



**BPF Study Paper on
The Potential Role of Hong Kong as a Captive Insurance Domicile**

1. Background

- i) The study reports of the 11th 5-Year Plan by both the HKSAR Government and the BPF identified captive insurance as a specific financial services opportunity for Hong Kong.
- ii) The formal recommendation of the Government Plan Study report is:

“Carry out detailed analysis on possible measures to enhance the development of Hong Kong into a regional captive insurance centre, targeting at those Mainland enterprises listed on overseas stock markets at the initial stage “
- iii) Whilst this is not the first time that the establishment of Hong Kong as a captive centre has been considered by Government, it is the China dimension and in particular the rapidly growing internationalisation of large mainland enterprises that provides a new and powerful dynamic for Hong Kong to consider positive action to develop as a competitive and recognised captive insurance centre.
- iv) A captive insurance company is in its simplest form a subsidiary company that only insures the risks of its parent. Captives first came into common use in the early 1980s and initially were generally domiciled in offshore locations which actively promoted a low cost, low tax and supportive regulatory environment, with credible but not over onerous supervision. More recently there has been a growing trend towards onshore captives where regulatory controls are supportive.
- v) Successful captive domiciles have almost all built their market leadership by focusing on their specific advantage, often tax related, and by being sensitive to the tax and regulatory policies of their targeted home markets.
- vi) These circumstances point to a new and unique opportunity for Hong Kong to offer Mainland companies and Mainland authorities the advantages of working and accumulating assets within One Country whilst enjoying the benefits and efficiencies of



an established international financial centre.

- vii) Whilst captive insurance on its own is a limited market, experience elsewhere demonstrates that it can be a major lever in generating growth of reinsurance and of insurance support businesses and other financial and investment activities.
- viii) Recent success in establishing Hong Kong as a bridge head for addressing securities and insurance related issues for mainland corporations, our favourable location, excellent communications, strong insurance, financial investment, accounting and legal skills base, together with a supportive regulatory philosophy all reinforce Hong Kong's strong claim to compete as a captive insurance domicile.

2. Purpose of the Study

- i) The aim of BPF is for this study to complement and support parallel considerations of the captive insurance issue by Government and insurance industry related bodies. Our focus is primarily on servicing the offshore risks and international operations of mainland companies at the initial stage. This area is seen as the essential platform for any wider development of Hong Kong as a captive insurance centre serving the wider Asian market in particular.
- ii) Our study examines:
 - Rationale and nature of captives
 - Benefits to the Mainland and Hong Kong of establishing Hong Kong as a captive insurance centre.
 - The Asian experience of captives
 - Political stability, regulatory and fiscal essentials
 - Resource requirements
 - Promotional issues

3. Conclusion of the Study

- i) BPF believes that Hong Kong's development as the captive domicile of choice to Mainland companies going international will bring benefit to both the Mainland and Hong Kong. For Hong Kong, besides adding depth to its range of financial services it will attract capital and investment and be ***a catalyst for strengthening Hong Kong's status***



as a regional reinsurance and risk management hub and as a base for specialist insurance and related skills. It will be *an encouragement to the establishment of representative offices of Mainland companies in Hong Kong and business tourism.* Mainland enterprises using Hong Kong as *a captive domicile* can be further encouraged to make full use of Hong Kong's international financial and legal services while retaining this sector *under One Country.*

- ii) There is a perception that captive insurance offers competition to conventional insurance. Whilst there is some basis for this, the reality is that the majority of risks insured by captives are those that conventional insurance are not prepared to handle, for which there is only limited capacity available or for which insurers encourage self retention. Consequently, captives frequently result in a “win-win” situation for all parties, especially when there is shortage in insurance capital (also known as “hardening” of market) due to economic cycle and/or unforeseen events. Given the current profile of the domestic insurance scene in China, where there is little apparent shortage of competitive priced insurance capacity for onshore risks, we expect that *the initial emphasis should be on servicing the offshore risk of Mainland companies.*

- iii) Initially the benefits to Mainland organisations of captive insurance will most likely become apparent from exposure to their use by acquired international operations. For this reason we recommend targeting Chinese companies with substantial foreign investments and offshore risks, where restructuring may provide immediate opportunity, ahead of other companies whose activities are purely domestic. For the latter the benefits for taking more risks in house will emerge in the longer term. *From Hong Kong's perspective it is important to be prepared to capture as much as possible of the prospective captive business, as it is associated with the growth and internationalisation of Chinese enterprises.*

- iv) Success in activating this is dependent on both internal and external factors. The key internal factors are a supportive and proactive regulatory and fiscal regime committed to the promotion of Hong Kong as a captive domicile. The study shows that competition in capturing captive business among various domiciles is about costs of services providers and competitive tax treatment, balanced with the presence of a strong professional infrastructure, support from a stable political environment and appropriate regulatory framework and supervision. The key external factor is the attitude of the regulatory and fiscal authorities in the captive parent home jurisdiction, which in our case is Mainland



China. *The support of the Mainland authorities for Hong Kong to become a captive centre of choice for Mainland enterprises is vital to success. This will best be achieved by our administration raising the issue with their Mainland counterparts at the highest policy levels*, including CEPA, and emphasising the growing global trend favouring the establishment of captives in specialist domiciles. Another factor is the ability of the captive industry to demonstrate the benefits of captive insurance and the advantages offered by Hong Kong to Mainland enterprises the receptiveness of which is essential.

- v) Whilst specialist technical resources required to support a captive insurance industry in Hong Kong are currently limited in quantity, they can be easily enhanced as the market matures. Major international insurance brokers and consultants providing the core services already have such expertise within their network and can relocate key personnel to Hong Kong as its status as a captive domicile is established. Hong Kong has a strong pool of skilled support staff in accounting, insurance and general administration, which is not the case in most captive domiciles. Hong Kong also has a large and high quality establishment in legal and accounting services, the two pillars of servicing captives. This highlights the key capability of Hong Kong as a captive domicile and the potential of the captive business to be a catalyst for broadening Hong Kong's role as a financial, insurance and reinsurance centre.
- vi) In particular success in establishing Hong Kong as the preferred captive domicile for Mainland enterprises is both the prerequisite and a natural platform for its development as Asia's leading regional captive insurance centre targeting other Asian multi-nationals.

4. The Rationale, Nature and Forms of Captives

- i) Currently there are some 5,000 captive worldwide. They operate in about 30 domiciles but are concentrated on the 12 locations that have more than 100 captives. Appendix 1 gives details of the top 10 captive domiciles.
- ii) The original driver for the emergence of captive insurance companies was the turmoil in the conventional insurance market in the 1980's leading to inadequate capacity and/or unrealistic pricing particularly for more exotic or industry specific risks. Examples include aviation liability, oil rigs, medical malpractice and other high level liability exposures.



- iii) A further driver has been the growing impact of risk exposures on global corporations and the resultant development of formal risk management disciplines as a critical element of good corporate governance. Inevitably, ***there are risks that can be better managed in house or are not easily transferred through conventional insurance.*** A corporation retaining and handling such risks internally has a greater incentive to reduce them through better management.
- iv) Furthermore, insurers may impose substantial deductibles on the basis that insuring working risk (losses likely to occur on a regular basis) can be labour intensive and uneconomic. Over time, the realisation that ***captives can be a powerful tool in risk management in terms of containing the cost of the risk and as an efficient way of funding that risk, thereby improving efficiency and profitability,*** has resulted in their far wider use by global corporations. Captives are now recognised more as a tool to enhance the business objectives rather than a defensive mechanism. An example of this would be the underwriting of a product guarantee through a captive as a tool of optimising cost of risks (by having better quality products than industry average) which can also lead to a business advantage. This and point (iii) in particular have great relevance to Mainland companies which face a different and even riskier business environment in terms of brand reputation and cost competitiveness as they go global.
- v) To illustrate the value of captives to major enterprises we have listed at Appendix 2 a number of real life (no name) examples of their use in different industries.
- vi) Apart from addressing unavailability of cover and/or improving cost of insurable risks, other ***considerations which may influence companies to establish a captive subsidiary*** include:
- **Evaluation of and provision for risk**
By definition risk is in the future. Making adequate but not excessive provision across the board in a large and diverse organisation points to the need for careful analysis and quantification of risks which make for better allocation of resources and business decision.
 - **Accounting treatment**
If a company decides to retain risks internally, a formal insurance entity such as a



captive will allow it to apply insurance accounting conventions which permit insurers to establish tax deductible reserves for both specific, quantifiable risks and anticipated risks. Otherwise, even if a specific provision has been made, this can create a tax disadvantage as the expense and tax deduction may not take place until claims are settled which can be delayed for years in some cases.

