

# Reg 114

## The Cost Benefits of Reg 114 Trusts

Reg 114 Trusts Can Significantly Reduce Collateral  
Expense for Corporate Insurance Buyers

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Today's economic and credit environments have made it increasingly expensive for large, commercial insurance buyers to collateralize their insurance programs, but "Reg 114" trusts can significantly reduce collateral expense and provide a cost effective alternative to letters of credit.

Commercial insurance buyers will often choose to retain significant portions of risk as a method of controlling insurance premium costs through the use of deductibles. While the insurance buyer agrees to pay losses within these deductibles, the ultimate responsibility for these losses remains with the insurance company in the case that the insurance buyer defaults on their loss paying obligations. In order to mitigate this credit risk, the insurance company will require the insurance buyer to post a form of collateral with the company as the beneficiary. The most often used form of collateral is the letter of credit ("LOC"). Collateral is also required in other similar insurance arrangements such as fronting carrier and reinsurer agreements with captive insurance companies.

### **The High Cost of LOC's**

Economic conditions have significantly increased the costs of utilizing LOC's as collateral. The credit crisis and economic deterioration that accelerated in 2008 and continues in 2009 has caused significant contraction in the availability of credit to organizations. Banks are in the process of repricing risk and capital costs have increased significantly for companies. Banking institutions are restricting the terms of revolving credit line commitments and as a result insurance buyers have reduced access to LOC capacity. For many companies, the process of pricing and negotiating

a revolving debt package has become much more difficult, even with relationship banks.

The reduction in LOC availability has also had the effect of increasing the costs associated with the LOC's. The increase in cost has been especially painful for companies experiencing financial distress, managing significant debt levels, and navigating restrictive loan covenants. Companies that operate in struggling industry segments or have special cash expenses associated with restructuring that result in weakening EBITDA are particular prone to reduced LOC capacity and increased costs. To put things in perspective, an increase of 50 basis points (bps) in the cost of an LOC for a company holding \$25,000,000 in collateral results in a \$125,000 increase in the annual cost of collateral. This is a material increase to expenses associated with corporate insurance programs and is a problematic scenario all too familiar for many large insurance buyers.

### **The "Reg 114" Solution**

"Reg 114" trusts are named for the Regulation 114 of the Official Compilation of Codes, Rules and Regulations (11NYCRR4) of the New York State Insurance Department. This regulation provides an overview of the "Reg 114" trust parties, including a Beneficiary (insurance company), a Grantor (insurance buyer's captive insurance company) and a Trustee (bank).

In a typical trust transaction, the insurance buyer utilizes the assets held by a captive insurance company to collateralize loss payment obligations. The Grantor (insurance buyer's captive) would deliver assets to a Trustee (bank) in the amount equal to the collateral requirements of the Beneficiary (insurance company). The Beneficiary will then have the right to demand possession of the assets in the trust to either pay or reimburse the Beneficiary in the case that the Grantor defaults on the loss payment obligations outlined in an insurance program payment agreement. The Trustee would then deliver the assets to the Beneficiary and would notify the Grantor. If the trust account size exceeds the collateral requirements (due to interest accrual or asset appreciation), there are stipulations in most trust agreements to release funds back to the Grantor above certain thresholds.

"Reg 114" trusts can significantly reduce collateral expense and provide a cost effective alternative to letters of credit. Bank charges for an LOC vary depending on the company's financial situation – 40 bps to 150 bps, or higher, depending on whether or not the LOC is secured by cash. "Reg 114" trusts are managed on an annual flat fee basis and can include market value fees. Bank charges for "Reg 114" trusts can be 25 bps to 40 bps, or less. The cost differential between "Reg 114" trusts and LOC's can be 50 bps or greater and often represents six-digit dollar amounts in annual collateral cost savings. These are recurring, annual cost savings.

"Reg 114" trusts also reduce the insurance program's utilization of a company's line of credit. In tight credit markets, freeing up credit for other business uses is a sure fire way for risk managers and insurance buyers to create value within the organization. The accounting requirements associated with "Reg 114" trusts are also beneficial. LOC's not only encumber credit within a company, they are accounted for as a liability on the corporate balance sheet and are often disclosed in the notes section of financial statements. On the other hand, "Reg 114" trusts are accounted for as a restricted asset. This

aspect is especially beneficial when considering solvency and financial ratio thresholds of insurance regulators in captive domiciles.

### Important Considerations

There are many important considerations in assessing the potential benefits of using a "Reg 114" trust to collateralize an insurance program. First and foremost, insurance buyers should review their insurance program payment agreements that address acceptable forms of collateral and open dialogue about a "Reg 114" trust with their insurance company, brokers, and consultants. While "Reg 114" trusts are gaining acceptance and popularity within the insurance community, insurance companies may still be hesitant to accept a "Reg 114" trust. Letters of credit are the preferred method of collateralization for insurance companies because they allow an immediate withdrawal of cash and they are well tested as collateral in bankruptcy proceedings.

