SOLVENCY II
2014

From the publishers of
CAPTIVE REVIEW

COMPLIANCE
Managers grapple with preparation for Solvency II's enactment

STRATEGY
Rethinking and adapting to comply across the board

PROTECTION
Solvency II is primarily established to protect EEA policy holders

Introduction

Solvency II has remained a prominent talking point within the insurance industry during 2014, with that likely to continue and even increase over the next 12 months. With implementation scheduled for 1 January 2016, the window for captive managers to ensure compliance is fast closing.

However, not all questions of how Solvency II will translate to the captive space have been satisfactorily answered. Issues around cost of compliance, impact on investment and reinsurance strategies, and potential incompatibility regarding the 99.5% confidence level required by the SCR calculation, to name just a few, are all still being hotly debated.

In this report, *Captive Review* speaks to leading industry experts about the various challenges captive owners and managers will face with the introduction of Solvency II. We also study how the captive industry as a whole has matured and developed, with new opportunities on the horizon as captives begin to reach a wider audience.

The expansion of Protected Cell Companies (PCCs) has also been a feature of 2014 with their benefits of cost-effectiveness and rapid set-up, while still being Solvency II-compliant, proving a strong pull for companies unwilling to commit to creating a fully-fledged captive.

Experts have emphasised the importance of having a robust, risk-based regulatory framework and the introduction of Solvency II is expected to provide this, without being onerous.

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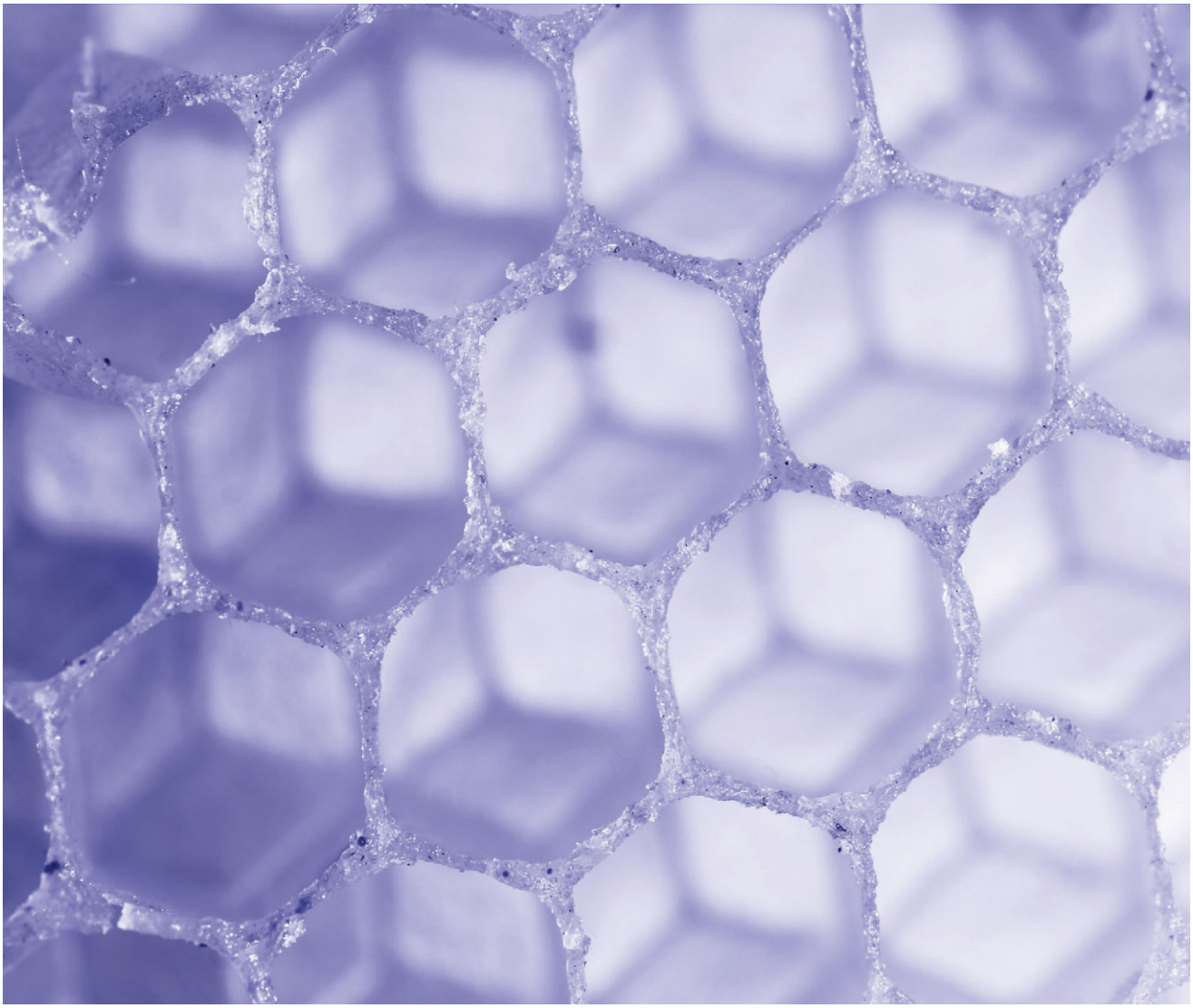


CAPTIVES COME OF AGE

Zurich updates *Captive Review* on how the maturing captive insurance industry is embracing a more holistic style of risk management by integrating life and non-life risks

Written by
Dr. Paul Wöhrmann

Dr. Paul Wöhrmann is a member of the executive staff and head of captive services for Europe, Asia-Pacific, Middle East and Latin America of Zurich. He has been with Zurich for more than 20 years. Wöhrmann is author of a large number of specialist publications on the development and structure of alternative risk financing solutions.

