

CAPTIVES

It is a fallacy to think Solvency II will only affect E.U. captives. Any captive that touches E.U. risk will be impacted.

On the whole, the insurance marketplace has weathered the unprecedented financial storm of the past year and, to the surprise of many, achieved a kind of balance. Big losses in 2008 and atrocious investment results led most observers to predict a hard market turn. The recession, however, had a dampening effect on demand that more or less balanced the pressures on supply, and the marketplace remains for the most part flat. How long this will last is unclear, but for now, the marketplace forces that push insurance buyers toward or away from alternative risk options are at bay. This does not mean the captives industry is static. Below we focus on two issues that bear watching: increased use of captives for employee benefits cessions and the coming of Solvency II rules in the E.U., which will have an impact across the ocean from Europe.

BENEFITTING FROM BENEFITS CAPTIVES

Employee benefits cessions to captives are generating increasing interest in the U.S., with a growing number of corporations with U.S. employees pursuing this option. Benefits captives are much more common outside of North America, particularly where multinational pooling is involved. The reason for the delay in the U.S. is that benefits plans typically are governed by federal laws set out by the Employee Retirement Income Security Act (ERISA). Benefits cessions to captives historically have required a regulatory exception involving a lengthy and expensive application and approval process.

In 2000, Columbia Energy received the initial exception, followed by Archer Daniels Midland in 2002. Subsequently, federal officials instituted a fast track approval process, granting approvals to applications incorporating plan components such as an A-rated fronting carrier, enhanced benefits, a domestic U.S. domicile and an annual actuarial analysis. So far, the most commonly approved lines are Long-Term Disability (LTD), Group Life and Accidental Death & Disability. But other lines are possible.

Four companies (Banner Health, Memorial Sloan-Kettering, United Technologies and Deutsche Post) were approved through the first two-thirds of 2009, following six approvals in 2008. Three more are currently pending (Microsoft, Dow Corning and R+L Carriers). Coca-Cola's application to cede retiree medical coverage was rejected for not following the requirements of the fast track process. Coca-Cola is evaluating whether to submit a complete review.¹



There are a number of traditional self-insurance and risk management benefits for using a captive for benefits funding, such as management of premiums and control of losses. However, an additional factor bolstering the appeal of captives is an IRS ruling that captive contributions constitute third-party or unrelated premium, strengthening the case for premium deductibility for traditional Property & Casualty cessions.

SOLVING SOLVENCY II

Two new words have entered the captive lexicon: *proportionality* and *equivalence*. The instigator of this new vocabulary is Solvency II, the European Union's solution to risk-based solvency for the (re)insurance industry. This regulatory regime goes into effect in 2013 but is already having a significant impact on the captive industry, which must come to terms with the implications of regulation targeted at and better suited to commercial carriers. A major area of concern is the way Solvency II treats the concentration of risks, which is integral to most captive business models. A captive with a single policyholder certainly presents concentration of risk. Under Solvency II, that could incur a capital penalty.

PROPORTIONALITY

The European captive industry is actively lobbying the E.U. Commission to *proportionally* apply aspects of Solvency II to captives in a way that reflects their unique status. They are arguing, in part, that the consumer protection requirements underpinning Solvency II should not apply when the financial institution subject to the regulation (the captive) is actually owned and funded by the captive's only consumer (the parent company). Proposals for some form of captive exemption from the full rigors of Solvency II are expected to be released shortly. These are expected to apply to pure captives only – entities that only underwrite the risks of the parent company.

In the meantime, what should European captive owners be doing? If not already familiar with Solvency II, they should get up to speed with the proposed regime. Next, they should participate in the consultancy process and, where possible, support captive interest groups such as ECIRO, an association of captive owners established to lobby for special treatment for captives under Solvency II. The detailed regulatory framework is under construction and now is the time to influence policymakers. Or, put another way, if you are not at the dinner table you could be on the menu.

Captives should consider conducting a quantitative impact study (QIS) to understand how their business plan might be affected by the coming capital requirements. (CEIOPS, the E.U. body currently driving the development of Solvency II, has so far solicited four QIS assessments, with a fifth due to commence in 2010.) With that information, captive owners will be in a better position to determine whether parts of their captive business plan can be modified to lessen capital drag or if they may face a potential shortfall in regulatory capital.

EQUIVALENCE

It is a fallacy to think Solvency II will only affect E.U. captives. Any captive that touches E.U. risk will be impacted by factors such as increased fronting fees and additional security requirements from local E.U.-admitted insurers. The scale of these increased costs will be dependent on the *equivalence* of the captive domicile's regulatory regime to Solvency II as assessed by the E.U. Commission. The closer the regulations are aligned, the lower the costs.

Non-E.U. domiciles are aware of the potential financial burden that could be placed on their captives. To minimize the damage, many non-E.U. domiciles are implementing new solvency regimes more closely aligned to Solvency II. The trick is to move close enough to Solvency II to satisfy the E.U. without surrendering the regulatory flexibility that made the domicile attractive in the first place. One difficulty at this point is that CEIOPS has not yet issued guidance on how equivalence will be assessed.

Bermuda and Switzerland are in the vanguard of this transition and are looking to introduce solvency regimes that are very similar to Solvency II. Domiciles with a predominantly non-E.U. client base may be more resistant to extreme regulatory change, even though most recognize the need to address the core principles of risk-based regulation. In the long run, what we are seeing is a fundamental change in insurance regulation to which the captive industry will not be immune. The industry itself will need to invest significant resources over the coming years to understand the impact of Solvency II and equivalent regimes, to influence the debate about the ultimate requirements of Solvency II, and to mitigate its impact.

A final point: those wanting evidence of the truism that *those who cannot remember the past are condemned to repeat it* need look no further than the news of closure of many captives of U.K. residential mortgage lenders. These captives were set up after the last U.K. housing market collapse of the late 1980s to protect against borrowers' default and guard against lax credit underwriting. After accumulating significant funds over a period of rampant house price inflation many of these captives were ultimately closed down to release valuable cash. The U.K. housing market has now gone full circle and entered another recession. Lenders have insufficient provisions to fund the cost of repossessions, many occurring as the result of poor underwriting of the loans. Expect to see a rash of mortgage indemnity captive formations in due course with assurances that the recent excesses of extending credit will not be repeated. Another truism comes to mind: *Plus ça change plus c'est la même chose!*²

¹ Source for company information: *Business Insurance* articles from March 2009 through September 2009.

² The more things change, the more they remain the same.

CONTACTS

Les Boughner

Managing Director
Willis North America Captive
Management Practice
+1 802 264 2064
les.boughner@willis.com

Malcolm Cutts-Watson

Chairman
Willis International Captive Practice
+44 (0) 1481 735628
cuttswm@willis.com