December
2010

Captive Insurance Company Reports

U.S. Taxation of Captives: Part 2—Tax-Exempt Owners

Editor's Note: This second of two articles summarizes taxation of captives owned or partially owned by U.S. tax-exempt organizations. It is an update of an article first written in *CICR* in April 2001 by McDermott Will & Emery. We assume the reader possesses a working knowledge of the fundamental tax principles set out in our November 2010 article, especially the basics of what constitutes "insurance" for federal tax purposes. We thank **Tom Jones,** head of McDermott Will & Emery's captive legal/tax team, and his captive team members **Kristen Hazel** and **Michael Fine** for contributing these articles. They may be contacted with questions or comments on either article at tjones@mwe.com, khazel@mwe.com, or mfine@mwe.com

In contrast to their taxable counterparts, tax-exempt owners generally seek to avoid their captive being classified as an "insurance company." Special federal tax issues arise when one or more tax-exempt organizations (such as hospitals and healthcare systems, colleges and universities, YMCAs, etc.) form and operate a captive insurance company. *Although tax deductibility of premiums paid by tax-exempt insureds is unimportant, ascertaining the proper tax characterization of the risk funding arrangement as qualifying or failing to qualify as "insurance" for tax purposes always is important.* To facilitate analysis, we will consider:

- ✔ Single-owner onshore captives
- ✔ Multi-owner onshore captives
- ✔ Single-owner offshore captives
- ✔ Multi-owner offshore captives

For lack of any commonly used name for captives with exempt organization owners, we will refer to these arrangements as "EO captives" and their parent as an "EO."

Tax Considerations for Onshore EO Captives

Corporations formed under the laws of a state or the District of Columbia are generally taxed on their worldwide income. However, a special Internal Revenue Code (IRC) provision permits risk pools covering only exposures of state political subdivisions and governmental instrumentalities to operate on a tax-exempt basis. School districts and similar public or municipal units typically use this

Also in this issue

Vermont Conference 6

Solvency II Main Focus on Luxembourg 8

Reproduced with permission of IRMI (www.IRMI.com). Copyright © 2010.
Further dissemination without specific permission is prohibited.

narrow exception to run tax-free their workers compensation and liability pools.

The Unrelated Business Taxable Income (UBTI) Conundrum

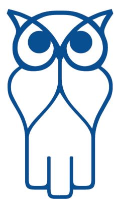
But why form an EO captive at all? Couldn't the EO simply set up an internal bank account to fund its exposures and those of unrelated parties? The answer, unfortunately, is "No." A specific IRC provision states that if an EO conducts a "commercial-type insurance" business which constitutes an insubstantial portion of its activities (measured by gross revenues), then the net insurance profit will be taxable to the EO as "unrelated business taxable income" (UBIT). Worse, if these insurance activities become *substantial* (a gray area, somewhere around 10 percent of its gross revenues), then the EO will lose its tax exemption. As we will see, an EO captive often will allow no or low-tax risk funding for its parent and unrelated parties that would be unattainable by the EO itself.

CICR is published in association with Towers Watson. For subscription questions or problems, contact IRMI customer service at (800) 827–4242. For content concerns, contact Stephen Scammell at (908) 273–8912 or e-mail scammells@comcast.net. For information on Towers Watson, visit www.towerswatson.com.

Editor **Stephen Scammell**
Editor Emeritus **D. Hugh Rosenbaum**
Contributors **Tom Jones, Kristen Hazel, Michael Fine**

Opinions in this report on financial, tax, fiscal, and legal matters are those of the editors and others; you should obtain professional counsel before taking any action on the basis of this material.

Annual Subscription: U.S. $449. Outside the U.S., contact IRMI for airmail postage charge. ISSN 1056–8158. Copyright © 2010 International Risk Management Institute, Inc. All rights reserved. Reproduction of this report by any means is strictly prohibited. *Captive Insurance Company Reports* and the owl logo are registered trademarks.



Published monthly by IRMI:
International Risk Management Institute, Inc.
Jack P. Gibson, Publisher
Bonnie Rogers, IRMI Editor
12222 Merit Drive, Suite 1450
Dallas, TX 75251 • (972) 960–7693
www.IRMI.com

Single-Owner Onshore EO Captives

An EO captive that does not write enough unrelated business to qualify as an "insurance company" will generate only investment, but no insurance underwriting, income. Whether it takes the form of a trust or a subsidiary, it can obtain its own tax-exempt status if it covers only the EO parent that created it and/or exempt affiliates controlled by the parent, and their respective employees. A number of hospitals operate tax-exempt captives in Vermont and Hawaii in this manner to fund institutional, employee and controlled affiliate risks. However, a simpler trust format typically is used by EO hospitals to self-fund medical malpractice risks (trusts require no capitalization, regulatory filings or domicile managers). The Internal Revenue Service (IRS) has officially recognized that such trusts, whether securing a separate IRS "determination letter" or operating as an "integral part" of the founding EO, are nontaxable.

