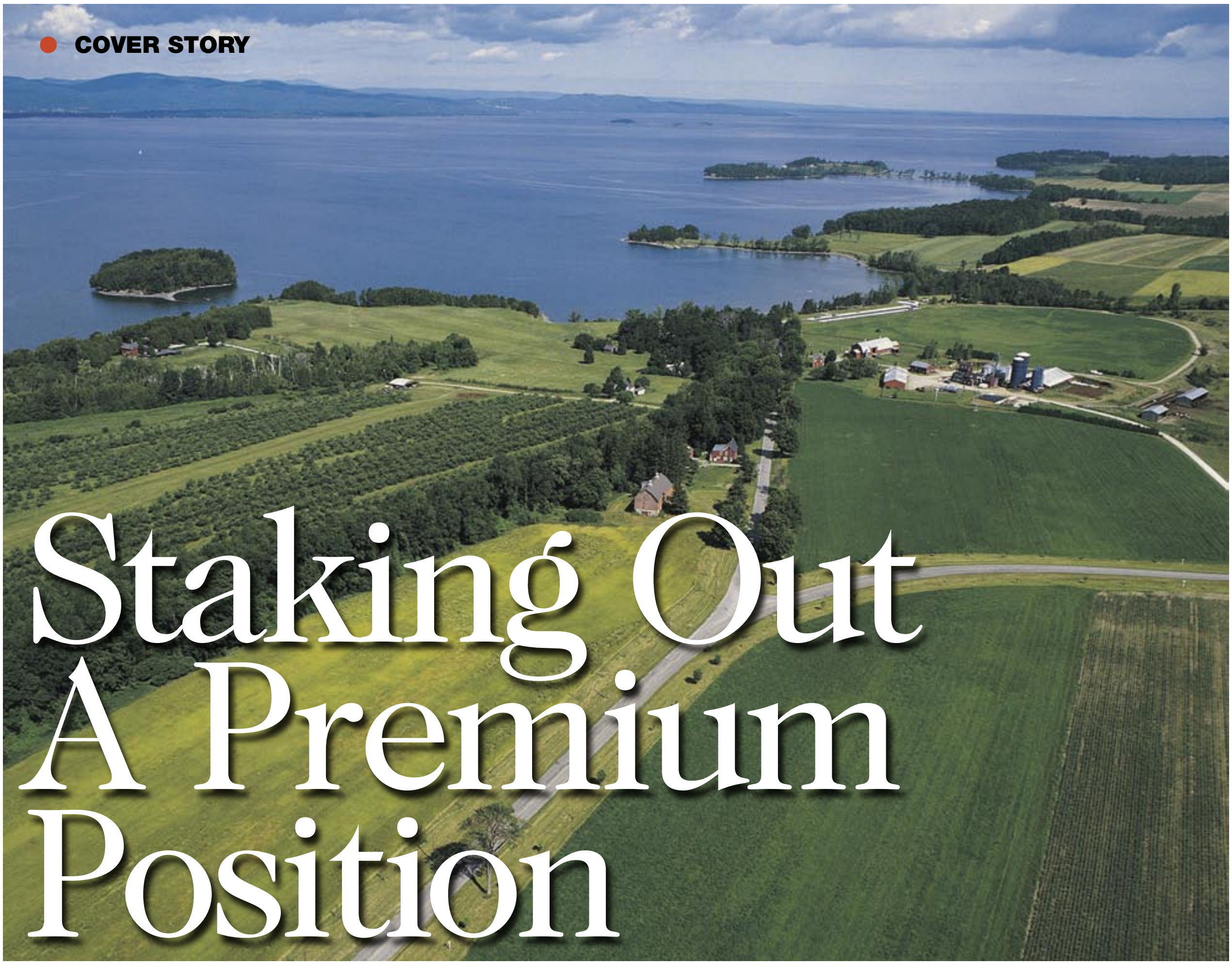

Staking Out A Premium Position

A tax break, preparing for the hard market and the Obama administration's tougher stance toward offshore domiciles are expected to benefit Vermont.

BY CYRIL TUOHY

The past year has been a tough one for new captive formations. Even the perennial domestic leader, Vermont, has had it rough, with just 16 new captive formations in 2008, down from 32 new formations licensed in the previous year.

But that nasty economic surprise slapping the Green Mountain State isn't going to deter the small band of hardy northerners working deep inside a corner of the state's Department of Banking, Insurance, Securities & Health Care Administration in downtown Montpelier.

