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Insurance & Risk Management News

CAPTIVE SURVEY 2017

Captives on the RISE

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An aerial photograph of the London skyline, featuring prominent buildings like The Shard and the Gherkin. Overlaid on the image are five colored squares, each containing text about insurance coverage. The squares are: a red square at the top left, a green square at the top center, a blue square on the right, a pink square on the left, and an orange square at the bottom right. The background shows a dense urban landscape with a mix of modern and traditional architecture under a cloudy sky.

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Captives on the rise

Commercial Risk Europe's Captive Survey

Captives have proved to be a remarkably resilient risk financing tool. The old accepted view had it that captives were useful in a hard market, but had little point in a soft market, other than being ready for when the underwriting cycle turned. But after years of soft markets, captives are not only still relevant, they are growing and are expanding into new lines of business and areas of risk. They have become an essential tool for the risk manager.

There has been captive growth every year for the past two decades and by the end of 2016, there were more than 7,000 captive insurers in use globally. The number of domiciles has increased as well, to about 70 across the globe.

While the majority of captives are writing standard property and casualty business, there are a growing number writing cyber, employee benefits, trade credit and many other lines. Captives are now being used to cover longevity risks, and are increasingly involved in insurance-linked securities transactions.

More and more companies in Latin America and especially Asia-Pacific are setting up captives, while in Europe and the US, the entry point for captive use has fallen to the point where many middle-market companies are using the captive solution, often via cell captives.

Captives are being used as strategic tools, not simply as a way to save on insurance costs. And the days of captives being used as tax vehicles are practically over.

With talk of a potentially hardening market following the run of catastrophes in late 2017, the captive sector may see even further growth. Certainly, existing captives will start to play more of a risk financing role, as well as their continued function as a strategic risk management solution. Growth is not simply about the numbers of captives, or the ever-growing number of domiciles. It is also about the amount of business being written by captives and the growing number of lines included.

There are of course challenges for captives. Regulatory and tax concerns continue, and there will always be so-called captives that are set up for pure tax avoidance reasons. But BEPS and other measures will soon make these increasingly rare. The perception of captives as tax avoidance vehicles is one that persists, and is not helped by the OECD's BEPS initiative, and the Panama and Paradise papers and the role of certain domiciles, but Ferma and others are working hard to dispel the myths, emphasise the risk management function and promote the legitimacy of captives.

The captive solution is well established, has stood the test of time, and continues to offer an efficient, cost-effective alternative for organisations, large or small, around the world.



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The Threat from BEPS

THE ORGANISATION FOR Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project has caused considerable concerns for captive owners since its action plan was published back in 2013. BEPS refers to tax avoidance strategies that exploit gaps and mismatches in rules to artificially shift profits to low or no-tax locations.

In the action plan, the OECD stated: "Related concerns are raised by deductible payments for other financial transactions, such as financial and performance guarantees, derivatives, and captive and other insurance arrangements, particularly in the context of transfer pricing."

There is therefore a suggestion that captives may be involved in profit shifting for tax reasons, and that perception has the ability to harm the reputation of the captive solution. This could then result in measures targeting captives when national administrations transpose BEPS actions into their national laws. That in turn could make it harder to justify captives to chief financial officers and boards.

To counter this, various organisations, including Ferma and Eciroa, have been campaigning to highlight the risk financing and risk management purpose of captives, as opposed to tax avoidance tools or profit-shifting vehicles.

So will the long-term effects of BEPS and other tax-related rules be detrimental to captives? On the contrary, says Barry Beard, head of global services and complex multinational, UK & Ireland, Chubb: "BEPS will continue to bring focus, transparency and consistency to pricing and decision making. However, more work has to be done to promote the value of captives and their benefits in light of BEPS – many risk managers are actively pushing for more visibility at board level and encouraging others to do the same."

The BEPS guidance is not specifically aimed at captives, but as Matt Latham, head of captive programmes, XL Catlin, points out, the OECD did express

concern that some companies might be using their captives as a tax avoidance measure – for example by charging higher premiums than are required to subsidiaries in high tax areas and moving the premium to a captive based in a low tax domicile to reduce their tax liabilities.

"It is extremely important that risk managers understand these issues," he says. "The OECD's guidance states that companies must be able to demonstrate that arrangements are driven by 'clear non-taxable reasons' and that there is governance and substance in place. Tax authorities may ask why an offshore jurisdiction has been chosen for a captive, and risk managers must be able to give a satisfactory answer. While insurers do not give advice on the structure or governance of captives, where we can help clients is by benchmarking to ensure that the premium the captive is charging is a fair commercial market premium."

SHORT-TERM IMPACT V LONG-TERM BENEFIT

The issue seems to be that in the short term, BEPS will not be good for the sector, but in the longer term, if the industry can overcome the initial perceptions of the OECD, and stress the risk management and risk transfer element of captives, then the impact will be less.

"In the short term, BEPS will definitely have a detrimental impact," says Christian Wertli, head of innovative risk solutions and director, corporate solutions, Swiss Re Corporate Solutions. "However, [in the] long term, BEPS regulations will set the standards for genuine captive companies. Overall, I'm quite optimistic for the captive industry for a number of reasons, not least that hardening markets will make self-insurance more attractive. But as for BEPS regulations, they will be painful for some companies – those set up for tax purposes or that don't carry genuine risk or that are too small to be sustainable – but will set a solid basis in the long-run."

Speaking at the Asian Captive Insurance Conference 2017 in Malaysia in the summer, on implications for captives

of BEPS, Michael Velten, Asia-Pacific financial services and insurance tax leader, Deloitte, listed some questions to consider:

- Is the captive performing substantive activities locally?
- Would the captive's transactions have been agreed between unrelated parties under comparable economic circumstances?
- Is there actual decision making in the right location at the right time?
- Is the captive effectively controlling the risks of the transaction?
- Is the risk transfer pricing done at arm's length?
- Is there supporting documentation?

And he proposed some measures to help mitigate BEPS risk:

- 1 Review operating models and guidelines
- 2 Review transfer pricing and update/revise where appropriate; revisit functional analysis
- 3 Document commercial rationale for the captive as well as its substance
- 4 Test transactions to ensure that they are rational
- 5 Ensure that there is control over the risks being taken by the captive.

Will Thomas-Ferrand, strategy and operations leader, EMEA and Asia-Pacific, Marsh Captive Solutions, says: "The long-term effect remains to be seen, however lobbying (such as Marsh's work with Eciroa and Ferma) is aiming to ensure there is no disadvantageous treatment of captives which are properly structured. There will have to be a demonstrable 'arm's length' business motivation for placing business within the captive, which can be demonstrated to be advantageous from a non-tax perspective. Captives will be required to have policies, procedures and substance in place that justify this arm's length, commercial decision making."

He adds: "The fact that a captive is part of the risk management toolbox for retaining risks in a formal, regulated manner that is regulated accordingly will need to be documented and clearly



understood in their business plan, which can take account of the group perspective but also needs to be robust enough to withstand challenges.”

Kiran Soar, a partner at law firm Ince & Co, believes that BEPS should not be detrimental to captive insurers: “BEPS has undoubtedly put a great deal of attention and focus upon captive arrangements and structures. However, captives run professionally and for the right reasons will continue to make sense in a post-BEPS world. BEPS also gives those in the captive world an opportunity to highlight the great work that captives (and their managers) do, not only to the

outside world, but also internally within a group structure. There is clearly more to be done, and captives will have to review all of their governance procedures to ensure everything is as it should be, but the rationale for a captive post-BEPS should not change.”

Captive owners and risk managers are working to challenge the perception that the OECD has of captive insurers, and a campaign spearheaded by Ferma is raising awareness about the true value and purpose of captives.

Nuno Simao Antunes, senior vice-president, head of multinational – EMEA, AIG, says: “It seemed initially as

though the OECD had a very negative view of captives, although this seems to be changing, not least as a result of Ferma’s work in this area. We fully support Ferma in its discussions with the OECD, and we are open to joining those discussions if there is a need.”

Mr Antunes says there seems to be a perception that a captive was essentially a tax-driven vehicle, but that is very far from today’s reality. “Captives are a central piece of their parent company’s risk management and risk financing strategies. Our clients will be able to demonstrate that there is a commercial rationale

for having a captive, that those captives are governed in accordance with the highest standards and that there is transparency in terms of the pricing that is established. It's our conviction that captives are, and will remain, valid and relevant for the foreseeable future," he says.

ADMINISTRATIVE BURDEN

Some observers point out that there will be increased administrative burden from BEPS, coming on top of Solvency II, which may have an impact on some captives. José Maria del Pozo, chief financial officer at Mapfre Global Risks, says: "This new tax regulation, as in the case of requirements for monitoring the activity such as the Solvency II model, will require a more robust and professionalised management of captives so as to justify the fact that the transactions are made based on an economic rationale, and to demonstrate that they are comparable to any transaction between independent parties. They will certainly require greater efforts for managing and documenting the transactions, which may represent an added difficulty for smaller institutions with fewer resources. We do not foresee any significant effects on larger, professionally-managed captives."

Adrik Nicholls, senior manager, transfer pricing, PwC, thinks the impact could be to see some captives close down. "We broadly see the captives market split as a result of the increased compliance requirements of BEPS being: first, those captive owners which see the increased administrative cost of running the business exceeding the commercial benefits (including representational consequences) and are therefore likely to wind down their business; second, those captive owners who consider it necessary to enhance or maximise the volume of business written through the captive to offset the increased compliance burden; and last, those captive owners adopting a wait-and-see strategy to test how extensive the additional compliance costs will be," he says.

He adds: "The effect being that those captives in the first category

are likely to consider the changes detrimental, those in the second category are seeking to maximise the opportunity and the last category considering it too early to tell."

As to whether BEPS will have an impact on the location/relocation of captives, Mr Nicholls says the selection of the captive location is primarily driven by regulatory considerations, such as speed of obtaining a licence to write insurance business or ready access to the regulator, and he does not expect this to change.

"As such, the relocation of captives is not likely to occur as a result of BEPS," he says. "In our experience, we have not seen any captives relocate with BEPS as the sole driver, however a number of captive operations are considering divorcing the captive's situs [where the property is treated as being located for legal purposes] for tax purposes from its regulatory location as a result of BEPS (ie being tax resident in another location, either through the controlled foreign company regime, formation of a permanent establishment, or moving the entity's tax residency)."

LEGITIMACY OF CAPTIVES

The captive sector has always had to work hard to justify captives to regulatory and tax authorities around the world, from CFC legislation, to the OECD's Harmful Tax Review, the Financial Stability Forum, the Financial Action Task Force on Money Laundering, and now BEPS. In addition, there has been plenty of unwelcome publicity for certain domiciles from the Panama and Paradise Papers – unrelated to captives but nevertheless tarnishing the domiciles' reputations.

The question is: is there much more the captive sector can do to persuade authorities of the legitimacy of captives?

Mapfre's Mr del Pozo says: "They must continue working to demonstrate that they are a useful instrument for optimising risk management in large groups or corporations, and are managed following the highest international standards in regard to regulatory

compliance, and particularly the various international regulations on solvency and financial solidity."

According to Chubb's Mr Beard: "It is easy to say there is always more people can do. Doing things as a group is clearly the optimal route, which the risk management associations are very focused on already. Captives will always be scrutinised by regulatory authorities, because they are insurance companies that have to comply with local insurance regulations. In addition, they are owned by a single parent or multiple parent insuring their risks – this will naturally receive scrutiny for risk transfer and risk shifting. Provided that captive owners understand the scope of regulation, there should be no adverse scrutiny from regulators."

For Ince & Co's Mr Soar, education and communication are essential: "There is clearly a perception that captives are another way of moving money into tax-friendly domiciles. However, in our experience, nothing could be further from the truth. Our experience is that captives are very professionally run, with the highest standards of diligence and conduct. That message however needs to be communicated to the OECD. Certain market organisations have already made a number of initiatives with the OECD and other authorities. However, the more that the relevant authorities such as HMRC see about the inner workings of captives in real-life examples, the more they will understand that captives are a very legitimate and necessary business structure."

Mr Soar believes that one of the impacts of Brexit may be for the UK to have a friendlier, positive approach to captives. "We wonder whether the UK (post-Brexit) might become more captive-friendly? Having accepted segregated SPVs as part of the ILS legislation, the next logical step would be for the legislation to be expanded to allow captive structures. Further, the UK will need to deal with Solvency II equivalence post-Brexit, and again could adopt a friendlier solvency approach to captives (for example, like Bermuda)."



EMPLOYEE BENEFITS

EB potential

IT HAS BEEN TALKED ABOUT FOR A very long time, but it does now seem that the concept of writing employee benefits through a captive has finally taken off. Willis Towers Watson notes in a recent report that the number of employee benefit captives has doubled in the last five years to approximately 85 and based on current activity, it predicts the number will double again in the next three years.

Willis Towers Watson states in its *Multinational Pooling and Benefit Captives Research Report 2016/2017* that well-managed captives can achieve savings of 25% or more, but may not be appropriate for every company. “Captives are now an established part of the employee benefit landscape for multinational companies. We are seeing growing interest in expanding the use of captives for some retirement savings and retiree medical risks,” says the firm, noting it has helped implement 15 employee benefit captives in the past two years.

And the Aon Risk Solutions *Global Risk Management Survey 2017* reveals that 10% of Aon-managed captives currently write employee benefits (excluding health/medical and life), and 20% plan to write employee benefits in the future.

THE BENEFITS

The reasons why companies are looking to write employee benefits through their captives are partly to do with cost savings, but also relate to better control of the benefits programme. “If you asked ten customers, five would say cost and five

would say control,” says Rob Brown, customer and distribution management – UK and APAC, Zurich Global Employee Benefits Solutions. “In many respects these are not mutually exclusive – if you maintain control over benefit design, rationalise medical inflation and make strategic investment in employee wellbeing by, for example, implementing a global EAP or allowing all employees to access the Headspace app to help address mental health issues, these will have a flow-on effect to claims and therefore cost, in a virtuous cycle.”

He adds that, other than unforeseeable catastrophic events, insurable employee benefits are very stable lines of business and, in many contexts, are a good addition to a captive programme.

Will Thomas-Ferrand, strategy and operations leader, EMEA and Asia-Pacific, Marsh Captive Solutions, agrees that both cost and control are important to the captive owner. “The control allowed by a captive to unify coverage levels and not expose smaller business units to more risk than they are comfortable with, is often cited as a key motivator,” he explains. “However, the control aspect then leads to cost reductions because it is only through collating and pooling the geographies that leverage with the global benefits providers can be achieved, and the risk diversification can become conducive to retaining larger portions of the retained portion. Therefore, the control aspect is usually the primary driver, but this leads to overall cost savings.”

A recent Marsh report, *Captives at the Core*, shows that the number of Marsh-managed

captives reinsuring multinational employee benefit risks continues to increase, pointing to the need for companies to create efficiencies as they face the triple threat of medical insurance cost inflation (nearly 10% globally for three years running), an ageing workforce, and a shift in responsibility for providing benefits from governments to corporations.

It notes that the cumulative costs to insure employee benefit risks often exceed those of global property and casualty insurance, yet benefit financing and governance is far less sophisticated. “We expect continued growth in captives writing multinational employee benefits over the next three to five years, as service support eventually follows a similar structure to global property and casualty programmes, which are centrally controlled with consistent and transparent governance,” states Marsh.

The report reveals that of the captives that write unrelated third-party risks, 39% of non-US-parented captives and 7% of US-parented captives write multinational employee benefit programmes. And 37% of US-parented captives, and 25% of non-US-parented captives write US ERISA employee benefits (group term life, long-term disability, accidental death and dismemberment) or voluntary benefits (critical illness, accident, or home/auto/umbrella liability insurance).

“The captive being involved in employee benefit programmes allows a more consistent employee benefits policy throughout the world for the group, as well as providing cost savings [and] higher purchasing power to enlarge local guarantees,” says Marine Charbonnier, head of A.R.T. solutions, AXA Corporate Solutions. “And for the captive, the benefits are diversification, lower global volatility, optimisation of the use of capital, and improved appetite of reinsurers in the business.”

The Willis Towers Watson research report notes that the financial savings of a captive writing employee benefits result from:

- Eliminating insurer risk charges and

Most profitable countries for all captive business

[Expressed as a percentage of all reinsured premiums per country]

1	Japan	55
2	Norway	44
3	Belgium	42
4	Guernsey	41
5	Poland	41
6	Australia	34
7	Netherlands	32
8	Switzerland	31
9	Spain	31
10	New Zealand	28

SOURCE: Willis Towers Watson's Multinational Pooling & Benefit Captives Research Report 2016/2017

underwriting profits

- Cashflow advantages (for example, paying premiums at the beginning of the year under annual in-advance or precession models, with claims paid out after they occur each quarter, investment returns on long-tail risk reserves)
- Improved control of claims and claim management
- Enhanced control over pricing and rate setting.

Non-financial benefits include:

- More control over benefit design and policy terms, such as exclusions, free cover limits and event limits
- Flexibility to make ex gratia payments that a commercial insurer would decline to accept
- Access to better financial and claim data to help design and carry out demand-side initiatives.

The Willis Towers Watson research report reveals that captive arrangements returned average surpluses of 8.1%, while the median captive return was 14.7%. It explains that the difference between the median and mean was largely attributable to the experience of one participating company with significant losses. When that captive is excluded, the mean and median returns are very similar, and both are higher than the results achieved under multinational pooling.