If a single-parent captive writes enough unrelated business to become ineligible for exempt status, the bad news is that it will then become a fully taxable property and casualty insurer. Although the good news is that it would be eligible for the benefits of "insurance company" taxation, few, if any, EOs would choose this approach because the entire risk pool (including parent coverage) would then be taxed. A fine point here is that the threshold for taxing the risk pool in the EO world is the more stringent "insubstantial" versus "substantial" gray line mentioned above, rather than the unofficial, more lenient 30 percent unrelated net retained

premium “rule of thumb” applicable in the taxable owner world.

Multi-Owner Onshore EO Captives

Surprising to nontax practitioners is the fact that a trust, captive, or other risk-bearing entity covering exposures of two or more unrelated EOs is considered engaged in a true “insurance” business under the IRC’s strict “commercial-type insurance” rules and therefore is a taxable entity. An example of this reality is three domestic EO (hospital and charity) risk pool taxpayers, which logically, but erroneously, believed their pools would inherit the participants’ EO status. All three lost court decisions on this point.

Tax Exemptions. Four narrow exceptions exist to automatic federal income taxation of onshore EO captives.

- ✔ Domestic captives formed by churches and associations of churches are eligible to obtain exempt status if certain IRC requirements are satisfied. In one well-publicized instance, a Vermont group captive formed exclusively by Catholic hospitals achieved such status.
- ✔ A particular IRC section grants tax-exempt status to non-life insurance companies if annual gross receipts do not exceed $600,000 and more than 50 percent of those receipts consist of premiums. Mutual insurance companies may qualify as tax-emempt under the same IRC section if their gross receipts do not exceed $150,000 and if premiums make up more than 35 percent of those receipts.
- ✔ Another obscure IRC section allows a charitable risk pool formed as a nonprofit organization under an authorizing state law exempting it from state tax, and which obtains at least $1 million in start-up capital from an unrelated charitable organization, to qualify for tax exemption.
- ✔ Lastly, a single member domestic limited liability company (LLC) captive, so long as it is not classified as an insurance company for tax purposes (usually because it covers no unrelated policyholders), is treated as a “disregarded entity” for taxes and thus is simply a part of its tax-exempt parent hospital.

Given the virtual certainty of full taxation onshore (at least where unrelated risks are or may in the future be included), forming an EO captive *offshore* historically has been preferable from a tax standpoint. As will be discussed below, however, unless an exception applies, a 1996 change in the IRC makes some taxation more likely for EOs owning offshore EO captives.

Tax Considerations for Offshore EO Captives

In 1996, the IRC was amended retroactively to the beginning of that year to clarify the law on taxation of EOs owning offshore captives. The change was sufficiently fundamental that it is worthwhile to provide the citation to this provision (IRC § 512(b)(17)) and to discuss briefly both pre-1996 and post-1995 situations.

Note that this entire offshore EO captive discussion assumes that no voluntary onshore tax election has been made (to our knowledge, never done by EO captives) and that the offshore EO captive has successfully avoided engaging in a U.S. trade or business. Although captive domiciles impose no corporate income taxes, captives (EO or otherwise, formed outside United States) are ineligible for U.S. EO status. Thus, if they do business in the United States, they will become subject to direct federal income taxation, including the possibility of a second tier “branch profits tax.” Finally, offshore EO captives face the same Federal Excise Tax and 30 percent withholding tax rules on U.S. source passive income as any other captive. Please see Part 1 (*CICR* November 2010 for a brief discussion of all these topics).

Single-Owner Offshore EO Captives—Pre-1996

A long line of IRS private letter rulings starting in the early 1980s consistently concluded that, in a single-parent context, owning an offshore captive does not adversely affect the exempt status

of an EO. These rulings also concluded that investment income generated by the EO captive, taxable currently to the EO parent as a deemed distribution under the controlled foreign corporation "Subpart F" rules is in the nature of a dividend, which by statute is excludable from UBTI. (*Note:* This exclusion is inapplicable if the EOs investment in the shares of the offshore captive was "debt financed"—that is, acquired with funds borrowed by the EO.) Further, in a 1990 ruling, the IRS allowed an offshore hospital captive, without changing the favorable tax result, to cover professional and general liability of taxable subsidiaries and controlled tax-exempt affiliates of the hospital, employees of any of these entities, and professional liability of voluntary (non-employed) medical staff of the hospital.

