FERMA regulation

Laurent Nihoul of FERMA's Captive Working Group suggests regulatory developments should not be described as a negative trend, but an opportunity to improve professionalism

What trends and developments are you seeing in the European captive insurance market?

I would highlight three major trends. The first one is about the regulatory environment. The maturing of the industry over the last decades has been logically accompanied by a growing level of professionalism and regulatory challenges. For example, the International Financial Reporting Standards (IFSR) consolidation rules and Solvency II for European captives, which have already changed the captive landscape. I do not see this trend slowing down. Solvency II is now up and running, the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) principles are obviously already a hot topic but let us also think about IFRS 17 and the US-EU agreement on insurance and reinsurance. That will add complexity to the captive industry, but this is the price to be paid by a mature industry to keep on growing.

The second trend I see is on the technical side. New risks and new solutions are more and more developed through captive entities. Employee benefits and cyber covers are currently on the front page and will keep on growing, but more sophisticated and innovative solutions will continue to appear.

The third trend will undoubtedly be about how risk managers and captive owners will adapt to the changes in the set of skills needed to cope with reporting (transfer pricing), tax (BEPS), regulatory (Solvency II) or internal financial aspects (being challenged by the chief financial officer about consolidation impacts). The continuous soft market we are facing, coupled to those increasing regulatory constraints, hence increasing running costs, will narrow the traditional positive contribution of captives to their parent companies, for example, financing frequency to lower the total cost of risk, and consequently risk managers will have to switch more and more from that old 'insurance oriented' model to more sophisticated approaches and skill sets (corporate finance analysis) in order to meet their senior management's expectations in terms of captives' return or profit. I do believe this will be a key, but interesting, challenge for our profession in the coming years and professional education will have a huge role to play.

Are captives still experiencing a complex regulatory environment in Europe?

The regulation surrounding captives has constantly been extended in the recent past and this is not expected to decrease in the future. So yes, and without a doubt, captives are experiencing a complex regulatory environment, and not only in Europe because that trend is global.

Solvency II was obviously the major change for European captives and we are now going out of the first years after implementation. What we see is that the market has finally positively adapted to the new set of rules and we have not experienced the disastrous consequences predicted before Solvency II Directive enforceability. In the very beginning, the new regulatory constraints were presented as the scariest threat captive owners would ever have to face.

European domiciles were predicted to be abandoned because of various arguments such as inadequacy between the new regime and captives' specificities; increased capital requirements; uncontrollable and unmanageable governance processes; and higher management costs. Obviously, the market has not avoided the closing of some dormant structures or the move of some frightened companies to non-EU domiciles but globally it is now working well.

This is a lesson for future regulatory developments: that should not be always seen as a negative trend but also as an opportunity to constantly improve the professionalism of the captive industry. With strict regulation comes a better governance. With better governance, you have far more solid business processes and rationale. And all of this gives you credibility and maturity to constantly improve the scope of your captive business in uncharted areas. The key is obviously to maintain the principle of proportionality and a constructive dialogue with the authorities to match the captive industry's specificities.

Has FERMA received positive feedback on its BEPS guidelines, released in June?

The Federation of European Risk Management Association's (FERMA) BEPS paper was indeed positively received by the OECD tax department. The OECD now recognises the role of captives as a genuine risk management tool and the related insurance benefit for companies. We have established a fruitful dialogue with the tax department and FERMA's paper has been passed on to the OECD transfer pricing and financial transaction working group. As such, we do believe that risk managers' concerns are now fully part of the discussion.

We will continue our dialogue with them to support a consistent multilateral approach by national authorities. Obviously FERMA wanted to dispel misperceptions about captives through detailed explanations about how and why they are used as a risk management tool by companies, but our main objective was and remains promoting consistency in the way BEPS principles will be applied to captives. At the core of our paper are the proposed guidelines, which are meant to support national authorities when transposing BEPS actions into their national laws. The guidelines cover three areas that raised certain questions of interpretation by the OECD members during the implementation stage of the BEPS actions published in 2015: commercial rationale, substance and governance, and transfer pricing. The objective of our guidelines is therefore, mainly to avoid creating a patchwork of diverging national legislations inspired by BEPS. We will continue to be involved and to follow up with the support of all national associations composing FERMA.

Are there any future plans to produce similar guidelines for other industry challenges?

FERMA's BEPS paper has been transformed into the first volume of a new collection, FERMA Perspectives, which we will be launching during the FERMA Forum in Monte Carlo mid-October. This first one is titled Captives in a Post-BEPS World and once a year we will publish a new volume gathering the thoughts and work of industry experts about topical matters.

We will undoubtedly continue to produce such guidelines and share knowledge with and for the industry, but it will not exclusively relate to captives and their challenges.

How will the signing of the US-EU covered agreement on insurance and reinsurance help captive entities in the European space?

According to its very specific nature, this agreement will mainly affect the global insurance and reinsurance market rather than the captive industry. It contains three substantive areas: group supervision, exchange of information and reinsurance, the latter being the most visible one for risk and insurance managers.

The removal of collateral requirements for EU reinsurance carriers operating in the US will certainly result in more additional capital available for the reinsurance industry, thus additional capacity for insuring and reinsuring risks. That could have an interesting impact on market prices for corporate insurance buyers and captive owners.

EU reinsurers' collateral burden in the US is estimated at approximately $40 billion. Even though the collateral relief will not be absolute or complete, and will have to meet several critical conditions, that could have an interesting impact on the reinsurance market capabilities in the coming years.

As such, we believe this is a valuable new step as we always promote regulatory changes aimed at improving market competition and flexibility because it globally helps FERMA members to achieve their objectives.

What will FERMA be working on over the next 12 months?

I was elected as a FERMA board member last June and was appointed as the new board leader for our Captive Working Group during our last meeting on 19 September. I will soon meet with my fellow working group members to draft our agenda for the next years.

On the captive side, we will obviously continue our dialogue with the OECD in respect of BEPS questions and their further developments as well as pursuing our monitoring of Solvency II practical impacts and potential solutions to be developed to help our national associations and their members in coping efficiently with the new regulatory framework.

We should also focus on IFRS 17, as it is expected to be another main challenge for captive owners in the next few years. After Solvency II, that will be the next big shift for insurance operations.

In short, this will represent a significant change in the way insurers have to calculate their best estimate for provisions and will involve in-depth actuarial tasks. With an implementation date expected for 1 January 2021, we have to start to focus right now.

Beyond the captive industry challenges, the workload for FERMA is still substantial: from Brexit to cyber risk developments, from environmental regulation to risk governance, the agenda is already full of exciting and interesting challenges.

Education is also key for us and the RIMAP (the European professional certification FERMA created over the past few years) being now up and running, we definitely have some more than interesting years to come for the European risk management community. CIT