Written by
Paolo Marini

Paolo Marini: In over 20 years with the Generali Group, Marini held several positions in corporate client relationship, sales and management in Italy, the US, Hong Kong and Belgium. Marini joined Zurich in 2011 as global head of customer management for Corporate Life and Pensions (CLP), with the mandate to develop the customer management function across CLP and strengthen the cooperation with Global Corporate.

The captive reinsurance market is maturing. Clear signs of this trend are the integration of life and non-life cover in single reinsurance captives with the advantage that a company gains a holistic view of its risks and that it can optimise its risk financing.

What was once a relatively new idea to bring life cover together with non-life in a single reinsurance captive has become a quite popular strategy for those companies who wish to actively manage and participate in their risks. Zurich is aware of at least 20 captives set up in addition to the estimated 50 to 60 in existence two years ago (*see further Wöhrmann/Marini: Captive Review Magazine, November 2012, p. 50*).

Gross written premiums by Zurich for life cover in captives rose 41% in the period between August 2013 and April 2014. Yet this is only a small portion of all the customers who operate a captive. We expect to see a continued increase in combined life insurance and non-life insurance programmes fronted for captives.

A holistic management approach

The expansion of the captive market has largely been organic. Having made the significant step of integration of life risks, which raises the role and profile of the captive within its parent company's insurance programme, captives usually then search for organic growth opportunities. As confidence in the captive grows by seeing provable cost and efficiency benefits, the parent looks to expand the captive's activities, for example, by including more countries in the fronted insurance program which is ceded to the captive.

With both life and non-life insurance programmes assumed by their captive, parent companies become more open to a holistic risk management approach; by optimising their risk finance cost, international companies may release assets which can be invested in making the supply and sales processes of their core business more efficient.

As reflected in Figure 1 (*opposite*), customers often wish the captive retention was limited by a cross-class aggregate, encompassing life and non-life risks and providing the customer with an overview of the total exposure of its captive.

The influence of Solvency II

We are seeing an increase in demand in Europe for reinsurance captives. This trend is influenced in part by Solvency II, where the rules provide capital credits for reinsurance companies that run diversified portfolios. The Solvency II rules determine that life and non-life risks do not correlate, so, in effect, if both risks are assumed by one single reinsurer, the diversification of the captive's portfolio is increased. This helps organisations meet Solvency II rules on capital adequacy.

Managing relationships

Another trend that is gaining prominence is for stronger collaboration between risk and finance managers and their human resource (HR) colleagues. Typically, risk managers are concerned with details such as property and liability. HR managers, on the other hand, are looking for greater transparency in their regional or global employee benefits programmes in order to identify improvements.

HR managers increasingly explore the potential of improving the life coverage and the related costs by using captive reinsurance. Risk and HR managers have different priorities, but the same broad goals in mind, even though their day-to-day contact is prob-

FIG. 1 | THE STRUCTURE OF AN INTEGRATED CAPTIVE SOLUTION FOR LIFE AND NON-LIFE RISKS

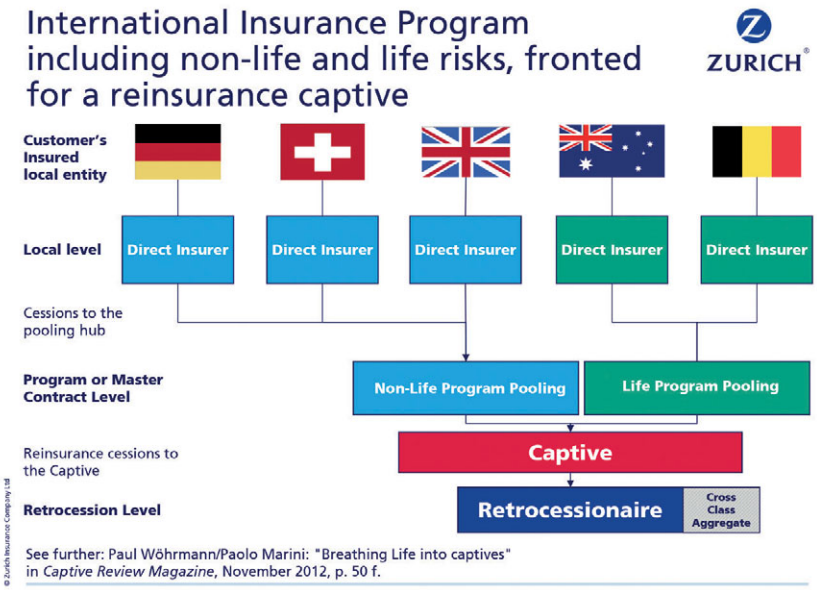
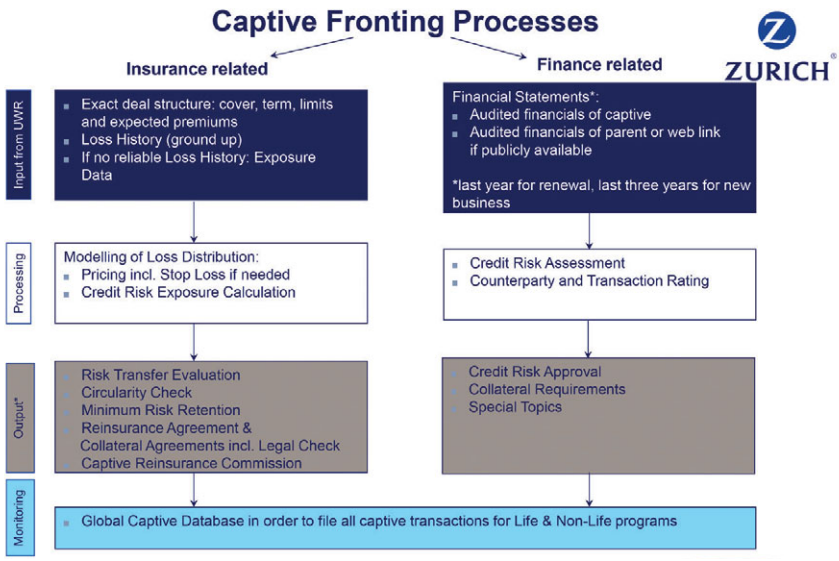


