The OECD and the Captive Insurance Industry: The OECD Report Re-examined

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Introduction and Overview

The report by the OECD, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices*, has produced a wide-ranging reaction in the economic, financial, political and popular literature.[2] Commentaries on the subject have been supplemented by a wider-ranging political and diplomatic movement which too has sought to place the report within an equitable and developmental perspective. One focus area which may add to this response lies in a sectoral examination of the report, determining how it impacts on specific areas such as banking insurance. This brief paper will explore this sector of insurance including captive insurance, an industry which is present in both the offshore financial centre and the metropolitan financial centres.[3] Insurance is a useful category for examination not only because of its presence in both types of centres but also because it represents a business sector which positively responds to issues within the report such as transparency and substantial business activity.

Captive insurance started in the second half of the twentieth-century essentially as a means of giving companies the ability to provide their

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2 A major body of this work has been undertaken on a continuous basis by Richard Hay whose most recent article, 'US Destabilises Assault on Offshore Centres', in *Tax Planning International Review*, Vol. 28, No. 9, September 2001, is a comprehensive review of the subject. Bruce Zagaris has also presented substantial contributions on the subject, as well as serving as a member of the Heritage Foundation, an organisation which was in the forefront of pointing out the weaknesses in the OECD Report.

3 A useful survey on insurance and reinsurance is to be found in the *Special International Financial Law Review* 1999 Supplement published by Euromoney Publications. Articles on Barbados, Canada, Germany, The Netherlands, UK and USA represent a useful compendium of the captive and non-captive jurisdictions.

own insurance. Its development was linked with the concept of facilitating the insuring of risks for which coverage was not available in the open market; in this regard it became synonymous with the implementing of self-insurance programmes. Captive insurance, however, extended its reach by giving companies the efficiency of bringing all of their insurance programmes into one company and accessing the worldwide reinsurance market. The facilitating environment of the captive insurance company has been so welcoming that many reinsurance companies themselves have structured some of their own corporations as captive insurers.

Development of Captive Insurance in Financial Centres

The captive insurance industry began as a way of providing attractively priced self insurance in a well-regulated jurisdiction. Pioneered by Bermuda in the mid-Atlantic, and Guernsey and Jersey in Europe, it rapidly spread to a number of offshore financial centres and subsequently to the USA and within Lloyds of London itself (see Table 1 and Figures 1 and 2). It is a fast-growing industry which provides protection to a single parent captive, as in the case of a single business, as well as to group or association captives as, for example, in the case of a group of emergency physicians or automobile dealers. The growth of the industry in different jurisdictions has been the result of specific policies; it is useful to isolate some of the jurisdictions and the macro- and micro-measures which have influenced and shaped individual policies.

In Bermuda the growth of the captive insurance industry was part of the overall planned development of international business from as early as the 1940s. It started through the introduction of ‘captives’ as essentially self-insurance schemes for non-Bermudian businesses which did not want to pay liability insurance premiums in the open market or which, for one reason or another, were uninsurable. It led the market continuously, and it also consistently introduced variations on the main theme. Hence, by the end of the 1990s, it had developed a carefully nurtured class system for insurance companies with varying levels of sophistication and complexity. At the most simple level, it continued to host the pure ‘captive’, merely insuring its own parent company together with the next level of captive taking on third party risks. However, it advanced into the area of the ‘captive’ loosely defined, acting as traditional reinsurer and most recently engaging in catastrophe risk and the more esoteric finite risk product.

Bermuda entered the captive catastrophe insurance business when it

Table 1. Captives by Domicile

Domicile	Number of captives	Domicile	Number of captives
Non-US Western Hemisphere		**US Onshore**	
Bermuda	1,405	Vermont	381
Cayman Islands	535	Hawaii	73
Barbados	237	Colorado	21
British Virgin Islands	184	Georgia	14
Turks & Caicos	63	Illinois	14
Bahamas	25	Tennessee	14
British Columbia	17	New York	12
Curaçao (Netherlands Antilles)	15	US Virgin Islands	7
Panama	2	Delaware	5
St Lucia	0	Florida	5
Subtotal	*2,483*	Kansas	4
		Rhode Island	4
Europe and Asia		Virginia	4
Guernsey	370	Maine	2
Luxembourg	273	Nevada	2
Ireland	178	South Carolina	2
Isle of Man	173	Washington DC	2
Singapore	54	Guam	1
Switzerland	32	South Dakota	0
Jersey	27	West Virginia	0
Gibraltar	12	*Subtotal*	*567*
Hong Kong	8		
Liechtenstein	2	Other US States	115
Lloyds	1		
Aland Island	1	All other non-US	162
Labuan	0		
Mauritius	0	***Total***	***4,458***
Subtotal	*1,131*		

