

# Captive Updates

Issued by the Risk Optimisation Group

## Captive News

Volume 2 / Issue 4 - August 2008

### UK: Vodafone CFC



On 4th July 2008, Vodafone 2 won its High Court Appeal against HM Revenue & Customs (HMRC) concerning the application of the UK's controlled foreign company (CFC) rules to EU based subsidiaries. The ruling specifically applied to the CFC rules as they applied prior to the Finance Act 2007 (which in summary provides for profits made by a subsidiary resident in the EU not to be taxed by HMRC until such profits are returned to the UK business) and shows a further relaxing of the approach taken by the courts in light of the Cadbury Schweppes decision, as discussed in Captive Updates Volume 1 / Issue 1.

Specifically, this case involved a finance company based in Luxembourg. Under the Cadbury Schweppes ruling, the European Court of Justice (ECJ) had concluded that the UK's CFC rules were incompatible with EU law unless the arrangement involving an EU subsidiary was a "wholly artificial arrangement". Therefore, the CFC rules could not be applied if "genuine economic activities" were carried on. As commented on at the time, this left significant scope for debate about how certain activities would be treated. Vodafone 2 argued that such a distinction should be completely eliminated. The High Court agreed effectively eliminating the application of the UK CFC rules to EU based subsidiaries. HMRC might appeal the decision.

Whilst this ruling does not impact the changes within the CFC legislation within the Finance Act 2007, the High Court commented that some doubt existed regarding whether or not the new rules were compliant with EU freedom of establishment rules.

This represents a further interesting development for captive owners in the UK with EU based captives. The ability to hold substantial funds within the captive, rather than having to pay the UK tax rate or making substantial dividend payments to the parent, increases the flexibility available to a company in pursuing a given risk financing strategy.

### EU: Launch of EIRCOA

The European Captive Insurance and Reinsurance Owners Association (ECIROA) is being formed in Luxembourg. The initiative, driven by members of the German risk management community, is one of several steps by companies within the European Union to present a more united approach in response to a changing regulatory environment. This represents a positive progression in this area and will hopefully be supported by captive owners across the EU. Further details of the Association can be found at [www.bieurope.com](http://www.bieurope.com).

### US: Contesting 'Cascading' FET

Insurance industry officials are urging Treasury tax officials to delay or rescind the US Internal Revenue Service (IRS) guidance that requires domestic insurers to pay an excise tax each and every time a premium is ceded to a foreign (re)insurer, as detailed in Captive Updates Volume 2 / Issue 3. The existing guidance is due to go into effect on 1st October 2008. The guidance is considered by the industry to be inconsistent with the purpose of the law that it interprets and contrasts the historical treatment whereby federal excise tax (FET) is applied only on the premiums transferred from the US to a foreign insurer.

The revenue ruling (2008-15) supports the IRS position that FET on premiums imposed by Sec. 4371 of the IRS Code of 1986 is a 'cascading' tax. The insurance industry representatives want the ruling withdrawn and the long-held position of the IRS on its 'cascade' theory to be abandoned.

## Fronting Trends

The Captive Insurance Companies Association (CICA), currently the only domicile-neutral captive insurance association, has revealed in its 2008 Fronting Survey that captive use of fronting and reinsurance has decreased compared with a year ago, despite the reduced cost. Respondents selected the primary reason for using a fronting carrier as the ability to issue admitted paper; the next highest reason being for regulatory compliance.

There was a 21.5% increase in the number of survey respondents reporting that their programme was not fronted. Also, respondents reported buying less reinsurance, with an 11.5% decrease year on year.

The biggest challenge faced by captive owners in the 2008 survey is considered to be getting the required services that have been paid for from the fronting company. This shows how far the fronting market has developed since the first survey in 2000, where the biggest challenge was finding a fronting insurer. This year's survey also covers reinsurance issues, employee benefits and comparative financial information about captives.

## UK: Taxation of Foreign Profits

HM Treasury hosted its first Business-Government Forum on Tax and Globalisation focusing on 'Taxing Foreign Profits' on 9th June 2008. Member companies of the group include BT plc, GlaxoSmithKline plc, BP plc and Rolls-Royce Group plc and economists from the Royal Bank of Scotland and Saïd Business School amongst others. The Forum discussed the current business taxation position, the package of foreign profit taxation reforms proposed so far and included recognition that "some aspects of the proposals were too wide-reaching". Input was sought on the way forward including a timetable for compiling a revised reform package.

