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**Solvency II to benefit captives but concerns remain**

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Preparations for EU domiciled captives appear to be on track for the January 2016 Solvency II implementation deadline, although aspects of the new capital rules still need clarification.



Günter Dröse, Chairman of the European Captive Insurance and Reinsurance Owners Association (ECIROA), is optimistic that captives based in EU domiciles-including Dublin, Luxembourg, Gibraltar and Malta-will be ready for the January 2016 implementation deadline. However, there are a number of areas where ECIROA has concerns.

"Captives in general should not have a problem implementing Solvency II next year, although there is the potential for some confrontation with local supervisors where interpretation of Solvency II remains open, most notably around how the principle of proportionality is applied," said Mr Dröse.

Proportionality is likely to be the biggest issue for captives, which are essentially subject to the same rules as commercial insurers and reinsurers under Solvency II, explained Mr Dröse. There is little guidance on how the concept of proportionality-which gives national supervisors the option of reducing the regulatory burden for less risky insurers-will be applied to captives, he said.

Challenges over proportionality will revolve around 'simplification without reducing', according to Derek Bridgeman, Vice President of Captive Solutions for Marsh in Dublin. For example, captives will have to produce the relevant corporate governance and risk management framework policy documents, however, applying proportionality, the process will not be as onerous as for commercial insurers, he said.

"Captive jurisdictions appear to be applying the principle of proportionality, however the impact of Solvency II will somewhat depend on how each jurisdiction translates its requirements into national law and how its insurance regulator then applies those requirements to captives," said Mr Bridgeman.

Mr Bridgeman believes that captives will be ready for the January 2016 implementation deadline. But implementation has placed additional demands on captive owners and managers, he said.

"The consensus is that captive market readiness has improved greatly for Pillars 1 and 2, which cover the areas of solvency capital requirement and corporate governance and risk management frameworks. This has seen captives complete forward-looking assessments of own risk (FLAOR), stress and scenarios-based testing, as well as reviews of their risk management framework," he said.

However, for Pillar 3 requirements, that cover the area of regulatory reporting, there has been little practical captive engagement with national regulators to date, said Mr Bridgeman.

"2015 should ensure that the captives are in a strong position ahead of implementation, however, this year will be a critical one for all captive owners, particularly around Pillar 3 reporting," said Mr Bridgeman.

Core rules around solvency, governance and quantitative reporting are 'stable', enabling captive owners to prepare for Solvency II, according to Mr Bridgeman.

However, there are a number of areas where clarification is required, he said.

For example, there are areas where Solvency II requirements will overlap with those of existing national regulators. The Irish regulator intends to maintain its SAO Actuarial Certification requirement, but many feel that more clarity is needed over how this will fit with the actuarial function requirement of Solvency II.

ECIROA has been working with EIOPA and the European Commission to iron out outstanding issues for captives that require clarification. For example, the definition of a captive under the directive could restrict captives' ability to underwrite third party liability risks, explained Mr Dröse. This is an issue that has yet to be resolved, although EIOPA is in discussion with the Commission, he said.

There are also unanswered questions for captive owners around equivalent regulation, under which European regulators will recognise insurance supervisory regimes in jurisdictions outside the EU. The Commission is currently negotiating so-called mutual recognition with regulators in Bermuda, Japan and Switzerland.

Equivalency has implications for the treatment of fronting insurers and reinsurers located outside the EU, potentially adding costs for captives, said Mr Dröse. While the Commission has given guidance on equivalency it has not explicitly referred to captives in the case of Bermuda, a major captive and reinsurer domicile.

"While EIOPA has agreed equivalency for insurers in Bermuda Class 4 and above, it did not refer specifically to captives. We have asked EIOPA for clarification," said Mr Dröse.

Mr Bridgeman believes that captives are unlikely to be included in the EU's equivalency agreement with Bermuda. As a result, captives based in Solvency II domiciles that insure a large policy limit and purchase reinsurance from a sister captive outside the EU-such as Bermuda or the British Virgin Islands-could potentially face higher counter-party charges under Solvency II.

However, it may be possible to mitigate this charge by purchasing reinsurance in the open market, retaining a higher limit in the European captive or potentially seeking a rating for the sister captive, explained Mr Bridgeman.

Indications are that many captives will face higher capital charges and compliance costs under Solvency II, although some are taking steps to reduce them. However, according to Mr Bridgeman, many captives are already beginning to see the benefits of the new regime.

For example, some captives are looking at potentially more efficient sources of capital, such as ancillary own funds or intercompany lending, he said.

Solvency II is also encouraging companies to make more efficient use of their captives. Many have diversified and added new lines, including employee benefits, cyber and supply chain, said Mr Bridgeman.

Captive owners are recognising that overall board ownership of the decision-making process is a critical requirement of the new Solvency II regime, added Mr Bridgeman.

"The most proactive owners have fully engaged with the ORSA requirement and see it as an effective enterprise risk management tool and recognise that the development of a risk management framework and scenario testing can generate capital efficiency," said Mr Bridgeman.

Despite predictions that Solvency II may result in some captives closing or moving domicile, the capital rules have not had a negative impact on captive numbers in EU domiciles.

"With the exception of those captives that were already in run-off, we have not seen captives closing or moving away from EU domiciles due to Solvency II. In fact, the certainty around Solvency II had a positive effect on recent formation activity across EU domiciles in 2014. We expect this trend to continue in 2015," said Mr Bridgeman.