



## FERMA's views on captive insurance companies

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### Executive Summary

The Federation of European Risk Management Associations (FERMA) represents the interests of more than 4700 European risk and insurance managers, of whom around a third work in organisations that use a captive insurance company to cover some risks for their operations<sup>1</sup>.

Since the publication of the OECD recommendations on Base Erosion and Profit Shifting (BEPS) in October 2015, several pieces of EU legislation<sup>2</sup> are challenging financial or tax aspects of captive insurance companies.

FERMA believes it is important that EU tax authorities preserve the risk financing capacities that the European captive insurance industry provides to EU parent companies, and other organisations, rather than reducing choices.

FERMA wishes to draw attention to the specific role played by captives for European companies:

- Captive insurance provides detailed risk information and trends specific to the activities of its parent organisation. It allows more accurate risk coverage linked to the actual exposure and a unique history of losses.
- Captive insurance is a risk management tool that enables European businesses to find additional capacity to cover the risks of their operations.
- Captive insurance contracts are genuine risk transfer transactions; pricing of captive products either follows directly commercial market pricing (e.g. if captive participates only as reinsurer) or established actuarial methods as used by any market insurer (in case of direct writing captives).
- Many elements of the operation of captives demonstrate their genuine, non-tax purposes, including:
  - ⇒ The payment of claims to insured entities;
  - ⇒ The payment of insurance premium taxes in source countries;
  - ⇒ The use of captives by public and not-for-profit organisations;
  - ⇒ The use of captives for group-wide programs;
  - ⇒ The existence of many on-shore captives in a number of EU/EEA countries (including Sweden, Norway, Denmark, Netherlands, Germany...)

<sup>1</sup> According to FERMA 2014 European Risk & Insurance report carried out among 850 risk professionals, 39% of respondents work in organisations using (renting or owning) a captive (<http://www.ferma.eu/app/uploads/2014/10/20140828-FERMA-2014-Presentation-FINALE-FINALE.pdf>), preliminary findings for 2016 seem to indicate that 34% of respondents work in organisations using (renting or owning) a captive

<sup>2</sup> Anti-Tax Avoidance EU Directive proposal (27 January 2016), Public Country by Country Reporting Directive Proposal (12 April 2016)



Captive insurance companies in EU domiciles are regulated under the Solvency II supervisory regime, and the International Association of Insurance Supervisors (IAIS) recognizes captives as an enterprise risk management tool for their owners<sup>3</sup>.

Captives are an integral part of the worldwide insurance and reinsurance market and are fully supported by commercial insurers or reinsurers with whom they deal. They contribute to the resilience of European businesses, and therefore, to economic growth.

## For risk managers, a captive is first and foremost an efficient risk management tool

With nearly 7000 captives worldwide, the risk management community knows well the reasons and benefits for organisations to use captive (re)insurers as “in house” insurance providers. These light structures are risk management and financing vehicles that supplement the imperfect insurance offer for large commercial insurance buyers by traditional insurers. They help provide a professional, “total cost of risk<sup>4</sup>” picture to organisations engaged in production, distribution and provision of goods and services in numerous countries.

Captives perform a genuine (re)insurance activity by ensuring that coverage of risks for large European organisations remains available and affordable - hence they protect the assets and resilience of European industry. The captive insurance sector in Europe is a dynamic and competitive industry that continues to innovate and expand to cover the growing need for alternative risk control and transfer solutions.

More specifically, a captive allows European organisations to:

- Obtain competitive premiums and better risk coverage. Captives typically have lower administrative costs and no marketing expenses compared to commercial insurance companies, and there is likely to be a greater discount for effective loss control.
- Access reinsurance markets to build higher levels of risk transfer capacity. This is especially crucial for organisations with very large risk exposures for which the commercial insurance market cannot provide enough capacity to match the desired level of protection.
- Build a better awareness of the cost of risk and loss control. The captive owner can have access to more detailed loss data than it would normally get from a commercial insurer. Risk managers can use that information to mitigate risk, for example, reducing the number of incidents and injuries. Operational risk exposures across group entities can also be consolidated within a captive as part of enterprise risk management.

Captives are an important risk financing tool of an organisation and an essential instrument to overcome risk-related restrictions imposed on companies by the regular insurance market. Captives are especially well-suited for more frequent small to medium-sized losses. They have lower operating costs than external insurers, which mean they can insure more risk for the same premium.

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<sup>3</sup> Application Paper on the Regulation and Supervision of Captive Insurers <http://www.iaisweb.org/page/supervisory-material/application-papers>

<sup>4</sup> Total Cost of Risk (TCOR) is the cost of managing risks and incurring losses. Total cost of risk is the sum of all aspects of an organisation's operations that relate to risk, including all insurance premiums retained (uninsured) losses and related loss adjustment expenses, risk control costs, transfer costs, and administrative costs. <https://www.irmi.com/online/insurance-glossary/terms/c/cost-of-risk.aspx>



Traditional insurers have a diversity of client organisations with different risk profiles. The limits of cover available, deductible requirements and/or premium levels that they set will take into account the whole book of business and so do not always reflect the risk profile of an individual organisation.

Captives, however, reward good risk management by identifying the most relevant risks and building statistics on losses and claims from their parent organisation. In this way, the captive's risk pricing can be more accurately adjusted to the individual risk profile and appropriate incentives offered to improve performance.

Without captives, organisations would either have to increase their risk transfer costs by purchasing more capacities on the commercial insurance market (if available) or increase the financial exposure of their operating units by retaining more risk on the balance sheet.