Single-Owner Offshore EO Captives—Post-1996

The 1996 IRC amendment now makes the relevant inquiry whether the EO owner of an offshore EO captive would generate UBTI if it were itself conducting the business of the captive. The mechanism for accomplishing this is a "look-through" approach treating any "insurance income" of the captive as being taxable as if it were generated by the EO parent itself. Therefore, the rules above describing an EO conducting a "commercial-type insurance" business, including UBTI or potential loss of EO status, will determine the outcome. But recall that a single-owner captive covering only parent and controlled affiliate risk, under case-law and IRS interpretations, does not create "insurance income," but rather only investment income. Thus, this IRC amendment should not change the favorable tax results previously obtained by EO captives where risks of only members of the same economic family (and their employees) are being funded.

A single-owner offshore captive that covers not only the EO, as above, but also other entities may avoid the "look through" rule by taking advantage of the amendment's specific definition excluding from UBTI coverage of "affiliates." In one respect, the amendment narrows the prior interpretation of "affiliate." Only EOs can be "affiliates," so coverage of, for example, a for-profit, noncontrolled (i.e., a taxable 50/50 owned joint venture) will generate UBTI. In another respect, however, the amendment liberalized the commonly accepted existing rule: The amendment allows coverage without UBTI of any tax-exempt "affiliate" of the EO that has "significant common purposes and substantial common membership, or directly or indirectly substantial common direction or control" with the EO.

This is broader than under the pre-1996 law, where, for two tax-exempt parties to be considered related, they must have had a relationship similar to that of parent-subsidiary. That is, previously one must have possessed the capability of electing a majority of the board of directors of the other. Further, coverage of directors, officers, or individuals who perform services for the EO or its "affiliate," primarily with respect to risks associated with those services, will not generate UBTI.

Multi-Owner Offshore EO Captives—Pre-1996

A few additional favorable private letter rulings were in a multi-shareholder rather than single-parent offshore EO captive context. Nonetheless, concern existed that under long-standing IRS pronouncements, offshore EO captives involving sufficient risk sharing and risk distribution among unrelated parties to constitute "insurance" were more vulnerable than single-parent EO captives to causing UBTI in the hands of EO shareholders. This was particularly so because these captives insure mostly risks of their EO shareholders or other related parties and thus were subject to stringent "Subpart F" rules targeting offshore related party insurance income (RPII).

Multi-Owner Offshore EO Captives—Post-1996

As mentioned, the 1996 IRC amendment mandates the "look through" approach with the result that, unless an exception applies, virtually all multi-owner, risk-sharing off-

shore EO captives writing coverage for at least a few unrelated EO owners will generate UBTI in the hands of these owners.

Tax Exceptions. There are two exceptions:

- ✔ The amendment contains a special rule applicable to colleges and universities and hospitals that "participate in an insurance arrangement that provides for any profits from such arrangement to be returned to the policyholders *in their capacity as such.*" Although no regulations have been issued interpreting this provision, it appears that offshore EO captives formed as mutual insurance companies or as stock companies that cannot return profits through share ownership, but only via the policies it issues, will qualify for the benefits of this exception.
- ✔ Where the EO participants in the offshore multi-owner EO captive establish "cells" or "separate accounts" such that no risk sharing or risk distribution can occur (short of the insolvency of the captive), no "insurance income" would exist, so favorable single-parent EO captive treatment would seem to be warranted. Consistent with this observation, the IRS in 2008 guidance and proposed Treasury regulations issued in 2010 continues to move in the direction of each cell being treated as a stand-alone taxpayer.

State Taxation of EO Captive Transactions

Although the situation varies dramatically from state to state, often state premium taxes supplant the state income tax applied to insurance companies, including both onshore and offshore captives. Although all states have premium taxes, they may not apply if only a "private procurement" of coverage is occurring, or if only "industrial insureds" are being covered, because such taxes are levied in exchange for the privilege of transacting an insurance business in the state. Most states impose an often weakly enforced "self-procurement tax" on premiums paid to an onshore or offshore captive, in some cases even if the coverage is actually not "insurance" under federal law, and even if no insurance producer or broker is involved. Status as an EO policyholder or owner usually is not relevant to applicability of this tax.

Reciprocal RRG—A Better Structure for Multi-Owner EO Captives?