Intent on regaining the upper hand against an anemic economy, which has cast a shroud on new captive formation around the country, Vermont captive insurance executives say they've got a plan to emerge from last year's long winter of new captive formations.

Yes, money talks. So, first off, companies creating a new captive in 2009 and 2010 in Vermont are going to get a tax break to the tune of $7,500.

David Provost, deputy commissioner of the Captive Insurance Division within the department, proudly notes that, while most states are desperate for money and looking to raise revenue in anyway they can, his team is doing just the opposite: giving companies a tax break.

"It's a little bit of an incentive," says Provost, "a little bit to thank you for coming. It's a nice gesture." The captive folks even have a nickname for the tax cut, calling it a "premium tax holiday."

"This is a long-term savings approach," says Dan Towle, director of financial services with the Vermont Department of Economic Development.

The tax break is tucked away in the state's annual "housekeeping bill," which flew through the state Senate last month without opposition. Passage was expected in the House, according to Vermont insurance officials.

If last year was tough, Vermont captive insurance officials say that at least 11 of the 16 newly registered captives were of the highest quality, so-called "pure captives," which reinsure only the risks of the parent corporation.

Of the remaining captives, two were set up as special purpose financial captives, one was set up as a branch captive, one as a sponsored captive and one as a risk retention group, says Provost.

The distribution of the new captives registered last year, says Peter Raymond, director of captives, is in line with the "usual ratios."

The first quarter of 2009, Vermont officials say, is off to a good start. Provost says a total of three new captives have been licensed so far this year, with another "four or five on our desk" as of early March.

Assuming a traditionally strong fourth quarter, first-quarter numbers put the state on track for between 28 and 32 new captives in 2009. Applicants, according to Provost, are waiting for the economic climate to settle.

"I think the market is going to turn around soon," adds Provost. "You can't keep losing money on the underwriting side and on the investment side. It's got to at least firm up."

When the traditional market firms up, that's the time when companies look once more to captive insurance vehicles to cover risks that have suddenly become more expensive to insure.

With carriers having just wrapped up a dismal earnings season, analysts and senior industry executives also say it's only a matter of time before rates begin moving up again. So far, rates have not moved up in unison, though analysts are looking to the second half of the year before rates harden in earnest.

Property rates continue to decline in many areas, for example, as are rates in casualty lines other than directors' and officers' in the financial services sector. Workers' comp rates are all over the map.

ASKING FOR MORE MONEY

The drop in the number of new captives registered in Vermont last year is exactly why state captive industry officials say they have no intention of backing off initiatives to encourage more companies to apply to set up shop.

Vermont-domiciled captives generate about 1,400 high-paying jobs in a state that relies heavily on tourism, officials say. The captive insurance industry brings in about $25 million in premium taxes annually, with the bulk of it going into the state's general fund.

summary

- Vermont is cutting taxes for new captive formations in 2009 and 2010.
- The captive division is asking for a bigger share of the premium tax proceeds.
- With the U.S. government looking to tax offshore domiciles, onshore domiciles could end up seeing big gains.

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- Fresh data from Vermont's captive insurance industry.

Since Vermont first opened its doors allowing for the creation of captives in 1981, the revenues from the tax levied on insurance premium volume has gone into the state's general fund.

Over the years, the amount collected has added up to a pretty penny. In 2008, the state is expected to collect about $24.5 million from premium taxes. Of that, 10 percent has gone to a special fund administered by the Vermont Captive Division to pay for salaries, regulation, administration, licensing and promotion.

But now, state officials have asked that the percentage be raised to 12 percent. "It's a premiums tax," admits Provost. "It doesn't mean it will be spent, but it's an additional revenue source."

Towle says it's important for captive regulators to increase their "special funds budget" to have the money should they need it and to generally police the growing industry.

Don't get Vermont captive insurance officials wrong. They're not asking to increase the premium tax. They're only asking for a small increase in the portion of the premium tax that goes to the state's general fund, to go to their kitty, the special funds budget.

Regulators may have to fill positions that were left vacant over the previous year, for example, says Towle. Or the department may need to pay for more improvements to its computer system to allow companies to amend their existing applications electronically.

"THIS IS A LONG-TERM SAVINGS APPROACH."

—Dan Towle, director of financial services, Vermont Department of Economic Development

The proposal to ask for a bigger share of the portion of the premium tax that goes to the general fund has been well received by state lawmakers, adds Towle. "The questions we had in the legislature were more about the premium tax holiday."

Lawmakers, along with Gov. James Douglas, have been supportive of the captive industry.

