



uch has been written over the past two years predicting a less than positive impact on the majority of captives when the Solvency II Directive is implemented in 2013. However, taking a simplified view of the Directive as a capital increase exercise misses the 'raison d'être' for the introduction of the legislation, which is to drive improved standards of risk management and greater financial stability across insurance companies as a whole, for the benefit of policyholders and, indirectly, shareholders.

Ironically, it may be possible in certain cases for some captives to go against the accepted logic and actually reduce capital requirements by lowering their risk profiles through improved governance and risk management. As a result, reduced premiums for the business unit policyholders of such captives may be possible, but these cases are likely to be the exceptions to the rule.

A great deal of effort has been expended by the captive lobby (ECIROA, FERMA, MIMA, and others) in defending the position that captives should be subject to less demanding Solvency II requirements than 'normal' insurers and are indeed worthy of special consideration given that:

- Risks insured in captives can be complex (they provide coverage not readily available in the commercial insurance market), and are more akin to those insured by niche underwriters. They do not necessarily follow traditional market cycles.
- Captive risks are limited in number and are restricted to those of the parent group (although in some jurisdictions risks of 'associated' companies are permitted).
- As 'mass' risks are not insured there is no risk to the public at large in the event of captive failure and consequently the laws of large numbers applicable to traditional insurers are less relevant.
- The number of asset classes tend to be limited compared to those found in the balance sheets of most commercial insurers and typically captives'

investment strategies are much less complex.

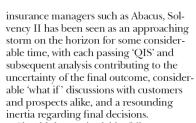
The final balancing act to be performed by Karel Van Hulle and his team at the European Commission will be determined by the persuasiveness of the captive lobby at the EU and national levels, the analysis of the QIS5 results, and of course, the advice given by EIOPA (formerly CEIOPS) to the EC. Not only will the outcome of the deliberations determine the growth or otherwise of the captive industry for the coming years, but also the types of captives which could rise to prominence as 'champions' in mitigating capital requirements under Pillar I, and the extent to which the provisions of Pillars II and III will be felt.

## The insurance managers' perspective

In the extensive cut and thrust of the debate on Solvency II and its impact on captives over the past years, the 'real and present danger' to service providers to the captive industry has hardly, if at all, been commented upon. From the perspective of

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Should the captive lobby fail to carve out some meaningful concessions along the lines of the 'simplification' and 'proportionality' proposals which result in serious capital increases under Pillar I. and excessive costs and resource allocation under Pillars II and III, the impact on the number of active captives and reduced interest on the part of potential captive owners would have severe consequences for most managers.

## The silver lining

During this unsettling period pending the implementation of Solvency II in Brussels, the enterprising insurance manager can assist clients and prospects in positioning themselves for a future in which risk-based capital adequacy, a consistent basis of asset valuation, greater risk management, compliance and disclosure will at least in the short to medium term, put greater financial and administrative pressure on captives and the broader insurance market alike.

Ironically, Solvency II could well be the catalyst that contributes to a new wave of captive formations or reformations and consequently, growth opportunities for insurance managers. This clearly goes against the current sentiment that Solvency II will lead to a thinning out of existing captives; especially those with already stretched capital positions and whose parents may be less than enamoured with the prospect of further capital and expense demands to keep their captives afloat under Solvency II provisions.

For such parents, particularly those in the middle market segment, replacing an existing captive and especially a reinsurance captive, by a protected cell or cells in a PCC, could prove to be a more economically viable alternative that would mitigate the impact of Solvency II. In this respect, Malta, as the only full EU/eurozone member state with PCC legislation and one which welcomes direct captives with resulting availability of EEA passporting rights, could be the domicile of choice for such a strategy. Substantial savings could be derived from the following:

 Pillar I capital requirements could be minimised compared to those for a full captive as the minimum guarantee fund for a protected cell would be met by the PCC 'core';

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- The potential additional costs imposed by compliance with Pillar II for a standalone captive could be considerably reduced depending on the strategy adopted by the PCC as regards risk management and compliance on behalf of its cells:
- Lower operating costs compared to most EU domiciles given Malta's modest salaries (despite maintaining highest quality financial services workforce), rental and other over-
- Direct captives using EEA passporting rights avoid the fees and the need for collateral security associated with fronting arrangements for reinsurance captives;
- Simplified administration freeing up management time and reducing costs.

Other financial advantages that could be achieved by replacing a full captive with a protected cell include:

- Release of capital to the parent group; Possible tax advantages compared to existing arrangements given Malta's OECD-compliant tax environment, its extensive double taxation treaties and its full imputation system of taxation linked to refunds upon dividend distribution (received by shareholders within weeks of tax being paid);
- The existence of tax efficient redomiciliation legislation facilitating the movement of captives from other
- Unlike many other onshore EU domiciles, ultimately closing down or migrating a Maltese captive to another domicile would not incur any claw back of tax benefits already

Re-domiciling an existing full captive to Malta could also be more advantageous than the status quo, depending of course upon the relative costs at the current domicile and other factors to be analysed during the feasibility study.

To date in the overall captive debate, the

manner in which PCCs will be regarded under the Solvency II provisions has not been specifically addressed. However, it is assumed that PCCs will continue to be considered as a single legal entity as is the case under Solvency I, and that their cells will continue to benefit from lower capital requirements compared to standalone captives.

During this period of uncertainty regarding the outcome of Solvency II provisions regarding captives, captive managers should not overlook regular appraisals of their clients' risk appetites and risk portfolios that may reveal opportunities to reduce capital requirements through changes in retentions, risks insured in the captive and of course reinsurance programmes.

The potential increases in capital requirements and costs needed to meet the more stringent provisions of Pillars I, II and III are a major concern to direct writers of third-party business, as well as to captives. Many of the smaller insurance companies that have been set up in recent years for the purpose of insuring extended warranty and similar 'consumer' coverages could equally consider the advantages presented by protected cells.

Whatever the implications of the Solvency II Directive on individual commercial insurers and captives, it is certain that those who have participated in the debate and the QIS exercises will have achieved a better understanding of the risks facing their businesses and the measures necessary to address and manage them from both a qualitative and quantitative standpoint.

Ron Clark is a director of Abacus Risk Management Services PCC Ltd, Malta. Prior to ioining Abacus, Mr. Clark was with the Zurich financial Services Group for 13 years serving as CEO of the Belaian. Luxembourg and Dutch operations and has occupied several underwriting managerial and CEO positions elsewhere in Europe and the US

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