

# KEEP CALM AND GET TO WORK

Captive owners should start talking  
to their supervisors at once to  
minimise the challenges  
of Solvency II

BY MATTHEW BROOMFIELD

**E**uropean captive owners shouldn't worry too much about Solvency II if their vehicles are well-managed and they can explain this to their local supervisors. The Directive will create some additional work, particularly in the first year and perhaps the second, but proportionality is very likely to be granted to captives, and the more familiar the industry becomes with the Directive's content, the more it can relax.

These are the views of Guenter Droese and Valerie Alexander, architects of the European Captive Insurance and Reinsurance Owners' Association. ECIROA has been lobbying the European

Commission (EC) and the European Insurance and Occupational Pensions Authority (EIOPA) regularly for captives to be granted proportionality under the Directive, since its formation in 2008.

ECIROA chairman Droese is now "convinced" that captives will be granted Solvency II proportionality by the EC, because the concept cannot be argued with from an intellectual standpoint. "All of our colleagues, captive owners, as well as captive managers, will have the opportunity to use the principle of proportionality, which is the key issue for captive owners to understand," he says.

"We need to ask ourselves: 'Can I fulfil as determined what the Directive



requests? Or, based on my situation, my size of risks, and the complexity of my activities, is my way of acting compliant with the requirements of Solvency II, or does my captive need to explain why it is in a proportionate sense fulfilling the Solvency II requirements?"

Droese concedes there is still uncertainty and speculation surrounding the Directive, however, and says everyone will have to wait for a final decision from the EC. "There will definitely be some changes, nobody knows exactly which ones, but there will be some."

This uncertainty is compounded, says Droese, by the fact that all of Solvency II's regulations will have to be transferred into national law, where the use of different terminology with different meanings might be difficult to combine with the wording of the EC regulations.

#### Get to work

The basic problem with Solvency II for captives is the additional workload and resultant cost, says Droese. "Another challenge is that captives have to implement, if they haven't done it yet, infrastructure which allows them to better understand their own organisation, and the interdependencies between various activities."

The capitalisation requirements under Solvency II's Pillar I are perhaps the most commonly cited challenge for captives. However, the biggest challenge is the the number of different bits of information an insurer has to collect and report on, says Droese. "The calculation of capital under Pillar I is based on different, or to some extent different, postings than the one on Pillar III. That is one of the problems of these reporting systems."

"If everything is disclosed, not only Pillar I data, but also Pillar III, the templates, the ORSA and the FSCR, then my question is: Who is verifying that this is all correct? It creates an extremely high workload for local supervisors to check all of this data," he continues.

"You have two narrative reports, the SFCR (Solvency Financial Condition Report) and the RTS (Report to Supervisors) and you also have the P&L and the balance sheet. Does someone really understand how all of it fits together?"

Captive owners will then discover there is a lot of information in the templates under Pillar III that is contradictory to what is learnt from Pillar I, which

is contradictory to what is learnt from the P&L and the balance sheet, says Droese. "So I'm pretty sure that no one will really understand, or can say, what is the actual situation of the insurance company."

#### Reporting under pillar III

One problem under the Directive's Pillar III is that EIOPA wants to introduce a Europe-wide, standardised format for reporting called XBRL, a reporting system used globally for exchanging business information. Droese is sure this is not something that is commonly used by captives.

EIOPA says it will provide this tool for free, which means it wouldn't immediately cost the companies anything, but then each company has to implement this type of application, and has to produce / establish links to all of their internal data collection tools. "This could mean a lot of work, and the bigger the company, the more work it would be. As far as I know, it could take anything from 12-15 months to fully implement," says Droese.

So although it sounds easy for insurers to use the XBRL tool for reporting there is a lot more work to be done to get them to the point where they can use it. "Also, as far as I know there is no final version; this means that we will have to wait for this time-consuming implementation," Droese adds.

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Some captive managers may try to implement this reporting tool themselves, because they could offer a standardised format for all of their customers, believes Droese. "They have a direct link between the various postings for the captive companies they manage, so they could do this very easily."

"But for smaller commercial companies and captives it will lead to a lot of costs for internal preparations and integrating of their IT systems. For smaller captives, manual entries may be easier and cheaper."

One example of the unnecessary work

#### POTENTIAL BENEFITS?

Some captive professionals have spoken of the possibility of certain domiciles benefitting from the implementation of Solvency II, in terms of captives re-domiciling to avoid the Directive's requirements.

However, Droese is "very sure" that the majority of captive owners will try to stay where they are, because in large organisations any change will require a lot of internal approvals to comply with the company's compliance regulations, which will create a lot of workload. "Moving the domicile of a captive will not be without additional cost," says Droese. "There might be a comparison between the additional work and cost involved in staying or moving, so I can imagine there will not be many changes."

