



# CAPTIVE BEST PRACTICE GUIDELINES

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# 1. Introduction

- 1.1. Captive Insurance Companies (Captives) are insurance or reinsurance undertakings. Their purpose is to provide insurance or reinsurance cover for the risks of the group to which they belong. They are run by a Board of Directors (the Captive Board) which makes all decisions regarding the Captive. This document aims at providing guidelines with regard to how Captives shall comply with the Level 1 requirements of Solvency II on System of Governance to the highest degree possible, taking into consideration the application of the proportionality principle and their special characteristics. Captives are an important risk management tool for multinational companies. They add flexibility to the tools available to the Risk Manager for financing and mitigating the risks of the Captive's Parent or Group Company in a cost efficient manner. Captives are often used to provide alternative solutions for risks which may not be provided for in the external insurance market and in many cases, add an extra level of protection (e.g. by insuring deductibles).
- 1.2. The characteristics of Captives are:
  - a) They have a restricted number of insureds / clients, usually their Parent Company and/or subsidiaries;
  - b) They write a restricted number of lines of insurance business (e.g. property damage & liability) and normally issue a small number of policies (e.g. one policy per insurance class) or sign a small number of reinsurance agreements;
  - c) They insure or reinsure a restricted number of risks; and
  - d) They generally have a stronger ability than commercial insurers to influence the risk management practices of their insured entities.
- 1.3. Captives are companies which often outsource up to 100% of their services to other professional companies. This outsourcing is done to ensure that a broader and more appropriate level of expertise is brought to bear on the company's activities, if needed.
- 1.4. The risk appetite for the Captive is determined by the Captive Board which has overall responsibility for the management of the underwriting risks and all consequential functions (such as reserving, investment management etc.). Due to the nature of Captives (as described above) the risk appetite and risk management procedures and techniques are transparent and can be easily documented and validated. The majority of Captive risks are easily explainable.
- 1.5. Captives should consider the Proportionality Principle when establishing corporate governance frameworks and risk management policies which should reflect the nature, scale and complexity of the Captive.

## 2. General Governance Requirements

(Solvency II, Level 1, Chapter IV, Section 2, Articles 41, 42 & 43)

2.1. In order to put in place a system of governance that provides for sound and prudent management of the business, the Captive Board is required to ensure that the business has a transparent organisational structure with clear channels of communication and segregation of responsibilities. Details of governance requirements must be documented and approved by the Captive Board which is responsible for the Captive's organization, administration and affairs, and regularly reviewed. The key items listed below will ensure that the General Governance requirements are fulfilled for the Captive.

### 2.2. Composition of the Captive Board

The Captive Board should be comprised of members who are of good repute and integrity and who have the appropriate qualifications, knowledge and experience to provide sound and prudent management of the Captive. They must be approved by the local supervisory authority and may be senior employees from its Parent Company or Group. The supervisory authority should be notified of any changes to the people running the Captive, along with evidence that the 'fit' and 'proper' requirements are being met.

### 2.3. Responsibilities of the Captive Board

The Captive Board is responsible for:

- a) Setting the strategic qualitative and quantitative goals of the Captive;
- b) Establishing and documenting all policies and procedures for corporate governance including the risk management policy and a formalized document that defines the design and operation of the Board itself;
- c) Checking, communicating and documenting guidelines and instructions on how the company should be run;
- d) Ensuring that there is satisfactory control of the Captive's financial accounts and management of assets;
- e) Ensuring that the Captive complies with all applicable laws and regulations;
- f) Defining the Internal Control and Internal Audit policy; and
- g) Defining the outsourcing policy.

### 2.4. Duties of the Captive Board

The Board shall:

- a) meet on an appropriately frequent basis;
- b) have in place a formalised document that defines the criteria and procedures for decision making;
- c) ensure that key functions are performed;
- d) establish such sub-committees if needed (to include external experts if appropriate) to report to the board on specific areas which ultimately impact the stability of the Captive;

- e) Examine the ability and capacity of any outsourced provider to deliver services to the Captive. Ensure that the terms and conditions of any outsourcing agreement are understood and monitor any outsourcing arrangements;
- f) Ensure that appropriate contingency planning is put in place for the areas where the Captive considers itself to be vulnerable.

