CFC CORNERSTONE FINANCIAL CONSULTING OF RAYMOND JAMES®

I have a Reinsurance Company, but now what?

Participation programs have drastically increased in the last decade for automobile dealers selling extended service contracts and ancillary products. This trend is likely to continue as dealers are seeing the potential benefits of sharing in the underwriting profit of various products and services.

The most common participation program we see is what is commonly known as the Producer Owned Reinsurance Company (PORC) through the Controlled Foreign Corporation (CFC) structure. In these structures, the reinsurance company is typically formed in an offshore domicile, but elects to be taxed as a US company by making an election under IRS section 953(d). These companies also elect to be taxed as a small Property and Casualty company under section 831(b). As a result of these elections, the companies are taxed only on investment income, not premiums, provided they are following the aforementioned guidelines.

Once the companies are formed, make the proper elections and funded, the reinsurance company will enter into a trust agreement as the Grantor with the Administrator as the beneficiary of the funds. This trust account will hold a set amount of the Unearned Premium Reserve (UPR) requirements, invested in accordance with the investment guidelines provided by the administrator or state statute.

In today's low interest rate environment, many reinsurance companies are seeing little investment income in the typically conservative investments they are allowed to fund the trust account. Many administrators will require the investments to include primarily Government Issued or guaranteed investments, highly rated corporate bonds, Certificates of Deposit and similar investments. Furthermore, the administrators will look to limit the duration of the portfolio (duration is a way of measuring how much bond prices are likely to change if and when interest rates change). As an example, if a reinsurance company is required to invest in US Treasuries with a duration less than 10 years and the 10 Year Treasury is yielding 2.00%, it is difficult for the trust to provide an attractive return without taking on additional risk.

Our team manages accounts for many reinsurance companies with similar investment guidelines. What's important is to review the investment policy associated with the administrator and attempt to identify areas within the guidelines that provide an opportunity for additional yield. Secondarily, we recommend all of our reinsurance trust set up "B" or "Surplus" accounts. B accounts are second accounts established in the name and tax ID of the reinsurance company, but not subject to the control of the trust. The owners' of the reinsurance company have complete control of the assets in a B account. These accounts are used to house assets that are in excess of the required Unearned Premium Reserve requirement of the trust. By sweeping funds above the UPR to a B account, reinsurance companies are provided the opportunity to invest in securities that provide a higher expected return (and inherently higher risk). Over time, by blending the return of the conservative trust account with a more aggressive B account, the owner of the reinsurance company should be able to expect a higher overall return while still maintaining the tax efficiency of keeping the funds in the name and Tax ID number of the reinsurance company.

Example A – XYZ Reinsurance Company has a trust account with $1,250,000 in assets held by ABC Bank as Trustee. The trust agreement states that XYZ must keep at least 105% of its UPR in the trust account. Based on the December 2015 statement, we identify that the UPR is $800,000, meaning $840,000 must be held in the trust account and $410,000 is available for distribution to a B account (trust may require beneficiary approval). This $410,000 can now be invested into an equity portfolio with a higher expected return. Because the B account was established in the name and TAX ID number of the reinsurance company, a taxable distribution has not occurred.

By regularly sweeping excess funds from a trust to a B account, a reinsurance company can diversify their overall holdings, and have the ability to invest more aggressively. They do not have to invest more aggressively, but they are provided that option by removing assets from the trust.

Our team has opened many B accounts and know the proper methodology to establish the account, and properly communicate with the trustee, the administrator and the reinsurance manager. It is imperative that everyone is aware of the intentions of the reinsurance company and that the proper documentation is in place. Typically these companies are formed offshore which requires an enhanced due diligence by the financial institution opening the B account.

If you are interested in learning more about B accounts, or other types of services our team provides, please do not hesitate to contact us.

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