A brief introduction to the principle of proportionality under Solvency II

Laurenz Littmann of **Morgan Lewis** provides an overview of the principle of proportionality under Solvency II as it applies to captives

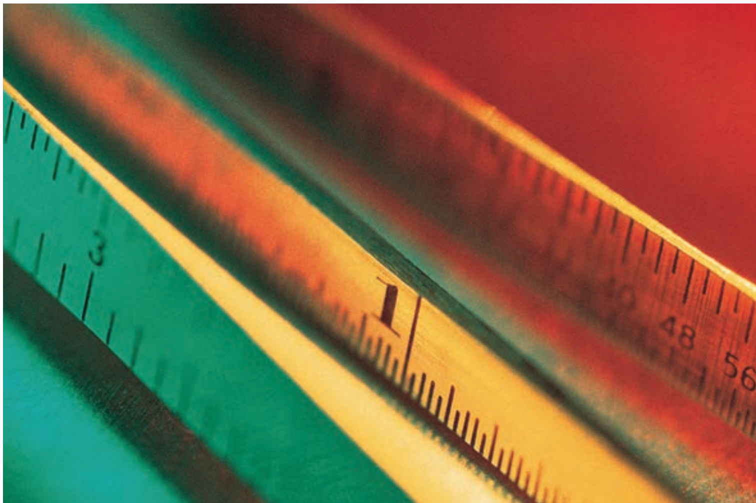
The upcoming Solvency II regime, which will reshape the regulatory landscape for insurance companies in the European Union, is expected to have a profound impact on the European captive industry. Captives are facing challenges in respect of all three pillars of the Solvency II framework: the requirements for the financial solidity of insurance undertakings (Pillar I), the corporate governance requirements (Pillar II) and the reporting and disclosure requirements (Pillar III). These challenges may affect the ability of European industrial and financial groups to apply captive solutions as an instrument for a sound risk management.

Proportionate treatment

The Solvency II Directive contemplates a paradigm shift from a "rules-based" to a "principle-based" approach to regulation. The principle of proportionality is the fundamental principle of the directive underlying this concept. The principle – as it applies to captives – is supposed to alleviate the effects that the new framework may have on captives in that it requires the legislative and regulatory bodies to consider the individual risk structure of captives and to ensure that the legislative and regulatory means employed are adequate and effective in achieving the ends pursued by the Solvency II framework. A stringent application of the principle of proportionality may offer solutions to the challenges that captives are currently facing; conversely, the currently proposed set of rules implementing the directive does not seem to be fully consistent with the proposed shift towards a "principle-based" and risk-sensitive solvency regime.

The issues ensuing from the new rules as they apply to captives essentially originate from the differences in their business model and risk profile in relation to a typical commercial insurance undertaking that the new regulatory framework is aimed at. In order to reflect their specific business model and risk profile, captives are to be afforded proportionate treatment under the Solvency II regime. The principle of proportionality requires that the regulations be proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance undertaking. Proportionate treatment means that the ways by which the legislative aims of the Directive are achieved may differ from one insurance undertaking to another based on their individual risk profiles. In addition, another facet of the principle of proportionality, which is well established under the constitutional law of the EU and many member states, becomes relevant for the application of the Solvency II framework on captives. The principle of proportionality also requires that the intensity and the consequences that the new regulation has upon its addressees be commensurate with the legislative objective that the regulation pursues. The principle of proportionality applies on all levels of the Lamfalussy process by which the Solvency II framework is implemented so that the European Commission has to observe the principle when promulgating the implementation measures; the member states have to observe it when transforming the directive into national law.

In order to grant captives proportionate treatment, the regulators and the legislative bodies have to consider that the risk structures of captives deviate from those of commercial insurers in that they are generally much simpler. Captives typically only have one policyholder and write a limited number of lines. In addition, the risks on the books of a captive tend to be significantly smaller since captives normally do not write CAT or excess layer risks.



The principle of proportionality also requires the legislators to look at the adequacy between the legislative objectives of the Solvency II framework and the effects that the regulation may have on captives. The main objective of the Solvency II Directive is the protection of the policyholders against a failure of an insurance undertaking; the secondary objective is the stability and strengthening of the financial system as a whole. One would be hard-pressed to find that the application of the new regulatory regime on captives will effectively promote any of the legislative objectives of Solvency II. A captive normally only has one policyholder that also is its owner (and that is funding the captive).

The insolvency of a captive would therefore not have an impact on a multitude of policyholders like in the case of a failure of a commercial insurer. Captives almost never have systemic importance for the financial system in its entirety. Their counterparties, for instance fronting insurers, are normally protected against a failure of a (reinsurance) captive by appropriate contractual arrangements (for example, simultaneous payment or cut-through liability clauses) and/or collateral (for example, letters of credit). The enforcement of the new requirements on captives is therefore only of limited relevance for the achievement of the legislative objectives pursued by the Solvency II Directive.

LAURENZ LITTMANN
is a member of Morgan Lewis's Insurance Practice. He advises clients on matters of European and German insurance law with an emphasis on financial lines and D&O insurance. His practice focuses on assisting policy-holders and captive insurers in connection with policy placements and coverage disputes.

Effects of the new framework

On the other hand, the effects that the new framework will likely have on captives – if it enters into effect in unmodified form – are particularly onerous and detrimental. As regards the solvency capital requirements under Pillar I, the concern is that the application of the standard formula disproportionately reflects the concentration risks typically associated with the size and the business model of captives. The financial performance of captives – for example, their strong combined ratios – is not specifically reflected in the formula. In effect, this may lead to solvency capital requirements for captives that might go beyond what would be necessary to meet the confidence level of 99.5% foreseen under the Solvency II Directive. In order to afford captives proportionate treatment, the Directive provides for simplifications that insurance companies, including captives, may apply in relation to the standard formula. The problem, however, seems to be that, under the implementation measures as currently proposed, the majority of the captives will not have access to these simplifications because the conditions under which captives are entitled to make use of the simplifications are defined too narrowly. The development and application of (partial) internal models does not seem to be viable for many captives because of the efforts and expenses associated with them. The instruments that the Directive contemplates to alleviate the impacts of Solvency II on captives may not be accessible to a large number of captives. This means that less intrusive instruments that are set forth in the directive to grant captives proportionate treatment are de facto not available to captives.

Observers have also raised concerns as to whether the Pillar II requirements for the corporate governance of insurance companies are fully compatible with the business model of captives. The adoption of these requirements may end up being too costly and burdensome for captives in light of their lean personal and organisational structure. Captives usually outsource certain operational functions to external management service providers. The transparency requirements under Pillar III are problematic as they may lead to a forced disclosure of confidential information of the industrial or financial group to which the captive belongs. Where commercial insurers provide information on their insured risks on an aggregated basis, a captive would potentially be obliged to disclose sensitive risk-related information on their parent company in the report on their solvency and financial condition required to be furnished under the Directive.

Given that the application of the new framework on captives does not materially advance the legislative objectives of the directive while adversely impacting captives in a way that is not in line with their actual risk profile, the question must be answered whether the implementation measures as currently proposed are in line with the principle of proportionality as the cornerstone of the new, "principle-based" regulatory framework. If the Solvency II regime enters into effect in unmodified form, this may put in question the ability of industrial and financial groups in the EU to rely on captive solutions as a risk management instrument. This potential outcome would fall short of the conception expressed in the Directive that captives form a valuable tool for effectively and efficiently managing risk that is worthy of protection.