Subsequent to this meeting, HM Treasury issued an open letter on 21st July on the review and taxation of foreign profits. HM Treasury noted that, subject to minimising the potential risk, it was interested in a foreign dividend exemption.

The taxation of foreign profits is clearly a very high issue with many businesses and the government. With rulings such as Vodafone 2 (see above), the discussion document issued last year on revised CFC rules (along with the recent open letter) and the news that Shire Pharmaceuticals is 'relocating' its tax residency to Ireland, HM Treasury is keen to demonstrate that action is being taken.

## US: RRGs to write Property Coverage?

Risk retention groups (RRGs) have been an area of significant growth for several years, primarily for medical professional liability. RRGs are typically formed by businesses in the same industry joining forces to become owners-insureds of their own insurance company.

New legislation to modernise the federal Liability Risk Retention Act (LRRRA) of 1986 would allow RRGs to write property coverage under H.R. 5792, the Increasing Insurance Coverage Options for Consumers Act of 2008, which would make it more affordable and accessible and provide greater coverage options. The existing LRRRA permits RRGs to provide commercial liability coverage, excluding workers' compensation.

In addition, the bill addresses several corporate governance standards for risk retention groups that the Government Accountability Office (GAO) recommended in its 2005 study of the RRG industry and concludes that RRGs are a beneficial form of commercial insurance.

In contrast, the National Association of Mutual Insurance Companies (NAMIC) said the new legislation could cause problems for insurance consumers and companies as it is thought it could create an unfair competitive environment as RRGs are subject to a lesser degree of regulation. The NAMIC, in a letter to the Chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, reports the differing views of State regulators, which "range from outright support to outright opposition". It expresses concerns over the ability of RRGs to manage catastrophe exposures.

## Dubai Issues First Captive Management Licence

On 14th July 2008 Marsh was awarded the first licence for captive management services in Dubai. Marsh Management Services (Dubai) Limited is the first company to be registered as an insurance manager by the Dubai Financial Services Authority (DFSA). It will offer captive management services from within the Dubai International Financial Centre (DIFC), which is authorised by the DFSA. There has been significant interest already, largely from property developers and those providing and developing basic industries, including energy and plastics companies.

The Managing Director of the DIFC Authority said, "DIFC is keen to provide the infrastructure, regulatory environment and support necessary for leading global insurance companies like Marsh to offer innovative solutions for their clients in the region."

High levels of economic growth in the Gulf region provide many opportunities for companies based in Dubai but also increase the number of corporate risks faced. The history of innovation in the Dubai market suggests that captive use will quickly increase. Dubai is recognised for having a good infrastructure and a well-developed insurance industry.

# Risk Optimisation: Capital Allocation

The allocation of capital is a decision that businesses make nearly every day. Competing requirements such as expansion into another country; diversification of the customer base; new product initiatives; and general capital expenditure are included in a discussion around the cost of capital, its availability and how it should be allocated. To 'win' the capital, a business unit must typically show a higher estimated return than other units and demonstrate how it will enhance the overall operating margin of the firm.

However, when it comes to purchasing insurance, the vast majority of businesses do not approach it in the same way as allocating capital. At worst, insurance is regarded as just another cost that must be incurred to operate and at best, it might just limit the financial downside of a new venture. Rarely is insurance purchasing subjected to the same rigour in justifying its cost allocation. But in reality the decision to purchase insurance and equally the retention of insurable risks should be subject to a discussion around capital allocation.

## Understanding capital allocation within the context of insurance purchase

How should a business go about evaluating whether the allocation of capital to insurance and the retention of risk are actually enhancing its return on capital? When faced with the question of whether insurance is 'good value', comments such as 'it was a €25,000 premium for a €5 million limit so it must be a good buy', or 'I'm happy to transfer the risk at that price', are often heard.

The same frequently applies regarding whether the level of risk retention is set at the right level and whether the manner in which it is financed is the most appropriate. An objective base, reflective of the risk and likely costs, is often intangible.

Three fundamental principles govern the process of evaluation. These are:

- position the purchase of insurance as one of a number of tactics that can be deployed, as part of a broader, long-term risk management and financing strategy
- focus on delivering a higher return of capital. This involves moving away from looking at the direct cost of insurance to the lost return to the business had it been deployed differently
- match the buying style of the business with its appetite to take risk, the losses it is likely to sustain and the capital cost associated with its various financing options.