created a regulatory climate to take on the business which had traditionally been the province of Lloyds of London but which had suffered serious financial losses as a result of property disasters such as Hurricane Andrew. It nevertheless provided the necessary regulatory environment by, among other things, requiring a property catastrophe company to provide capital and surplus of $100 million together with a solvency margin of at least 50 per cent of net premiums written.

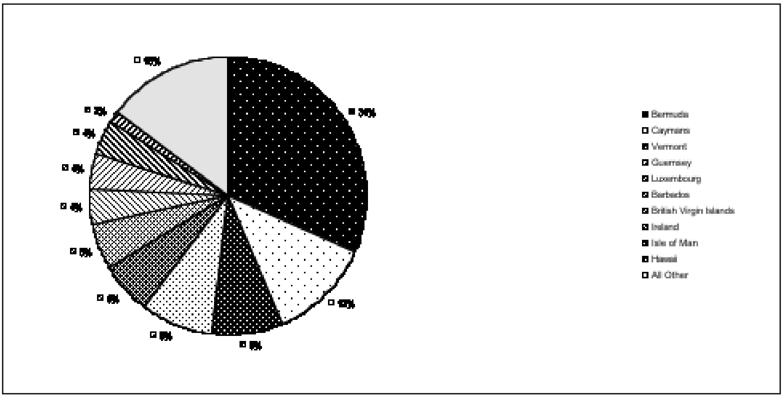

Figure 1. Captives Worldwide Statistics

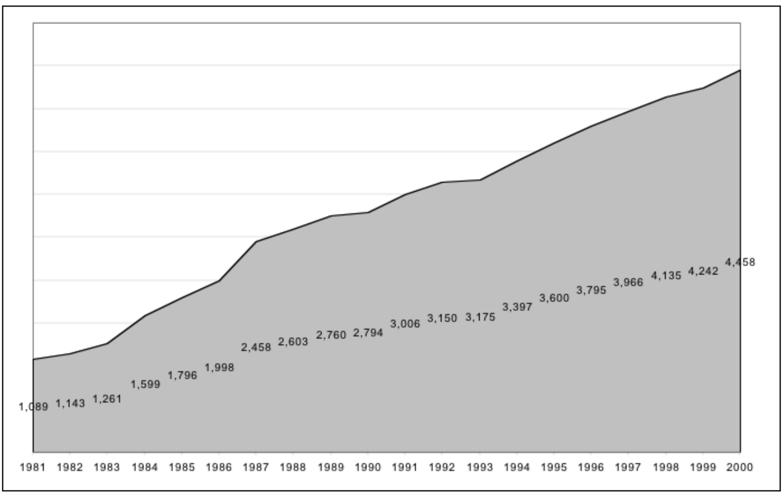

Figure 2. Long-term Growth in Captives

Barbados, as the sixth largest captive insurance domicile in the world, introduced legislation in 1983 to complement its old international business companies legislation (1965) and offshore banking, legislation (1979), and to make better use of its double tax treaty arrangements. Although Barbados' most active overall treaty use is with Canada, its captive insurance industry was given an original impetus by way of the Federal Excise Tax Exemption under its treaty with the USA. For the ability to establish a Barbados captive with a 'permanent establishment' and managed in Barbados allowed the US captive-owner the ability to be exempt from the federal excise tax under the treaty. It saved considerable costs. This treaty provision, if used sensibly with a managed Barbadian entity, became so attractive that eventually a Technical Corrections Bill was passed in the USA in an effort to level the playing field with Bermuda which had also signed a Tax Information Exchange Agreement with the USA. Nevertheless, Barbados was able to retain some major insurance entities which could justifiably, under the Double Tax Treaty, claim a 'permanent establishment' in Barbados.

Barbados has also remained the domicile of choice for Canadian interests through the Canada–Barbados Double Tax Treaty. In such a case, the captive must be resident in Barbados, and income generated from related foreign affiliates in the captive will avoid being considered Foreign Accrued Property Income and remains tax free until repatriated to Canada.