Least profitable countries for all captive business

[Expressed as a percentage of all reinsured premiums per country]

1	Canada	4%
2	Greece	3%
3	Panama	3%
4	Hong Kong	2%
5	Taiwan	0%
6	China	-1%
7	Egypt	-4%
8	France	-12%
9	Denmark	-22%
10	Ireland	-24%

SOURCE: Willis Towers Watson's Multinational Pooling & Benefit Captives Research Report 2016/2017

“These results are encouraging to captive users and those interested in using their captives, especially because some of the research participants have actively discounted premiums up front, ahead of reinsuring them to their captives – so their overall return is higher than the captive performance captured in the results,” notes the report. “That said, we urge caution: captives are not for everyone, and there are considerable costs and time involved in establishing and running successful captive programmes, which are not reflected in the results.”

GOVERNANCE AND CONTROL

“Using a captive means an organisation can ensure greater governance at a global level and can practice better active management of their employee benefits risk exposure,” says Andrew Stocker, head of business development at MAXIS GBN. “Using a captive also enables global headquarters to maximise cost containment measures, reducing the impact of rising claims cost while exploiting efficiencies of scale via global pricing strategies available from the fronting network. At the same time, they maintain greater control over local risk pricing. Local offices can then ensure that benefits are both compliant and appropriate for their specific markets.”

Alexandra Gedge, captives executive, JLT, says it depends upon the client,

but most parent companies now utilise captives as a means of reducing insurance costs and providing a mechanism for total risk management and risk financing. She lists the benefits as follows:

- Removes 'uninsurable risk' exposures from company balance sheet
- Control and flexibility over benefit design, membership and claims
- Creates additional capacity where limited availability exists within traditional commercial market
- Provides DIC/DIL coverage
- Premium stabilisation and retained underwriting profit
- Investment potential/cashflow control
- Corporate focus on risk management
- Centralised access to loss data
- Diversifies captive risk, which can offset solvency requirements under Solvency II.

CONSOLIDATING LIFE AND NON-LIFE RISKS

The point about diversifying captive risks is important for many European-parented captives in particular because of Solvency II and its increased capital demands. As Matt Latham, head of captive programmes, XL Catlin, explains, Solvency II has meant that some captives in EU domiciles are now subject to heightened governance and reporting requirements, as well as increased capital requirements. "This has prompted many captive owners to explore the benefits of writing more lines of business via their captive. The diversification of writing non-correlated business within a captive not only spreads the risk across a broader portfolio – the captive no longer has all its eggs in one basket as it were – it can also deliver real capital efficiencies under Solvency II. This is one of the major drivers of the trend we have observed of captive owners seeking to write a wider portfolio of risks within their captive."

The most efficient diversification is to consolidate life and non-life risks in a captive, and that means writing employee benefits. The Marsh report states: "Recent employee benefit captive implementations have been carried out by European multinationals, reflecting

increased sophistication among European captives in response to Solvency II, along with an increased appetite for captives. However, no one region, industry, or domicile leads the global charge. The common thread is an appetite and means to drive operational transformation."

Zurich's Mr Brown says there are many benefits to consolidating life and non-life risks, including cost management, control, frequent and actionable management information which helps to manage the experience on a quarterly versus annual basis and assists with local, regional and global budgeting.

"There are synergies such as a reduction in collateral requirements when both life and non-life lines are insured with a common insurer, and there may be added benefit for capitalisation requirements," he says. "From a reporting perspective, customers can view their data in a consistent format, which helps when reporting up the line."

He notes there are fewer drawbacks to consolidating risks, but these would include contagion risk. "For instance, if you insure a property programme and group life plan within a captive and incur a claim for fire and an insured employee perishes, there will be both property and life insurance claims for the same incident," he explains. "Considering this through a positive lens, there are insurers/reinsurers that can help manage these risks by providing financial solutions such as individual or aggregate stop loss. By doing this, you are getting all of the

"When both life and non-life lines are insured with a common insurer, there may be added benefit for capitalisation requirements..."

management information benefits from having everything go through the captive and mitigating the potential financial downside."

One major challenge in all of this is that writing employee benefits through a captive will involve much greater collaboration between risk managers and human resources, something that has not been notable in many companies.

Mr Stocker says that ideally, risk managers and human resources teams will work closely together on an employee benefits captive programme, with the risk manager focusing on the financial risk and balance sheet, while the HR manager concentrating on local benefits and plan design. HR will also work with the local offices to ensure relevance and compliance. "This collaboration is important in ensuring an employee benefits captive programme works successfully and, unfortunately, providers are not always able to solve this issue for clients if it does not. In practice, it does not always work.

Usually the discussion, agreement and planning will be done through a working group, or perhaps via an underwriting or management committee. However, some companies do not require this type of collaboration and are happy for their teams to work separately, or may not have the relationship between the global and local levels to guarantee effective communication."

Writing employee benefits through a captive has many challenges, but also considerable benefits. As the Willis Towers Watson report suggests, a multinational company with a track record of successfully launched global initiatives, including global property and casualty programmes, and good channels of communication, might be in a position to consider a captive solution.

"But a multinational company with little knowledge of its global benefits and limited track record of influencing local decision making about choice of insurer should be realistic about its short-term objectives and perhaps take a more evolutionary approach," notes Willis Towers Watson.

GLOBAL PROGRAMMES: Maximising the captive's value

A captive can play an important role in a multinational insurance programme but is by no means a necessity, and there are many multinationals that have a multinational insurance programme without the use of a captive. But a captive's involvement in the setting and funding of retentions can be vital to a multinational programme.

Salil Bhalla, head of complex multinational accounts – UK, AIG Multinational, says that captives are typically involved in retaining a primary layer in global insurance programmes, with the captive's actual net retention ranging from hundreds of thousands to hundreds of millions, depending on its size and strength. He adds that he also occasionally sees captives taking quota share and excess of loss positions on certain lines where this makes sense and matches their risk appetite.

Marine Charbonnier, head of A.R.T. solutions, AXA Corporate Solutions, says that a captive is best used in a global insurance programme if it is prepared for any changes in market conditions. In particular, she says that different options have to be possible including levels of gross and net retention, (re)insurers' involvement, and even alternative transfers, in order to be in a position to better negotiate in the event of tightening market conditions.

For many companies operating internationally, a centrally coordinated global programme is proving the most efficient way to manage their risks across multiple territories, says Matt Latham, head of captive programmes, XL Catlin. "Using a captive as part of this risk financing strategy can be an efficient way for them to retain some of their risks and get a real handle on controlling their losses. Owners can take truly meaningful retentions at the parent level – rather than at the local level. And this gives them a much greater transparency of their cost of risk – globally," he says.

Jose Carlos Nájera, chief underwriting officer at Mapfre Global Risks, explains that a captive is used as part of a company's risk management for implementing policies deriving from its strategy in terms of retaining and transferring risk. "As an instrument of retention, it allows the creation

of more efficient insurance programmes, and modulates the requirements of the insurance market in regard to retention, capacity and price, and implements coverage that is not granted by the market or is granted in a restrictive manner," he says.

"The intervention of a captive insurance company thus represents an instrument that provides access to the insurance and reinsurance market, and allows the optimisation, through the adequate retention policies, of the costs and scope of the coverage designed in the insurance programmes, enhances the control and autonomy over their management, and facilitates the implementation of insurance policies and their uniform application in branches and/or subsidiaries," he adds.

Captives can be easily integrated into global insurance programmes because many captives are set up as reinsurance rather than insurance carriers. This means a fronting insurer takes care of all insurance-related topics as part of a global insurance programme, says Helene Westerlind, global head of international programs, Zurich International Programs. "Integration of the captive as a reinsurer of a global insurance programme then allows the customer to participate on a global level, compared to the purely local participation through deductibles. A consistent approach and delivery of consistent captive reinsurance bordereau from a single source further allows for an efficient participation of the customer through its captive," she says.

CAPTIVE PRICING

Another useful advantage of a captive is that it facilitates the ability to allocate premium to subsidiaries and operating units, and thereby improve loss control and risk management. This is one of the major benefits of a multinational insurance programme, providing central control for the encouragement of risk management and loss control.

But how much flexibility is there in captive pricing to use it as a risk management tool for rewarding/penalising good risk management practices in subsidiaries, particularly given the focus on transfer pricing and tax authorities?

AXA Corporate Solutions' Ms Charbonnier

says: “Some captives have put in place tailor-made measures to reward or penalise pricing or deductible levels depending on claims history and/or preventive investment. With such measures, one of our clients has recorded a huge reduction in the frequency and average level of claims.”

Barry Beard, head of global services and complex multinational, UK & Ireland, Chubb, says captives are used most effectively to achieve a group-wide solution for risk management and risk retention. “There is good flexibility here subject to local pricing (whether by a captive directly or a policy issuing insurer) being appropriate for each risk when assessed at the local level. A risk manager and captive with a centralised view of their global programme and losses can more easily justify increasing premiums for poorer performing local operations as well as reward others. Accountability is a key benefit of a global captive programme.

AIG’s Salil Bhalla says: “After allowing for tariff rates and minimum premium thresholds, captives have flexibility in rewarding/penalising good risk management practices in subsidiaries by working collaboratively with their fronting partner. For global programmes, it does make sense to target premium increases at those subsidiaries that have the worst claims experience, even if at the programme level the captive serves to ‘smooth out’ the overall pricing.”

Insurers and captive managers point out that the important element with transfer pricing is that it is based on sound principles, technical criteria and robust data. It is certainly not straightforward and there can be challenges.

Christoph Betz, pricing specialist captive services, Zurich Commercial, points out that since the retention limits of captives are usually in comparable low layers, the pricing in most cases relies significantly on empirical claims data, and this data is impacted by risk management.

“Ironically, ‘too good’ risk management leads to scarce claims data, which can actually make pricing quite difficult – this can be bypassed by using additional industry data but you might actually lose a bit of the positive impact of the good individual risk management this way,” he says. “Breaking down the overall captive pricing to the single subsidiaries (in order to reward or penalise their risk management via their premium) can be a further challenge, since you narrow down your empirical data into smaller sets that might not be statistically relevant and you run into the danger of over-fitting the subsidiary data.”

Mapfre’s Mr Nájera explains that one of the main functions of a captive is to offer greater stability to their insurance programmes, so it must therefore be adequately capitalised and produce sufficient results to ensure its function is sustainable over time. “Therefore, the determination and assignment of prices to the different risks and subsidiaries must be governed by eminently technical criteria and not by any other kind. This implies applying corrective measures for pricing and retention in the case of subsidiaries and/or risks with poorer results, but must guarantee long-term profit in the mutualisation of the results of the programme as a whole,” he says.

David Lewis, director of European development, Willis Towers Watson

Global Captive Practice, adds: “It’s important to recognise that captives must be seen to adopt robust transfer pricing principles, ensuring that the transfer of risk takes place at a rate appropriate to the risk being presented. Within such parameters, however, is a degree of flexibility in internal premium allocation, enabling a risk manager to, in effect, reward or incentivise positive adherence to good risk management principles. This can often be best achieved using premium allocation modelling tools that support an allocation model that falls within the regulatory principles required, but which maps more effectively against the loss performance of internal subsidiaries.”

Transfer pricing is an important part of the Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting (BEPS) project, and captives have been perceived as a potential source of profit shifting. So will the transfer pricing elements of BEPS make it harder for captives to use pricing as a risk management tool for rewarding/penalising good risk management practices in subsidiaries?

Adrik Nicholls, senior manager, transfer pricing, PwC, does not think so: “Not in our experience. In fact, as BEPS focuses on aligning the reward of the business with the value driving locations, the BEPS programme should help to highlight the importance and value of the good risk management practices in local jurisdictions. It then follows that those locations should be rewarded in some way for those practices (eg by paying a lower premium). Where this may cause tension is if good risk management practices are identified in a location, but premiums are not downwardly adjusted.”

“The determination and assignment of prices to the different risks and subsidiaries must be governed by eminently technical criteria and not by any other kind...”

Ask the Expert: Chubb

Are captives being used in a broader way in terms of lines of business?

Captive owners are expressing an interest in adding additional lines into their captive. For Solvency II-impacted captives, some of the reasons can be explained by a willingness to increase the diversification of the exposure underwritten, which is factored into their capital allocation models. Another reason for some is that captives are becoming a heavier/costlier tool, so the CFO requires the captive to become a broader and more versatile tool for the benefit of the group.

How can a captive help an organisation gain better understanding of its risks?

Captive programmes help risk managers access a larger range of information. In such a structure, the risk manager gets the typical information from being an insured but also from the type of data that would be accessible by insurers or reinsurers. The risk manager will, for example, have access to a more detailed loss statistic.

Salvage and recoveries on claims will be visible for the captive as a reinsurer, although this may not be available if a captive is not involved. The fact that the risk is not simply transferred to a third party in a traditional insurance transaction, may also force some business units to rethink their approach to their exposure, and seek ways to minimise the group's P&L by investing in loss prevention/protection.

How important is it for a captive to be a profit centre?

Clients have a very different approach in this respect. Some will seek to have the benefits built up by a captive quickly shared with the operating units, in the form of better terms and conditions at the local policy level at subsequent renewal(s). Others will want to make sure the captive writes its business at a profit to ensure it remains a relevant tool for the risk management policy of the group in the long term.

For example, a captive built reserves over the long term can face situations where market terms and conditions become suddenly more difficult, and where these accumulated reserves are then used to smooth the impact on operating units. Some captives may also use the accumulated profit to then offer the group a cover that may be necessary but difficult to find at a reasonable price on traditional markets. Finally, some will also push this concept further by having the captive involved on the insurance business sold to end-customers.

Is the situation regarding captives and Brexit any clearer? What could the possible impact be?

With many details around Brexit still to be determined in negotiations between the UK and the EU, it is not possible to offer a clear and defined answer to this question at the current



time [November 2017]. Currently, it is a complex and uncertain picture.

How could and should captives be used to tackle emerging risks such as cyber and supply chain? How can they deliver more comprehensive coverage than the commercial insurance market can offer? Can risks like these be 'incubated' within captives before transferring to the commercial markets?

Exposures which are difficult to insure can often be earmarked in a specific section of a policy, with its dedicated limits and reinsured to a captive. After a few years' experience, the limit and premium can be adjusted to reflect the improved understanding of the exposure gained by the insurer and the captive.

In a recent environmental programme negotiation, we faced uncertainty around the exposure posed by a certain bacteria, mostly due to a lack of available information on the risk prevention and protection implemented by the business units. Rather than exclude it entirely, we agreed with the client to have a several millions deductible, that deductible being assumed by the captive, with the understanding that this deductible will be reduced at some of the next renewals when the exposure can be assessed in more detail.

—Rémy Massol, multinational director, continental Europe, Chubb

Captives and Capital Markets

WITH INCREASING TALK OF a possible hardening of the insurance market, captives will be well positioned to take a bigger role if required. At the same time, there are some signs that some corporates may be looking to use captives to directly access the capital markets for alternative and potentially cheaper coverage, according to captive managers.

“We are seeing signs that capital markets will continue to play an increasing role in captive strategies,” says David Lewis, director of European development, Willis Towers Watson Global Captive Practice. “Certainly, as the availability of new capital increases, and as investors seek opportunities for better returns, this is a trend that is likely to continue, particularly where more innovative structures are involved. While we have seen a sustained trend of soft market conditions, in both the insurance and reinsurance markets, it is quite likely that any hardening of rates will accelerate interest in alternative capital solutions.”

Alexandra Gedge, captives executive, JLT, says that access to reinsurance markets has long been a benefit of a captive, and owners have taken advantage of the diversified risk-financing options that come from owning a captive: “With insurance-linked securities (ILS) developments and other capital market appetite for insurance increasing, as it diversifies their investment portfolio, we could see more appetite here and thus the trend could grow. Naturally, if markets harden then corporates may be more interested in alternative options, including using a captive to access other markets (or setting one up in the first place).”

A recent Marsh report, *Captives at the Core: The Foundation of a Risk Financing Strategy*, explains that captives have increasingly used ILS to access reinsurance, especially where there is limited capacity in the current markets for the type and level of risk involved, and as a way of diversifying their reinsurance towers. “For example, an ILS can be structured so that a parametric trigger of certain intensity measurements, such as storm surges, will prompt catastrophe bonds. Or, for captives placing a higher layer of their reinsurance tower through an ILS structure, the parent company can access collateral funds for low frequency/high impact events in a relatively short timeframe,” states the report. It also points out that there may be positive solvency capital implications (especially with Solvency II), as the captive can provide collateral rating transparency.

Stuart King, president and CEO, Strategic Risk Solutions, explains that in the past, accessing such structures was prohibitively expensive, however more recent regulatory implications and technology-led solutions have made access easier. “I very much see accessing such structures for mature and sophisticated multinational captive owners increasing,” he says.

Back in September this year, a new segregated account company (SAC), Cerulean Re SAC, was formed in Bermuda through a joint venture between GC Securities and Marsh Captive Solutions. According to GC Securities, Cerulean Re, a private syndicated collateralised reinsurance platform, “provides an efficient and cost-effective placement process for collateralised reinsurance and private catastrophe bond deals”.

Marsh says the client base within Marsh Captive Solutions provides an opportunity to introduce elements of primary corporate risk to ILS transactions, adding that a wide range of triggers, including indemnity, industry index and parametric, are available, ensuring the correct type and level of coverage.

“ILS is an established part of the reinsurance and capital markets, and its participation is not wholly dependent on the (re)insurance cycle,” says David Priebe, vice-chairman, Guy Carpenter. “It is here to stay. Cerulean leverages this capacity to support uninsured and underinsured risks, including emerging risks such as cyber and the ‘internet of things’, and we are excited about its ability to help our clients bring opportunity to risk to grow profitably.”

