Position paper on

Treatment of captives in SOLVENCY II

1 Introduction

With Solvency II, the EU Commission aims to have a framework applicable to everyone. However, the arguments and facts presented in this paper substantiate the necessity to apply the principle of proportionality to smaller (re)insurance corporations (i.e. smaller either by business activity, policy volume or premium value), such as captives.

Captives do not compete for market share on the open insurance market as do commercial (re)insurers. The complex rules of Solvency II could discourage groups from forming new captives and could trigger a redomiciliation of existing captives to outside of the EU.

Captives are (re)insurance companies and as such they should have the same rights and obligations, however simplifications should be made. The challenge is to ensure that the special treatment of captives under Solvency II will not have an impact on the commercial insurers and reinsurers involved in the captives' insurance programmes, in a way that penalises them compared to non-EU (re)insurers.

We would welcome the opportunity to work with supervisors and other stakeholders on further developing the detail of the simplifications for captives within the directive with respect to Pillar I, Pillar II and Pillar III issues.

2 Nature and Rationale of Captives

A captive (re)insurance company is an affiliate created or owned by industrial, commercial or financial groups, the purpose of which is to (re)insure all or part of the risks of the group it belongs to. Coverage is implemented on the basis of guidelines issued by group management.

The design of a captive structure is based on the understanding that (with this instrument) an internationally operating corporation is optimising its own risk transfer, primarily by carrying part of the risk, after diligent assessment and based on their own (and other market participant's) past losses and claims experience.

The Risk Management departments of major industrial, commercial or financial groups are dealing with questions such as: (i) What are our risks? (ii) Should we retain or not retain those risks? (iii) How should we finance those risks?

Understanding and managing the risks (taking into account the objectives of the enterprise in a proactive way) is a real strategic challenge.

2.1 Captive Objectives

The motivations of an enterprise to create a captive are numerous and can vary considerably from one group to another, depending on its objectives, its location and its activities.

a) <u>Reduction or stabilisation of insurance premiums at group level</u>

   Captives are generally used to smooth out the impact of swings in insurance costs which follow hardening/softening markets. The managers of group subsidiaries are responsible for delivering set returns on target. The use of a captive will enable enterprises to consider the global economic situation of the group and will allow the group to benefit from the mutualisation of its risks. In addition, it can obtain better conditions by transferring a global risk portfolio to the market and can achieve increased power in negotiations with the insurance market.

b) Benefiting from a good risk management

The captive enables the group to preserve the benefits of its underwriting policy. On one hand, because the parent company can retain risks with a good loss ratio within the captive and on the other hand because the captive can generate a potential reduction of premiums. By having a captive, the company's insurance premium will be priced based on the group's own loss experience and will be less impacted by the downgrading of the loss experience of other insured parties. In addition, the group will gain an advantage from its risk prevention and management measures.

c) Optimisation of financial flows linked to risk management

Some risks cannot be transferred to the insurance market and are a threat to the profit and loss and balance sheet of the group. By using a captive, the group can protect its balance sheet by setting up technical reserves for future losses within the insurance accounting of the captive.

In addition, the captive is able to retain the return on accumulated funds. This return is lost when premiums are paid to a commercial insurer.

d) Solution to market inadequacies

During 'hard market' periods, companies may find it difficult to get the cover they require for certain risks. They may even be met with reductions in limits, increased deductibles and refusals from insurance companies to cover these risks. The captive provides the group with tailor-made covers that can compensate for these inadequacies, for example through implementing a specialised insurance wording where the market standard is not sufficient.

e) Direct access to worldwide professional reinsurers

Direct access to the reinsurance market reduces the number of intermediaries, diminishes the frictional costs and facilities the establishment of long-term and stable partnerships. In addition, the terms offered by the reinsurance market are generally more competitive (as structural costs are lower for reinsurers than for direct insurers) and the premiums required are specifically adapted to each client. The group could also have the possibility to implement long-term programs with some reinsurers.

f) Better control of risk management

A captive simplifies the centralisation of worldwide insurance programs and the gathering of information regarding risks. It enables risks to be managed at group level and guarantees a better risk awareness at operational level and an increased transparency of insurance-related costs. Having a captive provides management with a greater focus and a more strategic approach towards risk retention, risk capital allocation and risk tolerance.

