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Solvency II

Captives still in the dark about simplifications

Despite numerous uncertainties, captives should soon prepare for the requirements of Solvency II.

What are the requirements for company-owned insurers- and reinsurers according to the new system of European insurance supervision Solvency II? What are the consequences of the strict supervisory provisions for the captive industry in Europe? Even three years after the resolution on the Solvency II directive in November 2009, these questions are still unanswered. Simplified supervisory provisions for captives are still on the agenda of the European Captive Insurance and Reinsurance Owners` Association ECIROA in Luxemburg.

The association in which numerous companies with own captives are organized, calls for a special treatment of company-owned insurers under Solvency II. Captives and the insured industry are afraid that the strict supervisory requirements by Solvency II may ask too much from captives in terms of costs and administrative effort. Risk managers even doubt the future viability of a major part of European captives.

Captives particularly strained

Captives as insurance companies are subject to the provisions of the harmonized supervisory law according to Solvency II. This applies for the requirements according to all three pillars of the Solvency II regulation:

- Pillar 1: Capital requirements (solvability)
- Pillar 2: Qualitative requirements on risk management (Governance)
- Pillar 3: Reporting and public disclosure duties

While captive-owners first regarded the tightened capital requirements as the biggest strain, now the second pillar of Solvency II comes into focus. The second pillar demands an appropriate governance system and risk management. The implementation of requirements may imply high administrative (and thus financial) effort.

Of high importance is for example the question in what scope Solvency II guidelines regulate outsourcing. Captives often outsource all functions of the operative business to the parent company or external service providers such as specialized risk management companies or other (re-)insurers. By this, they ensure a profitable and efficient management of the captive.

As a consequence of the outsourcing, the insurance supervision is extended to the third party company. The outsourcing captive must ensure that also the third party company meets the supervisory governance requirements – that for example persons who fulfill key functions are reliable and have the required expertise. The captive has to enable access to relevant data to the supervisory authority even if the service provider as such is not a subject of insurance control. The governance-requirements of Solvency II concerning outsourcing especially affect captives due to their high outsourcing degree compared with other insurance undertakings. If Solvency II will hinder or restrict outsourcing, the efficiency of many captives might suffer.

A further challenge lies in the reporting and public disclosure duties for captives. The third pillar of the Solvency II-guideline regulates that insurance undertakings regularly transmit reports about their own capital endowment and risk portfolio to the supervisory authority and make extensive information available to the public. The public disclosure duties are an administrative burden with respective implementation costs. Further, the scope of public disclosure is problematic. Captives exclusively or mainly insure the corporation's own risks. Contrary to commercial insurers, information published by captives on risks and losses in any case reflects on the insured company. The public disclosure might force captives to publish company secrets of the insured parents.

Simplifications not specified so far

Against the background of the feared strains for captives because of Solvency II, a proportional application of the new supervisory law is necessary. The risk portfolio of cap-

tives is regularly less complex (due to a comparably small number of policies and business transactions) than that of other insurance companies. Due to their function and their risk profile captives have a specific nature which differentiates them from other commercial insurers. The Solvency II directive acknowledges this specific nature in recital 21. The so-called principle of proportionality shall ensure that supervisory regulations and measures are "proportionate to the nature, scope and complexity of the risks inherent in the business of an insurance or reinsurance undertaking."

The Solvency II directive contains approaches for a special treatment of captives. For captives the directive provides the possibility to make use of simplifications in the calculation of the required solvency capital. Which captives may obtain simplifications is left open at present. The captive definition of the directive presented in Article 13 only covers the so-called pure captives that exclusively insure the parent's own risks. A multiplicity of European captives also insures external risks (so-called broad captives or open market captives). According to the definition of the directive, broad captives are subject to all requirements for insurance undertakings. Simplifications regarding the solvency capital calculation are not given. Here is need for a revision. The supervisory authority does not treat broad captives proportionally if simplifications are only allowed for pure captives.

It is necessary that the European Insurance and Occupational Pensions Authority (EIOPA) and the European Commission (with appropriate implementation guidelines for the national authorities) ensure that all common captive models are allowed to make use of simplifications. However, the European supervisory authority even restricted the captive definition of the Solvency II directive in previously discussed proposals of such guidelines. Accordingly, the majority of European captives did not benefit from any simplifications. The principle of proportionality – as fundamental principle of the Solvency II directive – demands, however, special simplifications for all captives.

Implementation timeline is uncertain

In addition to the question which simplifications will be granted for which captives, it is in question from when on captives have to implement the Solvency II-requirements. The effective date of Solvency II was postponed several times. Currently, binding start time is 1 January 2014. However, EIOPA currently assumes an implementation of Solvency II from 1 January 2016.

There is uncertainty among market participants as well as national supervisory authorities with regard to the timeline and the nature of implementation measures. According to EIOPA it is necessary to implement certain key aspects earlier. The fact that EIOPA would like to implement some key aspects earlier will increase the uncertainty for captives.

EIOPA announced to issue implementation guidelines for national supervisory authorities. With these guidelines EIOPA will stipulate how the national supervisory authorities have to apply Solvency II. The authority wishes to avoid an overly divergent supervisory practice through national authorities. It opened a new consultation phase to their guidelines on 27 March 2013. It is not clear if the guidelines will specify simplifications for captives until conclusion of the consultation on 19 June 2013.

In the past few months, EIOPA's statements rose hope for simplifications. The European insurance supervisory authority publicly announced that captives and small insurance undertakings are going to be treated proportionally. Simplifications for captives are envisaged. Still, the granting of simplifications in the individual case would be the matter of national authorities.

Market adjustments expected

The new system of insurance supervision will in any case change the European captive landscape. There is the possibility that companies transfer risks from smaller captives to other risk takers or bear risks themselves. However, it is questionable if the often feared mass migration of captives to non-European domiciles will occur. Up to now such a trend is not perceptible. More likely is that companies particularly reconstruct smaller captives and transfer them e.g. into a Protected Cell Company (PCC).

There is the possibility that major captives will be strengthened as an instrument of risk management. If companies decide for keeping their captives despite increased requirements on capital endowment and cost-intensive administration, it seems advantageous to use the captive more intensively than before. The transfer of additional risks to the captive may then be a rational consideration. Especially, risks which are difficult to insure in the conventional insurance market might be increasingly covered by captives.

Captives will still be an important instrument of risk transfer

The primary supervisory aim of Solvency II – protection of policy holders – does not justify to impose the same supervisory burdens on captives like on other insurance undertakings. At the moment it is not clear which simplifications will be applied in the implementation of the directive. An application of Solvency II that provides captives, companies and national supervisory authorities with a clear action program still remains desirable.

Under the currently foreseeable requirements of Solvency II captives still remain an essential part of commercial risk management and instrument of risk transfer. It is recommended to follow the debates regarding guidelines and measures issued on the European level. Companies should ensure that their captives fulfill the current requirements of Solvency II as far as possible. Alternatives such as restructuring or change of domicile should be taken into consideration carefully.

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