

Releasing captive value

*Practical guide on captive
insurance and reinsurance
in Luxembourg*

2012



PwC Luxembourg (www.pwc.lu) is the largest professional services firm in Luxembourg with more than 2,100 people employed from 57 different countries. It provides audit, tax and advisory services including management consulting, transaction, financing and regulatory advice to a wide variety of clients from local and middle market entrepreneurs to large multinational companies operating from Luxembourg and the Greater Region. It helps its clients create value they are looking for by giving comfort to the capital markets and providing advice through an industry focused approach.

The global PwC network is the largest provider of professional services in audit, tax and advisory. We're a network of independent firms in 158 countries and employ close to 169,000 people. Tell us what matters to you and find out more by visiting us at www.pwc.com and www.pwc.lu.

Executive summary

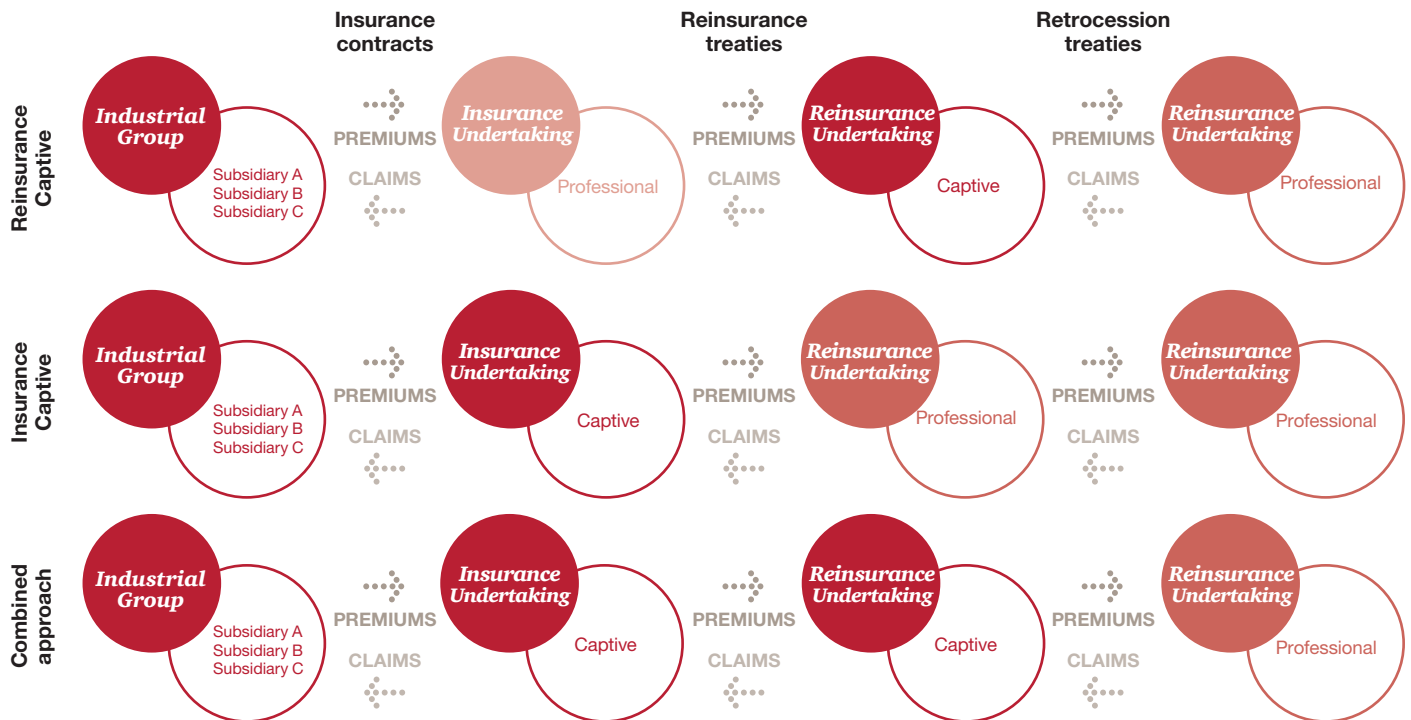
A captive is an insurance or reinsurance undertaking set up exclusively to insure or reinsure the risks of the group to which it belongs. In other words, it is a self-insurance vehicle that comes under the regulatory framework applicable to the insurance or reinsurance industry in its home jurisdiction.