- **Cash flow and fund management**

To the extent that organisations decide to retain risks in-house rather than transfer them to external insurers, a captive provides the vehicle to improve investment of the cash flow and build up of funds to finance future losses.

- **Access to reinsurance or specialist insurance markets**

By their nature reinsurance markets primarily serve the insurance industry, that is they are more wholesale than retail. Whilst wholesale/retail barriers are reducing, the establishment of a captive can facilitate more efficient and competitive access to the reinsurance market, with improved security. The improved security of direct access to a reinsurer for high level liabilities can be a major consideration when the financial security of frontline insurers is limited.

- **Tax considerations**

Taxation should not be the reason for deciding to establish a captive but is almost always a key issue in deciding domicile. This is because captives generally aim to grow their capital and underwriting capacity as quickly as possible to withstand more effectively the cost of risk and adjust levels of self insurance. Most major domiciles such as Bermuda are tax exempt though some captives cannot take advantage as the corporate owner's home jurisdiction taxes its offshore subsidiaries at domestic rate. This is one reason why the harmonisation with Mainland taxation rules and other policies (regulatory, fiscal, etc.) will be fundamental to the success of Hong Kong as a captive domicile.

vii) Captive insurance companies can take various forms but generally fall into one of three categories. These are:

- **Wholly owned subsidiary**

This is a subsidiary set up by an enterprise to insure in house risks only. Typically it is 100% owned by the enterprise and enters into a management contract with a



captive manager in its domicile of operation. Day to day management is conducted by the manager and the manager is supervised by a board comprising representatives of the owner, the manager and domicile based non-executive directors approved by the regulators.

- Rent-a-captive

This is a captive management structure managed by a captive manager (usually a division or subsidiary of an insurance broking house), which enables corporations to enjoy the benefits of a captive mechanism without establishing a dedicated subsidiary. It is also attractive to corporations who may not be ready for a fully fledged captive.

- Protected cell company

This is a natural progression from the rent-a-captive concept. Under this system, the assets and liabilities of each subscriber in the central structure is held in isolation (cell) and cannot be used to meet the liabilities of other subsidiaries (cells) if they fail. It requires specific regulatory support and safeguards. This approach appeals to conglomerates with varied business activities, and subsidiaries and associates, by enabling them to manage risk on a global basis with greater flexibility while retaining its impact within the different operating businesses. At least one major Hong Kong based corporation uses this approach.

5. Benefits to the Mainland and Hong Kong of establishing Hong Kong as a captive insurance centre

- i) As of June 2008, 77% of the US companies and 95% of the UK companies in the Global 500 have a captive. In comparison, none of the 20 Chinese companies in the Global 500 have a captive. The take up rate of Asia as a whole is also low, with that of Japan, the highest of all Asian countries, at 33% only. There is strong potential for captive growth in Asia.
- ii) ***Companies in the region, including Mainland, have tended to be “under-insured” in comparison to international standards.*** However, risk management and risk financing concepts have begun to take root. ***Coupled with the sheer size, astonishing growth and maturation of the Mainland economy, the outlook for captives as a risk management and financing tool is definitely positive.***



- iii) An opportunity clearly exists for Hong Kong to establish itself as a captive domicile in Asia in which Singapore is now the dominant player. A trend for favouring onshore domiciles means Hong Kong is in particular well positioned to become the onshore captive domicile for Mainland companies which we see will be beneficial to the Mainland, Mainland companies as well as Hong Kong.

5.1 Benefits to the Mainland

The benefits to the Mainland will lie in the support given to Hong Kong in strengthening its role as a leading Asian financial centre and in facilitating Mainland companies in their international expansion. This expansion will be subject to CFC (controlled foreign company) tax rules attributing the income of a foreign controlled company back to the Mainland tax jurisdiction in certain circumstances. ***By encouraging Mainland companies to locate their captives in Hong Kong they will be helping to retain skills and the accumulation of assets within One Country*** without unduly restricting their ability to continue existing or create new captive insurance vehicles for their international risks.

5.2 Benefits to Mainland companies

Mainland companies will have the advantage of dealing with compatriots in familiar circumstances and at the same time enjoying the benefits of an established international financial centre. To the extent that they use Hong Kong as a gateway to their international operation they will benefit from one stop shopping.

5.3 Benefits to Hong Kong

- i) These are the corollary of the above. As well as the additional business that captive management will bring to Hong Kong, the most potent benefit of this specialist service is that it will also act as ***a catalyst for wider engagement with Chinese multinationals***. It will also create ***a platform on which to build similar services to the Asian and global business community***.
- ii) Since, as with most financial services, captive insurance is not labour intensive, it can be argued that ***the potential for direct employment creation is limited***. However it does



provide additional revenue and job opportunities to those directly servicing captives including audit and tax firms, banks, commercial insurers and reinsurers, consulting firms, insurance brokers and tourism service providers and the likes.

- iii) A successful captive market will also have a ***positive impact on the insurance and reinsurance business and enhance Hong Kong's position as a leading financial centre.***
- iv) Singapore provides an example of this catalyst effect. It is the only captive domicile of significance in Asia with over 60 captives, principally based on its geographical and fiscal advantages for Australian captive users. Despite direct revenue generated by captive insurance being relatively small, Singapore's active and considerable drive of the initiative is part of a bigger goal to promote its status as a financial centre, especially as an insurance and reinsurance hub for the region which has been recording average growth in assets at respectively 12.3% and 17.8% since 1990. A comprehensive insurance market, including captive capabilities, forms part of a package to attract multinationals to establish regional head quarters there. Illustrating the leverage effect, whilst the assets of captives have grown by 156% from S\$1 billion in 1997 to S\$1.7 billion, those of all insurers have grown by 302% from S\$30 to S\$113 billion. By contrast the cumulative premium growth Hong Kong reinsurers for the same period was only 28%.
- (v) Another example is Bermuda, which credited the beginning of its insurance and reinsurance market to the captive industry in the 1970's. The island was almost entirely focused on captives up until 1980's and has developed many new mechanisms to expand their use. This and geographical proximity laid the platform for Bermuda to catch on the opportunities presented by the hard market conditions, catastrophes in the 1980's and 90's and the terrorist attack in 2001 in the U.S. in which each period has spurred on further development of Bermuda as a "risk capital". In 2005, Bermuda was home to a total of 1,312 insurers with total assets of US\$329.8 billion and capital and surplus of US\$110 billion^{1 2} and it is now one of the top five reinsurance markets in the world after Germany, the U.S. and Switzerland.
- (vi) Appendix 3 and 4 respectively contains a comparison of the growth in insurance business for Singapore and Hong Kong from 1990 to 2006 together with a more detailed

¹ Bermuda Insurance Market, <http://www.bermuda-insurance.org/x-default.aspx>



analysis of the captive insurance industries of Singapore and Bermuda and the related wider economic impact.

