



**FERMA information paper to OECD
in order to propose captive (re)insurance guidelines
to national tax authorities**

June 2017

As OECD members are moving towards the implementation stage of the BEPS actions proposed in 2015, certain questions of interpretation have arisen for owners of captive insurance and reinsurance companies.

In the interests of consistent implementation and legal certainty for both tax administrations and taxpayers, FERMA is suggesting guidelines to address captive insurance arrangements.

The objective of this paper is to present to the OECD a draft guidance which would help OECD and the national tax authorities to better comprehend the concept of captive insurance and reinsurance companies. It is expected that such an understanding would result in a proportionate level of scrutiny, by the respective tax authorities, as regards captive structures and a corresponding reduction in the requests for information when assessing multinational companies using captives¹, including their Country-by-Country reporting.

Please note this FERMA paper represents the FERMA membership comments and focuses on European resident multinational companies that utilise captives, wherever domiciled, as part of their group risk management strategy.

¹ For 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>



Executive Summary

This information paper reflects why and how risk management practitioners are using captives in their daily activities as one of their risk management tools.

We'll explain in details what is the Role of the Risk Manager in an EU based Multinational Group and why using a captive (re)insurance vehicle **(1)**.

We will give some statistics about captives and key figures **(2)** in order to demonstrate that the main financial ratios of the captive insurance industry are in line with the traditional insurance market.

In conclusion, in order to achieve a proportionate level of scrutiny by the respective tax authorities, FERMA proposes guidelines for the commercial rationale, the substance and governance, and the transfer pricing of captive structures to OECD and the national tax authorities **(3)**.

In annex, you'll find some practical examples and application of captive arrangements in multinational groups.



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

Abstract

Any kind of business is surrounded by and generates risks that can threaten the profitability or even the viability of any given company. The Risk Manager's role is in short to identify, assess and analyse those risks in order to define and implement the relevant risk management strategy aimed at mitigating the exposure for his/her company and at supporting its strategic objectives.

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

Within the context of the latter, the Risk Manager may use various tools to optimize the Total Cost of Risk² for his/her organization - of which widely known and efficient ones are (re)insurance transfer to third party insurance companies and self-financing solutions through captive (re)insurance companies.

A captive is an efficient risk management tool, as it is capable of supporting its entire organization to expand the scope of available insurance coverages, manage Total Cost of Risk, consolidate and mutualize group risks, and provide leverage and increased negotiation platform in discussions with the traditional insurance markets.

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 certain insurable risks of their operations Ref: FERMA's latest European Risk and Insurance Report³.

Before reaching the conclusion of using an alternative risk transfer option, like a captive insurance or reinsurance company, the risk manager of a multinational will normally go through a series of steps embedded in an Enterprise Risk Management (ERM) approach.

² 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 organization'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>

³ See page 18 of the FERMA European Risk & Insurance Report (October 2016) available at http://www.ferma.eu/app/uploads/2016/09/FERMA-ERIR-2016_VF_26_10_2016.pdf



1.1. What is 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 multinational group. It combines both likelihood and impact levels as well as financial exposure – nationally in country as well as 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** without any further actions.
- **Risk Avoidance** through, for instance, by 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** strategy: for instance, prevention and protection measures will be implemented to reduce the likelihood of occurrence and maintain the level of risk at an acceptable level.
- **Risk Transfer / Financing**: at the end of the risk management process, the risk transfer and financing options will be commonly considered for the residual part of the risk that cannot be avoided or for which the multinational group has no appetite or financial capabilities to retain. This will be primarily suitable for categories of risk with a rather low likelihood but a high-level impact from a commercial, economic and/or financial perspective.

Obviously, 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. Insurance cover with a third-party insurer is the most widely known. The risk manager will select the appropriate risk financing solution based on the Total Cost Of Risk (TCOR), the extent and the capacity of the proposed coverage (including policy wording) as well as the level of services (expertise available in case of a claim, loss control advices, etc.).