As a general rule, an insurance captive insures the risks of the group, which it reinsures either with a captive reinsurance

undertaking or on the professional reinsurance market.

A reinsurance captive on the other hand reinsures the risks insured by one or more direct insurance undertakings, known as 'fronters', which have issued insurance contracts with the group's entities. Below we show the contractual relations and financial flows inherent in the different business models observed.

Admissible business models



- Group
- Professional Reinsurance
- Professional Insurance

Introduction

This guide gives you practical information on captive insurance and reinsurance and shows how PwC Luxembourg can help you.

In recent decades, a growing number of captives have been created by companies of all sizes operating in various business sectors. Although 80% of CAC40 companies have a captive, unlisted medium-sized groups represent a large proportion of the market. In this respect, Luxembourg has positioned itself as Europe's preferred market, home to over 260 insurance and reinsurance captives representing 8% of the world's captives. Given the upheavals in the financial markets, and the insurance and reinsurance industry in particular, we believe it is important to highlight the various benefits of creating a captive, and the significant advantages offered by Luxembourg compared to other jurisdictions.

Advantages of the captive

The advantages of an insurance or reinsurance captive vary depending on the group's specific characteristics and requirements, and can be summarised as follows:

- reduce the overall expense of insurance costs;
- reduce a group's vulnerability to insurance market fluctuations;
- improve management and control of the group's risks and claims;
- optimise management of the retention;
- adjust insurance contracts to the company's specific needs;
- transform a cost centre into a profit centre;
- get direct access to the professional reinsurance market;
- achieve a first level of pooling at group level.

In this respect, the latest developments associated in particular with the financial crisis, consumer protection, climate warming, corporate responsibility and the adoption of Solvency II, have created a new stumbling block for insurance or reinsurance captives in terms of an internationally recognised regulatory and tax environment. We have noticed the following trends:

- increase in the cost of insurance and reinsurance;
- disengagement of insurance stakeholders from certain risks;
- appearance of new risks that are difficult for the traditional insurance market to insure;
- adoption by some countries of regulations that penalise captives based in tax havens;
- increase in excesses, exclusions and coverage limitations.

“A prime location for the insurance sector”

One of the advantages of Luxembourg is that lawmakers, decision-makers and regulators are all at close quarters and have traditionally enjoyed a relationship of mutual understanding with business. This leads to a rapid decision-making process as well as a stable and friendly business environment.

This stable environment is just one of the reasons that the Grand Duchy is considered “a prime location for doing business”, as the PwC Luxembourg publication “Luxembourg – Where else?” states. It cites ten main factors that make Luxembourg stand out: its strategic position at the heart of Europe, neutrality, welcoming and safe environment, financial well-being, skilled multilingual workforce, excellent infrastructure, excellent logistics network, host to top level multinational financial and IT clusters, flexible and open-minded authorities and an attractive lifestyle.

Nowhere has this close relationship between decision-makers and business been better illustrated than in the setting-up and phenomenal evolution of the Luxembourg financial centre. Indeed, the financial centre is now ranked one of the top in the world and accounts for around 30% of the country’s GDP, while Luxembourg UCITS account for about 27% of the European market.

Reduce
the overall expense
of insurance costs

Optimise
management of the
retention

Captive Insurance and Captive Reinsurance in Luxembourg

The appeal of the Luxembourg captive system is due mainly to:

Luxembourg's lawmakers, who for many years have played a pioneering role in Europe. They anticipated the 2005 European directive on reinsurance (2005/68/EC), they established a prudential framework for reinsurance as far back as 1991. This anticipation of the future European framework highlights the Luxembourg authorities' experience and understanding of the advantages of insurance and reinsurance.

The accessibility of Luxembourg's regulators, which has always been a main asset in the development of this industry. Finally, the stability of Luxembourg's fiscal environment, which in particular gives reinsurance captives the benefit of deferred taxation, is a main asset when it comes to choosing a location.

So, we have designed this guide to present a general overview of the main advantages entailed in creating a captive and using Luxembourg as the captive's domicile.

While all reasonable care has been taken in preparing this guide, there is no substitute for regulations. Should you have particular problems or need further information, please contact one of the team members listed at the end of this guide.

We hope you'll enjoy reading this guide.

