BUSINESS INSURANCE

Latin American Captives

2018 World Captive Forum

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Fort Lauderdale, FL

#WorldCaptiveForum

Agenda

- Bartolome Massot
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  - Captive as Risk Management Tool
  - The Latin American Captive
- Esperanza Borja Mead
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  - Challenges
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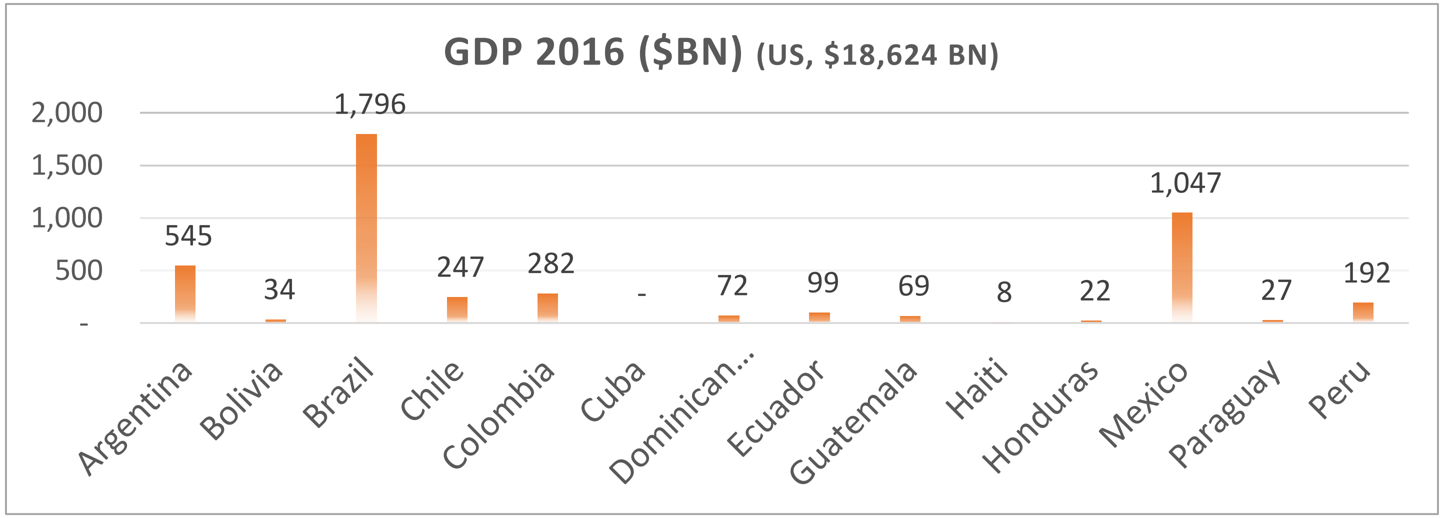
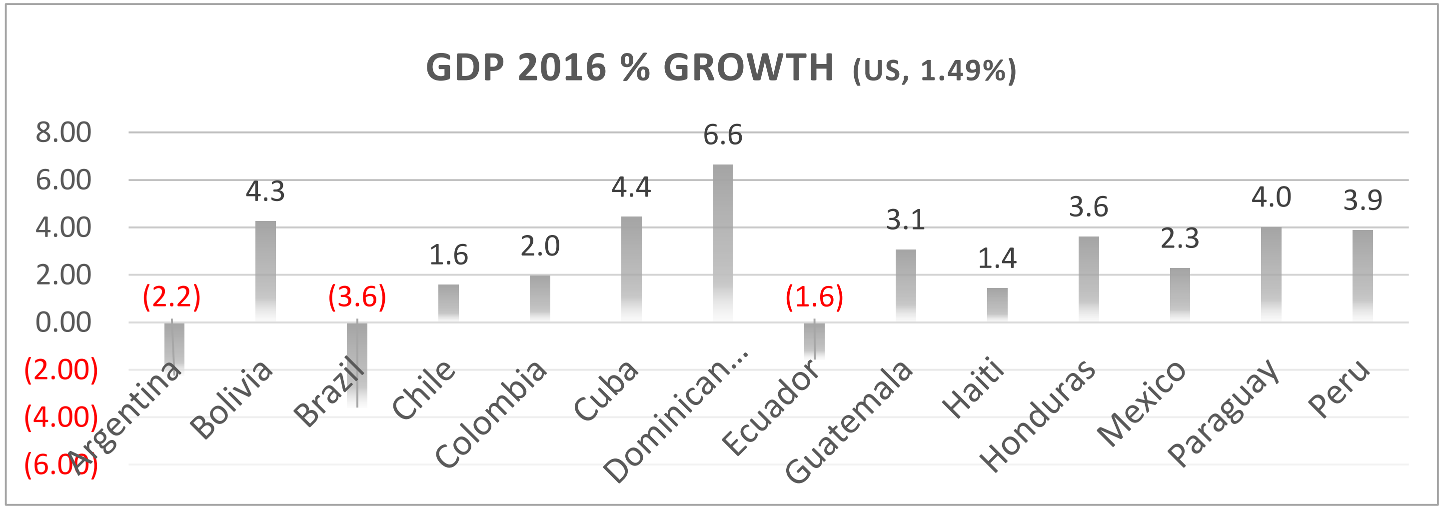
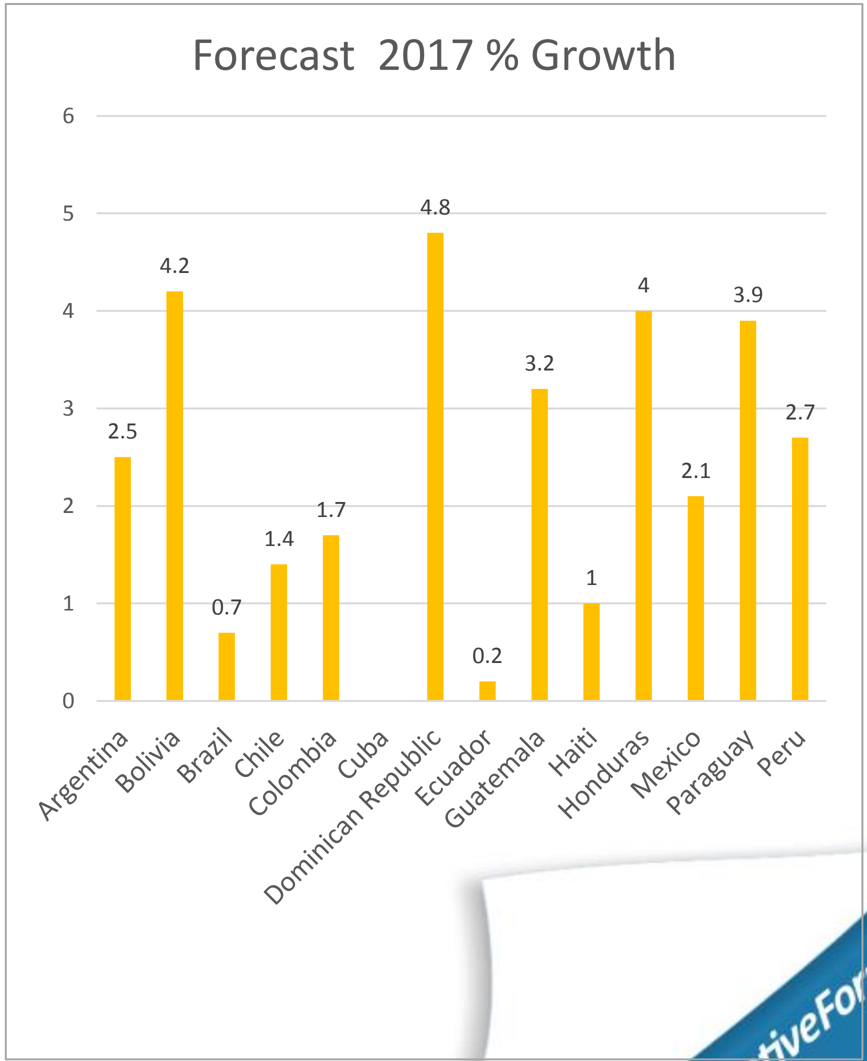
- Gabriel Rueda:
  - Case Studies
- Javier Ordoñez-Namihira:
  - Tax Regulation in Latin America
  - BEPS

