# Captive Reinsurance and Risk Management

## Make the most of emerging opportunities

### Luxembourg, an ideal domicile

The general economic climate and environment have increased interest in captive reinsurance given that it has become essential for companies to master risks and their cost with respect to new challenges and constraints.

A captive is a regulated entity exclusively set up to reinsure the risks of the group to which it belongs. A reinsurance captive reinsures the risks insured by one or more insurance undertakings (knows as "fronters") which have issued insurance contracts with group entities.

Incorporation of a captive is usually driven by different reasons, notably (i) reduce the overall cost of insurance, (ii) reduce the group's exposure to insurance market fluctuation, (iii) improve within the organisation the awareness, management and control of the group overall risks, (iv) get direct access to the professional reinsurance market, (v) optimise management of group risks retention, etc.

The latest developments associated in particular with the pandemic crisis, consumer protection, climate change, corporate responsibility and cyber risks have created a very conducive environment for the establishment of captive vehicles. In this respect, we have noticed the following trends on the market which are expected to be emphasised with this pandemic situation going forward:

- Increase the insurance costs linked to the traditional insurance market;
- Disengagement of insurance stakeholders for certain category of risks (e.g. events cancelations);
- Emergence of new risks which are difficult for the traditional insurance market to insure;
- The progressive adoption of anti-tax abuse rules would penalise captives historically set up in certain jurisdictions;
- Increase in excesses, exclusions and coverage limitations.

In this context, setting up a captive in Luxembourg could be the answer you are looking for.

## + Key benefits

### Operational benefits

1. Risk visibility/monitoring;
2. Mutualised risks (geographic, traditional and non-traditional);
3. Improved claim settlement and liquidity;
4. Enlarged and customised risk coverage;
5. Centralisation of risk management decision in one vehicle;
6. Cover special risk difficult to insure on the regular insurance market (property, liability...).
7. Enhanced risk awareness in the whole organisation.

### Financial benefits

1. Rationalise and reduce the cost of the direct insurance (mutualisation of risks at Group level);
2. Increase financial efficiency of risk management;
3. Tax equalisation provision and deduction benefit;
4. Insurance cost savings/ Improved agency ratings;
5. Reduce overall cost of risk;
6. Cash flow management;
7. Improved regulatory capital position and SCR.

### Other benefits

1. Access to the reinsurance/insurance market;
2. Internal capacity created;
3. Maintain control over claims analysis.

## Global market overview

Typically, allowing for costs and depending on the nature of risks incurred, international groups spending equivalent of several million US dollars per annum on insurance premium may consider the potential benefit of establishing a captive. This should be examined on a case by case basis.

**6,500**
captives worldwide

**≈ 90%**
of Fortune 500 companies own at least one captive

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# The business model of a captive

A captive can be a direct-writing company or a reinsurer of a fronting insurance company. Captive reinsurance companies are more commonly used on the Luxembourg market due to regulatory and financial considerations; for example, they are less demanding in terms of capital and easier to structure.

**Full self-retention**
Reserves on Balance Sheet

- Lower the short-term cost;
- but may not help the company to achieve protection in the event of a catastrophic claim;
- self-retention ideally apply for non-insurable risks with huge volatility and low severity.

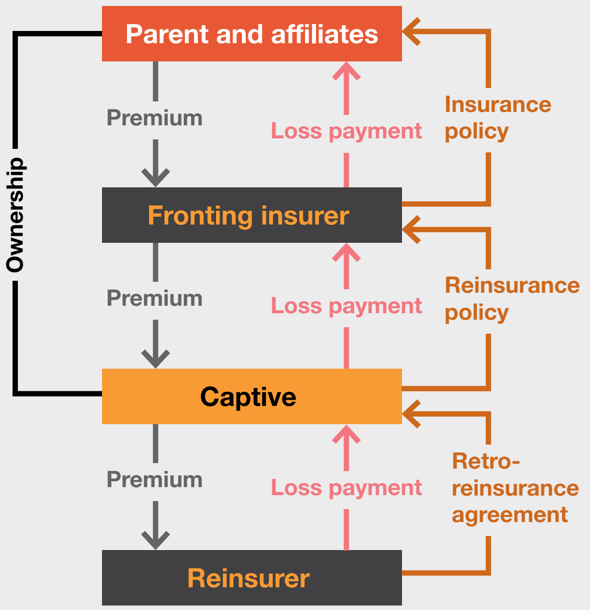
**Captive**
Alternative solution

- a mixture of risk transfer and formal self-retention;
- Captive ideally apply for the more volatile part of traditional risks as well as non-traditional insurable risks.

