

Captive Updates

Captive News

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Solvency II – Update

The Solvency II project continues to progress at speed (implementation date of the Directive is 31st October 2012). A total of 80 consultation papers (CP) have now been issued. The most recent CP, CP80, is currently the only paper open for comment. Of the most recent papers, the following provides an overview.

CP78 Third Country Equivalence – this CP closed in February. This CP addresses areas of consideration in relation to what a third country, i.e. a country not in the EU, would have to do in order to be treated as an equivalent country. Effectively it requires, at a 'high level', that such a third country will have implemented a capital, risk governance and reporting regime similar to Solvency II. Why is this relevant for captive owners not in the EU? Clearly if non-EU domiciles seek such equivalence then some of the concerns of captive owners in the EU would also apply to non-EU captives. Therefore, capital and risk governance requirements could potentially increase markedly.

What if a domicile does not seek equivalence? The key aspect relates to the 'value' of the reinsurance provided by captives in those third countries to insurers in the EU. The Directive states that such reinsurance will be discounted by at least 30%, i.e. any capital relief enjoyed

by a fronting company in respect of the reinsurance from a captive will be reduced by at least 30%. In order for this to be of a concern, one has to consider what capital relief such fronting carriers currently take for captive reinsurance. In many instances, the capital relief is often near or at zero and is one of the reasons collateral is frequently requested. However, fronting companies might make other changes concerning collateral or the overall fees they charge. This is an area for captive owners in non-EU jurisdictions to continue to monitor.

CP79 Simplifications for Captives – the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) issued implementing measures in January following this CP. There are a number of areas to be considered from such measures. In particular, the following specifies which companies will be treated as captives and therefore able to utilise the simplifications:

“The insurance obligations of an insurance captive undertaking only relate to contracts where all insured persons and beneficiaries in respect of unexpired risks are legal entities of the group of the captive undertaking and where all insured persons and beneficiaries were legal entities of the group at the time the contract was entered into.

The reinsurance obligations of a captive undertaking only relate to contracts where all insured persons and beneficiaries of the underlying direct insurance contracts in respect of unexpired risks are legal entities of the group of the captive undertaking and where all insured persons and beneficiaries of the underlying direct insurance contracts were legal entities of the group at the time the contract was entered into.

The insurance obligations of the direct insurance captive undertaking do not relate to any third party liability insurance.”

This significantly reduces the number of companies that currently count themselves as captives. Consequently, they will not be able to use any of the simplifications. How significant is this and how significant are the simplifications?

Within the Standard Model, no allowance was made for aggregate limits, which was clearly inappropriate for many captive owners; such aggregate limits can now be taken into consideration. However, one of the main capital 'drivers' for captives in the Standard Model related to the catastrophe risk and CEIOPS have made no adjustment in this regard. In other areas generally, the simplifications are not of significant value and sometimes result in a higher capital charge because any 'allowance' for a simplification has been at the lowest level possible.

CP80 Internal Models – this CP is currently open for comment. It addresses the considerations, from a regulatory perspective, as to what should be reviewed in the pre-application process for an internal model. Helpfully, it provides examples as to questions that a regulator might ask and the documentation that should be sought. From a captive perspective, given the relatively small number of captives that will be able to take advantage of the captive simplifications in the Standard Model, captive owners should be considering this area. Importantly, from a practical perspective, regulators are given a full six months to review an internal model. Therefore, certainly in discussions with major regulators, it is suggested that **internal models should be submitted by 1st November 2011**. Many regulators have already begun to ask captive owners whether they intend to pursue this route. Our recommendation at present is to indicate that an internal model (or at least a partial internal model) is under consideration in order for the captive owner to have maximum flexibility as further implementing measures are released by CEIOPS.

In respect of the foregoing, the application of the principles of proportionality is key. This requires regulators to approach captives giving due regard to the scale, nature and complexity of the captive. This area should become much clearer during 2010/11 as we move from 'what is Solvency II' to 'how we implement Solvency II'.

Captives and Employee Benefits Seminar

In February, Marsh and Mercer held another breakfast meeting, this time in Stockholm, on the subject of insuring employee benefits in a captive. The meeting was attended by Risk Managers and Human Resources Managers. Mike Green, European Head of International Health & Benefits at Mercer, stressed the need for groups to better understand their employee benefits risks and particularly to have a clear picture of the overall costs involved in financing them. Once this is understood, the possible savings that can be achieved through the optimal financing of these risks can be evaluated, e.g. via multinational pooling and/or captive financing.