There is a lot of talk about whether the market will harden. For some, it is wishful thinking by the insurance industry after so many years of soft markets, but many believe that the bottom has finally been reached. The views being expressed at the reinsurance meetings in Monte Carlo and Baden Baden suggest that the impact of the recent natural catastrophes (global insured catastrophe losses will exceed \$100bn in 2017) may be to harden the reinsurance market and in time, the primary market.

Capital markets have been increasing reinsurance capacity for some years, but some believed that when a major loss or series of catastrophic losses hit, the investors would run scared. However, this does not appear to be the case, and the cat bond market seems to be as strong and as active as ever. Captives and corporates may well look at capital market options if the market hardens significantly.

Tapping the Reinsurance Market

IT IS OFTEN SAID THAT ONE KEY benefit of a captive is access to reinsurance markets. Reinsurers are the ultimate risk takers and are specialists in catastrophe business. There is also the point that if the insurance market is soft, so is the reinsurance market, meaning that captives can gain reinsurance protection at lower attachment points, with more comprehensive coverage, and at a cheaper price.

As Kiran Soar, a partner at law firm Ince & Co, explains, flexibility is the key: “With reinsurance pricing remaining at an all-time low, a captive has the ability to tailor its own reinsurance buying programme, whether with the use of traditional treaty reinsurances or with the use of private collateralised reinsurance/ ILS type products. It allows the captive to buy reinsurance that truly reflects the risk that the captive and its underlying insured group is actually taking.”

Barry Beard, head of global services and complex multinational, UK & Ireland, Chubb, says a captive can directly write its own risk [for example an EU-based captive writing FOS] and then use a local policy-issuing insurance partner admitted to do insurance business in the location of risk, to place risk in other locations and cede them to the captive. The captive can benefit from buying its own global reinsurance programme and should achieve economies of scale from this, rather than a reinsurance programme of its own, and one that is priced separately for risk that it cannot write directly.

“The trade-off here is that the insurance partners used then have a gross line programme, which brings additional credit risk,” he says. “In our experience, the reinsurance markets are very accessible to captives and it is often the case that the captive has a wider choice of reinsurers competing for the business and can therefore achieve a cheaper price. While captives clearly make informed decisions on which reinsurers to use, based on factors other than just price, the list of suppliers is often wider than that of local policy-issuing insurance partners.”

Marine Charbonnier, head of A.R.T. solutions, AXA Corporate Solutions, explains: “With a captive, the risk manager has more possibilities to have access to the reinsurance market, and specialised reinsurers, particularly for multiline stop loss, and alternative solutions. The risk manager can challenge and use the direct market, having a more complete visibility of the various opportunities.”

In a captive survey of its own client base, Aon asked whether having access to reinsurance benefits captive owners, with 35% believing that using captives gives them moderate or significant access to markets they wouldn’t otherwise have been able to access. And 28.5% said that using captives has given them a more than 10% cost reduction through accessing additional markets, and moderate or significant coverage improvements from gaining access to these markets.

According to Will Thomas-Ferrand, strategy and operations leader, EMEA and Asia-Pacific, Marsh Captive Solutions, captives have traditionally been used to access reinsurance markets that may not otherwise be accessible. Examples include aggregated umbrella policies covering multiple risks with shared limits or aggregate stop-loss positions. He says this may provide more certainty to the parent and better pricing due to the diversification. He also points out that a captive may also facilitate access to government or industry facilities such as TRIA (Terrorism Risk Insurance Act) in the US or OIL (Oil Insurance Ltd), which can be advantageous.

Paul Woehrmann, head of captive services, Europe, Middle East, Africa, Asia-Pacific and Latin America, Zurich, says that captive owners have various opportunities to approach the reinsurance market: they can approach reinsurers directly, they could use the network of their fronting carrier or they can mandate a specialised reinsurance broker.

Access to the reinsurance market opens up arbitrage opportunities to captive owners, he says. “We have experienced three types of arbitrage:

pricing, wording and capacity arbitrage. As reinsurance carriers have no requirement to finance a large network and have most business in high excess layers, they may have a different pricing approach compared to insurance carriers. This may open up pricing arbitrage opportunities,” says Mr Woehrmann.

“A captive may also see a requirement to cover certain risks that the insurance carrier would have excluded, if not for the coverage through the captive reinsurance. Buying reinsurance on excess layers could make this step easier to implement. This would be an example of wording arbitrage. Finally, the customer may require insurance coverage that exceeds the capacity the fronting insurer is able to provide. Here, the captive could be used to participate in a share of the excess capacity required, while the rest is retroceded to the reinsurance market,” he says.

Paul Eaton, business development director, international, Artex Risk Solutions (Guernsey), says many captives use reinsurance to increase their capacity or limit their exposure in a cost-effective way: “Accessing the reinsurance market directly using a captive is a relatively straightforward process as there are many reinsurers that are keen to consider these risks, as this can be another source of premium income that might not be normally available.”

He lists some of the advantages:

- Possible arbitrage of the insurer market – reinsurers can have a different appetite and pricing approach compared to insurers
- Potential to offer wider cover where the captive is taking a sizeable first loss retention, reinsurers may be more flexible on wording/coverage
- The ability for the captive to underwrite greater capacity by using reinsurance to lay off risk
- Possible ability to write multi-line and multi-year deals that are sometimes restricted or prohibited by the direct insurance or subscription market
- Reinsurers are more inventive and

“Reinsurers certainly seem to be taking much more of an interest in the captive sector, according to captive managers. This is perhaps not surprising since most captives have intimate knowledge of the risks they are underwriting, and those risks are generally managed better...”

are able to arrange or design hybrid reinsurance deals that may involve capital markets/ILS arrangements

- Reinsurers may share underwriting knowledge with the captive to help develop the programme.

Jose Carlos Nájera, chief underwriter officer at Mapfre Global Risks, notes that access to the reinsurance market is broader, and more direct and transparent. “This means that certain markets have access to business which otherwise would be more restricted or even inaccessible to them. Additionally, the actual retention policy applied by the captives themselves may more efficiently address any restrictions that the re/insurance market may adopt in response to certain risks. This supports the argument that the reinsurance market should see captive companies as vehicles for – rather than as obstacles to – business.”

There are, however, challenges when it comes to captives accessing the reinsurance market, according to Salil Bhalla, head of complex multinational accounts – UK, AIG Multinational.

“When captives directly access reinsurance markets they arguably gain greater control over their programmes and costs, but in doing so may take on onerous responsibilities in terms of meeting PPWs, managing counterparty risk, loss reporting and loss recoveries, potentially facing foreign exchange and timing risks as well as ensuring concurrency between the front- and back-end arrangements. It is not for the fainthearted and we have observed that even though a captive may be able to access the wider reinsurance market,

they often choose to work with their usual partners rather than specialist and wholesale markets.”

Chubb’s Mr Beard says: “The risk manager can also restrict the direct insurance markets to quote for their own net shares only, limiting their use of facultative placement, and access these facultative markets from the captive, in a hope to capture the best deals available and the commissions reinsurance markets may pay.”

However, he notes that these structures bring additional ancillary risks to a captive, such as retrocessionnaires’ counterparty risk, possible basis risk between the policy wording fronted to the captive and the retro slips placed and so on. However, he says, in general, risk managers of large corporations deem that the benefits of this approach outweigh these possible risks.

REINSURERS KEEN?

Reinsurers certainly seem to be taking much more of an interest in the captive sector, according to captive managers. This is perhaps not surprising since most captives have intimate knowledge of the risks they are underwriting, and those risks are generally managed better.

“Reinsurers are now targeting captives more than ever before,” says Marsh’s Mr Thomas-Ferrand. “Several reinsurers are now developing a captive team within their underwriting division to specialise in captive arrangements, so the appetite from reinsurers is definitely there, especially when multiple lines of business can be considered.”

Christian Wertli, head of innovative risk solutions and director, corporate

solutions, Swiss Re Corporate Solutions, adds: “In general, all the major reinsurers are very open to working with captives, either as a frontier, quota share reinsurer or as excess-of-loss reinsurers. Issues might be on programmes where the reinsurer runs a credit risk on the premium payment. In these situations, reinsurers might be looking for parental guarantee, a letter of credit or other financial securities.”

Artex’s Mr Eaton says there are many reinsurers that actively pursue the captive reinsurance market and that many of the larger reinsurers have specific captive or fronting relationship teams. “Most of the larger reinsurers (and also many insurers) have experts in their teams that are keen to work with captives and can provide guidance on how best to structure a reinsurance deal. There are also numerous smaller reinsurance firms that are keen to access the captive market as they appreciate the fact that most captive owners establish their captives as a risk management tool and therefore have a strong ethos within their organisations to ensure the firm’s risks are managed effectively and efficiently in order to reduce claims,” he explains.

And another captive manager, Stuart King, president and CEO, Strategic Risk, says that reinsurers are looking to work closely and more directly with captive programmes to offer solutions to new and emerging risks. “In doing so, they are removing the administrative cost burden from more traditional insurance placement routes. This includes the continued popularity of exploring multi-year, multi-risk class products,” he says.



Focus on Asian captive market

THE CAPTIVE CONCEPT HAS been around for a very long time, but in Asia, while not unknown, it has remained relatively unexplored.

The region probably accounts for just 2%-3% of the total number of captives worldwide.

That is not to say it is not growing, but more importantly, the potential is enormous. Danial Mah Abdullah, CEO of the Labuan International Business and Financial Centre (Labuan IBFC) said recently: "We believe the Asian captive market will continue to grow at a steady pace. Asian corporations are viewing captives as a viable alternative risk management tool and the number who appreciate this concept is growing. While many companies will continue to depend on traditional insurance, those with the knowhow will explore greater business opportunities and risk management options through captives, especially when commercial premium rates make standard insurance untenable."

In its *Asia Market Review 2017*,

Aon notes that captive owners in Asia are showing an unprecedented level of sophistication and increasing their captives' involvement in non-traditional lines. It reveals that the Asian captive market continued to grow at a steady pace through 2016, and growing number of Aon-managed captives were seeking to increase participation in non-traditional lines such as cyber risk, environmental liability, trade credit and employee benefits.

Aon says it is "currently experiencing an unprecedented level of sophistication amongst captive owners in the region, the majority of which are gross line captives seeking to manage and control external risk transfer costs as well as group retention costs, taking a total cost of insurable risk (TCOIR) approach to risk-related decision making". It adds: "With the insurance market approaching the bottom of the cycle, captive owners continue to aim to reduce TCOIR, with an increasing emphasis on analytics, risk improvement and loss management in order to achieve TCOIR objectives."

Aon says it foresees continued growth in the formation of captives in the region, and is increasingly seeing captives used as a tool to control volatility, incubate or introduce new risks, and to increase the price competitiveness of their overall programme.

Despite the growth, there are still many challenges in Asia when it comes to captives. Regulations, culture and a lack of awareness or understanding of what a captive offers, all play a part in restricting growth. Sean Welsch, head of captive management and business development, Zurich Commercial, Asia-Pacific, says: "Overall, we see more interest in captives in Asia, though it is still small compared to Europe and the US. This is mainly due to misconceptions about captives, such as 'it's only about tax' or 'it is only for the biggest companies', and the fact that often people still think in terms of existing insurance placement and risk transfer, which in the current market environment is cheap. Also, most companies are unaware of the possibilities and benefits a captive can bring for

currently uninsured risk.”

“There is absolutely growth in Asia,” says Alexandra Gedge, captives executive, JLT, “but limits include regulation, such as traditional right of first refusal in India, and naturally with a lot of new companies there is a focus on their main business, as well as using profits to reinvest in the business, rather than setting up an insurance company. But driving growth in captives is a growing interest in financial services and developing capabilities in Asia.”

A survey commissioned by the Labuan IBFC, Attitude Towards Captive Insurance in Asia, found that three quarters (75%) of the respondents said a “lack of commitment” from internal decision makers is a key factor holding back captive use in Asia, while the soft insurance market and a “lack of understanding” were also cited as reasons.

Nevertheless, 75% acknowledged that the captive concept is mostly known to large Asian companies, while 61% think that a maturing risk management culture and the natural evolution of the company are the leading factors driving Asian companies to consider setting up a captive. More than half (57%) of the respondents believed that the momentum of captive insurance will continue at the current pace.

ASIAN DOMICILES

In terms of domiciles, the leading captive centre is Singapore with more than 70 captives, followed by Labuan in Malaysia with about 40 captives. Micronesia has 18 captives, all Japanese-parented and attracted by specific regulations, while Hong Kong, touted by many as having considerable potential, currently has just three captives. However, it is not just the local domiciles that are looking to attract Asian-parented captives. Guernsey, for example, has been pushing links with China in particular.

Earlier this year, the Guernsey Financial Services Commission signed a memorandum of understanding with the China Insurance Regulatory Commission (CIRC) of the People’s Republic of China. At the time, Kate Clouston, director of

An opportunity for Hong Kong

Back in March, the Hong Kong Financial Services Development Council (FSDC) released a report calling for action to be taken to further develop the region’s insurance and reinsurance industry, and highlighting the potential of Hong Kong as a captive domicile.

In the report, *Turning Crisis into Opportunities: Hong Kong as an Insurance Hub with Development Focuses on Reinsurance, Marine and Captive*, the FSDC says the goal is to establish Hong Kong as a world-class and leading captive domicile by 2020, with the aim of between five and ten captives licensed per year and 50 total captives by 2025. It says this is a realistic goal given the number of organisations in mainland China and the surrounding region that have the size, scale, risk profile and relevant growth plans to utilise captives. According to the report: “With mainland China’s initiative to internationalise the RMB comes the potential for Hong Kong to increase its financial product offerings. With close financial links, Hong Kong is the easiest and closest place to help facilitate China’s desire for internationalisation of its currency. This leads to potential for the growth of captives in Hong Kong.”

It goes on: “With an increasing amount of international exposure in mainland China, there is a market for companies with a desire to maintain a captive’s risk exposure in RMB to eliminate the risks of currency exchange rate fluctuations. American companies such as Procter and Gamble, Pfizer and General Electric, that would traditionally establish a captive closer to home, may have needs to cover their mainland China-based exposure with an Asian-based captive.”

But it also points to the potential for Hong Kong in attracting Chinese-owned captives. “Large, mainland China-based multinational companies have been in the process of identifying and quantifying their uninsured risks and have insofar found the risks significant. This is a critical exercise as top management understands the downside risk and impact on the balance sheet. As many of these companies are in emerging industries and locations where conventional insurers may have limited risk appetite or capacity, the only way to manage this risk and exposure would be through the creation of a captive,” the report states.

The report also notes some of the challenges in making Hong Kong a major captive centre. It says Hong Kong faces natural competition from domiciles in the region and globally: “We need more education for CEOs, c-suite and risk managers on the benefits and uses of captives. The general lack of risk management experience and knowledge in this area is a key issue for boards and companies...Hong Kong has traditionally been slow to promote the use of captives due to a lack of regulatory promotion, lack of incentives to compete with international domiciles and to a certain degree, a lack of understanding from the financial and corporate sectors of the benefits of, and uses for, captives.”

The report concludes: “Mainland Chinese companies, state-owned enterprises (SOEs) and regulators traditionally might not have full confidence in captives; however, this view is changing and we now see a great deal of opportunities for the growth of captives for mainland Chinese companies and SOEs. However, the relaxing of restrictions and opening up of mainland China to foreign companies means that the potential is there for Hong Kong to also host captives that support foreign companies’ growth and risk management programmes in mainland China and the broader Asian region.”

international business development at Guernsey Finance, said of the captive concept: “It’s a concept that is still being understood in China and Asia in general, but that is where future growth in the captives sector will be concentrated, as opposed to the US and Europe where their use and advantages are already well

known. Captives are certainly going to be at the forefront of innovation in Asia’s insurance market.”

JLT’s Ms Gedge says that it will probably be both Asian domiciles and the more traditional domiciles that will benefit from the growing interest in captives. She says a lot of Asian

companies have an appetite for Asian domiciles from a practical point of view, but also companies from Asia have captives in domiciles all around the world.

With the current developments in the domiciles, as well as overarching initiatives such as the Base Erosion and Profit Shifting (BEPS) initiative, the local domiciles will likely benefit more than the overseas domiciles, as they are onshore for the respective markets, says Zurich's Mr Welsch. "Nonetheless, some overseas domiciles could still be attractive to Asian customers due to some very specific offerings they have, which may go well with strategic goals of said customers," he says.

Kiran Soar, a partner at law firm Ince & Co, says it is difficult to say at this stage who will benefit most. "Having a regional centre is always attractive, however Hong Kong's status is relatively untested compared to, say, Bermuda and other more established traditional domiciles," he points out. "The Chinese in particular are looking at captives actively (and some significant captives have already been established) but rather than setting them up in overseas domiciles, there has been a drive to set them up locally."

Will Thomas-Ferrand, strategy and operations leader, EMEA and Asia-Pacific, Marsh Captive Solutions, says that geographically, Singapore, Labuan and Hong Kong are ideally positioned for Asian risk. "However, there is also interest in domiciles further afield such as Guernsey, Bermuda and the US. Much depends on the location of risks and the specialisation of the domicile in terms of handling the risks. Where risks have been traditionally placed through the London market and risk managers travel to London already, Guernsey may be at an advantage, and similarly for Bermuda and their market. US domiciles are more commonly used where an acquired business has a large proportion of US risk," he says.