Along with the conventional insurance market, there are also alternative risk financing solutions to transfer/ share the financial impact of an event. When insurance markets do not satisfactorily respond to certain risks, the risk manager can instead use, for example either 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 to the employees, investors, and customers of the multinational company but also to the wider community in terms of reducing the occurrence of damaging events (fire/explosions, injuries, pollutions, fraud, errors & omissions, etc.).

It will also assist in arranging adequate financial protection in case of occurrence of events despite prevention measures, and minimising the cost of those protections to maintain competitiveness towards the customers.



1.2. Why using a captive (re)insurance vehicle? Risk management process and methods that may lead to a decision of using 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 2015⁴, 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 would typically operate on either an insurance or reinsurance basis, depending on the risks they cover and the location of risks, on the legal and regulatory environment, and on the volume of business.

An insurance captive will issue insurance policies directly to the operating entities of its parent group and will manage and pay back related claims (often with the support of a specialised Third Party Claims Administrator) directly to the insured entity.

A reinsurance captive will underwrite a share of the insurance risk of the multinational group by partnering with a commercial third party insurer that will issue the local insurance policies to the operating entities. The third-party insurer will also manage the related claims and associated processes.

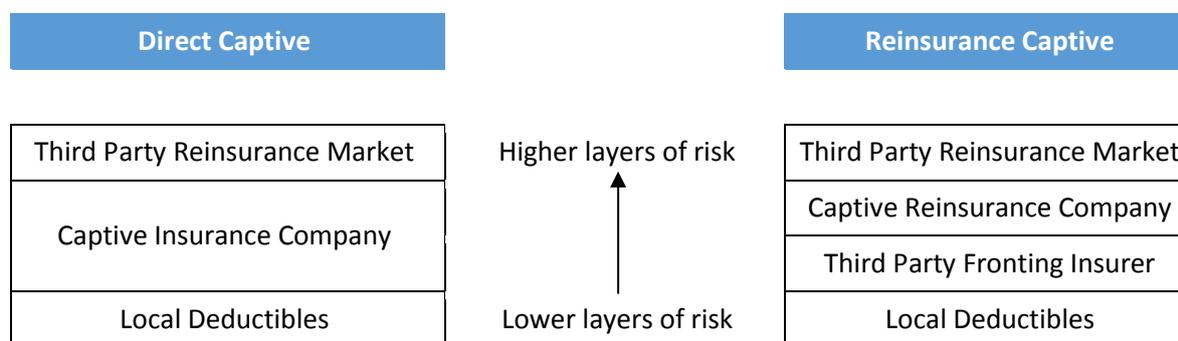
In such a reinsurance framework, there is no transaction between the operating entities and the captive who “follows the fortune” of the so called “fronting” insurer.

When deciding to use a captive, the parent company of the multinational group would need to have sufficient financial strength to support the operating costs and regulatory capital requirements, as well as the potential underwriting losses.

⁴ 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>



Typical captive structures are depicted in the two tables below:



1.2.1.1. Why multinational organizations use a captive?

Given the above definition the decision to set up and use a captive is linked to the specificities of the multinational organization with regards to its geographical scope, its business activities, its size, related risk profile and risk management strategy.

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

1.2.1.2. Re(insurance) Basics

We gather under this category the technical elements relating to (re)insurance covers and pricing structure as well as to improvements in the traditional insurance purchasing process.

In short, using a captive will allow an organization to increase the overall efficiency of its risk management and financing process by jointly ensuring more stability (through mitigation of insurance market pricing and capacity volatility) and flexibility (in responding to changes in risk retention and risk transfer strategies) to its insurance covers.

- **Reduction or stabilization of the Total Cost of Risk**

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

- **Direct access to worldwide reinsurers**

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

Following the same logic, it may also allow multinational corporations to access government pools (such as GAREAT in France, Pool Re in the UK, etc.).

- **Mutualisation and Non-Correlated Risks**

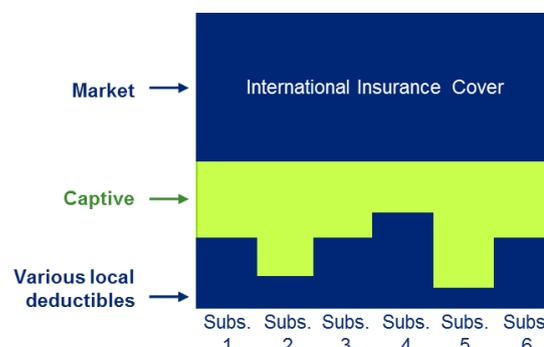
A captive is an efficient tool to access the very basic root of insurance which is mutualisation.