**Full transfer**
Outsource to 3rd party

- with a reasonable security and financial stability;
- a considerable cost;
- not all the risks can be transferred;
- full transfer ideally apply for traditional insurable risks (with predictable severity/volatility).

## Typical operational model for Luxembourg reinsurance captive




**Fronting insurer:** issues policies and provides claims-handling services.

**Captive insurer:** issues policies, provides claims-handling services, retains risk at the desired level and transfers excessive risk to the reinsurance market.

## Why Luxembourg?

Luxembourg is the largest captive location in the EU, with over **200 captive companies.** Here's why you should consider a Luxembourg-based captive:

### Regulatory perspective

- Well established legal framework for captive business;
- Lawmakers, decision makers and regulators traditionally enjoy a reputation of mutual understanding with business (and rapid decision making process);
- The EU Passport allows covering risks in the EU, i.e. no need of authorisation of each EU Member States before starting reinsuring.

### Financial and tax perspective

- Create equalisation provision to cover exceptional or significant claims, considered as equity under Solvency II;
- Equalisation provision is also tax deductible resulting in potential tax benefits.

### Operational perspective

- Easy access to dedicated experts and service providers working on a daily basis on this type of activity. They are all used to reinsure EU risks, especially since in the past five years several EU groups have decided to concentrate their worldwide captive business in Luxembourg.
- Improve cash flow position of the Groups (easier retention and redeployment of cash within the group).

# Your challenges

### Extent of self-insurance

- How many different risks are insured in the group? How many risks are not insured by the group?
- Which risks are you going to cover internally and externally?
- What is the best way of covering risks?

### Lines of business/risks to cover

Typically, reinsured risks in Luxembourg tend to include:

- Damage to products/goods during shipping or storage, raw-material shortages, and operating-loss cover;
- Risk of bankruptcy of a provider/partner;
- Deterioration in premises/factories; and
- R&D related risks (i.e. discontinuance of development projects, regulatory approvals, etc.);
- Risks related to more restrictive regulatory requirements (e.g. on development, testing, manufacturing, drug pricing, distribution, etc.);
- Product risks, such as risk of products recall/ negative quality control (including reputational risk), risk of dependency on suppliers/third party providers, generic/branded product competition;
- Legal proceedings (e.g. patent litigations, product liability claims by consumers/third parties (including reputational risk), anti-trust/ governmental proceedings);
- Credit risk/financial risk/liquidity risks;
- Human resources risks (“key-man” health insurance/strike of employees);
- Cyber risks, geo-political risks & environmental liabilities.

### Legal/regulatory issues

- How do you get the required approval from the regulator?
- How do you handle the paperwork?

### Captive management

- Who will be in charge of captive management?
- Who are the other service providers (e.g. actuary, auditor, tax advisor, etc.)?

### Solvency and liquidity of the captive

- What is the scale and timing of funding and regulatory capital requirements for initial set-up or acquisition and for future operations?

### Operational considerations

- How to best accommodate regulatory/tax/ transfer pricing compliance requirements?

# Our Solutions

## Set-up

- Feasibility studies/Business planning;
- Tax structuring and tax studies;
- Risk management review;
- Support to licensing & regulatory consulting;
- Identification of business risks.

## Enhancement

- Captive health check;
- Program expansion (e.g. employee benefits);
- Risk management review;
- Strengthen the overall tax position of the captive.

## On-going Maintenance

- Assurance services;
- Acturarial Services;
- Tax compliance services;
- Transfer pricing support;
- Corporate tax structuring;
- Indirect tax services;
- Corporate governance services.

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