Mr Welsch says that with the current developments in the domiciles, as well as overarching initiatives such as BEPS, "the

"Captive activity has been expanding with Chinese parents, although this has focused largely on state-owned enterprises to date, forming captives within mainland China for their Chinese risk..."

local domiciles will likely benefit more than the overseas domiciles, as they are onshore for the respective markets".

Austin Su, head of global fronting and captive management, Asia-Pacific, AIG, says that smaller or regional companies tend to set up captives close to the region, for example Singapore, Labuan and Hong Kong. For large multinational companies, he explains that the captive domicile varies depending on the corporate strategic needs, for example, perhaps using a traditional domicile such as Singapore (particularly those captives with Australian parents); Micronesia is attractive to Japanese-owned captives due to its vicinity and pro-business regulations.

CHINESE EXPANSION

It is perhaps not surprising that much of the focus on the potential of Asia for captives is on China, as it is for the wider insurance industry and beyond. It certainly seems probable, following the experience of western companies, that as Chinese companies get bigger and expand overseas, this will drive captive formation.

"Captive activity has been expanding with Chinese parents, although this has focused largely on state-owned enterprises to date, forming captives within mainland China for their Chinese risk," says Mr Thomas-Ferrand. "Chinese companies already own captives as a result of the acquisitive expansion globally and some of these are in the more traditional captive domiciles. As the corporations start to look at risk

globally, as well as regionally, this trend is expected to continue, although the capital requirements for setting up the first captive in mainland China are high, which makes this a somewhat slow process."

Christian Wertli, head of innovative risk solutions and director, corporate solutions, Swiss Re Corporate Solutions, says: "Globally, over 90% of Fortune 500 companies have a captive, however China only started to allow setting up captives at the end of 2013 [CIRC's 'Circular on the Supervision of Captive Insurance Companies', issued on 2 December 2013]. There is huge potential in China and reinsurers should stay close to those developments. We estimate that around 250–300 companies meet the RMB100bn (+/- \$15bn) asset threshold to be eligible for setting up a captive."

However, he does not believe Chinese expansion overseas is the main driver for Chinese companies setting up captives. "Rather, I think companies want to keep premium in-house, take control over policy wordings, and are looking to have direct access to insurers and reinsurers. Currently, there are only a handful of Chinese companies with captives – COSCO, CNPC with onshore captives; and Sinopec and China General Nuclear Power Group, and China National Offshore Oil Corporation, setting up captives in Hong Kong. Let's keep in mind that these companies are massive. Their captives are also huge and insurance companies in their own right – in other words, hardly comparable with the 'traditional' captive insurance companies we've seen historically."

Third-party underwriting – opportunities and pitfalls

WHERE A CAPTIVE HAS been around for some years, is very well capitalised, and has built up underwriting expertise and experience in particular areas, it may make sense for it to look at third-party underwriting. This is certainly not for every captive and should not be undertaken lightly, but it can provide benefits in terms of profits, diversification and risk information.

So what are the main considerations for a captive undertaking third-party underwriting? “I think there are two issues,” says David Lewis, director of European development, Willis Towers Watson Global Captive Practice. “Firstly, from a regulatory perspective, ensuring that the captive is appropriately licenced and capitalised to transact the intended third-party business. Secondly, the potential administrative issues that arise from direct policy issue and claims handling. Where the captive is acting as reinsurer, such issues are of less concern, with responsibility sitting with the fronting carrier but, as a direct writer, the obligations of direct policyholder interface can be significant.”

Alexandra Gedge, captives executive, JLT, says captives have the same considerations when adding any line of business. “They should consider their appetite for the additional risk, loss history, experience writing insurance, whether they have the right licence, but also whether clients would have the interest in buying insurance and whether they (or an insurance partner) have the administration and claims capabilities to offer good customer service.”

She adds that putting third-party insurance through a captive is valuable to captive owners because it can make profits for the captive, which can in turn offset premium and demonstrate to the customer a commitment to good risk management.

Third-party underwriting is not particularly common among captives.

According to Aon Risk Solutions’ *Global Risk Management Survey 2017*, 10% of the captives managed by Aon currently write third-party business, with 12% planning to write third-party business in the future. Of those that currently write third-party business, a quarter had parents based in Asia-Pacific, 14% in Middle East and North Africa 14%, 12% in North America, and just 7% with Europe-based parents.

Marsh reported a similar story in its recent survey, *Captives at the Core: The Foundation of a Risk Financing Strategy*, which found that 13% of US-parented captives managed by Marsh write third-party/unrelated risk, and 13% of non-US-parented captives.

“Where the business is genuine third-party business, this will help to establish that the operations are conducted at arm’s length...”

Of the non-US-parented captives that write unrelated third-party risks:

- 39% write multinational employee benefit programmes
- 28% write customers’ programmes (for example, extended warranties, phone protection, and auto rental)
- 25% write suppliers, vendors, and/or non-employed contractors
- 25% write US ERISA employee benefits (group term life, long-term disability, accidental death and dismemberment) or voluntary benefits (critical illness, accident, or home/auto/umbrella liability insurance).

Captives engage in third-party underwriting to achieve a number of

goals, says Todd Cunningham, head of strategic risk solutions and captives, Zurich North America. “First is a diversification of risk apart from the captive owner’s organically generated risk. This has the benefit of potentially reducing volatility to the captive balance sheet and may also substantiate tax treatment of captive cessions. An additional benefit may also be for a captive to gain insights about risk that they may not have if they only reinsure the exposures of the owner. If the third-party business is profitable, so much the better,” he says.

One advantage that third-party underwriting can bring is that the captive may be more likely to be able to show a tax authority that it is acting like a commercial insurer, something that is particularly important in the context of the Base Erosion and Profit Shifting initiative. Adrik Nicholls, senior manager, transfer pricing, PwC, says: “Where the business is genuine third-party business, this will help to establish that the operations of the captive are appropriate and are conducted at arm’s length.”

Stuart King, president and CEO, Strategic Risk Solutions, says that in his direct experience, such arrangements are a great way for captive owners to generate “new-new revenue streams”. He points out that very often the risk is anti-selective, ie only offered to current customers as a way to increase customer loyalty. He believes that understanding the underlying risk and pricing is key to success.

The main consideration is the amount of third-party risk written and any regulatory conditions applying, he explains. And he adds that, depending on the domicile, if the proportion is high, a more robust governance structure is often sought (ie independent non-executive directors and the like) as the underlying insured is a third party, as opposed to the captive parent’s own risk.

Ask the Expert: Zurich

Is it getting harder for risk managers to justify a captive insurer? Is there more pressure on captives to prove their value?

Ron Davis, EVP, head of customer management, Zurich Commercial: No matter how well a business is doing, we're seeing all businesses are pursuing continuous improvement and seeking efficiencies. There is growing pressure on all professionals to find new levels of efficiency and effectiveness in everything they do. Risk managers are counting on us and other business partners to help them deliver increasing value for their companies. We contribute to this by leveraging our expertise, risk insights and thought leadership. In terms of programme structure and design, a captive is one of the tools that can help a company reduce its total cost of risk. We are one of the world leaders in international programme management and we've tailored a large number of innovative captive solutions together with customers and their brokers.

Is the value of a captive more about risk management than reducing premium costs?

Ron Davis: Each company needs to have a think through what they're trying to achieve and how they can best reduce their total cost of risk in a sustainable and economic manner. For many companies, a captive can play an important role in the programme structure and design. Premium costs are an important factor, but it's only one part of the equation. A captive supported by world-class loss prevention and risk management services can help reduce frequency and severity of loss.

For many companies, loss costs far exceed premiums, so using a captive to self-assume frequency of loss and taking proactive steps to reduce the frequency is in the company's best interests. We work with many companies to help them create greater awareness with the leaders and employees about being more risk-aware and implementing safety and loss prevention best practices so they can improve their risk profile. It's important to look at loss prevention as an investment, not just a cost.

How important is it for a captive to be a profit centre?

Reto Heini, senior corporate relationship manager, Zurich Global Employee Benefits Solutions:

We would say that the role of the captive has changed somewhat during the course of the past decades. Two major factors which have led to changes in the strategic objectives of captives are the regulatory and economic landscapes.

Regulation continues to evolve and increasingly focuses on matters such as solvency, cross-border compliance and arms-length pricing principles (witness Solvency II and BEPS in recent times, for example). From an economic landscape perspective, the high interest rate environments of the 1970s and 1980s have given way to much lower interest rate environments in recent years. This has had the impact of reducing the generous investment returns that captives used to be able to generate many years ago to much more modest levels, and means that profits now need to be through a mixture of underwriting discipline and real risk premium generation rather than (among other things) relying on high investment yields.

We have seen the emergence of a trend during the past ten years, whereby more captives are positioned as existing to help improve financing efficiency rather than to explicitly make a profit. It is too much of a generalisation to say, but my perception is that the older, mature captives are more likely to operate on a profit centre basis, while the newer incarnations tend to be more profit-neutral, and would in an ideal world simply look to cover the net costs of risk with a modest risk margin for future fluctuations.

From the perspective of control, influence and direction of day-to-day business, being a profit centre obviously has advantages in that the captive can to a greater degree define strategy and future development on the back of its own financial contribution to the overall parent company performance, and can be benchmarked against other trading companies within the same group.

While being a profit centre has some obvious advantages, as long as shareholder and stakeholder expectations are properly set, then we do not consider being a profit centre to be absolutely imperative for the success of the captive.

How easy is it to switch domiciles and in what circumstances would this make sense?

Balz Meierhans, senior legal counsel, captive services, Zurich Commercial: Switching domiciles requires the captive to be released by the regulator of the old domicile and accepted by the regulator of the new domicile. The complexity of each step depends on the respective jurisdiction. An alternative would be to create a new captive in the new jurisdiction and put the old captive into run-off at the existing domicile. A switch (or redomiciliation) therefore may make sense where the decision makers want to avoid a run-off, for example when the captive contains long-tail risks that would require a long run-off period. Another reason could be the decision makers wanting to abandon the old domicile as soon as possible, for example due to reputational considerations.



The Captive Healthcheck

When establishing a captive, the parent company will engage a broker or independent consultant to carry out a feasibility study. However, many parent companies fail to carry out regular reviews and audits of their captives over many years. This is akin to writing a disaster recovery plan, and then keeping it in a drawer and never updating or testing it.

There are many reasons for carrying out a captive audit, not least the rapidly changing risk environment, emerging exposures, new structures and solutions in the market, and the issue of corporate governance and regulation, not to mention the ever-changing state of the insurance market and the underwriting cycle.

In general, there are two types of audit or review: strategic reviews and compliance reviews. The latter are usually regulatory requirements and will be both internal and external audits. As Xavier Groffils, Benelux captive fronting manager, Zurich

Insurance, explains, captives – like all insurance and reinsurance-regulated companies – need to perform internal and external audits in order to comply with regulations. “Before official publication, all companies need to have their accounts reviewed by an auditor, which will sign off the content. The external audit is generally performing duties concerning misstatements caused by fraud or error, evaluation of the accounting policies and accounting estimates, evaluation of the presentation of the accounts and an opinion on the going concern of the company.”

STRATEGIC REVIEWS

He continues: “The internal audit is compulsory under the European Solvency II regime (Directive 2009/138/EC) and also entails the examination and evaluation of the adequacy of the internal control system and governance of the company. It aims as well to define whether such systems are sufficient and appropriate to the activity of the captive.”

Strategic reviews are not legally

required but are essential to ensure that the captive is performing efficiently and still adding value to the parent. “A captive audit (commonly referred to as a strategic review) is an opportunity for an existing captive owner to understand whether their captive continues to deliver good capital value, whether improvements can be achieved that better reflect the current needs of their business or, in some instances, whether the captive remains viable,” says David Lewis, director of European development, Willis Towers Watson Global Captive Practice.

He explains that as part of a typical review, it is critical to begin by fully understanding the current shape, challenges and demands of the business – it is highly unlikely that a captive established some years ago will be fully aligned to these new challenges and opportunities. “From that, it is possible to establish – through a process of analytical and strategic review and challenge – what the optimum ‘future state’ of a captive might be,” he says. “In

other words, if no captive existed, what would an optimum programme look like? Would a captive even be needed or could better value be obtained through an alternative structure? If a captive still offers value, what does the optimum configuration of captive involvement look like? Is the captive in the best domicile for the current and future needs of the corporation?”

Will Thomas-Ferrand, strategy and operations leader, EMEA and Asia-Pacific, Marsh Captive Solutions, says a strategic review of an existing captive should be part of the routine risk management process and can take several forms. At its most basic, he says, especially in Europe (following Solvency II principles), it should include an annual forward-looking assessment of how the captive will be used in the next two to three years, assessing the capital to support the risks the captive assumes and the operational risk the captive is exposed to.

He notes that the changing risk tolerance and appetite of the parent should clearly be considered during this process, as well as the market price and availability of transferring risk, and the developing risks a captive parent is exposed to.

At less frequent intervals, a more formal captive strategic review may be of value, he says. “This could be triggered by acquisitions, emerging risks or significant changes in claims activity, regulations or market pricing and availability. The more formal strategic review usually encompasses a captive adviser working together with brokers, and the risk manager often using analytics to lay out the options available. Key factors such as capital optimisation, collateral level and total cost of risk can be weighed up. Sometimes the domicile of the captive or the amalgamation of multiple captives can be considered if applicable, or alternatively the setting up of an additional captive for an additional benefit to the parent,” he explains.

Stuart King, president and CEO, Strategic Risk Solutions (SRS Europe)

says it is important to take clients back to the corporate risk register(s) and build up from there. He says the steps are:

- The financial risk-bearing capacity of the owner – how much risk it can lose before impacting financial standing
- The risk appetite of the owner – a corporate might have a large financial risk tolerance but the management might be conservative
- Mapping the risk register to insurance covers purchased to obtain a picture of the total cost of risk, which includes an evaluation of known historical losses and then understanding risks a captive might participate in.

Zurich’s Mr Groffils says the captives’ board of directors are getting more and more involved with technical insurance issues around strategic decisions for the captive. “In this area, the demand for studies and actuarial support is increasing in order to get a better view of how to optimise the use of capital, check the suitability to write a new line of business or maybe redefine the structure and limits insured/reinsured. Since the introduction of Solvency II regulation, captive directors better understand their tangible role in the management and the strategy of the captive, which sometimes even influences the whole risk management of the group. In that area, it is key to get the support of people having the knowhow and deep experience of insurance and reinsurance risk modelling and pricing.”

Paul Eaton, business development director, international, Artex Risk Solutions (Guernsey) Limited, says: “The scope of the audit may be determined by the trigger and focus on a specific area but in general should see that the controls and authorities delegated by the board are being adhered to and that reporting to the board is timely and accurate. Specific focus should be given to insurance and reinsurance documentation as these are often the main risk exposures of a captive, as well as having a rigorous and

commercial approach to pricing.”

REGULAR REVIEWS

Clearly, regular strategic reviews of the captive are vital, but how often should such reviews be carried out?

According to Mr Eaton: “Historically, captive programmes were implemented and renewed for a number of years without significant and regular review. Today, the speed of change in the insurance market, regulation and fiscal regimes mean that the captive’s role is continually under review to ensure that it is delivering real value. Often this process starts as soon as renewal is completed and while CFOs focus primarily on financial benefits, any review should also consider less obvious operational efficiencies of using a captive.

Relocating a captive is not always a simple process, but the captive domicile should be reviewed every few years.”

SRS Europe’s Stuart King says captive owners are encouraged to review the captive participation each year as far too often ‘renewing as expiring’ is the norm, whereas the corporate owner’s risk profile has likely changed – particularly if it is in a growing industry.

However, from the perspective of a multinational captive owner, tax audits are rare. Any inspection is often focused on ensuring an appropriate allocation of premium to the local risk and adherence to generally accepted practices of transfer pricing, he says.

Willis’s Mr Lewis notes that a strategic review is typically triggered by an extraordinary event such as acquisition or merger, or by a significant shift in corporate strategy. “However, there is a strong argument for suggesting that reviews should be held more regularly – perhaps every three or five years – to reflect the indisputable fact that both the captive world, and corporate environment, are fast changing. A captive is a significant and important capital investment – it is no different to any other subsidiary and should be subjected to the same levels of corporate scrutiny and challenge.”



Funding Longevity Risk

THERE HAS BEEN considerable interest in using captives to finance longevity risk (the risk that pension schemes may have to pay people benefits for longer than originally planned) in the past year or so. In the past few months, the UK has seen two very large deals and according to David Lewis, director of European development, Willis Towers Watson Global Captive Practice, there continues to be rising interest in the provision of longevity risk financing through captives.

He says this is partly driven by the increasing concerns of pension funds about the impact of longer life expectancy, and partly driven by the continuing appetite of reinsurers to write longevity exposures in order to hedge against existing mortality risk.

The latest longevity transactions include one involving the British Airways Pension Scheme insuring £1.6bn of the scheme's pension liabilities against longevity risk through its Guernsey-based captive, and another covering about £3.4bn of liabilities for some 7,500 pensioner members of the Marsh & McLennan Companies' UK Pension Fund, also through a Guernsey-based captive.

These two deals involve the transfer of substantial pension liabilities to an incorporated cell company (ICC) structure in Guernsey, says Mr Lewis, pointing out that currently, the greatest interest in longevity solutions is coming from UK pension funds where defined benefit pension arrangements create more onerous long-term obligations.