Having established the principles, three broad steps are involved in pursuing an optimal programme that ensures capital is correctly allocated. These are:

### Step 1: understand the strategy and current position of the business

This is wide-ranging, covering areas such as historical losses, business continuity, corporate governance, board level attitudes toward risk, identification of information gaps and a 'snapshot' of the business. This part of the process contains many qualitative aspects and is vital in the engagement process of senior management

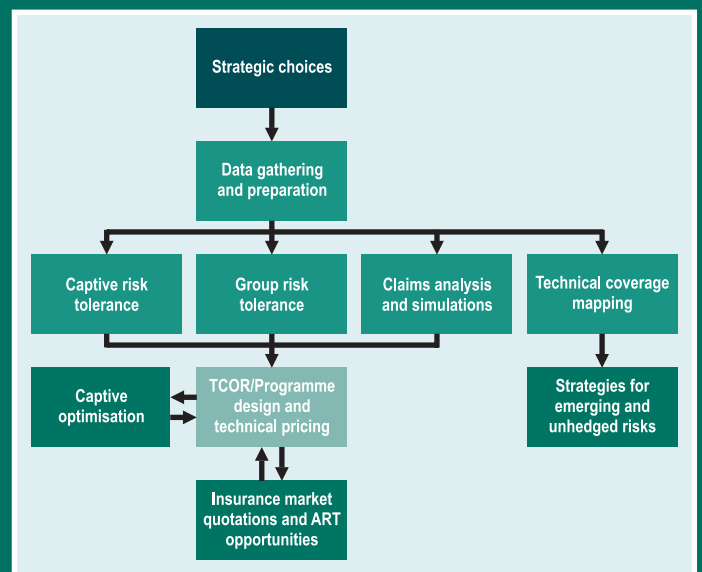
### Step 2: analyse and model data

Creating decision-making tools from raw data is a critical stage in the process. Different aspects within this include stress testing the adequacy of current risk financing arrangements, defining an appropriate risk tolerance calculation for the business, analysing the current structure and retention levels, creating theoretical and market based pricing models and the evaluation of alternative risk financing tools

### Step 3: design and place risk financing solutions

This is the critical point at which it is possible to demonstrate that capital has been allocated as efficiently as possible. Having established which risk financing structure is most appropriate, in terms of type, limits and retentions, the placement must be finalised. A final decision will need to be made around carriers, a risk in itself, but with the underwriting submission having been enhanced through this process, more market interest should have been created.

The figure below illustrates the component parts of the process:

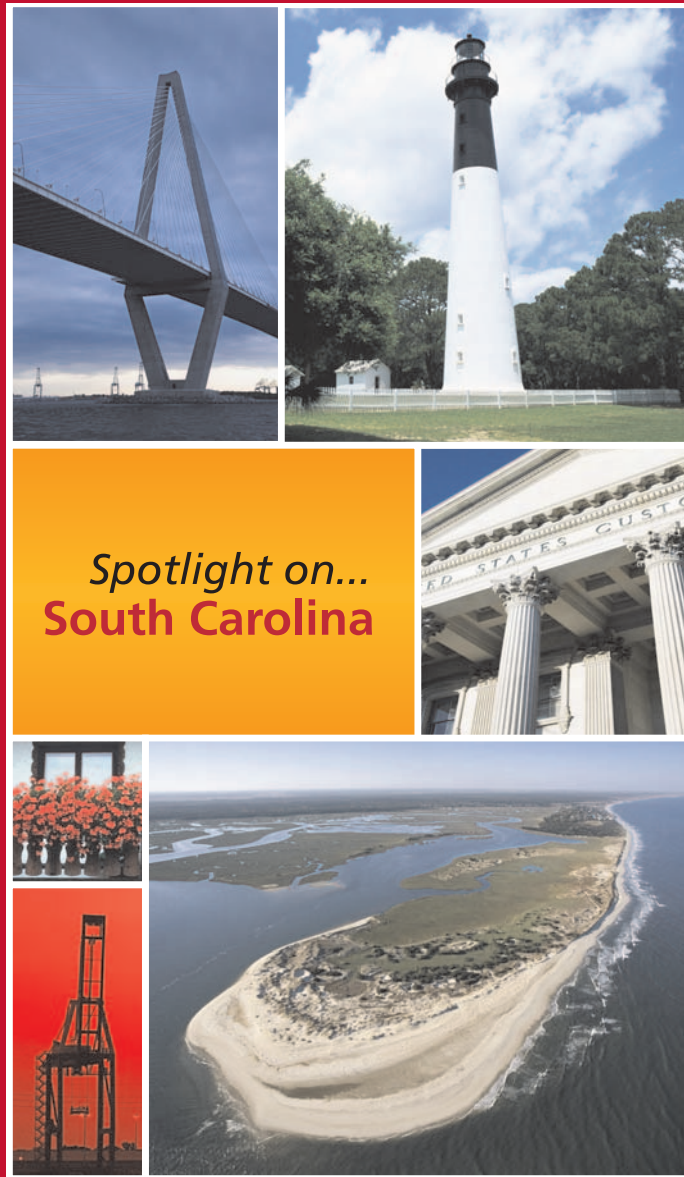


The next issue of Captive Updates will address the strategic use of capital in optimising the use of a captive.