As we have seen, the 1996 IRC amendment substantially reduced the tax advantage of offshore domiciles for EO captives and therefore renewed EO interest in onshore captives generally and risk retention groups (RRGs) specifically. RRGs can be viewed as special purpose onshore group liability captives, which are fully taxable entities qualifying as "insurance companies" eligible to deduct reserves for future losses. From a regulatory standpoint, under the federal Risk Retention Act, they have the ability to write liability coverage nationally on an "unfronted" basis from a "captive friendly" state (such as Vermont or Hawaii) and to solicit new business elsewhere without violating state insurance laws.

A reciprocal is unique in that it can take advantage of the EO status of its participants notwithstanding its domestic charter. A specific IRC provision permits a reciprocal to deduct, up to the amount of statutory income, profits allocated to each participant's "subscriber savings account." No cash changes hands; these accounts are merely bookkeeping entries standing in the name of each insured. If the insureds are EOs, there is no correlative income inclusion when the allocations are made. Thus, the surplus of the reciprocal is maintained for regulatory purposes at the same time the reciprocal's tax burden is greatly reduced by effectively shifting it to EO policyholders.

IRS Form 990—Return of Organization Exempt from Income Tax

Beginning in 2009, IRS Form 990, the annual tax return for organizations exempt from federal income tax, includes questions applicable to their ownership and operation of captives. Because this recently revised Form 990 is complex and extensive, we mention only three

KEY TAX POINTS TO REMEMBER

- ✔ Single-owner **onshore** EO captives generally strive to avoid "insurance company" tax status, by limiting their risk funding to related members and their employees, in order to avoid tainting the entire pool by causing it to forfeit its tax-exempt status.
- ✔ Single-owner **offshore** EO captives generally strive to avoid "insurance company" status, by limiting their risk funding to related members and their employees, in order to escape paying Federal Excise Tax and to prevent throwing off "unrelated business taxable income" taxable in the hands of the EO owner.
- ✔ Multi-owner **onshore** EO captives are rare, unless formed as controlled "fronting" vehicles rather than risk bearers, since they are fully taxable except as noted above.
- ✔ Multi-owner **offshore** EO captives typically use one or more of the special rules or definitions in the 1996 IRC amendment or other means to prevent generating UBTI taxable in the hands of the EO owners.
- ✔ A popular multi-owner group structure for liability exposures only of EOs is an onshore "risk retention group" formed as a "reciprocal exchange" allowing favorable onshore regulatory access combined with the equivalent of offshore tax benefits.

items here. *First, exempt organizations with foreign financial accounts* (presumably other than "commingled funds") *must report them* in Core Form, Part V, Lines 4a and 4b. *Second, exempt organizations with captives (wherever domiciled) will need to report the existence of, and certain transactions (such as capital contributions) with, the captive on Schedule R* (Related Organizations and Unrelated Partnerships) to Form 990. *Third, exempt organizations with offshore captives will likely have to complete Schedule F* (Statement of Activities Outside the United States). IRS guidance on the Schedule F indicates, for example, that an exempt organization must report expenses if it sends directors to board meetings outside the United States and the expenses exceed a $10,000 threshold. ■

THE USUAL CAVEAT

We ask our readers to observe our usual caveat that the contents of this article are of a general informational nature and are not intended to constitute specific legal or tax advice. There is no such thing as truth in these tax factors—there are only positions.

Vermont Conference

The Vermont Captive Insurance Association held its 25th annual conference in August with the theme "Passport to Captive Success." Attendance increased slightly from last year's decline, with over 1,160 registrants this year. Representatives from 42 states and 9 countries attended.

The conference had fewer exhibitors as well, now totalling 102, down from last year's 109. The exhibitor's hall continues to be packed, however, filling the main exhibitor area, the hallways around the conference rooms, and also one of the three larger conference rooms. They also held the opening captive basics sessions off-site at the University of Vermont's Davis Center, just up the road. However, for the next day and a half, all of the sessions were held at the Sheraton. From what we heard, there is some consideration to moving the conference to Stowe next year, but that remains to be seen.

CICR comment: A nice change, great location, but only convenient if you have your own car or rent one—but worth some thought.

The conference changed its format a bit. First, it shrunk the nonbasic sessions to 1½ days,

down from 2. However, 3 sessions were run concurrently, thereby having the same number of sessions in total. From what we heard, many attendees tend to leave in the second afternoon anyway, and this was designed to accommodate the normal session shrinkages. All of the sessions were generally 1¾ hours.

Three changes were made to spice things up. The opening session included a "Double Indemnity" game show, which was much fun for the contestants and audience. Also, the "Meet the Markets" session for investment managers and collateral suppliers was held in the tent. The conference also held separate two peer group roundtable sessions: one for manufacturing and one for banking and insurance captive owners.