FIG. 2 | BRIDGING THE CAPTIVE FRONTING REQUIREMENTS



ably quite limited. One interesting development we have observed is that it is often the cost pressure most of the international companies face that brings risk managers and human resource managers together to explore the possibilities of achieving a more cost-effective insurance solution for the company's life and non-life risks. Once these experts sit around the same table, the idea of a combined insurance solution will soon be pursued.

Compliance perspective

A recent development we are seeing more of is that risk managers are broadening their focus beyond traditional areas, such as underwriting performance and claims ratios. There is a growing emphasis on the consequences of failing to comply with regulations. If you want to integrate life insurance into your captive you must consider a wider range of compliance requirements.

Captive reinsurance demands more compliance checks compared with traditional third-party reinsurance. Generally, there are several governance requirements to meet. First, a captive must assume sufficient risks in order that the cession may be qualified and accounted as reinsurance transaction. Second, the premium must be at arm's length. Third, the reinsurance wording and collateral agreement must be clear and unambiguous.

By including life risks in a captive, collateral requirements can probably be lowered as a result of the diversified portfolio.

Most insurance companies front life and non-life programmes for captives separately by using their life organisation for life risks and their non-life organisation for non-life risks. A consequence of these separated fronting activities can be that the customer is handled in an uncoordinated and ineffective way, starting with different claims and premium reports for life, different collateral requirements through to different governance checks.

In Europe, Zurich has implemented an aligned and customer-centric process for all its captive customers. Hence, the customer receives one Zurich assessment including both life and non-life businesses. This new innovative approach is potentially unique in the European market.

We believe that taking such a sophisticated and holistic approach to compliance is another sign of a maturing captive market (*see Figure 2, above*) .

Room for smaller players

Perhaps the clearest evidence of maturity is when the captive concept begins to reach a broader audience. There are signs that this is starting to happen in the US and Europe, where interest is growing in providing risk transfer into a captive not for one large organisation only but for multiple, smaller companies.

This could open the door for smaller businesses to be involved in risk financing solutions, particularly companies that operate in only a handful of countries. In the next few years we will probably see new legal concepts such as protected cell or incorporated cell companies to support medium-sized companies in managing their risks. This development is at an early stage, but would signal another exciting new direction in the evolution of risk sharing solutions.

Thus, the world of risk sharing solutions is not only open to the big global players, but also to smaller companies willing to self-finance some of their risks.

CAPTIVES, SOLVENCY II AND PCCS

Peter Gatenby, of Mazars, speaks to *Captive Review* about the challenges facing captive owners with the introduction of Solvency II

Back in January 2010, CEIOPS issued a paper covering SCR (Solvency Capital Requirement) simplifications for captives. The objective of the paper was to elaborate on possible simplifications for the calculation of the SCR for captives. These simplifications were designed to benefit those captives opting to use the standard formula approach to calculating the SCR.

Subsequent guidelines on the calculation of technical provisions and the SCR do not explicitly mention captives, although they do cover simplifications by way of proportionality which will apply to captives. In reality, it will be in the remit of local regulators to agree the proportionality principles to apply in their jurisdictions.

The minimum capital requirement (MCR) is calculated as falling between 25% and 45% of the SCR with rules for the absolute floor which vary by type of business insured. Captive insurers are treated in exactly the same way as all other firms, which means that the floor for those insuring general insurance risks is €2.5m and those insuring long-term insurance risks is €3.7m. The only concession for captives is for pure reinsurers where there is a lower floor for captive pure reinsures of €1.2m.

Written by
Peter Gatenby

Peter Gatenby leads the actuarial work of Mazars in the life, pensions and healthcare sectors. Responsible for developing the actuarial practice of Mazars on a worldwide basis, he provides both actuarial and general management consultancy to clients. Gatenby has over 30 years of experience gained primarily in the life, healthcare and investment management sectors.

When it comes to Pillar II and Pillar III, there are no concessions for captives in the guidelines and implementing measures except for the areas where proportionality might apply. Consequently, it will be necessary for captives to comply with the various elements of the systems of governance requirements. This includes guidelines covering the general governance of a captive ensuring that the board is accountable for making sure that all aspects of Solvency II are both understood and complied with; fit and proper requirements for board members, key staff and policies and procedures; the risk management policy and risk management system; capital management policy and a medium term capital management plan internal controls and internal audit; the actuarial function and outsourcing.

Of particular importance is the actuarial function, which is something that is new to captives with general insurance liabilities.

As for Pillar III, there are numerous quarterly reporting templates (QRTs) required under the guidelines and no obvious concessions for captives. There are also further regulatory reporting requirements under Solvency II and local regulators can also add their own national specific templates. However, local regulators may, at their discretion, relax the reporting requirements for captives, but that will be up to the regulator in each jurisdiction.

The bottom line seems to be that there are some potential simplifications that will apply to some captives under the proportionality rules but that on the whole many captives will have to comply with the full set of Solvency II rules and guidelines as if they were a fully fledged insurer.

> **"Many captives will have to comply with the full set of Solvency II rules and guidelines as if they were a fully fledged insurer"**

What's different about captives?