6. The Asian Experience of Captives

- i) Captive insurance is not a particularly well understood or widely used concept in Asia. In the past, this has been a significant disincentive for Hong Kong to seek to be a captive centre although many larger corporations in Hong Kong with international activities either own or have access to captives. For the most part these are domiciled offshore. The only captive domicile of significance in Asia is Singapore, who has over 60 captives. Industry experts attribute the past absence of incentives to form captive insurers in Asia to four factors:
- generally soft domestic insurance markets with adequate capacity at low rates
 - the absence of high level liability exposures
 - unsophisticated risk management and risk financing expertise
 - the absence of domestically based and substantial global corporations until the recent years.
- ii) Nevertheless it is relevant to note that throughout South East Asia in the latter part of the 20th century many local entrepreneurs took advantage of limited insurance regulation to form in house insurance companies which represented in essence a captive insurance vehicle. These proved to be both the cause and victims of soft domestic insurance markets and have mostly developed into conventional domestic insurers or ceased to operate. The key rationale for Hong Kong to position itself as a captive domicile at this time is that there is fundamental change to all the above factors.
- iii) Two new factors lead us to believe that ***demand for captive insurance will emerge in Asia in the medium term.*** The first is the increasing scale and globalisation of large Mainland and Asian corporations driving the demand for more sophisticated risk management and risk transfer options. The second is that a combination of bear investment markets and inflationary pressures will, as in the 1970's and 80's, undermine global insurance capital and capacity, so increasing the difficulties faced by major corporations in obtaining affordable placement of more exotic risks. ***Success in capturing this anticipated business demand will depend on being properly***

² Insurance Information Institute, http://www.iii.org/commerciallines/global/bermuda/?table_sort_740727=3



positioned in advance to compete for business as it arises. Reacting to demands as they develop without preparing the regulatory and tax environment or strong marketing of our strengths both at Government and industry level would allow other domiciles to gain a foothold in the new Asian market and represent a lost opportunity. This is therefore seen as ***a single window of opportunity likely to be open only for a limited time.***

7. The Political Stability, Regulatory and Fiscal Essentials

- i) The success or failure of a captive domicile depends on its political stability, as well as the regulatory and fiscal environment in both the domicile itself and the home domicile of those seeking to use it. All must be favourable for success.
- ii) ***Captive management is a highly competitive business*** with many jurisdictions competing as captive domiciles. Price of management services and convenience of location are factors in the choice of domicile but the key considerations are the quality and nature of regulation, capital requirements and taxation. Most corporations seek a domicile for their captive which gives assurance of credible regulation that fosters legitimate operations combined with genuine flexibility to meet individual circumstances.
- iii) There can be no doubt that Mainland corporations which identify the benefits of a captive will be looking for the best option and if Hong Kong is to compete for the business, particularly on a start up basis, it must be competitive with the best. It is not sufficient that we have an environment which broadly follows the major competition in a passive sense. ***There must be a commitment by both regulators and the industry to taking the lead and meeting competition head on.***
- iv) Appendix 5 and 6 show respectively the cost composition and regulatory framework of Hong Kong and other major captive domiciles and indicate that Hong Kong is competitive in terms of set up and operating costs, being only slightly more expensive than Singapore, the cheapest of the domiciles listed. Its regulatory framework is, again, comparable to Singapore and Vermont but compares unfavourably in two areas: it only allows one type of captive – i.e. pure captive, the most basic model; and it does not allow captives to take non-in-house risks which other domiciles do permit in approved circumstances. These severely limit the use of captives and indicate lack of flexibility in meeting the specific needs of captive users which is a common feature of all leading captive domiciles.



Other leading captive domiciles also structure minimum capital and other requirements according to the types of captive in which pure captive, given its limited application, is at the low end of the table. In this respect, Hong Kong is not particularly attractive in that, for example its minimum capital requirement at \$2 million is at the top end of the range for pure captives. Overall, therefore, ***Hong Kong currently offers less but has requirements that are as or even more stringent than its competitors. It will be essential to review these areas to ensure Hong Kong is more competitively placed.***

- v) It must be said that in the past, particularly pre 1997, political uncertainty was a major barrier to Hong Kong as a potential reinsurance or captive insurance centre. This barrier no longer exists, especially in the context of targeting Mainland enterprises. Conversely recent political developments in Bermuda have created an atmosphere of uncertainty that could give Hong Kong a competitive advantage.
- vi) ***Whilst tax considerations are seldom a primary concern in the decision to establish a captive they are an important factor in the selection of the captive domicile.*** As previously mentioned, the ability to accumulate tax deductible reserves for risk exposures is a key element in the captive rationale. The tax treatment of both profits and reserves by the captive domicile and its acceptability by the captive owner's home jurisdiction are therefore critical.
- vii) Several leading captives centres, including Bermuda, exempt captives from tax. In comparison, in Hong Kong, a captive insurer will only be exempt from tax where its premiums do not fall within the ambit of the definition of "Hong Kong premiums" (and its related investment income is also non taxable).
- viii) A summary of the existing Hong Kong tax regime for insurers, life, non life and reinsurers together with a commentary on the tax treatment of captive insurers in Singapore and Bermuda are attached at Appendix 7.
- ix) Although Hong Kong's existing insurance provisions can operate to provide a reasonably favourable tax environment to captive insurers in Hong Kong uncertainty on this score is a contributing reason why only a handful have chosen Hong Kong to set up operations.
- x) ***For Hong Kong to attract more captive insurers from the Mainland or elsewhere it should therefore either implement an exemption from tax for captives or***



substantially simplify the current tax provisions to clarify when captive business will be taxable in Hong Kong. Since the double tax agreement between Hong Kong and China should be an incentive for Mainland corporates to establish a captive in Hong Kong the anticipated attitude of Mainland authorities to our captive tax regime will need to be assessed.

8. The Resource Requirement

- i) Regulatory circumstances from the owner's or captive's jurisdiction demand day to day management of captive insurers to be conducted in the domicile including the maintenance of accounts and full business records. There is also likely a requirement for the board to meet in the domicile and include acceptable residents as non-executive directors. Hong Kong is well equipped to provide all accounting and legal administration management and investment services through existing resources. Technical captive management expertise is generally provided in all major jurisdictions by dedicated divisions of major international insurance brokers. Several of these brokers already have expertise based in Hong Kong on a regional basis and supporting the offshore captive operations of Hong Kong companies. As it is these same brokers who will be spearheading the frontline marketing of captives to Mainland enterprises, they can be relied on to build staff establishments and expertise through relocation of existing qualified staff and training. Even in Bermuda, the home to nearly 990 captives, the total number of staff with captive specific expertise is unlikely to exceed a few hundred. ***In short the availability of appropriate resources to meet demand is not seen as a constraint.***

9. Promotional Issues

- i) In the past and indeed today, Hong Kong has never been regarded either by Government or the business community as a competitive or even appropriate captive domicile. To change this mindset and convince the authorities on both sides of the border, Mainland and Hong Kong based corporations and other corporations operating in the region that Hong Kong is a captive domicile of choice, there is a need to market Hong Kong not just a good place to establish a captive but the best.
- ii) **Until agreement is reached at least in principle on essential changes to our own regulatory and fiscal environment further promotion would prove futile.**



- iii) Therefore assuming such agreement is reached, ***the next essential is to convince the Mainland authorities to give their full support and to introduce the regulatory and fiscal measures that favour Hong Kong as a captive domicile. This is an initiative which needs to be taken at the highest possible government level, by the Financial Secretary and or the Chief Executive himself.***

- iv) Once this is in place and only when it is Hong Kong will need to mount ***an intensive campaign promoting Hong Kong as a centre of excellence for captive insurance targetting Mainland and other corporations*** through the Hong Kong Trade Development Council, Government trade representatives, Invest Hong Kong and similar bodies. It has been a common feature of all successful captive domiciles that they have directed substantial resources to marketing and to representation at international risk management and reinsurance gatherings.

