SOLVENCY II: WHAT HAPPENS NEXT?

After more than a decade of design, debate and delays, the European Union's much anticipated new solvency regime takes effect from 1 January. Having failed to secure a separate class of insurer for captives, owners and service providers will be beholden to the requirements as interpreted by their domicile's regulator. Over the following pages, leading industry players provide their thoughts on the impact Solvency II will have on the captive industry over the next 12 months

Compiled by
Richard Cutcher

Vincent Barrett,
Chief commercial officer, Aon Captive & Insurance Management

Much of the previous uncertainty has now been removed for Pillars One and Three (quantitative modelling and regulatory reporting) thanks to detailed guidance from EIOPA, the EU-wide regulatory body tasked with providing guidance on how the Solvency II directive is to be implemented. This leaves Pillar Two (systems of governance) including the ORSA. Perhaps this element of Solvency II remains to be discovered in terms of actual regulatory practice in each respective EEA domicile.

The difficulty is that Pillar Two is especially principles-driven with the relevant paragraphs in the directive being very concise and also subject to an overall (silver bullet) principle of proportionality. Whilst EIOPA has issued guidance (amounting to many thousands of words) in recent years, it is still up to the Board of the Undertaking to represent its systems of governance and forward planning to the regulator as being fit for purpose, compliant with the directive, proportional and therefore practically achievable.

This link with proportionality and "practically achievable" is incredibly important for a captive, but its systems of governance must still be compliant with the directive and subsequent guidance from EIOPA. While some regulators may essentially "give up" and accept that the board will represent in good faith that its systems of governance are adequate, others may probe, test and challenge. This is the problem – the uncertainty of the regulatory response to whatever is proposed.

A good way to resolve this uncertainty is to design a system of governance that meets all the known regulatory requirements and then transform this into a database platform which can produce summary information for the board at a high enough level to keep the system of governance "practically achievable" and meaningful. This is essentially the Aon approach. Many regulators are already familiar with this approach so we expect this to gain rapid acceptance during the next 12 months and thereby remove a lot of uncertainty.

Dr Paul Woehrmann,
Head of captive services, EMEA/APAC/LATAM, Zurich Global Corporate

We expect that most captive owners and managers are busy implementing business and operational change initiatives in anticipation and preparation for the Solvency II implementation. The first 12 months will be challenging as the effectiveness of the changes will be "stress tested". As the regional implementation authorities will start to enforce compliance with Solvency II, captive owners will learn first-hand whether or not their captive structures, financial make up, processes and reporting capabilities will meet the requirements. As a result, we expect that an increasing number of customers will need their insurance partner's support, expertise and advice to address identified critical compliance issues.

In particular, the implementation of the reporting requirements under Pillar Three of Solvency II may present significant challenges. We see the additional and more granular reporting which is needed to meet regulatory requirements and deadlines is one area where captives might struggle to compile reports requiring timely access to a range of data sources such as their fronting insurers, captive manager, broker, banks and investment managers. A lack of adequate resources to deliver compliant reports may push captive owners to look at outsourcing opportunities and enlist third-party service providers. Additionally, some captive owners may consider alternatives including virtual captive concepts such as segregated account structures and protected cell captives.

As the implementation of Solvency II becomes "real" we expect many captives to rethink their captive strategy and explore either "growth", "shrink" or "exit" as possible options. A growth strategy that aims to incorporate additional risk such as international employee benefits may make sense as a captive owner can leverage diversification and benefit from a lower portfolio volatility. This is rewarded with lower minimum capital requirement. Additionally, economies of scale can lower administrative costs relative to the captive's risk and increase return on capital. If growth is not a viable option, some captive owners may seek to close their captive or move to the above mentioned virtual captive concepts.

Jo Willaert
President, Federation of European Risk Management Associations (FERMA)

The role of EU member states is now

crucial in the implementation of Solvency II as each national authority will be responsible for ensuring that the capital and governance requirements are effectively applied by its insurance industry.

This raises two important points to watch: The cost of regulation and proportionality. To deal with the Solvency II workload, local supervisors will require appropriate resources to have sufficient staff both in numbers and expertise. Of course, this is likely to mean higher regulatory costs that are imposed upon insurers. This is already the case with the rising fees of the Prudential Regulation Authority (PRA) in the UK, justified partly by the Solvency II implementation.

On proportionality EIOPA said it will also closely monitor the way the Solvency II system of governance is implemented in the different member states and this includes the principle of proportionality embedded in the Solvency II Directive.

EU captive jurisdictions such as Ireland, Malta or Luxembourg will have to apply the principle of proportionality, depending on the nature, scale and complexity of the underwriting entity, therefore the impact of Solvency II will also be conditioned by the local implementation (i.e. translation, definition…) of the principle by the local insurance supervisors.