Some of the characteristics of captives do not fit easily into Solvency II, including:

- Captives are specialist underwriters limiting their risks to those of their owners.
- The law of large numbers may not apply to captives where the number of risks is limited.
- Policy wordings are often bespoke to the owner.
- Investment strategy is often limited to a small number of assets that may also reflect the nature of the ownership.
- Many of the operational processes are outsourced and some of those processes differ

from those of the traditional market.

- Captives do not always follow the insurance market cycle.
- Shortage of expert insurance resource.
- The risk appetite of the captive's owner may not be aligned to the 99.5% confidence level required in the SCR calculation. This means that the captive will be required, by regulation, to hold more capital than is commercially sensible to meet the needs of the parent.

The challenges for captives

- How can Solvency II be geared to meet the nature, scale and complexity of captives?
- The cost of resources to meet the requirements. Lack of resources cannot be used as an excuse for failing to meet regulatory standards.
- The impact of Solvency II on the investment strategy of the captive.
- The impact of Solvency II on the reinsurance strategy of the captive.
- How to calculate the SCR, whether using standard formula or an internal model, and how to perform the forward-looking capital projections required for the ORSA.
- Are there any ways that the SCR can be reduced if on first calculation it seems onerous?
- For small captives, what options are there to avoid having to tie up capital to meet the MCR absolute floor?
- How can the cost of implementing Pillar II and Pillar III be reduced and/or shared?

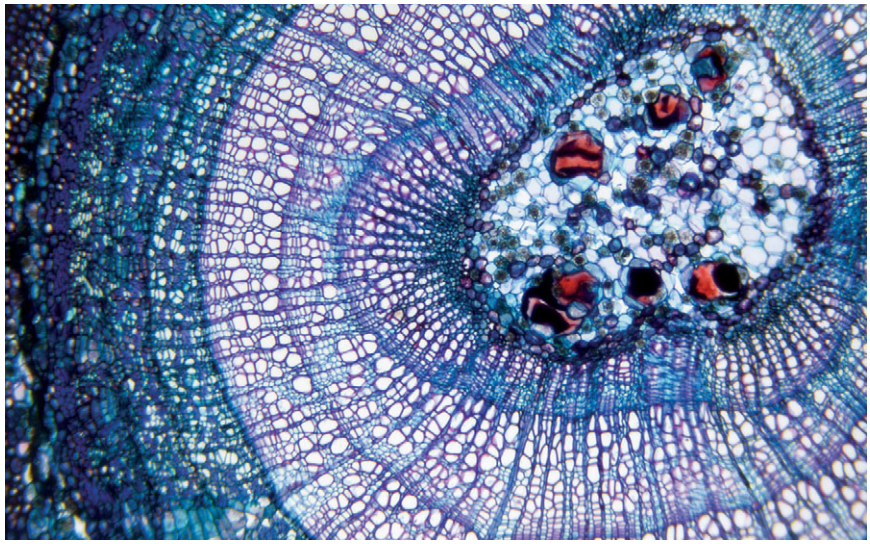
One of the ways that the SCR can be managed is to introduce an element of further diversification. The standard formula allows for diversification benefits if they exist. Some captives have already started to bring in new lines of insurance such as employee benefits and/or other lines of insurance from the owner.

One solution that could have tremendous benefits for both small and large captives alike is to become cells in a protected cell company.

Protected cell companies (PCCs)

A PCC is a single legal entity that is structured in two parts, the core and an unlimited number of cells. Assets and liabilities are fully segregated between cells and between the core and the cells. A cell has no separate legal identity. Within a PCC structure, the cells are approved to write insurance and/or reinsurance business. The core maintains and controls all the activities of the PCC.

From a regulatory point of view, where a liability is attributable to a cell, the cellular assets of the cell will be used to meet that liability. The core assets can be used to meet the liability only when the cellular assets have been exhausted and cellular assets from other cells cannot be used to meet the liability of the cell.



"A PCC is a single legal entity that is structured in two parts, the core and an unlimited number of cells. Assets and liabilities are fully segregated between cells and between the core and the cells"

It is possible to structure a PCC in a way that only the cellular assets of a cell may be used to satisfy the liabilities of that cell with no recourse to the core assets.

In a Solvency II world, a notional SCR (nSCR) will need to be calculated for each cell and then aggregated at the core level. In other words, the SCR for the PCC as a whole is the sum of the notional SCR (nSCRs) for each cell and the nSCR of the core.

The rules allow for diversification benefits to be used in the calculation of the nSCR for each cell and the core but do not allow for diversification between cells and the core.

Where an individual cell does not have sufficient own funds to meet its own notional SCR, the deficit may be covered by the 'own' funds outside of the cell, which could be transferred to meet the deficit. This would be an added benefit for the cell where the cell has secondary recourse to the 'core' (more so where a PCC has a capitalised core). The PCC could lend excess capital held in the core to the cell owner in order for the cell to satisfy its notional SCR.

When it comes to the MCR and the absolute floor, there is potentially a large benefit for the cells in that the absolute floor is calculated at the PCC level. This means that individual cells still need to calculate and comply with their MCR in the usual way; however, they do not need to meet the absolute floor as a cell. The PCC must hold capital at the absolute floor level and the overall MCR will be the sum of the cell's MCRs and the core's MCR.

The benefits of the PCC structure are even more useful when it comes to looking at the Pillar II and Pillar III requirements. Much of the systems of governance work can be carried out at the core or PCC level and will not be required separately for each individual cell; for example, one actuarial function, one ORSA, one risk management system. This will significantly reduce the potential costs for each cell.

Only one set of QRTs will need to be submitted although there may be separate pages for each cell and hence the cost of producing the quarterly and annual reports will be shared by the cells in the PCC structure.

In summary, Solvency II does apply to captives and there are many challenges. However, there are also solutions to these challenges and with our expertise in the major insurance centres around Europe, Mazars is ideally placed to assist captive owners and managers.