Longevity deals may not be limited to the UK. Paul Eaton, business development director, international,

Artex Risk Solutions (Guernsey), says: "Our understanding is that there are similar scheme structures in Canada and Netherlands and therefore these jurisdictions may also be receptive to similar longevity insurance structures. We believe that most of the larger schemes have longevity on their radar as a risk that can be mitigated through the use of risk transfer, and we know that some are actively investigating this area."

CAPTIVE CONDUIT

Mr Lewis explains that, in essence, the captive acts as a conduit to reinsurance markets keen to write longevity risk as a hedge against their existing mortality exposure, typically arising from underwriting traditional life risks. "The captive will, therefore, typically retain no risk itself. Reinsurers with large life insurance portfolios are looking to hedge the risk of people dying earlier than expected, with a complementary longevity portfolio. In most instances, access is provided through an ICC structure, providing third-party sponsored access to a lower-cost cell facility that then engages with a selected panel of reinsurers," he says, adding that Willis Towers Watson's ICC, Longevity Direct, based in Guernsey, was a pioneer in this technology.

Transactions are typically structured as the captive acting as insurer to the pension scheme and buying reinsurance, on a back-to-back basis, to cover 100% of the original risk, explains Mr Eaton. He says the insurance deals are typically structured in a similar way to a swap contract, with the pension scheme agreeing to pay to the captive a monthly premium that is equal to the projected benefits payments, plus a risk premium that is an agreed percentage of the

projected benefits payments.

The risk premium is derived from the pricing required by the reinsurer for the longevity risk transfer they are accepting, he says, and the captive pays to the reinsurer the monthly insurance premiums collected and the reinsurer agrees to pay the actual monthly benefit payments.

"There continues to be interest from reinsurers in longevity risk and our understanding is that there is sufficient capacity and appetite to support demand," says Mr Eaton. "However, it is important to note that reinsurers are keen to underwrite longevity risk as it provides a hedge against the aggregation of mortality risk in their life portfolios. Therefore, if there are a number of significant deals then the interest and/or pricing may change as a result."

The benefit for reinsurers is that it gives them indirect entry into markets that may not otherwise be available to them, and collateral arrangements provide them with the protection against credit risk associated with unrated insurers. However, Mr Eaton says he has seen a number of reinsurers willing to look through the captive to the financial strength of the pension scheme and relax the collateral arrangements accordingly.

For the pension scheme, the benefit of using a captive is primarily to reduce the overall cost of the transaction by offering direct access to the reinsurance market without the use of an intermediary, says Mr Eaton. "Additionally, using a captive also offers flexibility to the pension scheme in relation to the appointment of service providers to administrate the transaction, as well as flexibility in the event of the pension scheme seeking a buyout arrangement."

Ask the Expert: AIG

Why use a captive when commercial prices are cheap?

The value of the captive goes far beyond pricing and pure financial value. On the one hand there is the certainty that if there is a turn in the market, a company can accommodate that. But there is also the whole issue of risk management and being able to act in a much more intelligent way. For example, one advantage of the captive is that because it gives corporations access to more structured data, it allows them to have a better insight on losses that will then enable enhanced prevention and also to be more creative in terms of active risk management, allowing for a more granular risk/reward strategy. Additionally, self-insurance creates a different culture, psychologically, across the organisation.

Is the captive market expected to continue to grow?

If you look at Europe, there hasn't really been growth, in fact numbers have declined in certain jurisdictions. But this is not the full picture. As companies continue to expand, their global insurance programmes incorporate those new territories and risks. Where captives are involved, the business being written is becoming more and more international, incorporating a growing number of territories, and also new lines of business. So the number of captives may not be growing, but there is more risk going into them, both from a geographic and a product perspective.

What are the growth areas for captives?

Property and casualty continue to be the most frequent lines, but we are seeing an increasing number of clients in Europe putting other lines into their captives, or looking at doing so. There is much greater interest in putting cyber risk into a captive, looking at trade credit, non-physical damage business interruption, reputational risks, and employee benefits – areas that you wouldn't have traditionally seen in a captive.

Cyber is the biggest growth area. We have done, and continue to do, cyber lines for a number of our clients through the captive. Employee benefits also has significant potential for growth and it may be at the point in which we will see an acceleration of that growth. As risk managers continue to expand their roles, it will become easier for them to prove the value that a captive can also provide when managing employee benefits.

Can 'incubating' an emerging risk in a captive help to ultimately find coverage in the insurance market?

We should all be focused on going beyond our comfort zone. Is there a way we can go further by sharing this risk and trying to come up with a different solution? We are interested in looking at how we can partner with captives

and try and do something that is not usually available as a product in the insurance market. We should look more at how we can leverage data analysis and risk engineering, and use those capabilities to then establish partnerships between clients, commercial insurers and captives.

What are the benefits of consolidating life and non-life risks in a captive?

In the Solvency II environment, the fact that these are non-correlated risks will very likely have a positive impact in terms of the overall capital requirements. Also, employee benefits exposures generally represent an important expense and in the end are fairly predictable and actuarially-driven, as there is much less volatility than with property risks, for example. It would seem natural to bring employee benefits into a captive, especially if you already have one. There are of course different challenges (when compared to P&C programmes) in terms of implementing employee benefits in a captive, but it is something that we will see continuing to grow.

Has the industry improved when it comes to contract certainty? Is this a problem for captives?

My answer is definitely yes, it has improved, although certainly not enough. A large number of captive programmes are multinational and even if the policy issuance cycles have been shortened in multinational controlled master programmes, it's not infrequent that contracts are only made available after the effective date. This may cause issues in terms of the ability to pay losses locally, uncertainty and unnecessary friction between all clients, brokers, insurers, captives and reinsurers.

Captive programmes are usually complex, with a reinsurance structure that may include dozens of entities. On top of that, captives will want to have the premiums paid to them in a relatively short timeframe, sometimes so that they can themselves pay their reinsurers. So in order to achieve contract certainty, it's important to follow a robust end-to-end process that allows the time to execute on all the required tasks, not just in the country where we will issue the master, but also for all the local policies.

This is an area to which we have been dedicating a lot of attention in the past couple of years, and we have partnered with brokers and clients to successfully change the way in which multinational captive programmes are executed, meaning that all policies are issued prior to the effective date of the contract. We believe this is where the market is going and we will continue to work with brokers and our clients and their captives to achieve that goal.

—Nuno Simao Antunes, senior vice-president,
head of multinational – EMEA, AIG

Risk managers still value captives but rules are making it tougher

FOR THIS YEAR'S REPORT, we carried out an online survey of readers to take a snapshot of views on hot topics related to captives. The results of the survey very accurately matched up with the opinions expressed during the series of roundtables and one-to-one interviews that we carried out for this year's Risk Frontiers survey. They also concurred with discussions held through the course of the year at our own events and industry events such as Airmic, AMRAE, GVNW and of course the Ferma event in Monte Carlo in October.

The bottom line appears to be that while most in the market believe captives are a valuable and valid part of the risk and insurance management toolbox, and offer useful options when the standard commercial market fails to adequately respond, the rules, regulations and perception about captives are making it harder to justify them. The stubbornly soft commercial insurance market in Europe and worldwide does not help either.

But the fact remains that the number of captives worldwide continues to rise and, as noted later in this section in the analysis of captive prospects in Asia, there are healthy prospects for the sector in faster-developing regions of the world than in mature North America and Europe.

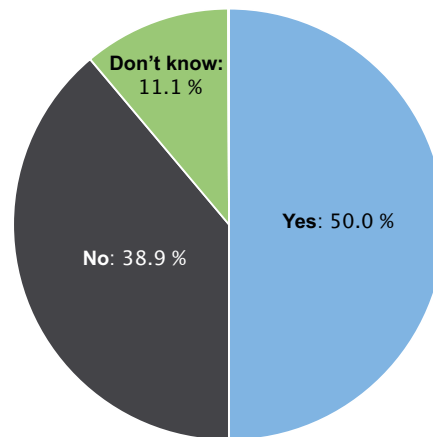
So the demand, actual and latent, is definitely there and risk managers are interested in the potential for innovative solutions using captives and the capital markets, and new technology such as blockchain. But it seems that circumstances – economic and political – are conspiring to make this not as easy as it could or should be.

This is why the lobbying work from bodies such as Ferma in areas like the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting (BEPS) initiative is so

important. The risk management and risk transfer community clearly needs to work hard and in a joined-up manner to protect and nurture the captive case.

So what were the individual questions, answers and conclusions to be drawn from each one?

Is it getting harder for risk managers to justify a captive insurer? Is there more pressure on captives to prove their value?



Not surprisingly, given the intense international focus on tax dodging, transfer pricing and offshore financial centres as a whole, post-Panama Papers, the answer to this question was yes for 50% of respondents. Some 38.9% said no and 11.1% were not sure.

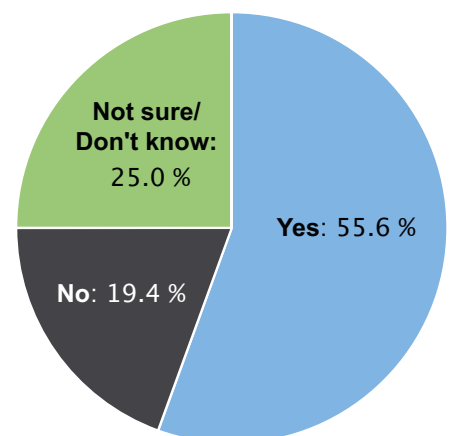
Five minutes before writing this section, this author received an email from Guernsey Finance in which CEO Dominic Wheatley wrote a cogent and impassioned plea explaining the benefits and innovation brought to the world of risk management

“The fact remains that the number of captives worldwide continues to rise...”

and transfer by such centres.

But, especially as the commercial and corporate insurance market remains so soft, it is not surprising to find so many risk managers saying it is harder to justify the captive than ever before. As noted above, the European market needs to get behind Ferma's efforts to promote the true value of captives before someone makes a very poor and ill-informed decision.

Has BEPS increased the administrative time and costs of running your captive?



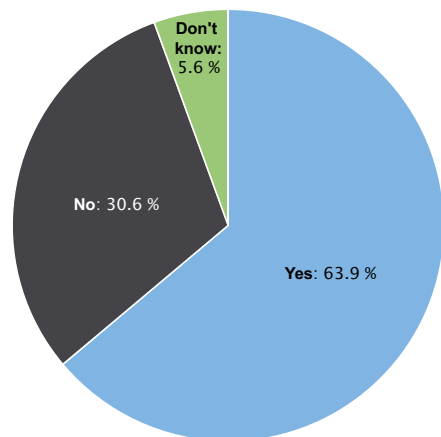
Again, not surprisingly a majority (55.6%) said yes, a big minority (41.2%) said no and 11.8% said they were not sure.

BEPS is inevitably going to add to the workload and cost of running the captive, just as Solvency II did and continues to do.

These things need to be taken seriously in the modern economy, in which corporate governance has become so important for any organisation that cares about its reputation and wants to be taken seriously.

It is likely that such a high proportion of respondents said 'no' because BEPS is not in force yet, not because they do not believe that ultimately it will take time and cost to implement and make sure that internal management and the authorities are happy.

Do you use your captive and its pricing of insurance as a risk management tool for rewarding/penalising good risk management practices in subsidiaries?



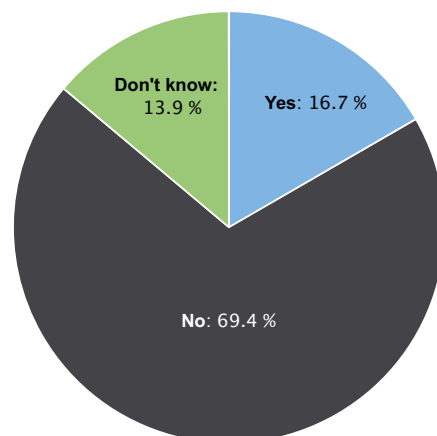
A big majority of risk managers who took part in this survey (63.9%) said that they do use their captives to reward and penalise risk management practices within subsidiaries. Only 30.6% said they do not and 5.6% were not sure.

This is generally encouraging because, apart from securing coverage for difficult risks and finding cost-effective solutions from alternative markets, this is surely a fundamental reason for using a captive.

Professional risk and insurance management does not come naturally to local managers with tough budgets, cost controls and sales targets. They will naturally seek to cut costs (and sometimes corners) and think of the short term above the long term. A captive can be a powerful tool to force local managers to think of the bigger picture, especially if their insurance costs are rising because they have failed to manage their risks adequately and prevent losses.

“ This is generally encouraging because, apart from securing coverage for difficult risks and finding cost-effective solutions from alternative markets, this is surely a fundamental reason for using a captive...”

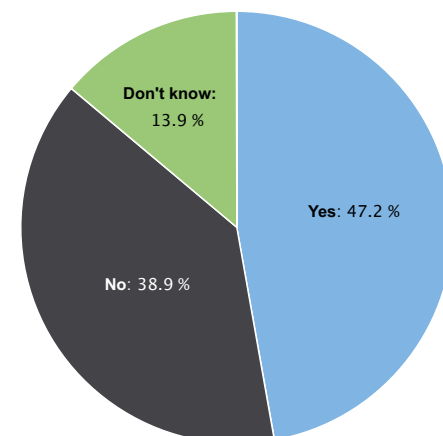
Is your captive involved in third-party underwriting?



This question produced a rather surprising answer. Some 16.7% said no while 69.4% said yes. Much of the debate about the applicability or otherwise of the principle of proportionality for Solvency II was based around whether the captive was a true ‘pure’ captive, only writing parent company risks, or a ‘commercial insurer’ because it underwrites third-party risks. No doubt, BEPS will be more difficult to comply with for a captive that writes third-party risks than one that only writes parent company risks.

But there is a big caveat here. Third-party risks can actually mean the risks of companies within the same group and even individuals when dealing with employee benefits, pensions and the like. So, as with much of the captive world and regulation, there is plenty of room for discussion and a need for a flexible approach and understanding from the authorities when they investigate captives.

Is it important for your captive to be a profit centre?



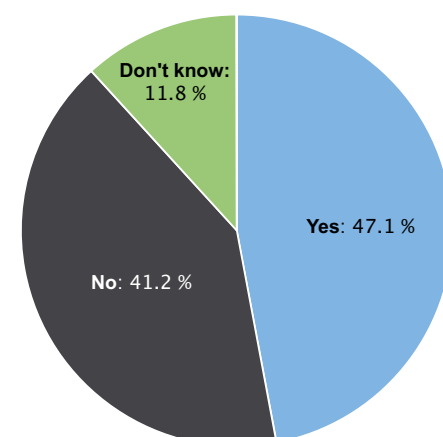
The response to this question was pretty mixed. Some 47.2% said yes while 38.9% said no.

The reason for this is probably quite simply down to individual circumstances and the attitude of the CFO and wider management about the whole point of the captive.

If you take a pure risk management approach to the captive, then it will not matter so much whether it makes a profit or not. If the CFO wants to see it used as a tool to force local operations to more effectively manage their risk, reduce losses and thus insurance costs, then being a profit centre will be more important.

It is likely that most captives serve both purposes and whether or not being a profit centre is important depends upon the balance of priorities for that company in that particular moment of time.

Do you use your captive to access the reinsurance market?



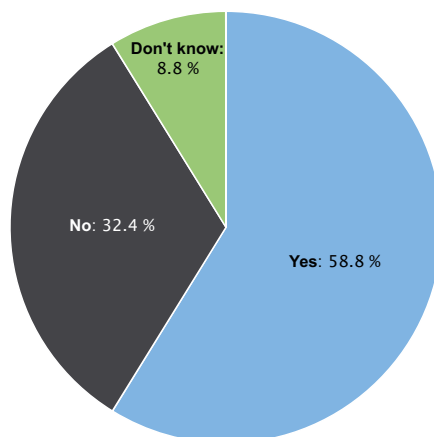


This was also a pretty balanced response, with 47.1% saying yes and 41.2% saying no. Evidence would suggest, however, that were it a harder primary insurance market, the proportion of positive answers would have been higher.

Direct access to the reinsurance market can offer cost savings, as well as alternative and, at times, more innovative solutions. It is likely that, over time, demand for direct reinsurance coverage for captives will rise. It is no surprise that those leading international reinsurers that have recently set up dedicated operations for the corporate insurance space all target captives as key sources of new business.

Have you considered 'incubating' an emerging risk in the captive, with a view to gaining data and risk information that can ultimately help to find coverage in the insurance market?

This was a positive response, with some 58.8% of respondents saying yes and 32.4% registering no. Why positive? Well, it seems pretty obvious to this observer that the captive is the perfect tool to use to help build the track



Have you consolidated life and non-life risks in your captive (or are you considering this)?

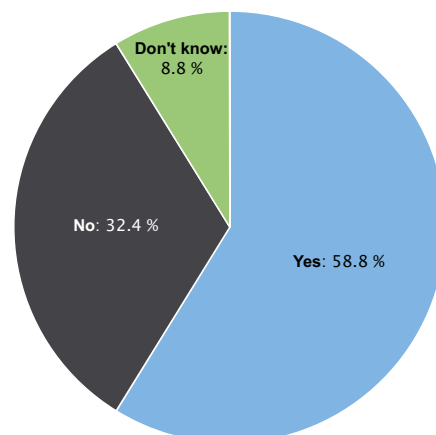
This was again not a very surprising result. It has been some time now that the market has been selling the concept of the inclusion of employee benefits risks into the captive, which were traditionally dealt with by human resources (HR).

