



CAPTIVES IN A POST-BEPS WORLD



This first edition of FERMA Perspectives shows that captive insurance can make a real contribution to the enterprise risk management of multinational groups while at the same time complying with fiscal and tax regulations.

We believe it will be useful for European risk managers in several ways. First, it shows how European multinationals can demonstrate that their captive has true economic value and meets regulatory and corporate governance standards. This is particularly important following adoption of the OECD Base Erosion and Profiting Shifting (BEPS) regulations¹.

Second, it gives the risk manager a good basis of communication with the group's senior management about captive insurance. Finally, it is a useful introduction to concepts and best practice for risk managers considering setting up a captive. It will help dispel misperceptions about captives.

In times where regulators require increasing control of risk appetite and when the insurance market fears (or declares) itself to be unable to cover extreme risks such as Hurricanes Harvey or Irma, a captive is one of the best means of securing the risks of companies.

FERMA is grateful to our subject matter experts, Carl Leeman, Chief Risk Officer, Katoen Natie; Fabrice Frère, Managing Director, Aon Risk Solutions; Praveen Sharma, Managing Director Global Practice Leader - Insurance Regulatory & Tax Consulting, Marsh; Derek Bridgeman, Vice President and Solvency II leader EU, Marsh Captive Solutions group, and Laurent Nihoul, General Manager - Corporate Risk and Insurance, ArcelorMittal for their hard work and valuable insights without which this report would not be possible. We also thank all the other contributors from our 22 member associations for their commitment to the preparation and success of this document.

Jo Willaert,
President of FERMA

¹For a similar OECD guidance on BEPS, see OECD Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13 published on 5 December 2016, available at <http://www.oecd.org/tax/beps/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.htm>

FERMA brings together 22 national risk management associations in 21 European countries. Together we represent the interests of more than 4800 risk and insurance managers in Europe active in a wide range of business sectors.

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Executive Summary

Any business is surrounded by and generates risks that can threaten the profitability or even the viability of the company. The risk manager's role is to support his/her company's strategic objectives by mitigating the exposures that these risks create. This means identifying, assessing and analysing those risks in order to define and implement the relevant risk management strategy.

The risk management strategy encompasses multiple approaches, including prevention and information measures, risk monitoring, business continuity management and risk transfer/risk financing solutions.

Within the context of risk financing, the risk manager uses various tools to optimise the Total Cost of Risk² or TCOR for his/her organisation - of which widely known and efficient ones are (re)insurance transfer to third party insurance companies and self-financing solutions such as captive (re)insurance companies. Before deciding whether to use an alternative risk transfer solution, such as a captive, the risk manager of a multinational group will normally go through a series of steps embedded in an enterprise risk management (ERM) approach.

There are many misperceptions about captives, but used well, a captive is an efficient risk management tool. It can give the entire organisation a way to expand the scope of available insurance coverage, manage TCOR, consolidate and mutualise group risks, leverage discussions with traditional insurance markets and offer added value to customers.

In this FERMA Perspectives, we explain the role of the risk manager in an EU-based multinational group as well as the purpose and value of a captive (re)insurance vehicle in the enterprise risk management programme.

We give some statistics about captives and key figures in order to demonstrate that the main financial ratios of the captive insurance industry are in line with the traditional insurance market.

In the annex, there are practical examples of the application of captive arrangements in multinational groups.

² Total Cost of Risk (TCOR) is the cost of managing risks and incurring losses. TCOR 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>

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1. THE ROLE OF THE RISK MANAGER AND CONCEPT OF RISK MANAGEMENT IN AN EU-BASED MULTINATIONAL GROUP

The risk manager's role is to support his/her company's strategic objectives by mitigating the exposures that these risks create. This means identifying, assessing and analysing those risks in order to define and implement the relevant risk management strategy.

The risk management strategy encompasses multiple approaches, including prevention and information measures, risk monitoring, business continuity management and risk transfer/risk financing solutions.

1.1. The Role of the Risk Manager in an EU-Based Multinational Group

1.1.1. Enterprise Risk Management (ERM)

An important part of the risk manager's role is to conduct a diligent assessment of all the possible risks encountered by his/her multinational group. This combines both likelihood and potential impact levels as well as financial exposure. This will be nationally and internationally. The ERM approach allows the proper identification, analysis, evaluation and handling of the risks.

1.1.2. Risk Treatment (ISO 31000 wording)

When risks have been properly assessed following the ERM principles, the risk manager must consider several types of risk responses:

- Risk acceptance / tolerance / retention taking no further actions.
- Risk avoidance stopping the activities that created the risk in the first place, especially when the risk combines both high likelihood and high impact levels.
- Risk control / reduction implementing prevention and protection measures to reduce the likelihood of occurrence and maintain an acceptable level of risk.
- Risk transfer / financing: finally, considering methods of financing or transferring the residual part of the risk that cannot be avoided or for which the group has no appetite or financial capabilities to retain. This is primarily suitable for categories of risk with a rather low likelihood but a high-level impact from a commercial, economic and/or financial perspective.

All these techniques and analysis will be specific to each organisation and different among the sectors.

1.1.3. Focus on Risk Transfer / Risk Sharing (ISO 31000 wording)

Risk transfer itself includes several risk financing options. Buying insurance cover with a third-party insurer is the most widely known. The risk manager selects the appropriate risk financing solution based on the TCOR, meaning the extent and capacity of the proposed coverage, including policy wording, and the services offered by the insurer (expertise in case of a claim, loss control advices, etc).