### **3. Risk Management System**

**(Solvency II, Level 1, Chapter IV, Section 2, Article 44)**

3.1. In order to comply with Article 44, the Captive has to put in place a proportionate risk management system covering the following risks: Underwriting & reserving; asset liability management; investments; liquidity and concentration risk management; operational risk management; and reinsurance and other risk mitigation techniques. The risk management system shall define a risk management strategy, policy, and reporting procedures necessary to identify, assess, monitor, manage and report risks. The Captive Board must ensure that the risk management system is suitable.

#### 3.2. Risk Management Strategy

The Captive is usually a very lean organisation comprised of its Board and outsourced functions. Therefore the risk management system for a Captive is very straightforward. The Captive Board should document its risk strategy and corresponding risk positions.

The risk management strategy should include provisions to regularly review the processes in order to ensure that they remain efficient and effective and take into account relevant changes in the risk profile of the undertaking.

#### 3.3. Risk Management Function

The person or persons carrying out the risk management function must meet the 'fit' and 'proper' requirements. The risk management function for a Captive can be carried out by a member of the Captive Board.

#### 3.4. Risk Management Policy

The risk management policy of the Captive should cover all the risks included in the SCR as per Article 101(4) of the Level 1 text and also other risks that may be considered materially relevant in the context of the Captive's business. Therefore the Captive should have a specified and documented risk management policy which includes the following areas :

##### a) Underwriting and reserving

The policy should cover the type of risks the Captive is willing to accept, underwriting procedures, underwriting limits, reinsurance and other risk mitigation strategies, reserving policy (including IBNR reserves) and procedures for claims management.

##### b) Asset-liability management

Assets and liabilities should be monitored according to duration and congruence.

c) Investments

The investment policy shall be defined. The use of derivatives or other financial instruments with similar characteristics shall be addressed.

d) Liquidity and concentration risk management

Guidelines for ensuring that the Captive maintains sufficient liquidity as needed to meet requirements and maintains adequate assets to cover technical reserves.

e) Operational risk management

The Captive should establish guidelines for identifying and assessing the operational risks it is exposed to due to internal factors and for ensuring that there are proportionate internal controls in place to manage these operational risks.

In the areas where the Captive considers itself to be vulnerable, the Captive should have contingency plans to make sure that business disruption and/or possible losses are limited if there is an unforeseen interruption to the business. Contingency plans should be documented and appropriate to the size of the Captive and its structure. Captives may be included in the contingency planning of their Parent Company or Group provided there is specific planning for the Captive. Where the Captive outsources the majority of its management and administration functions, the Captive Board should review the contingency plans of the Service Provider to ensure that the specific requirements of the Captive have been met. The Captive's contingency plan should include processes to minimise disruption to the Captive's business in the event of a failure of the Service Provider.

f) Reinsurance, Alternative Risk Transfer (ART) and other risk mitigation techniques

The reinsurance, Alternative Risk Transfer (ART) and other risk mitigation techniques and structure must be clearly specified.

g) Credit risk management

h) Strategic risk

The Captive Board should document its risk strategy and corresponding risk positions in accordance with Level 1 ORSA requirements (Article 45.2).

i) Internal control and Compliance

In order to comply with Article 46, the Captive Board has to put in place an effective and efficient Internal Control system, both insourced or outsourced, covering: Administrative and Accounting Procedures; Compliance with laws and regulations; Impacts of possible changes in the legal framework; and Assessment of the non-compliance risk.

The Captive should have a compliance function which will report to the Captive Board.

