GLOBAL PROGRAMMES 2014

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From the publishers of

CAPTIVE REVIEW

COMPLIANCE
Increasing complexity demands extra scrutiny

TRANSPARENCY
Tax authorities seeking more information than ever before

SOLVENCY II
Careful thought required for captives running global programmes

Introduction

Businesses' global insurance programmes have developed significantly since *Captive Review* last visited the issue in 2013. The theme of compliance remains a hot topic in the space, but it has only become more complex through the introduction of transfer pricing and increasingly complicated local regulation in jurisdictions around the world.

The implementation of Solvency II in Europe is on the horizon, while further challenges are arising as insurance groups attempt to comply with Fatca in the United States as well as the changing approach from the Organisation for Economic Co-operation and Development are all putting pressure on base erosion and profit-shifting (BEPS) work streams.

Tax authorities all over the world are increasing their scrutiny of captives and asking more questions than ever before in the drive towards greater transparency throughout the insurance space.

In the *Global Programmes Report 2014*, *Captive Review* speaks to leading industry experts about how best to tackle issues such as local regulation and how to avoid common pitfalls when designing your programme's core policy wordings.

This edition also features a roundtable discussion with contributors from ACE Group and Ernst & Young, who discuss the various emerging challenges captive owners and managers will encounter in the near future.

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GLOBAL PROGRAMMES: THE KEY CONSIDERATIONS

Marty Scherzer, president of AIG Global Risk Solutions, talks to *Captive Review* about the key factors involved with managing successful global fronting programmes

Captive Review (CR): Why do companies establish fronting programmes?

Marty Scherzer (MS): Companies use fronting programmes for various reasons. A company might be seeking a solution for a risk that the traditional insurance market does not address, or addresses inefficiently. Similarly, a company might have a new or emerging risk that it is not sure how best to address. Fronting programmes are attractive to companies that have a complex multinational programme they wish to make more efficient by retaining risk. Some companies establish fronting programmes to obtain evidence insurance for a risk that they want to retain. Others prefer fronting programmes because the company can benefit if losses are favourable. A fronting programme can provide an insurance policy to satisfy a counterparty who is uncomfortable with a risk and either will not accept a company's credit or requires the company to post collateral for a risk that the counterparty doesn't understand. Alternatively, a company might want to use a fronting programme to strengthen its product's sales proposition by insuring purchasers of its products.

CR: How does a global fronting solution help clients drive cost-efficiencies?

MS: In a fronted insurance programme, the insured retains risk rather than transferring it to an insurer. Fronting programmes enable clients to benefit if losses are favourable. They may also provide tax efficiencies. Our experience shows that most companies who employ a fronting programme save money because they no longer trade money with their insurer and keep a keen focus on reducing losses because they are funding them.

Written by
Marty Scherzer

Marty Scherzer is the president of Global Risk Solutions (GRS) at AIG. GRS provides innovative and market-leading solutions for: global fronting, alternative solutions, breakthrough innovation, captive management and assumed reinsurance.

CR: What key factors should a company consider before establishing a global fronting programme?

MS: A company should have a clear vision of its goals for the fronting programme and communicate that vision to its fronting carrier. Fronting programmes can address many needs such as enhanced control over the insurance programme, insuring risk not covered by the traditional insurance market, potentially reducing the total cost of risk, and providing proof of insurance, to name just a few. To be able to tailor a programme to a client's specific objectives, its fronting carrier should have a clear and in-depth understanding of what those objectives are. Because there are so many variables that must be considered when designing a fronting programme, it is essential that a fronting carrier dedicate time and effort engaging the client in consultative discussions so that it truly understands the client's goals.

The company also needs to consider the amount of risk it wishes to retain and its preferred method for retaining that risk. Does it have sufficient information to accurately assess the risk it is retaining? Will it utilise a captive or a cell captive? Is a structured insurance programme a better solution? Would the company prefer an indemnity programme? Does it have sufficient liquidity? The appropriate financing vehicle depends upon the client's goals and fronting carriers should work with each client to determine the right vehicle to meet its needs.

"Our experience shows that most companies who employ a fronting programme save money because they no longer trade money with their insurer and keep a keen focus on reducing losses because they are funding them"

CR: What are the major benefits of centralising international insurance programmes as opposed to using individual firms in each jurisdiction?

MS: I believe there are three key reasons for centralising international programmes: control, coordination and efficiency. Primarily, there is much greater control over the scope of coverage, meaning that the programme can efficiently target only those areas where coverage is desired and carve out those areas where it is not. It is also easier to understand and confirm the client's intent and objectives.

In terms of coordination, the insurer can work with the client to structure and implement a cost-effective, seamless programme that provides locally admitted policies where required, and a master policy to supplement that coverage as needed. There will be consistency of coverage terms, limits and deductibles across the programme, allowing a risk manager to assess loss trends more accurately. Similarly, the insurer and client can decide upon and plan for the risks that the client wishes to retain via a fronting programme and those risks that the client wishes to transfer to an insurer. With a complete picture of the global programme, the insurer for a centralised programme is well positioned to advise the client on best practices in terms of programme structure, country-specific restrictions that may affect the programme and policy wording concurrency issues.

Having a centralised administration hub with an experienced team, advanced technology, and standardised automated processes helps ensure that the programme is managed efficiently. It is difficult to standardise, automate and have the same level of control over a programme when policies are issued by multiple insurers and as a result, there is much higher probability of there being coverage gaps and increased costs.

CR: What capabilities should a company look for when choosing a fronting carrier?

MS: There are a number of things that a company should be evaluating, and again they are tied to the company's objectives. If a company needs a comprehensive global programme, then clearly its fronting carrier needs to have global expertise and capabilities, as well as in-depth knowledge of local country regulations so that it can help the company to design a compliant programme. Companies with multinational programmes should seek out a carrier with a global network of policy issuing offices that can provide locally admitted insurance coverage wherever needed.

A fronting carrier should have an infrastructure that smoothly facilitates all of the operational aspects of fronting including administration, servicing, reporting, claims handling, loss control and loss prevention services. Is there a clear, consistent and timely flow of information and communication between the policy issuing offices, the administration hub, the captive and other parties to the transaction? Does the carrier have in place the technology, people and processes necessary to ensure seamless, efficient cash flow movement? The ability to be insightful and flexible is also a key component. Does the carrier truly understand what the company wants its fronting programme to accomplish and does it have the flexibility to tailor the programme accordingly? These are the types of questions a company should be asking when shopping for a fronting carrier.

> "A fronting carrier should have an infrastructure that smoothly facilitates all of the operational aspects of fronting"

In addition, remember a fronting programme is an insurance programme, so companies also look for excellence in traditional insurance services such as administration, servicing, reporting, claims handling, loss control, engineering and other loss prevention services.

CR: How should a fronting carrier help clients deal with the varying regulatory challenges?

MS: As regulators are looking at programmes with greater scrutiny, we are seeing regulatory issues becoming more of a concern for clients. An experienced fronting carrier has in-depth knowledge of various regulatory environments, understands the strategies for building effective fronting programmes in those environments, and has the multinational tools and resources to do so – all of which it shares with its clients. Fronting carriers and insureds have a mutual interest in protecting their reputation.

Our larger clients are very aware of the ramifications of not abiding by local regulations, so being compliant is a high priority for them. We are seeing the same trend among emerging companies doing business in the multinational arena. These companies want to be sure that the programme's insurance policies meet local regulations.

It can be difficult to navigate these regulatory environments, particularly in developing markets where regulations may change more often. It is vital for a fronting carrier to know the local regulatory environment and practices so that it can help clients design a compliant programme. A fronting carrier with an extensive global network and a commitment to its global business will make the investments needed to ensure that it understands existing regulatory environments, anticipates any changes and has the resources in place to successfully deliver programmes that meet clients' needs.