Captive regulation in other domiciles is also changing, notes Alexander. "The IAIS are working on their insurance core principles (ICPs) and are producing guidelines for captive regulation which can be used by supervisors when regulating captives in the various domiciles. While the requirements may not be as detailed as Solvency II, they are also requiring a higher level of governance."

that might arise from Pillar III is if a captive has nothing to report for a particular template, says Alexander. "It is still necessary to send the templates with a zero response which will lead to a lot of unnecessary work for captive owners."

ECIROA has suggested a set of templates for captives, which they describe as appropriate and proportionate but so far this suggestion has not been adopted by EIOPA.

"Captive owners are prepared to disclose with appropriate documentation what they are doing, and how they are doing it, but I think it is unnecessary to



document processes to the same extent as even a small commercial insurer. It should really be a minimum," says Alexander.

Droese explains: "When you consider reports for a large multinational insurer, I can imagine that they will produce a huge number of documents just to describe their activities and processes, whereas we say for a captive you'd need about 15-25 pages. And this is a big difference."

However, Droese expects that they will end up closer to the 15-25 pages, based on the proportionality principle, instead of 10-15 folders.

#### Engage now!

The real question surrounding Solvency II is how it will be applied 'country by country,' says Droese. "The EC and EIOPA don't want to determine anything so far because they don't want to jump into the shoes of the local supervisor. So, they are saying that it is up to the local supervisor to decide how it should be applied."

Captive owners should therefore start talking to their supervisor straight away, says Droese. "It is our recommendation that captive owners approach their local supervisors, show them what they want to submit and what they can document, and ask the local supervisor: 'Do you believe this is in line with the requirements?'"

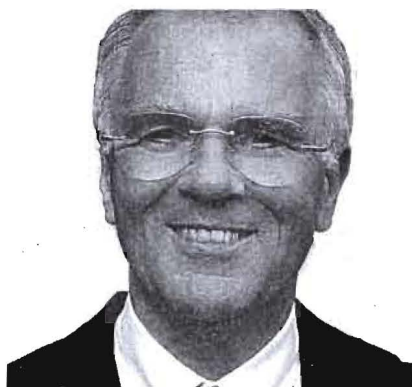
After this, many captive owners will be more relaxed, believes Droese. Alexander adds: "We have to explain how we document our activities, including risk management procedures, and prove that this is in line with the targets of Solvency II. To do this, we have to consider what the targets are and what the tools requested by the local regulators and the EC are. By engaging at an early stage with the local regulators, and discussing with them how the governance requirements can be met, in most of the cases neither captives nor insurance companies will have huge problems."

#### One haircut for everyone?

EIOPA and the EC say they don't want to align the structure of insurers, says Droese. "They still believe that each and every insurer may have their own identity, their own flexibility and use it, so that there are no fears that you can't distinguish insurer A from insurer B. They believe there will be differences."



Valerie Alexander



Guenter Droese

#### EUROPEAN CAPTIVE FORUM

Despite the challenges posed by Solvency II, Droese and Alexander are confident about the future of the European captive industry. Organising the European Captive Forum, which will take place again this November in Luxembourg, has reinforced for Alexander the importance of captives as part of the risk management strategy of multinational companies.

"We've also learnt that there's a lot of experienced and knowledgeable professional people involved within the captive industry, from the side of captive owners, captive managers, insurers and consultants," she says.

"I'm pretty sure the European Captive Forum may accelerate developments in the captive market," says Droese. "There have been some fears that captives will be closed down in the future, but I'm pretty sure there will be more established."

But this can only be achieved if there is some flexibility in a company's underwriting approach, setting of reserves and price setting, says Droese. "Otherwise you would never have differences between insurance companies. The more precisely you determine everything, the more you reduce the possibility for competition."

And this is Droese's fear. "We should not have too much specified and detailed in such a way that all the companies have to follow the same structure, attitude, and assessment criteria, because you wouldn't have competition anymore."

Innovation would also be stifled, believes Droese. "Should insurers now try to differentiate themselves when they don't know how the Directive will impact their P&L, either positively or negatively, in the coming years?" asks Droese.

The extent of detail and specificity is a key flaw in Solvency II, and obstructs its acceptance by the global captive industry, believes Droese. "I think that from a global perspective, it is rather counter-productive that in Europe we're now determining and precisely specifying requirements in such a broad fashion. If Solvency II didn't have such broad and detailed requirements, I can imagine that other countries would follow it more readily."

It is the directive's specificity that is provoking a counter-reaction against Solvency II, believes Droese. "I think that at the start of the intensified supervision, Solvency II (which I mentioned for the first time two years ago), was aiming to be the standard for the whole world, including the US."

"But when you see that we are now broadening it, deepening it, asking for hundreds of bits and pieces so that nobody really understands the added value for either the supervisor, the market, or the customer, then we should not be surprised that non-EC supervisors say it is too much work, and that they cannot follow, or do not want to follow."

The more the requirements are intensified, the more others will be provoked to look for an alternative, says Droese. "We should never forget that Solvency II is primarily principles-based. And what we are doing now, with the implementing measures, and all the other things on levels 3 and 4, is the exact opposite," he says. "We are now digging deeper with rules, rules, rules, and this is scaring the other supervisors." ☐