So far, despite higher capital charges and compliance costs, it is acknowledged that Solvency II will drive captives in the right direction in terms of risk governance. In fact, the ORSA, a key element of Solvency II Pillar Two, is also an opportunity for organisations to be smarter in using their captives, with more diversification and a more efficient decision-making process.

On 26 November 2015, the Bermuda supervisory regime was officially recognised as fully equivalent with the Solvency II regime. This does not, however, apply to captives and it is as yet unclear what would be the additional requirements for an EU (re)insurer doing business with a captive located outside the EU, including Bermuda.

In our *FERMA Risk Management Benchmarking Survey 2014*, 55% of respondents thought Solvency II would favour risk mitigation policies in their organisation in interesting the management to reduce its expected losses. It will be interesting to reassess this element in 2016 with the new edition of our benchmarking survey.

As Gabriel Bernardino, chairman of EIOPA, rightly said at an international conference on 2 September 2015: "Capital will never cover up for the lack of proper governance!"

Matt Latham
Head of captive programmes, XL Catlin

Given the numerous delays and the column inches written on the subject, I would hope that captives and their parent companies have already assessed the impact of Solvency II and developed suitable strategies to remain effective in the new environment. Those that are ill-prepared for the increased capital, governance, financial reporting and management time required may want to reconsider whether a captive subject to Solvency II rules still makes sense for them, but I think most have already made that decision and will be continuing.

Under Solvency II it is widely accepted that the amount of capital captives need will be increased, and we have seen captive owners look at the drivers of that capital calculation to consider ways that those increases can be mitigated and capital efficiency can be improved. The main change we have witnessed is the addition of new types of risk into the captive that have low correlation with the existing portfolio and as a result increase diversification.

This trend was supported in a survey we conducted for UK risk managers earlier this year when 71% said they were considering adding new lines of business to their captive. Most popular among those new risks were employee benefits and cyber, but we have also seen evidence that risks where no traditional insurance solution exist, such as non-damage business interruption and reputational risk, are being considered.

Another strategy that captive owners can utilise to impact capital is a change to more efficient programme structures. I have spoken before about captives with "gross" line programmes looking to move to a "net" line structure to remove any credit risk to reinsurers. This more simple structure will also improve efficiencies and reduce any operational risk as there are less entities to move premium and claims payments through.

Captives have proved over the years that they are able to adapt to new regulations and rules and are showing this once again. If one of the outcomes of Solvency II is having a more agile captive market that is prepared to innovate then this will be a positive impact.

Konstantin Langowski
Financial analyst, analytics, A.M. Best Europe - Rating Services Ltd

Initially, it appeared that captives and their owners viewed Solvency II as a burden due to cost issues. A.M. Best's rated captives, however, appear broadly to hold the view that the higher costs from increased requirements in terms of risk management and governance are offset by a better understanding of their risk profiles. Over the next 12 months, A.M. Best believes that Solvency II will be seen as a positive development for those captives that expand their risk management capabilities and offer greater value to their parent companies.

Although it was felt that Solvency II would only concern European Union-based insurers, A.M. Best believes that knock-on effects are already impacting industry practise globally and influencing regulators elsewhere to adopt risk -based regulatory regimes.

As Solvency II's capital requirements under the standard formula will often be demanding for insurers that do not generate a high level of diversification benefit in the calculation, parent companies have also been reviewing the acceptance of new risks in existing captives to increase diversification. A captive that is able to accept different risks would ultimately be of increased value to its parent.

Falling corporate tax rates in Europe and a soft insurance market globally, means captives must continually justify their existence. Over the next twelve months captives will, more than ever, have to demonstrate their business cases to their parents by proving they add value to the risk management process.

Chris Lay
President, Marsh Captive Solutions

A key area for attention in 2016 will be the individual approach on implementation which will be adopted by national regulators. Not only is there a desire to achieve commonality in approach across all countries, but additionally the extent to which principles of proportionality will be applied by individual states will be closely followed.

At a more detailed implementation level there are a number of areas where greater guidance and clarity is needed before the full impact of certain aspects of the new regime can be assessed. This includes areas such as the treatment of Deferred Tax Assets, the regulatory response to new investment and capital forms not expressly considered in the legislation as adopted, and indeed the precise approach to equivalency or non-equivalency in key jurisdictions outside the EU.

Now that captive owners are fully familiar with the new regime, and through the ORSA process have become more sophisticated in their thinking around capital utilisation and investment return, we are likely to see a broader integration of captives into the risk management and enterprise risk techniques of their parent groups. With the pursuit of capital efficiency we anticipate seeing an increase in diversification of captive risks – beyond the traditional areas of property and casualty, into non-traditional areas such as employee benefits, supply chain and cyber risk.