26th June 2008

Appendix 1 - Top 10 Captive Domiciles

Top 10 captives	No. of captives		
	2007	2006	2005
Bermuda	958	989	987
Cayman Islands	765	740	733
Vermont	567	563	542
British Virgin Islands	409	400	383
Guernsey	368	381	382
Barbados	235	235	301
Luxembourg	208	208	208
Turks & Caicos	169	169	166
Hawaii	163	160	158
South Carolina	158	146	122
Subtotal	4,000	3,991	3,982
Worldwide Total	4,861	4,936	4,882
Top 10 as a % of total	82%	81%	82%

Source:

Business Insurance, March 3, 2008

Business Insurance, March 12, 2007

Business Insurance, March 6, 2007

Appendix 2 - Case studies of how Captives can benefit an organisation

- i) Group of hospitals and other out-patient facilities in United States
- Twenty locations in the Eastern U.S. with over 3,000 beds
 - Has owned a Bermuda Captive for the last five years which underwrites general liability claims
 - The Captive not only streamlined the group's insurance purchasing, but also its risk management strategy – due to increased accountability and communications
 - Despite fluctuations and soft premiums in the region, the group has consistently achieved savings of 5 to 20% in Total Cost of Insurable Risk (“TCOIR”) via the Captive, which can be attributed to:
 - Steady improvement on its already good claims history, both in frequency and severity
 - The group's enhanced control over claims handling process, especially claimants seeking significant amounts and/or involving potential litigation
 -
 - The group's positive reputation in safety and risk management has created a competitive advantage over other healthcare providers in the region.
- ii) Manufacturing company with operations in Asia, Europe, North and South America
- Has owned several Captives over the last 30 years in Bermuda as well as European domiciles
 - Underwrote property damage / business interruption (“PDBI”), general and auto liability as well as workers' compensation risks throughout the years
 - Premium savings varied considerably from year to year, the Captives succeeded by retaining risks strategically and benefiting from:
 - Greater control over process and payment of workers' compensation claims, especially those related to chronic industrial disease
 - Provide considerable risk bearing capacity if needed – certain layer/coverage was extremely difficult to obtain during hard insurance market
 - Generate underwriting profit from joint ventures, especially where the

particular operations have strong risk management and positive loss history

- Access to “trapped cash” through insurance premiums, as it is very onerous to re-patriate cash from certain South American countries. However, it is worth noting the premiums charged to such subsidiaries are reasonable compared to market rates.

iii) Information technology and business process consultant with operations worldwide

- Has owned an onshore U.S. as well as an offshore Captive over the last 10-plus years
- Underwrote PDBI, general liability, workers’ compensation, errors and omission (“E&O”) risks throughout the years
- Achieved considerable savings in the first three lines of business, which also allowed the Captive to accumulate significant capital to take on the more expensive and volatile E&O risk
- Retaining the E&O risk is especially significant for this group because:
 - The risk for this particular group is extremely difficult to price in the commercial market due to the constant evolution of the relevant technologies / processes and few comparable / similar operations in the IT / consulting business
 - Insuring such risk often involves providing sensitive operational and/or research and development details to external parties. While such parties sign and are very unlikely to violate confidential agreements, the stake is too high for potential information leakage.

iv) International conglomerate with operations in Asia Pacific, Europe and North America

- Has owned an European-domiciled Captive for over five years
- Achieved savings in TCOIR by virtue of the group’s diverse risk spread – operations in significantly different industries and location
- In addition to savings, the Captive improves accountability and performance measurement of its subsidiaries via:
 - Premium allocation model – business units with good loss history and

strong risk management are rewarded by reduced premium charges and vice versa

- As the group's risk retention is quite high, it would distort the subsidiary's financial performance if large / unusual losses are expensed. The subsidiaries' financial performance is important for this group, as it often makes new investments and divests existing ones.

v) Oil and Gas explorer and distributor with operations in various offshore locations

- Has owned an Asian-domiciled Captive for over five years
- Achieved considerable savings in TCOIR (15-20%) over the last five years, through a streamlined risk management practice
- However, the most significant value provided by the Captive are:
 - Access to specialty oil and gas reinsurance facilities – which provide a forum and network for risk managers to exchange best practice ideas, in addition to increased reinsurance capacity and savings
 - Ability to finance coverage that would be otherwise difficult to obtain as many of the group's operations are located in remote and/or high risk areas. For example, it was able to arrange terrorism coverage shortly after 9/11.

Appendix 3- Summary of Insurance Growth in Singapore and Hong Kong 1990-2006

Singapore	Total Assets	Year-on-Year	Total Assets	Year-on-Year	Ratio of	Total Assets	Year-on-Year	Captives Assets
	All Captives	Growth Rate	Prof. R/I	Growth Rate	vs. Prof R/I	of All	Growth Rate	as a % of All
Year	(in S\$ million)	(%)	(in S\$ million)	(%)	(_ to 1)	Insurers	(%)	Insurers (%)
						(in S\$ million)		
1990	488.9	n/a	1,055.7	n/a	2.16	8,360.7	n/a	5.8%
1991	582.5	19.1%	1,253.1	18.7%	2.15	9,793.9	17.1%	5.9%
1992	654.7	12.4%	1,421.0	13.4%	2.17	11,899.9	21.5%	5.5%
1993	694.4	6.1%	1,455.5	2.4%	2.10	14,199.2	19.3%	4.9%
1994	838.9	20.8%	1,649.8	13.3%	1.97	17,026.1	19.9%	4.9%
1995	882.7	5.2%	1,969.3	19.4%	2.23	20,451.3	20.1%	4.3%
1996	884.4	0.2%	2,222.0	12.8%	2.51	24,622.6	20.4%	3.6%
1997	956.8	8.2%	2,581.0	16.2%	2.70	28,165.9	14.4%	3.4%
1998	844.0	-11.8%	2,710.7	5.0%	3.21	31,378.1	11.4%	2.7%
1999	858.7	1.7%	3,081.2	13.7%	3.59	38,858.7	23.8%	2.2%
2000	846.7	-1.4%	3,504.3	13.7%	4.14	45,409.8	16.9%	1.9%
2001	777.7	-8.1%	4,208.7	20.1%	5.41	59,696.7	31.5%	1.3%
2002	890.5	14.5%	4,361.4	3.6%	4.90	66,789.0	11.9%	1.3%
2003	1,385.2	55.6%	4,697.4	7.7%	3.39	77,406.4	15.9%	1.8%
2004	1,527.3	10.3%	5,202.7	10.8%	3.41	86,552.9	11.8%	1.8%
2005	2,033.8	33.2%	6,070.0	16.7%	2.98	102,428.4	18.3%	2.0%
2006	1,739.3	-14.5%	6,622.5	9.1%	3.81	113,411.3	10.7%	1.5%

Avg annual growth since 1990

9.5%

12.3%

17.8%

Avg annual growth since 1997

8.8%

11.2%

16.9%

Net growth since 1997

156.6%

302.7%

Hong Kong	Net Premiums Prof. R/I (in HK\$ million)	Year-on-Year Growth Rate (%)	Net Premiums All Insurers (in HK\$ million)	Year-on-Year Growth Rate (%)
Year				
1990	n/a	n/a		
1991	998.1	n/a	7,090.80	
1992	1,183.6	18.6%	9,068	27.9%
1993	1,715.3	44.9%	10,594.20	16.8%
1994	2,019.3	17.7%	12,370.60	16.8%
1995	2,375.9	17.7%	13,296.20	7.5%
1996	1,945.3	-18.1%	12,033.20	-9.5%
1997	1,778.1	-8.6%	12,634.7	5.0%
1998	1,565.0	-12.0%	12,221.1	-3.3%
1999	1,300.1	-16.9%	11,127.6	-8.9%
2000	1,366.0	5.1%	12,199.8	9.6%
2001	1,550.7	13.5%	12,793.3	4.9%
2002	2,594.3	67.3%	15,903.2	24.3%
2003	3,001.4	15.7%	16,570.8	4.2%
2004	2,172.1	-27.6%	15,966.9	-3.6%
2005	1,823.0	-16.1%	15,641.7	-2.0%
2006	1,787.5	-1.9%	16,198.1	3.6%
Avg annual growth since 1997		3.0%		3.2%
Net growth since 1997		0.5%		28.2%

Appendix 4 - CAPTIVE INSURANCE IN SINGAPORE AND BERMUDA

Singapore

Captive insurance industry

Singapore is currently the largest captive domicile in Asia with 61 captive insurance companies and 5 captive managers. Singapore witnessed good growth over the past years, recording average annual growth rate of near to 23% since year 2000³.