Advantages of the Insurance and/or Reinsurance captive

The set up of an insurance and/or reinsurance captive is based on three strategic criteria: location, choice of vehicle and risks covered. The main elements of these criteria are detailed in the following chart:

Strategic decisions

Location	Vehicle	Risks
<ul style="list-style-type: none"> • Presence of local professional experts who have experience in the captives sector (captive manager, auditors, etc.) • An appropriate tax framework for this type of structure • A regulator with the flexibility to adjust to market requirements • Multi-lingual • ... 	<ul style="list-style-type: none"> • Choice between an insurance captive, a reinsurance captive or a combined approach • Legal form of the captive (limited liability company, mutual association, etc.) • Acquisition of a pre-existing structure or creation of a new structure • ... 	<ul style="list-style-type: none"> • Employers' liability/Workers' compensation • General/Third party liability • Property • Professional indemnity • ...

Although Luxembourg fully meets the location requirements, the group must be able to give an adequate response to the other two criteria, taking specific endogenous and exogenous factors into account.

Firstly, the following endogenous factors need to be looked at:

- Group's maturity level in terms of risk management;
- Location of the parent company and its subsidiaries;
- Risk to which the Group is exposed (individual, sector and general risk);
- Policy implemented to cover risks.

Secondly, the following exogenous factor also need to be look at:

- Appetite of direct insurers for the risks to which the group is exposed;
- Non-double taxation treaties between the domicile of the parent company and that of the captives;
- Capitalisation on pre-existing activities in the captive's area;
- Level of qualifications need.

Luxembourg tax and regulatory framework

Why Luxembourg?

Reputation and professionalism

With 96 insurance companies, 261 reinsurance companies and 15 foreign insurance branches, Luxembourg is one of the European Union's major centres for the insurance and reinsurance industry.

As well as covering all business sectors, Luxembourg's insurance industry is characterised by a high volume of premiums (in excess of 13 billion euros in 2008), mainly made by cross-border business.

A look at the history of reinsurance in Europe shows that Luxembourg has been and continues to be a driving force in the reinsurance industry, as confirmed below.

In 1984, Luxembourg set up a legal, regulatory and tax framework favourable to reinsurance companies, a framework which also encompassed reinsurance captives. The appeal of Luxembourg's regulatory framework is clear from the steady rate at which captives were created in the 1990s.

In 2005, the European directive on reinsurance, whose main objective was to establish a single European passport within the European Union, implicitly endorsed the regulatory framework established by Luxembourg back in 1991, nearly 15 years earlier.

Without going into detail, the intention of Directive 2005/68/EC was to establish a harmonised prudential framework within the European Union. This harmonisation is focused mainly on the introduction of a single passport that allows a captive under the supervision of its Member State of origin to cover risks within the European Union without having to apply to other Member States for a licence. This directive also lays down prudential regulations relating inter alia to the creation of technical provisions and the investment of representative assets. These regulations as transposed into Luxembourg law are briefly described below.

Finally, the directive also explicitly endorsed Luxembourg's prudential system, based inter alia on the right of Luxembourg reinsurance undertakings to equalise claims fluctuations for future years and to cover special risks through the claims fluctuation provision.

The legal framework

Main regulatory requirements applicable to the legal framework of insurance and reinsurance captives:

	Insurance Captive	Reinsurance captive
Minimum guarantee fund	Minimum guarantee fund of EUR 2.3 m or EUR 3.5 m depending on the risk category insured.	Minimum guarantee fund of EUR 1.225 m or EUR 3.2 m depending whether captive reinsurance or professional reinsurance undertaking.
Business plan	<p>The business plan should include the following components:</p> <ul style="list-style-type: none">• The risks the undertaking intends to cover;• For all “life insurance” classes, a description of the technical basis for calculation of premiums, mathematical provisions, surrender and paid-up values;• The reinsurance policy principles;• A description of the components of the minimum guarantee fund;• An estimate of the set-up costs of the administrative departments and the production network; the financial resources available to give the help promised;• In addition, for the first three periods of activity, a forecast profit and loss account specifically detailing overheads (including commissions), premiums/ contributions, claims and allocation to the technical provisions, for both direct insurance and reinsurance accepted and ceded, a cash flow forecast and estimates of financial resources allocated to cover technical liabilities and solvency margin.	<p>Similar to insurance captive, except:</p> <ul style="list-style-type: none">• Full details of the ceding and retroceding insurance or reinsurance undertaking (including country of establishment and applicable regulatory supervisory framework);• In addition to the forecast profit and loss period, a forecast balance sheet for the first three periods of activity.