The British Virgin Islands, as one of the more recent jurisdictions with captive-insurance legislation, carefully fashioned its 1994 statute so as to allow effective regulation within a friendly business environment. It sought thereby to mirror the Bermuda and Barbados regimes, as well as the many other existing captive-insurance jurisdictions. Its financial services secretariat recognised that as a zero tax jurisdiction with a favourable climate of client confidentiality and with the fastest worldwide IBC growth rate, the need to stress the regulatory element was paramount. Hence the 1994 insurance legislation provided information access to foreign regulators and law enforcement officials in cases where there was suspicion of specific criminal offences. While the legislation still sought to ensure that it was attractive enough to capture offshore insurance and reinsurance companies, it nevertheless, maintained a respect for effective regulation.

In ensuring such regulation, like the other captive jurisdictions, it required that yearly audited financial statements for each company be filed with the regulatory authorities. It also gave to the Governor the right to approve merges and portfolio transfers, as well as the ability to suspend or cancel an insurer's licence. Further, the legislation allowed the transfer of long-term insurance business in whole or in part only if sanctioned by the Court.

When Ireland introduced its captive-insurance legislation, it sought to carve a special market niche by way of the direct writing captive. It courted and achieved success as a result of the ability to write insurance on a service basis – '*direct*' – throughout the EU, thereby reducing the expense of fronting fees. This business opportunity was enhanced by the adoption of the Second Non Life Directive (88/357/EEC) and the Third Non Life Directive (92/49/EEC) which allowed the setting up of a single insurance entity in Dublin, with the ability to write directly in most EU countries.

Ireland has adopted the main regulatory features present in the older jurisdictions, such as Bermuda, Barbados and Guernsey, particularly in the licensing procedures for captive-insurance companies. As with all of the jurisdictions, regulation starts *ab initio* with the initial application for licensing by the captive. At that stage, a detailed application document must include all details on the proposed company's activities by way of a business plan with *pro forma* financial projections, copies of policy wordings, justification for premium ratings, claims handling and reinsurance particulars, copies of the company's management agreement, biographical details of the proposed directors and sample copies of the proposed corporate constating documents. As with the other captive jurisdictions, the licence application must also specify the classes of insurance which the captive proposes to write.

One challenge which is a by-product of the direct writing captive is the need for regular and detailed financial reporting to be made available to regulators. However, the Irish experience has been good in that requests from local country regulators are dealt with by one regulator to the other regulator and not by the company's managers. The ongoing financial reporting and the need to keep acceptable levels of solvency, common in the other captive jurisdictions, is also a feature of the Dublin regulatory framework.

Ireland's example was followed, from a business and regulatory perspective, by Gibraltar when in 1996 it introduced re-domiciliation legislation allowing it to attract existing captives already established in other jurisdictions. This feature buttressed the ability of Gibraltar domiciled captives, like their Dublin counterparts, to write direct insurance in the European Union. As a dependent territory of the UK, and part of the EU under Section 227(4) of the Treaty of Rome 1973 and the Act of Succession 1973, it enacted legislation allowing compliance with EU directives, including those dealing with insurance.

There is an implied sanction of Gibraltar's regulatory regime, for its insurance legislation was reviewed by the UK's Department of Trade and Industry. Such acceptance by the UK is a recognition of captive insurance as an industry, and an approval of the direct writing of insurance by Gibraltar's captives. It is an acceptance which is multilaterised by virtue of its practice within the EU. In this regard, it is a multilateral governmental acceptance not dissimilar to the same recognition given by Barbados captive insurance through its double tax treaty with such partners as Canada and the USA.

The captive-insurance domiciles therefore reflect a balance between aggressive insurance business development within a framework of self imposed and externally sanctioned industry regulation. It is a dynamic industry which gives rise to a continuing set of complex business arrangements, and which is represented by the novel forms of insurance and reinsurance practised by both offshore and onshore jurisdictions.

A Dynamic Multilateralised Industry

It is possibly in the area of reinsurance and alternative risk financing that the offshore captive insurance industry has made welcomed incursions into the global insurance market. While it is now readily accepted that some of the traditional captive jurisdictions are hosts to some of the most important reinsurance entities and are also in the vanguard in the development of new reinsurance products, it is nevertheless necessary to conceptually explore reinsurance so as to better understand the transparent industry convergence in this area between the offshore and the onshore.