There are also alternative solutions to transfer/ share the financial impact of an event in addition to the conventional insurance. When insurance markets do not satisfactorily respond to certain risks, the risk manager can instead use, for example, a captive insurance company, insurance bonds or contractual sharing of risks.

Consequently, the decision to set up and use a captive insurance or reinsurance company is only one among the many possible outcomes of an ERM approach.

A thorough ERM process within an organisation can be beneficial not only for the employees, investors and customers of the multinational company. It also benefits the wider community by reducing the occurrence and impact of damaging events, such as fires and explosions, injuries, pollution, fraud, errors & omissions, etc. It also assists in calculating adequate financial protection for events that occur despite preventive measures, and minimising the cost of those protections to maintain competitiveness.

1.2. Why Use a Captive (Re)insurance Vehicle?

Risk management process and methods that may lead to a decision to create or use a captive

1.2.1. Definition of and Business Reasons for Captives

In Chapter 2 of its Application Paper on the Regulation and Supervision of Captive Insurers dated November 2015³, the International Association of Insurance Supervisors (IAIS) defines a captive as “an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties”.

Captives typically operate on an insurance or reinsurance basis, depending on the risks they cover, the location of risks, the legal and regulatory environment, and the volume of business.

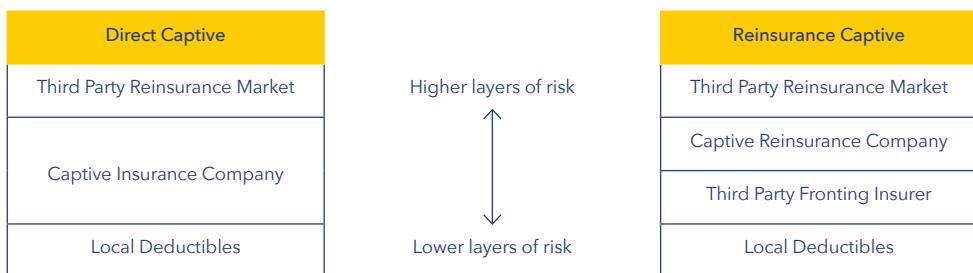
An insurance captive issues insurance policies directly to parent company or its operating entities and manages and pays back related claims (often with the support of a specialised third party claims administrator) directly to the insured entity.

A reinsurance captive underwrites a share of the insurance risk of the multinational group by partnering with a commercial third party insurer that issues the local insurance policies to the operating entities. This is described as a fronting agreement. The third-party insurer manages the related claims and associated processes.

In such a reinsurance framework, there is no transaction between the operating entities and the captive, which “follows the fortunes” of the fronting insurer.

Before deciding to use a captive, the parent company of the multinational group will need sufficient financial strength to support its control and governance, operating costs, regulatory capital requirements, and as well as potential underwriting losses.

Typical captive structures are depicted in the two tables below:



³ International Association of Insurance Supervisors (IAIS), Application Paper on the Regulation and Supervision of Captive Insurers, November 2015, <https://www.iaisweb.org/page/supervisory-material/application-papers//file/58019/application-paper-on-the-regulation-and-supervision-of-captive-insurers>

1.2.1.1. Why do multinational organisations use a captive?

Using a captive will allow an organisation to increase the overall efficiency of its risk management and financing process. It can ensure more stability in insurance covers through mitigation of insurance market pricing and capacity volatility, and allow flexibility in risk retention and risk transfer strategies.

The decision to set up and use a captive is linked to the specific geographical scope, business activities, size, related risk profile and risk management strategy of the multinational organisation.

Captives may play a role in multiple ways for optimising the risk financing / transfer strategy of a multinational corporation. The main advantages can be summarised through two aspects: (re)insurance basics and risk control.

1.2.1.2. (Re)insurance basics

This category includes the technical elements relating to (re)insurance covers and pricing structure, as well as improvements in the traditional insurance purchasing process.

- Reduction or stabilisation of the TCOR

Using a captive to buffer market conditions and develop an accurate (re)insurance strategy for financing low- to medium-impact risks over the years is more efficient and less costly than traditional insurance covers.

- Direct access to worldwide reinsurers

A captive allows the multinational a direct relationship with the reinsurance market which may offer greater capacity, lower prices, a larger geographical scope and more flexibility than the primary insurance market.

By the same process, it may also allow multinational corporations to access government pools, such as GAREAT in France, Pool Re in the UK, etc.

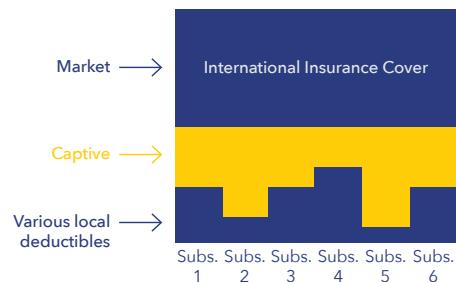
- Mutualisation and diversified risks

A captive is an efficient tool that employs the basic principle of insurance which is mutualisation.

Combining non-correlated risk retentions, such as property and transport, and varied geographical exposures will improve the diversification and mutualisation effect within a multinational corporation, thus creating additional positive impacts.