CR: What are the areas you see as driving continued growth potential for fronting?

MS: Our growth spans a spectrum of markets and geographies. It really is not limited to any one particular area. As companies in Latin America and Asia continue their economic expansion, they are looking to adopt more sophisticated risk management approaches that include fronting.

In the US, we are seeing opportunities resulting from the Affordable Care Act as more middle-market companies look to provide benefit solutions and medical stop loss coverage via a captive programme.

Another source of growth results from companies expanding into global markets at a much earlier stage in their development than they did in the past. The risk managers at these companies are exploring fronting solutions to address their multinational exposures.

Fronting opportunities are often presented when a company faces new regulations requiring insurance to cover risks that the company prefers to retain as it has done in the past. A fronting solution can enable the company to satisfy this insurance requirement and still retain the risk.

As I mentioned earlier, middle-market companies are showing an increased interest in captives. Fronting programmes are a cost-effective risk management tool for this segment as 'rent-a-captive cells' provide a low-cost alternative to a standalone captive and can be formed quickly with minimal start-up costs. To capture the growing demand from this market segment, AIG has recently established a segregated cell company in Bermuda that complements AIG's existing cell company domiciled in Vermont.

A MULTINATIONAL FUTURE

Andrew Kendrick, president at ACE European Group, speaks to *Captive Review* about the results of its study of European risk managers

Multinational programmes are rapidly becoming the industry standard in Europe. The range of risks for which risk managers and captive owners want solutions is growing – with a particular emphasis on emerging and liability risks. Yet multinational programmes can be complex to understand, and there needs to be better education and dialogue around both their benefits and complexities. With demand set to grow significantly over the next three years, brokers and insurers will certainly need to ensure their service is up to par.

In ACE's latest study of 280 European risk managers, 90% of companies agreed that their risk profiles are growing more complex. At the top of their concerns are the risk management implications of the rising exposure to emerging markets and the growing complexity of international regulation.

In addition, achieving consistent, compliant insurance cover in today's environment is becoming more difficult under traditional approaches such as relying on a single global policy or a patchwork of uncoordinated local arrangements. A comprehensive multinational programme is usually a better solution and around half of risk managers say their company has one or more multinational programmes in place today, and 83% expect that to increase over the next three years.

Risk managers view consistency and compliance as the top benefits of implementing multinational programmes as they improve the consistency of their insurance arrangements globally and help them ensure that their insurance arrangements are compliant with evolving regulations. A significant minority also believe their multinational programmes allow them to make the claims process more efficient and to drive efficiencies.

Written by
Andrew Kendrick

Andrew Kendrick is president of ACE European Group. He is responsible for the company's property and casualty (P&C), accident and health (A&H) and life, and specialty personal lines insurance operations in ACE's 19 countries and territories across the region as well as its global wholesale business headquartered in London, ACE Global Markets. He assumed his current role in 2004 and was additionally appointed senior vice president, ACE Group, in March 2014.

Furthermore, risk managers are increasingly targeting multinational programmes beyond the 'standard' property and casualty risks. Indeed, when asked what risks their multinational operations are most exposed to, four of their top six relate directly to liability issues including professional indemnity and directors and officers liability, highlighting the increasingly challenging operating environment for decision-makers in a more globalised and post-crisis world. Environmental liability is also among them, underlining a growing awareness of new and emerging liabilities on a global scale. Cyber risk, which has a significant liability dimension too, is also in the top six and expected to grow over the next three years.

Yet a significant number of risk managers still believe that taking a multinational programme approach is unnecessary, mostly due to their global footprint not being wide enough to justify it. This may be the case for some domestically focused companies, yet some may simply be failing to appreciate the impact of growing regulatory divergence on their current insurance arrangements, both in terms of the compliance and execution risk.

Another reason given is cost concerns, yet it is often only when a company makes a claim that it discovers that cutting corners in the short term can prove to be a false economy. Interestingly, more than a quarter of respondents agree that multinational programmes have a positive impact on costs by driving economies of scale, while 15% point to their benefits in streamlining things and reducing duplication.

Our research also highlights that what European risk managers are looking for from their insurance partners is practical expertise and support in guiding them through four areas of potential complexity: DIC/DIL implementation; local policy compliance; timely programme reporting and information; and cross-border claims management. Generally, there is a strong focus on service in the research findings with more than a third of risk managers wanting to have agreed service standards in place with their insurer.

So, while the research does not suggest that risk managers are unhappy with their insurance partners overall, fewer than 30% of risk managers are currently very satisfied with overall service levels from their insurer in respect of their multinational programmes. Fewer still are very happy with claims performance (surely the acid test of any insurance programme), insurer responsiveness to their budgetary pressures, consistency of coverage and availability of effective technology solutions. This shows that the insurance community still has some way to go to make global programme solutions more seamless for risk managers. However, it is a challenge that, at ACE, we are certainly up for.

GLOBAL PROGRAMMES ROUNDTABLE DISCUSSION

Representatives from ACE Group and Ernst & Young discuss the evolving role played by captives and the various emerging and ongoing challenges facing captive owners

Captive Review (CR): In your opinions, what is currently the single biggest regulatory or compliance issue for captives and why? How can it best be addressed?

Michael Furgueson (MF): We've all witnessed the increasing momentum around tax scrutiny recently, with 'the double Irish', the online and traditional retailers, and US tax inversion deals all in the spotlight. So I wasn't surprised that, when speaking recently with the risk manager of a very large UK plc, that is a very active user of captives for risk finance and, separately, with someone from one of the largest insurance brokers in the world, they both stated one of the biggest issues they are dealing with is questions raised by fiscal authorities around cost of risk and transfer pricing of their insurance programmes. This is in turn part of a more significant trend towards the examination of inter-company charges that are ongoing over all aspects of business. The tax authorities have, in some ways, recently 'discovered' captive insurance and inter-company insurance cost allocations and are now asking more questions than ever before.

Another question, of course, relates to Solvency II and how captives will be treated and how or if proportionality will be incorporated into the framework. There is an expectation that Solvency II will recognise the unique role captives play and there will be a rational, business-oriented approach, even if there will likely be higher capital and governance burdens for captives to meet.

Jeff Soar (JS): Tax authorities are now much more experienced in dealing with insurance and they are using their experience from dealing with large third-party insurance players to move into the captive space. The global projects run by the OECD around base erosion and profit shifting (BEPS), are focusing on getting the appropriate amount of taxation for each country, depending on what is happening in that location. The OECD's '*Addressing base erosion and profit shifting*', for example, mentions captives and base erosion through the use of insurance captives a number of times. It is one of the only specific planning mechanisms which is mentioned throughout the document, but captives do come up. Ultimately, captives are right in the centre of global revenue authorities focus at the moment and that will be a challenge going forward.

Clive Hassett (CH): The captives that are reasonably well capitalised already and have a very clear track record of profitability, stability and underwriting results, which have followed a consistent risk-management strategy (as opposed to those that are a vehicle for leveraging and arbitraging tax regimes) should be less negatively affected by future regulation. People in the former category tend to be less worried about the impact in terms of additional capital and are therefore quite sanguine about what legislation will eventually will be produced. It is probably the more speculative users of captives that are likely to be impacted.

CR: What do you think is currently the biggest tax-related issue or development for captives and why? Again, how can it best be managed or addressed?

Andrew Spry (AS): Financial institutions are currently under intense scrutiny regarding perceived shifting of profits to low-tax jurisdictions, and nowhere is this more apparent than for captive insurance companies. G20 and UK and US government pressure continues to build in relation to transactions with so called 'tax havens' under both BEPS and ATP (Aggressive Tax Planning) work streams.