Combining non-correlated risk retentions (e.g. Property, Transport, Liability, etc.) and gathering insurance covers from a diversified geographical scope will improve the diversification and mutualisation effect within a multinational corporation, thus additional positive impacts.

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

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



- **Negotiation tool**

According to its central position and global view on a given organization's losses, a captive can easily be used as a central underwriting and (retro)cession unit. One of the greatest benefit of owning a captive is probably using it as a central and global vehicle to leverage the global negotiation power towards brokers and (re)insurers.

1.2.2. Risk Control

This second dimension is mainly about the role of an efficient risk financing tool such as a captive in the 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, and 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 group to 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 may add to its group is the ability to provide coverage for risks that are emerging and not yet well known by the insurance market (e.g. cyber risk exposure) or because of their very specific nature and potential impact (nuclear, aircraft, natural disasters, etc.).

- **Improved claims handling**

A captive provides opportunities to improve claims handling policies and procedures, allowing for example 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 given multinational group, a captive can be used as a central unit for insurance data collection coming from all the said group entities (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 an operational level and increase 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 (mitigating marketplace pricing and capacity volatility)
- Obtain coverage for risks traditionally not readily available or economically feasible in the commercial markets
- Provide flexibility in responding to changes in risk retention and risk transfer strategies
- Build a better awareness of the cost of risk and loss control with central accountability for risk management
- Reduce and/or smooth the total cost of risk including administration costs
- Access reinsurance markets
- Maintain control over claims
- Obtain access to government pools (e.g. terrorism insurance such as GAREAT, Pool Re etc.)

1.2.3. Why other risk treatment alternatives may not be satisfactory?

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

- | | |
|--|---|
| <p>i. Conventional Insurance</p> <ul style="list-style-type: none"> • High premiums • High deductibles • Numerous exclusions • Short term coverage • Volatility in total cost of risk • Unsatisfactory claims management process | <p>ii. Bonds and financial instruments</p> <ul style="list-style-type: none"> • 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. Cost of products would increase and/or financial protection for customers and communities in case of occurrence of an event would be deteriorated.



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

In this respect, captives form an integral part of the multinational organisations risk management strategy and is generally accepted by the worldwide insurance markets as it offers a fully regulated environment to risk retention / risk sharing strategies.



1.2.4. Choice of the domicile: main drivers

The decision about the location of a captive insurance or reinsurance company will be based on multiple drivers.

First, the [risk management objectives](#) of the organisation, its own and specific risk profile, will drive practical considerations about the type, quantity, and geography of risks and whether the captive is to write direct or provide reinsurance. Different forms of captives exist and some domiciles have developed specific knowledge over certain types (e.g. Protected Cell Companies).

Depending on that risk profile and insurance needs, the [insurance regulatory requirements](#) of source jurisdictions will equally be assessed to fit the organisation's risk transfer requirements (e.g. 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](#) experienced with captives' business model such as captive managers, actuaries, auditors, lawyers and third party loss adjusters to support the captive activities is another key driver behind the selection of an appropriate jurisdiction for establishing a captive.

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 towards captives and (re)insurance.



2. KEY FIGURES AND STATISTICS ABOUT CAPTIVES

Abstract

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.

Insurance and reinsurance being highly regulated businesses under the supervision of strong governmental bodies and a 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 could not consequently be drastically different from traditional commercial insurers, except for their lower level of diversification.

The following benchmarking analysis is based on a sample of 2,256 captives managed by Marsh and Aon worldwide, out of a total market of 6,800 captives, of which 462 captives were isolated as EU-parented captive residents worldwide. (Reference date is 31st December 2015).