Economic Context







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Source: World Bank

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Economic Context

Stat	Argentina	Brazil	Colombia	Mexico
Industries	Food processing Motor vehicles Consumer durables Textiles Chemicals Petrochemicals Printing Metallurgy & steel	Textiles Chemicals Cement, lumber, iron ore, tin, steel Aircraft Motor vehicles	Textiles Beverages, Food processing Oil Clothing Chemicals Gold, coal, emeralds	Food and beverages Tobacco Chemicals Iron, steel, Petroleum Mining Textiles Motor vehicles Consumer durables Tourism
Sector > Industry	30.6%	27.4%	38.1%	34.2%
Sector > Services	59.1%	67.2%	55.1%	62.1%
Sector >Agriculture	10.3%	5.4%	6.8%	3.7%
Industrial Production growth rate	6.7%	11.5%	5.5%	6%
Market capitalization of listed companies	$34.24 Bn	$1,230 Bn	$56.2 Bn	$348.35 Bn
Number of SMEs	0.9 million	4.9 million	0.6 million	2.89 million
Real growth rate	1.9%	0.9%	4%	3.6%
Medium term lending rate	14%	37%	13%	5%

Source: World Bank, ECLAC

Captive Market

Mexico & Colombia in lead:

- Varied captive structures
- Consistent growing interest
- Receive the most effort from the captive sector promoters

Peru, Argentina and Brazil, highly underdeveloped markets due to:

- Captive concept not well understood/communicated
- Perceived Regulatory barriers
- Large Commercial Insurers in fierce competition
- Large companies with strong foothold in their industry

Captive Market

Tax and Regulatory Environment throughout Latin America:

- Changes in Domestic Tax Legislation – Tax Regime
- Exchange of Information – Effective TIEAs
- Insurance Laws and Regulators' requirements
- Approach towards OECD "BEPS Project"

General Tax Implications for a Captive:

- Withholding Tax on Reinsurance Premiums
- Deductibility of Premiums?
- Loans from Captive?
- Taxation on Investment Income derived by Captive
    - CFC Rules: Accrual recognition and Reporting

General Tax Implications in Mexico for a Captive

Withholding Tax on Reinsurance Premiums:

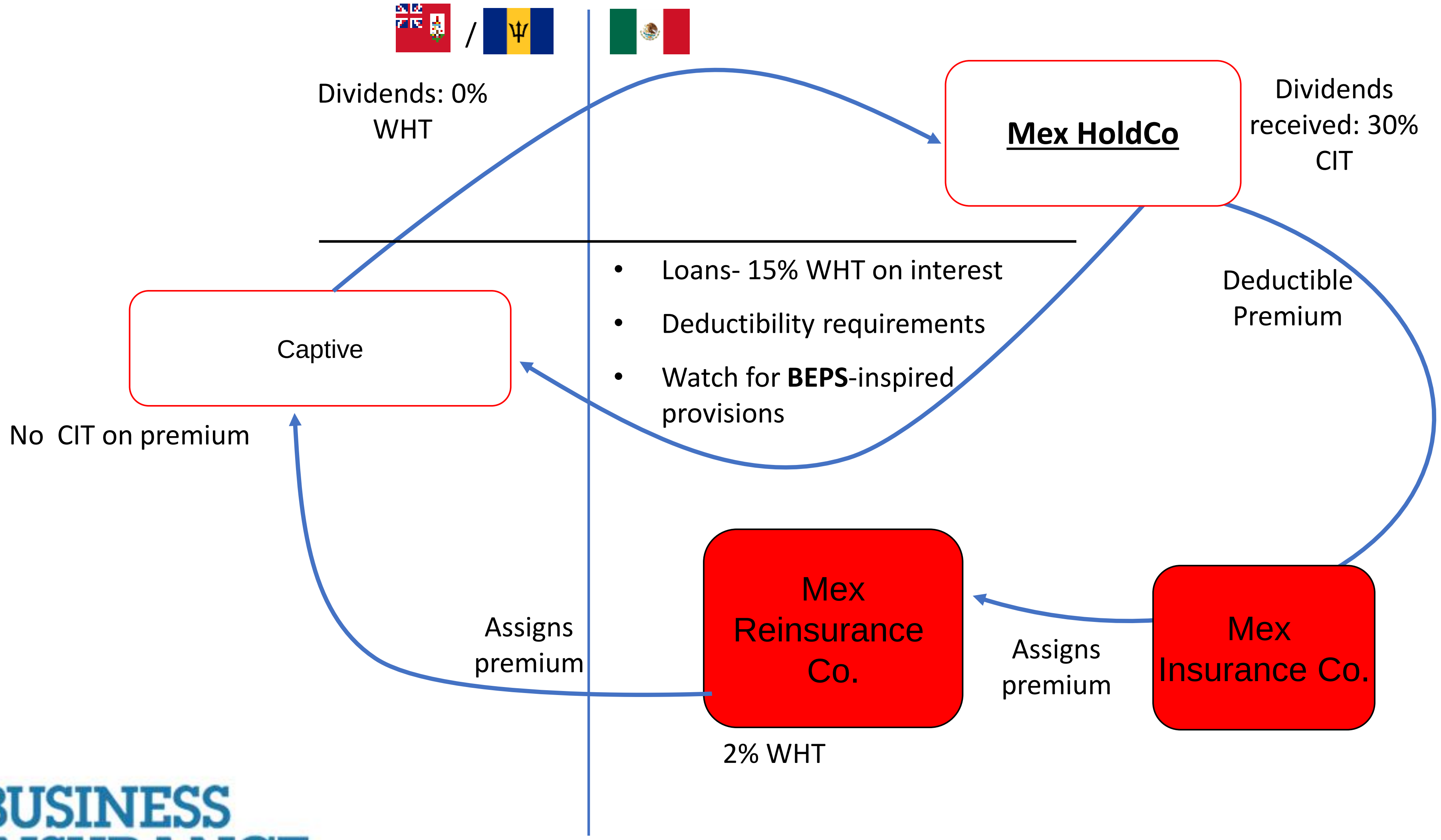
- General Rule: 2%
- GAAR: 40% - TIEA between Mexico and multiple jurisdictions