#### **"Reg 114" Trust Contract Negotiations:**

The "Reg 114" trust agreement is somewhat standardized in the trust business community. Insurance buyers will work with an insurance broker or consultant to establish agreement between the involved parties on the trust form to be used. The draft agreement is usually circulated by the Beneficiary (insurance company). Notably, Chartis (formerly AIU and AIG) uses an escrow contract form which differs from the standard "Reg 114" language. Trustees and Grantors will often request specific changes to the standard form. While it is expected that corporate legal departments will review the trust contract language, it should be pointed out that Beneficiaries are very hesitant to make significant changes to the contract. This hesitancy results from the State of New York's regulation of insurance companies' ability to use acceptable collateral for Schedule F credit purposes. In other words, most insurance companies will not change the trust language to the point that it impairs their ability to claim the "Reg 114" trust as acceptable collateral on their Schedule F statutory form.

### **Establishing Contractual Relationship Between the Captive and the “Insured”:**

More often than not, the party to the insurance program payment agreement (ie, the “Insured” entity) that outlines collateral requirements is not the same entity as the captive insurance company. The insurance company beneficiary requires a contractual relationship between the captive insurance company and the entity party to the insurance program agreements. Establishing the relationship can be accomplished in several ways, and preferred methods vary between insurance companies. For example, the captive insurance company can pledge the trust assets on behalf of the insurance program entity. This “on behalf of” language is inserted directly into the “Reg 114” trust contract. Alternatively, the insurance company will require the insurance program entity to assign its rights to the captive insurance company loss payments, depending on the structure and involvement of the captive company. These “assignment of rights” agreements are separate contracts and are used, notably, by Chartis.

**Acceptable Banks / Trustees:** The bank utilized for a “Reg 114” trust arrangement typically must be a member of the Federal Reserve System, or a New York State-chartered bank or trust company. Insurance company credit departments also maintain a list of acceptable bank and trustee institutions and will follow the National Association of Insurance Commissioners (NAIC) acceptable bank list. While the acceptable bank criteria typically follow generally accepted credit ratings of bank institutions, insurance companies will also be hesitant to work with banks that they have had a particularly bad experience with in the past. For these reasons, it is always important to have banking partners pre-approved by the insurance company credit departments.

**Acceptable “Reg 114” Trust Assets and Investments:** Securities are limited to cash and equivalents, U.S. Treasury Securities, and fixed income securities rated A or higher. “Reg 114” trusts are not allowed to hold equities. Initial trust assets are wired from the captive insurance

company to the Trustee (bank). The assets are either liquidated and then wired or securities and investments are transferred in kind. Once the assets are funded into the “Reg 114” trust, the insurance buyer can choose several different investment management approaches. Companies can invest the assets in liquid money market funds without active oversight – this is the least expensive alternative. The trust assets can also be actively managed by either a capital management group within the Trustee bank, or by a third party asset manager that is approved by the Trustee. The asset manager will invest the securities within the parameters of the “Reg 114” trust agreement. While there is a range of investment alternatives in “Reg 114” trusts, it is important to note that some Beneficiaries (insurance companies) will assign “risk charges” to certain investments, typically those greater than 1 year in duration (ie, Treasury Notes, commercial fixed income securities). In these cases, the Beneficiary will require the Grantor to fund additional amounts in the trust to compensate for the additional investment risk.

### **Business Case Study**

Beecher Carlson was recently engaged by a client in the lodging/gaming industry segment to examine the benefits of a “Reg 114” trust. The company had been taken private in an LBO transaction by management and several private equity groups. Additionally, the economic conditions had caused significant declines in EBITDA at their hotel and casino properties. The company’s leveraged balance sheet and weakening EBITDA resulted in their banking partner reducing their access to letters of credit and increasing the cost to use the remaining LOC capacity. The company’s cost to maintain nearly \$40,000,000 of unfunded LOC’s with two different insurance companies increased from less than 100 bps annually to over 300 bps. By utilizing a captive insurance company domiciled in Bermuda, the company was able to fund the entire collateral requirement for both companies in two “Reg 114” trust accounts and reduce the cost of collateral to under 40 bps. The recurring savings were over \$1,000,000 annually and the

insurance programs utilization of the company's available credit line was reduced significantly. Meanwhile, the Bermuda captive continued to operate within the parameters of financial and solvency ratios set by the Bermuda Monetary Authority (BMA).

### **A Smart Move in Tough Times**

Current economic conditions are putting increasing pressure on today's financial and risk managers to reduce expenses, deploy capital effectively, and manage efficient use of the company's access to credit. Insurance program collateralization requirements can represent significant costs and can reduce availability of credit. But, "Reg 114" trusts can be a cost effective alternative to traditional LOC's when collateralizing insurance programs.

"Reg 114" trusts are becoming increasingly popular and more widely accepted in the insurance and risk management community, but assessing the potential benefits of a trust requires in depth analysis and dialogue between stakeholders. The implementation of a "Reg 114" trust also requires agile project management and a partner that can work across boundaries to get the job done. Beecher Carlson's specialized solutions, analytical thinking, and commitment to reducing our client's total cost of risk create an ideal partner for helping clients assess, implement, and manage a "Reg 114" trust. Beecher Carlson has consummated multiple "Reg 114" transactions for clients across industry segments, representing over \$100,000,000 in collateralized trust assets and millions in savings to our client's bottom line. Contact Beecher Carlson today to see how you can unlock potential savings in your insurance program collateral requirements.



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