It means that the tax authorities are increasingly focusing on insurance and it is likely to translate into greater transparency and a coordinated multilateral approach to international tax by the end of 2015. The tax authority focus has been brought to the fore particularly by local territory compliance requirements, transfer pricing, Controlled Foreign Company (CFC) legislation in the UK and the various permanent establishment (PE) discussions.

JS: When we look to the future, BEPS is going to be the key focus for captives in my view. If we

MEET THE PARTICIPANTS

Mike Furgueson is president of ACE's Multinational Client Group, responsible for the company's multinational underwriting and business development activities across its international markets. He also oversees ACE's Bermuda-based captive management business. Based in New York, he has over 25 years of industry experience.

Remy Massol is director of multinational services for ACE's Continental Europe region and is based in Paris. With more than 17 years of industry experience in captive fronting and multinational programmes, he has worked in Brussels, New York and France.

Andrew Spry is head of tax at ACE European Group. Based in London, he has more than 13 years of tax experience gained in senior tax and management roles for various professional and corporate entities.

Clive Hassett is director for multinational services at ACE European Group, responsible for the company's multinational proposition across the EMEA region. A UK qualified accountant, he has been with ACE and its predecessor companies for 21 years and is based in London.

Jeff Soar is a partner at Ernst & Young, where he leads the insurance tax practice for EMEIA. He covers all aspects of the insurance industry and specialises in the global specialty insurance and reinsurance market, advising captive insurance companies and captive managers on a wide range of tax issues.

look internationally at what captives need to focus on most from a tax perspective, it has to be transfer pricing.

From a UK perspective, it's transfer pricing and the CFC regime. The UK CFC regime changed a few years ago and specifically changed terms for the insurance industry. It now broadly states that, if you are carrying on an activity which gives rise to profits outside of the UK, then you should be able to exclude both the underwriting profit and investment return from the UK tax authorities. If your company is over-capitalised, which is admittedly a difficult term to define, then you might bring the investment return on the over-capitalised element back to the UK tax jurisdiction.

AS: In terms of local territory compliance requirements, you have UN and EU blacklisting gaining traction with individual tax authorities. Most territories are now creating lists which highlight potential tax havens. This will lead to a much greater compliance burden and will impact long-running captive structures. A good example of this is France, as the most recent territory to set out controls where transactions with non-cooperative jurisdictions are subject to potentially onerous controls in transfer pricing and withholding tax (WHT), combined with severe penalties for non-compliance.

This raises the question in certain territories around the fundamental tax deductibility of certain premiums, where reinsurance to low-tax jurisdictions and tax haven black listed countries will be in focus – and certain tax authorities may seek to disallow the deduction of premiums or alternatively local legislation may apply WHT to the transaction. A good example of this is Belgium, which has introduced new WHT regulations in 2013, which results in a 16.5% tax being applied to reinsurance with non-treaty countries. Other territories also use WHT in this way and many governments are currently checking through the numbers to see what works and what the industry may be willing to accept.

JS: There is another layer of tests where you have a captive insurance company which is defined not just as what we would consider captives, i.e. self-insurance by a multinational. The definition is extended to include instances where you have third-party customers that have only bought insurance as default with a product. An example of this is provided by mobile phones, which are often sold with insurance coverage by the companies' captives. In this instance, the profits become taxable in the UK – unless your captive is established in an EEA country, doesn't include UK-sourced risk and is done for good commercial purposes. Simply, if your substance is overseas, if you're not over-capitalised and not pushing UK risk to the overseas subsidiary company and it's located within the EEA, then there should be no tax.

There is a general principle around risk sharing in the US that if one company cedes risk to another, that's actually not 'risk sharing' but 'risk moving' and the IRS has quite rightly not seen the sense in that and denied deductions. It's always difficult in insurance to draw solid lines between what is acceptable and what is not, but tax authorities have now started to say that you have to demonstrate proper risk sharing. Four or five companies ceding risk to one does make sense, but one company simply moving its risk to another is just risk moving. You must show you are sharing and spreading risk in order to take deductions.

CR: Why is transfer pricing becoming a more important issue?

JS: The world is a much more connected place now and you see much more in the way of multinational group structures. It makes sense to try and cluster people who do the same thing in one place and cross-charge around the group. It's a similar scenario from a risk perspective. You have multinational group structures, with multinational risks, so it would make sense to manage those risks in one or two central places. Because of the explosion of multinational transactions (but also because of the general global focus on centralisation) that naturally leads to more tax authorities finding it more important to focus on when something enter or leaves their borders and making sure they are getting their fair share; and that's where transfer pricing comes in. You have to make sure that everything done within a group is being done as if it were in the third-party market.

AS: Fundamentally, tax is simply the government's income stream and each tax authority is looking to protect that income. The rigour in pricing is actually coming from an increase in audit activity by tax authorities and the associated scrutiny. We are seeing an increase in enquiry activity by tax authorities across all transfer pricing arrangements – evidenced, for example, by the growing number of transfer pricing tax audits. This is driven by the perception that insurance and reinsurance to captives can sometimes be designed as a mechanism by groups to shift profits from high to low-tax jurisdictions. So I think it's fair to say that taxation of multinationals will be a big issue for the next decade or more, in part because so many large companies are sitting on significant cash piles.

In the UK, for example, I believe there are numerous insurance companies under active transfer pricing enquires, that includes reinsurance to captives. The fact there is such a high level of focus by tax authorities on the insur-

ance industry, given their extreme resource constraints, demonstrates a perception that the pricing of reinsurance is potentially a valuable revenue source, given the top-down bases of pricing, the sheer volume of transactions that go on and the size of them. In the UK, HMRC has concluded that a small adjustment to commission rates can have a massive tax effect.

CR: What are the challenges facing tax authorities experimenting with transfer pricing?

Remy Massol (RM): One of the difficulties around transfer pricing is the fact that insurance prices have been very volatile over the years and it is extremely difficult to have an agreement on what is a technically fair price in a given country and in a given year. When this year's renewals are 30-50% cheaper than three or four years ago, does that mean the price then was overstated? Prices are set by market forces, competition fighting for business and available capacity. When you look at risk appetite from a captive point of view, for a particular exposure, the perception of the risk is usually the same over time, captives typically favour stability of prices over time, so premiums for a captive layer may very well be similar to three years ago. Does that mean the captive is overcharging its subsidiaries or not? Transfer pricing is very difficult in our market where premiums for large corporates can go up and down by huge margins from year to year.

CR: What are the challenges facing fronting companies when dealing with transfer pricing?

AS: Many captives are unable to operate around the world without the involvement of a global insurer because in most cases they aren't licensed to write direct insurance. They have to work within a fronting insurer, such as ACE, in order to issue local policies and to pay claims against those policies which they then recover from the captive. In the past there has been less rigour about how the pricing of insurance was implemented for risks in individual countries. Therefore, that pricing may have potentially been put in place at the wishes of the captive to charge a particular premium in a country because they got a tax advantage for deductibility of premium, rather than the validity of premium pricing compared to the cover offered, in a technical sense.

It is important to note that insurers are very heavily regulated and our prime responsibility and focus is to make sure that when we, as the fronting insurer, issue insurance policies in specific countries and conduct the business and paying of claims, it is done in a standalone, self-contained way that stands up to scrutiny in terms of pricing and how we handle claims. Captives must be aware that, when an insurer is fronting for them, the insurer's compliance with all these relevant points is the dominant requirement, not the underlying premium allocation methodology that best suits the captive.