- Consolidating international insurance covers in line with local needs and risk profiles

A captive can be an efficient tool to consolidate the deductibles or coverage of a multinational company's entities within an international (re)insurance strategy, despite potential differences in size, related risk profiles and specific local needs, as depicted in the picture to the right.



- Negotiation tool

Thanks to its central position and global view on the organisation's losses, a captive can easily be used as a central underwriting and (retro)cession unit. One of the greatest benefits of owning a captive is that it can be a central vehicle to leverage global negotiating power with brokers and (re)insurers.

1.2.2. Risk Control

This second dimension is mainly about the role of a captive as an efficient risk financing tool with additional opportunities for enhanced risk management and risk control.

- Solution to market inadequacies (coverage for non-traditional or overpriced risks)

From time to time, the traditional insurance market dictates restrictions to some policies, particularly in hard market conditions, or is unwilling to provide cover for certain risks.

The use of a captive to buffer market conditions or to provide additional capacity can be an answer. By filling market gaps, a captive is a useful tool to actively help its owner avoid lack of cover or overpriced insurance solutions. This will lead to an improved loss control efficiency.

A traditional example of the added value a captive (re)insurance company can add to its group is the ability to cover risks that are emerging and not yet well known by the insurance market (e.g. cyber risk exposure) or which have a very specific nature and severe potential impact (e.g. nuclear, aircraft, natural disasters).

- Improved claims handling

A captive provides opportunities to improve claims handling policies and procedures, for example allowing more flexible processes to accelerate claims management and settlement procedures.

- Improved data collection, loss control and prevention measures

According to its central role within a multinational group, a captive can be used as a central unit for insurance data collection coming from all the group's entities, such as loss statistics, nature of the cover, control measures, intermediation costs, recourses, etc.

A captive can promote greater awareness of factors that commonly give rise to losses and be a strong support to improve loss prevention and control policies as well as to initiate relevant control actions.

This in turn enables risk to be managed at group level, guarantees better risk awareness at operational level and increases transparency regarding insurance-related costs.

In summary, the main business reasons to have a captive are the following:

- Increase overall efficiency of risk management
- Increase long term stability by mitigating market pricing and capacity volatility
- Obtain coverage for risks not readily available or economically feasible in the commercial markets
- Provide flexibility in responding to changes in risk retention and risk transfer strategies
- Build better awareness of the cost of risk and loss control with central accountability for risk management
- Reduce and/or smooth the TCOR including administration costs
- Access reinsurance markets
- Maintain control over claims
- Obtain access to government pools, e.g. terrorism insurance via GAREAT or Pool Re

1.2.3. Limits to Other Risk Treatments

Even with a good knowledge of its risk exposure, a multinational group may face the following issues with its risk financing solutions:

I. Conventional insurance

- High premiums
- High deductibles
- Numerous exclusions
- Short term coverage
- Volatility in Total Cost of Risk (TCOR)
- Unsatisfactory claims management process

II. Bonds and financial instruments

- Complexity
- Prohibitive initial set up costs
- Capital and accounting constraints

Without an appropriate alternative, such as captives, operating entities within a multinational group would either experience higher operating costs or would be left exposed to higher volatility and financial risk. The cost of products would increase and/or financial protection for customers and communities would deteriorate in case an event occurred.

Such potential adverse impact on the financial and economic outcome of a multinational group would be unacceptable to the board of directors from a good corporate governance perspective and to the investors.

In this respect, captives can form an integral part of the multinational organisation's risk management strategy and are generally accepted by worldwide insurance markets as they offer a fully regulated environment for risk retention / risk sharing strategies.

1.2.4. Choice of Domicile: main drivers

The decision about the location of a captive insurance or reinsurance company has multiple drivers.

First, [the risk management objectives](#) of the organisation, and its specific risk profile, will drive practical considerations about the type, quantity and geography of risks to be covered through the captive, and whether the captive is to write direct or provide reinsurance. Different forms of captives exist and some domiciles have developed specific knowledge about certain types, such as protected cell companies.

The [insurance regulatory requirements](#) of source jurisdictions will need to be assessed to fit the organisation's risk transfer requirements. For example, only a US insurer can write certain US risks such as Workers' Compensation or Motor and within the European Union only a direct writing insurance captive would be able to cover compulsory and non-compulsory classes of risks located in all the EU member states.

The [availability of a network of professionals](#) with experience of the captive's business model, such as captive managers, actuaries, auditors, lawyers and third party loss adjusters, is another key driver behind the selection of an appropriate jurisdiction.

Finally, the [level of operating costs](#) as well as the regulatory capital requirements will be considered, along with the experience of the local regulator and existence of specific laws/regulations for captives and (re)insurance.

2. KEY FIGURES AND STATISTICS ABOUT CAPTIVES

The benchmarking analysis below shows that captives are comparable to traditional insurance companies when it comes to their underwriting results, taxation and level of equity and solvency parameters.

As insurance and reinsurance are highly regulated businesses under the supervision of strong governmental bodies and strict regulation at

European level (Solvency II), this should not come as a surprise. Captive companies have to meet the same set of supervisory requirements (i.e. corporate governance, minimum solvency level, fit-and-proper constraints for their management bodies, etc.) and so cannot be drastically different from traditional commercial insurers, except for their lower level of diversification.