UK: HM Revenue & Customs (HMRC) Revisions to CFC Rules

In January HMRC issued a discussion document 'Proposals for controlled foreign companies (CFC) reform' concerning long awaited potential revisions to the UK's CFC rules. The document sets out the principles and proposals for modernising the UK tax treatment of CFCs in a way that 'enhances the competitiveness of the UK whilst providing adequate protection of the UK tax base'.

Its proposals, relevant to UK captive owners, are:

- Profit derived from premium received from non-UK sources would not be subject to UK taxation, i.e. a captive in a zero tax domicile will pay zero tax on profit from non-UK sourced premium income;
- The 'de minimis' rule will be increased from £50,000 (which was introduced in 1998) to a much higher (unspecified) level, i.e. if a captive's profit is below the de minimis level it is not subject to UK taxation.

The potential impact of this is positive as it provides potential for cost savings currently not achievable. As an example, the costs associated with fronting could now be offset by the profit generated that is not subject to tax. This is particularly relevant in the Solvency II debate in terms of considering the value of an offshore versus onshore domicile, in that it contributes to the financial benefits more typically associated with offshore domiciles.

Click [here](#) to access the discussion document. The consultation period runs until 20th April 2010. The Government aims to release a further document on the proposals, along with draft legislation, later in 2010 with a view to legislating in the Finance Bill 2011.

US: Two Private Letter Rulings

The Internal Revenue Service (IRS) has ruled that quota share reinsurance arrangements are 'insurance' and continues to apply prior principles. The two Private Letter Rulings (PLRs) in relation to this are essentially restatements of prior rulings dating back to 2002 and 2005. (A PLR is a ruling that an individual taxpayer requests so it is not the same precedential value as a Revenue Ruling, which is a ruling to the general tax-paying public.)

On 11th December 2009, in PLRs 200950016 and 200950017, the IRS ruled that quota share reinsurance arrangements qualified as 'insurance' for federal income tax purposes based upon the fact that both risk shifting and risk distribution were present in the arrangements. The rulings confirm the application of insurance principles derived from prior IRS rulings.

EU: QIS5

CEIOPS has set up a Task Force to meet QIS5 (the Final Quantitative Impact Study under Solvency II) deadlines and deliverables. It will be responsible for supporting all relevant expert groups in preparing and running the exercise according to the work plan agreed between CEIOPS and the European Commission.

According to CEIOPS' press release on 28th January 2010, "The Task Force will aim to ensure the overall coordination of the exercise in close cooperation with the Solvency II expert groups. The Task Force will also seek to ensure that overlapping areas in the QIS5 exercise are dealt with in a consistent manner." It is important to note that both the Federation of European Risk Management Associations (FERMA) and the European Captive Insurance and Reinsurance Owners Association (ECIROA) are being consulted as 'expert groups'.

There are certain deadlines by which CEIOPS must deliver on its further contribution to the Impact Assessment of Solvency II Level 2 Implementing Measures. "CEIOPS is expected to provide a complete draft of the QIS5 technical specification along with a comprehensive calibration paper by end of March 2010 to enable the Commission to publish final technical specifications by end of June 2010."

The Commission has requested that the exercise be run between August and mid-November 2010.

EU: Solvency II Legacy Concerns

The Association of Run-off Companies (ARC), the UK trade body for (re)insurance legacy management professionals, through its recently formed Solvency II Working Party, has responded to the third round of the Solvency II Consultation Papers issued by CEIOPS.

There are concerns that run-off companies' specific needs have not been considered in the Solvency II proposals thus far. Key concerns include the unreasonable capital burden on the run-off sector and the prospect that reporting and data quality requirements could result in unaffordable additional expenses. ARC is in dialogue with the Financial Services Authority about its concerns.

US: TRIPRA

The Obama Administration released its proposed 2011 budget on 1st February 2010. The budget reasserts the administration's position to reduce Federal support for the Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA) backstop. The proposal is to increase the insurer deductible progressively to an unspecified amount (currently 20% under TRIPRA) in 2011 and again in 2013. This was originally presented by the US Office of Management and Budget in its report 'Terminations, Reductions, and Savings, Budget of the US Government, Fiscal Year 2010'.