CR: How well is the concept of transfer pricing understood among multinational companies today?

RM: The complexity around multinational programmes and captive programmes has been increasing with more and more local regulations, which are little known to clients, although they are impacted by them. They are seeing some premium transfers being delayed because of the documentation that is now required locally for anti-money laundering purposes, for example. They are also encountering the new US Fatca rules for the first time. Captive owners must now be familiar with Fatca requirements to understand the IRS form they must complete, even when their programme only has a marginal US exposure. Some clients are wondering where the complexities will stop. There is also some concern that regulation will eventually render captive programmes too costly for them to manage. At the moment, risk managers see the many benefits that captives bring and are confident that these benefits outweigh the additional difficulties and time investment that is required to manage them. But some risk managers are also unsure if this will continue to be the case in the future.

MF: This issue for risk managers also ties back into the discussion on Solvency II. Risk management departments are not getting bigger; in some cases they are getting smaller and in all cases their resources are being stretched. Some risk managers who heavily use captives are looking ahead with concern at the costs of these arrangements, where an insurance company issues local policies and fronts most or all of the risk for the captive, are going to go up as a direct result of the additional capital burdens and costs that insurance companies are incurring as a result of meeting Solvency II requirements.

CR: To conclude, what are the central issues a captive owner must consider at the moment and in the future?

AS: The key points a captive owner should bear in mind with regard to transfer pricing are the following:

First, substance, is not just about acceptance of risk but what is going on around the insurer such as management of cash, investment decisions – we need to think of the captive as a standalone entity/ in a standalone nature.

Second, the commercial rationale behind the use of the captive needs to be considered. This may include such areas as better and deeper coverage terms, diversification and risk management strategy among other things.

Third, pricing, where the technical approach needed to price internal reinsurance treaties is complex. As a result of BEPS, tax authorities require a 'two-sided analysis' of the pricing, looking at it from the perspective of the cedant and the reinsurer to establish whether the arm's length price is commercially attractive for both parties.

For captives of non-insurance groups, the key challenge is obtaining accurate claims data in particular where the event has a low probability of occurrence, i.e. a one in 500 year event, to estimate the cost of claims. This could leave captives open to a challenge on the actual level of premium charged.

The fourth area encompasses regulatory and capital considerations. As background, based on recent enquiries and the UK's Dixons case (the key metric that tax authorities use to test whether the reinsurer is seeking to make excessive profits on the reinsurance contracts is the return on capital (ROC) metric). The return on capital benchmarking is used as a 'sense check' as to whether the captive reinsurer is seeking to earn excessive returns on the contract and is therefore out of line with the market.

ROC benchmarking could potentially be impacted by: Solvency II, where a reinsurance contract is entered with a territory that is non-Solvency II compliant, which will impact the recognition of capital in the UK: Potential concentration and credit risk points being raised by the PRA: Captives are less diversified then standard reinsurers, therefore the ROE/ ROC is harder to justify and means that the ROE/ ROC should be viewed over a longer period/ trend cycle to ignore spikes/ volatility.

The fifth area to consider is documentation. This is key. Increased jurisdiction transfer pricing documentation requirement and disclosure of inter-group transactions flowing from such areas as country-by-country reporting (CBCR), territory specific disclosure requirements around group structure and inter-group transactions, such as in the case of Italy and France, will mean greater transparency of the substance and profits earned by the captive.

The final point is to expect a tax audit and to plan accordingly.

THE GLOBAL SERVICE CHALLENGE

Captive Review catches up with Michael Furgueson, president, global accounts for EMEA at ACE Group, to discuss the growing service challenge for captive owners and their fronting insurers

Written by
Michael Furgueson

Captive Review (CR): What would you say is the biggest challenge captive owners face in respect of servicing their multinational programmes today?

Michael Furgueson (MF): Captive owners operating multinational insurance programmes face a myriad of complex issues around the world every day. From talking to our clients, I believe that managing claims is also becoming an increasingly complex issue in today's more dynamic regulatory, compliance and business environment. Losses are equally becoming increasingly complex and more multinational in nature. According to our research with 280 risk managers across Europe, two-thirds say they are experiencing more claims outside their home market, and 72% say their multinational claims have become more complex generally. This certainly fits with our own experience at ACE.

CR: In the context of a multinational programme, what does good claims service look like?

MF: One of the key challenges for any captive owner can be trying to resolve claims across borders as the question is no longer simply about whether a given claim is covered by an insurance policy. In a more complex compliance environment, it is critically also about whether that claim can be compliantly and efficiently settled. Effective claims resolution is the acid test of any insurance programme. So it's unsurprising that, when we recently asked European risk managers what they most want from a fronting insurer, their greatest priority was effective claims handling, followed by quality of service generally and, in third place, accurate and insightful claim reports. Clients want and need a claims process which works when they need it most, which is transparent, and which gives them access to the information they need, quickly.

> **"We've enhanced the platform to provide multinational clients with online access to claims information"**

CR: You've recently made some enhancements to your ACE Worldview technology platform with the claims challenge in mind. What are they?

MF: Over the past 12 months, we've enhanced the platform to provide multinational clients with online access to claims information, making it easy to track in real time the status of a loss and the overall claims performance of their programme. For captive programmes and accounts with a large frequency of claims, it can now also provide clients with detailed loss data. This includes aggregate and individual claim data, such as paid losses, expenses and recoveries. You can choose to see recent claims activity from various parts of the world on your dashboard or receive the most recent summary of your claims activity. You can also download your loss history and, since claims information is refreshed every week, it is always up to date.

CR: How else can captives benefit from ACE Worldview?

MF: We know that when you are managing a global programme involving captives, one of the most complex activities can be tracking cash flows. With ACE Worldview, we've made sure that the owner can see where premiums are received and when they are transferred to the captive. They can ask for detailed premium reports and choose to receive an email alert when a particular premium is received by ACE or paid to the captive.

More generally, all of our multinational clients and their brokers can now benefit from the same core features that assist them in keeping track of their global insurance programmes – have policies been issued, premiums paid, claims made, and what are the local compliance issues they need to navigate? Worldview is designed to help them answer these and other important questions effortlessly, in real time.

To see a short film about ACE Worldview, go to: http://youtu.be/uIN9SMQmC10

THINK LOCAL

Clive Hassett, director of multinational services for Europe, ACE Group, speaks to *Captive Review* about the importance of 'thinking local', even when designing a global insurance programme

Soft insurance market conditions and regulatory uncertainty have certainly helped contribute to a slowdown in new captive formation. Still, there is no doubt in my mind that existing captives are becoming more sophisticated and their scope of interest is growing in many cases.

At ACE, we recently conducted some detailed research with 280 European-based risk managers and the results support this view. Three-quarters agree that, as they seek to manage their multinational risk, their use of captives will increase over the next three years.

The study tells us something else that echoes our recent experience at ACE. Risk managers, across all major industry sectors, are increasingly using more advanced 'multinational programme' structures to manage their cross-border risk. They recognise that it is becoming more difficult to achieve consistency, compliance and certainty under traditional approaches that depend on a single global policy or a patchwork of uncoordinated local arrangements.

Why is this the case? At the heart of the reason, I believe, is a fundamental paradox. Although globalisation and multinational trade are the dominant engines of the world economy today, there are few common global commercial standards, regulations or legal frameworks around which companies can operate, or by which they are supervised. It is certainly true for insurance. This means that a 'single global policy' approach is no longer reliable in delivering a compliant solution for multinational risk. It also means that it can be a real challenge to keep up with the continual regulatory change that takes place at a local level.

