ECIROA's QIS 5 analysis

Results from Ireland and Luxembourg

by *Valerie Alexander, spokeswoman for the European Captive Insurance and Reinsurance Owners' Association (ECIROA)*

The results of the fifth Quantitative Impact Study (QIS 5), published by the European Insurance and Occupational Pensions Authority (EIOPA) in March 2011, included some limited information on captives. Of the around 350 captives that will be affected by the introduction of Solvency II, the results of 175 were printed. It could be that more captives submitted the QIS 5 but some did not identify themselves as captives and are therefore included in the insurance company results.

Very few of these captives used the captive simplifications. This is not surprising as the criteria for using simplifications set by EIOPA effectively rules out their use for around 80% of captives.

As it was difficult to draw any meaningful conclusions from the EIOPA report, and in order to provide some statistics to support the argument for proportionate treatment for captives under Solvency II, ECIROA collected QIS 5 results for 132 captives, the majority being domiciled in Ireland and Luxembourg (39 and 58 respectively).

This produced some interesting results:

1. 30% of the sample have an SCR below 100%. This compares to 15% market-wide. It does not necessarily mean that these captives are in difficulty as only 3% of the sample had an MCR below 100% (market-wide 4.6%) so this is more likely an indication that the standard formulas as applied to captives are not appropriate.
2. Direct writing captives have more issues than reinsurance captives. This is being driven by default risk, particularly in Ireland and is likely to be arising out of reinsuring to unrated counterparties (i.e. other captives outside of the EU).

DISTRIBUTION OF SCR COVERAGE – REINSURANCE

TOTAL CAPTIVES: 78 (IN 1.000 €)

DISTRIBUTION OF SCR COVERAGE – INSURANCE

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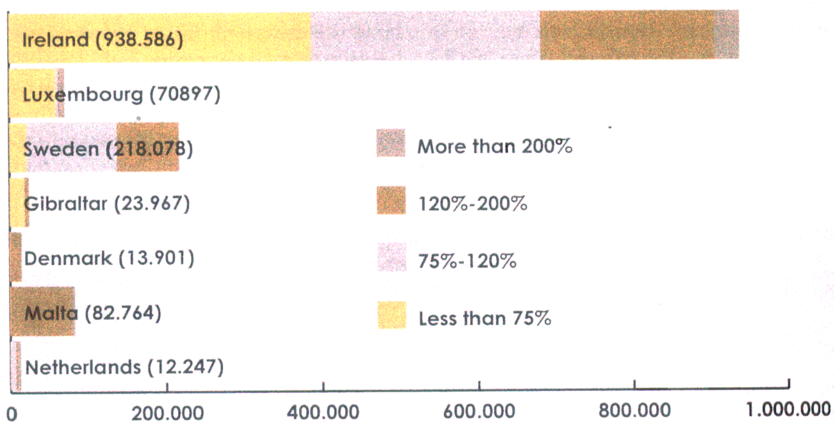


3. Cat risk is too complex for captives and over-estimated.

Captives are exposed to cat risk but on a much smaller scale than other larger undertakings. The policies underwritten by captives normally sub-limit cover for natural catastrophe risks and these sub-limits are always below (or equal to) the limit applying to the fire risk.

Risk management techniques used by captives have not been recognised in the calculation. Captives manage catastrophe risks by the inclusion of annual aggregate limits on policies and by the purchase of stop loss reinsurance, which limits their exposure in any policy year.

Also, the premium risk for captives is significantly less volatile than that for larger commercial undertakings. Captives normally underwrite a limited number of policies with premiums fixed at inception for, in most cases, annual policies.

We are waiting for the report of the Cat Risk re-calibration task force and hopefully the need for different treatment of captives in this area will have been recognised.

4. Concentration risk is not appropriate for captives.

Considering the business models of captives, the proposed requirement for them to increase the number of their deposit accounts to seven is extremely onerous and costly. There needs to be a re-calibration of the thresholds to a realistic and proportionate level.

A differentiation between 'external' investments and 'group' deposits or loans should also be possible. Where a captive is placing its assets back with the treasury department of its parent or in a fixed interest account, for example, these assets could be set off against indemnifiable claims in the (unlikely) event that the captive has difficulties in paying. In other words, the parent company is holding security against future payments.