Main regulatory requirements applicable to the legal framework of insurance and reinsurance captives:

	Insurance Captive	Reinsurance captive
Investment policy	Assets representative of technical provisions should take into account the type of business operated by the undertaking in such a way as to make sure security, return and liquidity of their investments, and be diversified and adequately spread according to investment guidelines as defined by the RGD dated 14 December 1994 (as amended).	Assets representative of technical provisions (including the equalisation provision) should take into account the type of business operated by the undertaking in such a way as to make sure sufficiency, liquidity, security, quality, return and congruence of their investments, and be diversified and adequately spread to avoid any undue risk concentration or exposure to a single issuer or group.
Technical provisions	Sufficient technical provisions need to be set up for the undertaking to meet, as far as can reasonably be foreseen, any liabilities arising from insurance policies. Technical provisions, irrespective of their nature, are computed contract by contract. Deviation from this rule might be authorised by the CAA on request.	Similar to insurance captive, except: <ul style="list-style-type: none"> • Under certain conditions, discounting might be authorised for technical provisions; • Creation of an equalisation provision is mandatory up to a certain level.

The tax framework

Captives are subject to taxes applicable to commercial companies with a registered office in Luxembourg: corporate income tax, net wealth tax and municipal business tax. Specific regulations on the taxation of authorised reinsurance undertakings have been introduced. Like banks, reinsurance undertakings can also get the tax neutralisation regime of fiscal exchange gains on equity investment. These different taxation systems are summarised in the following table:

	Insurance Captive	Reinsurance captive
Corporate income tax (CIT) and Municipal business tax (MBT)	Like all Luxembourg commercial companies, reinsurance undertakings are liable to corporate income tax at the rate of 21.84% (22.05% as from 1 January 2011) and municipal business tax at a rate of 6.75% in Luxembourg city (overall rate of 28.59%, as from 1 January 2011: 28.8%). CIT taxable base corresponds in principle to the accounting result after deduction of some exemptions and addition of some non-deductible charges (e.g. corporate income tax, municipal business tax, net wealth tax and tax on director's fees). The MBT is levied on profits determined after deduction of an allowance of EUR 17,500 on the taxable base for corporate income tax. Corporate income tax and net wealth tax are not deductible from profits for the computation of this tax.	
Provisions related to technical provisions	As a general rule, captives must create sufficient technical provisions at the end of each financial year. Under Article 167 of the Luxembourg tax law, such technical provisions are tax-deductible.	

	Insurance Captive	Reinsurance captive
Characteristics of the tax system applicable to equalisation provision	An equalisation provision might be created under certain conditions to cover special risks (must be approved by the CAA).	In principle, Luxembourg reinsurance captives benefit from a deferred taxation regime. This regime arises from the fact that reinsurance captives partially or totally neutralise their financial and technical profits by charges linked to the equalisation provision. It should be noted that the principle of covering significant and exceptional risks borne by reinsurance captives by creating this provision is explicitly provided for in Directive 2005/68/EC. For your convenience, the rules applicable to this equalisation provision are described in detail on the next page.
Exemption of income arising from investments	Like all commercial companies, captives are eligible for the participation exemption regime.	
Net wealth tax	This tax is levied, at a rate of 0.5%, on the net worth of the company at the beginning of the year. This tax is not deductible from taxable profit when calculating corporate income tax and municipal business tax. "Net worth" is equivalent to the net assets of the company as adjusted for certain items mainly relating to buildings, deferred gains and significant investments in other companies. The equalisation provision is regarded as a liability in determining net worth. This tax might be reduced by up to a fifth of the profit amount allocated to a special provision held in the balance sheet for the next five years.	
Registration fees	As from 1 January 2009, capital duty has been abolished and replaced by a fixed registration fee of EUR 75 payable upon incorporation of Luxembourg companies, amendments of the articles of incorporation or transfer to Luxembourg of the registered office or place of effective management.	
Value added tax	All reinsurance companies are liable to VAT, although the majority of their activities are tax-exempt. Under VAT law, captives might recover input VAT proportionately to insurance premiums that derive from reinsurance undertakings located in countries outside the European Union.	
Premium tax	Luxembourg has an insurance tax premium, which is applicable if the insured is a Luxembourg resident or if the item insured is located in Luxembourg. A tax rate of 4% on premiums is applicable to all types of insurance. An extra tax of 6% is applied on premiums for fire insurance policies. No premium tax is payable on life insurance premiums or reinsurance premiums.	
DTT eligibility	Like all ordinary commercial companies, insurance captives benefit from double taxation treaties.	