Written by
Clive Hassett

Clive Hassett is director for multinational services at ACE European Group, responsible for the company's multinational proposition across the EMEA region. A UK qualified accountant, he has been with ACE and its predecessor companies for 21 years and is based in London.

> "A 'single global policy' approach is no longer reliable in delivering a compliant solution for multinational risk"

Various programme structures have been promoted from time to time that have been claimed to remove the need for local policies as part of a multinational solution. However, to a large degree, these discussions are fuelled by the simplistic view that, provided some reference source says that 'non- admitted' insurance is allowed, there is no need for a local policy and insurance can be provided by a policy issued in the home domicile of the parent company.

Today, to design a global insurance programme with its underlying local policies based solely on where non-admitted cover is allowed or not is at best imprudent and, at worst, negligent.

A far more considered approach is required in order to decide whether or not a local policy should be issued. This decision should take into account the nature and the value of the assets requiring insurance, any business activities that require evidence of insurance cover and, perhaps most importantly, the desired practical and financial outcome in the event of a claim.

Our European research shows that two-thirds of multinational risk managers are experiencing more claims outside their home market, and three-quarters say that their multinational claims experience has become more complex generally. In such an environment, it has never been more important to 'think local' in order to avoid the delays, uncertainties and coverage questions that are likely to arise when seeking to adjust a difficult claim under a wording not developed for use in that territory.

Ultimately, when choosing a fronting insurer, I believe that means choosing carefully – one who understands the importance of using local language policy documentation in a contractual framework designed to operate according to the laws of that country – and one who understands the growing importance for multinational captive owners of cross-border claims certainty.

MARITAL BLISS OR TROUBLE AND STRIFE?

GETTING YOUR WORDINGS RIGHT, TO AVOID A COSTLY DIVORCE

Kiran Soar and Roderic Jones, of Ince & Co, updates *Captive Review* on the key issues that must be mutually agreed for an insurer's relationship with its client to be a long and successful one

When a client entrusts its Global Programme to an insurer, the intention is (usually) to ensure that the relationship is a long and fruitful one; primarily by easing the administrative burden on the client to place a multitude of risks individually and across various jurisdictions whilst providing the insurer with a fair premium for the risks that it takes on.

But like any successful marriage, anticipating and dealing with likely issues from the outset usually avoids trouble later down the line. Below we take a quick glance at some of the issues that parties ought to bear in mind at the start, or where necessary during the course of, their relationship.

Something old...

Many fronting solutions involve the use of captives. Some insurers (although not all) seek the posting of collateral by those captives for at least part of that risk which is re-assumed by them where the insurer acts merely as a front, or even where the insurer is a pure front, to assist with the claims administration process. The collateral can be posted as a simple letter of credit (LOC) in favour of the insurer, or the parties can enter into a trust agreement (Trust Deed) with one of the banks that offer such services (the Trustee).

An LOC obviously needs to be linked to the relevant policy payment obligation, which sounds obvious but we have seen circumstances where the reinsurer had to pay twice, once by release of their LOC and second through their policy payment obligation to pay claims.

While the market is generally well versed in negotiating and entering into insurance and reinsurance agreements, there are a number of legal issues that arise when considering trust deeds that deserve particular attention.

Written by
Kiran Soar

Kiran Soar is a partner in Ince & Co's insurance and reinsurance group, and leads its captives team. Soar specialises in alternative risk transfer and captive insurance. He has represented a number of captives in relation to reinsurance issues, and also assists captives and insurers/reinsurers in structuring their global reinsurance programmes.

Written by
Roderic Jones

Roderic Jones handles a broad range of commercial litigation and arbitration matters across several of the firm's practice areas, advising on insurance, reinsurance, dry shipping and professional negligence disputes. He has brought or defended claims for ship owners, charterers, insurers, assureds and reinsurers as well as other parties to commercial disputes. Jones speaks French and prior to joining Ince gained an LLM in Maritime Law from UCL.

Banks often appear loathe to amend their 'standard terms', but it is usually possible to remove the most egregious terms in the contracts through negotiation. The key points that the parties ought to pay keen attention to are:

- The duties assumed (and, more importantly excluded) by the trustee banks.
- Ensuring that the posted collateral is acceptable to both parties and that there are clear mechanisms for draw-downs.
- Set off provisions. Banks will often want provisions that will allow them to set off other debts owed by either party to the trust deed from funds held in any trust account. Obviously, this may diminish the security provided.
- Release of collateral, particularly where claims are reported. The calculation of Outstanding and IBNR values needs to be clearly defined to avoid issues when determining the amount of collateral that must remain after the relevant policy expires.

Something new (ish)...

Traditionally, the most cost-effective solution for clients when they have to deal with the restrictive regulatory regime prevalent in many countries has been to put in place one of three structures:

- Admitted programmes
- Fronting arrangements; and/or
- DIC/DIL cover.

Each of these has well-known and different implications with regard to cost and the administrative burden on the client, or its captive.

In recent years, however, an increasing number of global programs have taken advantage of the relatively broad concept of 'insurable interest' under English law in order to attempt to simplify, and therefore make more cost-effective, the way in which they deal with local compliance rules.

By removing any subsidiaries, joint ventures or affiliates based in difficult jurisdictions from the global policy, they significantly reduce the risk of breaching that jurisdiction's law on admitted insurers. Any losses suffered by those entities are then covered by insuring the parent company's financial interest in the entity rather than the entity itself. While not a cure-all (some local jurisdictions may, for example, require that companies take out a particular form of insurance which will still have to be purchased from an admitted insurer), such an approach has the potential to bring enormous long-term cost savings to both the captive and the reinsurer.

Business interruption remains a difficult area, particularly in the claims context. The tensions between tax-effective business and accounting structures can directly conflict with the need to prove that a particular loss was suffered in a particular location (for policy attachment purposes). We frequently see situations where claims are made on master policies by a corporate which has suffered no actual loss (as a result of internal accounting actions).

Properly structuring and drafting such a policy is complex. As parties seek to become more efficient and inventive in their solutions, it is critical that their policy wordings are adapted to ensure that the obligation to pay claims falls in the right place, at the right time and in the right way.

Something borrowed...

The very nature of global programmes makes them vulnerable to systemic risks. Stephen Catlin, a figure whose thoughts on risk management are not easily ignored, has recently identified three of particular concern:

- Terrorism
- A global pandemic
- Cyber risk

Clients, their captives and insurers are already clearly alive to cyber risk issues, particularly loss of data, fines and penalties and also cyber-attacks.

The insurance market is however still trying to figure out how best to respond to such claims. Lloyd's syndicates, and those in the company market, often insist on the inclusion of the Institute Cyber Attack Exclusion Clause (CL380) or its equivalent to avoid the risk of potential vertical accumulations of losses arising from a cyber-event. This clause excludes:

"Loss damage liability or expense directly or indirectly caused by or contributed to by or arising from the use or operation, as a means for inflicting harm, of any computer, computer system, computer software programme, malicious code, computer virus or process or any other electronic system."

While there are insurers who will agree to write back cyber cover, careful thought needs to be given to the level of risk that the client and/or its captive is willing to take. A captive would also need to ensure that if it writes such a risk, it reviews whether or not its reinsurance programme will respond to a cyber-event.

Something blue...

Whenever a claim goes all the way to court, (at least) one party is going to lose and ostensibly surprising decisions can leave the losing party feeling more hard done by than John Lee Hooker after he's been left by yet another lady.

The floods that afflicted Thailand illustrated a fundamental problem at the heart of many global programmes; aggregation.