## Captive insurance companies are regulated and transparent entities

### Regulated entities

The EU captive industry is one of the most sophisticated marketplaces globally. Among the main business reasons for the selection of an appropriate captive jurisdiction are the capacity of the local insurance supervisor to regulate captives in an effective and proportionate way and the availability of suitable services.

The EU captive industry is highly mature in terms of technical capabilities and highly regulated by supervisory authorities in captive domiciles under the new Solvency II regime.

Solvency II and the IAIS Principles<sup>5</sup> require that captive insurance companies have robust risk and capital management strategies in place, accompanied by strong corporate governance and reporting requirements. The board of the captive, which has the first and foremost responsibility to manage this insurance operation successfully in accordance with its business plan, decides the functions, risk and capital of the captive, even if day to day management is delegated to a professional manager. The role of the owner is, as in any other subsidiary, to preserve its interests as the shareholder by supervising the board.

Like any insurance contract, captive insurance transactions are subject to insurance premium taxes (IPT) in the source countries. These tax revenues would not exist if the captive owners opted for self-insurance. Moreover, captive insurance companies are fully exposed to the corporate tax rules applicable in its EU domicile and thereby contribute a fair share of its profits to society.

In addition, member states may have specific, captive-related tax regulations. In Germany, for example, the tax regime treats income sourced from a captive in a low tax jurisdiction as if it were realised under the prevailing local high(er) corporate income tax scheme of the captive's parent company.

A strong captive insurance industry is a global competitive advantage for Europe that should not be underestimated. European rules on captives need to preserve the competitiveness of this tool because the ultimate goal is to serve its parent company.

- Claims payments made in the EU economy contribute to the resilience of European businesses.
- Reduced cost of risk and enhanced control of losses give EU organisations an incentive to increase their level of investment which contributes to economic growth.

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<sup>5</sup> IAIS Insurance Core Principles November 2015

[http://www.iaisweb.org/modules/icp/assets/files/151201\\_Insurance\\_Core\\_Principles\\_updated\\_November\\_2015.pdf](http://www.iaisweb.org/modules/icp/assets/files/151201_Insurance_Core_Principles_updated_November_2015.pdf)



The existence of a captive increases the chances of “survival” of an organisation. Thanks to tailor-made coverages through its captive, and the potential for direct access to the global reinsurance market, the organisation is better protected in case of a severe loss that would not be covered in a same manner by the traditional insurance market.

## **Transparent entities**

The list of captives in each EU jurisdiction is available in full transparency, and the biggest captive jurisdictions worldwide have all implemented the automatic exchange of information in tax matters.

Captives are all subject to licensing by their local insurance supervisor, who checks the ultimate beneficiaries and board members.

Captives are included within the list of consolidated companies in the owner’s annual report and are subject to external audit, as well as quarterly or annual reporting to their supervisory authority and ‘on-site’ inspections by the supervisor.

## **Perception of captives by tax authorities is challenging alternative risk financing in Europe**

Despite these facts and a successful history of more than 50 years, captive insurance is now affected by negative references<sup>6</sup> in the BEPS reports. Tax authorities are increasing regulatory scrutiny of captives and requiring organisations to demonstrate that their captive arrangements are driven by “clear non-taxation reasons”. This will generate further significant administrative costs for captives, and risk managers will need to be able to show to their senior management that there is continuing added value in owning a captive.

Tax authorities, when considering captive transactions, should take into account that one of the fundamental reasons for using a captive is to protect the assets of an organisation when the traditional insurance market, for some reasons, cannot offer a coverage that fits the needs of the organisation.

Insurance supervisors across the globe do recognise that captives have few transactions, a limited number of policies and low complexity, and thus do not conduct activity every day. The captive business model, therefore, is built around proportionate supervision and low operating costs. Decision-making always remains with the captive’s board of directors (or committees where applicable), which is controlled by the parent organisation.

Executing the board’s decisions, however, is generally delegated to a professional captive management company; hiring a full time employee for every captive would be uneconomical for captive owners and unlikely to provide all the necessary skills, such as underwriting, accounting and finance.

In addition to professional managers, captives use other service providers to support their activities, such as actuaries, lawyers and third party loss adjusters. The availability of a network of such professionals is another key reason behind the selection of an appropriate jurisdiction for establishing a captive.

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<sup>6</sup> See Final Report of Action 3 on Controlled Foreign Company (CFC) Rules (p.43), also Final Report of Action 8-10 on transfer pricing (p.40) <http://www.oecd.org/tax/beps/beps-actions.htm>



FERMA and the risk management community, therefore, ask for a sense of proportion regarding scrutiny and documentation requirements. The use of a captive as an integral part of the corporate risk financing and management strategy will remain a valuable solution if there is no new significant increase in the operational cost of captives following the implementation of Solvency II earlier this year.

## Conclusion

The treatment of captives under the upcoming ATA Directive should remain consistent and aligned with the Solvency II regime where captive insurance companies are subject to the same regulatory environment in terms of governance, risk and capital as other insurance and reinsurance companies.

FERMA believes it is crucial that tax authorities understand the positive technical risk management aspects that captives can represent for multinational organisations.

Although FERMA is convinced that EU domiciled captives will pass the BEPS test, the administrative costs of owning a captive are very likely to rise. As a consequence, there will be an increase in the total costs of doing business that will not help accelerate economic growth.

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FERMA - The Federation of European Risk Management Associations brings together 22 national risk management associations in 21 European countries. FERMA represents the interests of more than 4700 risk and insurance managers in Europe active in a wide range of business sectors from major industrial and commercial companies to financial institutions and local government bodies. More information can be found at [www.ferma.eu](http://www.ferma.eu)