Equalisation provision for reinsurance undertaking

In addition to the technical provisions referred to above, the Grand Ducal Regulation of 5 December 2007 requires the creation of an equalisation provision. This equalisation provision is intended to cover exceptional or significant claims which might occur and are tax-deductible.

The equalisation provision is determined separately for each risk category according to the past claims ratio.

Individual coefficients, established by Luxembourg's Insurance Supervisory Authority, the Commissariat aux Assurances (CAA), are attached to each risk or risk category. The method used to determine them is based on internationally recognised scientific criteria, and so measurable objectively.

The ratios are set at six times the standard deviation of the "loss premium" ratio recorded for a given risk or risk category. Generally speaking, all actuaries and insurance professionals consider the standard deviation to be a good indication of the actual fluctuation in insurance or reinsurance coverage claims. Each ratio is in principle subject to a lower limit of 2.5 but could be brought down to 0 if the observed fluctuation in claims does not call for a provision to be created. It is worth noting that the established ratios are reviewed every five years, or more frequently when a reinsurance company's business plan undergoes material changes. This review aims to monitor the trend of the fluctuation in claims for insured risks.

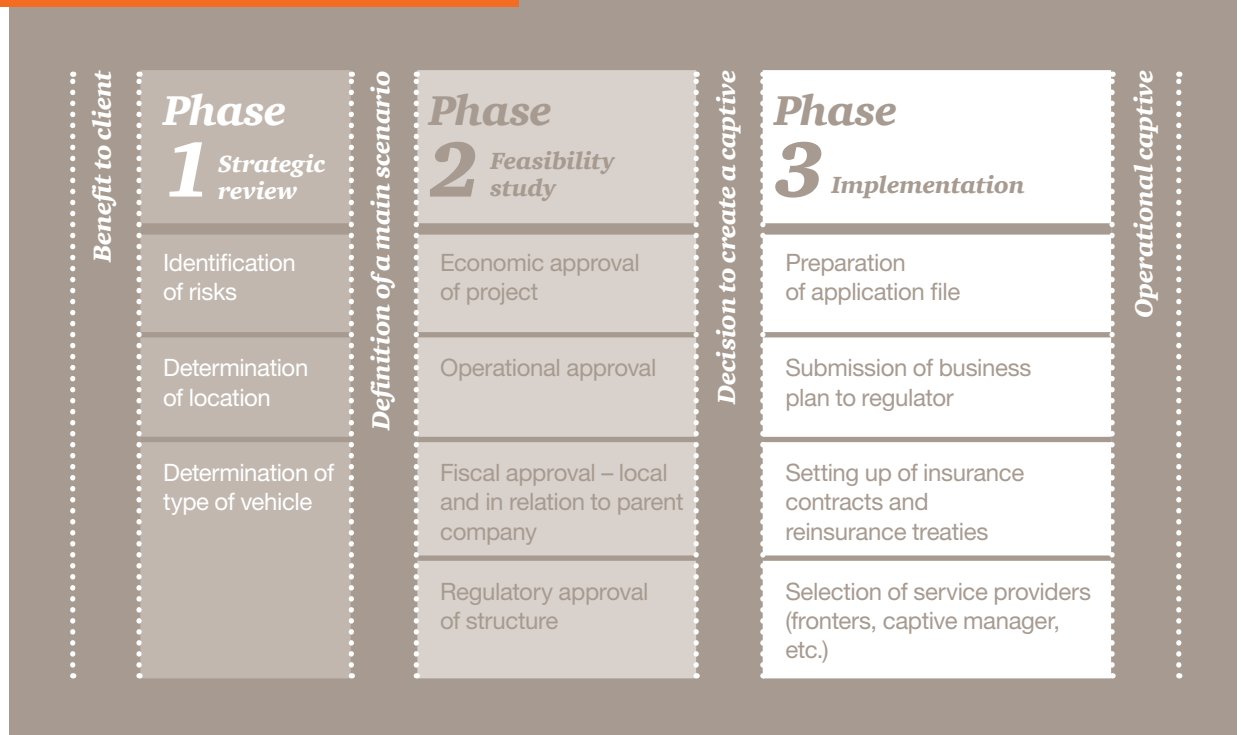
Although the individual coefficients are no longer limited in theory, there is nevertheless a ceiling for the equalisation provision which cannot exceed 17.5 times the average net premiums earned by the reinsurance undertaking over the last five years. By introducing such a limit, the regulation goes beyond the equalisation provision regime introduced by the 87/343/EC directive.