Scope	Sample of 462 captives
UNDERWRITING	<i>Figures in USD</i>
<i>Gross Premium Written</i>	12 bn
<i>Net Premiums</i>	9.9 bn
<i>Net Claims</i>	7.1 bn
PROFITABILITY	
<i>Net Profit Before Tax (NPBT)</i>	1.5 bn
<i>NPBT (including equalization reserves)</i>	1.78 bn
TAXES PAID	
<i>Tax on profit</i>	300 m
SOLVENCY	
<i>Net Assets</i>	16.8 bn

Scope	Sample of 462 captives	European insurance industry benchmark (property and casualty)
UNDERWRITING		
<i>Loss ratio (Net Claims/ Net Premiums)</i>	72%	n/a
PROFITABILITY		
<i>Net Profit Before Tax (NPBT)/ Gross Written Premiums</i>	12.2%	15.41%
<i>NPBT (including equalization reserves)/ Gross Written Premiums</i>	14.8%	n/a
TAXES PAID		
<i>Tax on profit/ NPBT</i>	18%	12.12%
<i>Tax on profit/ NPBT (including equalization reserves)</i>	15%	n/a
SOLVENCY		
<i>Net Assets/ GWP</i>	1.40	1.25

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

These figures show that in respect of the 462 captives owned by European resident multinational companies, US\$10bn net premiums have been underwritten and US\$7bn net claims have been paid back to the multinational group's operating entities (loss ratio of 72%).

The net profit before tax in total for these captives is 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 when covering large industrial risks because the "Law of Large Numbers" does not apply for these risks in the same way as with personal/household insurance or car insurance.



Natural hazard is a prime example of this, where losses when they occur can only be financed by collecting and setting aside premiums over a long period of time.

Aerospace risks, nuclear risks, pollution risks, surety risks, non-proportional reinsurance etc. have similar characteristics. Consequently, countries like Belgium, France, Germany, Luxembourg, or Sweden have implemented such catastrophe/equalisation reserve requirements for a wide or narrower spectrum of risks depending on the country. In such case, net profit can only be assessed over a multiyear period.

2.1. Comparison with similar figures for 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 (**15.41%**), it is apparent that captives are not making excessive profit compared to the European commercial insurance markets.
 Source - <http://www.stern.nyu.edu/~adamodar/pc/datasets/marginEurope.xls>
- Taxes paid by captives in the above 462 captives represent US\$300m which lead to an **effective tax rate** of **15%**. Comparing this effective tax rate with the effective tax rate of European commercial insurers (**12.12 %**), it is apparent that captives' corporate income tax liabilities are very much in line with those paid by the European commercial insurance markets.
 Source - <http://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 capitalized compared to the European commercial insurance markets. A slightly higher ratio for captives is justified by a lower diversification of risks as compared to commercial insurers, 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%
USA 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 in all jurisdictions worldwide with only a European captive. Consequently, some EU parented captives are domiciled in the US (mainly Vermont) or other jurisdictions globally (such as Singapore) to access local markets.

2.3. TOP 5 Industry Analysis

Sector	% of the 462 captives
Industrial companies	47%
<i>of which</i> Manufacturing	10%
Transport & Logistics	10%
Energy	10%
Pharma & Chemicals	7%
Food & Agribusiness	6%
Natural Resources	4%
Financial Institutions	17%
Business & Professional Services	11%
Retail & Wholesale Trade	8%
Construction Services	6%

Based on the above, it is apparent that EU parented captives are mainly created by industrial groups (e.g. manufacturing, transport, energy, pharmaceuticals companies, food system, and natural resources).



2.4. TOP 10 Line 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%

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 of the captive business.

Other lines of business also reflect the fact that captives can help in covering critical risks of multinational groups where an appropriate scope of coverage might not be available from “standard” commercial insurance products or at prohibitive prices. Professional Indemnity, Employers Liability, Crime, or Product Liability / Product Recall are prime examples of this.



3. PROPOSAL FOR GUIDELINES TO NATIONAL TAX AUTHORITIES

It is the opinion of FERMA, given the data, examples and explanations about captives provided in this document, that the compliance of a captive (re)insurance entity with a majority of the principles and best practices described below should ensure that it is not considered as a tax avoidance vehicle by the respective tax authorities.