Deductibility of Premiums:

- Indispensable –e.g. actual risk transfer; commecial insurance market does not usually cover risk
- Business Reasons & Substance
- FMV / Transfer Pricing analysis

Loans from Captives: See next slide

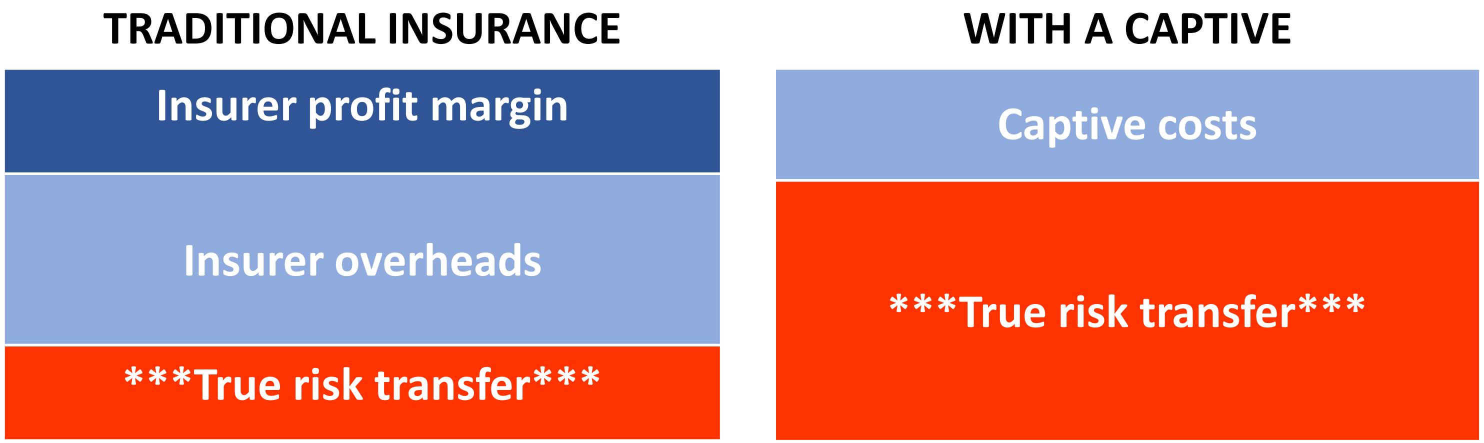
General Tax Implications in Mexico for a Captive



Captive as Risk Management Tool

- **Control**
  - Increased control over Insurance lifecycle
- **Coverage**
  - Increased Coverage
  - Tailor-made policies
- **Prevention**
  - Increased control over risk enables improved loss prevention and loss frequency
- **Lower Costs**
  - Tailor-made policies improves loss severity and risk financing costs
  - Captive enables access to RI markets
- **Revenues**
  - Over capital invested
  - Premium holidays

Captive as Risk Management Tool



- Traditional insurance: not 100% of premium paid is used to truly transfer risk
- A captive can be used to increase the proportion of premiums paid to truly finance risk transfers
- The costs of insurer overheads and margins are saved, achieving equivalent (or better) coverage at a lower cost via a captive

CAPTIVE OBJECTIVE = LOWER TOTAL COST OF RISK

Captive as Risk Management Tool

- Retention of underwriting profit:
  - When losses are lower than expected, the premiums paid to the captive represent profits to the captive owners – With traditional insurance, this would simply be lost money and profit for the insurer

Example:

Premium		$100M
Incurred losses	$25	
Captive expenses	$25	
Residual	$50	→ ***Profit available to captive owner***

- With a well-designed program, the captive goal is to become a ***profit center by controlling the costs or risk***

Captive as Risk Management Tool

A captive is an ***extremely flexible risk management tool***. The owner can decide, for example:

- Retentions in captive, and levels reinsured
- Exact suite of service providers chosen to best service the captive
- Risks insured in captive – the captive does not have to cover all risks:

'Good' Risks **Good historical loss ratio**	**Place in captive.**
'Bad' Risks **Bad historical loss ratio or limited experience**	**Exclude from captive; insure via traditional means.**

- ***CAPTIVE OBJECTIVE = COMPLETE CONTROL OVER ENTIRE RISK MANAGEMENT PROGRAM***

Captive as Risk Management Tool

- ✓Ideal for uninsurable risks or “good risks”
- ✓Adds overall value by enhancing cost control
- ✓Stabilizes insurance costs
- ✓Reserves represent a source of loan capital over time
- ✓Defers tax and improves tax position over short and medium term

Captive as Risk Management Tool

Many different types of captive exist, depending on the needs of the insureds, including:

Single Owner

Direct

Reinsurance

Multiple owner: group / association

Direct

Reinsurance

'Pure' captives. Separately incorporated company.