3 The Solvency II objectives

Captives usually have a simple risk structure compared to a commercial (re)insurance undertaking. We therefore believe that supervisors should develop a different and more appropriate supervisory approach to captives taking into consideration their nature and purpose

This should not be linked to the size of the captive but to the nature, scale and/or complexity of the risks supported via the captive structure.

EU OBJECTIVE 1: Improve protection of policyholders and beneficiaries

This objective has limited applicability to captives, since the original policyholder of an insurance captive is normally also its owner. This applies also indirectly to reinsurance captives.

The goal of customer protection to secure policyholders, individuals (private lines) as well as commercial corperations or big international enterprises, will not be impacted by captives. Neither a single captive nor a group/community of captives may have a chance to produce a crisis or a significant impact on the whole insurance system. Systemic risk is therefore not relevant.

This is a good reason why the rules for captives should be simplified.

The arguments against each sub-objective of Solvency II (a-e) below further support why there should be an introduction of special captive rules within the Solvency II framework.

a) Align capital requirements with the underlying risks of an insurance company

I. A captive is usually an integrated part of its owner's risk management programme.

II. As mentioned above, the rules should take into account the size, nature and complexity of the captive. The nature of the risks is similar to that of a commercial (re)insurer but the degree and diversity of exposure differ substantially. Captives do not have a portfolio of different policyholders, but instead have a limited number of policies per line of insurance to optimise the risk transfer strategy of their corporate group.

III. Captives normally have a good knowledge of reported claims since their owner is the only claimant and do not need to use actuarial evaluations of market experience etc. to properly establish their ultimate net loss reserves.

IV. Captives do not compete with the financial markets as commercial insurers may.

V. Corporations use their captives to manage the group's transferable risks.

b) Maintain strong, effective insurance protection while achieving optimal capital allocation

Some of the peculiarities of captives directly affect their solvency requirements under Solvency II in a negative way. For example:

I. Concentration of assets. For a captive it is not always appropriate to hold a diversified portfolio of investments. Therefore captives sometimes pool part of their accumulated funds with one or two banks.

II. Often the captives' insurance portfolios are limited to a few lines of business, thus causing a lack of diversification. It is a special feature of captives to underwrite just some lines of business. This is one of the reasons why fronting insurers diligently use insurance and finance experts to check the structure of the underwritten portfolio and the technical provisions.

III. A captive writing a single line, or a few lines of business has the potential for high claims volatility. Unlike commercial insurers captives do not have stable portfolios or homogeneous risks. A limited portfolio and a low number of transactions will result in actuarial computations that are statistically unreliable. Statistical volatility will lead to volatility in the level of capital.

IV. Significantly, captives are calculating more conservatively compared to commercial insurers, especially in structuring their reinsurance agreements. Captives typically have a combined ratio lower than 100% and very often have an annual aggregate limit within their contracts.

V. Most captives are unrated and the capital charge for the fronting insurer may be high. Therefore the rating of a captive should always be seen in connection with the rating of the owner (the parent company). However contract clauses such as "simultaneous payment clauses" or "cut-through-liability-clauses" reduce the risk for the insurance market. Referring to II. above we emphasise the fact that fronting insurance companies use their expert teams to check the financial strength of their counterparty captive (re)insurer.

Other factors mean risks are of less impact in a captive:

VI. The policyholder being a group company, the risk of being sued by a policyholder is low.

VII. The operational risk is low if the captive has few transactions or a limited number of policies. A contributing factor in reducing the operational risk further is the fact that very few captives have their own employees. (please refer to c below).

c) <u>Ensure that companies improve their risk management practices</u>

Captives are generally limited in size and typically many functions of the captive are outsourced including the day-to-day management. A recent captive study conducted by Marsh shows that over 65% of captives operate with expense ratios of 5% or less.

