As France, Italy and the UK consider introducing their own captive framework, should captive owners be careful what they wish for?

The Rise Of European Captive Nationalism

Guernsey, Luxembourg and Dublin have long dominated Europe's captive landscape. In the main, European businesses, including those in the UK, have looked to the specialist centres to domicile their captives and it has been a successful strategy.

However, while Solvency II has brought a degree of consistency across the EU jurisdictions, the lack of proportionality applied to captives has created an administration heavy, expensive environment to operate a captive in. Add to this the growing scrutiny arising from captive parent jurisdictions on substance, transfer pricing and tax transparency and it's not difficult to understand why some corporates may be pondering whether it's worth running their captives closer to home.

At the end of 2020 it emerged France's risk management association Amrae had joined a working group exploring whether a new regulatory and tax framework could be developed for captives in the country. Five captives are currently domiciled in France.

"The attractiveness of the French domicile is still quite low due to the current tax and regulatory environment," says Francois Beaume, speaking to *GCP Insights* in his capacity as an Amrae vice president. "Due to the pandemic and the current insurance market context, we feel that there is a change of gear and a clear desire of the French government to facilitate the creation of new captives in the country."

Beaume adds that established domiciles such as Dublin and Luxembourg remain suitable "but there is a need to render captives simpler and more attractive to French companies by facilitating their creation in France".

While we await a proposed French framework, there is an expectation existing laws concerning equalisation reserves could be applied to captives, which would aid its appeal. The use of equalisation reserves, allowing captives to retain surplus capital at a lower tax rate, has long been an attractive feature of Luxembourg and helps captives to build funds in case of catastrophic losses.

For Amrae, the priority is creating a regulatory environment that appeals to new captive formations rather than a desire from existing captives to redomesticate. "The plan is to render attractive the creation of new captives in France, as of now we don't think that redomestication is contemplated," Beaume adds.

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A similar discussion is ongoing in Italy, led by the risk management association ANRA. Alessandro De Felice, chief risk officer of Prysmian Group and president of ANRA, says the local regulator, IVASS, wants to understand the differences between the European captive centres and the existing regime in Italy.

"These discussions were very positive because we both understand that currently there is no reason captives cannot be formed in Italy," De Felice tells *GCP Insights*. "Clearly it depends a lot on the priorities and strategy of the captive. If it is to finance your multinational risk, then Italy is suitable. If the priority is purely fiscal optimisation for your company then Italy might not be the right location."

He adds that ANRA has driven this dialogue because of concerns about a new interpretation of transfer pricing rules in Italy that could bring overseas captives into breach. As a result, some Italian-owned Dublin-domiciled captives are now paying the balance between the Irish (12.5%) and Italian (24%) corporation tax rates to the Italian government.

"This could be a really important moment because some Italian companies,

in response to the hardening market, might evaluate whether to form a captive in Italy," De Felice says. "For larger companies, having a captive abroad is not a big challenge, but for smaller Italian businesses it could be an interesting opportunity because you can do it in Italy, in your language and get consulting in Italy."

At present there is little sign other European countries or risk management associations are looking to follow France and Italy's lead.

BaFin, Germany's financial regulator, has been somewhat preoccupied with the fallout from its mishandling of Wirecard's collapse which led to both the head and deputy head of the regulator being forced out. Holger Kraus, head of the captive committee of Germany's risk and insurance managers' associations, tells *GCP Insights* there has been no indication from BaFin that it is considering a captive framework and he does not believe this to be a priority for the regulator or the association.

Going mainstream

Any new regulatory framework will need to be assessed in detail before deciding whether a 'new' domicile will be successful or not. The principle, however, of more countries formally embracing the captive concept and recognising it as a valued risk financing tool is being welcomed by captive managers.

Ciaran Healy, director of client solutions – EMEA at Aon Captive & Insurance Management, tells *GCP Insights* this moment is "symbolically significant".

He says: "This is acknowledgement from two of the EU's most influential players that captives are not only legitimate risk management tools but that they recognise how important they are to the corporate community and want to provide a local platform to facilitate their growth."

William Thomas-Ferrand, international practice leader at Marsh Captive Solutions, believes these discussions, being led by risk management associations, is further evidence of the growing desire to form captives as insureds grapple with the hard market.

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"It's fascinating and it's because the need for captives has increased so dramatically in this current market, captives are really desired by corporates," he tells *GCP Insights*. "We're seeing huge activity. As a result, instead of being embraced just in a few domiciles, bigger countries are now becoming more aware of them and wanting to embrace them. I think that is driving it.

"The irony is that some of these countries have attacked captives in the past from a tax perspective, but if they're now promoting them, or at least in conversations internally about promoting them, it shows they have accepted captives as a valid structure."

No place like home

While the initiative in France is not driven by a desire from existing captive owners to redomesticate, *GCP Insights* is aware of at least one Italian-owned Dublin-domiciled captive that is actively exploring this possibility with the Italian regulator.

For now, the primary motivation looks geared towards facilitating new captive formations. If a regulatory environment is established over time, however, the narrative will return to whether existing captives can or should move 'home'.

"This has been a talking point amongst a section of the European captive community for a few years and it does come up as part of strategic dialogue with clients, but the genuine intent to have the captive in the home jurisdiction is far from widespread," says Healy.

"It is typically a response to an internal question, quite often from the tax department, who oftentimes do not understand the captive domicile dynamic and wonder why the activity is not performed at the headquarters.

"This question is probably becoming more common due to the greater reporting requirements that tax departments have such as the BEPS county-by-country reporting, but an explanation of the domicile dynamic and the captive strategy tends to satisfy this."

Claude Weber, managing director of the Marsh Captive Solutions Luxembourg office, says the costs of redomestication will need to be factored into any decision and emphasises that until we know more about proposed frameworks it is hard to know whether moving home will be of interest to a significant group of clients or not.