The following benchmarking analysis is based on a sample of 2256 captives managed by Marsh and Aon worldwide, out of a total worldwide market of 6800 captives, of which 462 were identified as EU-parented captive residents.

Scope	Sample of 462 captives
UNDERWRITING	Figures in USD (fiscal year to 31 December 2015)
Gross Premium Written	12 bn
Net Premiums	9.9 bn
Net Claims	7.1 bn
PROFITABILITY	
Net Profit Before Tax (NPBT)	1.5 bn
NPBT (including equalisation reserves)	1.78 bn
TAXES PAID	
Tax on profit	300 m
SOLVENCY	
Net Assets	16.8 bn

Scope	Sample of 462 captives	European insurance industry benchmark (property and casualty)
UNDERWRITING		
Loss ratio (net claims/ net premiums)	72%	n/a
PROFITABILITY		
Net profit before tax (NPBT)/ gross written premiums	12.2%	15.41%
NPBT (including equalisation reserves)/ gross written premiums	14.8%	n/a
TAXES PAID		
Tax on profit/ NPBT	18%	12.12%
Tax on profit/ NPBT (including equalisation reserves)	15%	n/a
SOLVENCY		
Net assets/ GWP	1.40	1.25

(*) Source: New York University Stern School of Business indicators for European Property & Casualty insurance industry.

These figures show that in fiscal 2015, the 462 captives owned by European resident multinational companies, underwrote US\$10bn net premiums and paid back US\$7bn net claims to the multinational groups' operating entities (loss ratio of 72%).

The net profit before tax in total for these captives was US\$1.5bn, or US\$1.78bn when allocations to catastrophe/equalisation reserves are included. Catastrophe/equalisation reserves are imposed by insurance regulators in some countries, and allowed in other countries, to compensate for the lack of

mutualisation that can exist for captives when covering large industrial risks.

Natural hazard is a prime example of this, because large losses can only be financed by collecting and setting aside premiums over a long period of time. Aerospace, nuclear, pollution and surety risks, and non-proportional reinsurance have similar characteristics. Consequently, countries like Belgium, France, Germany, Luxembourg and Sweden have implemented catastrophe/equalisation reserve requirements, for a wider or narrower spectrum of risks depending on the country.

In such cases, net profit can only be assessed over a multiyear period.

2.1. Comparison with European Commercial Insurers

- Comparing the captives' net profit before tax on gross written premium ratio (14.8%) with the pre-tax unadjusted operating margin of European commercial insurers (15.4%), it is apparent that captives are not making excessive profit compared to the European commercial insurance markets.

Source

www.stern.nyu.edu/~adamodar/pc/datasets/marginEurope.xls

- Taxes paid by captives in the above sample represent US\$300m, which leads to an effective tax rate of 15%. Comparing this effective tax rate with that of European commercial insurers (12.1%), it is apparent that captives' corporate income tax liabilities are in line with those paid by the European commercial insurance markets.

Source

www.stern.nyu.edu/~adamodar/pc/datasets/taxrateEurope.xls

- Comparing the captives' net assets on gross written premium ratio (1.40) with the book value to sales ratio of European commercial insurers (1.25), it is apparent that captives are not excessively capitalised compared to the European commercial insurance markets. A slightly higher ratio for captives compared to commercial insurers is justified by a lower diversification of risks, which implies higher regulatory capital requirements.

Source

<http://www.stern.nyu.edu/~adamodar/pc/datasets/taxrateEurope.xls>

2.2. Domicile Analysis of Benchmarking Sample

	% of the 462 captives
European Domiciles	53%
US Domiciles	8%
Rest of the World (Bermuda, Guernsey, Singapore...)	39%
	100%

The table above shows that EU-parented captives are mostly domiciled in European countries, such as Luxembourg, Ireland, Sweden, Germany, Netherlands, and Malta.

Due to insurance regulations in some countries (e.g. USA or some Asian countries), it is not possible to underwrite local risks with only a European captive. Consequently, some EU-parented captives are domiciled in the USA (mainly Vermont) or other jurisdictions globally (such as Singapore) to access local markets.

2.3. TOP Sectors Industry Analysis

Sector	% of the 462 captives
Industrial Companies	47%
	10%
	10%
	10%
	7%
	6%
	4%
	17%
	11%
	8%
Construction Services	6%

The above analysis shows that EU-parented captives are created mainly by industrial groups.

2.4. TOP 10 Lines of Business Analysis

Underwritten Line of Business	% of the 462 captives
Property	22%
General/Public Liability	15%
Marine	10%
Auto Insurance	5%
Workers' Compensation	5%
Professional Indemnity	5%
Employers' Liability	4%
Crime/Fidelity	4%
Terrorism	3%
Product Liability	3%
Construction Services	6%

The lines of business clearly reflect that captives are used in the same way as open market insurance, with Property, Liability and Marine constituting around half the captive business.

Other lines of business also reflect the fact that captives can help in covering critical risks of multinational groups when an appropriate scope of coverage may not be available from traditional commercial insurance products or at acceptable prices. Professional Indemnity, Employer's Liability, Crime and Product Liability / Product Recall are prime examples of this.