During the conference, Deputy Insurance Commissioner **David Provost** proudly announced that Vermont had already licensed 39 captives in 2010—its sixth best year ever. Other conference highlights are discussed below.

Analysis Paralysis. This session mostly addressed *enterprise risk management (ERM)* and attracted about 45 attendees. We thought the presenters did a good job addressing the never-ending questions about ERM and why so many projects just don't work. **Corey Gooch** of Aon offered these three reasons: projects are too big with no measurable results, often they are compliance driven, and usually there is no executive support.

John Bugalla of ermINSIGHTS, said that CEOs wonder why they should do more ERM if greater value cannot be achieved. A major problem is practitioners are having a problem describing the value equation to the C-suite. Mr. Bugalla believed there are two main purposes: value protection and value creation. An ERM analysis needs to quantify these to the enterprise. Unfortunately, practitioners rarely are able to quantify risk very well.

What about risk maps? The problem that he sees with risk maps is they do not reflect the risks that affect value creation in the organization. Usually they only reflect one-off risks. "Analysis is good, but unless you act on it, and use it to create value, paralysis takes place." He went further: "Employees tend to only focus on their own limited boxes, versus worrying about the entire spectrum of risk." Finally, risk tolerance varies greatly between top executives and department heads: top execs always have much greater risk tolerance than individual department heads.

PROBLEMS WITH MOST ERM ANALYSES

- ✔ **Backward-looking methodology for future risks.** Is the past a true indicator of the future?
  - Actuarial methods
  - Not considering systematic shifts (not "normal times")—major discontinuities can be normal
- ✔ **Ad hoc approach to risk tolerance.** There is inconsistency in defining tolerance.
- ✔ **Bogging down in an extensive risk inventory.** Too much obscures the major drivers.
  - Lack of a value-driven perspective—everything is considered important
- ✔ **Focus on event risk but missing value drivers.** This is a common problem with insurance folks.
- ✔ **Missing interconnectedness between risks.** Not all risks are siloed.
- ✔ **Failure to account for psychological distortions in risk judgment.** Consider the human element.
- ✔ **Focus on only the downside** (i.e., risk is a four-letter word). Risk can offer rewards too.
- ✔ **Compliance mentality.** Meeting compliance checklists misses the main ERM points.

Source: ermINSIGHTS

However, Mr. Bugalla believes that by properly defining the value model, ERM studies *can* be effective. This is not for the amateurs, however. Finding the right consultant, who can guide and shape the ERM process, can go far to assure an ERM project success.

CICR comment: Mr. Bugalla is associated with the Stanford Center for Professional Development at Stanford University in California, which offers 6 2½-day courses on ERM to obtain an ERM certificate.

Reinsurance: The Devil Is in the Details. In this session, which attracted about 100, **Mary Mauck** of Artex made three excellent points:

1. Reinsurance agreements are *not* standard. This is the greatest area of debate between the captive and reinsurers. (*CICR comment:* And a good reason to hire an attorney who specializes in insurance contracts to review these agreements, rather than rely just on your reinsurance broker—especially as many brokers are better at doing deals than tying up loose contractual ends.)
2. Fewer banks can now offer back-to-back letters of credit (LOCs) today, and often reinsurers would like some diversification from a few banks, given the preponderance of so many LOCs with a few larger banks.
3. On captives making financial distributions to members, reinsurers often have the final say in whether a captive can make these distributions. (*CICR comment:* We wonder how many group captive members knew this when they invested in the captive.)

Greg Lang of Munich Re then said that no captive owners think their collateral is too low.

CICR comment: How much should collateral be? That varies considerably, based on the findings from the annual CICA fronting survey. (See *CICR* June 2010, page 9, for the chart "On What Is Collateral Based?") ■

Solvency II Main Focus in Luxembourg

Editor's Note: CICR Editor Emeritus **Hugh Rosenbaum** covered this conference.

Some 620 people turned up, out of 830 registered, for the European Captive Forum 2010, the first all-European captive conference. The numbers attending made the event into something important in captive conference circles, surpassed in recent times only by Vermont's August conference. There have been other Luxembourg Rendezvous conferences, attracting 100–200 delegates, but this one was different for these main reasons:

The Organizers: The successor name for Risk and Insurance Research Group Ltd. (RIRG) was *Captive Review,* part of the same company, whose people did all the work and made it happen. The European lobbying group for captive owners, European Captive Insurance and Reinsurance Owners' Association (ECIROA), organized the sessions and held a membership meeting, which attracted a large number of captive owners. The third name on the organizer list was the American Captive Insurance Companies Association (CICA), whose name appeared as supporter and whose chairman **Karin Landry** appeared on stage at various times.