In fact, the joke among administrators during committee hearings is that lawyers and accountants from the banking and securities side of the department dread following the administrators from the captive side because the lawmakers are so receptive to hearing from officials of the captive unit.

To critics, raising the special funds percentage may seem absurd and counterintuitive. Who would think of asking for more money when the number of new captives registered in Vermont in 2008 was less than half the number of new captives registered the year before?

Why ask to raise the captive division's share of the premium tax by two percentage points while at the same time promoting a two-year moratorium on taxes and fees imposed on formations?

The lessons of the past provide a partial answer, according to Towle.

As domestic competitors retrench in the face of budget cuts, hiring freezes and a soft market, Vermont officials see this as the perfect opportunity to take some market share from other jurisdictions—if not now, then in the next year or two, when the market hardens again.

States that in the past decided to cut their nascent captive programs in favor of more important priorities have never been able to come back when the market hardened and companies needed an alternative to the traditional market.

Vermont captive officials, with nearly 30 years of experience in forming captives and shepherding captive insurance laws through the legislature, have seen it happen.

"If you drop it, you can't come back," says Provost. Cash-strapped Arizona, for example, hasn't filled the spot formerly occupied by Rod Morris, the vice president of insurance responsible for captives.

As far as Vermont is concerned, the captive industry is far too important a source of revenue to ignore, even if it means increasing the cash stream to the special funds budget by 20 percent. It is too big an industry in too small a jurisdiction to be ignored.

So when the state's captive administrators ask for what amounts to a departmental raise, which they insist they've not done since the captive industry was started in 1981, lawmakers from both parties were all (receptive) ears.

The state is also adopting amendments that allow for international reporting standards in addition to U.S. GAAP reporting standards when accounting for captive insurance revenue.

Vermont officials are confident the market will come back, and when it does their state will be in stronger position.

A computer system activated during the past year allows operators of existing captives to amend applications by Internet and e-mail.

In a world where 30-day or 60-day approvals are required for changes in an application, Raymond says Vermont has the staff and the infrastructure to approve changes within 24 hours, and important changes at that.

A $20 million dividend payment, for example, can be authorized within hours, even if the request comes through on New Year's Eve.

"It's a huge advantage for us and people like that," he says.

ONSHORE DRIFT

For the first time in more than a decade, offshore domiciles are nervous, really nervous, about the U.S. government's determination to get what it believes is its fair share of income tax premium

"Offshore insurance and reinsurance will be considerable targets to Congress for raising money," says Robert H. Myers Jr., managing partner with the law firm of Morris, Manning & Martin LLP. "Insurance is always on list to raise money."

And while Myers admits that the coming fight over taxing offshore businesses will in the end hurt all captives, the pain will be felt by offshore domiciles more than onshore domiciles.

"It will increase the cost of reinsurance, and it has implications for ceding companies and captives looking to aggregate risks offshore," says Michael Mead, president and CEO of the Lionheart Insurance Group.

Mead notes that the Captive Insurance Companies Association, the Vermont Captive Insurance Association and a number of other insurance-related lobbies have come out against the bill, HR 6969.

Onshore jurisdictions like Vermont, despite their opposition to the bill, stand to gain from the perception, real or not, that they can provide a relative safe haven compared with offshore domiciles. At least that's the way Vermont captive officials see it.

In the new era of austerity, with millions of Americans unemployed and the securities industry and Wall Street blamed for much of the economic carnage, corporations are not keen to be singled out as the fat cats with money stashed offshore.

"The current talk makes being offshore that much less attractive whatever happens to the Obama budget," says Provost. "It's hard to perceive Vermont as a boondoggle."

The scandal surrounding the selling of unregulated insurance products to cover mortgage defaults, which almost cost AIG

its very existence, adds Myers, will reinforce the importance of a strong regulatory structure … and that can only be to the benefit of the Vermont captive industry.

"We can whine about regulations, but it has maintained solvency and insurance has done well and captives have done reasonably well," Myers told an audience of captive managers gathered for the annual meeting of the CICA in Indian Wells, Calif., in March.

"IT'S A LITTLE BIT OF AN INCENTIVE, A LITTLE BIT TO THANK YOU FOR COMING. IT'S A NICE GESTURE."

—David F. Provost, deputy commissioner of captive insurance, Vermont Department of Banking, Insurance, Securities & Health Care Administration

"It's all the unregulated stuff that creates the problem," he said.

And that's exactly why Vermont captive industry officials believe they are in the best position to benefit when rates harden.

When it comes to the regulation of captive insurance companies, Vermont practically wrote the book.

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