Rent-a-captive and segregated cell structures

Not separate incorporation. Less control but lower costs than other captive types.

Cost	Captive	Cell
Full Control	✓	✗
Capital	✓	✗
Regulatory fees	✓	✗
Management fees	✓	✓
Auditor's fees	✓	✗
Director's fees	✓	✗
Indirect costs	✓	✓
Liquidator's fees	✓	✗

The Latin American Captive

Reinsurance Market / ILS / Risk retention

Captive
- Formed overseas
- TIEAs applies

Fronting Insurer
- Front is referred as “Emisor Local”. Registered in insured’s country
- Requires collateral and fronting fees

Cedent
- LatAm insurers typically take risk

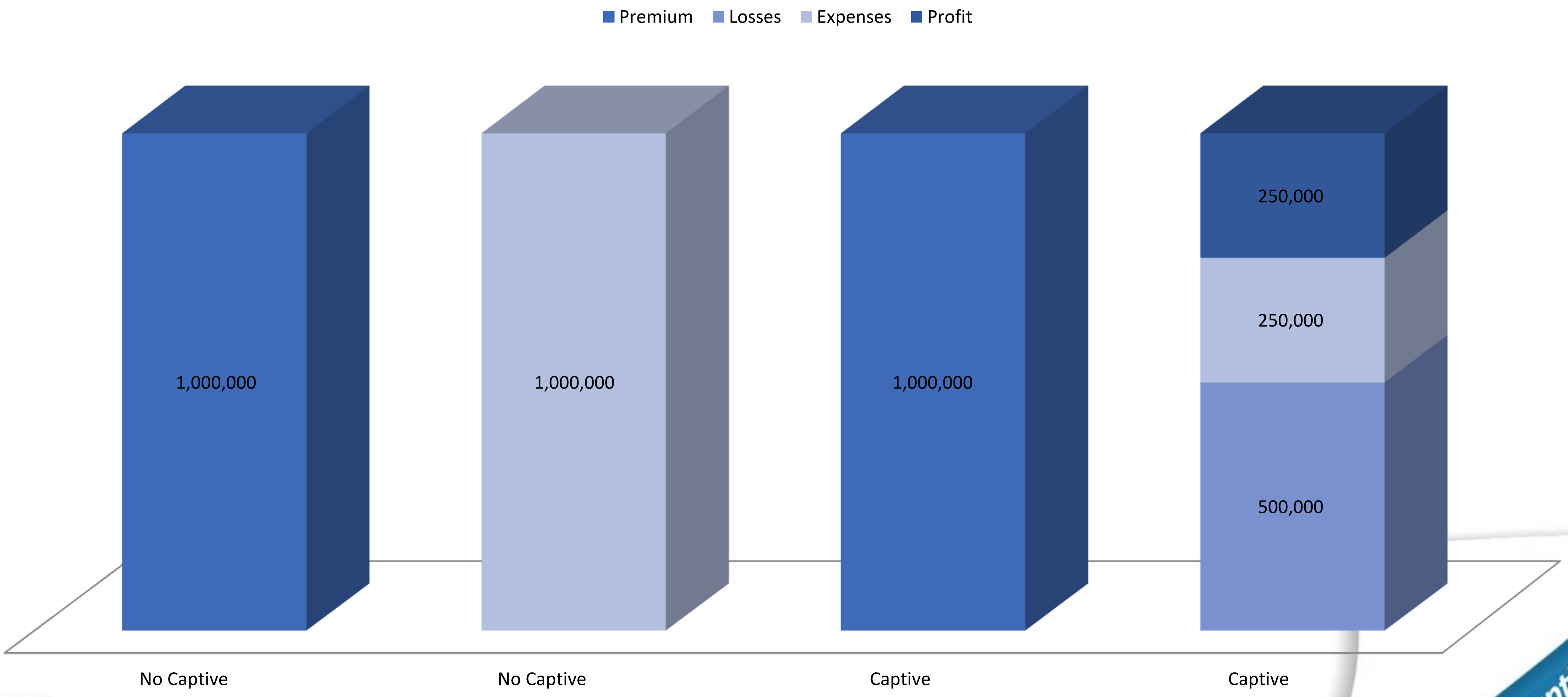
Insured

BEPS Risks in the Insurance Sector

The main general BEPS risks in the insurance sector (including captives) relate to:

- Excessive interest deductions in entities that are part of a group with an insurance company.
- Insurance companies, and entities in a group with an insurance company, using interest to fund non-taxable income.
- Excessive premiums.

Why a Captive?
Opportunity of Underwriting Profit



Note: Hypothetical example

Why a Captive?
Opportunity of Underwriting Profit

Note: Hypothetical example

Why a Captive?

- **Benefit from Excellent Loss Control**
  - Good historical loss ratios.
  - Greater underwriting profit.
- **Feasibility Study – Reasonable Premiums**
  - Determine if a captive is the right solution for the business.
  - Develop reasonable premiums by an actuary.
  - Requires approval of the actuary in the selected domicile.
  - File with the regulator of the selected domicile.

