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# Make the case for captives

## *Captive Review* urges the captive industry to make the case for captives under Solvency II

### Introduction by Gavin Bradshaw, editor, *Captive Review*

At *Captive Review*, although at times it may seem like much of our interest is focused on the US onshore, Bermuda and Caribbean and UK/ European offshore markets, we like to think that we take a global view of captives and the issues that affect all regional markets, irrespective of their size and global prominence.

Solvency II is a global issue. While the immediate impact of the draft Directive following the 2012 implementation date may appear to be of concern only to EU-based insurers, in truth interest in the issue has spread far and wide – to the offshore domiciles serving the UK, European and US markets and as far away as Asia-Pacific domiciles, like Singapore and Labuan.

And the issue is not one that simply concerns captive owners and the managers of their captives. Regulators are taking into account what changes might be required of their jurisdiction's regulatory framework; reinsurers and fronting carriers are keeping an eye on potential opportunities offered by Solvency II; and the ratings agencies will be looking to Solvency II as a possible boost to the numbers of rated captives – both as an additional inducement to providing fronting paper to captives and of keeping collateral requirements low.

With the QIS5 consultation process due to commence imminently, now is a good time for *Captive Review* to put its shoulder to the wheel and assist in persuading captive industry participants to get involved in the process, keeping the European Commission informed of the necessity for special attention to captives, as distinct from commercial insurance companies.

To open our campaign, we invited Jeanette Rödbro, executive manager of the European Captive Insurance and Reinsurance Owners' Association (ECIROA) to outline the difficulties for captives and make the case for greater captive involvement in Solvency II.

Now is the time to get involved!

### Jeanette Rödbro, executive manager, ECIROA

When you are travelling at 150 km per hour, it is better to be in the driving seat!

In January, Karel van Hulle, head of Insurance and Pensions at the European Commission, said that he only wanted to hear solutions, not just more complaints. This is exactly the same approach that the captive industry is taking. After enduring a long dark autumn and winter, the spring has started bright for captives. Together with the Federation of European Risk Management Associations (FERMA), AON and Marsh, ECIROA is working on how proportionality could be applied to captives.

Our initial proposals have already been forwarded to Karel van Hulle who now has at least one solution on his table. The recent change to a more open-minded approach by the EU Commission and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is warmly welcomed by the lobby group for captives.

Since ECIROA was formed in August 2008 with just five members, the association has grown to 60 members with more companies joining every week. It represents financial, commercial and industrial multinational companies owning captives in Europe. Members come from all parts of the world and are using captives as important risk-management tools for their businesses.

One of the important tasks of the association is to get national bodies to understand that the captive issue is not only a concern for the countries domiciling captives, but for the countries where the captive owner is located – in other words, every country. The association has been working hard to get all of our actors on the captive scene to star in the same production.

One of the darkest points last autumn was when the captive industry's comments and reactions to the draft CEIOPS CP-79 (its consultation paper on simplifications/ specifications for captives) had virtually no impact on the actual paper released in September. The major concern was the limited application of the simplifications proposed, which meant that the intention to grant a special status for captives was completely missed.

In association with:

ECIROA

CEIOPS changed the definition of captives as under the Level 1 text so that captives allowed to use the captive simplifications would be reduced to only a very small number of companies. This treatment was clearly unfair as captives would follow the 99.5% confidence level requested for all companies under Solvency II.

The simplifications should just reflect the simple structure of the captive business and thus be proportionate to the size, nature and complexity of the company. Additionally, the current proposed standard formula, when applied to captives, results in much higher levels of prudence for captive undertakings than for commercial insurers and reinsurers because the current formulae are not adapted to the business model of captives. Both the formulae and the corporate governance principles need to be simplified and aligned to the captive business model.

These issues are not just relevant for companies with captives in Europe, but also for those who have captives in non-EU domiciles, such as Guernsey and the Isle of Man. These domiciles are currently considering the issue of equivalence – in other words, will they adopt an 'equivalent regulatory regime' to that proposed under Solvency II. So far, most are taking a 'wait and see' approach, with the exception of Bermuda, which has publicly consulted on equivalent status for part of its reinsurance industry. The issue which is still uncertain is whether reinsurance by an EU-domiciled insurance carrier to a captive in a non-EU equivalent domicile will allow the insurer any capital relief. There has been very little response from the major insurers to requests from the captive group to support them in ensuring this does not happen.

In the letter recently forwarded to Karel van Hulle, the captive group (ECIROA, FERMA, AON and Marsh) has suggested that the simplifications for captives may be applied by entities meeting the definition of captives as under the Level 1 text. Furthermore, the group has given some suggestions as to how the different risk modules under Pillar 1 could be modulated to better reflect the risk structure and insurance portfolios of captives.

The group has also suggested that current best practice should be described, for example, as to how captives use their parent-company governance practices; the current role and quality of captive board members in the area of risk management and so on. This best practice 'list' could serve as a welcome standardisation on the Pillar II requirements for captives, making use of the proportionality principle to ease the administrative burden for captive owners.

Karel van Hulle asked for a "short, simple and beautiful" suggestion on how proportionality could be applied to captives and the captive group has fulfilled his request completely and is now hoping to have more success with him than they had with CEIOPS.

> "The current proposed standard formula, when applied to captives, results in much higher levels of prudence for captive undertakings than for commercial insurers and reinsurers"

### QIS 5

The next thing the captive group is focusing on is the consultation on the Technical Specifications (TS) for the Fifth Quantitative Impact Study (QIS 5). QIS 5 is the final test of the Solvency II regime and is therefore extremely important. The consultation will start in April 2010 and the final TS will be published by the EU Commission in June. The actual QIS exercise will run between August and mid-November 2010.

The captive group hopes that its suggested simplifications for captives will be tested and therefore wants to stress that it is very important that all captives participate in the exercise. Of course, the study will provide quantitative feedback but it is also essential to give qualitative feedback on, for example, how different calculations reflect the risk of captives. Furthermore, a participation in QIS 5 should be a prerequisite for good corporate governance in any multinational group. This is the last chance for all captive owners to know the important parameters for the survival of their captive.

Joining ECIROA and participating in the QIS 5 exercise will ensure that the captive owners' journeys are safe and that the final destination is worth the distance travelled. CR