In June 2000, South Carolina signed into law its captive legislation and today sits on the verge of issuing its 200th captive license. The domicile has set many growth records along the way and is now a premier captive domicile in the United States and on the global stage.

South Carolina is home to many Fortune 500 owned captives but it has raised the bar in a number of ways. It was the first to allow captives to form using limited liability legislation and is second to none when it comes to the infrastructure surrounding securitisation captives commonly coined in the domicile as Special Purpose Financial Captives (SPFCs). In addition to complex financial structures, the domicile grew savvy in all industry disciplines through partnership and collaboration with captive owners, peer state regulators and other captive domiciles, both onshore and offshore. In addition, the domicile's regulators commonly participate on and chair national committees that discuss and affect captive and risk retention group governance. Regulators in South Carolina can often be heard stating that their philosophy is to be "fair, flexible and firm". It is this regulatory mentality that has allowed the domicile to flourish in such a short period of time.

Marsh manages 34% of South Carolina's captives, which accounts for over US\$21 billion in premium. The annual premium tax cap of US\$100,000 and an enduring captive infrastructure complement its easy-to-navigate regulations, reasonable fees, and wealth of service providers, making South Carolina a popular US onshore captive insurance domicile.



## Spotlight on... South Carolina

### West Virginia Frees WC Market

The American Insurance Association (AIA) has announced that the workers' compensation (WC) market in West Virginia has been opened up to private carriers. The provisions found in S.B. 1004, signed into law in February 2005, have been enacted and will transform the state-run monopoly to a free-market system. At least 25 private carriers have already filed paperwork.

In other states, history has shown that privatising WC enhances the market as carriers compete for business. West Virginia's model is based on the successful model of Nevada, which segregated historical liabilities from the new business written by the new company. In 2006 West Virginia converted its state fund into a "private mutual company", which will now compete with private carriers. Rates decreased by over 30% in the transition period alone.

There are now only four states that provide WC through a state monopoly: North Dakota, Ohio, Washington and Wyoming.

### Marsh Launches new Insurance and Tax Consulting Unit

Marsh has formed an Insurance and Tax Consulting Unit, a specialist practice dealing with tax and insurance regulatory issues. Lead by Praveen Sharma, the unit provides additional expertise in the areas of compliance, regulatory, admitted and non-admitted covers and taxation.

### Asia Pacific Rendezvous

The deputy managing director of the Monetary Authority of Singapore (MAS) said, at the Asia Pacific Rendezvous, that "as Asia is poised to embrace more sophisticated risk management solutions, captive insurance will have a role to play". He referred to the virtual absence of captives in China and Japan's biggest companies. The MAS released a Consultation Paper on Proposed Regulatory Framework Governing Special Purpose Reinsurance Vehicles (SPRVs) in May 2008. In Singapore in 2007 the captive industry recorded gross premiums of close to S\$750 million, which represents 22% of Singapore's offshore insurance fund business.

# Domicile Developments

## Reclassification of Bermuda Class 3 Insurance Companies

The Bermuda Monetary Authority (BMA) has recently outlined proposals for reclassifying its Class 3 insurance licenses to expand the definition of Class 3 insurers, and to enhance the regulatory requirements for commercial insurers.



There are currently four Classes: Class 1 is largely single parent captives, Class 2 mainly multiple-owner captives, Class 3 for (re)insurers writing more than 20% unrelated third-party business and Class 4 for large commercial (re)insurers. Class 3 companies represent a range of companies, including captive insurance companies and small commercial insurers.

The act, Insurance Amendment Act 2008, will apply to companies already registered as Class 3 insurers as well as future incorporations. Importantly, most captives currently licensed as Class 3 that write unrelated business are likely to experience little change.

