an LoC's value can be adjusted at a day's notice while a Reg. 114 trusts' net funding level is adjusted quarterly. Both LoCs and trusts are relatively flexible solutions because it is possible to reduce collateral requirements as loss payments are made.

Making an informed choice

Captive insurers need to consider the requirements of their fronting companies when deciding between a LoC or insurance trust. Some fronting companies may prefer bank obligations because they are familiar with them and do not want to have to monitor trust assets.

Equally, a fronting company may favour the simplicity of LoCs compared to trusts: should they need to make a claim they can simply draw the LoC.

In contrast, the claims process relating to a trust can be more involved, requiring multiple signatories before the release of securities. Furthermore, LoCs are seen by some as safer: not only does a bank act as guarantor but the collateral buffer is more generous than for trusts. Conversely, in the event of a bank liquidation, a trust would survive the insolvency process whereas a LoC would not.

Captives also need to take into account their own credit strength when selecting a product. Smaller companies may have limited access to credit and therefore may not be able to obtain cost-effective LoCs. Other captives may be eager to free up existing credit for other business requirements by moving from LoCs to trusts. However, Citi's LoC programme offers meaningful facilities for companies across the credit spectrum. In addition, these facilities are offered without compromising overall credit lines availed from the banking system.

The final word

Ultimately, captives need to ascertain what is driving their choice of LoC or insurance trust. The factors affecting their decision are necessarily unique: captives should not be swayed by bullish articles or conference speeches. Selecting either a LoC or a trust is a complex process and detailed consideration of the advantages and disadvantages of each option is essential if the most cost and risk-effective mechanism of supporting reinsurance obligations is to be chosen.

Citi is willing to engage with clients on their captive's specific needs and routinely works with clients individually to provide the most appropriate products, whether LoCs, insurance trusts or a combination of the two. ☺

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