Free Entry: The main reason why there were so many delegates was the organizers' decision to have all expenses (and profit) paid for by the sponsors and to allow everyone free entry, and that included free lunch, too! Service providers, insurers and reinsurers—not just identifiable buyers and "risk managers"—all attended free. This format was tried earlier, in February in London, and is now becoming the European standard.

The Financiers—Sponsors: The high-ticket sponsors were called "Level 1 Sponsors," after the Solvency II directive process which started with level one and is now at level three. They were Munich Re, Zurich, and the British Virgin

Islands (BVI), a non-European captive domicile. Level 2 sponsors were Aon, Ace, Chartis, Deloitte, Ernst & Young, KPMG, PWC and Kane. Level 3 sponsors were Allianz, Generali, Marsh, Mazars, R&Q, XL, and Willis. Also Qatar and Guernsey, two more non-European captive domiciles, were Level 3 supporters. These sponsors, plus others who paid to sponsor speakers, lunches, or to have their names in the program, along with the exhibitors, were the ones who financed the event.

CICR comment: We note with interest the position, possibly pecking order, of the major captive managers in the three sponsorship levels (Aon and newcomer Kane on Level 2, Marsh and Willis on Level 3) and the appearance of three non-European domiciles, while neither Ireland nor Malta were on the list.

There were 28 exhibitors, a larger number than at previous Luxembourg Rendezvous. The exhibitors and sponsors had access to a computerized appointment system, and the larger ones were assigned meeting rooms for the appointments.

More Buyers and Captive Owners. European captives are almost entirely single-owned, with very few producer-owned reinsurance captives (PORCs). In addition, there are many owners and users of cells, although these cells are mainly located outside of the European Union (in Guernsey and Isle of Man, for instance). There were some 180 delegates representing captive owners, or potential owners, advertised in a list by the organizers before the conference began, as an attraction for others, and for the 75 percent of service providers, too. Another interesting feature of the captive owners attending in Luxembourg was the high proportion of self-managed captives attending (many ECIROA members manage their own captives).

Sessions, Subjects. There were 2 general and 26 concurrent sessions, some lasting only 30 minutes, others overlapping in starting and ending times, usually a choice of 3 at any one time. The focus of 9 of the sessions was on Solvency II, as was the focus and involvement of ECIROA at this conference. ECIROA is trying desperately to get *simplification* and *proportionality* for captives into the Solvency II implementation measures to neutralize some of the heavy effects on captives (See *CICR* October 2010 for a list of them.) There were two sessions devoted to employee benefits in captives, and a longer session on "basics." The organizers did allow at least two infomercials as sessions, one by a loss information system, the other for collateral alternatives. All the sessions were in English, with no translators needed.

Solvency II, the Main Themes. Here are the main themes along with *CICR* notes:

Capital and Financial: The "what and how" of Pillar 1, which is the financial and capital requirements for all insurers including captives was constantly repeated. *"Calibration" is the term for how much risk capital will be required: more for most captives.* There will be restriction of loanbacks, a preferred technique from European captives, and penalties in the form of even more capital required for real or imagined concentration of risk or assets. Repeated often was the importance of EU captive owners participating in the modeling exercise Quantitative Impact Study 5 (QIS5). A large number were reported to be working it up for their 2009 figures, possibly as many as 40 percent of them. It is hoped that the more captive data they have in the standardized modeling form, the better will be the arguing position for simplification and proportionality for captives. "Not enough," implied **Karel van Hulle,** the wily and savvy European Commission head of the Insurance and Pensions unit (see *CICR* August 2006 for his first appearance at a Luxembourg conference). "50–60 percent participation in QIS5 would look more convincing to me." The results of the compilation of QIS5 data on captives should be out by spring 2011.

CICR comment: A previous study, QIS4, revealed some 38 percent of captives falling short of solvency capital required. There have been unofficial predictions that the percentage could be even higher when the QIS5 results are known.

Mr. van Hulle went on to challenge the audience of owners, managers and service providers to offer examples—concrete examples and good suggestions—for the application of proportionality (relaxation of requirements) for captives. He revealed that in spite of all the huffing and puffing by the captive community, he had received only *one* such recommendation so far. "How can we improve things," he thundered, "if you don't give us examples?"

CICR comment: Such lists already exist, such as the one drawn up in Bermuda for relief for class one insurers (own business only) from the rigors of proposed governance requirements, to make Bermuda acceptable as an equivalent jurisdiction for Solvency II purposes.