In conclusion, we have to come back again to the importance of the proportionality principle for captives. ECIROA is asking the European Commission to make it clear that the principle of proportionality will be applied not only for small insurance undertakings but also for captive insurance and reinsurance undertakings.

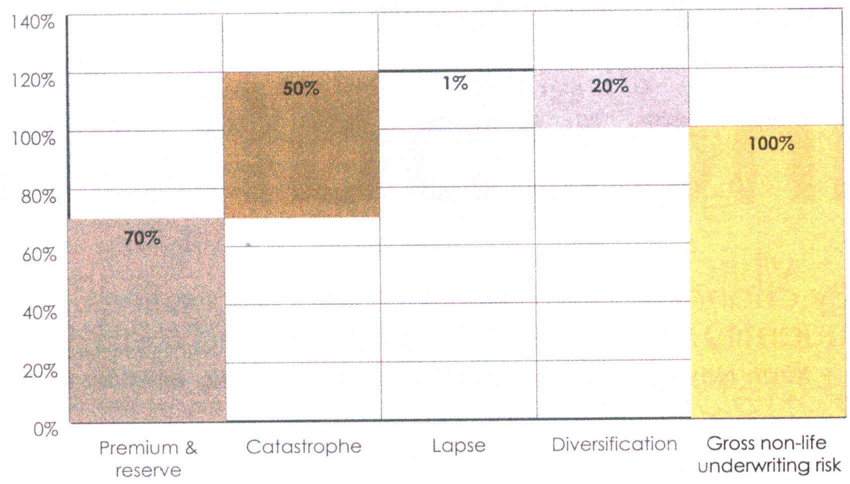
This can be done by amending Article 29 (4) of the Directive to: "The Commission shall ensure that implementing measures take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular to captive insurance and reinsurance undertakings and small insurance undertakings."

Proportionate treatment for captives should include (a) simplified calculations to assess their Solvency Capital Requirement (b) appropriate governance requirements and (c) suitable disclosure requirements.

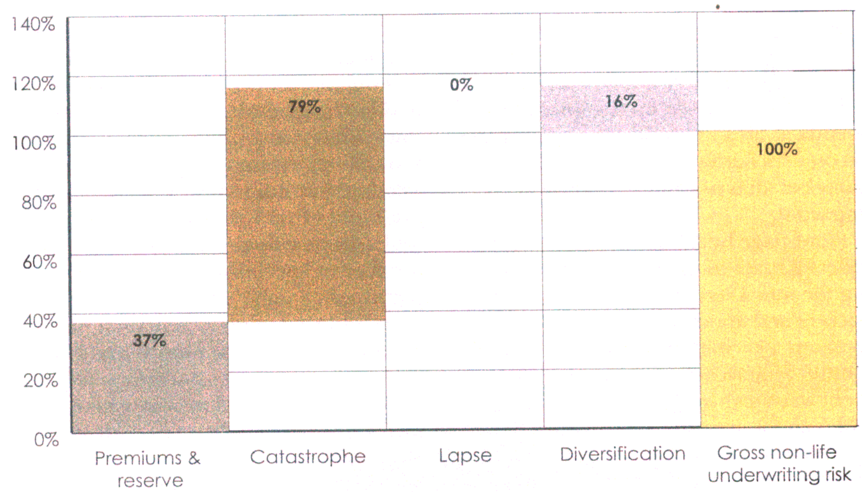
It is disproportionate to require most captives to apply the standard formulas for Pillar 1. Pillar 2 requirements do not take into consideration the typical captive structure where the administration of the company is 100% outsourced to a professional captive management company. And with regard to Pillar 3, why is it necessary to publish information when no one will want to read it. The policyholder (parent) has full access to all information, as do regulators.

There are still uncertainties about how the proportionality principle will be applied by regulators and clarification of this from the EC would be welcomed by all captive industry participants.

NON-LIFE UNDERWRITING RISK COMPOSITION (SOLO)



COMPOSITION OF NL UNDERWRITING RISK - CAPTIVE



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