The changes are intended to take place in two phases, **Phase I** being the reclassification of Class 3 insurers into three categories as follows:

<b>Class 3</b>
Percentage of unrelated business is 20-50% of net written premium
<b>Class 3a</b>
a. Insurers whose percentage of unrelated business does or is projected to exceed 50% of net written premium and/or net loss and loss expense provisions; and
b. Where the unrelated business net premiums do not or are not projected to exceed US\$50 million
<b>Class 3b</b>
a. Insurers whose percentage of unrelated business does or is projected to exceed 50% of net written premium and/or net loss and loss expense provisions; and
b. Where the unrelated business net premiums do or are projected to exceed US\$50 million

Companies likely to be Class 3a or 3b will be required to submit an application for re-registering under the new class by 31st December 2008 or face having its current registration cancelled by the BMA. It is expected that all new licenses will be issued by 31st March 2009.

**Phase II** will look at the adoption of a Risk Based Capital approach for the newly classified companies. It is expected that the implementation of the risk based capital approach will commence in early 2009. Marsh is working with the BMA in this regard.

The BMA have made it very clear that Section 56 exemptions will be available from these regulations in certain circumstances such as for those companies underwriting warranty, credit card insurances, other connected risks and certain pooling arrangements.

## Luxembourg Stamp Duty

In his recent state of the union address the Luxembourg Prime Minister stated that Stamp Duty, which had been reduced from 1% to 0.5%, will be abolished altogether in 2009. Thus, there will be no stamp duty payable on capital, or any increase in capital, for a captive. The progressive reduction of income tax from the current 29.63% to 25.5% over the coming years was also announced.



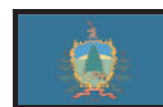
## Isle of Man Captive Conference in London

The Manx Insurance Managers Association (MIMA) will host the first in its new series of "Captive Conferences" in London on 9th October 2008. The aim of the conference is to provide a thorough exploration of the future of captive insurance and Isle of Man's key role. Speakers have been selected for their pre-eminence, experience and knowledge of the international captive insurance industry. The Director of Isle of Man Finance said that the conference offers an opportunity to develop a "close relationship" with the City of London. To register for the conference, please visit [www.isleofmancaptives.im](http://www.isleofmancaptives.im).



## Vermont 23rd Annual Conference

The Vermont Captive Insurance Association (VCIA) presented its 23rd annual event, the largest gathering of captive industry leaders, in Burlington 12-14th August 2008. The aptly titled event, "Solving the Risk Management Puzzle", provided a platform to learn innovative risk management and captive management solutions to topical issues faced by the industry.



One of the ways that VCIA makes the conference educationally accessible to all is to provide an introductory Captive 101 session on the opening day. The 18 sessions in this year's conference included a session from the new team of regulators, enterprise risk management as it relates to captives, innovative captive uses and an Internal Revenue Service update of current proposals.

Several new networking events were scheduled for the opening day, the popular roundtable discussions featured on day two and the final day was dominated by educational sessions.

## Guernsey Insurance Forum in London

The keynote speaker at the Guernsey Insurance Forum (GIF) in London on 12th November 2008 will be Hamish McRae, an Associate Editor of The Independent. He will consider the macroeconomic implications of the credit crunch on the UK and global economy at GIF 2008.



Topics include the management of risk in a soft market, Solvency II, benchmarking versus investment return, regulatory approaches to captives, documentation risk, enterprise risk management and employee benefits.

The conference is part of the 'Achieving Excellence' event series that Guernsey is hosting throughout 2008. For more information, please visit [www.gicma.gg](http://www.gicma.gg).

## New Captive Domicile: Connecticut

Connecticut, known for being one of the largest players in the US commercial insurance industry, will become the 28th state to enact captive law. The new law, effective 1st January 2009, is a close resemblance to Vermont's captive law; for example, it has an identical premium tax structure with taxes based on premiums, ranging US\$7,500 - 200,000, and minimum capital and surplus requirements of US\$250,000 for single-parent captives, US\$750,000 for association captives and US\$1 million for risk retention groups.

Captives will be allowed to be licensed for a single business and its affiliates, or a group of companies in the same industry, or for coverage of an association's members. The captive law allows formation of RRGs as stock, mutual or reciprocal insurers; capital and surplus requirements are US\$1 million.

Captives will be permitted to underwrite commercial property and casualty insurance, including workers' compensation, and life and health insurance and annuities, but not private passenger auto or homeowners insurance.

Fees will include an application fee of US\$800, the "reasonable cost" of legal, financial and examination services the Insurance Department requires to review the application, and a \$300 annual licensing fee.

For further information about Captives or Captive Solutions go to:  
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