Issue Review
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Solvency II Disclosures Demonstrate Strong Capital Positions for European Captives

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On May 20, 2017, single entity (solo) risk carriers in Europe were required to disclose publicly a Solvency and Financial Condition Report (SFCR) as part of the Solvency II regime. The report provides an insight into the company's financial condition as at December 31, 2016 and is part of Pillar III of the Solvency II regime.

Pillar III aims to harmonise and improve the transparency of financial disclosures to the market, as well as to enhance consumer protection. The reports must contain quantitative and qualitative information relating to business performance, corporate governance, risk management and capital levels. The purpose is to impose greater market discipline and confidence, as well as to support the overall objectives of the Solvency II regime of creating a stronger and more uniform regulatory environment for capital adequacy and risk management.

A.M. Best has obtained and analysed the SFCR announcements from its rated European captives and has held discussions with captive managers regarding the disclosure process.

General Observations

A.M. Best notes that the majority of the sampled captives did not publicise their SFCR reports, which might seem surprising given the requirement for public disclosure. However, Article 301(4) of the Delegated Acts (Directive 2009/138/EC) specifies that, "Where insurance and reinsurance undertakings do not disclose their solvency and financial condition report on a website in accordance with paragraphs 1 and 2, they shall send an electronic copy of their report to any person who, within five years of the disclosure date referred to in Article 300(1) requests the report". As the majority of captives do not maintain a web presence, it seems that most captives use this option.

Group entities have a different deadline of July 1, 2017 for SFCR publication. The sampled analysis showed that non-insurance operations with more than one captive and who structure these under an intermediate holding entity (and which creates consolidated accounting reports) will be reporting under group rules.

Strong Solvency II Capital Positions

Reported Solvency II ratios (that is the ratio of Solvency II available capital to the Solvency Capital Requirement (SCR)) of the reviewed sample of captives are very strong, with sample coverage ratios ranging from about 160% to 240%. A.M. Best notes that this observation is in line with expectations as the captives it rates tend to be well-capitalised. Furthermore, the disclosure of own funds and the composition of SCRs show that own funds for each analysed captive is comprised exclusively of unrestricted Tier 1 capital.

A.M. Best also notes that its sample of captives did not use any transitional measures on technical provisions. Transitional measures can enhance solvency ratios compared to how risk carriers might look under the new regime without these amounts. Additionally, the

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widely reported adoption of long-term guarantee measures (the matching and volatility adjustments) by life companies has also not been used. It should be noted that only one captive in A.M. Best's sample has life operations. These components were introduced as part of the development of Solvency II which has been implemented as a package.

Narrative Disclosures Vary in Quality

A.M. Best has observed notable differences in the style and quality of the narrative part of the disclosures among its sampled captives, in particular in the description of governance and risk structure.

Reporting requirements are implemented at member-state level. This has resulted in some divergence in reporting standards and interpretation of the legislation by national regulators. SFCR quantitative data is prescribed by the European Insurance and Occupational Pensions Authority (EIOPA), who have also provided the format for how the data should be presented. However, A.M. Best believes that the guidance around qualitative disclosure is broad and does not define the details of disclosure.

A.M. Best notes that EIOPA's "Guidelines on reporting and public disclosure" state that: "Under section 'B.1 General information on the system of governance' of the SFCR as defined in Annex XX of Delegated Regulation [(EU) 2015/35], insurance and reinsurance undertakings should explain how the key functions have the necessary authority, resources and operational independence to carry out their tasks and how they report to and advise the administrative, management or supervisory body of the insurance or reinsurance undertaking."

However, A.M. Best has observed that the SFCR filings of the sample tend to be purely factual in their description of governance and risk structures, and mostly fail to provide insight into how these structures benefit the company.

Most A.M. Best-rated captives are able to articulate and illustrate their risk management framework and capabilities as part of the interactive rating process. Furthermore, as A.M. Best has commented in the past, it believes that the overall risk management capabilities of rated captives have strengthened during the preparation for and implementation of the Solvency II regime. A.M. Best's view is that the disclosures fail to do justice to the risk management and governance practices of the captives, as well as of the importance of these functions to captives and their parents.