The leading providers of specialist services and coverage for the employee benefits market say that demand is certainly rising for captive services. Evidence gained from our discussions with risk managers across Europe during the year suggests that risk managers are working more closely with their colleagues in HR to at least explore this potential.

record and loss experience needed to negotiate broader coverage on better terms in trickier risk areas.

Do not be surprised to find that in next year's survey a higher proportion of risk managers will say that they are incubating emerging risks within their captives.

Retaining these risks within the captive surely also helps focus the corporate mind upon the risk identification, measurement, management and mitigation of these risks.



Europe's risk managers see options for innovation with captives

THIS YEAR'S EUROPEAN RISK Frontiers survey, carried out with risk managers across Europe from March to September and published at the Ferma Forum, did not find a great deal of concern about the future of captives because of Base Erosion and Profit Shifting (BEPS), Panama Papers and the like.

In fact, on the whole, Europe's risk managers actually see a lot of potential in captives to be used as strategic incubators for emerging risks that the standard insurance market understandably finds difficult to measure, model and ultimately price.

The captive is also a useful tool to access alternative reinsurance and even perhaps insurance-linked securities capacity, to cover more esoteric risks in a cost-effective manner.

There is clearly a concern that the mounting regulatory matters such as BEPS (see in-depth analysis below) and Solvency II bring added cost and hassle that make captives more difficult to justify. But many European risk managers seem comfortable with their captives and regard them as a basic tool to help deliver the best coverage on the best terms possible.

In this sense, for now, the biggest threat to captives does appear to be the stubbornly soft commercial insurance market. Why bother with the cost and compliance headaches when you can buy such cheap commercial insurance all over Europe and in most parts of the world?

During the survey, we asked Belgian risk managers whether the use of captives was becoming more popular with risk managers and their companies. Why bother with insurance when you can simply retain the risk in a captive and save all that hassle and expense?

Ultimately it comes down to two factors – the extent of your risk appetite and the adequacy of the response from insurers, says Sabine Desantoine, insurable risks manager at ING Belgium

and Belrim president. "I would say that the question of whether to retain rather than transfer risk is one that is being asked more and more."

However, while risk managers may be asking the question, many are finding that establishing a captive involves more hassle and expense than it used to. "Setting up and running a captive is becoming a more capital-intensive exercise thanks to regulations like Solvency II and Basel III," says Ms Desantoine. "And following the financial crisis, companies are more cost conscious. So you have to assess the internal (balance sheet, size of the risk) and external (regulation) costs of setting up a captive."

Companies must also look at their own capabilities and scale, says Michelle De Vlieger, an independent director and management consultant. "The company has to be big enough to manage a captive and for the larger risks there has to be a reinsurer behind it all. But it is not just about size. There also have to be some fiscal and process benefits from having a captive. It can be a great way to divide risks, but I think with all the regulation there could be a backlash and more risk managers could turn back to insurers."

The impact of Solvency II, Basel II and the Organisation for Economic Co-operation and Development's (OCD) BEPS measures could all affect the use of captives. Risk managers and their associations such as Belrim need to support efforts by Ferma and others to explain the economic viability of the captive and show that it is not a tax-dodging vehicle. They also need to redouble efforts to demonstrate the economic benefits at a time of tight expenses, agree the Belgian risk managers.

"A captive is first and foremost a risk management tool as opposed to a way to save money," says Ms Desantoine. "Maybe that principle was lost a little bit in recent years as captives became more popular and as companies became more cost conscious. Even the best concepts

can be open to abuse. But I think the risk management community has to do more to explain to regulators about why we use captives and the benefit they provide," she adds.

During the French leg of this year's survey, Anne-Marie Fournier, risk and insurance manager for French luxury goods company Kering, was asked if retaining a decent share of the corporate risk within the captive, despite soft markets, helps to build confidence in your loss prevention and risk management. Wouldn't this then make it easier for the insurer to take an ERM approach to the coverage?

Ms Fournier agrees. "Yes. A captive is all about sharing risks. If we want the insurers to share in our risks and believe in our risks, then using the captive is a good idea and an added sign that we can do this together," she says.

Spanish and European captive owners should not be overly concerned about the OECD's BEPS initiative, as long as their captive is being used correctly as a genuine risk management tool, rather than for fiscal purposes, according to Daniel San Millán, risk manager at leading Spanish conglomerate Ferrovial and founding president of Spanish risk management association IGREA.

"I am not worried about BEPS. If you are using your captive as a fiscal tool, then it is dead anyway. A captive is a risk management tool. When I talk to my colleagues about the captive, I do not talk about fiscal matters. I know that captives may have originally been used in this way a long time ago. But today, captives are a central risk management tool," Mr San Millán says.

Mr San Millán points out that a bigger threat to captives is actually the soft market. "I think the biggest risk for captives is actually the soft market. It is so, so soft that captives are not seen as an efficient use of capital anymore. But this is not my strategy. My strategy is to capitalise the captive so that we are ready for the bad times ahead," he explains.

Ferma acts on BEPS to justify captives

IN JUNE OF THIS YEAR, THE Federation of European Risk Management Associations (Ferma) released proposed guidelines for captive (re)insurance arrangements to provide risk managers with a consistent implementation of the Organisation for Economic Co-operation and Development's (OECD) recommendations on Base Erosion and Profit Shifting (BEPS).

Ferma explained that the guidelines are meant to support national administrations as they transpose BEPS into their national laws.

The guidelines cover three core areas that raised certain questions of interpretation by the OECD members during the implementation stage of the BEPS actions published in 2015.

These were: commercial rationale, substance and governance, and transfer pricing/premium-setting process.

The report drew on contributions from all Ferma's 22 member associations.

It explains the concept of captive (re)insurance companies and, for the first time, presents compiled data on premiums, profitability and taxation levels from a sample of 462 captives owned by European resident multinational companies.

This analysis shows that captives are not tax avoidance schemes as suggested by some but valid risk management and transfer vehicles that offer substantial benefit for corporations and are not designed to dodge tax.

Jo Willaert, president of Ferma, said at the time of launch: "The objective of such guidelines is mainly to avoid creating a patchwork of diverging national legislations inspired by BEPS. Captives serve an important enterprise risk management role with true business purposes for European businesses and other organisations.

Although captives are only a very small portion of BEPS, Ferma believes that national authorities should be guided in how to assess captive arrangements

according to BEPS recommendations."

Carl Leeman, leader of the captive project group, Ferma board member and chief risk officer at Belgium-based logistics firm Katoen Natie added: "Our document demonstrates that the main financial ratios of the captive insurance industry are in line with the traditional insurance market. The paper, enriched and approved by our 22 national associations, represents a strong consensus within the European risk management community on how captives are supporting the operations of their parent organisations."

Ferma explained that while the data for the report is drawn from European companies, it has global application because the BEPS recommendations are being adopted by many jurisdictions around the world.

For this reason, Ferma presented the report to the International Federation of Insurance and Risk Management Associations. This means that risk management associations in other parts of the world such as RIMS in the US, Parima in Asia, IRMSA in South Africa and ALARYS in South America can use the work to spread the message about the validity of captives in their regions as BEPS actions are implemented.

FERMA also discussed the paper in early June with the tax department of the OECD in the context of its Public Discussion Draft on Financial

Transactions and Transfer Pricing.

Gilbert Canameras, secretary general of Ferma, former president of French risk management association AMRAE and group risk and insurance officer for metals and mining company Eramet Group, gave a presentation on the BEPS report during the recent Ferma Forum in Monte Carlo.

Mr Canameras said that, on the substance and governance side, the documentation should demonstrate elements like the captive board of directors meeting in person and within the captive jurisdiction at least twice a year, and the board comprising at least three people, including a resident of the captive domicile.

These first two prongs should not be difficult to comply with, as many of these steps are obvious to captive owners and experts. But the third prong, the transfer pricing/premium-setting process, may be a bit more challenging, said Mr Canameras.

Documentation that would justify the appropriateness of the pricing for a captive acting as an insurer includes a documented and transparent premium-setting process, market quotes from third-party insurers or reinsurers, or a benchmarking analysis and a model-based technical premium using standard actuarial methodologies based on loss history, exposure measures or cost of capital, according to the guidelines.

For a captive acting as a reinsurer, the documentation to support the captive decisions further includes evidence that reinsurance pricing follows the fronting insurer's pricing.

"We can explain very clearly the premium-setting process," said Mr Canameras. "After that, it's the fiscal regulator's decision." European captives are already dealing with Solvency II requirements and will likely be sufficiently compliant, Mr Canameras added. "The sole problem could be captives that are not able to explain the premium transfer," he said.

"This shows that captives are not tax avoidance schemes as suggested by some but valid risk management and transfer vehicles..."

Ask the Expert: AXA Corporate Solutions



Ask the Expert: Marine Charbonnier, head of A.R.T. solutions, AXA Corporate Solutions

1. How can a captive help an organisation gain better understanding of its risks?

A captive can consolidate detailed information on the risk profile and its evolution, insurance and reinsurance market conditions, the global cost of retention – alone and globally with the pooling effect – that helps groups to:

- Understand the risks over the medium to long term
- Decide on preventive measures
- Finance with adapted levels of deductible and captive retention
- Adapt transfer using various possibilities – traditional and non-traditional.

2. Is it getting harder for risk managers to justify a captive insurer? Is there more pressure on captives to prove their value?

As for all non-core activities, the justification of a captive's value is a recurring topic. Captives have to be explained regularly and its added value demonstrated to the top management by the risk manager.

Better knowledge and understanding on risk profiles, centralised risk management, steering of global retention and insurance

purchase with an improved visibility and understanding of risk profile is completed by pooling. A captive can help to smooth over time premium budgets of subsidiaries providing operational and financial protection.

Value can also be about delivering coverage extensions and risk incubations of emerging risks very close to the real operational exposure.

3. Is the value of a captive more about risk management than reducing premium costs?

Logically, they are inseparable! But premium cost will depend on the level of the captive retention and its own pricing. Premium cost is just one component of the total cost of risk. This criteria, the total cost of risk, is much more relevant, and is used and closely followed more and more by our clients. It takes into account external premium being paid to third parties and the cost of the captive retention itself covering mainly its own claims...and generally the cost of loss prevention.

4. How important is it for a captive to be a profit centre?

Captive have to be profitable to ensure the profitability of its capital and maintain its activity of protecting subsidiaries. But its objective is usually not to be a profit centre. Reserves, net income and cumulative past results can be used to reduce premiums to subsidiaries, negotiate a higher level of retention with the (re)insurer, enlarge guarantees, add new lines for underwriting, etc.

5. How easy is it to switch domiciles and in what circumstances would this make sense?

The reasons for changing domicile can depend on many own group criteria. The effectiveness of moving a captive will depend on regulatory

requirements and all stakeholders' effectiveness, adaptation, proactiveness and coordination. Concerned entities could be:

- The captive managers
- All insurers and reinsurers involved since beginning of the activity
- Actuaries
- TPA
- Legal and tax advisers.

A precise and controlled project organisation is key to switching domiciles.

6. What are the benefits/drawbacks of consolidating life and non-life risks in a captive?

Life and non-life risks have different risk profiles. By integrating employee benefits risk, which is historically less volatile, into property and casualty risk, which has usually higher levels of risk, our clients are also able to decrease the overall volatility within the captive.

At the same time, our clients increase the solvency of their captive in the event of a major incident, without significantly adding to the captive's overall risk.

7. Can 'incubating' an emerging risk in a captive help to ultimately find coverage in the insurance market? Is this mainly about gathering risk and claims data?

Incubating emerging risks in a captive must truly help the risk manager to have a better knowledge of its risk profile. But first of all it helps him or her to define the need for guarantees, to map exposures using scenario analysis, to internally make sense of insurance and to motivate loss prevention actions.

After the risk has been incubated in a captive, the insurance market should be more open with more proven technical information due to experience and its quantitative and qualitative data.

Captives: Recognised and valued

LAURENT NIHOUL, FEDERATION OF EUROPEAN RISK Management Associations (Ferma) board member and general manager – corporate risk and insurance, ArcelorMittal, has been involved with the federation’s project on captives and its efforts to ensure that they are not perceived as tax-dodging vehicles under the Organisation for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) initiative. Mr Nihoul explains the aims and benefits of the project and how it is hoped that clarification will lead to consistency of implementation of BEPS in relation to captives.

Q: How is the BEPS campaign going? Has there been much contact with the OECD on this matter? What is the current position of the OECD on captives in relation to BEPS?

A: Ferma launched in September 2016 a campaign to change misperceptions of captive insurance by tax authorities and ensure a consistent implementation of the OECD recommendations on BEPS. Although captives are only a very small portion of BEPS, Ferma believes that national authorities should be guided in how to assess captive arrangements according to BEPS recommendations.

After a first meeting with the OECD tax department, in June 2017 Ferma published an information report to allow OECD members to assess, in a consistent manner, the compliance of captive (re)insurance arrangements with the BEPS recommendations. The report draws on contributions from all its 22 member associations. It explains the concept of captive (re)insurance companies and, for the first time, presents compiled data on premiums, profitability and taxation levels from a sample of 462 captives owned by European resident multinational companies.

Our paper was well received by the OECD and we are pleased that the OECD recognises the role of captives as a risk management tool and the related insurance benefit for companies.

Q: With regards to the new BEPS tax rules, is it mainly a question of trying to satisfy the OECD of the validity of captives and dispelling misperceptions?

A: Not only that, obviously, Ferma wanted to dispel misperceptions about captives through detailed explanations about how and why they are used as a risk management tool by companies. But Ferma’s main objective is about promoting consistency in the way BEPS principles will be applied to captives. At the core of our paper are the proposed guidelines, which are meant to support national authorities when transposing BEPS actions into their national laws. The said guidelines cover three areas that raised certain questions of interpretation by the OECD members during the implementation stage of the BEPS actions published in



2015: commercial rationale, substance and governance, and transfer pricing/premium-setting process. The objective of our guidelines is therefore mainly to avoid creating a patchwork of diverging national legislations inspired by BEPS.

Q: Is the aim to have the OECD make this explicit in its recommendations, so as to avoid unwelcome interpretations by national authorities?

A: BEPS actions are now implemented in many OECD jurisdictions. Our information paper on captives should be seen as guidance to help the OECD and the national tax authorities to better comprehend the concept of captive insurance and reinsurance companies. Our paper was received positively by the OECD tax department. We invite the OECD to take into account our guidelines in future guidance documents and hope we will be able to continue our dialogue with them to support a consistent multilateral approach by national authorities.

Q: Is the campaign also aimed at national regulators in terms of their potential interpretation of the OECD recommendations?

A: As mentioned, Ferma’s aim in publishing this report is to allow OECD members to assess, in a consistent manner, the compliance of captive (re)insurance covers with the BEPS



recommendations. When it comes to national regulators, we believe that our national member associations are the right level to become the relevant stakeholders for tax authorities. Each jurisdiction may have a specific tax culture and it's important that they have a local risk management association in front of them to pursue a more detailed dialogue about the rationale of captive companies and their contribution to the economy.

Q: Are there any indications that the OECD (or national regulators) has taken on board Ferma's concerns about the new rules?

A: The OECD is now aware of and recognises the role of captives as a risk management tool and the related insurance benefit for companies. We have established a fruitful dialogue with the tax department and the Ferma paper have been passed on to the OECD working party on transfer pricing and its financial transaction working group. As such, we do believe that risk managers' concerns are now fully part of the discussion.

Q: Is the main impact on captives in

“ It is the main message from the risk management community that Ferma wants to highlight: the contribution of captives to the financial protection of industries and the global economy should be recognised and valued appropriately by the regulators...”

terms of the additional administrative cost incurred in responding to greater scrutiny from tax authorities? In terms of transfer pricing, could it reduce the ability of a captive to use pricing as a risk management tool for rewarding/penalising good risk management practices in subsidiaries?

A: Increased scrutiny from tax authorities has indeed led to additional administrative cost because of the time and resources spent on the response. Demonstrating the added value and business rationale of a captive is not an issue for risk managers and their companies, but we are concerned that the additional administrative burden of owning a captive could

become uneconomic.

Our information paper shows that claims of €7.1bn were paid by our sample of 462 captives owned by EU parents, composed mostly of industrial companies in manufacturing, transport and logistics or energy. Let us bear in mind that captives' indemnification money is not only a financial flow, its ultimate goal is to be used by companies to repair or renew their damaged assets and get back to business as quickly as possible. It is the main message from the risk management community that Ferma wants to highlight: the contribution of captives to the financial protection of industries and the global economy should be recognised and valued appropriately by the regulators.

THE FIGURES:

Captive insurers are no different from commercial insurers but pay more tax

THE FEDERATION OF European Risk Management Associations' (Ferma) benchmarking analysis, carried out by New York University Stern School of Business, shows conclusively that captives are comparable to traditional insurance companies when judged by underwriting results, taxation and level of equity and solvency.

The federation points out that insurance and reinsurance is a highly regulated business. Captives have to meet the same supervisory requirements – corporate governance, minimum solvency levels, fit and proper constraints for management etc – as the traditional market under Solvency II.

The diversification benefits gained by broad-based insurers and reinsurers should theoretically be balanced out by 'proportionate' treatment granted to captives by their national supervisors.

The figures compiled by Stern show that, of the 462 captives owned by European resident multinational companies that were included, \$10bn of net premiums have been underwritten and \$7bn of net claims had been paid back to the multinational group's operating entities. This gave a loss ratio of 72%.

The net profit before tax for these captives in total was \$1.5bn or \$1.78bn when allocations to catastrophe/equalisation reserves are included. Ferma explained that 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.