Tesco placed a global programme with Ace (local policies issued for its stores in Thailand and a master policy on a DIC/DIL basis). During the 2011 flooding in Thailand, Tesco properties over a wide area were damaged over an extended period of time. The insurance policies unfortunately contained conflicting aggregation provisions:

- An 'hours' clause allowing aggregation only of losses occurring within 72 hours;
- A broad based 'loss occurrence' provision that arguably allowed Tesco to aggregate all of its Thai losses, even though they happened over a broad period of time and across a wide geographical area.

The case that went to trial involved a dispute between a reinsurer and its own retrocessionaire about the basis of the settlement. Tesco were not involved but at the heart of the decision was the underlying aggregation decision. Ace settled the claims as one aggregable loss of £80m but reinsurers up the line challenged this saying there were multiple loss occurrences and the hours clause applied (which would have severely reduced Tesco's claim).

Although it all seemingly worked out well for Tesco, the reality is that the language was ambiguous. We commonly see policies which contain simply inconsistent provisions, and with such large sums at stake, there seems to be little value in leaving matters to chance.

Marital bliss

The bottom line is that global programmes offer efficient and cost-effective solutions. But care needs to be taken with drafting the relevant policies focussing in particular upon:

- Risks covered: what is and is not covered? How broad are policy exclusions?
- Collateral: how is it treated, what happens if there is a claim?
- Aggregation: how will multiple losses be treated?
- Governing law and jurisdiction: do you have clear provisions? Are they consistent? Have you considered modern dispute resolution provisions that will allow you to sort out differences without full blown litigation?
- Understanding business interruption: Have you considered how and where your group accounts for profit and where in any group that loss is incurred? Is it covered?
- Are your insurance and reinsurance wordings back to back, particularly where a captive is involved?
- Does one size really fit all? Consider the risks your organisation will face. A client with the risk of multiple claims in the US would likely have different wording and risk issues to a more international client.

Each programme is unique and offers its own challenges but dealing with the wordings and policy issues up front will ensure a smoother path to marital bliss, rather than a messy divorce.

"As parties seek to become more efficient and inventive in their solutions, it is critical that their policy wordings are adapted to ensure that the obligation to pay claims falls in the right place, at the right time and in the right way"

TIME FOR A RE-THINK?

Matt Latham, head of captive programmes at XL Group, speaks to *Captive Review* about the far-reaching effects of Solvency II on captives in global programmes

Written by
Matthew Latham

As head of captive programmes for international property and casualty at XL Group, **Matthew Latham** is responsible for driving new captive fronting business and for ensuring that existing clients get a high quality and consistent level of service. Prior to joining XL Group, Latham spent nine years at AIG, most recently leading the UK client management team.

The formation of new captives for large corporates peaked in the late 1980s and early 1990s. Since then the governance and regulation of captives has changed dramatically. Some owners will have adapted how their captive operates to meet these changes but many won't have fundamentally changed the way their captive programmes are structured.

After a number of false dawns, the biggest change of them all – Solvency II – is about to appear over the horizon from 1 January 2016 and it is critical that captives are ready for this change.

Solvency II is only applicable to insurance companies in EU jurisdictions or countries seeking equivalence, who will have similar local regulation to Solvency II. However, insurers located in EU territories that reinsure to so-called 'offshore' captives will be subject to Solvency II, so most captive programmes will be impacted.

Solvency II, what it includes, and whether it should apply to captives, has been written about extensively. That is not the purpose here, but it is important to note that Solvency II moves all affected insurers and reinsurers to a risk-based system for calculating capital, rather than static measures applied to premium and claims. This brings in a whole new set of considerations for captive owners including credit risk, diversification, correlation, operational risk and investment risk.

Captive structures

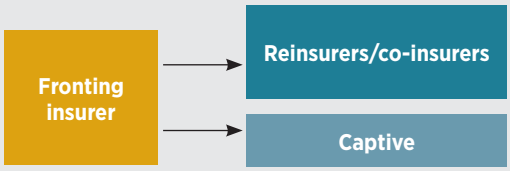
The typical captive that participates in their parent's global programmes will use a global insurer to issue local policies for some, or all, of their programme. The captive will then participate in two ways, which are commonly referred to as 'net line' or 'gross line'. The insurance industry is good at jargon so to make sure we understand this correctly an explanation is required.

First, the net line programme.

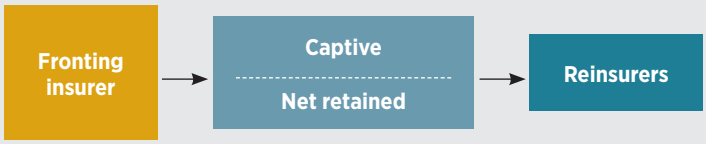
This is the structure we most frequently see and it is where the insurer reinsures to the captive only the risk that the captive wishes to retain. The insurer then keeps the rest of the risk or reinsures/co-insures directly. This is illustrated in the 'Net Line Progamme' diagram (*p21, top left*).

The gross line programme is where the insurer reinsures all of the policy limits to the captive. The captive then decides how

NET LINE PROGRAMME



GROSS LINE PROGRAMME



much risk it wishes to retain – typically a primary layer – and reinsures the remainder to a panel of reinsurers, usually led by the original insurer. See the 'Gross Line Programme' diagram (*top right*).

While there are advantages to both types of structure, the advent of Solvency II and other risk-based capital regimes means the balance will be firmly tipped towards net line programmes.

Net line

The net line programme should be simpler and easier to administer, cheaper and more capital efficient. Let's see why.

• **Administrative efficiency**

With a net line programme there are fewer entities to pass premium through as the captive does not need to pass part of the premium on to reinsurers (a significant amount of which may be coming back to the original insurer who had the premium initially). Similarly, any claims payments would also be delayed by this extra step in the chain.

• **Cost efficiency**

The fronting fees that the insurer charges will reflect the administration and complexity of a programme, as will any captive management fees so the net line programme should not just save time, but also money.

• **Capital efficiencies**

Under Solvency II, or any other risk-based capital system, credit risk needs to be assessed. For a net line programme where the captive only takes the risk they wish to retain, there will be no reinsurance and therefore the credit risk from reinsurers failing to honour their obligations is eliminated.

Perhaps more importantly though the fronting insurer will be subject to a capital charge for the credit risk associated with reinsurance recoveries, which is most significant if the counterparty is unrated and in a Solvency II non-equivalent territory. If the programme is on a gross line basis the size of the exposure will be larger and the capital charge higher as the full limits are reinsured. This can be mitigated through provision of collateral, but not eliminated. Given that most companies are looking to minimise collateral, such as Letters of Credit, this is not ideal.

If we go back five to 10 years, not all fronting insurers understood the true cost of this business and the capital required to support it and therefore did not build this cost into their fees. Those days are now gone and insurers are likely to pass on the capital charges, so captive owners need to understand that a structure that has more credit risk will mean a higher fronting fee.

> "With a net line programme there are fewer entities to pass premium through as the captive does not need to pass part of the premium on to reinsurers"

Gross line

Proponents of gross line programmes will point to some advantages that they bring and these are discussed below, along with a challenge about whether the benefits can be met in other ways.

• **Access to the reinsurance market**

One benefit that is frequently cited for a gross line programme is access to reinsurers. This was once very important but in today's environment the same reinsurers can be accessed by the fronting insurer or act as a co-insurer (many of the largest reinsurers have set up primary insurance arms to access clients direct). Most global programmes are designed holistically so negotiations with reinsurers should be no less advantageous wherever they sit in the programme.

• **Ceding commissions**

It is typical that ceding commissions are charged on reinsurance placements and a gross line programme will give captives access to these. These will help with the running costs of the captive. However, the overall economics of the transaction should be the same on a net line basis as the reinsurers should be prepared to accept the same reinsurance premium net of commission direct from the fronting insurer, which means that the total premium paid can be reduced by the ceding commission that the captive would have charged. This saving can be used by the owner to put additional funds in the captive if required, although most captives have a surplus of funds so this should not be necessary.

