Make the most of reinsurance captive

Luxembourg: an ideal domicile

International groups face ever-growing and more complex risks as their businesses expand to new sectors and markets. Few companies have been more successful than Chinese ones in growing their activities across the globe. However, with an expanding global footprint, companies need to invest more resources in managing their operational and financial risks, as well as the uncertainties of changing political and economic systems.

Since some of these risks are difficult or impossible to cover using traditional commercial insurance providers, the questions are "How can you best manage your group risk portfolio?" and "Can this costly issue be turned into an opportunity?"

Setting up a captive in Luxembourg could be the answer you're looking for.

Key benefits of a captive insurer for Chinese companies

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*

Financial benefits

1. *Insurance cost saving*
2. *Improved agency ratings*

Other benefits

1. *Access to the reinsurance/ insurance market*
2. *Internal capacity created*
3. *Tax deductions/benefits*

Global market overview

There are close to ***7,000 captives*** worldwide. Furthermore, approximately **90%** of Fortune ***500 companies*** own at least one captive.

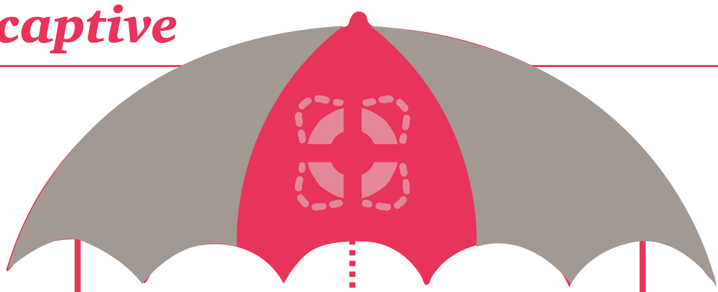
Typically, allowing for costs and depending on the nature of risks incurred, international groups spending equivalent of several million US dollars per annum on insurance premium may consider the potential benefit of establishing a captive. This shall be examined on a case by case basis.

The business model of a captive

A captive is a regulated insurance or reinsurance entity set up by an international business group. The captive examines the group's insurance needs, and can then decide which risks to maintain within the group and which ones to insure with third-party insurers.

Using a captive to capture risks at group level, it can achieve the best pricing for its risks on the market whilst ensuring that the amount and nature of the coverage is most appropriate for the group's business and overall strategy.

A captive can be a direct-writing company or a reinsurer of fronting insurance companies. Captive reinsurance companies are commonly incorporated in Luxembourg due to regulatory and financial considerations.



Full self-retention
Reserves on balance sheet

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

Captive
Alternative solution

- a mixture of risk transfer and formal self-retention
- captive ideally applies for the more volatile part of traditional risks as well as non-traditional insurable risks

Full transfer
Outsourcing to 3rd party

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

Case Study

Here is an illustrative example of why using captive, by assuming a company will face a major damage/loss every two years.

With proper risk management, a captive reinsurance company is able to create a considerable capacity (technical profit) for the group.

Scenario 1 - Self-retention

	Premiums received/(paid)	Claims/(Loss)	Admin	Liquidity	Capacity (cumulative)
Year 1	-	(850)	-	(850)	
Year 2	-	-	-	-	
Year 3	-	(1.700)	-	(1.700)	
Year 4	-	-	-	-	
Year 5	-	(500)	-	(500)	(3.050)