Detailed and day to day duties of the Internal Control function could be outsourced to a dedicated resource of the Captive's management company.

j) Internal audit

In order to comply with Article 47, the Captive has to put in place an independent internal audit function with a remit, of at least, assessing the adequacy and effectiveness of the Internal Control function (Article 46) and the System of Governance as a whole.

A Captive should fall within the scope of the Parent Company or Group internal audit function. Where it is excluded on the basis of materiality, a Captive will be expected to out-source its internal audit function to an external company which has appropriate and relevant experience.

The internal audit function should report to the Captive Board. The internal audit function should prepare an audit plan setting out the audit scope and frequency. This plan should be submitted to the Captive Board for approval.

All internal audit or review functions should have a complete and unrestricted right to obtain information from all sources.

## **4. Actuarial Function**

**(Solvency II, Level 1, Chapter IV, Section 2, Article 48)**

- 4.1. In order to comply with Article 48, the Captive has to ensure certain company decisions are based on expert technical actuarial advice. The Actuarial Function should provide the Captive Board with a report which not only contains details of the appropriateness of the underlying methodologies, models and assumptions used in the calculation of technical provisions, but also allows for the impact of the underwriting policy, reinsurance arrangements and risk management systems in place. The actuarial function can be outsourced. The person or persons carrying out the actuarial function must meet the 'fit and proper' requirements.
- 4.2. Tasks of the actuarial function include:
- a) coordinate the calculation of technical provisions;
  - b) ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;
  - c) assess the sufficiency and quality of the data used in the calculation of technical provisions;
  - d) compare best estimates against experience;
  - e) inform the administrative, management (Captive Board) or supervisory body of the reliability and adequacy of the calculation of technical provisions;
  - f) express an opinion on the overall underwriting policy;
  - g) express an opinion on the adequacy of reinsurance arrangements;
  - h) contribute to the effective implementation of the risk-management system referred to in Article 44, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5, and to the assessment referred to in Article 45.

## 5. Outsourcing

(Solvency II, Level 1, Chapter IV, Section 2, Article 49)

5.1. In order to comply with Article 49, the Captive has to ensure it meets its obligations, as outlined in the Solvency II Directive, whether or not any functions and / or activities are outsourced. The Regulators must be alerted prior to any outsourcing of critical or important functions or activities. Likewise, the Regulators must be notified of any subsequent change to the scope of the outsourced functions or activities.

5.2. Some Captives will employ Parent Company or Group Company staff to carry out some of the functions (e.g. where certain expertise is needed or where it is more cost efficient).

The outsourced services may include (non exhaustive list):

- a) Actuarial services
- b) Investment Management
- c) Internal Audit
- d) Captive administration services
- e) Claims management
- f) Insurance broking including arranging reinsurance and retrocession contracts
- g) Legal services
- h) Internal control and compliance support
- i) Risk management support

5.3. In all cases, the Captive should develop a written Outsourcing Policy which describes the decision process behind the outsourcing of the various functions, how the Provider has been selected and how they are monitored. The Captive Board is responsible for the selection and monitoring of Service Providers, as well as regular assessment of the outsourced functions.

5.4. Captives should have a written Service Level agreement in force with each Provider for critical functions which documents the services to be provided. This agreement must clearly state:-

- a) The respective rights and obligations of the Captive and the Service Provider;
- b) The duties and responsibilities of both parties;
- c) The ability of the Service Provider to comply with all laws and regulatory guidelines;
- d) The basis of remuneration for the services provided;
- e) What the cancellation provisions are for either party and they must allow a sufficient time for the Captive to find an alternative solution.

5.5. The Service Provider must demonstrate before selection that:

- a) it has an adequate risk management and internal control system in place
- b) it is able to deliver the required functions satisfactorily

- c) the same provisions apply as to the Captive regarding safety and confidentiality of Captive information
- d) it is able to respond to any questions addressed directly by the supervising authority
- e) The staff chosen by the Service Provider are of the required competence and experience and meet the 'fit' and 'proper' requirements.
- f) It has adequate contingency plans in place.