• **Control and access to data**

Another more qualitative argument for a gross line programme is that it gives greater control to the captive. With programme design more commonly being looked at in the whole rather than in separate chunks and all data available to the captive and its parent, there seems no reason why this should be so.

Writing this article I was reminded of something a colleague once said to me: "Gross premium is vanity, bottom line is sanity". Those responsible for their captives should have the confidence to tell their internal stakeholders that a captive with less premium can have just the same ability to help the parent deliver its strategic goals, yet in a more profitable and capital efficient way with less administration.

In light of the changes to the regulatory and pricing environment that we are seeing, this is a good time for risk managers to undertake a review of their captive in order to satisfy themselves that it has the optimum structure.

KNOWLEDGE IS POWER

Karen Jenner, of Fiscal Representatives, discusses the need to understand local regulatory requirements to have a successful global programme

As the thirst for global knowledge and compliant global insurance programmes grows, the landscape continues to evolve: incorporating emerging markets, the expansion of the EU and the changing ability to write non-admitted insurance. This leaves the insurer, risk manager and broker not only needing to keep abreast of the regulatory requirements, but also additional local compliance, of which a major component is IPT and other indirect taxes. This involves not only understanding what taxes are due but also how they are to be applied and settled.

Earlier this year saw the release of Insight Risk Manager, a database of regulatory requirements developed to assist risk managers assessment of the overall compliance of their global insurance programmes. This product is the collaboration of Airmic and insurance information specialists Axco, and covers regulations in 30 countries, which represent 93% of the world's property and casualty insurance premiums. The tool has undoubtedly provided more clarity and assurance to risk managers around global compliance requirements than was previously available, although regulations are only one piece of the puzzle.

Once the regulatory piece is understood, further local considerations include mandatory retentions and cessions, currency restrictions, compulsory pools and reinsurance requirements, in addition to the challenges of the filing and settlement of applicable premium taxes and parafiscal charges.

Written by
Karen Jenner

Understanding and keeping abreast of premium tax compliance requirements is another complex area requiring specialist knowledge and understanding. Global knowledge has to be continually updated; this is costly from both a resource and financial perspective, especially if it is to be both reliable and specific.

Even when an insurer has access to the various applicable rates of premium taxes across territories, applying these to the various insurance products can create challenges. Although in the EU the First Non-Life Insurance Directive (73/239/EEC) provides for the 18 classes of insurance business, these are often not referred to in local IPT legislation. One example is around class 7 – goods in transit insurance. In Germany, Spain and the UK, goods transported internationally are exempt from premium tax although tax does apply to domestic transits. In Italy, the type of vehicle involved in transportation is key in defining the application of premium tax, whereas in the Netherlands, all goods in transit risks are exempt. Outside the EU there are further insurance classifications that equally do not necessarily match up to local premium tax legislation.

Again in the EU, the Second Non-Life Insurance Directive defines location of risk rules to determine where premium tax liability arises. Rules differ, however, even in Europe – in Switzerland for example, Swiss stamp duty is only payable where the policyholder is located in Switzerland. In the US, location of risk rules differ again. For example, since 2011, policyholders with a 'home state' of Texas, (i.e. where risks located in Texas attract the largest percentage of premium under the US insurance policies), that independently procure non-admitted insurance, are only subject to Texan tax law. This may not, however, be consistent with rulings in other states – one must then consider the legislation and requirements of the other states where risks are located to ensure duplication of premium taxes will not be due.

Captives writing non-admitted insurance into the US must also consider FET and ultimate reinsurance. Although the captive may be able to secure an FET exemption,

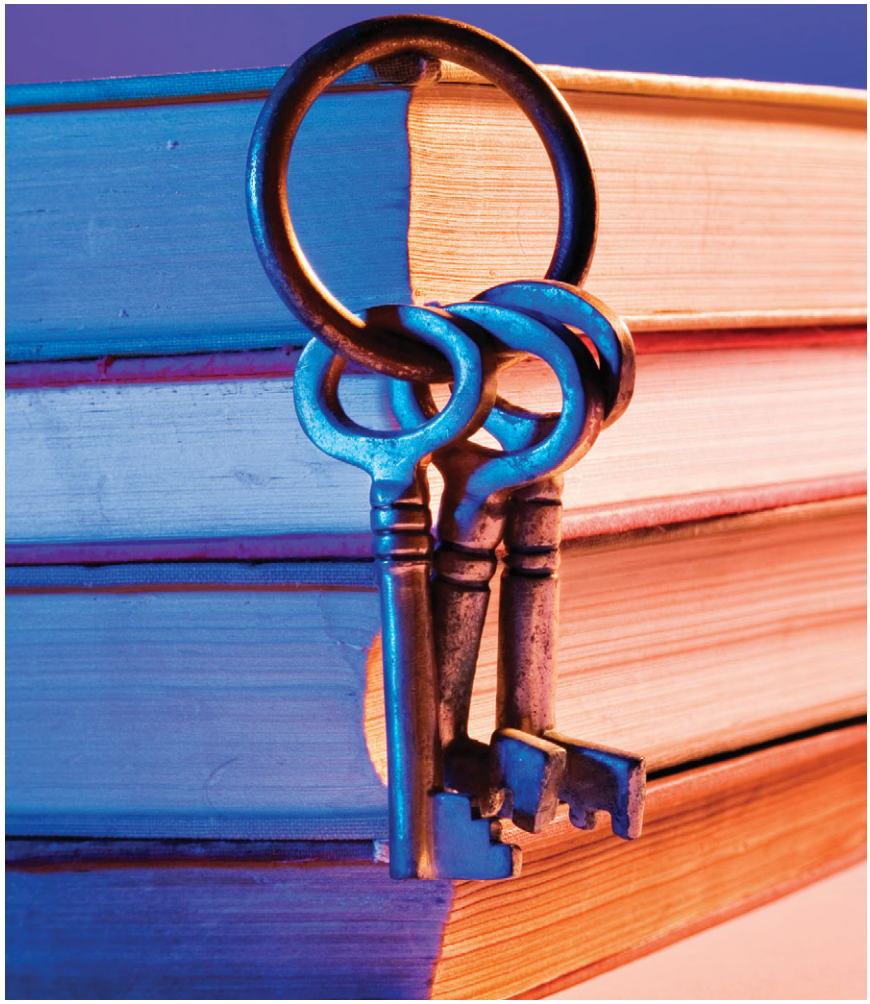
> **"Even when an insurer has access to the various applicable rates of premium taxes across territories, applying these to the various insurance products can create challenges"**

where there is retrocession to a market or reinsurance captive in another domicile FET cascading tax may apply.

When exploring premium tax regimes for the first time there is a significant amount of research required. Firstly, applicable local legislation must be considered. This brings the challenge of interpretation, in addition to translation. For example, some Greek IPT legislation is in Classic Greek, proving a challenge for interpretation for even native Greeks. Knowledge and understanding of local market practice is also key, as this can offer differ from requirements laid out in premium tax legislation.

As well as understanding and keeping up to date with the various rates of premium tax and stamp duties, the application of such rates and any possible exemptions must be considered. Rules and rates can sometimes differ for insurers and captive insurers. For example, in Ireland captive insurers are exempt from the Insurance Compensation Fund (ICF) levy. There can also be different requirements for domestic insurers to those based overseas. One example is Singapore, where a local GST charged to domestic insurers currently does not apply to foreign insurers writing on a non-admitted basis.

