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# Captives and global programmes: A synergistic relationship?–Ken Read, Aon Risk Solutions London

By Ken Read, Aon Risk Solutions London
Email Author

Captive insurance companies represent a well-established mechanism to provide financing for retained insurable risk and are used by many organisations as a part of an overarching strategy to minimise their overall Total Cost of Risk, being valuable (particularly, but not only) in bridging the 'risk appetite' gap between that of individual operating units/subsidiaries and that of a parent Group. The effect is to retain claims that might otherwise be covered by the insurance market and would, longer-term, attract the margin in insurers' premium to cover costs and provide a return on capital.

Global/multinational insurance programmes are also a well-established tool in a risk manager's armoury and, again, a global programme is often a fundamental element in an organisation's strategy to minimise its Total Cost of Risk, in this case through the achievement of: cost effective insurance utilising economies of scale, consistent but focused coverage and centralised control. Multinational programmes are very helpful in addressing the needs and complexities of a multinational business.

Given that multinational programmes often incorporate a significant level of retained risk for the insured organisation, it is clear that captives and global programmes are complementary tools in minimising risk-transfer costs. It is, therefore, not surprising that captives participate in many global programme structures, either as a direct underwriter or, more often, through the provision of reinsurance capacity via a 'fronting' insurer.

The involvement of captives in multinational programmes is long-standing practice (thirty years plus) and has, generally, been beneficial to insurers and insureds alike. However, over time there have been challenges. For example, the restrictions to the use of non-admitted insurance that exist in a number of countries, together with the difficulty and cost of complying with the ever increasing requirements to collect and remit many premium based taxes, levies and charges, have caused a trend for captives to withdraw from the direct provision of insurance and move to the provision of reinsurance cover.

Conversely, the increasing level of collateral required generally by fronting insurers has tested the willingness, and sometimes ability, of captives to participate effectively through reinsurance.

Despite such challenges, captives and global programmes continue to provide beneficial compatibility to multinational insurance purchasers and are a popular combination. However, there are some potential evolving developments that can be expected to affect captives and their effectiveness in supporting multinational programmes.

The first is the OECD initiative on Base Erosion and Profit Shifting (BEPS), which has been launched at the behest of the G20. Within this initiative the OECD is pursuing 15 separate but interrelated action areas, all of which could affect captives. However, the outcomes of some of these actions points are likely to be particularly relevant to captives writing multi-national programmes. These action points are, in summary:

- Action 3 - Recommendations to strengthen Controlled Foreign Company rules.
- Action 4 - The treatment of loan interest and payments for other financial transactions.
- Action 5 - Preferential tax regimes as a harmful tax practice.
- Action 9 - Development of rules to prevent BEPS by the transference of risks or the allocation of excessive capital within a group.
- Action 13 - Disclosure of income, economic activity and taxes paid country by country.

Whilst none of these issues are new to captives, it appears that ultimately the BEPS initiative will require captives and/or their parents to take a more robust approach to the determination of terms for a captive programme and how a captive is operated, which will almost certainly result in an increase in the compliance and/or operational burden and the corresponding costs.

Of course, none of this represents an unsurmountable obstacle but it is reasonable to expect that the efficiencies achieved through a captive participation in a multinational programme will be impacted to some degree.

The second is the implementation of the Solvency II regulatory regime. Now, much has already been written about Solvency II and its impact on the insurance industry, including the captive sub-set, that I will not repeat here. However, it is worthy of note that many (probably most) of the captives involved in multinational programmes will not be subject to Solvency II or Solvency II equivalent regimes, particularly those captives participating via reinsurance, as these are located mainly in jurisdictions that are outside of the EEA and are not proposing to adopt a Solvency II equivalent regime. A quick review of Aon's internal captive database suggests that, on a global basis, approximately 80% of single parent captives, i.e. those most likely to be supporting multinational programmes, are located in non-Solvency II jurisdictions.

As most of these captives are not rated, in simple terms a fronting insurer within the Solvency II area will not be able to achieve full recognition of reinsurance to such a captive as representing mitigation of risk, and therefore achieve a corresponding mitigation of its Solvency Capital Requirement, unless the reinsurance to the captive is supported by either a collateral instrument issued by a suitably credit-rated institution or by a guarantee from a suitably rated parental entity.

Again, this is not a significant departure from current practice from the captive perspective but, at least in theory, any flexibility in the requirements of fronting insurers in this regard is likely to reduce. However, so far there has been no discernible trend towards the hardening of terms for fronting in advance of Solvency II, due at least partly to the level of competition in the global insurance marketplace.

So, whilst it is reasonable to conclude that the environment in which captives in the multinational programme space operate is going to become more onerous, there is every reasonable expectation that captives will cope without too much difficulty and that owners of captives will be benefiting from the support captives provide to multinational programmes for many years to come.