OPPORTUNITY REPLACES FEAR FOR SOLVENCY II

The clock continues to tick towards Solvency II activation, but the attitude seems to be only becoming more positive

Solvency II has been more than 10 years in the making and the captive sector has not been alone among the wider insurance industry in arguing and fighting its corner with respect to the evolution and implementation of the directive.

At times, Solvency II has divided the industry and inevitably the consultation and lobbying process led to a degree of scare-mongering and extreme negativity as to what the effects its ultimate implementation would be.

A certain amount of clarity, however, has emerged since the Omnibus II Directive on 11 March 2014, which stipulated Solvency II would come into effect on 1 January 2016.

Vincent Barrett, managing director for captive and insurance management at Aon Global Risk Consulting, believes there is now a much stronger element of calm among owners and service providers, as well as a willingness to work through it.

"All ships rise on the tide and captives have always played the role in the regulatory environment that they find themselves in," he tells *Captive Review*.

"That doesn't mean there isn't objection to new regulation, but once the regulation is in place then obviously the captive as a subset of the overall industry sector plays the same role as it always has done. It has reached its end and people are looking at the positive aspects of having enough capital and by comparison better run companies."

Written by
Richard Cutcher

From speaking to managers, carriers and captive owners, there is a recognition that the industry has done well to educate and discuss at length not only what the implications are for captive insurance companies, but also how they can avoid being hit with inflated capital requirements and manage a bigger reporting burden.

"In regards to Solvency II, the glass is not half empty, but half full. While there are additional investments necessary, there are also a lot benefits that companies can capture," Dr Paul Wöhrmann, head of captive services, EMEA, Asia & Pacific, LATAM, Zurich Insurance Group. "The market has analysed, taken knowledge and we believe it is now thinking about Solvency II in a different way and with a more optimistic view."

Diversification

One of the biggest opportunities perhaps forced upon captive owners as they seek to avoid increased capital requirements as part of Pillar I is the need to further diversify the risk being written through the captive.

While another well-trodden argument over the past two years against forming a captive has been the soft insurance market, there does remain a number of emerging and underrated risks which have not softened to the same extent as traditional lines.

"Some of the more proactive clients have spent the last two years looking at options and certainly there has been renewed vigour around diversification in recent months," Barrett says.

"Some of the more emerging or underrated risks that are very topical such as cyber, brand protection and some supply chain exposures that companiess have but haven't included as part of the captive programme historically are increasingly coming under consideration."

"The glass is not half empty, but half full. There are additional investments necessary, however there are a lot benefits that companies can capture" PAUL WÖHRMANN

For Wöhrmann, the "big opportunity" arises from the added motivation to begin writing more life risks through non-life captives.

By doing this the captive owner is truly adding "non-correlating risks" to its pool and can begin receiving the capital credit for it.

"Solvency II provides an opportunity to bring together different types of risks," he says. "There is a growing demand from large companies in Europe to identify this opportunity and we have been invited by a lot of our customers to present this approach."

Wöhrmann says real movement in this space is likely to occur during 2015 as captive owners seek to ensure their compliance and capital efficiency as 1 January 2016 approaches.

"In our experience clients are thinking about this opportunity, but they need to discuss it by involving colleagues from human resources and the CFO which takes time. We won't know how the majority of customers running a captive in Europe will decide until next year."

Reporting concern

Anders Esbjörnsson, group risk manager at Swedish construction firm NCC and managing director of its home-domiciled captive NCC Insurance, told *Captive Review* earlier this year it was not the capital requirements in Pillar I that were concerning him and his peers, but rather the reporting requirements found in Pillar III.

NCC began the process of liquidating its Luxembourg reinsurance captive around four years ago in a bid to focus on its Swedish entity and Esbjörnsson believes a convenient added bonus from that action will be the ability to keep a closer eye and handle on the day-to-day management of the increased reporting demands.

"A lot of captive owners in Sweden, including myself, are a bit worried about the impact of the Solvency II legislation," he says. "Not Pillar I – the capital demands – but on compliance and reporting. I think we are a bit anxious about where it is taking us and how expensive it will be."

Wöhrmann agrees that the primary challenge that remains facing Europe's captive owners is the reporting restrictions since it will require additional workload.

He believes the reporting demands may also impact on the relationships the captives have with their fronting partners.

"A lot of captives will need more precise information on claims payment, claims reserve and specific claims information rather than only having it aggregated," he adds. "There might be an impact on the fronting services because if fronting carriers are not prepared to provide more specific information to the captives, there could be some concerns or problems."

Intellectual growth

There is no doubt, however, that risk managers and insurance buyers in general have benefited intellectually from the discussions and debates surrounding the Solvency II conundrum.

"It would be difficult to find a risk manager who does not think it is appropriate to hold enough capital for the risk they have taken on" VINCENT BARRETT

The potential demands and impact it could have on their businesses has forced them into much more complex and sophisticated conversations on risk transfer and distribution.

"The risk managers have spent time working out what it means specifically for them, especially with regards to the first two pillars," Barrett adds.

"Largely we have seen benefits to come out of it. It would be difficult to find a risk manager who does not think it is appropriate to hold enough capital for the risk they have taken on so Pillar I really facilitates that discussion with their treasury folks."

In relation to the potential addition of more life risk to captives, Wöhrmann believes this is also proving a valuable learning experience for risk managers and their businesses more generally.

"There is an increasing interest between risk management and HR management on the customer side to initiate discussions, share opportunities and analyse growth," he says. "This has more or less happened thanks to Solvency II and those two insurance buyers – risk managers for non-life, HR managers for life – now talk more with each other."

Wöhrmann adds: "The risk management in Europe has become much more sophisticated thanks to Solvency II due to the training needed in new areas, underwriting decisions becoming more complex and more intellectual capital being required to run the captives."