Finally, the physical filing and settlement process has to be identified and in some cases established with the local tax authorities to ensure compliance for overseas insurance companies. Recent expansion of the EU in Hungary, Croatia and Poland has often tested the knowledge and capacity of local tax authorities to handle the additional volume of pasporting transactions. Ascertaining the process of registering an insurer as a taxpayer in a new jurisdiction is required in addition to understanding what tax points are to be applied; whether monthly, quarterly or annual returns are to be filed; the filing and payment deadlines to be met. A recent example is in Poland where the Insurance Ombudsman Charge has been extended to apply to EU insurers writing risks in Poland on a freedom of services basis. The charge is handled by the ombudsman and not a tax authority, and although the amount and payment methods are known, the details of the process are still to be refined. Insurers must decide whether waiting for full clarification is more important than avoiding any penalties that may be applied for late settlement of any taxes and charges. Even within the EU, requirements for a formal fiscal representative in the filing process must be determined and can differ. For example, a fiscal representative is still required in Spain and Portugal.



Where regulations allow and where payment of premium taxes can be made by the policyholder, there are additional opportunities for captive insurance companies to write directly in a compliant manner in some territories, using their own local insured and/or a fiscal agent in the process. Examples of this include Australia and New Zealand. In Australia, federal income tax is levied on premiums paid overseas to non-admitted insurers, but can be settled by the local policyholder as a 'deemed agent' of the foreign insurer for tax settlement. Captives should consider this additional 3% deducted from premiums paid overseas as an additional cost to writing direct into Australia on a non-admitted basis. Again the varying state taxes can be typically settled by the local policyholder based on the location of risk, with additional taxes applying in some states to fund fire and emergency services. Multiple state locations will increase the complexity for the captive insurer and requirements of local policyholders in territory. In New Zealand, a foreign captive insurer can reduce fronting costs by writing on a direct basis and relying on the local insured as their 'deemed agent' for settlement of up to three potential separate taxes. Income tax is an additional charge of currently 2.8% deducted from premiums transferred to overseas insurers. Additionally, an earthquake levy and a fire services levy could be payable, depending on the coverage provided.

Global compliance is ultimately achieved through the shared communication, knowledge and responsibility of all involved in the process – insurer, insured, broker and captive manager – with the engagement of legal and tax specialists where required.

AVOIDING COVERAGE PITFALLS WITH GLOBAL CONTINUITY

Paul Wordley, of Holman Fenwick Willan, speaks to *Captive Review* about the challenges and pitfalls captive managers should consider when managing a global insurance programme

Written by
Paul Wordley

Captive Review (CR): What are the benefits and challenges of running a global programme through a captive?

Paul Wordley (PW): The primary benefit is more control over the risk within the organisation. As well as it being a risk financing, it's also a risk management tool, as you have a better understanding of what risk is in the various business units around the globe.

However, most people start using captives for purely financial reasons. In other words, they want to take more risk on their balance sheet, pay less premium and transfer less risk into the reinsurance market, so they use a captive to collect premium and issue insurance and buy reinsurance, depending on what their appetite for risk retention is. This means they are less reliant on the reinsurance market if it gets too difficult. It puts the business on both sides of the deal as, if they don't like the terms offered for a renewal from the market, they can increase the role of their captive.

CR: When identifying fronting partners for a global programme, what are the key considerations?

PW: One of the main considerations will be whether a fronting partner has a presence in all the jurisdictions in which you operate. You need someone who has the licences to do the classes of business you are doing in your captive, in all relevant jurisdictions.

Secondly, you need someone who is going to be a good partner in terms of dealing with local regulatory compliance and claims, because a lot of fronting partners insist on having their own local wordings or are required by local law to use local wordings. Sometimes these are driven by regulation from a particular jurisdiction and they will be different from the core or master wordings the captives have, which will be the basis of the coverage it issues and the reinsurance it buys.

The main issue is to make sure that your local fronting partner is going to work with you in the event of a claim, rather than doing its own thing, which technically it may be entitled to do because it's their paper in the jurisdiction and it's their balance sheet that is first at risk if there is a large claim.

In summary, you ideally look for a spread of licences, a mutual purpose and alignment of objectives.

CR: Are there common regulatory and compliance pitfalls and how can they be navigated?

PW: The first pitfall has to be that businesses aren't necessarily checking that they are complying with every local regulation in the jurisdictions within which the captive operates. A captive will have limited licensing, depending on which part of the world it's based in. It may be able to insure directly in a number of jurisdictions but there will be several where it can't and therefore it has to rely on a local insurer, and sometimes businesses don't check what the local requirements are. Often people think they are compliant until they are audited and it turns out they are not.

If you have a central policy, a core (master) wording, that provides the coverage that the multinational is buying, but you are also using locally required wording, the latter could offer narrower or broader cover. You therefore need a mechanism that brings that local wording back to the master policy. The traditional route is a difference in conditions clause, but it is really a difference in coverage because sometimes terms and conditions in the English language can mean one thing under English law and something completely different under another law.

Quite a few programmes get caught out because they rely on the DIC in the master policy to bridge the gap locally. By providing additional cover locally to the business unit, the captive may actually be breaching local regulations because it isn't licensed to provide the additional insurance.

> **"One of the main considerations will be whether a fronting partner has a presence in all the jurisdictions in which you operate"**

For example, HFW currently is looking at a global programme from a multinational company and it turns out that they are not complying with their obligations in a key jurisdiction where they have assets. Under local law they are required to have local law as the proper law of the insurance. It doesn't have to be from a local insurer but must be local law.

CR: What risks are you running by not being compliant?

PW: The first thing is you will be running a coverage gap because you may not actually be getting the local cover you think you have through the master wording and through the reinsurance programme. In other words, you may not be giving the local insured, your business unit, the cover you have for the whole corporation.

In addition, you may be committing a regulatory offence: in most jurisdictions that means a fine. In some jurisdictions non-compliance would invalidate the policy. In South Korea, it's a criminal offence to provide insurance coverage without a licence to do so.

CR: How important are the core (master) wordings in a global programme and how can the insured avoid policy gaps?

PW: The core wording is absolutely essential because with global programmes for multinationals they are really insurances that become reinsurances because the captive is involved. The insurance coverage is set out in the core wording, but then you must have a series of contracts, known as insurance architecture, to deliver risk transfer from local businesses, through a local 'fronter', into the captive, back out to the reinsurance market, possibly via a reinsurance captive if it's a European multinational. All those contracts have to be consistent and be based on the same core wording. Sometimes they try to do this by incorporation provisions, but of course if you have different laws from different jurisdictions covering those various contractual links you might not have consistency in incorporation.

For example, a local business running a mine in a jurisdiction like Brazil or Indonesia. At the top of the chain you have a large insurance firm sitting in London, with a long series of contracts between itself and the Brazilian mine. There has to be a way of getting that core wording coverage all the way from top to bottom and vice versa when there is a claim.

CR: What are the legal challenges associated with claims handling when running a global programme?

PW: There are different challenges associated to different types of claims but a general example is the local requirements that must be complied with. You also have to negotiate with reinsurers who will be used to managing large, complex claims when your insured may not be, such as business interruption claims. In complex claims, the associated fact management and issue identification and resolution for those claims can be daunting.

> **"You also have to negotiate with reinsurers who will be used to managing large complex claims when your insured may not"**

Ultimately, you need to invest twice in your global programme. First, when you buy it you need to dedicate time to due diligence on the policies and contracts you are using to make sure what you are trying to achieve, i.e core wording coverage for your whole business, is attainable or you are at least aware of the problem areas.

Second, once a claim occurs you then put all this into practice and afterwards invest again depending on the type and size of the claim.

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