"We anticipate that the growth rate in the number of captives with the EU domiciles will increase, and believe the EU captive market will become one of the more sophisticated markets over time"
Chris Lay

Captive owners are also likely to explore alternative forms of capital (Tier 2/3 Capital) in order to strengthen their capital base. The use of Letters of Credit, Parental Guarantees, Subordinated Debt and Unpaid Share Capital are options which will be explored.

Regarding the impact on the global captive market, fears that there would be a fall-off in onshore EU captives post Solvency II have proven to be ill-founded. We anticipate that the growth rate in the number of captives with the EU domiciles will increase, and indeed we believe the EU captive market will become one of the more sophisticated markets over time.

In our own business we anticipate there will be a greater call for the services of captive managers and advisors as captives address evolving aspects of the SCR calculations and focus further on a fully integrated service solution across all three Solvency II Pillars.

Guenter Droese
Chairman, European Captive Insurance and Reinsurance Owners` Association (ECIROA)

Captive owners will need to communicate with local supervisors to find common sense about structure, volume and confidentiality of the required delivery to their supervisor. The majority of captives are prepared for all questions to be discussed. It should be helpful to form a professional and friendly relationship with the respective regulator.

Europe has committed itself to Solvency II, but globally we will have to wait and see how much the request for equivalency may have an impact on some capital calculations for market participants, insures and captives; as well as the insurance premium development.

Paul Owens,
CEO, Willis Global Captive Practice

With the final countdown to Solvency II now underway it is worth trying to predict the likely impact. Initially many commentators suggested that there would be a flight from Solvency II domiciles to those outside the regime. Yes, we have seen a few look to move or even close and would expect some owners to continue to monitor the situation. Solvency II is becoming the gold standard and will continue to be so. Captive owners will want to operate in best in class environments which Solvency II brings.

It is likely that non-EU domiciles will look to equivalence or implement their own version, particularly a risk based capital (RBC) framework, in order to compete and maintain stability.

One concern is the lack of proportionality with regard to captives versus full insurance companies. Hopefully regulators will recognise this as they gain experience in the new world and modify their approach accordingly – reducing some of the burden. One impact of the new requirements may be owners who have decided to go self-managed may require more support from expert advisors as they recognise the new skills needed to fulfill the mandatory requirements. But predictions of slowing growth in Europe are unlikely to materialise. Yes, there are more overheads and bureaucracy but a captive solution should take all factors into account when assessing the viability. Some growth, interestingly is likely to come from the use of PCC structures and using captives to write additional – non correlated risks – such as Employee Benefits – that improve capital efficiency. I think the key is not to fight the changes but embrace it.

Clive Hassett

Director for multinational services, ACE European Group

Insurers and captives should by now understand all of the reporting and governance implications of Solvency II – and many such as ACE already have their frameworks in place. Yet it will only be post-implementation that we will understand how local financial regulators choose to involve themselves and exercise their roles. There is clearly room for variation between countries, in particular in the area of proportionality. Lack of consistency could be a real challenge to manage and, longer- term, may lead to the re-domiciling of some captives to more favoured locations, if certain regulators are perceived to be more flexible than others.

Now that all EU insurers are operating on the same basis from a perspective of common capital and solvency rules, albeit with differing internal models, it will also be interesting to see if there is any consistency of approach in underwriting strategy, reinsurance and capital management. Several major insurers have spoken recently of the need for the market to improve profitability and return on capital.

Some of the trends we could see include: a widening of the classes of business written by captives into newer and emerging lines accompanied by an increase in premiums to existing captives to provide some capital relief and make greater use of self-insurance capability; rising frictional costs (such as LOC/ trust fees) if there is greater demand on increasing or extending collateral requirements followed by continued rationalisation to close or merge individual units, in order to avoid unnecessary administrative and governance overheads; and greater attention paid to investment management and asset selection, potentially with more outsourcing to specialist investment managers.

Dave Provost

Deputy commissioner of captive insurance, Vermont

Captive regulation in the United States is naturally based on the tools used to regulate traditional companies, modified for the limited purpose that captives serve. There are many similarities between the seven core principles of the US state-based system for regulating insurance solvency and the three pillars of Solvency II. Of course there are just as many differences, too, but I expect that the US and EU will recognise each system as equivalent in effectiveness.

That said, this is not a high priority for our US based captives. It is obviously something we are watching closely, but Solvency II does not directly impact the operation or regulation of our captives. Certainly, it can be an important consideration when dealing with multi-national reinsurance treaties, but I don't see anything insurmountable there. We will continue to focus our efforts on prudent regulation of our captives, proportional to the risk retained.