BERMUDA: BUSINESS AS USUAL FOR CAPTIVES

James Berry, managing director at KPMG, speaks to *Captive Review* about the reasons why Bermuda's captives will be well placed for the implementation of Solvency II

Written by
James Berry

James Berry is a managing director in KPMG Bermuda's insurance practice. He specialises in audit and advisory services for a variety of (re)insurance clients including captives, advising businesses with respect to regulatory obligations including Bermuda insurance regulation and Solvency II.

Captive Review (CR): With Solvency II on the horizon in Europe, what is the current regulatory stance from the BMA?

James Berry (JB): The Bermuda Monetary Authority (BMA) has spent a number of years developing a risk-based framework for insurance supervision, including seeking equivalence with Solvency II, which is assessed by the European Insurance and Occupational Pensions Authority (EIOPA). The initial assessment by EIOPA in 2011 found Bermuda's regulatory regime to be largely equivalent to Solvency II for the commercial sector, with some caveats. However, Bermuda's captive sector was excluded from the assessment conclusions, given that the lower capital requirements for captives do not follow the same risk based approach.

Following that initial assessment, the BMA and EIOPA agreed that captives do not need to follow the same regulatory regime as the commercial sector. This agreement was made on the basis that equivalence is not necessarily having an identical framework to Solvency II, but more about having equivalent outcomes to Solvency II. Given Solvency II is fundamentally established to protect EEA policy holders, there is a strong argument to suggest that regulating captives in accordance with Solvency II type regulation is not necessarily that meaningful.

As a result there are two distinct segments of the Bermuda supervisory framework: the commercial sector is on track for equivalence with Solvency II, and the captive sector does not have to follow a Solvency II equivalent regulatory regime. This is an important distinction in ensuring that Bermuda's regulation of captives remains robust, yet proportionate.

CR: Will Solvency II have any direct effects on Bermuda-based captives?

JB: Not Solvency II itself, but the efforts of the BMA to seek Solvency II equivalence for the commercial sector is just part of an ongoing commitment from the BMA to have a robust, risk-based regulatory framework. In going through the entire framework, the BMA did recognise that while there was no need to change minimal capital levels for captives, some limited improvements to the regulation of captives would be appropriate. While this isn't directly as a result of Solvency II there are some limited changes to the Bermuda captive regulatory regime.

Firstly, an increased focus on corpo-

> **"The Bermuda Code of Conduct has been introduced, with proportionate application to captives given their lower risk profile and complexity, and captives must formally confirm their adherence to this code"**

rate governance has already been implemented. The Bermuda Code of Conduct has been introduced, with proportionate application to captives given their lower risk profile and complexity. And captives must formally confirm their adherence to this code. Secondly, following a trial run in 2013, it is expected that there will be some limited enhancements to statutory reporting for captives for 2014 year ends, which will be filed electronically. These will consolidate existing requirements, in terms of statutory financial statements and returns, and also add a risk self-assessment, which will cover areas such as underwriting, investing and reserving risk. That self-assessment will only be done on a qualitative basis, not a quantitative basis. Importantly, there are no changes to the minimum capital requirements for Bermuda captives.

Finally, to the extent that captives operate segregated cells, there will also be some more detailed statutory reporting on the segregated cells themselves.

CR: Did the BMA work well with Bermuda's captive market during the negotiations with the EIOPA to address concerns?

JB: There was initially some concern among captive owners and captive management companies, when these regulations were being developed that the prospect of an enhanced statutory return or an increase in the amount of regulation among captives was going to be a disincentive for captives to be based in Bermuda, by being unnecessarily complex. However, the BMA worked very closely with captive managers and other stake holders to make it very clear that there would be no change to minimum capital requirements, no quantitative disclosure and that the enhanced reporting would be fairly limited. As a result, there is an understanding that the limited changes to the regulations are proportionate and appropriate for the captive market and do not materially change the nature of captive regulation in Bermuda.

CR: How does the BMA operate with other regulators on a global scale?

JB: The BMA works very closely with other regulators in supervising large insurance groups and considering other regulatory regimes, such as Solvency II and the NAIC's Solvency Modernization Initiative, to ensure the Bermuda framework remains risk-based and appropriate for the Bermuda market. It is an active member within the International Association of Insurance Supervisors (IAIS) and seeks to ensure that the Bermuda framework and its outcomes are consistent with the Insurance Core Principles of the IAIS.

"At a time of significant global regulatory change, we welcome the opportunity to assist our clients in preparing the risk self-assessment in a sensible and proportionate way"

CR: How is KPMG working with its Bermuda clients to navigate through these issues?

JB: From a captive perspective we are discussing the limited amendments to the Bermuda regulations with captive owners and captive management companies to ensure that they are aware of the changes and the new requirements around the qualitative risk self-assessment. We have the benefit of working with a number of clients and so we are able to advise them individually on the most appropriate amount of qualitative discussion and the depth of discussion that is reasonable for that specific captive. At a time of significant global regulatory change, we welcome the opportunity to assist our clients in preparing the risk self-assessment in a sensible and proportionate way given that the regulation of Bermuda-based captives has not materially changed.

EMBRACING CHANGE – REGULATORY INNOVATION

Angele Grech, director of the MFSA Authorisation Unit, speaks to *Captive Review* about Malta's innovative establishment of a regulatory regime for protected cell companies

Insurance is a dynamic industry operating in a world of risk and uniquely exposed to uncertainty. To succeed, it needs to be flexible and innovative. In parallel, regulatory change is transforming the face of insurance. The Solvency II project, which originated some 13 years ago, aims for a robust framework that captures the economic reality of the asset-liability position of insurers and brings capital closer to the insurers' risk profile. The framework promotes a strong risk culture embedded in the insurers' organisation and nurtures strong risk management capabilities. This is a steep shift from the fragmented and outdated approach of the current, rules-based Solvency I regime, which primarily focuses on the capital adequacy for insurers without catering for risk management and governance within firms.