Reinsurers assume risks from insurers – namely primary insurers or ceding companies – who have sold policies to the insureds. Within the concept of reinsurance, coverages are included which are placed 'on top of' a particular firm's self insured retention. While it is referred to as direct excess reinsurance, it is not in essence true reinsurance. It does create a situation that resembles reinsurance arrangements since the retention by an organisation is like the primary insurer's risk retention. Reinsurance is either 'facultative' or 'treaty'. The former gives protection to the primary insurer for individual risks and accordingly is written on a policy specific basis. Treaty reinsurance provides cover for a class of insured or a block of business.

The insurance industry and its derivative, the reinsurance industry, are by their nature dynamic, since risk is not static and exposure, while not necessarily infinite, must however be managed and controlled within safe financial limits. The recent development whereby the insurance markets and the capital markets have been judiciously used in joint enterprises has had at its core the need to extend the insurance product to its maximum feasible capacity. In this regard, the offshore captive insurance jurisdictions have been important components in transactions which seek to obtain this elasticity of investment and better insurance utilisation. In particular, the jurisdictions of Cayman Islands, Bermuda and Barbados have been critical components within such novel structures.

To place this trend within a theoretical framework, it must be recognised that different types of insurance liability will require different levels of capitalisation. It is a truism that the greater the risk which is assumed, the more capital and reinsurance an insurer will need so as to be able to write the related risk premium. The traditional position has been that the assets in insurer's insurance funds have had to be liquid and placed in very highly rated securities. The trend has changed, however, and with the help of some captive insurance jurisdictions insurers now seek to match their insurance fund assets to their claims liabilities as they develop.

The use of captives is now particularly effective in the novel area of securitisation of insurance risks. This new practice encompasses the grouping of a portfolio of similar risks to be underwritten in a corporate vehicle. It is in turn then able to issue debt or equity securities to investors in exchange for their cash investment in the corporate entity. The investor, therefore, is able to make a corresponding, although indirect, investment in the financial results of the particular insurance risks.

The captive jurisdiction takes on a special significance, since conventional reinsurance may be too costly or inflexible, thereby making probable the use of the special purpose entity or existing reinsurance company. In this regard, securitisation of insurance risk must be distinguished from making an investment in an insurer's stock. For in the case of an insurance investment, there is an inherent limitation since the assets of an insurer will generally be limited to certain categories of investment. Such investments will carry a fairly well defined performance within the context of contemporary capital markets. For investment in the shares of an insurance company will only offer a significant return if the company makes an above average underwriting profit net of expenses.

The advantage of securitisation is the versatility which it affords in avoiding the duplication of exposure to similar risks within an investor's existing investments with those present in the securitising insurer's own investment portfolio. The investor has the ability to focus on the parts of the insurer's portfolio of insurance risks which the investor views as likely to generate the greatest pure underwriting profit, while at the same time not sharing in the wider operational and investments risks of the insurer. Hence, with securitisation the insurer may select the particular insurance business which requires particular investment effort. The use of securitisation, for example by way of offering to institutional investors of securities issued by a catastrophe reinsurer, has been successfully deployed by way of a Cayman Islands 'special purpose vehicle'. It is the flexibility of the Cayman legislation as a captive insurance jurisdiction which gives scope to such effective use of a global financing instrument such as securitisation.

While securitisation represents a novel and current basis for the formation of captive insurance structures, the more conventional reasons remain as compelling characteristics in facilitating insurance cover of a multilateralised structure. Japan is useful as a pedagogical analysis since as a very dynamic economy within jurisdiction which is small in size, it is easy to dissect its captive anatomy. Since 1953, a Japanese captive has been established for insurance of one of its oil companies; in the 1970s Japanese shipping companies with substantial international operations also set up captive insurance structures. In the 1980s and 1990s, as Japanese trading and manufacturing companies expanded their operations in new directions, including insurance and reinsurance, they established captives in the jurisdictions with favourable legislation such as Bermuda, Singapore, Ireland, Vermont and other US domiciles, Luxembourg and Guernsey.