FERMA would like to highlight that the following recommendations should be seen as a set of examples and meaningful principles aimed at supporting local tax authorities in their assessment process. FERMA's aim is not about providing a comprehensive checklist of documentation to be reported.

Proposed recommendations can be divided into three main dimensions, each corresponding to the key questions of interpretation that have arisen over the past 12 months:

1. Commercial Rationale
2. Substance and Governance
3. Transfer Pricing (premium setting process)

3.1. Commercial Rationale

Documentation that would justify the commercial rationale of either 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) Total Cost of Risk ("TCOR") analysis showing how the captive framework can reduce 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 otherwise imposed by the insurance market.
- d) Analysis explaining why the risk could not be retained on balance sheet – financial, legal, IAIAS, cross border constraints, FX, etc.
- e) Justification that standard insurance products in the marketplace are providing insufficient coverage against the group needs and that there is business added value to build an extended coverage.
- f) Justification that local insurance available to subsidiaries in their marketplace would be costlier at similar terms & conditions than the allocated cost resulting from the group captive programme.



- g) Justification that premiums flowing in the captive framework 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 place, for business facilitation purposes (i.e. insurance as part of the business process 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 the loss experience, derive better risk prevention programmes, reduce claims administration expenses and commissions, etc.



3.2. Substance and Governance

Documentation that would justify the appropriateness of the substance of a captive framework includes some elements of the following or any other demonstration of substance by the captive owner.

- a) The captive Board of Directors meets in person and within the captive jurisdiction at least twice per year.
- b) The captive Board of Directors comprises a minimum of 3 persons, of which at least 1 Director is resident or has his/her main place of work within the captive jurisdiction.
- c) Rationale for the choice of either own personnel or third party service providers (e.g. professional captive manager, claims adjusters, actuaries, etc.). Presence or not of employees on the payroll is based on consideration of the volume of underwriting and claims activities, which may or may not require an amount of workload that justify the hiring of permanent staff. Two factors should be considered:
 - i. Number of insurance/reinsurance contracts.
 - ii. Volume and complexity of claims activities (unless outsourced to a professional third party claims administrator or 'TPA').

It is generally considered that it would not be economically justified for a captive to hire a full-time employee instead of procuring the services of a third-party captive manager if the captive requires less than 1,000 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 4 key functions (Risk Management, Actuarial, Compliance, and Internal Audit). These roles are pre-approved by the local regulator and generally performed by out-sourced service providers and individuals with the appropriate skills and experience.
- An Actuarial Opinion on Technical Provisions is required for the Board, and 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 would justify the appropriateness of the pricing of a captive framework 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 insurance/reinsurance programme in which the captive participates.
- Market quotes from third party insurance or reinsurance 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

Abstract

The purpose of this section is to provide you with concrete and practical examples about how a captive may be successfully utilised by a multinational organization to optimize its overall risk management and risk financing process.

- **Example 1:** Captive is utilised as a risk pooling entity.
- **Example 2:** Professional Indemnity exposure with contractual obligation to provide evidence of insurance to third parties.
- **Example 3:** Captive providing direct access to specialty reinsurance markets for specific industrial risks not available/inefficiently priced within traditional primary insurance market.
- **Example 4:** Captive providing insurance to customers in the manufacturing industry.

For each example, we follow the same structure:

- Background about the risk issues faced by the multinational organization.
- Alternatives and potential solutions which have been considered and finally implemented.
- Outcome and key benefits achieved by the organization from the utilisation of a captive entity.



EXAMPLE 1 - Captive is 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 has a business philosophy based on autonomy granted 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 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 a loss and no insurance. In addition, management performance was based on the local entity's profitability and in the event of a large loss the local bonus pool would have reduced or been lost completely as the local retained earnings would have been eroded without some form of insurance against potential volatile losses.