Resource Burden

A.M. Best has received feedback that the Pillar III workload is, in several cases, considered onerous and costly. In particular, captives that are reporting in local GAAP as well as International Financial Reporting Standards (IFRS) indicated that the completion of a third set of financial reporting under Solvency II is a heavy burden. Narrative comment (that is, the qualitative disclosure) is also required to explain the quantitative disclosures and their relationship to other publicly available documentation, such as IFRS reporting.

Some captives consider the reporting requirements under Solvency II to be inappropriate for such entities given the functionality of captives, which provide (in most cases) cover only to their parents. Therefore, the regulatory objectives of improving market discipline and policyholder protection by means of public disclosures were viewed with scepticism in light of captives' business models. Nevertheless, most captive managers appreciate that the overall implementation of Solvency II has improved their general risk management capabilities and enabled them to manage their capital requirements better on a risk-adjusted basis.

Some national regulators have made it clear that they would apply the principle of proportionality in the supervision of firms, so that the SFCR disclosures should be proportionate to the nature, scale and complexity of captives. However, the Solvency II Delegated Acts do not clearly define the application of proportionality with regard to captives. One captive manager noted that the general feedback from its local regulator was that a general exemption of the qualitative or quantitative parts of the required disclosures was unlikely to be granted.

Conclusion

In conclusion, A.M. Best expects the majority of its rated captives to maintain strong SCR ratios to support their capital management strategies. However, captives that approach Pillar III solely as a compliance-related tick-box exercise risk missing an opportunity to present the strength of their overall governance and risk management capabilities to the market.

Initially, the Solvency II regime was largely viewed by the captive industry as an onerous regulatory imposition. However, A.M. Best notes that the captives it rates now hold the general view that the higher cost of increased requirements in terms of risk management and governance are offset by the benefits provided by a better focus and understanding of risks. The captives that are able to expand their risk management capabilities will offer greater value to their parent companies in the longer-term.

A.M. Best also believes that captive owners, especially those whose captives are an integrated part of their overall risk management strategy and not just a financing tool, now appreciate the Solvency II objectives to enhance and incentivise risk management. Improvements in captives' ability to identify, quantify, understand and manage risks are viewed positively. A.M. Best believes that it can point to such improvements during the implementation of Solvency II in risk management and governance among its rated captives. However, there is room for improvement in the articulation and detail of SFCR disclosures.

Exhibit 1

Examples - A.M. Best-Rated Captives

Ratings as of Jun. 19, 2017.

AMB #	Company Name	Domicile	Best's Financial Strength Rating (FSR)	Best's Long-Term Issuer Credit Rating (ICR)	Best's FSR & ICR Outlook / Implication	Best's FSR Action	Rating Effective Date
94157	Builders Reinsurance S.A.	Luxembourg[1]	A-	a-	Stable	Affirmed	2-Jun-17
56998	Casiopea Re S.A.	Luxembourg[1]	A-	a-	Stable	Affirmed	13-Oct-16
85437	Delvag Versicherungs-AG	Germany[1]	A	a	Stable	Affirmed	24-Aug-16
94069	Enel Insurance N.V.	Netherlands[1]	A-	a-	Stable	Affirmed	8-Jun-17
90115	Eni Insurance Designated Activity Co.	Ireland[1]	A	a	Stable	Affirmed	8-Sep-16
78032	Intercona Re AG	Switzerland	A+	aa	Stable	Affirmed	2-Jun-17
57796	Jupiter Insurance Ltd.	Guernsey	A	a	Stable	Affirmed	27-May-16
86910	National Grid Insurance Company (Isle of Man) Ltd.	Isle Of Man	A	a	Stable	Affirmed	20-Apr-17
56736	Rembrandt Insurance Co, Ltd.	Bermuda	A	a	Stable	Affirmed	15-Sep-16
95043	Sigurd Rück AG	Switzerland	A-	a-	Stable	Assigned	23-Nov-16
56958	Solen Versicherungen AG	Switzerland	A	a+	Stable	Downgraded	21-Jul-16

Notes:

[1]: Solvency II regulated.

Source: *Best's Statement File - Global*, A.M. Best data & research

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