Why a Captive?
Actuarial Opinion – Reasonable Loss Reserves

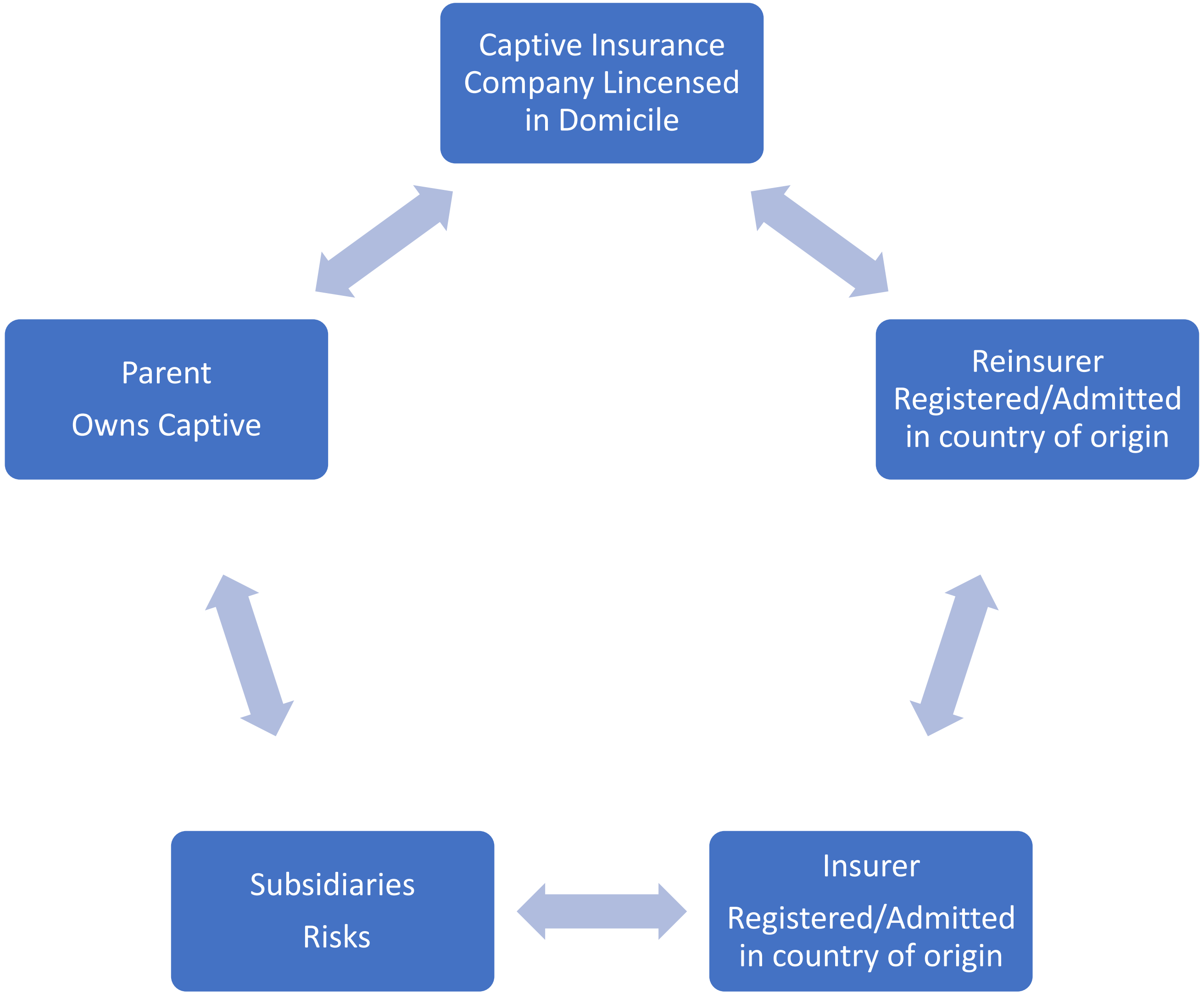
- Actuary determines Incurred But Not Reported (IBNR) reserves at year end.
- Actuary issues a statement of actuarial opinion giving an opinion on the adequacy (or inadequacy) of the loss reserves. It is filed with the regulator of the selected domicile.
- Actuary prepares actuarial report with exhibits that supports the opinion.   It is provided to the regulator only if requested.

Why a Captive?

- **Lines of Business Covered**
  - Property Insurance
  - Casualty Insurance
  - Financial Lines
  - Cyber Liability
  - Terrorism Insurance
  - Catastrophe risks

- **Direct Access to Global Reinsurers**
- Since the captive is an insurance company, it can retain some risks and buy insurance for the remaining risks from reinsurers.
- Examples of reinsurers:
  - Swiss Re
  - Munich Re
  - Lloyds
  - Hannover
  - Scor
  - AIG
- Savings by negotiating lower reinsurance premiums.