The federation pointed out that natural hazard is a good 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 cases, net profit can only be assessed over a multi-year period," states the report.

The comparison between 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%), shows that captives are not making "excessive profit" compared to the European commercial insurance markets, concludes the report.

The analysis also found that taxes paid by captives by the 462 captives represent \$300m, which leads to an effective tax rate of 15%. This compares with the effective tax rate of European commercial insurers of 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," finds the analysis.

And, by 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 clear that captives are not excessively capitalised 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," states the report.

Another potential misconception about captives is that they are all based in exotic offshore domiciles that have inevitably been dragged into the Panama papers scandal and so must be dodgy.

The majority of the captives that took part in this survey (53%) were based in Europe. Another 8% were based in the US and 39% in the rest of the world in domiciles such as Bermuda, Guernsey and the like.

The report explains that there are good economic, not necessarily fiscal, reasons for hosting captives outside of Europe. "Due to insurance regulations in some countries (eg US 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," states the report.

Based on the survey, the authors conclude that EU-parented captives are mainly created by industrial groups in areas such as manufacturing, transport, energy, pharmaceuticals companies, food system and natural resources.

The lines of business underwritten by the captives "clearly" reflect that captives are used in the same way as open market insurance, with property, liability and marine comprising about half of the 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 it is at prohibitive prices. Professional indemnity, employer's liability, crime or product liability/product recall are prime examples of this," concludes the report.



Asian financial centres gearing up for captive explosion

THE POTENTIAL FOR CAPTIVES in China and the wider Asian region is “huge” according to Keith Xia, head of risk management, business reputation and responsibility, global risk management at InterContinental Hotels Group and head of the Pan Asia Risk & Insurance Management Association (Parima) in China (see related story).

But while *Commercial Risk Asia* continues to pick up news of the creation of Chinese captives and the excitement felt in Hong Kong about the potential for captives to help manage the massive investment and risks associated with China’s ‘Belt and Road’ initiative is evident, the numbers are still tiny compared with North America and Europe.

Reportedly, the latest new captive in China is the seventh in total.

The potential remains very much potential. But regulatory and fiscal misperceptions that are still holding the region back need tackling. The authorities are trying to address these issues.

The Monetary Authority of Singapore (MAS), for example, last year introduced the Organisation for Economic Co-operation and Development’s (OECD) base erosion and profit shifting standards (BEPS).

MAS will also withdraw its tax exemption on 31 March 2018, to comply with OECD guidelines. The report suggested that this is a “positive step” for Singapore, as the option will remain for organisations to use Singapore as a route into Asian markets.

The Federation of European Risk and Insurance Management Associations and Insurance has shared its excellent guidance for national supervisors and fiscal authorities on how to make sure captives are compliant for BEPS with Parima through their common membership of the International Federation of Risk & Insurance Management Associations.

The Insurance Authority (IA) of Hong Kong is also keen to ensure that its rules and regulations are up to speed with global practices to help foster a captive sector.

John Leung, CEO of the IA, gave a speech in October at a conference in Hong Kong organised by the *Financial Times* during which he said that the Belt and Road Initiative, “is expected to bring enormous new business opportunities in the coming years”, not least for captives.

“From the perspective of the Hong Kong insurance industry, we can play a key role in providing insurance and brokerage services for the large-scale investment and infrastructure projects under the Belt and Road Initiative. We can also provide reinsurance services for mainland insurers underwriting Belt and Road infrastructure projects. At present, there are 18 professional reinsurers in Hong Kong, including a number of internationally renowned firms which possess a wealth of technological knowhow and experience in international reinsurance placement,” explained Mr Leung.

The supervisor added that the Equivalence Assessment Framework Agreement on Solvency Regulatory Regime, signed between the insurance regulators of Hong Kong and mainland China in May this year, will “strengthen the competitiveness of Hong Kong reinsurers in arranging reinsurance coverage for mainland insurers” and help them to better manage and diversify their risks.

“Furthermore, Hong Kong is an ideal place for mainland enterprises to set up captive insurers as we have in place various policies to facilitate the setting up of captives here. With more mainland enterprises seeking to ‘go global’ under the Belt and Road Initiative, setting up a captive in Hong Kong can help them manage their new risk exposures, including those along the Belt and Road,” said Mr Leung.

And Labuan is trying to up its

game. Tan Sri Muhammad bin Ibrahim, chairman of the Labuan International Business and Financial Centre (IBFC) recently stated in his keynote address at the Labuan Industry Annual Dinner about the urgent need for the body to “reinvent itself” to stay relevant. He said the IBFC needs to reinvent itself in order to survive in “a new world reality”.

The chairman pointed out that Malaysia, until early this year, had been an observer of the OECD’s BEPS initiative. Since January 2017, it had, however, agreed to become a participating member in the Inclusive Framework.

“Work has commenced on reviewing respective jurisdictions’ preferential tax regimes against the standards outlined, to combat harmful tax practices. The standard, which forms one of the four BEPS minimum standards, will require authorities to step up on transparency and substance rules for geographically-mobile activities, such as financial services. It seeks, for one, to prohibit the shifting away of income into preferential tax regimes where businesses have little or no economic activity. Such international developments will directly influence IBFC’s business model going forward,” he said.

“The world that we live in, since the creation of offshore Labuan in the 1990s, has drastically changed. What was relevant then is no longer relevant. We have no choice but to change with it. It is an opportune time for us to review of the current tax framework for Labuan,” added the IBFC leader.

In the summer, Ahmad Hizzad Baharuddin, director general of Labuan FSA, addressed the Asia Captive Congress held in Kuala Lumpur. During this conference, the findings of a survey of the sector including 112 risk managers and sponsored by the IBFC were revealed, and would have made for pretty sober reading for anyone keen on the development of the Asian captive sector.

It found that of 6,168 captives

worldwide, only 148 are based in Asia-Pacific (2%). Of the 616 new captives licensed last year, only eight were in Asia-Pacific.

This survey found that a “lack of commitment from internal decision makers” is holding back captive use in Asia. There is a common perception that captives are only suited to the largest companies and worse still captives are all too often regarded as a “pure tax play” within the regional risk and insurance management community.

Not surprisingly, a gradually maturing risk management culture and difficulty in finding coverage for more difficult risk portfolios such as cyber, are among the drivers of captive interest.

The good news for the captive sector is that some 90% of respondents said they expect growth in the number of captives domiciled in Asia. The key is to overcome the knowledge gap and lack of commitment from internal decision makers. Clearly, the highly competitive and soft commercial insurance markets are not helping the case of captives in Asia. But those who took part in this survey also cited high setup costs and regulatory concerns and the perception that captives are a “pure tax play”.

The good news for the Labuan IBFC from its survey was that 64% of respondents said they perceive Labuan to have a ‘fair’ reputation as a captive domicile, with 32% saying ‘strong’. Almost 70% of respondents are “very comfortable” using Labuan as their captive domicile.

But Mr Baharuddin conceded that there is plenty of work still to do. “Captives are also unfamiliar territories for many, with its misconception and misperceptions, while opening opportunities. The survey results and the panel discussions amplify the need for decision makers to appreciate that applying captives help to improve how you manage and finance risk, and priorities need to be given to analysing organisations’ or groups’ risk programmes,” he said.

And up came BEPS again. “In the last panel led by Michael Vellen, he

“The good news for the captive sector is that some 90% of respondents said they expect growth in number of captives domiciled in Asia. The key is to overcome the knowledge gap and lack of commitment from internal decision makers...”

explained the BEPS concepts that bring forth the reality that there are only two things certain in life – death and the taxman. The panel brilliantly advised the conference with the forthcoming BEPS adoption and its implementation, [noting that] tax considerations should not be the primary driver. That is both a very practical suggestion as well as foresight. In Labuan IBFC, substance requirements and information exchange with other tax authorities would be an inevitable outcome as Malaysia is committed to the BEPS framework,” he said.

But it is not all doom and gloom. Despite the obvious challenges raised by the director general and the need for regulators across the region to up their game in the new environment, the prospects for captive growth in Asia remain “enormous” in his view.

“China is now very fast raising the awareness and interest in alternative risk transfer programmes, given the robust economic growth and the resultant growth in insurance penetration. While we heard conservative Japanese companies shy away from tax planning or cost-saving endeavours, it is noted that there is a changing of tide in recent years due to the possibility of a new tax regime and the presence of international Japanese subsidiary overseas. The room for growth is therefore enormous in Asia-Pacific, since in Asia, the knowledge and understanding of the full capacities of captives is still at its infancy stage,” said Mr Baharuddin.

The supervisor also noted that the underinsurance phenomenon remains a typical feature in many Asian economies. Over time, in his view, the captive

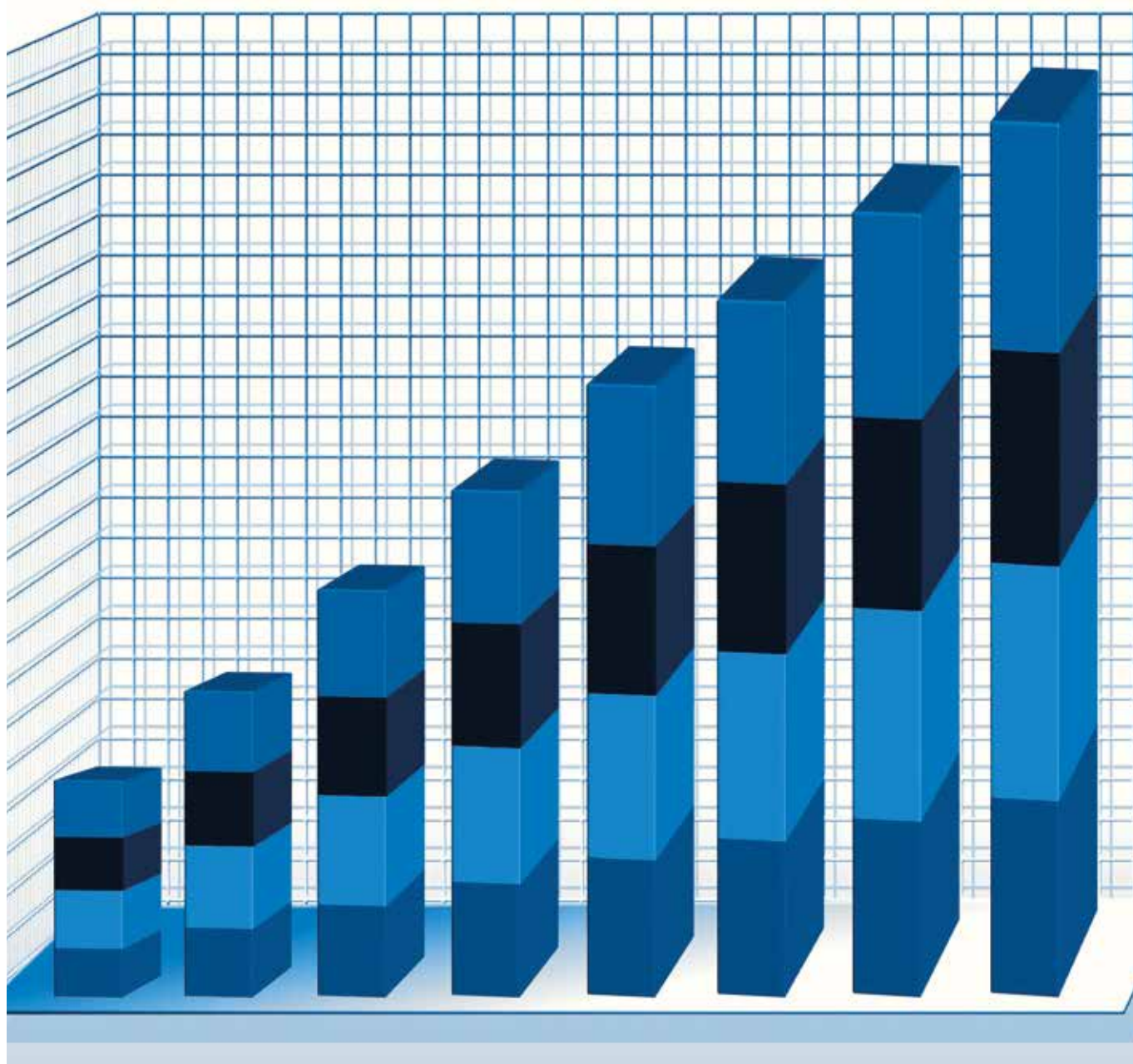
should be an attractive solution for many businesses as they evolve alongside Asia’s robust economic expansion, in particular cross-border trade activity and proliferating infrastructure development, such as China’s Belt and Road Initiative, as noted by Mr Leung of the IA.

“These would certainly present a strong case for captive business to flourish. As corporations in this region get larger and more sophisticated, with the continuous education to create awareness of captives, coupled with the heightened level of risk exposures and coverage required, there will be more corporations looking at captive propositions as a viable alternative risk transfer vehicle and eventually see the economic merits of keeping and self-insuring some of their risks in-house,” he said.

Mr Baharuddin said that established international financial centres such as Bermuda and Guernsey remain the most popular domiciles for captives. But he added that he is “happy to note” that domiciles such as Labuan and Singapore are emerging as leading destinations in the region for captives because they are “very attractive” in terms of capital requirements and solvency regimes, flexibility of investments, as well as reputation and effectiveness of supervision.

The figures suggest that Labuan IBFC does have the capability to be a lead player in the development of the Asian captive market.

Mr Baharuddin reported that as of August, Labuan IBFC was home to 203 insurance and insurance-related entities, including 43 captives. The captive business generated aggregated written



premium of \$348.6m in 2016.

Interestingly, the majority of the captive business is currently derived from outside Malaysia. Asia is the main contributor, with almost 75% of the premium, and the remaining 25% is with EU- and US-parented captives. “There is of course, still considerable room for Labuan’s captive industry to continue to position itself to serve the Asian market,” he pointed out.

To effectively tap into these opportunities, an enabling environment created by a facilitative regulatory framework is needed and Labuan is on the case, said the regulator. “The authority, through engagement with the relevant stakeholders including the

industry players, continues to review the legislation to ensure that it is on a par with international standards and best practices, as well as to allow for diversification and broadening of niche products and services offerings in Labuan IBFC. The current Labuan legislation is regarded as the most market-adaptive, compared to other captive markets, especially the provision on protected cell companies (PCC), both conventional and Islamic. In addition, to further enhance the business proposition and provide certainty to prospective investors, Labuan FSA has issued a clarification note on the solvency requirements for Labuan PCCs, in 2016,” he explained.

“Leveraging on the critical mass

of the insurance expertise, robust and yet flexible regulatory regime and wide spectrum of risk management products, Labuan IBFC is well positioned to progress into the next phase of development as one of Asia’s leading captive insurance hubs,” he added.

“Asia is in an exciting phase of growth; and captive insurance is certainly an important component of the evolving business infrastructure and financial markets. The prospects for captives are bright and all of us here can play a greater role to serve the needs of the captive industry in Asia, by offering solutions for risk diversification and for more efficient capital and balance sheet management,” he concluded.

ASIAN CAPTIVE POTENTIAL: The risk managers' perspective

RISK MANAGER READERS of *Commercial Risk Asia* were asked whether they use a captive and, if not, what might persuade them to do so. The responses showed an even split but with a slight majority (45%) already using a captive and a further 15% planning to do so.

Captives are especially popular in the more established Asian insurance markets of Hong Kong and Singapore. Hong Kong-based telco PCCW has had a captive in place since 2007 and it has proven to be an “extremely valuable” vehicle for the company, says David Ralph, senior vice-president, risk management.

Mr Ralph says that for companies with a global programme, a captive is a necessity. It is invaluable for smoothing the costs of risk financing, tailoring coverage specifically for a company's own risks and, most importantly, driving down an appreciation of the cost of risk to the general employee population, says Mr Ralph.

“Nothing makes them sit up more than when you say: ‘Yes, we have insurance but a very significant amount is self-insured and every time we pay a claim, that comes directly off the group's bottom line and thus out of your bonuses’,” he explained.

“When the company's bonus pool is directly impacted by the size of losses paid by the captive, it's amazing how much all levels of the company, from the MD to the newest recruit, are engaged in risk management,” added Mr Ralph.

CAPTIVE BARRIERS

For those risk managers that do not yet use a captive, size is a commonly cited issue, as also found by the Labuan International Business and Financial Centre's recent survey (see related story).

“I think we are too small to have one,” says Guan Seng Khoo, risk manager at Changi Airports International. But while size may

impact the ability to fund a captive, Dr Khoo recognises the benefit of self-sufficiency in terms of liquidity and capital allocation. “The enhanced capital management would be my biggest motive for having a captive, as opposed to the risk transfer benefits.”

A number of risk managers are currently engaged in feasibility studies to see if using a captive would make sense. “We want to test the following hypothesis – rather than managing our risks through a decentralised insurance approach to a group consolidated insurance programme, we would be better off using a captive. If the hypothesis is proved, it could be another way of saving costs and improving efficiency,” says Victoria Tan, group head for risk management and sustainability at Philippines-based conglomerate Ayala Corporation.

Geography and the respective regulatory regimes play a big part in the feasibility of captives for many risk managers.

For example, in Indonesia the captive concept is not recognised by the Financial Services Authority, known locally as the Otoritas Jasa Keuangan, and they are instead classified as standard insurance companies, making them less appealing options for companies. Consequently, companies such as ABM Investama, the investment arm of Indonesian energy group Tiara Marga Trakindo, that are keen to manage their own risks and insurance spend, have set up segregated accounts to fund their risks.

