



Ensuring the proportional treatment of captives under Solvency II

1. Aon supports the Solvency II Directive and its objectives, and welcomes the provisions on proportional treatment of captives as emphasised in Recitals 18, 19 and 21 and in Articles 29, 41 and 86.
2. Aon is concerned about departures from the principle of proportional treatment of captives under the Directive in recent CEIOPS advice and national competent authority guidance.
3. Proportional treatment for captives should include simplified calculation for captive (re)insurance undertakings to assess their solvency capital requirements, suitable corporate governance and public disclosure requirements.
4. Aon encourages policy makers and legislators to support amendments to clarify the provisions of the Directive and to ensure that the principle of proportionality in the Directive is clearly reflected in Level 2 implementing measures.
5. Aon would like to develop a better understanding of why insurance companies writing premium of less than €5m are not being permitted to operate on a Freedom of Services basis if they seek exemption from Solvency II.
6. Aon also seeks clarification on how costs will be judged in relation to the increased regulatory oversight that will be applied to captives and small commercial entities.

Proportional treatment for captives under Solvency II

Aon welcomes the introduction of the Solvency II Directive and supports the principles underlying the legislation, provided that the principle of proportionate treatment of captive insurance and re-insurance undertakings included in the Directive is enforced.¹ Captive insurance and reinsurance undertakings (or 'captives') are substantially different from commercial insurers and reinsurers. Captives are owned by the undertaking's policy holder. Captives insure their corporate owner's liabilities exclusively. Captives are typically small with a simplified governance structure and outsourced management.

The Solvency II Directive recognises the unique nature of captives. Recital 21 states that –

[the Directive] should also take account of the specific nature of captive insurance and captive reinsurance undertakings. As those undertakings only cover risks associated with the industrial or commercial group to which they belong, appropriate approaches should thus be provided in line with the principle of proportionality to reflect the nature, scale and complexity of their business.'

However, this Recital is not legally binding and the key provisions in the Directive do not provide clear and differentiated treatment for captives. Since adoption of the Directive in 2009, Aon notes several apparent departures from the 'principle of proportionality' set out in Recital 21. These departures include

¹ Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) OJ L 335 17.12.2009, pp. 1–155

the CEIOPS guidelines on the calculation of capital requirements for captives and, most recently, the advice following the fifth quantitative impact study (QIS5).²

Ill-considered and disproportionate treatment of captives under Solvency II will severely damage the captive sector in the EU and will increase risks for captive owners. Captives are a key instrument for effective risk management. Captives insure risks that the commercial insurance market cannot or will not insure. Without captives, many corporations would be forced to transfer significant risk back on their balance sheets.

Aon urges policy makers and legislators to support suitable amendments to Solvency II through the Omnibus 2 Directive to clarify the proportionate treatment of captives under each of the three 'pillars' of the legislation (capital requirements, corporate governance and disclosure obligations). Aon also calls on policy makers and legislators to ensure that Level 2 implementing measures for Solvency II provide clearly and explicitly for the proportionate treatment of EU-registered captives.

Pillar 1 – Capital requirements must be applied proportionately to captives

Pillar 1 (Articles 100-131) of the Directive sets out a new Solvency Capital Requirement (SCR) for all insurance and reinsurance undertakings, including captives. Article 109 of the Directive permits the use of a simplified calculation for the SCR for sub-modules and risk modules where "the nature, scale and complexity of the risks they face justifies it and where it would be disproportionate to require all insurance and reinsurance undertakings to apply the standardised calculation."³

The simplified calculation should be appropriate for most captives. Captives exclusively insure the liabilities of the parent. Most risks insured by captives tend to be simple rather than complex. It would be grossly disproportionate in most cases to compel captives to apply the standard formula.

However, CEIOPS advice on Article 111 disavows proportional treatment for captives. CEIOPS proposes that captives only be permitted to apply the simplified calculation if they insure persons and beneficiaries who are legal entities of the group and do not underwrite any of the parent's compulsory liabilities.⁴ Given the level of mergers and acquisitions activities today, we estimate that the requirement for persons and beneficiaries to be legal entities of the group would exclude 80% of the captives using the simplifications. Furthermore, it is common practice for captives to underwrite compulsory liabilities of the parent corporation. Many captive owners elect to insure suitable compulsory liabilities through their captives because of the unwillingness of commercial insurers to pay out on time on smaller and mid-sized losses.