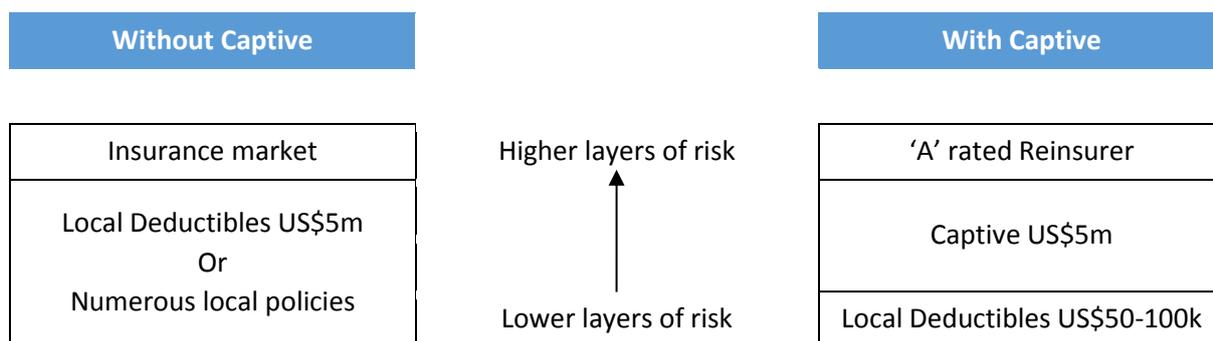
The group was looking to improve its overall risk management process and consolidate operational risks from each of the subsidiaries. The group is engaged in many risk prevention programmes and wanted to provide an effective risk management process with the necessary tools to implement such programmes.

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. This arrangement will provide the opportunity to pool the risk of the individual subsidiaries and regions, many of which will have varying needs in terms of retention and limits.

The Group will have oversight of the overall group risk and determine the policy for the whole group. It 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 had recommended to put in place a captive insurance arrangement where the first US\$5m, each and every loss and in the annual aggregate, were to be retained within the captive, local deductibles for group entities ranged from US\$50k to US\$100k each and every loss depending on financial strength and claims experience. Additionally, catastrophic loss exposure above US\$5m could be reinsured to a third party 'A' rated reinsurance companies in the marketplace.



The captive issued up to 4 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 engaged 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, 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 focussed on underwriting performance monitoring. All Insurance & operational risks are directed and monitored by the Risk Management Function of the captive who 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 had 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 and 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 third party insurance while providing additional deductible buy-down insurance to the smaller entities to ensure they were financially protected to a level that they could tolerate and withstand.

If the smaller entities had opted to purchase more local insurance (to in-fill the global group 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, would have increased cost of capital for the Group, and would have deteriorated return on capital ratios. Such higher amount of capital would not have been needed to run the subsidiaries’ operations and would have only been needed to face rare catastrophic loss events.



If all local deductibles would have 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 environment, and would have resulted in 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

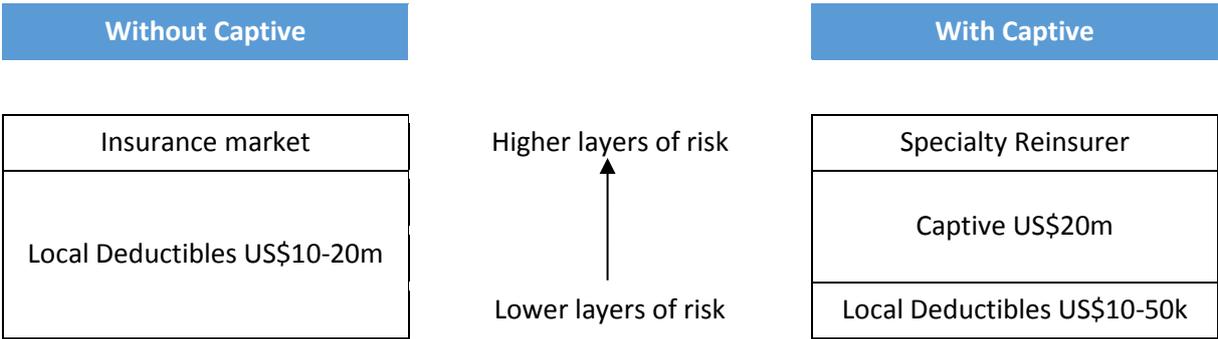
Background and Risk Management Issues

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

Alternatives Considered and Implemented Solution

The Group had approached the commercial insurance markets to buy PI insurance but cover was only available with a substantial deductible of US\$5m per loss. The Group decided that a captive insurance company was the best option, whereby 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 to meet not only the contractual obligations 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 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 reinsured 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 good credit rating was used to issue the policy and the risk was reinsured to the captive, so that the insurer’s net risk retention is minimal).