As insurers respond to these new regulatory developments, they are faced with strategic and operational challenges. As insurers adjust, they innovate – and look for opportunity in change.

In developing a supervisory framework for insurance companies, the Malta Financial Services Authority (MFSA) has adopted a dynamic and proactive approach to market needs through the evolving of prudent, sustainable and innovative regulation. The MFSA values an open communication and dialogue with stakeholders and this has resulted in the development of new regulation to keep abreast with market changes. As an ongoing process the MFSA has sought to balance innovation with sound institutional development through sustainable regulation.

Written by
Angele Grech

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The establishment of a regulatory regime for protected cell companies (PCC) in insurance is a prime example of regulatory innovation. Malta introduced the PCC regime in 2004 and is the only full European member state to offer PCC legislation.

The PCC is a single legal entity authorised in terms of the Insurance Business Act (Cap 403) and the Companies Act (Cell Companies Carrying on Business of Insurance) Regulations, 2010 (S.L. 386.10). It is structured in two parts; a non-cellular part (the core) and an unlimited number of cells. Despite the segregation of assets and liabilities that exists between protected cells and the core and among the protected cells themselves, a cell has no separate legal identity.

For regulatory purposes, where any liability arising is attributable to a cell of the PCC, the cellular assets of a cell will be primarily used to meet the liability of that cell and the non-cellular assets (also known as the core assets) can be utilised to meet the liability of the cell, only when the cellular assets of the cell have been exhausted. Cellular assets from other cells cannot be used to meet the liability of the cell.

"The framework promotes a strong risk culture embedded in the insurers' organisation and nurtures strong risk management capabilities"

PCCs may be used for reinsurance, insurance and captive business. Within a PCC structure, the cells are approved to write re/insurance business. The core, on the other hand, may or may not be authorised to write re/insurance.

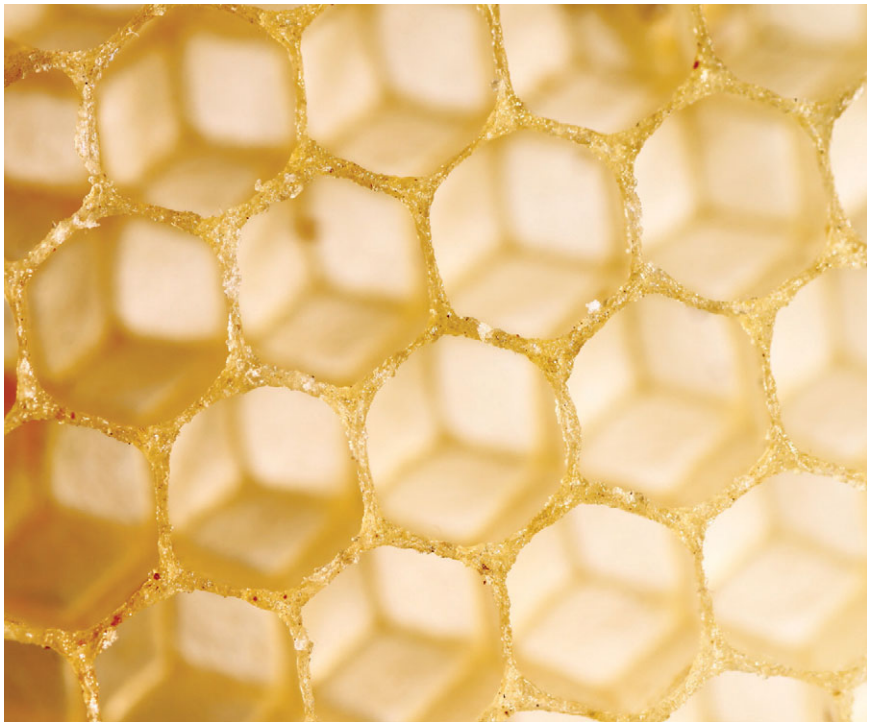
The core of the PCC is the provider of capital for solvency purposes and in the event that any of the cells become insolvent, the core should transfer capital to meet the liabilities of the cell. The core also maintains and controls all the activities of the PCC.

Under Solvency II, the core and cells within the PCC structure are treated as ring-fenced funds. The Solvency II framework adopts a complementary three pillar approach. As a single legal entity, the PCC needs to comply with Solvency II as a whole thereby offering a proportionate facility for cells. This is key when it comes to addressing all requirements under the three pillars of Solvency II.

Pillar 1 sets out a valuation standard for assets and liabilities and introduces two capital requirements, the solvency capital requirement (SCR) and the minimum capital requirement (MCR). The MCR is an absolute minimum floor that, if breached, will trigger serious regulatory intervention and potential licence withdrawal. The SCR, on the other hand, is a target level that the firm should aim for. Breaching the SCR will be considered by the regulator as a sign of a firm's deteriorating financial soundness and intervention will take place so that the firm takes appropriate action to restore the SCR. For PCCs, the notional SCR needs to be calculated for each cell as well as the core in the same manner as if they were all separate undertakings. The SCR for the PCC as a whole is the sum of the notional SCR for each cell and the notional SCR of the core.

As one legal entity the PCC has a single board of directors which manages the affairs of the PCC as a whole. It therefore follows that in respect Pillar 2 (Risk Management and Governance) all systems of governance requirements, including key functions and the 'own risk' and solvency assessment process, will be under the control of the board of directors with cost sharing opportunities for cells.

Likewise, under Pillar 3, a PCC will also need to satisfy regulatory reporting requirements as one single legal entity and this can be of a cost benefit to cells operating within the structure.