“From an internal perspective we have a captive, but from the perspective of audit we do not. So regulation is in fact a big barrier to the development of the captive sector in Indonesia,” says Bernado Mochtar, head of enterprise risk management at AMB.

“For a captive in Indonesia, you need a legislative process. You need to establish a reinsurance company and you need a certain level of capital, which

is quite large. The captive also needs a certain level of operational processes. But companies need to raise deductibles in order to obtain lower premiums and so retain a substantial level of risk,” he explains.

Regulation is also a barrier to the creation of a captive in India. “There are no tax advantages for captives in India and this [should be] one of the main advantages of a captive,” says Saurabh Verma, Pan-Asia Risk and Insurance Management Association board member for India, and risk manager with a leading Indian conglomerate.

“If you want to self-insure then you have to put up the same capital as a commercial insurer, which is about \$18m-\$20m. So, if you want a captive insurer, you need to persuade the boss that you need that asset. Regulations do not allow you to go to Bermuda or another such domicile,” explains Mr Verma.

CAPTIVE USERS

Meanwhile in Malaysia, the big buyers of corporate insurance regularly employ captives, some of which are used to cover employee benefits and other self-financing risks, as is the case for Petronas, the state-owned oil and gas company. A big benefit of this approach is the ability to control risks, says Raziyah Yahya, general manager, risk and insurance, at Petronas.

“Our captive writes parent-only risks and all operations are included. It is financed by only our own equity and this helps us determine what we are actually buying,” she says.

The biggest change in the use of captives may well come in China. There are currently only seven reported captives in China. But the government has stated that it is keen to see the development of the sector and the Chinese insurance regulator is also actively promoting the concept.

Hong Kong is also keen to establish itself as a vibrant captive centre,



especially for Chinese corporations with international expansion underway or planned.

According to Keith Xia, head of risk management, business reputation and responsibility, global risk management

at InterContinental Hotels Group, the captive market could rapidly take off as more Chinese companies expand overseas and see other ways to manage risk.

There are challenges, such as the fact that so many Chinese corporates are

state-owned and the insurance market is so cheap, plus there is a conservatism among a lot of Chinese companies when it comes to insurance and many are happy to be led by their broker. But as Mr Xia says: "The potential is huge."

Taking a strategic approach

Paul Woehrmann, head of captive services Europe, Middle East, Africa, Asia-Pacific and Latin America

Currently, the entire insurance and reinsurance market is in a state of great change and over time, could become perhaps more consolidated because the industry is under rising pressure. This is largely due to the steadily decreasing premium rates leading to lower margins, while additional capacity is entering from the financial market. Another kind of market consolidation can be observed as a result of M&A transactions performed by captive owners.

After an M&A transaction, the captive owner will prioritise its business partners under a new insurance and retrocession structure, despite the fact that each insurer and reinsurer is interested in keeping the existing business relationship. If this is the case, then various business scenarios could be considered.

In order to make sure that the risk transfer is handled efficiently, captive owners could consider an insurance carrier with a large and robust insurance network, able to manage a global insurance programme with consistent wording. The related risks could then be reinsured to the captive on a proportional basis. Former insurance providers with substantial capacity, but without access to a comprehensive global insurance programme infrastructure, could offer their capacities as retrocession protection behind the captive.

Interestingly, we have experienced these trends in our current competitive market environment. We are seeing that large European captive owners are using their captives more actively – optimising insurance and reinsurance structures to:

- Bring two worlds (life and non-life) into one reinsurance captive
- Benefit from arbitrage opportunities in the markets (pricing, coverage and capacity)
- Strengthen the core business of the captive owner
- Develop solutions for new risks. Larger internationally-operating

industrial captive owners are using highly experienced insurance companies as fronting partners, allowing them efficient access to the reinsurance market through their captives. Having a captive on board allows their owners to optimise pricing, coverage and capacity strategies across the insurance cycle. Large European captive owners have successfully started to follow such a strategic approach under a holistic view.

In the past, the majority of captive reinsurance programmes were reinsured by fronting insurers on a non-proportional basis within primary layers. This is due to the financial incentive for captive owners to influence future frequency claims through active risk management and the systematic identification, assessment and improvement of risk. As a consequence, the cost of risks can be reduced, and profitability will be protected by introducing appropriate risk control measures, which reduce future claim frequencies and the cost of premiums.

Despite the soft market development, we have observed that within the portfolios of our captive customers, there has been a more active use of reinsurance captives – especially for large captive owners.

Customers who consider a change in their buying behaviour for arbitrage opportunities need an insurance partner with a specific proposition to meet their needs. This partner should be able to deal with the new and growing demand by reinsurance captives to leverage tangible benefits of portfolio diversification. At Zurich, we see three different categories of arbitrage opportunities where captive owners can capture tangible benefits:

- Firstly, pricing arbitrage especially for medium and high excess layers between the insurance, reinsurance and ILS market.
- Secondly, coverage and wording arbitrage in order to issue tailor-made insurance programmes, for example on cyber risk with wordings that meet the captive owner's expectations. Captives would accept insurance policy exclusions. Hence,

the wording of the insurance coverage could be much broader than that of the retrocession level behind the captive. In other words, the captive would cover any deviation.

- Finally, capacity arbitrage. Capacity arbitrage has been experienced in the banking and mining industry. Such a solution generally requires substantial captive risk retention and attention for counterparty credit risk matters.

Fronting insurers are then faced with complex customer service expectations, especially if the fronting insurer is also acting behind the captive on a retrocession panel. Such risk transfer levels require proven IT interfaces between the retrocession, reinsurance and insurance level.

Therefore, it is vital that captive owners select a well-rated and reliable corporate insurer capable of paying and servicing claims, which are ultimately reinsured to the captive. Zurich has the experience required to manage such complex captive owner requirements on a global scale and captive owners can expect comprehensive support that is consistent, end to end and worldwide.

An effective and professional captive fronting partner should be able to:

- Simplify management across lines of business
- Solve complex insurance problems
- Access a strong and reliable global network
- Address insurance premium tax compliance for captive programmes
- Provide accurate, transparent and timely bordereaux reporting through a single ceding party.

CONCLUSION

The current market environment provides attractive and comprehensive risk self-financing and risk transfer solutions, which could create persistent business opportunities for various market participants. Corporate insurers that operate globally might find they are increasingly asked by captive owners to keep their network infrastructure available, for a commission, for more lines of businesses.

CAPTIVES: Challenging environment but adding value

Marine Charbonnier,
head of A.R.T. solutions,
AXA Corporate Solutions

Captives are in a very challenging environment: stronger regulation, technical justification in soft markets, financial and tax pressure, increased reporting and disclosures.

An increasing number of captives have a high level of management, governance infrastructure and expertise and are exploring the many benefits of including more services, as well as diversified portfolios.

The greater focus by parent companies leads to reviews of their performance, challenging the status quo and thinking strategically to take the right actions in order to optimise added value and to reduce the cost of risk globally.

New requirements are related to:

1. The principle of using a captive as a major component in a company's risk management strategy by using capital more efficiently with non-correlated risks. This means they are increasingly expanding their underwriting:

- By including lines previously uninsured because the insurance market may be reluctant. Thus, the parent company and its subsidiaries protect their profit and balance sheet from losses due to the volatility of risks with budget stability.
- By diversifying with employee benefits and pensions.

2. A proper management of assets taking into account regulation and risks that arise due to mismatches between the assets and liabilities.

3. In some cases, a change of domiciliation due to group objectives and constraints.

AXA Corporate Solutions

AXA Corporate Solutions' experience in terms of captives is longstanding, sound and customer-driven.

Our experience in a nutshell (2016 data): 200 sessions to captives fronted by AXA CS, all lines of business including ART throughout international traditional programmes and emerging risks. Our skilled teams work together on captive client accounts on a daily basis.

AXA CS captive services

- Client-focused to suit their requirements.
- AXA CS coordination team and the dedicated ART team have a deep experience of the captive market, also as previously reinsurer, broker, captive manager and even as captive internal control.
- Our solid competencies help corporates in terms of efficiency because our captive services and solutions comprise a wide range of offers for different clients and their captives' needs.
- Furthermore, as we work in a highly regulated sector which impacts AXA CS and our captive clients, we understand captives' constraints and requirements.

Range of services and solutions

- We offer high-quality support services with innovations within this area, for instance, using specific IT tools. This is very useful for the captive itself, the risk manager and the account consolidation as cash is an important issue for all clients.
- We support the captive from its creation to its closure: technical business plan support, underwriting file, portfolio transfer and commutation.
- We can advise on captive involvement in international programmes: technical business plan with actuarial modelling.
- We issue specific policy extensions to cover emerging risks: cyber, non-contingent business interruption, supplier/client failure, impossibility

to access a site, reputational risk, weather risks (in partnership with AXA Global Parametrics), employee benefits (in partnership with MAXIS), group pension (AXA UK, AXA France etc).

- We bring our claims management expertise with highly technical added value for traditional risks as well as for the emerging risks.
- We accompany developments in other new areas such as affinity solutions underwritings with AXA PARTNER.
- We manage claims from usual frequency claims to very complex and specific claims.
- We coordinate between traditional lines of business and our ART team to take into account all the dimensions of the client exposures and needs.
- We design captive protection with multiline structured stop loss.
- And we purpose alternative and complementary risk management tools: structured policies.

CONCLUSION

As a multi-services player, we listen to our clients' needs and we are able to adapt our solutions.

- Captive clients face the same issues as us. We can find solutions to our clients' needs by offering additional expertise within the AXA Group, such as asset management (AXA IM), portfolio buyback (AXA LM), and prevention (AXA MATRIX Risk Consultants).
- Given the importance of compliance with regulations and legislation, our expert teams involved in captive client management are regularly trained on: BEPS, Solvency II.
- Extensive preparation of annual account closing: particular and exhaustive reporting (reinsurance split), specific meeting with the captive manager or reinsurance broker if needed.

Huge potential for captives in Asia-Pacific

Tony McHarg, head of multinational, Asia-Pacific, AIG

The ongoing economic growth in Asia-Pacific (APAC) has resulted in a rising demand for insurance and, at the same time, risk management continues to be an area of increasing focus and attention. It is perhaps not surprising then that APAC has long been seen as the next growing market for captive insurance.

Challenges to overcome

However, while APAC may have huge potential in terms of captives, growth in the region remains slow. One reason for this is that captive insurance is held back by a lack of understanding and developed risk management culture. While there is an increasing focus on risk management, particularly across larger and state-owned companies in the region, the actual number of experienced risk managers, level of in-depth knowledge in captive insurance and their influence corporately remains relatively limited. This represents a challenge in overcoming the perceived complexity of captive establishment and utilisation. In addition, the soft risk transfer market is not helping the situation. In the eyes of many, the highly competitive risk transfer market reduces the incentive for utilising captive solutions. Furthermore, due to the lack of a centralised mandate, a number of captives that have been established to date often have to compete internally to capture the fragmented insurance placements into an evolving captive programme.

Unlocking the potential

Faced with these challenges, what can be done to unlock the region's potential for captive insurance? The region is seeing an increase in the number, complexity and maturity of multinational companies, and with this comes a growing need for an integrated global risk management programme. In this context, the benefits of a captive as part of such a programme for multinational companies are well

established.

As companies become multinational, there is often a corresponding increase in the importance of the risk manager/insurance function in the corporate hierarchy and its decision making, increasing the likelihood that risk management/financing solutions such as captives are considered and adopted by companies.

While the use of captives is often considered the sign of a mature risk environment in more mature markets, captives can play a meaningful role in fostering advancement of risk management across emerging market conglomerates/companies. Captives can do this by being utilised as the vehicle to efficiently consolidate currently fragmented placements and related risk exposure and claims experience, while at the same time coordinating the advancement of risk management.

Perhaps the most important element to stimulating growth is tackling the lack of awareness of the benefits of captive insurance, in particular through the use of continuing education. More comprehensive/end-to-end understanding of captive solutions is key to promoting risk management culture. We have found that clients in APAC are particularly interested in the success stories of how western and developed companies in their industry utilise captives. This can provide a strong testimonial for risk managers in helping to gain internal support for the solution. There is an important role here for major insurers and brokers to promote and educate the market, and to invest in resources that help that process.

China's enormous potential

Within APAC, China is one of the main potential growth regions for captive insurance. Growth is expected to come from state-owned enterprises (SOEs) and large private multinational companies, which are recognising the need for risk management through the use of captives. One of the main drivers for this is the need for solutions as the companies' risks become more sophisticated and global,

and the increasing pressure on large SOEs to become more efficient.

Another major impetus is the extensive and ongoing overseas Chinese foreign investment, including the Belt & Road Initiative, which is mainly being driven by SOEs and private multinational companies – in particular, energy, construction, infrastructure and telecommunication companies. A number of these organisations either have already established captives, or are interested in learning how to achieve cost savings and risk management benefits through the use of multinational captive programmes.

The potential for captive insurance in China is also being supported by the regulator in China. The China Insurance Regulatory Commission (CIRC) is taking a more positive, supportive approach to the use of captives, and captive insurance development is included in CIRC's outline for insurance reform and innovation under the 13th five-year directive.

However, the government's mandate toward tighter capital solvency, offshore investment and currency control for financial services companies, may impact CIRC's policy and supervisory guideline on captive insurance.

Hong Kong's role

Hong Kong is likely to be one of the main beneficiaries from the growth of large multinational Chinese company-owned captives, mainly because of its internationalisation, robust and practical regulations, and the associated supporting platform. The first Chinese captive, CNOOC Insurance Limited, was established in Hong Kong. Currently there are more Chinese-owned captives registered in Hong Kong than in other mainland domiciles. However, jurisdictions such as Shanghai, Beijing, Shenzhen and Tianjin are seen as the potential competing domiciles on the mainland.

There are many reasons to be optimistic about the future growth of captives in Asia and the next few years should start to see that potential unlocked.

A growing role for captives in multinational risk transfer

CHUBB

Barry Beard, head of global services and complex multinational, UK & Ireland, Chubb

With increasing volumes of regulation and ever more rigorous compliance requirements, companies with international operations face a higher risk of financial penalties, reputational damage and the possibility of invalid claims if their insurance programmes fail to comply with local regulations.

Against this backdrop of rising risk and complexity, it should be of little surprise that more businesses are turning to captives as a flexible, cost- and capital-efficient mechanism for multinational risk transfer. Here, Barry Beard, head of global services and complex multinational, UK & Ireland, Chubb, examines some of the issues and opportunities in multinational risk transfer.

An important driver of complexity in multinational risk management is the growing tendency of local governments to restrict access to dynamic capacity outside their borders. This manifests in a number of different ways – for example by restricting the amount of risk that can be exported; or by subsequently changing the amount of information required to quote on ground-up risk, given that portions of that risk are now insured or reinsured by domestic entities.

Quality and reliability are key

These restrictions on exportability mean that in some circumstances, multinational clients are no longer able to reinsure 100% of local risks outside their country and are reliant on local insurers and reinsurers to pay a proportion of their claims in those territories. Given that in many instances the availability of financially strong insurance and reinsurance markets is very limited, companies will find that the quality of the cover they are able to access may not meet their needs.

There may also be a concern that local markets are not diversified in their mix of risk and may be accruing much higher aggregations of risk than can be meaningfully managed by their capital position, which may of course lead to issues with reliability of claims support and future claims payments.

In other instances, the available insurance and reinsurance markets locally are very limited, so the client has to acknowledge that the quality of insurance may not be up to the high standards of those when risks are exported into the global reinsurance marketplace.

Many countries permit 100% reinsurance to foreign reinsurers, while others limit the amount ceded to 90% or

“Many countries permit 100% reinsurance to foreign reinsurers...”

lower with the remainder retained by the local ceding company. A captive using a local policy-issuing insurance partner admitted to do insurance business in the location of risk, is able to provide local insurance and at the same time provide and access overarching international capacity to reinsure local risks.

Two considerations are relevant when ceding to international reinsurers. First, that local risks in many countries (such as India for example) may still have to be offered to local insurers first, and only upon declination of such risk may it be ceded compliantly to an international reinsurer.

Second, and a growing trend, concerns the insistence by local regulators on reinsurance cessions out of a country being collateralised by the reinsurer

positing local collateral in respect of reserves ceded outside the country. This is to ensure that the unlicensed foreign reinsurers' non-payment of covered claims does not place the local insurer in financial jeopardy. Such collateral can take different forms but a common one is the requirement to retain premiums locally being withheld to offset potential future claims. This ultimately adds cost and impacts cashflow.

Brexit is a complicating factor

Brexit is another complicating factor as it is likely to impact captives. Whatever form Brexit finally takes, our position is that risk managers will need to review their captive risk profiles and insurance programmes very carefully with independent advisers, financial and tax consultants, as well as monitoring markets closely to ensure solvency and licensing obligations are met.

Reliable compliance hinges on ability to manage change

Compliance in the multinational captive insurance context is dynamic and evolving. From core multinational lines such as property and casualty, and directors and officers liability, to specialty multinational lines such as cyber, environmental liability, terrorism and business-travel accident solutions, Chubb is committed to – and continues to invest in – meaningful solutions for the evolving challenges of our clients and brokers.

Captive insurance programmes have historically been, and will always remain, a focus of regulatory and tax scrutiny. Genuine, real, commercial substance is critical when building multinational captive insurance programmes and the basis of any transaction is the presence of a clear commercial rationale and appropriate substance. With the right controls, governance and transfer pricing mechanisms, captive structures will be better prepared to withstand international regulatory and tax scrutiny.



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