The Japanese captives have been formed in an effort to secure greater control of risk financing; to encourage risk management and develop risk financing; to obtain insurance cover not available on the Japanese market; to transform cost centres into profit centres; and to directly access the reinsurance market with its increased capacity, information and education. They have also availed themselves of the new techniques such as securitisation to obtain cover for high exposure risks such as with earthquakes or petrochemicals. While tax is an important factor, it is not the sole factor and it is not the main *raison d'être* in the formation of the Japanese captive – a feature which is virtually the same in all captive insurance structures. In the case of Japan, its companies are taxed on their worldwide income when repatriated to Japan. Provided that the captive pays income tax in excess of 25 per cent, the remainder of its income is not taxed unless and until it is repatriated to Japan. This tax regime has some similarities with the Canadian and American captive structures established in Barbados where the presence of a double tax treaty allows for greater flexibility.

The multilateralised captive structure is accordingly one which takes optimal advantage of the prevailing legislation, regulation and taxation in a captive insurance domicile while at the same time facilitating the orderly development of global insurance arrangements. This predominant and positive feature of the captive has been given such favourable recognition by the fact that within the captive domiciles themselves there is increasing activity for formation of captives in other captive insurance domiciles, as for instance in the case of the Caribbean electric utility companies considering the scope for structuring a group captive in a Caribbean captive insurance jurisdiction.

The positive features of the captive have also received the imprimatur of US regulatory authorities recognised by the inward movement of establishing captive insurance domiciles within the USA itself. American captive insurance jurisdictions such as Vermont, Illinois, Arizona, Colorado, New York, Hawaii, Massachusetts, Ohio and US Virgin Islands now complement the older offshore jurisdictions such as Bermuda, Cayman Islands and Barbados. Furthermore in Europe, even though Ireland may be considered a tax encouraging domicile, it is Germany which acts as a captive insurance jurisdiction to some of the world's Fortune 500 Captives. The captive insurance company is, therefore, increasingly a creature which may be nurtured offshore or onshore – a feature which recognises its legitimate business purpose. Its increasing multilateralised focus is also represented in the fusion of captive and non-captive legislation, as in the case of the recent Barbados legislation which allows for setting up of offshore and onshore insurance structures under one umbrella statute and further utilisation, if available, of tax credits under applicable double tax treaty legislation.

The captive insurance industry meets the standards of substantial business activity set out in the OECD report. Not only does it encapsulate very dynamic international insurance business activity as represented in conventional and non conventional uses, but it is also one which is substantially managed in the various captive insurance jurisdictions. Major international insurance brokers and intermediaries have established offices in these jurisdictions. While Bermuda represents an extreme case, with every major insurance entity having established a real presence in that country, Barbados, Cayman Islands, Guernsey and others also manifest varying levels of substantial business activity. In the case of Barbados, the industry employs over 200 people directly and a much larger number indirectly. It also adds significantly, as in the case of Bermuda, to the Barbadian tourism industry where many people make frequent visits to attend statutory meetings as well as meetings which are set up for pure business planning, development and execution. The insurance industry also transfers technology so that many professionals learn new skills in international insurance and more generally innovative financial service products.

The Challenge of Regulation

The OECD report considers the issues of transparency and regulation as critical to an orderly world financial order. The captive insurance industry manifests regulation and suspension at a micro level within the particular jurisdictions, and at a macro and more discrete level by way of participation in the various international bodies specifically established for the purpose of ensuring greater supervisory oversight.

All the captive jurisdictions carry very comprehensive procedures for the licensing of an insurance company and equally elaborate requirements for its ongoing operations. All the initial licence applications call for detailed information about the proposed directors and shareholders, as well as carefully spelled out business plans with *pro forma* financial projections for at least five years. These plans also spell out net and gross premiums income as well as the reinsurance programme (if applicable) by class. These licence applications are buttressed by legislation in all of the jurisdictions which sets out margins of solvency which must be maintained throughout the life of the captive. Hence, there is an implied ongoing legislative oversight which is complemented by the requirement, in all the jurisdictions, to file annual financial statements with the regulatory authority. Furthermore, all the captive jurisdictions do not allow fundamental corporate or financial changes without the approval of the regulators, even if, in some cases, the requirement is one of mere notification. It is, therefore, not surprising that the level of insurance insolvencies in captive insurance jurisdictions is low.[4] Indeed, where those insolvencies have taken place, the cause cannot with justification be attributed to insufficient regulation.