In Mr. van Hulle's view, and this is a direct quote: "We want the whole world to move to risk-based solvency supervision—something along the lines of Solvency II."

Oh, and captive owners should not get so interested in the "small company exemption" in the Solvency II Directive for those writing less than €5 million annual premium. That exemption only applies to direct-writing companies, not to reinsurers, and most EU captives are reinsurance captives.

Big News on Captive Definition: Annick Felten, from the Luxembourg Insurance Commissariat, revealed that the definition of insurance business for captives has been favorably redefined and broadened. Business is no longer restricted to coming from risks of legal entities 100 percent owned by the captive owner, a particularly onerous previous limitation. Now, only one kind will put a captive into the commercial insurer category, and that is if a captive writes direct compulsory lines such as employer's liability. "It appeared in the SCR 14.126—you should have read that," she said.

CICR comment: Good news for those who feared that reinsuring employee benefits business to a captive would put them outside the captive definition. Further, it's surprising that the broadened definition was already published, and appeared to come as a surprise to the ECIROA team. At least they won't have to look for simplification relief on that point.

Corporate Governance: ECIROA is working on an antidote for Pillar 2, the governance requirements for insurers, whose requirements would add unnecessary paperwork and processes to captive insurance companies. For instance, the requirement for an annual internal audit by the captive itself should be relaxed, recognizing the owner's own internal audit of the captive in the course of their internal audit process, even only every few years. They are working on what they are calling a "best practices" document for captives, which will be restricted to 100 percent outsourced management captives, because most of the functions and governance requirements in these captives are provided by captive management companies. The draft of Pillar 2 implementing measures, scheduled for the end of 2010, has been put off until June 2011. Only after receiving comments and having discussions will it become official, and it is to be effective January 1, 2013.

Proportionality: This is what local regulators will be able to apply to simpler captives to neutralize and reduce the workload required by the Solvency II Directive—as long as the objectives of the Directive are achieved. An example is that of the requirement to document compliance. In Ireland, there is a local requirement that each captive appoint a compliance officer—usually one of the management company staff. In Luxembourg and Guernsey there is no requirement for a compliance officer.

What ECIROA would like is case-by-case judgment on proportionality by the domicile regulator for individual captives, and the ability to agree on a customized version of the governance requirements for each one. Luxembourg's influential and long-serving regulator **Victor Rod** agreed, supporting the idea of "room for individual treatment when it comes to supervision." To make sure this gets through, though, captive owners were urged to carry the urgent message of its desirability to every European insurance commissioner, not just those

in captive domiciles, because these other supervisors have representatives on the Committee of European Insurance and Occupational Pensions (CEIOPS), the technical advisory group that advises the EU Commission. And, according to what the ECIROA lobbyists are finding out, they don't talk about captives with each other, either.

Breakout Sessions. Selected points from the breakout sessions we attended follow:

One Big Captive: The interesting case study of the EADS captive, Aero Re, was given a time slot of 30 minutes, which was outrageously little for a captive whose retention is €250 million ($350 million) for property and liability coverage for the largest airframe manufacturer in Europe. EADS makes Airbus planes, helicopters, satellites, and other high-value equipment. Chairman **Ingo Zimmerman** said, "A captive is not just for low-level frequency claims. It should take on higher and higher levels of risk, and become the centralizer for the gains resulting from serious loss prevention." And, he told us, EADS's captive aims to make a profit, to keep increasing its retention, and to respond to insurance market "surprises." His time frame for measuring cost of risk as influenced by the captive is 5–10 years, certainly not just 1 year. Aero Re writes no third-party risks or employee benefits.

Shell's Captive: According to **Alan Davies,** Shell's vice president of Risk and Insurance (and former VP of Pensions), Shell's captive reinsures buyout of legacy pension plans from countries where Shell has reduced or ceased operations. His example was clear: It costs about 29 units to provide a pension of 1 unit for an individual, multiplied by the pension amount and the number of individuals. The initial cost, fronting fees, and other costs to transfer that into the captive are small, compared to the total amount transferred. He also described a classical captive advantage: if one wants to end a pension plan by getting an insurance company to issue annuities to the individuals, valued by actuaries at a present value of 100, they will charge a price of 140, just to be sure. The owners believe they can settle all the obligations for a present value of 80, so they pay the 140, have it reinsured to the captive, and keep the difference (if it works out as expected).

Fit and Proper Persons: Marsh's **Fred Gabriel** reminded us of those terms that describe *what captive board members are supposed to be: fit* means in their qualifications, knowledge, and experience; *proper* means good reputation and integrity.