Challenges
Cost of Double Fronting – 2% to 6% of the premium for each fronting

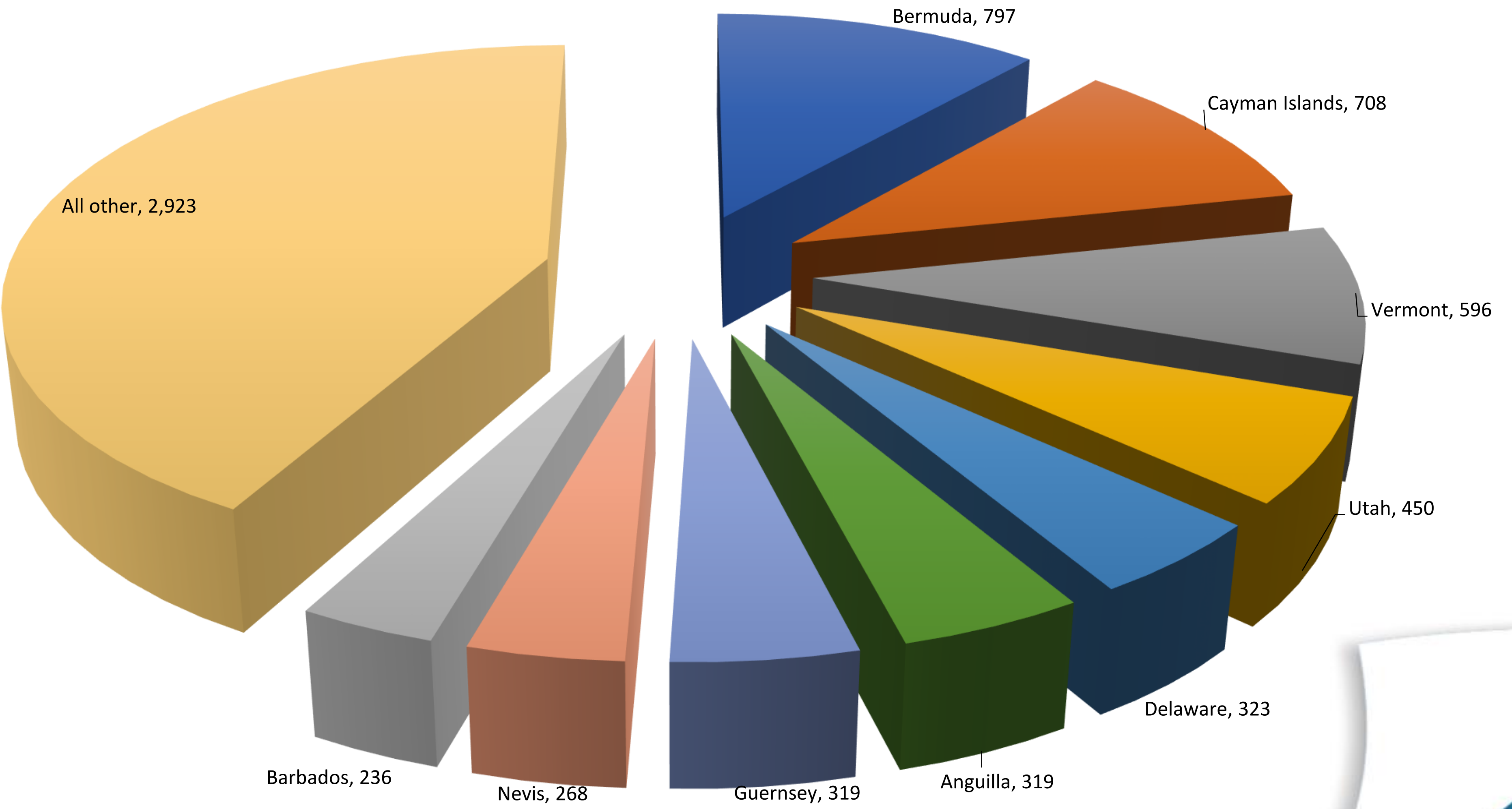


Challenges

- **Cost of Managing the Captive**
  - Approximately 3% to 6% of premium (minimum of $100,000) for a standalone captive.
  - Captive Cells are a less expensive alternative.

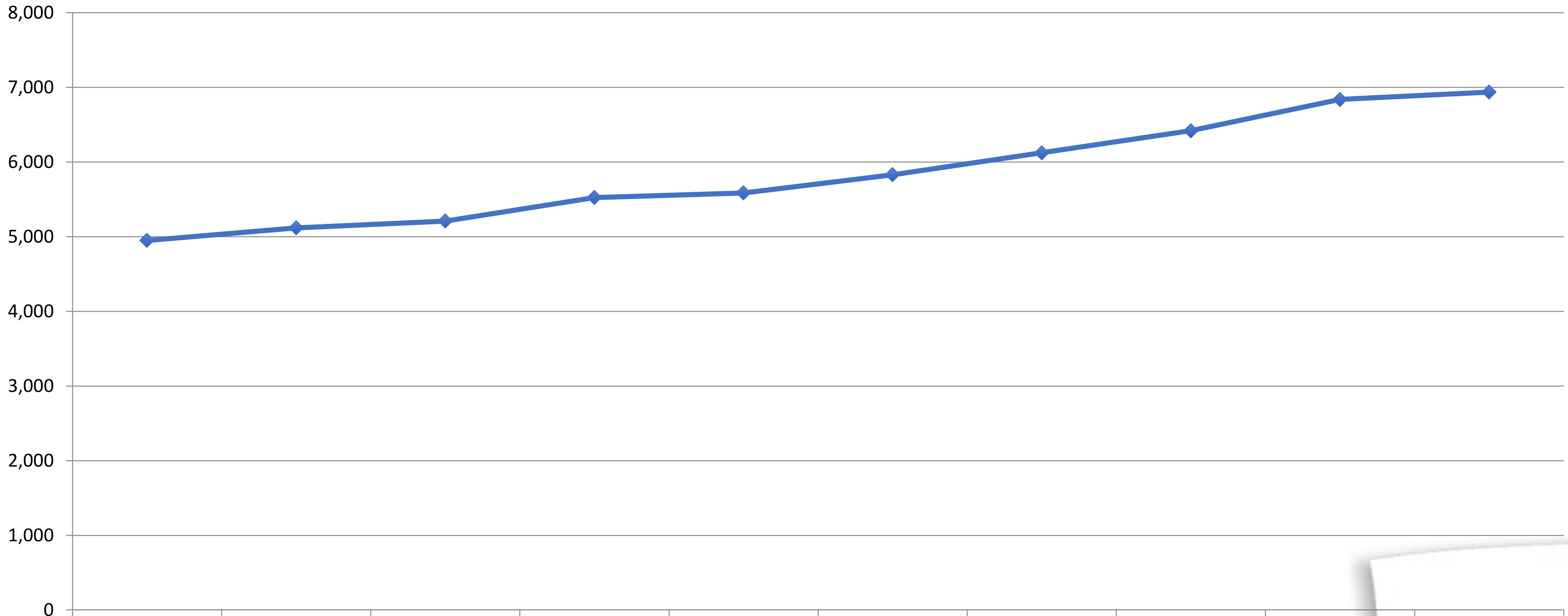
- **Lack of Understanding**
  - Provide more education on how captives work.

Challenges
Capital Requirements & Regulations Vary by Domicile & Class of Business



Source: Business Insurance 2016 Captive Managers & Domiciles Rankings & Directory.

Total Captives Worldwide



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Total Captives	4,951	5,119	5,211	5,525	5,587	5,831	6,125	6,420	6,839	6,939

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Source: Business Insurance 2016 Captive Managers & Domiciles Rankings & Directory.

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Total Captives in Latin America

Less than 3% → Opportunity

Summary

- Provide opportunity of underwriting profit.
- Need to overcome challenges.
- Deliver more education on how captives work.
- Result growth opportunity for captives in Latin America.

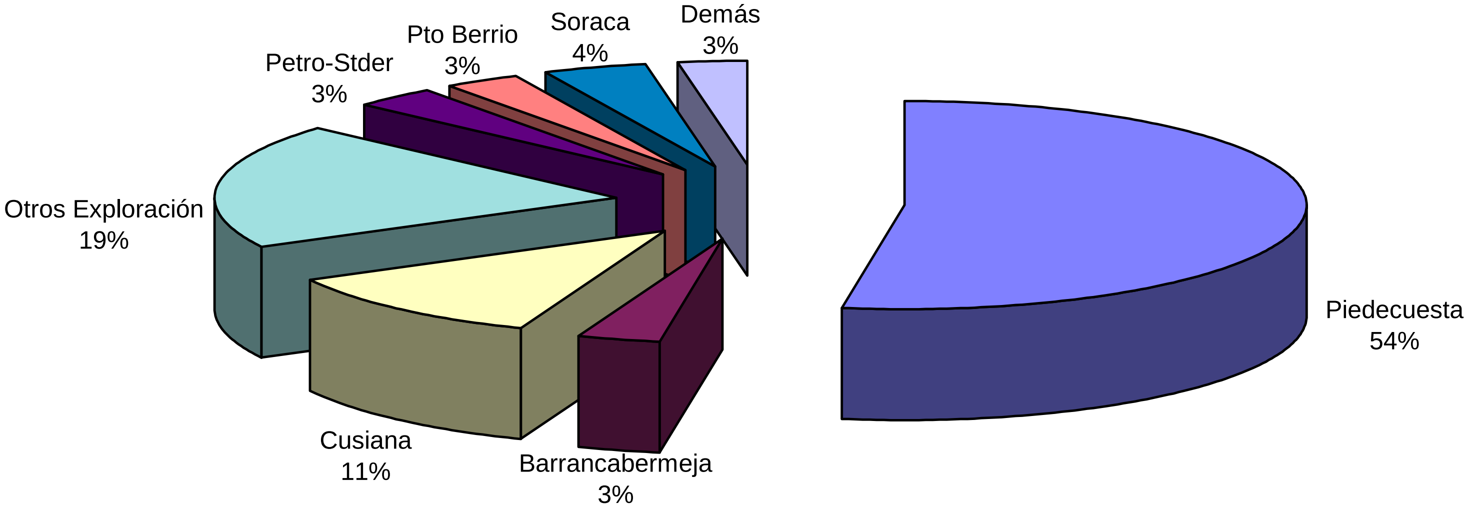
Rent-A-Captive (A solution for middle market clients)