Regulation of the captive is also evidenced at the macro level through the supervisory activities of the International Association of Insurance Supervisors (IAIS) and the Offshore Group of Insurance Supervisors. In the case of the Offshore Group, its principal objects are carefully spelled out in its charter and include the establishing of standards for supervision and the facilitating co-operation between Supervisors of offshore insurance business. It makes as a condition of membership the need for the new member to agree to be supervised in accordance with the standards by the Group. Furthermore, elaborate provisions call for the presence of an Evaluation Panel which acts as a screen for new membership applications, and the Group has established standards for the supervision of insurance business to be adhered to by all members.

The International Group naturally has a larger membership and resources. Many of the offshore captive jurisdictions are represented. Furthermore, it extends observer status to a wide range of international insurance businesses, national insurance associations, international governmental organisations and international law firms as well as international accounting firms and leading research institutes. It has established a shared Supervisory Standard on Licencing and in October 2000 developed a very comprehensive Licensory Textbook. In 2001 it launched an Insurance Regulation Database. This body is very keenly involved in training of staff from various insurance regulatory agencies and its Technical Committee is in the vanguard of developing and main-

4 See the very useful text *Cross Frontier Insolvency of Insurance Companies* by Gabriel Moss QC (Sweet & Maxwell, London 2001) and, in particular, the article on Bermuda by Ian Kawaley and on Barbados by Trevor Carmichael.

taining standards in accounting, reinsurance and disclosure. A critical feature of its work is the multilayered involvement of critical persons within the international insurance industry as was evident in the Tripartite Insurance Fraud Conference organised jointly with the Association of British Insurers, the Association of Chief Police Officers and the International Association of Insurance Fraud Agencies. It attracted at least 80 delegates from 17 countries and the offshore captive insurance jurisdictions were to a large degree represented.

Captive insurance regulation is strong within the jurisdictions themselves through the various supervisory offices as well as in the broader international context through the vibrant oversight organisations. The regulation within the jurisdictions is within the licensing procedures as well as the ongoing statutory solvency and reporting requirements and is complemented by the discrete supervision exercised by the international regulatory bodies. The mix of internal and external regulatory forces have ensured the healthy development of the captive insurance industry, a regime which had its origins in the offshore financial centre and is now also strategically present in some of the 'onshore' OECD jurisdictions.

The Aftermath and Beyond

The captive insurance industry as practised in the offshore financial centres is clearly not in conflict with the principles and spirit of the OECD report. The nature of the industry, its extension to OECD, some jurisdictions, the substance of the industry generated from within the particular domiciles, and the overall domestic and international regulation and supervision, all contribute to insulating the captive insurance industry from the criticisms within the report.

Appearing before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs, the US Treasury Secretary expressed concern about the ability of one country or a group of countries to interfere in another country's methods of structuring its own tax system. The OECD itself has agreed to three modifications to the repor: that coordinated defensive measures would no longer be taken against perceived offending jurisdictions; that the text of 'substantial activities' would no longer be applicable; and that the time for offending jurisdictions to commit to 'transparency' and 'exchange of information' would be extended to 30 November 2002.

The OECD published a new report on 11 July 2001 entitled 'A Report on the Misuse of Corporate Vehicles for Illicit Purposes', put together by its Steering Group on Corporate Governance. It calls, among other things, on intermediaries engaged in forming corporate entities to maintain information on beneficial ownership or undertake investigations on such ownership where suspicious behaviour is apparent. It has also extended the period for jurisdictions to make a commitment to transparency and regulation from 31 July 2001 to 28 February 2002.

Irrespective of the reports, it is clear that there is a need to examine such reports in a sectoral sense as has been undertaken in relation to captive insurance within this chapter. When one considers that the scope of the insurance industry and the banking industry has become less obvious as a result of features such as securitisation, it is evident that matters such as transparency and regulation need to be considered also in an industry specific sense to the degree that it is possible.[5] It is, therefore, not surprising that industry bodies including the International Actuarial Association are examining such issues. Such an examination will seek to establish that the concerns of the OECD reports are neither purely jurisdiction specific nor industry specific, particularly where the boundaries of industry and jurisdiction are no longer best viewed in the earlier conventional sense of the twentieth century.

5 The Report of the Working Group on Offshore Centres of the FSF recognised that the growth of London as the largest offshore banking centre was directly related to regulations placed on the US banking sector. London has also been a leading insurance and reinsurance centre and epitomises the insurance/banking fusion common to both the offshore captive and the onshore reinsurance company.