3. DEMONSTRATING RISK MANAGEMENT VALUE

FERMA believes by using the data, examples and explanations provided in this document, combined with compliance with a majority of the principles and best practices described below, a multinational group will be able to demonstrate that its captive fulfils a genuine risk management purpose and so should not be regarded as a tax avoidance vehicle by the respective tax authorities.

The following recommendations should be seen as a set of examples and meaningful principles, not a comprehensive checklist of documentation to be reported.

3.1. Commercial Rationale

Documentation that justifies the commercial rationale of forming or continuing a captive as a viable risk management tool includes some elements of the following list or any other demonstration of business rationale by the captive owner.

- a) Analysis showing how the TCOR captive framework can reduce the TCOR for its parent group.
- b) Total premium statement showing how the captive framework can save costs for its parent group by reducing total premiums paid outside the group, avoiding numerous local policies and potential duplications, accessing reinsurance and/or specialty capacity more directly, etc.
- c) Risk bearing capacity analysis showing how the captive framework can add value to local subsidiaries by reducing deductibles for local operations against the optimal risk retention level determined at group level, or against significant deductibles imposed by the insurance market.
- d) Analysis explaining why the risk could not be retained on the balance sheet - financial, legal, International Association of Insurance Supervisors guidance papers, cross border constraints, foreign exchange, etc.
- e) Demonstration that standard insurance products in

Proposed recommendations can be divided into three main dimensions, each corresponding to the key questions of interpretation that have arisen:

1. Commercial rationale
2. Substance and governance
3. Transfer pricing (premium setting process)

the marketplace provide insufficient coverage against the group needs and that there is added value to the business in building extended coverage.

- f) Demonstration that local insurance available to subsidiaries in their marketplace would be costlier at similar terms and conditions than the allocated cost resulting from the group captive programme.
- g) Demonstration that premiums flowing into the captive are determined according to "arm's length" principles and collected from numerous countries where the group has operations on a risk-based methodology.
- h) Revenue statements showing how the captive framework enables the group to generate additional sources of revenues.
- i) Analysis showing why insurance is utilised from a captive framework, and not from the traditional insurance market, for business facilitation purposes vs. risk transfer needs, for instance for Transport or Trade Credit insurance.
- j) Analysis showing how the captive framework enables the group to reinforce its control over the risk exposures and loss experience, develop better risk prevention programmes, reduce claims administration expenses and commissions, etc.

3.2. Substance and Governance

Documentation intended to justify the appropriateness of the substance of a captive framework includes some elements of the following:

a) The captive's Board of Directors meets in person and within the captive jurisdiction at least twice a year.

b) The captive's Board of Directors comprises a minimum of three persons, of which at least one Director is resident or has his/her main place of work within the captive jurisdiction.

c) There is a clear rationale for the choice of either own personnel or third party service providers, for example professional captive manager, claims adjusters and actuaries etc.). The presence or not of employees on the payroll is based on consideration of the volume of underwriting and claims activities, indicating whether the workload would justify the hiring of permanent staff. Two factors should be considered:

1. Number of insurance/reinsurance contracts.

2. Volume and complexity of claims activities unless outsourced to a professional third party claims administrator (TPA).

It is generally considered uneconomic for a captive to hire a full-time employee instead of using the services of a third party captive manager if the captive requires less than 1000 hours of insurance/reinsurance technical activities per financial year (contract and claims management time).

d) The captive has an underwriting committee or an underwriting function that makes underwriting decisions and monitors underwriting performance locally in the captive jurisdiction.

e) All key functions including the Directors of the captive require pre-approval based on fit and proper standards from the local insurance regulator in the captive jurisdiction.

f) The captive's shareholding requires pre-approval based on fit and proper standards from the local insurance regulator in the captive jurisdiction.

g) The captive is subject to a corporate governance code (or equivalent regulation) in the captive jurisdiction.

h) The captive is subject to a "risk-based" insurance regulatory regime in its jurisdiction, in line with the Insurance Core Principles of the International Association of Insurance Supervisors, or to full Solvency II regulations or equivalent regime.

i) The captive performs regular technical and financial reporting in full transparency to the local insurance regulator in the captive jurisdiction.

j) Statutory audit services are provided by reputable audit firms in the captive jurisdiction.

k) The captive engages local resources, either as third party professional captive managers, or as employees, with relevant experience, skills and capacity for underwriting support, accounting, company secretarial, local compliance and regulatory reporting.

Specific additional rules that captives must comply with in EU domiciles as they are regulated under the Solvency II regime:

- The captive has four key functions (risk management, actuarial, compliance and internal audit). These roles are pre-approved by the local regulator and generally performed by outsourced service providers and individuals with the appropriate skills and experience.

- An actuarial opinion on technical provisions is required for the Board, and is prepared by the actuarial function annually.

The actuarial function is also required to provide an opinion on underwriting policy, reinsurance, solvency capital requirements and Own Risk and Solvency Assessment Report (ORSA) annually.