- A SAC (Segregated Accounts Company), can hold several cells and hence optimize the expenses for the cell owner.
- A cell acts the same as whole captive within the placement of the risk, either retaining or not a share of the exposure.
- Risk Management is key for the creation of "Taylo-Made" solutions.
- A cell is just a vehicle for setting the feasibility of the solution requested by the client.
- Cells can be used wholly owned risks as well as to provide to solutions to a group of stakeholders.

A Cell for a contractor who requires a CPE policy. (Contractor´s Plant and Equipment)

Summary of Equipment covered			
Range (USD)			
From	to	Quantity	Share %
1	5.000	8	3%
5.001	10.000	6	3%
10.001	20.000	90	38%
20.001	40.000	17	7%
40.001	80.000	23	10%
80.001	160.000	12	5%
160.001	300.000	41	17%
300.001	600.000	38	16%
600.001	More	2	1%

Locations throughout the country



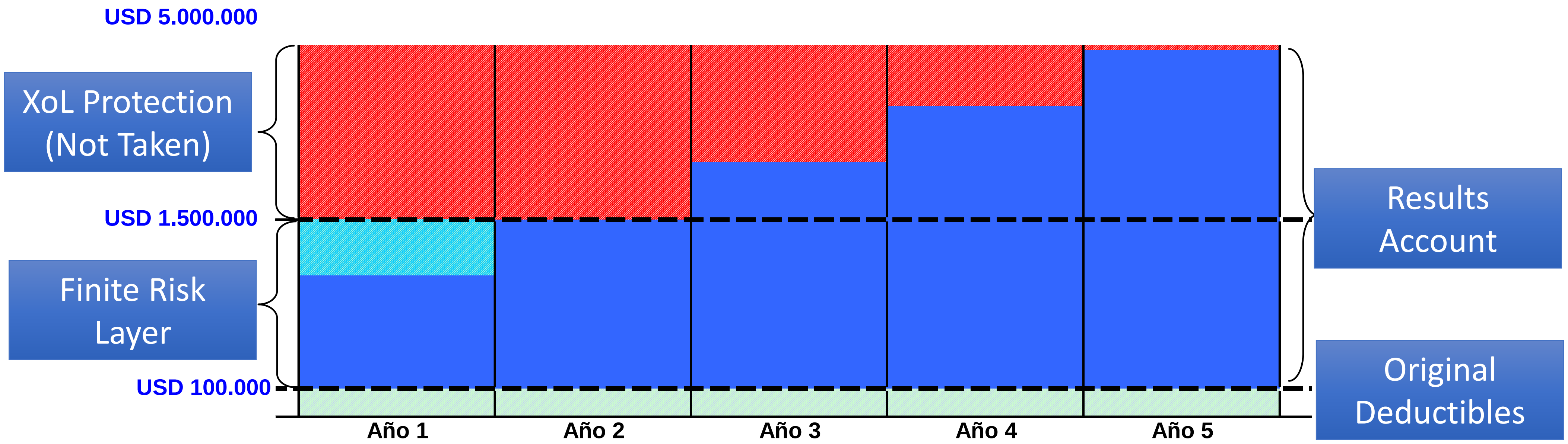
Equipment covered included: Side booms, cranes, Bulldozers, Compressors, water pumps, power plants, etc.

Drilling equipment was left, to be covered by a later policy.

A Cell for a contractor who requires a CPE policy. (Contractor´s Plant and Equipment)

- At the beginning the client was of the idea of buying coverage only for cat exposed locations and improve the basis of the coverage they were buying.
- But as the analysis went on the idea of a self retention fund was getting the best result for the owner.
- At the beginning it was offered a finite risk layer protected by an XoL layer on top of it.
- The risk appetite of the client encourage them to retain the whole exposure, en particular due to the small print on traditional coverage they obtained in the past.

A Cell for a contractor who requires a CPE policy. (Contractor´s Plant and Equipment)



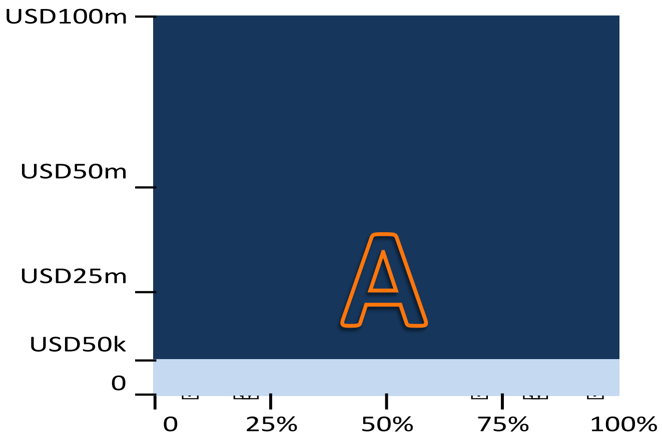
	Año 1	Año 2	Año 3	Año 4	Año 5	Total
Prima a Pagar	USD 1.099.203	USD 1.099.203	USD 1.099.203	USD 1.099.203	USD 1.099.203	USD 5.496.015
Fronting Cedente en Colombia	USD 27.480	USD 27.480	USD 27.480	USD 27.480	USD 27.480	USD 137.400
Fronting reasegurador Intl.	USD 27.480	USD 27.480	USD 27.480	USD 27.480	USD 27.480	USD 137.400
Fee Alquiler Celda	USD 43.968	USD 43.968	USD 43.968	USD 43.968	USD 43.968	USD 219.841
Cuenta de Experiencia	USD 1.000.275	USD 1.000.275	USD 1.000.275	USD 1.000.275	USD 1.000.275	USD 5.001.374