Within this framework, the reinsurance company must create an allocation corresponding to the technical balance and partially the financial balance. The latter is determined on the basis of a technical rate, established as in life insurance, at 60% of the rate of return of long-term government bonds and applied to the technical provisions recorded in the latest annual accounts. Each year, the CAA publishes the rate applicable by currency. This means that the portion of income made by a return above the technical rate would have to be linked to the profits and would be subject to tax before possibly being distributed as dividends. It is also worth noting that capital gains or losses on "investments and debts on related undertakings" are excluded from the financial balance to be allocated to the equalisation provision.

But, to make sure that the equalisation provision is sufficient to cope with fluctuations in claims for insured risks, the entire financial balance must be allocated as long as the equalisation provision stays under 30% of the maximum theoretical amount as indicated above.

Set up of a Luxembourg captive

A insurance and reinsurance captive is set up in the following stages:



Application File

An application file has to be submitted to the CAA for authorisation. Under current law, the following information has to be provided in the licence application:

- **Shareholding or member structure, which needs to be transparent. The quality of these shareholders or members must be satisfactory, given the need to ensure sound and prudent management of the undertaking.**
- **The central administrative office, which needs to be established in Luxembourg**

- **The legal form: an insurance undertaking can adopt one of the following forms:**

- “Société anonyme” (Limited liability company)
- “Société en commandite par actions” (Limited partnership with shares)
- “Association mutuelle d’assurance” (Mutual association)
- “Société cooperative” (Cooperative company)
- “Société cooperative organisée comme une société anonyme” (Cooperative company organised as a limited liability company)
- “Société européenne” (European company)

- **A reinsurance undertaking can adopt one of the following forms:**

- “Société anonyme” (Limited liability company)
- “Société en commandite par actions” (Limited partnership with shares)
- “Association mutuelle d’assurance” (Mutual association)
- “Société européenne” (European company)

Articles of incorporation

The articles of incorporation of the undertaking, following registration at a local notary’s office, have to be provided along with the file. Accordingly, the law of 10 August 1915 relating to commercial companies is applicable to captives, except where specifically stated otherwise in the law of 6 December 1991.

Value, at your terms

We have developed our captive expertise through the provision of dedicated specialists across a variety of business areas. Our insurance and reinsurance practice in Luxembourg has more than 70 professionals and we benefit from close contacts in our network. Whether you need help with the regulatory set up, tax structuring, audit or transaction support for your captive, our experienced insurance and reinsurance team will support your projects, in every stage of the captive lifecycle.

How we can help you?

Phase

1 *Strategic review*

Phase

2 *Feasibility study*

Phase

3 *Implementation*

Our services

- Regulatory assistance
- Optimal location/vehicle analysis
- Financial forecast preparation
- Actuarial services
- Corporate Tax structuring
- Analysis of VAT treatment of flow
- Project management and coordination with stakeholders
- Transfer pricing review
- Tax compliance
- Advice on accounting treatment of specific (re)insurance captives under
- Group GAAP (IFRS, US, etc.) and impact on Group consolidated accounts/reporting package
- Mergers and acquisitions:
 - Potential target assessment
 - Valuation services
 - Negotiation of acquisition
 - Financial due diligence
 - Regulatory due diligence
 - Tax due diligence
- Legal and contractual audit
- Issue of reports on contributions in kind, interim dividends, etc.

To get started, call

Paul Neyens

Audit, Insurance Industry Leader
Phone +352 49 48 48 4011
paul.neyens@lu.pwc.com

Claude Jacoby

Audit, Regulatory
Phone +352 49 48 48 2534
claude.jacoby@lu.pwc.com

Grégoire Huret

Corporate Finance
Phone +352 49 48 48 5731
gregoire.huret@lu.pwc.com

Marc Voncken

Audit, Solvency II
Phone +352 49 48 48 2461
marc.voncken@lu.pwc.com

Géraud de Borman

Tax
Phone +352 49 48 48 5818
geraud.de.borman@lu.pwc.com

Christiane Schaus

Audit
Phone +352 49 48 48 5738
christiane.schaus@lu.pwc.com

Additional Contacts

Commissariat aux Assurance (CAA)
www.commassu.lu

Associations des Companies d'Assurances (ACA)
www.aca.lu

Association luxembourgeoise des actuaires (ALAC)
www.alac.lu

Association des Gestionnaires de Réassurances
www.agere.lu