Own Review of Solvency Assessment (ORSA): This is one of the obligations under Solvency II, to be carried out annually, or more often if necessary. Guernsey had something like it, but left the techniques up to the individual managers or insurers to present what they thought were the proper methods to accomplish it. **Fred Gabriel** of Marsh called up the regulators in European domiciles—Luxembourg, Sweden, Malta, and Ireland—to find out what they were doing about defining or setting guidelines for the oncoming ORSA. He found that none had gotten very far except to discuss it.

CICR comment: The ORSA calculation or model has to be "evidenced as independently assessed." A full employment assurance for local actuaries, and a higher cost for captive owners!

Disclosure: The dreaded threat under Pillar 3 of Solvency II of having to publish all and everything about a captive, something that might give away valuable commercial or negotiating secrets, may be alleviated by the argument that such disclosure would serve no public interest. Because captives are already disclosing quite a lot, if not "everything," to their local regulator, according to local practice, their owners want the same assurance of confidentiality they now enjoy. Sounds reasonable, but again, the mitigation of disclosure for captives is a point that has to be won by convincing regulators country by country.

Insurance Return on Equity: **Rudolf Flunger** of Swiss Re described the low return on capital of worldwide insurers, now down to 5–6 percent; 4 percent for American property and

casualty companies. But even that is artificially high, because in 2009, companies reduced their combined ratios by 4 percent by taking out $9 billion in "redundant" loss reserves. He showed us that cash flow for insurers has actually been *negative* for insurers for the last 2 years, meaning that *paid* losses and costs are higher than premiums collected.

He went on to describe the basic value propositions of captives, as seen by insurers fronting or reinsuring them:

- ✔ Risk pooling and cost allocation
- ✔ Insurance cycle management
- ✔ Prudent reserving for difficult risks

Low Tax Deemed "State Aid": In Liechtenstein, according to **Guy Soussan,** a Belgian tax and regulatory expert, the capital tax of 0.1 percent is all that domiciled captives have to pay in lieu of tax on profits or investment income, by special derogation of local tax practice. On March 24, 2010, an owner lost a case in which this was deemed to be State Aid to a few companies. Although under appeal, Mr. Soussan suspects they will lose the appeal, and have to retrospectively reimburse a lot of unpaid tax. The Swiss captives that relocated to Liechtenstein are not going to be happy with having to pay back 10 years of taxes, "and other countries will not fail to observe with intense interest this opportunity to recover back tax revenue," he added.

Protected Cell Companies (PCCs) under Solvency II: In a rambling and confusing session, the discussion went back and forth about whether a cell company (that's the core plus the cells) will be considered the security for fronting purposes under Solvency II, or whether each individual cell will have to be. The Maltese, who were out in force, espoused the whole entity argument, while others argued individual cells. A representative of Atlas cell company in Malta scored an important point in reminding us that the big advantage of cell companies is that they combine and provide a lot of the governance required under Solvency II, thereby resulting in substantial cost savings. As cells don't even *have* boards of directors, they can't apply the governance one by one anyway.

CICR comment: Good point, it seems to us. We could imagine a hybrid treatment of cell companies and cells: full financial requirement under Pillar 1 for individual cells, but satisfaction of governance requirements by the whole cell company under Pillar 2.

In the same session **Annick Felten** of the Luxembourg Insurance Commissariat described their view of the equivalence question. The older European Reinsurance Directive still applies. Each local regulator is free to decide whether to approve of any given territory. This means, for instance, that if a fronting company can convince its local reporting regulator that reinsurance to captives in a non-equivalent state is acceptable, then the *whole territory* where the captive is located is acceptable. It would behoove these non-EU states to negotiate with individual EU countries the way she interprets things now, but it would be much more logical to have an EU-wide acceptance if one lead EU jurisdiction approved.

CICR comment: Sounds familiar to American-based captive owners, doesn't it?

And International Financial Reporting Standards (IFRS) Are Coming: **Jerome LeCocq** of Deloitte warned us of the oncoming requirements under these new accounting rules that will make things even more complicated for captive managers who have to keep the accounts under local Generally Accepted Accounting Principles (GAAP), international standards, and possibly client management accounting as well. The individual captive will be obligated to report under IFRS if it is consolidated into a parent company that reports under IFRS. Loss reserves will have to be recalculated, discounted, and risk margins added. Equalization reserves will be out, and so will most financial structured reinsurance. It will be in place and required worldwide by January 1, 2013 worldwide (except maybe in the United States). ■