The 2011 budget generally proposes reduced Federal intervention in TRIPRA, and specifically identifies:

- Increasing the deductible to be paid by insurers;
- Increasing the insurer co-participation;
- Increasing the event trigger;
- Removing coverage for acts of domestic terrorism;
- Reducing the recoupment percentage from 133% to 100%.

Whilst this proposed budget simply reasserts the position detailed in the first report of efforts by the Obama Administration to reduce government spending – and remains limited in terms of specifics on how changing TRIPRA would reduce the federal government spending – TRIPRA remains on the list of items being assessed.

The proposal raised last year by the Obama Administration was not taken up by Congress for evaluation. Senior House Financial Services staff have indicated there remains zero appetite for reopening Terrorism Risk Insurance Act (TRIA) to make the proposed changes. Marsh's Terrorism Insurance Task Force is researching this issue, along with external advisers, and will monitor the situation.

Among other proposals, it would remove coverage for domestically inspired acts of terrorism and increase private insurer deductibles and co-payments.

Domicile Developments

New Zealand Foreign Insurers Unregulated

According to the New Zealand Captive Insurance Association (NZCIA), drafted insurance legislation would allow foreign insurance companies to operate on an unregulated basis. The Insurance (Prudential Supervision) Bill would not regulate foreign companies that set up insurance subsidiaries in New Zealand. The Bill "regulates domestically-owned captives, but does not provide for foreign-owned captives to be licensed, nor to be subject to the offences under the Bill". NZCIA President Peter Lowe said the Bill, which was drafted by the Reserve Bank contrasts with the views of both the OECD and the International Association of Insurance Supervisors. There are 22 captives in New Zealand according to the NZCIA.



Changes include:

- The introduction of multiple classes of insurance licences;
- Provisions regarding the regulation and supervision of insurance managers, intermediaries and loss adjusters;
- Reporting duties of insurance managers.

The new legislation will position the insurance industry in the BVI to meet international insurance standards and should simplify the current governing statute. It is introduced in conjunction with 'robust' regulations and a new Regulatory Code. The Insurance Regulations, 2009, replace the Insurance Regulations, 1995. The Regulatory Code, 2009 contains detailed requirements that support the general framework established by the primary financial services legislation. It is hoped that the new Act and Code will encourage the development of new and more sophisticated types of insurance companies.

Labuan's Takaful Captive Guidelines for 2010

The Labuan Offshore Financial Services Authority (LOFSA) is expected to announce guidelines for a Takaful (shariah-compliant) captive insurance model in June 2010 to service the Islamic market. According to captivereview.com LOFSA's director general Datuk Azizan Abdul Rahman is quoted by local press as saying that the authority has received requests from companies to set up an Islamic captive vehicle.



Isle of Man Amends Customs Agreement

There has been a change in the VAT revenue sharing arrangement (the 'Customs Agreement') between the Governments of the Isle of Man and the UK. It benefits both countries as it allows free trade between the UK and the Isle of Man without customs barriers. As the UK is a member of the European Union, the agreement means the Isle of Man is effectively in customs union with the entire EU.



Micronesia's Legal Provisions for Captives

New public law has paved the way for a new type of captive. According to the government of the Federal States of Micronesia (FSM) the signing into law of Congressional Act No. 16-17 into Public Law 16-17 amends Title 37 (Insurance) of the Code of the FSM by including a definition of a new type of Captive Insurance Company, the Multiple Corporate Captive (MCC) Insurance Company, and also provides for the issuance of Captive Insurance Managing licenses. The law states that MCCs are one or more corporations who are organised, or have the intent to organise, as a group of corporate captive insurance companies under the laws of the FSM and defines the laws that they must operate under. MCCs now become subject to Corporate Income Tax under Chapter 3 of Title 54 of the FSM Code, creating consistency in the tax laws for captive insurance companies.



The Customs Agreement includes the pooling and sharing of VAT receipts and other indirect taxes and it is this part of the agreement that has been revised, according to Isle of Man Finance. There is no effect to business; this is a domestic issue that affects the future loss of income to the Isle of Man. The Isle of Man Government is confident it will be able to respond successfully to this most recent challenge, which it says is a separate and distinct issue from its 0/10 Corporate Tax Policy, and maintain a competitive business environment.

Isle of Man Introduces Corporate Governance Code

The Insurance and Pensions Authority (IPA) has released a consultative draft of the Corporate Governance Code of Practice for Insurers. The Code will effectively codify under regulation the corporate governance requirements that captives will be required to follow. Certain aspects of the code will have little or no effect as many captives typically perform these requirements as a matter of course. However it will raise the bar for some. The concept of proportionality is also in the code and at present Marsh is working to clarify with the IPA what this will mean in practice.