Scenario 2 - Third-party insurance

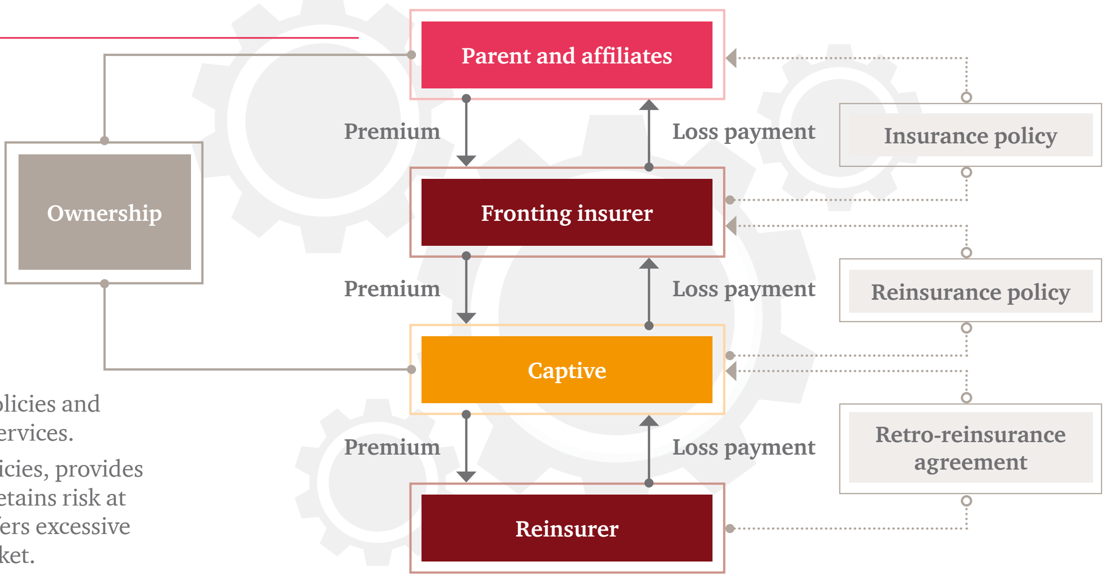
	Premiums received/(paid)	Claims/(Loss)	Admin	Liquidity	Capacity (cumulative)
Year 1	(1.200)	850	-	(350)	
Year 2	(1.250)	-	-	(1.250)	
Year 3	(1.300)	1.700	-	400	
Year 4	(1.325)	-	-	(1.325)	
Year 5	(1.350)	500	-	(850)	(3.375)

Scenario 3 - Captive insurance

	Premiums received/(paid)	Claims/(Loss)	Admin	Liquidity	Capacity (cumulative)
Year 1	1.200	(850)	(250)	100	
Year 2	1.250	-	(250)	1.000	
Year 3	1.300	(1.700)	(250)	(650)	
Year 4	1.325	-	(250)	1.075	
Year 5	1.350	(500)	(250)	600	2.125

1. By self-retaining risks, although there is no cash out every year, the volatility on profit will be high (expenses are charged on occurrence.)
2. By going to the market, the risks and management responsibility will be fully transferred and costs would be stable per annum. However, there is a certain cash out every year and the total costs for covering the risks could be even higher than that under self-retention way (depending on the nature of risks.)
3. By creating a captive reinsurance company, it will create a capacity for the group, which allows to absorb the volatility. In the meantime, although there will be an increase in risk management related administrative costs (e.g., costs for fronting issuers and other captive operational costs), the group can keep technical profitability created by the captive.

Typical operational model of a 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?

China has finally embraced the captive concept, with at least five captives formed in Hong Kong and Mainland China in the last five years.

However, the risks they cover are limited to Chinese territories. The risks outside of China can be further managed through an overseas captive company. 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

Your challenges

Before setting up a captive in Luxembourg, you will need to answer some strategic questions:

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:

- Credit and financial risk;
- Cyber risks;
- Damage to products/goods during shipping or storage, raw-material shortages, and operating-loss cover;
- Risk of bankruptcy of a provider/partner;
- Risk of product recall/negative quality control (including reputational risk);
- Deterioration in premises/factories; and
- Key-man health insurance and employee strikes.

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?

Our solutions

Set-up	Enhancement	On-going Maintenance
Feasibility studies/Business planning	Captive health check	Assurance services
Tax structuring and tax studies	Program expansion (e.g., employee benefits)	Actuarial Services
Risk management review	Risk management review	Tax compliance services
Support to licensing & regulatory consulting		Transfer pricing support

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