According to Aon's recent report on Global 500 companies, Asian markets offer the biggest growth potential, as only 27% of Asian Global 500 companies have captive insurance⁴. With the rapid growth of Asian economies and as Asian enterprises become more sophisticated and embrace enterprise risk management, many of these corporations will be looking at captives as an alternative risk transfer vehicle and there will be great potential for growth in the captive insurance industry⁵.

Singapore has a mix of many positives - a stable political situation, pro-business environment, sound regulatory framework skilled and educated workforce, excellent infrastructure and world class amenities, and a strategic geographic location with connections to all parts of Asia and Australia/ New Zealand. It has attracted many international insurers and reinsurers. There are 56 direct insurers (including Life, General and Composite) and 28 professional reinsurers⁶.

Please refer to Appendix 4.1 for tax treatment of captive insurers in Singapore.

Economic impact

Supporting ancillary services in the insurance ecosystem

The growth in the insurance industry has resulted in the development of insurance-related service providers such as in accounting, legal services, loss-adjustors and information technology/ e-platform providers. Singapore has two of the top forensic

³ Keynote Address by Ms Teo Swee Lian, Deputy Managing Director, MAS, 9 July 2007.

⁴ The Business Times, Singapore rises as a major regional reinsurance centre, 16 May 2007.

⁵ Keynote Address by Ms Teo Swee Lian, Deputy Managing Director, MAS, 9 July 2007.

⁶ Speech by Mr Ong Chong Tee, Deputy Managing Director, MAS at the Singapore International Insurance Conference, 17 May 2006.

insurance accounting and claims firms. In addition, entities such as Ri3K, the world's only insurance electronic trading platform from the UK, use Singapore to assist cedents and reinsurers in facilitating better auditability and process clarity with their highly sophisticated technology infrastructure. There are also increasing number of specialised legal firms who have set up in Singapore and these have greatly broaden the range of niche services available in the Singapore insurance industry.⁷

Singapore is looking at deepening its pool of underwriting and broking expertise, especially in the more specialised risks, and to increase the capacity to underwrite such niche risks. Singapore is also encouraging greater specialisation and new techniques in the industry, for example by having specialised service providers to support the industry, and by facilitating access to a wider variety of risk and capital management tools for insurers⁸.

Reinsurance and Islamic insurance

Singapore is also looking at increasing capacity and attracting new capital into Singapore. In this respect, it is encouraging reinsurers in Singapore to further build up the pool of necessary expertise with the underwriting authority and capacity in Asia, to take on Asian risks. An area which has seen resurgence in Asia and the Middle East is Islamic finance. There is a corresponding strong interest seen in the development of life and general takaful business. Reinsurance or retakaful will play an important role in providing capacity to support the growth of the emerging takaful industry⁹.

Given the critical mass of reinsurance activity in Singapore, Singapore is keen to attract retakaful (reinsurance) players to Singapore. To-date, Singapore has 2 reinsurers, Tokio Marine Retakaful and Scor Vie, who already provide retakaful capacity¹⁰.

⁷ Speech by Mr Ong Chong Tee, Deputy Managing Director, MAS at the Singapore International Insurance Conference, 17 May 2006.

⁸ Speech by Mr Lim Hng Kiang, Deputy Chairman of the MAS and Minister for Trade and Industry, at the General Insurance Association 40th Anniversary Dinner, Singapore, 26 October 2006.

⁹ Speech by Mr Ong Chong Tee, Deputy Managing Director, MAS at the Singapore International Insurance Conference, 17 May 2006.

¹⁰ Speech by Mr Ong Chong Tee, Deputy Managing Director, MAS at the Singapore International Insurance Conference, 17 May 2006.

To ensure that Singapore does not miss out on the exponential growth of Islamic insurance in the region, the Finance Minister has, in the 2008 Budget, announced an incentive scheme offering a 5% incentive tax rate for five years to qualifying insurers on income derived from writing offshore takaful and retakaful business. The incentive is available upon application to, and approval from, the MAS. The window period for approval is five years from 1 April 2008 to 31 March 2013.

Attracting captives from diversified industries

Corporations from more diversified industries are setting up captives in Singapore. This is a reflection of the flexibility for the captive insurance facility¹¹.

Encouraging innovative products

Singapore has achieved a critical mass of insurance players and activities, becoming an insurance hub. This critical mass means a wide range of insurance products and services are available¹².

The Singapore government is considering insurance-linked securitisation (“ILS”), which can enhance insurers' competitiveness. ILS enables insurers to transfer risks to the capital market to strengthen their balance sheets. These securities are expected to contribute to a more diverse and vibrant capital market. The global ILS market saw a record level of issuance in 2005, and 2006 looks set to exceed 2005. While there are few ILS deals sponsored by Asian insurers, it is expected that insurers become increasingly sophisticated and focused on efficient management of risk and capital. The Monetary Authority of Singapore has developed a regulatory framework for ILS for consultation with the industry¹³.

Bermuda

¹¹ Keynote Address by Ms Teo Swee Lian, Deputy Managing Director, MAS, 9 July 2007.

¹² Speech by Mr Lim Hng Kiang, Deputy Chairman of the Monetary Authority of Singapore (“MAS”) and Minister for Trade and Industry, at the General Insurance Association 40th Anniversary Dinner, Singapore, 26 October 2006.

¹³ Speech by Mr Lim Hng Kiang, Deputy Chairman of the MAS and Minister for Trade and Industry, at

Captive insurance industry

Captive insurance business played a founding role in the creation and development of the Bermuda market and remains one of its best-known core activities¹⁴. The bulk of Bermuda's captives are US -owned entities, accounting for over 60% of Bermuda's insurance formations, often used to insure and reinsure retentions on general liability, auto liability, workers compensation, property and marine programs and to access the reinsurance markets¹⁵.

Since the early 1990's, one of the fastest-growing captive categories has been that of health-care or medical malpractice captives. The US-based ownership of these captives is diverse, ranging from groups to single-parent, from tax exempt hospitals to for-profit health maintenance organizations and physician-controlled entities. Some US health-care providers see the captive vehicle as a means of offering competitive professional liability coverage, while others use their captives to fund for the capitated risks they assume and for access to provider excess and health maintenance organisation stop-loss reinsurance¹⁶.

Increasingly, captives are being used by larger corporations to enhance core products. They are also playing major roles in long-range, strategic planning as more and more companies seek optimum retentions and exert greater, in-house control over their financial exposures¹⁷.

Please refer to Appendix 4.1 for tax treatment of captive insurers in Bermuda.

the General Insurance Association 40th Anniversary Dinner, Singapore, 26 October 2006.

¹⁴ Captive Insurance in Bermuda: How and why to form a captive

¹⁵ Captive Insurance in Bermuda: How and why to form a captive

¹⁶ Captive Insurance in Bermuda: How and why to form a captive

¹⁷ Captive Insurance in Bermuda: How and why to form a captive

Economic impact

At the end of December 2006, Bermuda's (re)insurers had aggregate total assets of \$440.4 billion, which represents a 33% increase over the \$329.9 billion achieved the previous year. Captives accounted for \$72 billion in total assets and almost \$22 billion in gross premiums written. A total of 71 new insurance and reinsurance companies were established in the Bermuda market during 2007, compared to 82 in 2006¹⁸.

The critical importance of the Bermuda Insurance and Reinsurance industries to the United States economy has been spelt out in a new report titled "The US Economic Impact of Bermuda Based Insurers and Reinsurers". This was conducted by GSP Consulting Corp of Pittsburgh, Pennsylvania for the Association of Bermuda Insurers and Reinsurers ("ABIR") and released in November 2007. The report reveals that Bermuda firms employ 9,600 Americans directly in the United States and indirectly generate an additional 95,045 jobs. The firms paid \$17 billion in property claims in 2005 for hurricane damage, representing 25 percent of the total property damages covered. In addition, the report said that the Bermuda firms account for 26% of the total US reinsurance market and generate as much as \$96 billion of the gross output for the US insurance market¹⁹.

¹⁸ Strong market growth continues, Bermuda Insurance Update, 2008 Vol. 1

¹⁹ ABIR report highlights importance of Bermuda to the US economy, Bermuda Insurance Update, 2007 Vol. 4.