Click [here](#) for consultation documents (consultation closed).

BVI: New Insurance Act

The British Virgin Islands (BVI) Financial Services Commission (FSC) has introduced the BVI Insurance Act, 2008, which came into effect on 1st February 2010. It repeals and replaces current legislation, Insurance Act 1994, and is intended to provide a more transparent and cost-effective regime for the jurisdiction's insurance industry.



Bermuda: Tax Information Agreement Negotiations

Bermuda has concluded negotiations of bilateral agreements with Belgium and India, which provide for a full exchange of information on criminal and civil tax matters between Bermuda and the Kingdom of Belgium and India respectively.



2009 in Summary...

2009 was a year to take stock and plan for the future. With the global insurance markets remaining soft on the whole, the impetus to establish a captive was reduced for many companies enjoying very competitive market rates. In contrast, we have witnessed an increase in the proportion of captive owners seeking to optimise their captives to reduce associated costs, such as capital requirements, and ensure alignment with their business and risk financing strategies. As such we have seen an increased interest in captive amalgamations or disposals (e.g. where there has been an acquisition), resolution of legacy issues (e.g. removal of historical liabilities) and parental loans (to maximise use of capital). Equally, the launch of a new insurer, Grafton (Europe) Insurance Co Ltd, focused on historical liabilities, was a further major development in the resolution of historical liabilities for captive owners. There has also been an increased focus on a wider use of captives including the less traditional employee benefits and third party business.

The spotlight has been on the captive domiciles that have graduated from the OECD's 'grey list' to its 'white list' as new tax information exchange agreements aid international financial transparency. Taxation continues to be an area of debate as the UK awaits amended CFC legislation and tax deductibility of technical premiums, whilst the US continue to face the threat of losing reinsurance premium tax deductibility.

The proposal or introduction of new or amended legislation to enhance insurance laws has been widespread, including a number of US states, China, Labuan, Malta and Canada. Despite the soft market conditions, captive formations reportedly increased in the fourth quarter in 2009 across a number of domiciles, particularly in the US.

In the EU, the implementation of Solvency II in October 2012 draws nearer. As captives prepare to run QIS5 models in 2010, and as consultation papers continue to be issued, the clarity around Solvency II and its impact worldwide continues to progress.

US: Offshore Reinsurer Deductions Targeted Again

The Obama Administration's proposed 2011 budget also reopens the issue of taxing offshore insurers; the provision intends to deny a US non-life insurance company a deduction for certain excessive non-taxed reinsurance premiums paid to affiliates. This is because reinsurance transactions with affiliates that are not subject to US federal income tax on insurance income can result in US tax advantages, which can be seen as an efficient way of reducing US tax.

Under the proposal, a US insurance company would not be allowed a deduction to the extent that the foreign reinsurers or their parent companies are not subject to US income tax with respect to the premiums received, and the amount of reinsurance premiums paid to foreign reinsurers exceeds 50% of the total direct insurance premiums received by the US insurance company and its US affiliates for a line of business.

The proposal resembles similar initiatives launched last year (as reported in Captive Updates Volume 3 / Issue 4) to disallow the deduction for non-taxed reinsurance premiums between related parties.

Captive Event Calendar 2010

<p>CICA International Conference 7-9 March 2010, Florida</p>	<p>Montana Captive Insurance Association's 5th Annual Conference 19-21 July 2010, Montana</p>
<p>World Insurance Forum (WIF) 14-16 March 2010, Bermuda</p>	<p>Vermont Captive Insurance Association's Annual Conference 10-12 August 2010, Vermont</p>
<p>Western Region Captive Insurance Conference 5-8 April 2010, Arizona</p>	<p>FERMA Seminar 29-30 September 2010, London</p>
<p>RIMS Annual Conference and Exhibition 25-29 April 2010, Massachusetts</p>	<p>FERMA Risk Management Forum 2011 2-5 October 2011, Stockholm</p>
<p>AIRMIC Annual Conference 15-16 June 2010, UK</p>	<p>National Risk Retention Association's 2010 National Conference 27-29 October 2010, Washington D.C.</p>
<p>Bermuda Captive Conference 27-30 June 2010, Bermuda</p>	<p>Cayman Captive Forum 30 November - 2 December 2010, Grand Cayman</p>

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