"A fundamental question for any domicile will be what their definition of a captive is," Weber explains. "If equalization reserves or the principle of proportionality are introduced, they could only be applied to captives. If the definition of a captive in France is quite strict, as to consider liability as third-party risk, for example, this would exclude quite a lot of companies from forming a captive in France. If they chose a broader definition then it is possible they could have some success."

Careful what you wish for

De Felice is convinced that allowing the formation of captives in the insured's own country will open up the concept to a much wider group of companies. "In the past a captive was seen as only for more refined or sophisticated companies that has an advanced alternative risk transfer strategy," adds De Felice. "The fact you can do it in your own country may help other companies better understand this instrument and adopt it. The hard market with higher rates, higher retentions and reduced capacity is only going to improve this possibility."

Consultants *GCP Insights* spoke to from both Aon and Marsh said they would continue supporting captives whether they are domiciled in traditional captive centres or not.

"We already have brokerage offices in France and Italy, so we could easily put people in one of those countries if clients wanted us to," Thomas-Ferrand says. "My feeling is that clients would still

want managers if they were domiciled in their home country. It will depend on the regulators as well, whether they require a manager to be licensed."

There was a warning, however, that any move towards new, 'home country' domiciles would need to be thoroughly assessed and the pros and cons balanced. As discussed, one of the drivers appears to be a frustration among captive owners at the increasing scrutiny captive arrangements are receiving from tax authorities as a result of BEPS initiatives.

"There are many captives that pay their tax in the home country as well because you don't set up captives for tax arbitrage, you set them up for risk management purposes," Thomas-Ferrand says. "If you're already paying the tax of a home country, why not stay with a regulator and professionals who know how to service the captive rather than having to take the risk of an unknown environment. That's the downside."

This approach has become increasingly common in Guernsey with many UK-owned captives electing to be taxed in the UK. This way they continue to benefit from the specialist captive regulation and infrastructure of an experienced captive domicile, while removing any question marks concerning tax strategy.

There may also be an unrealistic expectation of reduced costs by moving a captive into the insured's home country. There are currently 10 captives in Germany, a handful in the Netherlands and 42 in Sweden. The experience of the local captive community is often one of frustration with the way Solvency II is applied. *GCP Insights* has seen comparisons that show managing a captive in one of these countries can be almost three times more than a comparable captive managed in Luxembourg or Dublin. We are also aware of one Swedish-owned captive that redomesticated to Sweden, but later closed down due to the increased cost base. It is now exploring a cell option in Malta.

Assessing what the advantages of moving a captive home may be, Healy says short of a new USP being developed for one of these emerging domiciles the simplified tax treatment is the standout benefit.

"You would infer that the advantage would be a more simplified tax relationship with the captive and therefore tax reputational risk is the key benefit and perhaps additional convenience of having the captive manager 'next door'," he says.

"However, like almost all business decisions, there are pros and cons with the various options and unless the captive support infrastructure is adequate, you swap one set of risks for another. For example, the regulatory and operational risks (such as outsourcing risk) increase.

"There is also a danger of an under estimation of the importance of expert service providers and the outsourcing model in the captive success story. A smoothly run captive requires a significant amount of effort behind the scenes, especially in a Solvency II environment.

"This is a point that largely goes undocumented, but if you look at the locations where outsourcing is less prevalent, you tend to see significantly higher cost profiles and less entrepreneurial programmes as more internal time is directed to operations and regulatory requirements. So moving the captive 'home' should be done with a clear understanding of the support available."

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EXCLUSIVE: UK government explores regulatory framework for captives

The United Kingdom could be the next European country to introduce a regulatory framework for captives after the London Market Group (LMG) stepped up its discussions with the government on the topic. *GCP Insights* understands the government is looking for "quick Brexit wins" and views captives as one option that could easily leverage London's existing reputation as the world's leading reinsurance centre.

Discussions are at an early stage, but there is a strong appetite within the LMG to make progress. One option would be to open up protected cell companies (PCCs) to permit their use for captive business. PCCs were introduced in the UK when regulations for facilitating insurance linked securities (ILS) came into force in 2017. Currently they only allow their use for ILS business, however.

It remains to be seen whether UK captives would have to follow the EU's Solvency II regime. Bermuda's success in achieving Solvency II equivalence for its commercial (re)insurers, while keeping captives outside of the regime, has set a precedent that the UK could seek to replicate.

The proposals being discussed by the LMG and the UK government are separate to those under development at Lloyd's. *GCP Insights* understands a pilot scheme for applications to form a 'Captive Syndicate' within Lloyd's could be opened as soon as May and the market will be looking for ideal candidates to take part.

Oliver Schofield, managing partner at independent captive consultancy RISCS, is excited at the prospect of being able to use Lloyd's to facilitate captive business.

"The most attractive aspects of captive syndicates at Lloyd's will be the ability for a captive to be able to issue policies globally wherever Lloyd's have local licenses," he tells *GCP Insights*. "This is a value that Lloyd's brings to all syndicates and captives will be included in that. In addition, a captive syndicate will automatically be a rated entity. Both of these are benefits that are being sought by captive owners.

"I think the interest will come from larger multi-line captive owners and prospective owners. The cost base is likely to be less attractive to mono-line captive owners who currently use a cell structure."

Concerning the news the LMG is exploring the introduction of a regulatory framework for captives in the UK, Schofield adds: "If UK domiciled captives were required to adhere to Solvency II rules then I believe that would effectively kill off any interest.

"Secondly, the UK would need to allow cells as well as pure captives. More and more mid-size companies are establishing cells rather than pure captives so this will be critical for a successful UK captive product." ■