TAX TREATMENT OF CAPTIVE INSURERS IN SINGAPORE AND BERMUDA

Singapore

To further support the growth of the captive insurance industry, which contributes to the Singapore's position as an insurance hub, Singapore announced a tax exemption model for captive insurer in its 2006 Budget whereby approved captive insurance companies²⁰ will be granted tax exemption on the following income for a period of 10 years:

- (i) Income derived from accepting insurance covering offshore risks²¹; and
- (ii) Dividends and interest derived from outside Singapore, the gains or profits realised from the sale of offshore investments, and interest from Asian Currency Unit deposit derived from:
 - o The investment of its insurance fund for offshore insurance business; and
 - o The investment of its shareholders' funds used to support the offshore insurance business.

The window approval period for captive insurance companies to be approved for tax exemption is from 17 February 2006 to 16 February 2011 (both dates inclusive).

This serves to level the playing field with major captive domiciles²².

²⁰ "Captive insurer" means an insurer whose registration is restricted to the carrying on of business which consists principally of risks of its related corporations, and includes a rent-a-captive insurer.

²¹ "Offshore risk" means any risk outside Singapore and —
(a) in relation to direct general insurance or facultative general reinsurance, the insured is not a person resident in Singapore or a permanent establishment in Singapore; and
(b) in relation to treaty general reinsurance, not less than 75% of the total risk in terms of gross premiums is outside Singapore,
and where any such risk is in transit in Singapore, it shall be deemed to be outside Singapore;

²² Speech by Mr Ong Chong Tee, Deputy Managing Director, MAS at the Singapore International Insurance Conference, 17 May 2006.

Bermuda

Application can be made for a Certificate of Tax Exemption from the Minister of Finance under the provisions of the Exempted Undertakings Tax Protection Act of 1966. This exemption guarantees freedom from any Bermuda tax on profits or income (except for annual government fees, local land taxes and employment taxes should the captive have a work force present in Bermuda) until 28 March 2016, a date which is regularly rolled forward²³.

²³ Captive Insurance in Bermuda: How and why to form a captive

Appendix 5 - Cost of establishing & on-going operation of a captive

A comparison between Hong Kong and selected domiciles

(in HK\$)

Reflects the range of expenditures depending on size and complexity of captive insurer.

Often, the top end can be exceeded by large and sophisticated captives.

<u>Incorporation / Setup Costs</u>	<u>From</u>	<u>To</u>
Hong Kong	200,000	400,000
Bermuda	300,000	600,000
Guernsey	300,000	600,000
Singapore	220,000	400,000

Mainly consist of:

1. Company and regulatory fees for the first year (payable upon incorporation / licensing)
2. Implementation fees by the captive manager
3. Incorporation fees by corporate secretary
4. Travel costs by owners (from HK, where applicable)
5. Audit fees on certificate process

<u>Annual Operating Costs</u>	<u>From</u>	<u>To</u>
Hong Kong	600,000	1,100,000
Bermuda	700,000	1,800,000
Guernsey	750,000	1,500,000
Singapore	500,000	1,000,000

Mainly consist of:

1. Annual company and regulatory fees
2. Annual audit and tax advisory fees
3. Captive management fees
4. Consulting and actuarial fees
5. Corporate secretary fees
6. Travel costs by owners (from HK, where applicable)

Appendix 6 - Regulatory Framework of Hong Kong and Major Captive Domiciles

Domicile	Hong Kong	Singapore	Bermuda	Cayman islands	Vermont
Number of Captives	2	65	990	740	563
Minimum Capital Requirement	HK\$ 2m	S\$400,000	US\$120,000- US\$1 m	US\$120,000- US\$360,000	US\$250,000- US\$1 m
Types of Captive(s) Allowed ⁽¹⁾	1 (Pure captives only)	2	9 (No existing types are excluded)	9	4
Non-In-house Risks Allowed	No	Yes	Yes	Yes	Yes
Solvency Margin Requirement	The greatest of: (a) 5% of the net premium income; or (b) 5% of the net claims outstanding; or (c) HK \$2m	The solvency margin requirement for Singapore Insurance Fund is the highest of the following amounts: (a) S\$400,000; (b) 20% of net premiums written; or (c) 20% of the claim liabilities	The minimum surplus- US\$0.12m Premium test - First US\$6m of premiums is 20% - Net premiums in excess of US\$6m is 10% - Loss test/ loss and expense reserve is 10%-15%.	Flexible, but held to a general guideline of 3:1 to 5:1 premium to surplus ratio	No minimum ratios required; ratios are a function of coverage, limits and parent or sponsoring organisations financial stability.
Local Taxes	Corporate tax rate: 16.5%	Tax exemption for 10 years to captive insurers carrying on offshore insurance business. The scheme is open to both existing and new captive insurers.	Tax free until 2016	20-year guarantee on income tax exemption.	Premium tax ranging from 0.19% to 0.048%
Other Remarks	Exempted from the general authorisation requirement.	All captive insurers are required to establish their operations in Singapore as subsidiaries.	No existing income tax structure for both local and foreign business.	No existing income tax structure for both local and foreign business	

Notes: (1) Types of captives include: pure captives, group captives, joint venture captives, association captives, industry captives, open market captives, rent-a-captives, alternative financing captives and segregated portfolio captives.

Appendix 7 - Taxation of Captive Insurers in Hong Kong

In Hong Kong, there are specific provisions relating to the taxation of insurance companies, and these specific provisions form an exclusive code for determining the assessable profits from insurance business.

There are effectively two provisions that deal with determining the taxable profits from insurance business. The first provision applies to life insurance business, whilst the second provision deals exclusively with general (or non-life) insurance business. The provisions classify insurance business between life and general insurance, regardless of whether the business represents captive insurance business or not. However, as we refer to below, the tax legislation does provide for a concessionary tax treatment for the reinsurance of ‘offshore’ risks, which would have particular application in respect of captive business.

As there is no specific provision that deals with the taxation of captives, the taxation treatment of a captive operating in Hong Kong will:

1. depend on whether the captive undertakes life or general insurance; and
2. if the insurance represents general reinsurance business, whether such business involves the reinsurance of offshore risks and therefore entitle to a concessionary rate of tax.

We therefore briefly explain how the respective types of insurance business are subject to tax under the existing provisions of the Inland Revenue Ordinance (“IRO”) – all section references below are references to the IRO.

Life insurance

For companies carrying on life insurance business, Section 23 is the operative provision which calculates the assessable profits from such business. However, it is important to note that life insurance business for tax purposes only includes certain classes of long-term business under the Insurance Companies Ordinance (“ICO”).

For tax purposes, life insurance business is specifically defined as the following types of business, which are specified in more detail in the ICO:

1. Life and annuity;
2. Marriage and birth;
3. Linked long term; and
4. Tontines.

All other categories of insurance are treated as non-life (or general) insurance for tax purposes.

For life insurance business, Section 23 calculates the assessable profits under one of two methods. The default method calculates the assessable profits using a simple 5% of net premiums. If an election is made, the assessable profits are calculated using a more complicated basis involving the insurance surplus. A further explanation is contained in the attached **Appendix 7.1**.

For general insurance business, which is essentially any insurance other than life

insurance, the provisions for determining the assessable profits are laid down in Section 23A. In respect of general insurance business, essentially the taxable profits are calculated as being the taxable premiums and investment income, less a deduction for provisions, reserves and operating expenses relating to the earning of the premium. Further details on the calculation are contained in the **Appendix 7.1**.

We note that it may be more common for a captive to carry on a business that would involve general insurance as defined under the Hong Kong tax legislation. Accordingly, the comments in this paper focus more on the tax aspects of general insurance business as they would apply to captive operations.

Competitiveness of Hong Kong tax legislation

Although Hong Kong does not have a specific exemption that applies to captive insurers operating in Hong Kong, the existing provisions applying to insurance companies provide a reasonably favourable tax environment for captives to operate from Hong Kong.