Furthermore, most captives are not complex operations supporting sophisticated internal functions but instead comply with the risk management function of the parent company. A captive is obliged to obey the established, sophisticated internal control and reporting guidelines and policies of the group. Control over outsourced functions is required under the corporate governance obligation separate from solvency rules.

d) <u>Ensure a high standard of risk assessment and efficient capital allocation</u>

Under a) above it is mentioned that captives have a better risk knowledge than regular (re)insurers as the same group is both the underwriter and the risk owner.

The corporate governance rules are increasingly important. When, according to these rules, risks have been identified these should be adequately treated through a dedicated capital allocation or transferred. The captive is an important tool which makes it possible for the company to retain risks within the group, should it wish to do so. Such a decision is relying on a detailed analysis of the potential impact on the strategic goals of the company. The decision is also relying on the most efficient allocation of capita which includes risks retained by the group via its captive. For the policyholder (i.e. the group) a solid reinsurance programme is more important than capital allocation. A proper capital allocation becomes necessary only when third party risks are protected.

e) <u>Increased competition and transparency should also lead to improved product development and pricing</u>

The setting of a captive premium is usually done on an arms length basis from insurance companies. Underlying the pricing from the insurance company is the loss history of the specific company and not a mixed portfolio from the overall classes of business.

Captives design and develop tailor made policies which are only partly transferable to the insurance market.

EU OBJECTIVE 2: Improve international competitiveness of EU insurers

A real competition between captives and fronting- or reinsurance companies does not exist. Captives are used to cover the gaps created by the unwillingness of the insurance market to pay for smaller or mid-sized losses and claims which may be evaluated as a money-exchange-process.

As mentioned in the introduction, captives do not compete for market shares on the open insurance market. Instead the risk of not adapting the rules to the peculiarities of captives could be that the strong competitive offshore captive market would gain a significant advantage over the EU captive domiciles. We believe that the necessity for corporations to use captives is strong enough to drive these captive owners to consider moving their captives outside of the European market.

EU OBJECTIVE 3: Deepen integration of the EU insurance market

The development of a proportionate, risk-based approach with appropriate treatment both for small companies and large, cross border groups (as stated under the objectives) would impose special, simplified requirements for captives.

Further the EU Commission would like a harmonisation of the solvency rules across EU, to modernise surveillance and remove arbitrary restrictions. These goals could be achieved with simplified rules for captives.

Finally the Commission would like to move towards a more transparent regulatory regime. Here we would like to request a differentiation between disclosure to regulators and disclosure to the public. Whilst disclosure to regulators does not cause any problems, public disclosure could be harmful to the parent group and to the captive in certain cases. Furthermore, there is no public interest for disclosure and transparency towards the market as the stakeholders belong to the same group and therefore already have access to the information through other channels. The policyholder has access to the information via the group accounting and risk management department whilst insurance and reinsurance companies request information as described in “EU Objective I”, 3 b) II.

4 Executive summary

As the Framework Directive establishes the proportionality principle as a general principle we strongly request for captives to be exempted from the normal Solvency II regulations and demand simplified regulation following the spirit of this principle.

PILLAR I

Captives are generally limited in size and day-to-day management is normally outsourced. Fully implementing Solvency II for captives would substantially increase running costs and may make captives financially unattractive ..

Furthermore, captives will not be able to develop an internal model which could take into account the peculiarities of this risk management tool. It is therefore very important that new Solvency rules are adopted for captives in a way that will not penalise them for operating in a niche where the target risks of Solvency II are insignificant. We must make sure that the simple structure (few insurance lines, limited investment portfolio, low number of transactions etc.), will not work against the captive in a solvency perspective.

Taking all of the above into account we request to have a solvency standard adapted to the risks within captives where calculations could be made “in-house”, speedily and without a substantial increase of workload.

PILLAR II

As discussed under 3 b) VIII and c) the operational risk for a captive is low due to its simple structure and to the fact that the captive normally has no employed personnel. This simple structure does not support sophisticated internal functions. As the captive normally abides by the different management functions, corporate policies and organisational structure of the parent company, we believe that the proportionality principle could leave the operational risks of a captive outside Solvency II.

PILLAR III

As discussed under the last two paragraphs in “Objective 3” the disclosure for captives should not involve public dsclosure. Some companies are required to disclose their risk management strategy in their annual reports and would thus be faced with unnecessary duplication of effort.