The  factor

There are many factors that will influence a fronting insurer's decision about whether to front a captive. Solvency II, however, is perhaps the most important

by **Clive Hassett**

There can rarely have been a time, since the emergence of captive insurance companies, when there has been such a prolonged period of introspection about the nature of their future role within corporate risk management strategy.

This is not to say that in general terms there is any doubt about the validity of corporate self-insurance, risk financing and the continuing importance of captives. But due to a combination of circumstances, there has been, and continues to be, a good deal of questioning as to the shape, structure and financing of captives' ongoing activities.

This is no bad thing as this self-examination is overdue and should help create a strong, sustainable and more focused captive industry in the future.

This perfect storm has blown up through the combined forces of the global financial crisis of 2008/09, Solvency II, low investment returns, increased international regulation and the stirring of trade protectionism. This is teamed with a number of corporate trends such as increased M&A, higher standards of corporate governance and new emerging risks.

Demands of Solvency II

Solvency II is perhaps the most important of these challenges because it goes to the very heart of the captive concept, by setting out the financial and management rules involved in establishing and operating an insurance company, be it captive, retail or reinsurance.

However, it is ironic that Solvency II, which is designed to protect consumers and prevent market disruption, is disproportionally affecting captives, the one sector that has very little impact on the wider public insurance market.

Following the publication of the QIS5 results in mid-March 2011, both captives and traditional insurers will continue to lobby the European Insurance and Occupational Pensions Authority (EIOPA) on a range of issues, from the treatment of catastrophe exposures through to the impact of reinsurance contracts, and will press their cases for adjustments to the proposed rules and procedures.

The Omnibus II proposals published in January 2011 may offer some relief, at least in terms of providing a significant transition period. However, in the meantime, corporate risk managers, treasurers and accountants, together with their advisors, continue to mull a number of Solvency II related issues such as:

- Is there still an adequate business case for a captive?
- How would they fund projected increases in capital?
- How will they resource the increased management and oversight burden?
- Should a change of domicile be considered?
- Will their partner insurers revise the current fronting arrangements?

Companies that have embraced captives as part of a long-term corporate risk management strategy and are actively run as risk funding mechanisms are likely to be able to accommodate the demands imposed by Solvency II. However, captives that have been set up opportunistically to take advantage of a particular situation or are used in a less formal way are likely to find that Solvency II will present more challenges and their continuance may be harder to strategically justify.

As such this is an opportune time to streamline and reduce a corporate group of captives down to a more manageable number; for example, one onshore US captive to handle US risks and an offshore vehicle for the rest of the world.

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There is also a lot of attention directed towards captives that have long term exposures, with or without ongoing loss activity. Many corporate CFOs will want to look very carefully at a subsidiary that requires capital support, operates in a regulated environment but does not actually have any day to day strategic relevance to core business activities. If capital is constrained in an organisation it is likely that it would be redeployed into mainstream corporate operations. Under such circumstances, insurers will have opportunities to bring products to the table so that captives of this type can be extracted from the corporate balance sheet along with costly and collateral arrangements. Indeed, there are already examples and some special purpose vehicles established to achieve just that (see cover feature, on page 25).

As if the financial challenges of Solvency II were not enough for captives to come to terms with, the governance requirements of Pillar II introduce a new level of oversight designed to identify, assess, and monitor all risks within the captive. Such a framework is designed for traditional insurers but unless the concept of proportionality becomes a reality, captives will have to cope with these requirements.

Existing third-party captive managers can assume this burden but it will come at a price and demand significant management involvement. This aspect of Solvency II will certainly focus the parent company's mind and will force it to examine alternatives. The use of protected cell captives could potentially be an option that is cheaper and easier to manage *(see Spring clean on page 25)*.

Captives and fronting

Captives require insurers to front for them wherever they do not have licences to write business directly. In the same way that captives are examining their strategies in the light of Solvency II, traditional insurers are doing exactly the same, although on a larger and more complex scale. As the major insurers build and refine their internal capital models, captives tend to feature in a supporting role, as a sub-set of overall reinsurance consideration.

Insurers recognise captives as an essential and established part of the risk management process and the majority of insurers are constructively looking at how to work with captives under Solvency II, so that fronting arrangements can be maintained. For insurers that

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already manage the capital implications of fronting, it is possible that there will not be any need to change their approach, although it is likely they will require more detailed and regular information about the captive's activities, structure and financials than before.

Broadly speaking, the current high level of surplus capital within the global insurance industry suggests there will be adequate capital and that insurers will be prepared to front for captive programmes. However, the position could well change if capital became constrained.

In such a scenario, insurers might want to direct their capital towards their own underwriting activities where, because of market conditions, returns were at an attractive level. This would create an interesting dynamic as there would be two competing strategies in play. Insurers seeking to deploy their capital in core, risk transfer underwriting activities and captives looking for additional fronting capacity to mitigate rising open market premiums. As with many aspects of the insurance business, this will be a period where relationships will count and why it is important that captive and risk transfer activities are complementary and built on solid, long-term relationships between insured and insurer.

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Cost-effective solutions

Insurers consider a range of factors when evaluating whether or not to front for a captive and Solvency II could lead to some subtle variations in their approach.

Insurers are, above all, in business to use their capital to take risks on behalf of a client who pays a premium for this transaction. Providing fronting services, which is normally done to support a client and add value to an existing business relationship, sits alongside this strategy and gives rise to two questions:

1) How should the fronting activity be priced, as underwriting pricing tools obviously do not apply?
2) How do you manage the transactional and credit risks inherent in fronting?

Solvency II has a bearing on both of these questions and it is these issues that will drive changes to the way that insurers treat captive-fronted programmes in the future.

Leaving aside basic transactional fees, insurers will need to be clear on the effect that a particular fronting programme has on their internal capital model, as this will be the key price driver. This could be a relatively complex calculation with different captive programmes and structures producing different results, with the length of tail being an important consideration.

Ultimately, a price will be charged based upon the insurer's own cost of capital that is then modified by the particular captive fronting arrangement. These 'modifiers' will aim to put a price on the actual or theoretical increase in the cost of capital generated by the fronting programme and will also include charges for transactional and credit risk as well as profit.

Solvency II is likely to cause insurers to be more rigorous about the collateral provisions they apply and to more actively manage cash flow and reinsurance recoverables, both of which can affect regulatory capital requirements.

The existence of an acceptable external rating may allow some collateral relief, at least on short-tail business, but insurers will always want to perform their own assessment of a captive's financials as well as its operational strategy and overall underwriting activity. In addition, an insurer will want to understand the relationship a captive has with the parent company and how this might affect levels of surplus and cash flow. The outcome of the insurers' own evaluations are likely to carry more weight than the external rating.

The debate around domicile is extremely complex but fronting insurers will look at whether a captive is domiciled in a Solvency II environment. The issue is not dissimilar to that of obtaining a financial strength rating, as a Solvency II-based captive will be subject to a rigorous regulatory regime that will give comfort to a fronting insurer. However, there are non-Solvency II domiciles where the level of supervision and accounting standards are very strong and do not give any cause for concern. Therefore, fronting insurers will view the country of domicile as just another factor, albeit an important one, that needs to be considered when reviewing specific fronting arrangements.

In conclusion, the topicality of the Solvency II framework is such that further twists will influence outcomes and plans. It is very much in the interests of insurers, insureds and their professional advisors to work together and develop strategies that will continue to facilitate workable, long-term and cost-effective risk financing solutions.