The favourable tax treatment and concessions under the current regime includes:

- **Hong Kong premiums** - The provisions only apply to tax business relating to Hong Kong insurance premiums. Accordingly, profits related to non-Hong Kong insurance premiums are effectively not subject to tax. For general insurance business, Hong Kong premiums are defined to include:

- (a) premiums in respect of non-life insurance contracts made in Hong Kong;

and

- (b) premiums in respect of non-life insurance contracts where the proposals for such insurance contracts are made to a corporation in Hong Kong.

In accordance with this Section, the captive's exposure to Hong Kong tax will principally depend on whether the company derives premium income that is considered to be "premiums from non-life insurance business in Hong Kong". To the extent that the premiums received by the captive under the insurance contracts are considered to be premiums from non-life insurance business in Hong Kong, such premiums derived will be taxable in Hong Kong.

Premiums that do not fall within the ambit of the above provisions are effectively not taxed.

Contracts made in Hong Kong

Under the first limb of the definition, the premiums must be derived from insurance contracts made in Hong Kong to be considered Hong Kong premiums. There is little guidance on what is meant by "contracts made in Hong Kong" for the purposes of Section 23A. In our experience, the Inland Revenue Department ("IRD") has focused more on the location where the insurance contracts are legally executed for insurance law purposes to determine whether the contracts are made in Hong Kong. Accordingly, if such contracts were prepared and legally executed in Hong Kong, the premiums from such contracts are likely to be considered to be premiums from non-life insurance business in Hong Kong under Section 23A.

However, given the limited guidance on the meaning of the term *made in Hong Kong* for the purposes of Section 23A, it remains possible that the IRD could take into account all the steps leading to the execution of the contract to determine whether the premiums fall within the definition of Hong Kong premiums. This approach would be consistent with the applicable test in determining “source” of profits in a non-insurance context. Under general source principles, a contract would be considered to be made in Hong Kong if it was “effected” in Hong Kong. The IRD takes the view that “effected” refers to all steps leading to the existence of the contract, including the initiation, negotiation and conclusion of the agreement. Thus, where the contract is made may not be analogous to where the contract is signed or legally executed.

Based on the above, premiums would not be considered Hong Kong premiums if all activities in relation to the initiation, negotiation and execution of the insurance contracts take place outside Hong Kong.

Proposals made to a Hong Kong corporation

Under the second limb of the definition, to be considered Hong Kong premiums, the premiums must be derived from insurance contracts where the proposals for such insurance contracts are made to a corporation in Hong Kong. Hence, if the proposal is made to an offshore company, then, the premiums would fall out of the second limb.

Given the intrinsic link to Hong Kong in both limbs of the definition, if a captive

could structure its operations such that all its activities relating to the insurance contracts were carried out outside of Hong Kong, it is possible to argue that premiums are not made in Hong Kong and therefore are not subject to Hong Kong tax.

- **Non-taxable investment income** – For general insurance business, certain investment income is also specifically not subject to tax. This includes dividend income, most forms of bank deposit interest, and investment gains from most forms of offshore securities. Accordingly, insurance operations can be structured to generate large amounts of non-taxable income.
- **Offshore reinsurance** - The Hong Kong tax rules also contain a concessionary tax treatment for business involving the reinsurance of offshore risks. Such business is subject to tax at that concessionary rate of 50% of the current corporate tax rate of 16.5% to give a tax rate of 8.75% (or 8.25% for the 2008 year). We provide some further comments on the offshore reinsurance business below.

Therefore, in summary, the current tax treatment in Hong Kong to captives is potentially very favourable. If a captive could show that its insurance business arose from “offshore” contracts, such business would not be subject to Hong Kong tax. Further, if a captive was engaged in the reinsurance of offshore risks and was otherwise taxable in Hong Kong, the captive would qualify for the concessionary tax rate of 50% of the prevailing tax rate.

Having said that, the captive industry in Hong Kong is not free from challenge by the

Hong Kong tax authorities. We consider some of the issues that captives are facing in Hong Kong.

Key tax issues faced by captives in Hong Kong

- **Full exemption** – Although the tax treatment to captives under Hong Kong’s existing insurance tax regime may be relatively favourable, groups looking to establish a captive may not necessarily share the same view when comparing Hong Kong to other jurisdictions that exempt captives from tax. Such jurisdictions include Singapore and the largest global captive market, Bermuda. Accordingly, Hong Kong may need to consider the introduction of a similar type of exemption in an attempt to attract further captives to establish in Hong Kong.
- **Home country tax implications** – The tax treatment in the home country of the parent of the captive may also influence where to establish a captive insurer. For PRC corporates, they may prefer to establish a captive in Hong Kong given, amongst other things, the double tax agreement between Hong Kong and China. However, it is important that PRC tax implications be considered in setting up captives offshore.

Improvements to the tax regime to benefit Hong Kong captives

We set out below some possible suggestions aimed at improving the current tax regime to benefit Hong Kong captives:

(i) Tax concessions

In the late 1990s, in order to promote Hong Kong as a regional centre for reinsurance operations, the IRO was amended to introduce a concessionary tax rate for qualifying offshore reinsurance business. The concessionary tax rate is equal to one half of the prevailing profits tax rate. Please refer to **Appendix** for further details. The underlying principle for this concession is to exempt premiums received by a reinsurer from reinsuring offshore risks. This is consistent with the territorial approach to taxation in Hong Kong.

Hence, in order for Hong Kong to stay competitive and develop to be a regional centre for captives, it may need to offer a similar system to other jurisdictions to entice countries to set up in Hong Kong. One viable possibility is to extend the current concession given to the reinsurers to cover all captive businesses rather than just reinsurance business. As a captive, it is likely that a significant portion of its premium would be derived from insuring offshore risks (i.e. group companies located outside Hong Kong). Given the similarity of these two insurance businesses, there are good arguments that the concession should apply to captive business in Hong Kong as well.

(ii) Tax exemption

To further support the growth of the captive insurance industry, to complement Singapore's position as an insurance hub, Singapore announced a tax exemption model for captive insurers in its 2006 Budget whereby approved captive insurance companies²⁴ will be granted tax exemption on the following income for a period of 10 years:

(iii) Income derived from accepting insurance covering offshore risks²⁵; and

(iv) Dividends and interest derived from outside Singapore, the gains or profits realised from the sale of offshore investments, and interest from Asian Currency Unit deposit derived from:

- The investment of its insurance fund for offshore insurance business;
and
- The investment of its shareholders' funds used to support the offshore insurance business.

The window approval period for captive insurance companies to be approved for tax exemption is from 17 February 2006 to 16 February 2011 (both dates inclusive).

²⁴ "Captive insurer" means an insurer whose registration is restricted to the carrying on of business which consists principally of risks of its related corporations, and includes a rent-a- captive insurer.

²⁵ "Offshore risk" means any risk outside Singapore and —

- (a) in relation to direct general insurance or facultative general reinsurance, the insured is not a person resident in Singapore or a permanent establishment in Singapore; and
- (b) in relation to treaty general reinsurance, not less than 75% of the total risk in terms of gross premiums is outside Singapore, and where any such risk is in transit in Singapore, it shall be deemed to be outside Singapore.

The above incentive serves to level the playing field with major captive domiciles and the government is confident that Singapore will be as competitive in attracting Asian captives to be domiciled in Singapore²⁶.

Accordingly, one suggestion could be to consider a similar exemption in Hong Kong to remove uncertainty as to any potential Hong Kong tax exposure faced by captive insurers if they were to set up in Hong Kong. The tax exemption legislation could, for example, operate to exempt a Hong Kong resident captive insurer from Hong Kong profits tax where it insures offshore risks²⁷. However, this tax exemption may not apply where the Hong Kong captive insurer insures onshore risks as this clearly falls within the Hong Kong profits tax net.