3.3. Transfer Pricing (premium setting process)

Documentation that can show the appropriateness of the pricing of a captive's underwriting includes some of the following:

a) For a captive acting as a direct insurer:

- Documented and transparent premium setting process.
- Market quotes from third party insurance or reinsurance companies, or benchmarking analysis, in respect of the insurable risks, then adjusted by appropriate factors to come up with a comparable price.
- Model-based technical premium using standard actuarial methodologies based on loss history and/or exposure measures and/or cost of capital.

b) For a captive acting as a reinsurer:

- Evidence that reinsurance pricing follows the fronting insurer's pricing and/or the pricing from other participants in the (re)insurance programme in which the captive participates.
- Market quotes from third party (re)insurance companies, or benchmarking analysis, in respect of the insurable risks.
- Model-based technical premium using standard actuarial methodologies based on loss history and/or exposure measures and/or cost of capital.

c) For the subsidiaries:

- Documented and transparent premium allocation model based on type of activity, legal environment, exposure measure (e.g. turnover, insured values, payroll, and number of vehicles...) and loss history if available.

ANNEX: CASE STUDIES PRACTICAL EXAMPLES

This section provides concrete and practical examples that show how a multinational can use a captive successfully to optimise its overall risk management and risk financing process.

- Example 1: Captive utilised as a risk pooling entity.
- Example 2: Professional Indemnity exposure with contractual obligation to provide evidence of insurance to third parties through a captive.
- Example 3: Captive providing direct access to specialty reinsurance markets.

- Example 4: Captive providing insurance to customers in the manufacturing industry.

Each example describes:

- Background about the risk issues faced by the multinational organisation.
- Alternatives and potential solutions which have been considered and finally implemented.
- Outcome and key benefits achieved by the organisation.

EXAMPLE 1 - Captive utilised as a risk pooling entity

Background and risk management issues

A multinational manufacturing group has a global insurance programme with a large policy deductible to reduce insurance costs. This group's business philosophy grants autonomy to its business units. Those smaller subsidiaries are based in different countries around the world. Both the group and its subsidiaries felt that the high deductible envisaged at group level to reduce the cost of risk left the business units too financially exposed.

A stress testing study showed that a single large loss could bankrupt some of the smaller entities and would require the parent to invest more capital in the absence of insurance. In addition, management performance was based on the local entity's profitability and in the event of a large loss without some form of insurance, the local bonus pool would have been reduced or lost completely as the local retained earnings would have been eroded.

The group was looking to improve its overall risk management process and consolidate operational risks from each of the subsidiaries. The group is engaged in many risk prevention programmes and wanted to provide an effective risk management process with the necessary tools to implement such programmes.

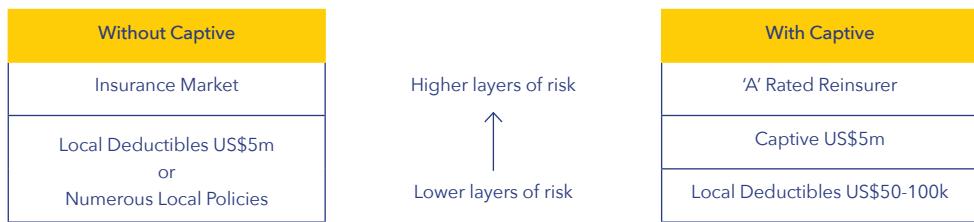
Alternatives considered and implemented solution

The group could have decided to purchase the insurance in the local market for each entity. However, this would have been very expensive and would not have provided sufficient flexibility to manage and centralise retentions, pricing, risk engineering and claims management.

In order to manage the overall insurance exposure and the TCOR, the Group decided that a captive insurance arrangement was the most appropriate solution, where its role would be to cover risks from all group entities before accessing the commercial reinsurance market for catastrophic loss coverage.

The group had excellent governance and controls in place, and the maximum single loss had not exceeded US\$5m in the previous 10 years. Consequently, a risk bearing capacity analysis performed by third party actuaries recommended a captive insurance arrangement where the first US\$5m, each and every loss and in the annual aggregate, would be retained within the captive. Local deductibles for group entities ranged from US\$50 000 to US\$100 000 each and every loss, depending on financial strength and claims experience. Additionally, catastrophic loss exposure above US\$5m could be reinsured to third party 'A' rated reinsurance companies.

This arrangement provided the opportunity to pool the risk of the individual subsidiaries and regions, many of which had varying needs in terms of retention and limits. The group has oversight of the overall group risk and determines the policy for the whole group.



The captive issued up to four insurance policies in each of the 21 countries in which the group had local operations. Renewal date was January 1st each year for all policies. Historically the group incurred on average 350 claims annually and it used the services of a third-party claims adjuster to monitor and report claims to the captive on a monthly basis. A third-party professional captive manager in the captive jurisdiction was engaged to prepare underwriting information and undertake the premium billing and collection to/from the insured subsidiaries, as well as general accounting, management and regulatory reporting, and compliance activities.

All decision making and income generating activities are supported by the captive underwriting committee which meets three times a year within the captive jurisdiction. One meeting focuses on renewal discussion and decision making, while the two other meetings deal with underwriting performance monitoring. All insurance and operational risks are directed and monitored by the risk management function of the captive, which reports to the Board of Directors at least twice per year. The capital requirement was derived using the Solvency II regulation applicable in the captive jurisdiction (so-called Standard Model of Pillar I of Solvency II), and the Board set a solvency ratio target of 120% on regulatory capital requirements.

Premiums paid by the group subsidiaries to the captive are set on an arms-length basis. They are correctly priced by a combination of comparable market pricing benchmarking, and modelling performed by qualified actuaries using transparent methodologies based on risk exposure and historical loss experience.