In addition, taking into consideration the specific business model of captives, the proposed concentration threshold in the CEIOPS advice on article 105.5 (f) would be overly onerous and imply that captives are required to increase their atypical numbers of deposit accounts from 3 to 7. Most captives run a balance sheet that is substantially below €100m and spreading deposits and investments too thinly is both costly and highly inefficient. We believe that regulators need to treat captives with a combined qualitative and quantitative approach.

Pillar 2 – Sophisticated governance structures for captives do not make sense

Aon is equally concerned about the expected impact of the Pillar 2 (Articles 41-50) provisions of the Directive on EU-registered captives. The Directive sets out detailed provisions on corporate governance for all insurance and re-insurance undertakings. These include mandatory internal controls, a separate and independent internal audit function and restrictions on the outsourcing of operational functions.

² CEIOPS: "Advice for Level 2 Implementing Measures on Solvency II: SCR standard formula Article 111 (j) Simplifications / Specifications for captives", [CEIOPS-DOC-74/10](#) (29 January 2010).

³ Article 111 grants the European Commission powers to adopt delegated acts for the simplified calculation and the "criteria that insurance and reinsurance undertakings, including captive insurance and reinsurance undertakings, shall be required to fulfill in order to be entitled to use each of those simplifications."

⁴ See CEIOPS (2010) [(j)].

These provisions may be appropriate for commercial insurance and reinsurance undertakings. However, Articles 41 to 50 make no reference to differentiated treatment or implementation of the above provisions for smaller commercial undertakings or captives.

Captives typically have a simple management structure, which reflects their typically low risk profile. Most captives outsource management and operational functions to specialist risk management companies like Aon. Strictly applying the above corporate governance provisions to EU-registered captives would be disastrous. Any new 'internal control' function would simply duplicate the captive's management structure. Few if any captives could afford stand-alone internal audit functions. It is unclear in the legislation whether these tasks could be outsourced to a captive manager, which undermines the business case for most EU-registered captives.

Pillar 3 – Captives require differentiated and specific rules on public disclosure

Aon supports the general principles of transparency underlying Pillar 3 provisions on the disclosure of information (Articles 51-56) and would emphasise that we are 100% onboard with the requirement to disclose information to regulatory bodies. However, Aon is greatly concerned that the Directive's provisions on disclosures to the public could be applied to captives without consideration to the prospective harm of disclosing un-aggregated information on policy holders.

Article 51 of the Directive specifies that all insurance and reinsurance undertakings must publicly disclose, on an annual basis, a "report on their solvency and financial condition" including information on governance and risk profile, each category of risk insured or reinsured, exposures to said risks, risk concentrations and mitigations, assets, technical provisions and other liabilities.

Commercial insurance and reinsurance undertakings typically have thousands of policy holders and would provide the above information on an aggregated basis. However, captives have only one policy holder. Any captive publicly disclosing the above information would in effect be disclosing detailed and sensitive information about risks to the parent and how those risks are managed. There is no legitimate public interest in this disclosure of such information. In fact, the public disclosure of information on captive-managed risks such as kidnap and ransom cover or litigation liability could gravely endanger the parent corporation and its employees.

The way forward

Aon believes that the proportional treatment of captives is in the general interest. Captives play a vital role in helping European corporations manage risk. It is in the general interest that Europe maintains a well-regulated and vibrant captive insurance and reinsurance sector.

Aon calls on the European Commission, the Member States and Members of the European Parliament to (1) support amendments to the Solvency II Directive through the Omnibus II Directive to specify the proportional treatment of captives, and (2) to ensure that implementing measures for Solvency II include proportional treatment for captives.

Specific amendments to the Solvency II Directive include -

- Specific reference in Article 29 (3) & (4) to captive insurance and reinsurance undertakings availing of the principle of proportionality due to the nature, scale and complexity of their business.
- An exemption from Article 51 to disclose publicly a report on their solvency and financial condition. A public report would identify a single policy holder and specific, sensitive risks insured by that policy holder, we believe that captives must be provided with real proportionality reflecting their simple management structure and low risk profile.
- We would emphasise our view that a proportionate treatment for all captives is more appropriate than a regime that includes an exemption for companies writing premium below a certain threshold and would re-emphasise our view that a more appropriate approach to concentration risk for captives is required.

Questions and comments

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