(iii) Clear guidelines on the taxability of premiums for captive insurers

The current provisions are potentially favourable to captives operating in Hong Kong. However, the current tax law is not clear on when insurance premiums are considered Hong Kong premiums and hence, taxable, as this is determined by where the insurance contracts are “made”. In this regard, there is very little guidance on where the insurance contracts are “made” for the purposes of the above insurance tax rules. This could involve a considerable degree of uncertainty as it requires an examination of the facts and circumstances

²⁶ Speech by Mr Ong Chong Tee, Deputy Managing Director, Monetary Authority of Singapore, at the Singapore International Insurance Conference, 17 May 2006.

²⁷ “Offshore risks” will have to be specifically defined.

surrounding each and every insurance contract. Such uncertainty is potentially a deterrent to captives looking to set up in Hong Kong. If captive insurers have a clearer understanding of how to structure their business operations to remain competitive with captives established in other jurisdictions that provide for a blanket exemption from tax, captives are more likely to consider Hong Kong as an alternative base to set up operations.

Accordingly, in the absence of a specific exemption from tax, further detailed guidance will be required from the IRD in respect of the following:

- Clearly stipulate when a captive's insurance contracts will be considered by the IRD to fall within the definition of Hong Kong premiums;
- Specify the activities that should be undertaken outside Hong Kong in order for the IRD to accept that the captive's insurance premiums are not considered to be taxable in Hong Kong; and
- Remove any ambiguity to captives considering setting up in Hong Kong as to when their reinsurance business will or will not be taxable in Hong Kong.

(iv) PRC tax treatment of insuring with Hong Kong captives

There will be a need to consider the applicability of PRC tax implications when PRC companies insure with Hong Kong captives.

A. Taxation of Life Insurance Operations

Under Section 23 of the Inland Revenue Ordinance (“IRO”), there are two alternative methods to calculate the assessable profits in respect of life insurance business.

(i) 5% of net premiums

Under the first method, which applies automatically, the assessable profits of a company's life insurance business are deemed to be 5% of premiums, net of reinsurance ceded, from life insurance business undertaken in Hong Kong. Premiums that do not fall within the specific definition (refer below) are not assessed. The deemed profits are then subject to tax at the normal profits tax rate, which is currently 16.5%.

Premiums from life insurance business in Hong Kong are defined to include all premiums received or receivable in Hong Kong from both residents and non-residents and all premiums receivable outside of Hong Kong from Hong Kong residents where such premiums are in respect of policies the proposal for which were received by the corporation in Hong Kong.

For an insurance company using the 5% of premiums method, the company's investment and other income is not separately assessed.

(ii) Adjusted surplus

As an alternative to the first method, an insurance company may make an election to be assessed on the “adjusted surplus” from its life insurance business. In effect, this election results in the life insurance assessable profits being calculated using actuarial valuations.

An election to use the adjusted surplus method is irrevocable and must be followed for all subsequent periods. To calculate the adjusted surplus, the surplus (i.e. the excess of the life insurance fund over the company’s estimated liability of its life insurance fund) or deficit at the end of the basis period is adjusted for the following specific items.

The following are added to the surplus:

- Any deficit of a previous period where the deficit is included in the actuarial report for that period;
- Any non-deductible expenses charged against the life fund;
- Other sources of income or profits of the company not included in the life fund (other than general insurance business which is assessed under a separate provision);
- Any balancing charges; and
- Any appropriations of profits or transfers to reserves, other than transfers to policyholders, which were charged against the life fund.

Deducted from the surplus are the following:

- The surplus of a previous period retained in the life fund;
- Any transfers or appropriations to policyholders which have not been charged against the life fund;
- Any allowable expenses which have not already been charged against the life fund;
- Capital receipts or transfers from reserves which have been credited to the life fund;
- Depreciation allowances; and
- Dividend income.

Adjusted surplus attributable to onshore business

In accordance with Hong Kong's territorial source concept, only the adjusted surplus attributable to Hong Kong premiums are subject to profits tax. The adjusted surplus as calculated above is allocated between Hong Kong and offshore life insurance business by reference to the proportion of Hong Kong premium income to total premium income. Hong Kong premiums are defined as all premiums received or receivable in Hong Kong from both residents and non-residents and all premiums receivable outside of Hong Kong from Hong Kong residents where such premiums are in respect of policies the proposal for which were received by the corporation in Hong Kong.

Other Taxes

Other taxes and duties that may apply to an insurance company operating in Hong Kong include:

Capital Duty

Capital duty is levied on the initial and any subsequent increase in the authorised share capital of a company registered in Hong Kong. Capital duty is payable at the rate of HK\$1 per HK\$1,000 of authorised share capital, but is capped at HK\$30,000 per transaction.

Stamp duty

Stamp duty is levied at varying rates on a variety of documents, including the following:

- | | |
|---|--|
| Transfer of immovable property | <ul style="list-style-type: none">• 3.75% for property sold for more than HK\$6 million• HK\$100 for property sold for less than HK\$1 million• varying rates for property sold for amounts in between HK\$1 million and HK\$6 million |
| Contract note for sale or purchase of Hong Kong stock | <ul style="list-style-type: none">• 0.1% on the consideration on the value on every note bought and every note sold |

B. Taxation of Non-Life Insurance Operations

For companies carrying on general insurance business, which is essentially any insurance other than life insurance, the provisions for determining the assessable profits are laid down in Section 23A of the IRO. In respect of general insurance

business, only those premiums which arise from insurance business in Hong Kong and onshore investment income are subject to profits tax.

Very broadly, the assessable profits from general insurance business are calculated as follows:

- Gross premiums from **insurance business in Hong Kong** less premiums returned to the insured or paid on corresponding reinsurance;
- Interest or other investment income arising in or derived from Hong Kong;
- Balancing charges calculated under the depreciation provisions; and
- Non-deductible expenditure.

Less:

- Increases/decreases in net reserves for unexpired risks;
- Actual losses net of amounts recoverable under reinsurance;
- Agency expenses in Hong Kong, where they relate to the earning of assessable income;
- If applicable, a fair proportion of any Head Office expenses;
- Depreciation allowances;
- Capital profits (if any); and
- Dividend income.

Taxable premium income

Only premiums earned from insurance business in Hong Kong are included in the calculation of assessable profits. Such premiums are defined in the IRO as representing all premiums in respect of contracts of insurance, other than life insurance, made in Hong Kong or contracts of insurance for which the proposals to the corporation were made in Hong Kong. It is important to note that the location of the insured risk or of the counter party is irrelevant for determining the assessability of premiums to Hong Kong tax.

Investment income

Investment profits that are considered to be sourced offshore, profits of a capital nature and dividends are all excluded from the calculation of assessable profits from general insurance. With respect to determining whether a profit is of a revenue or capital nature, it should be noted that case law has established that most investments made by an insurance company are trading investments, the profits from which will be subject to tax if sourced in Hong Kong. Only in exceptional cases will an insurance company be able to argue that its investments are considered to be of a capital nature.

C. Taxation of Qualifying Reinsurance Business

In order to promote Hong Kong as a regional centre for reinsurance operations, the IRO was amended recently to introduce a concessional tax rate for qualifying offshore reinsurance business. The concessional tax rate is equal to one half of the

prevailing profits tax rate, i.e. currently 8.75% (50% of 16.5%), and applies from the 1998/99 year of assessment onwards to the assessable profits derived from the business of reinsurance of offshore risks, other than from the business of life insurance and life reinsurance. For the concessional rate to apply, the company must be authorised to carry on reinsurance business in Hong Kong only and must also make an election to qualify for the concession. Once the election is made, it is irrevocable and applies to all future years.

Qualifying reinsurance profits

Qualifying offshore reinsurance gains or profits represent premiums from the reinsurance of **offshore risks**, as well as gains or profits from offshore reinsurance investments (which are essentially investments made from such premiums).

Premiums from the reinsurance of **offshore risks** are defined as premiums in respect of the reinsurance of any risk **outside of Hong Kong** or **in transit in Hong Kong**, and

- (a) in relation to facultative general reinsurance, the reinsured is not a person resident in Hong Kong or a permanent establishment maintained in Hong Kong;
and
- (b) in relation to treaty general reinsurance, not less than 75% of the total risk in terms of gross premiums is outside Hong Kong or is in transit in Hong Kong.

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