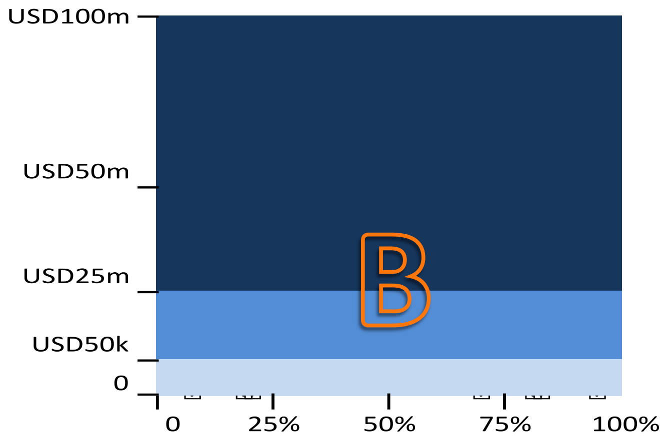
A Cell for a contractor who requires a CPE policy. (Contractor´s Plant and Equipment)

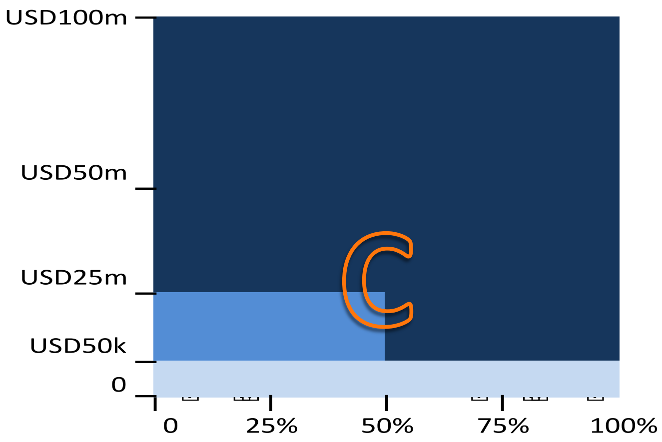
- Loss record for the programme was exceptional, as most of the partial losses were serviced at their own workshops.
- No total losses for more than three years guaranteed a full funding of the limit covered.
- The programme continued at full retention.
- This programme was latter expanded to cover the perforation equipment.

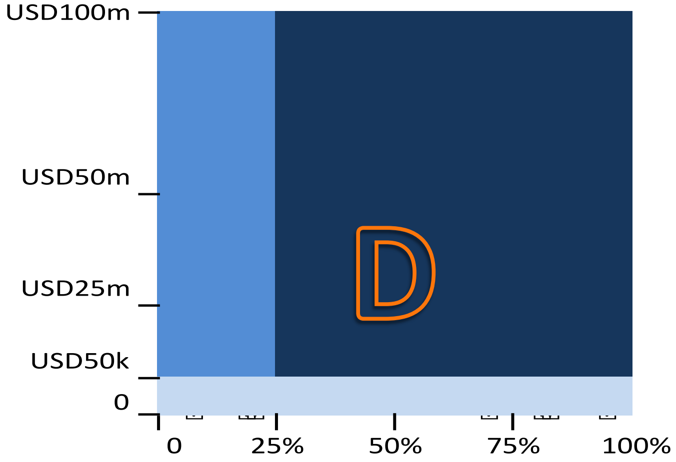
A Cell for Mortgage debtors of a Bank

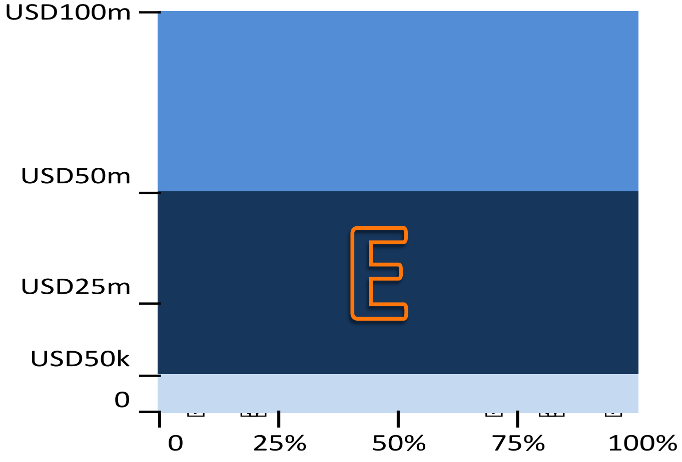
<u>Differente Alternatives for Different Lines of Business</u> :











A. No Retention
B. Retaining a primary layer.
C. Retention of a primary layer on a QS Basis.
D. QS Retention.
E. Retention of XS layer above PML.

The use of the cell can change, depending on the risk the parent company wants to write or front.

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A Cell for Mortgage debtors of a Bank

- The use of a Cell for this particular client, has been proved to be very successful throughout years, as:
  - Managed to have competitive cost in comparison to other local insurers.
  - Taylor Made Products are being offered to their client base.
  - Low Exposure to losses due to a comprehensive reinsurance programme.
  - Revenue of more than USD4m per annum.
  - Loss record of 30% on the reinsurance programme, has enable the client to approach other reinsurers in order to obtain better terms and conditions each year.
- Their Risk Management strategy is focussed on:
  - Ceding good quality reinsurance with adequate levels of retention.
  - Retain limits based on their retrospective underwriting of their portfolio.

Q & A

Moderator:

- Eduardo Fox I Economist I Appleby I EAFox@applebyglobal.com

Speakers:

- Bartolome Massot I Chartered Accountant & Chartered Underwriter I Quest GroupI bartolome.massot@questgroup.com
- Javier Ordoñez-Namihira I Lawyer I Baker McKenzie Javier.Ordonez-Namihira@bakermckenzie.com
- Esperanza Mead I Actuary I Actuarial Factor I emead@actuarialfactor.com
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