The captive issued up to 3 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. As such the Group engaged 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, 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 & operational risks are directed and monitored by the Risk Management Function of the captive who 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 had set a Solvency ratio target of 130% on regulatory capital requirements to demonstrate 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 facilitated the Group to provide, at acceptable economic conditions, evidence of insurance in order to meet contractual arrangements with third parties, statutory obligations, and risk management decisions on risk transfer.

The Group concluded that the utilisation of a captive as part of the group risk management framework added significantly business value, as opposed to purchasing cover from the insurance market, in terms of managing total cost of risk, 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 would have incurred significant additional cost if it had purchased 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 was 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 had been able to tailor its policy language, manage claims and direct subsequent reinsurance, to ensure the Group attained the widest possible coverage and limits exclusions, in line with the specificities of the Group’s products and services.

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



EXAMPLE 3 - Captive providing direct access to specialty reinsurance markets for specific industrial risks not available/inefficiently priced within traditional primary insurance market

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 total cost of risk (retained losses plus total premium plus related expenses) the Group decided that a captive reinsurance company was the best option, whereby its role as a reinsurer will facilitate the strategy of accessing the specialty reinsurer OIL⁵ for rated reinsurance capacity which is not available in the commercial market.

The Group had oversight of overall group risk and determined the policy for the Group. There is an overall limit of €2bn with the overall policy fronted by an 'A' rated EU resident insurer, subject to Solvency II or equivalent regime. A Risk Bearing Capacity study done by third party actuaries had determined that €19m excess of €1m should be placed with a reinsurance captive established in an EU domicile with excess risks of €20m and above being retroceded to third party reinsurers. OIL had been chosen so as to facilitate access to specialty reinsurance capacity which would be unavailable or financially inefficient in the commercial market.

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 due and claims due, so that two underwriting committee meetings per year is sufficient. All insurance & 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 capital requirement is derived using the Solvency II Standard Model and the Board of Directors had set a Solvency ratio target of 180% on regulatory capital requirements considering the low frequency / high severity of the underlying risk.

Outcome and Key Benefits

The captive has facilitated access to specialty reinsurance from OIL for the PDBI/CAT risk element not generally provided by the commercial insurance and reinsurance market. This strategy has increased the amount of cover available to the Group and provided greater competition and better pricing from

⁵ Oil Insurance Limited (OIL) is an 'A'-rated Bermuda-based mutual insurance company with 50+ members who are engaged in energy operations. It was founded in 1972 by 16 oil companies and it provides its members with up to US\$400 million per occurrence capacity.



the marketplace. This would not have been available to the Group if accessing only the traditional insurance market.

As natural catastrophes become more frequent and spread to unprepared locations, the environmental insurance market may begin to harden its pricing strategy.

Having a captive as part of the group risk management framework also provides the Group with access to coverage at a more stable cost and prepares the Group for a real “worst-case scenarios.”



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 more and more 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 propose to 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 are generally charge higher premium prices for such products than what it effectively costs a manufacturer to provide such services, due to the insurer's infrastructure costs (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 in the relationship between the car manufacturer and its customers which is not aligned with the strategy pursued by the Group.

Since providing such extended warranty services forms an integral part of the commercial strategy of the Group, it was critical to offer competitive pricing and 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 buy 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 determined the scope of coverage, the pricing strategy, the in-scope countries, and it regularly reviewed underwriting performance to potentially adjust pricing or coverage. All insurance & 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

Such framework generated a new source of revenues for the Group, helped increase customers' protection and loyalty, and provided the Group with full ownership on the lifecycle of the product.



Contact Person: Julien Bedhouche, FERMA EU Affairs Adviser, julien.bedhouche@ferma.eu

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