SOLVENCY II – AN ASSET TO CAPTIVES?

Valerie Alexander of **ECIROA** believes that captives are a valuable risk management tool for companies to utilise – here she assesses how the Solvency II Directive will affect the captive industry

THE INTRODUCTION of Solvency II and the impact on the captive insurance industry is the issue that is keeping many European captive owners awake at night. Others are sleeping soundly, blissfully unaware of the nightmares to come.

Solvency II was approved by the European Parliament in Strasbourg in April 2009 with the goal of ensuring the financial stability of insurance undertakings and of protecting policyholders. The aim is to have a 'less rules and more principle-based' system focusing on insurance and reinsurance companies' knowledge and management of their own risks.

Solvency II is made up of three 'Pillars', all of which have major implications for captive owners.

Pillar 1 – quantitative requirements
Pillar 2 – requirements for governance and risk management
Pillar 3 – disclosure and transparency requirements

It establishes the proportionality principle as a general principle that applies throughout the directive and which is intended to take into consideration the nature, scale and complexity of risks. This is an important principle for all small and medium-sized insurers and especially captives. The wording included in 14a of the texts adopted on 22 April 2009 is as follows:

'The new Solvency regime should not be too burdensome for small and medium-sized insurance undertakings. One of the tools to achieve this objective is the proper application of the proportionality principle. This principle should apply both to the requirement on insurance and reinsurance undertakings and on the exercise of supervisory powers.'

This new regulation is being introduced via the Lamfalussy process, a process of flexible law making made up of four 'levels', each focusing on a specific stage of the implementation. We are currently at Level 2 in the process, with CEIOPS performing the role of advisor to the European Commission and engaging with stakeholders via the issuing of Consultation Papers. CEIOPS has stated that they are keen on open and transparent dialogue with all stakeholders.

One of these stakeholders is ECIROA (European Captive Insurance Reinsurance Owners Association), a relatively new organisation which was formed in August 2008 and which is very active in the consultation process, engaged specifically on captive issues. In a short time, ECIROA has grown to 55 members representing captive owners from 12 countries and is still growing. We believe that Solvency II will be an asset to captives provided that their different risk profile, size and relative simplicity is taken into consideration. Our aim is to ensure the continued existence of captives by finding solutions which enable them to meet the requirements under the three Pillars, especially by achieving recognition of the simplicity of our companies under the proportionality principle.

The captive industry has developed greatly since the early days and captives have become a very important risk management tool for multinational companies. They provide an alternative solution for risks, which may not be provided for in the external insurance market and in many cases, add an extra level of protection (by insuring deductibles, for example). The introduction of Solvency II without recognition of the simplicity of captive structures will have a dramatic impact upon the captive community, leading to increased costs for all and possibly the demise of some. The general consensus is that capital is expected to increase for all captives under the new regime. As well as the cost and capital implications of Pillar 1, including the possibility of insurers increasing their fronting fees for captives, the Own Risk and Solvency Assessment (ORSA) requirements of Pillar 2, necessitating captives who have their own risk managers, internal audit function and so forth, will be a major contributing factor.

Corporations that have their captives outside of Europe will also be impacted as many captive jurisdictions such as Guernsey, Isle of Man and Cayman Islands are considering adopting an equivalent solvency regime (equivalence, for example).

Why should the proportionality principle be applied to captives?

- Captives are normally small undertakings insuring the risks of their parent and underwriting a limited number of policies and classes;
- They limit their exposure by the implementation of aggregate policy limits and/or the purchase of stop-loss reinsurance;
- Their risks are identifiable, calculable and provable and can be easily presented to regulators. In fact, regulators will be able to see full information on all exposures and claims reserves, details that cannot be made available to them by major insurers;
- They normally employ a small number of their own staff or outsource their administration to professional captive managers, who are themselves subject to regulation;
- The vast majority do not have third-party policyholders and are insuring only the risks of their parent company – an important point for Pillar 3 which requires that undertakings publish their solvency capital requirement (SCR) information by making their Solvency and Financial Condition Report publicly available.

A consultation paper on simplifications for captives (CP79) was issued by CEIOPS in November but unfortunately this focused only on Pillar 1. It started out by defining the criteria for simplifications to apply, effectively defining captives (despite the fact that captives are already defined in the Framework agreement). These criteria include:

1) that captives are only (re)insuring 'insured persons' or 'beneficiaries' which are legal entities of the group of the captive undertaking and which were legal entities at the time the contract was entered into.

- Who are the insured persons and beneficiaries? Phrases normally understood to refer to individuals and not companies and if so, how can they also be legal entities?
- What is the position where a captive is underwriting employee benefit programmes?
- What happens when a corporation merges with or takes over another company during the policy year?

2) that they are not underwriting compulsory third-party policies

- Only approximately 40% of captives do not underwrite liability risks and the majority who do, reinsure third-party risks underwritten by commercial insurers.

It is obvious that these criteria were drafted by people with limited knowledge of captives and their risks, and if they are applied, there will be almost no captives that qualify for simplifications. Furthermore, introducing these criteria goes against the general principle that Level 2 of the process cannot be more restrictive than Level 1. The response from captive owners must be that they will not accept the criteria.

So if not simplifications, what is the alternative for captives?

- They can use an internal model. Some of the captive management companies are currently developing these but there are cost considerations which may make this option unviable.
- They can join with, and support the lobbying activities of ECIROA and other bodies such as FERMA, AIRMIC, DIMA, AGERE, MIMA etc. It is vital that regulators of member states are made aware of the scale of the captive industry and its importance to major corporations. Those states that have the biggest influence on the process, having the highest number of votes, are those that have a small number of captives (France and Germany, for example). It is therefore extremely important to educate them so that they understand the structure and activities of captives and realise the extent of their role in the insurance and reinsurance market. It must also be borne in mind that there is no competition between captive insurance companies and the traditional insurance market. These lobbying activities are not just for captives but are also in the best interest of Europe's multinational industrial, commercial and financial institution companies from all European nations.

There is still some time before the implementation of the Directive in October 2012 but is there enough time? There were 20,000 replies to consultation papers submitted to CEIOPS in September, which they must read, analyse and respond to. We wait to see how many of the comments made relating to captives result in any changes; however, we do not expect CEIOPS to be either willing, or to have the time to make any changes. Everything then depends upon the reaction of Karel van Hulle (European Commission) and his entirely new crew.

It is essential for captive owners to persuade their national politicians to put pressure on the Commission. We are currently facing the risk that we will end up with an unbalanced system where the large insurance companies will be given greater flexibility by their complex internal models using a large number of diversification effects and small companies with a simple to understand business model will be very strictly regulated. Is this proportionality? We have to make sure that the introduction of Solvency II is adding value, not just creating bureaucracy.

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