Outcome and key benefits

The captive enabled the group to avoid buying excessive insurance in the market while providing additional deductible buy-down insurance to the smaller entities to ensure they were financially protected to a level that they could tolerate.

If the smaller entities had opted to purchase more local insurance (to cover the global policy deductible), the group's consolidated insurance costs would have increased significantly.

If the group had opted to invest more capital upfront in every subsidiary, it would have been inefficient, increased cost of capital for the group and eroded return on capital ratios. The additional capital was not needed to run the subsidiaries' operations and would have only been used for rare catastrophic loss events.

If all local deductibles had been increased to the level of the group policy deductible, it would have led to increased risk and volatility for the local subsidiaries, many of which are operating in non-regulated environments. There would also have been less transparency, compliance and control over risk from a group risk management perspective.

The captive arrangement also allowed risk management to gather central loss information and then to tailor subsidiary-specific risk prevention initiatives to improve the loss experience.

Thanks to good risk management practices, the group can take advantage of mutualising internally its first layers of risks rather than subscribing on the insurance market at higher costs.

EXAMPLE 2 - Professional Indemnity exposure with contractual obligation to provide evidence of insurance to third parties through a captive

Background and risk management issues

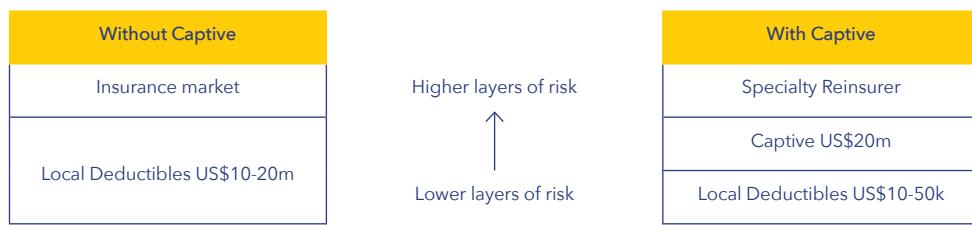
A top tier financial services multinational group has subsidiaries in many countries. The group has potentially significant Professional Indemnity (PI) exposure. Additionally, the group has contractual obligations to provide evidence of insurance cover for PI risks to its customers and to the local regulators.

Alternatives considered and implemented solution

Cover was available on the commercial market but only with the substantial deductible of US\$5m per loss. The group decided that a captive insurance company was the best option. Its role as a primary insurer would be to cover risks in the EU member states where the firm has operations. This solution provided the opportunity for the group to meet not only the contractual obligation, but

also enabled the captive to provide a tailored insurance policy wording and manage claims for the group entities.

As a result, the group had oversight of the overall group PI risk and could determine the policy coverage for the whole group. It had excellent governance and controls in place and the maximum single loss had not exceeded US\$20m in the previous 10 years. Consequently, the Group decided to retain the first US\$20m each and every loss and in the annual aggregate within the captive. Excess exposure was reinsurance to third party reinsurance companies at competitive rates and conditions. The captive operated on a direct insurance basis for most countries, but sometimes also on a reinsurance basis if "rated" insurance paper was required. In this case a third-party insurer in the local market with a good credit rating was used to issue the policy and the risk was reinsurance to the captive, so that the insurer's net risk retention was minimal.



The captive issued up to three policies in each of the 19 countries in which the parent company had local operations. Renewal date was July 1st each year. The company offered varying deductibles ranging from €10 000 to €50 000 for each of the insureds and on average will incur more than 500 claims annually. The group engaged a third party claims adjuster to monitor and report claims to the captive on a monthly basis. A third party professional captive manager in the captive jurisdiction was engaged to prepare underwriting information, undertake the premium billing and collection to/from the insured subsidiaries, as well as general accounting, management, and regulatory reporting and compliance activities.

All income generating activities related to the captive insurance programme are supported by the captive

underwriting committee with decision making at the captive local level within the captive jurisdiction. Meetings take place quarterly within the captive jurisdiction. All insurance and operational risks are directed and monitored by the risk management function of the captive which reported to the Board at least twice per year. The capital requirement was derived using the risk-based model imposed by insurance regulation in the captive jurisdiction, and the Board set a solvency ratio target of 130% on regulatory capital requirements to demonstrate the financial strength of the captive when dealing with commercial reinsurers.

Premiums paid by the local operations to the captive were set on an arms-length basis and correctly priced by qualified actuaries using transparent methodologies based on risk exposure and historical loss experience.

Outcome and key benefits

The captive enabled the group to provide, at acceptable economic conditions, evidence of insurance to meet contractual arrangements with third parties, statutory obligations and risk management decisions on risk transfer.

The group concluded that the use of a captive as part of the group risk management framework added significant business value, as opposed to purchasing cover from the insurance market, in terms of managing TCOR, administrative and operational issues, and overall control.

Without a captive, the group could not provide same level of indemnities to its customers in case of errors & omissions, or it would have incurred significant additional cost to purchase insurance from third party insurers.

The group would have also lost control of claims management, which could be highly sensitive in professional indemnity matters. It would have exposed the group to adverse reputational risks that it was keen to avoid. The manner and timeliness of claim handling and settling were very important to the group.

The captive has also facilitated access to specialty reinsurers in the marketplace which increased the capacity of the coverage and ensured greater competition and better pricing for insured risks. This would not have been available to the group via the traditional insurance market.