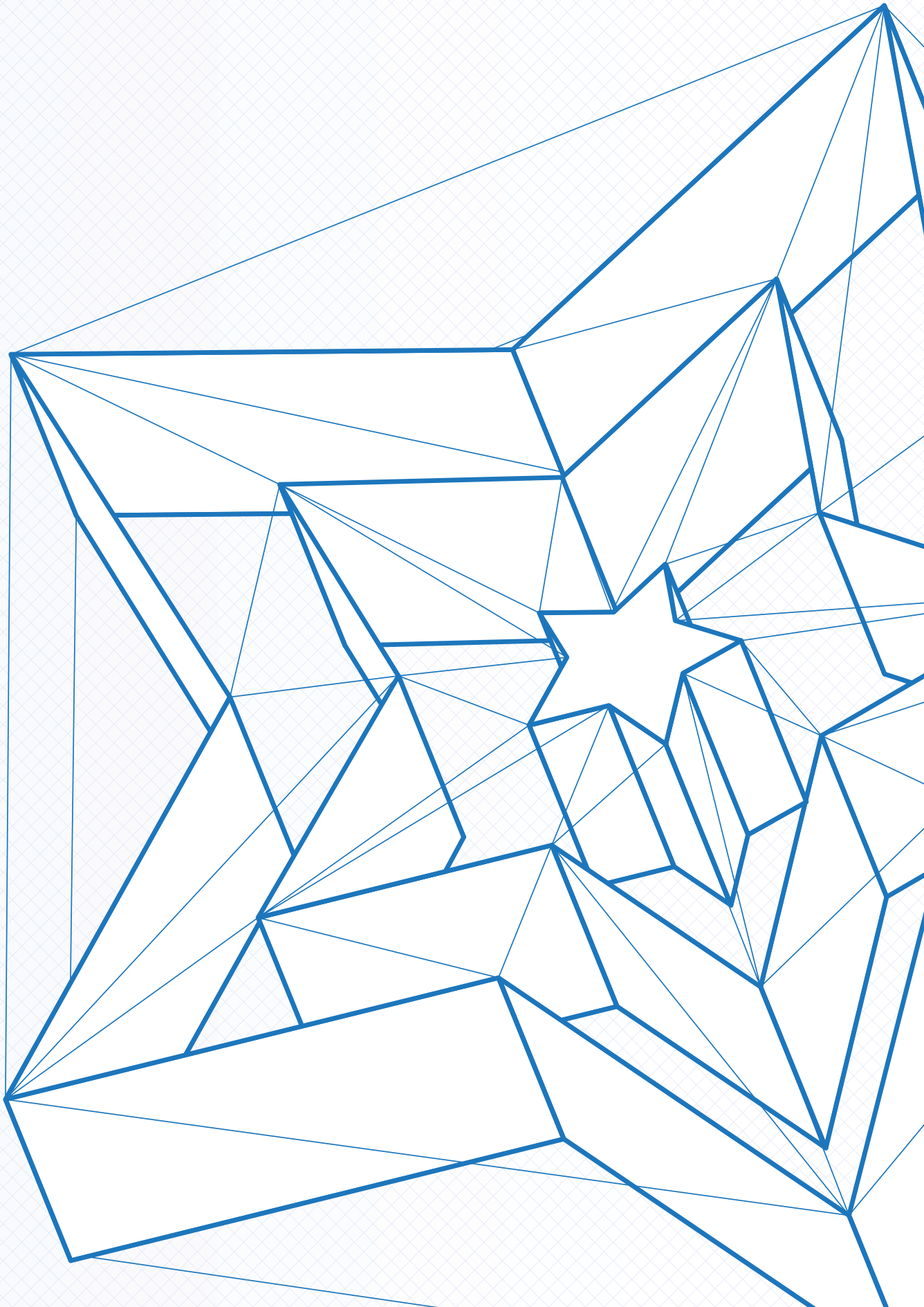
"Cells provide the facility of flexibility, speedier set-ups and cost-effective solutions while being fully compliant with the Solvency II regulatory regime"

Accordingly, and increasingly so for small captives, cells provide the facility of flexibility, speedier set-ups and cost-effective solutions while being fully compliant with the Solvency II regulatory regime. The concept of proportionality is fundamental to Solvency II and cell structures present a solution for smaller captives who may be concerned that the compliance burden may be too onerous for a stand-alone company.

Malta's regulatory framework caters for the establishment of PCCs, whether through incorporation, conversion or re-domiciliation (under the Continuance of Companies Regulations (S.L.386.05)) as well as through the creation of cells and the transfer of cellular assets from and to other PCCs.

In addition, new regulations – the Securitisation Cell Companies Regulations, 2014 – continue to build on the 'protected cell' concept by adapting and extending the protected cell company structure to cater for securitisation activity. These regulations set out a framework for a new type of cell company acting as a reinsurance special purpose vehicle in Malta – the Securitisation Cell Company. Through fusing the highly sophisticated frameworks provided in the Securitisation Act (Cap. 484) and the Reinsurance Special Purpose Vehicle Regulations (L.N. 452 of 2013) with the cell company concept, the regulations now provide a legally entrenched framework for segregation of different sets of assets and risk instruments within a single special purpose vehicle, the SCC, thereby allowing for the launch of multiple insurance-linked securities without incurring any risk of cross-contamination between the different sets of creditors and investors.

There is little doubt that significant regulatory change will continue. Faced with such a reality, in a world of uncertainty, insurers look for opportunity in change. As regulators, the MFSA continues to recognise the importance of maintaining an appropriate balance between preserving the safety and soundness of the system and allowing the flexibility for insurers to create business value through performing their intended functions in an environment which fosters sustainable growth.



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