It may create some opportunities for US based domiciles when companies are considering forming in a Solvency II jurisdiction versus a US domicile. Solvency II may make it more complicated to form in certain jurisdictions. The application of the proportionality principle may also create some opportunities in the EU; there will be room for variations even among EU jurisdictions.

Malcolm Cutts-Watson

Independent captive consultant

There are eight key developments that I believe will play themselves out during the first 12 months of Solvency II implementation and reach beyond the directly affected European domiciles. They are:

- Domiciles worldwide will look to bring in Solvency II style regulation in 2016. Some will be a straight copy, others will water down to provide a Solvency II-lite version
- EU captives will consider their optimum domicile and some will move offshore
- Venture capital will enter the EU small insurer space to provide much-needed solvency under Pillar One
- Work will continue under Pillar Two to refine management and governance

of risk processes and documentation appropriate to the business risks
- Pillar Three reporting will cause the biggest headache
- Regulators will be overwhelmed with filings
- Smaller captive managers, without deep technical resources, will struggle to continue inside the EU
- Focus will turn from liability to the asset side of the insurers' balance sheet

Sarah Goddard
CEO, Dublin International Insurance & Management Association

Solvency II. The only two words which have both kept me awake at night and sent me to sleep, for more years than I care to remember. It's been touch and go at times, frustrating, revealing, challenging, engaging, and it still feels a little unreal.

According to writer Philip K Dick, "Reality is that which, when you stop believing in it, doesn't go away." Using that logic, it finally looks like Solvency II is here to stay, as it morphs from the semi-abstract into full tangibility.

In the short term, the new risk world – new processes, systems, approaches, perspectives, challenges, structures, relationships, reports, analyses, supports, assessments, interpretations, applications – will increasingly be absorbed into the corporate DNA of the captive industry. Many of these aspects of Solvency II have already been brought into play over the past few years in Dublin, but the full switch-on will highlight detail which has previously been hiding in the Solvency II shadows. Captive managers and owners alike are going through an intensive phase of adaptation with the sheer volume of the known knowns, and adding the challenge of the unknown unknowns will make for an unprecedentedly busy year.

But practice makes perfect and conquers concern. Captives have already proved themselves versatile in assimilating much of the new risk topography, increasing lines of business to reflect diversification benefits, actively implementing capital efficiency programmes and developing refined ORSAs. The more that these and other elements such as supervisory reporting are undertaken, the more the industry will become habituated to the new environment.

> "Although Solvency II is labelled as a maximum harmonisation directive, jurisdictional differences will emerge"
> Sarah Goddard

Although Solvency II is labelled as a maximum harmonisation directive, jurisdictional differences in treatments and application will emerge during the next few months and years. Ultimately, captives need to ensure that they are treated appropriately for their business risk profiles, and the refinements at both national and European level will be key over the next phase of regulatory development.

Dominic Wheatley
Chief executive, Guernsey Finance

The EU insurance industry is very large and complex, populated by every conceivable insurer from large global multi-line insurance groups down to niche regional mono-line companies. Any regulatory system that is going to be effective in supervising such a diverse and complex beast will itself be large and complex.

Of course, following the issues that emerged in the international banking industry in 2008, the key drivers of Solvency II are the need to control systemic and group risk – that is, risks associated with the leveraging of internal capital by multiple insurers that share one group balance sheet, and the risks associated with the widespread sharing of risk through coinsurance and reinsurance arrangements that can result in under- or un-appreciated consolidated exposures by individual insurers. Small wonder that the Pillar Two and Three requirements relating to governance and regulatory oversight are both detailed and onerous.

However, in among the complex jumble of insurers are captives: special purpose subsidiaries designed for the efficient financing and management of retained risks by larger corporate insurance buyers. Not only do these have no group or systemic risks associated with them but their failure would affect no retail insurance buyers or vulnerable third parties. As insurers of the risks of their own parent they are the very opposite of those for whom Solvency II was designed. Therefore, it would be of little surprise if captive owners regarded the heavy burden of regulation under Solvency II to be disproportionate to the risks their captives present from a regulatory standpoint.

This in turn could lead to a growing number of them finding a more effective business environment in Guernsey, Europe's largest captive insurance centre, which has not pursued Solvency II equivalence. Regulation here is both proportionate and responsive to the needs of small and niche insurance companies, including captives. Not only is this more cost effective for the captive owners, but the regulatory outcome is also far better, a fact borne out by the extremely low level of failures among Guernsey captives over the last 30 years, and is fully in line with global standards.