As the primary insurer, the captive has been able to tailor its policy language, manage claims and direct subsequent reinsurance, so that the group attains the widest possible coverage and limits exclusions, in line with the specific nature of the group's products and services.

At the time of the captive was set up, the group undertook a qualitative domicile comparison study. It wanted to locate the captive in a jurisdiction where it could write insurance directly across all EU member states that the group had operations; that it could access a workforce with the necessary skills and experience, and that there was a dedicated and proportionate regulatory framework for captives.

EXAMPLE 3 - Captive providing direct access to specialty reinsurance markets

Background and risk management issues

A multinational group in the energy industry has high value plants in many countries worldwide with potentially significant Property Damage and Business Interruption CATastrophic event (PDBI/CAT) exposures. Due to the size and specificities of the risk exposures, there is a lack of capacity and efficient pricing in the traditional insurance markets. High levels of capacity exist to adequately protect the group against such risks, but only via specialised reinsurance markets.

Alternatives considered and implemented solution

In order to manage its PDBI/CAT exposures and the TCOR, the group decided that a captive reinsurance company was the best option. The captive's role as a reinsurer would facilitate access to the specialty (re)insurer OIL⁴ for well rated capacity which was not available in the commercial market.

The group had oversight of overall group risk and determined the global insurance policy for the group. There was an overall limit of €2bn with the policy fronted by an 'A' rated EU-resident insurer, subject to Solvency II or equivalent regime. A risk-bearing capacity study by third party actuaries had recommended placement of that €19m excess of €1m with a reinsurance captive established in an EU domicile with excess risks of €20m and above retroceded to third party reinsurers. OIL could provide that additional, specialist capacity for the PDBI/CAT exposure.

All income generating activities are supported by the captive underwriting committee with decision making at a captive local level within the captive jurisdiction. The captive issued one reinsurance policy to the 'A' rated fronting insurer and entered into one retrocession policy with OIL. Claims are managed by the fronting insurer who provides the captive with quarterly statements of account, detailing premiums and claims due, so that two underwriting committee meetings per year are sufficient. All insurance and operational risks are directed

and monitored by the risk management function of the captive which reports to the Board at least twice a year. The capital requirement is derived using the Solvency II Standard Model and the Board of Directors set a solvency ratio target of 180% on regulatory capital requirements considering the low frequency / high severity nature of the underlying risk.

Outcome and key benefits

The captive has facilitated access to specialty reinsurance in the form of a retrocession from OIL for the PDBI/CAT risk element that would not have been possible otherwise. This strategy has increased the amount of cover available to the group and provided greater competition and better pricing from the market. This would not have been available to the group by using only the traditional insurance market.

As natural catastrophes become more frequent and spread to unprepared locations, the insurance market may begin to harden its pricing. Having a captive as part of the group risk management framework provides the group with access to coverage at a more stable cost and prepares the group for a real "worst-case scenario".

⁴ Oil Insurance Limited (OIL) is an A-rated Bermuda-based mutual insurance company with 50+ members who are engaged in energy operations. Founded in 1972 by 16 oil companies, it provides its members with up to US\$400 million per occurrence capacity.

EXAMPLE 4 - Captive providing insurance to customers in the manufacturing industry

Background and risk management issues

Multinational groups such as car or electrical equipment manufacturers increasingly invest in the quality of their products by reinforcing their production processes and their R&D activities. Consequently, they have confidence in their products, and are often willing to propose extended warranty options to their customers. Doing so they have a better control over product costs as they handle the whole lifecycle process from production to repair, and they increase customers' protection and loyalty to their products.

In this example, a multinational car manufacturer produces cars globally and has put the priority on high quality and security. With a total of 4 million cars produced in 2015, the group is a leader in the market and invests millions of dollars in innovation and services. The group relies on its strategy and is willing to offer its customers 3-year extended warranty contracts under which it covers motor damage, as well as mechanical or electrical defaults.

Alternatives considered and implemented solution

The group initially envisaged partnering with a commercial insurance company to place such risks in the market. But traditional insurers generally charge higher premiums for such products than it effectively costs a manufacturer to provide the services, thanks to cost of the insurer's infrastructure (sales network, policy administration, dedicated claims management processes, numerous types of insurance products to handle, customers' data management, etc.). It would also

introduce a third party into the relationship between the car manufacturer and its customers, which is not aligned with the strategy pursued by the group.

Since such extended warranty services is an integral part of the commercial strategy of the group, it was critical to offer competitive pricing. The group therefore decided to self-insure the corresponding risk by setting up a captive insurance company to act as a primary insurer, and to issue extended warranty insurance contracts to its customers at the time they bought the car. This strategy also enables the group to have oversight of the exact coverage provided, its conditions, claims process and the covered countries.

All income generating activities are supported by the captive underwriting committee with decision making at the captive local level within the captive jurisdiction. The underwriting committee determines the scope of coverage, the pricing strategy and the in-scope countries, and it regularly reviews underwriting performance to adjust pricing or coverage as needed. All insurance and operational risks are directed and monitored by the risk management function of the captive who reports to the Board at least twice per year. The regulatory capital requirement is derived using the Solvency II Standard Model.

Outcome and key benefits

This programme created a new source of revenue for the group, helped increase customers' protection and loyalty, and provided the group with full ownership of the lifecycle of the product.



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