



SOLVENCY II 2015

RISK DIVERSITY

Captives look to mixing lines of risk to achieve capital efficiency

HIDDEN CHALLENGES

New hurdles being discovered for compliance

RAISING THE BAR

Solvency II expected to promote higher global regulatory standards

From the publishers of

CAPTIVE
REVIEW

USING EMPLOYEE BENEFITS TO DIVERSIFY YOUR CAPTIVE

Vittorio Zaniboni, chief technical officer at Generali Employee Benefits, talks to *Captive Review* about how captives can optimise their capital requirements in a Solvency II environment

Captive Review (CR): What features of Solvency II is forcing captives to diversify their risk?

Vittorio Zaniboni (VZ): Solvency II standard formula is based on a modular approach that implies the computation of solvency capital requirements (SCRs) for several risk modules. The basic solvency capital requirement (BSCR) is then computed as the sum of the SCRs for market, counterparty default, life underwriting, health underwriting, P&C underwriting and intangible assets risk sub-modules, reduced by an effect of diversification.

The total SCR is finally calculated as the sum of BSCR and the operational risk SCR along with an adjustment factor. The logic behind the importance of diversification in the calculation of the economic capital is linked with the idea that, by including uncorrelated risks within the same portfolio, the loss volatility of the same portfolio decreases sensibly.

There are many possible ways of achieving risk diversification in a portfolio; one



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of the most effective is the business lines diversification (mixing P&C business and life business), whose efficacy is due to the very low stochastic correlation between the respective losses.

In practical terms, this is confirmed also by the Fifth Quantitative Impact Study (QIS5) for Solvency II, which showed that the diversification benefit impacted for 32% the BSCR of monoline companies, rising to 46% for group companies.

CR: Is this requirement likely to affect a lot of captives? How onerous is it?

VZ: While only about 10% of the roughly 5,000 captives present on the market are EU based, even non-EU based captives are affected by the Solvency II regulations as long as they want to insure or reinsure risks based in the EU.

In this respect the official granting of Solvency II equivalence to seven non-EU countries (Switzerland, Australia, Bermuda, Brazil, Canada, Mexico and the US) is very recent news. Under this ruling “EU insurers can use local rules to report on their operations in third countries, while third country insurers are able to operate in the EU without complying with all EU rules” (European Commission, June 2015). Following this ruling more than 50% of existing captives are based in a Solvency II, or Solvency II equivalent, domicile.

According to the forthcoming Solvency II regulation, captive companies will be impacted according to the principle of proportionality (which states that the Solvency II regulation should be fulfilled considering the nature, size and complexity of the risks undertaken). This principle should allow captives to reduce their solvency capital requirement (SCR) assessment, and, according to the simplified structure and the own-retained risk profile, captive companies should not face the same expensive process as commercial insurers will. For example, being asked for

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lower reporting documents due to their lack of complexity compared to traditional insurers.

CR: For captive owners that must now diversify their risk under Solvency II, is employee benefits a viable option? What are the advantages?

VZ: Employee benefits is probably an 'ideal candidate' for risk diversification for a portfolio of P&C industrial risks. First of all the likely size of any single claim in the EB space is usually a fraction of the typical P&C industrial claim, and this generates a much lower volatility of the expected loss ratio of the portfolio. Another important aspect is the likely stochastic independence of the EB risk among themselves as well as from the corporate P&C risks.

On top of this, we need to consider that the captive might realistically believe that their parent risk management measures differentiate their loss experience from the one of their peers, therefore allowing the captive to benefit from an advantageous claim experience and reduced exposure to catastrophic risks.

CR: What are the challenges in including employee benefits in a captive initially? What are the common pitfalls?

VZ: Apart from the capital requirement advantages linked with the inclusion of human capital risks in the captive, all the parties involved should not forget that the main purpose of reinsuring EB schemes in the captive is to allow a better and a more efficient management of this schemes from the corporate level.

The captive in this respect is to be seen as a tool and an asset for the parent to improve the effectiveness of their EB solutions. This means that having EB in the captive will require the captive manager to strongly involve the corporate (and local) HR functions in the decision making process, and to develop a strong sensitivity for all the EB related issues. This has to be seen as a joint-venture between HR and the captive, and assuring an early buy-in from the HR functions has proved to be the primary success key.

Another critical area is the level of central control the parent needs to have on the local subsidiaries. In order to facilitate and govern the implementation of the EB reinsurance framework, a solid internal communication and control facility is of fundamental importance.



CR: Is there a minimum headcount above which the inclusion of EB business in the captive becomes economically and strategically convenient?

VZ: In the definition of the minimum critical mass needed to justify the inclusion of EB business in the captive, there are many factors which should be considered. Apart from the most immediate ones (geographical distribution, level of central co-ordination at corporate level, pre-existence of a P&C captive) the level of complexity of the local EB schemes as well as the type of the current local insurance set-up play an important role.

There is usually a reasonable consensus on the assumption that the inclusion of EB in the captive starts making economic sense from 5,000 employees worldwide.

CR: Is Solvency II the main driver behind the current trend for employee benefits being included in captives? If not what is?

VZ: The number of captives writing EB business has risen quite steadily in the past years; up to only few years ago, no more than 20 captives on the market had EB business in their portfolios, while in 2015 we reached the considerable level of 85.

Evidently the upcoming implementation of the Solvency II framework, and the corresponding diversification advantages played a big role in this burst of interest, but I believe that more and more corporations are looking at captives as 'business tools' to control, co-ordinate and govern

their EB strategy worldwide.

The EB data that captives collect and analyse can be invaluable during harmonisation processes or global EB budgeting and may have a key role in enhancing the engagement of the employees' community. Moreover, managing EB business via their own captive provides corporations the level of flexibility, adaptability and reaction time which often more traditional type of solutions are struggling to offer.

CR: How can EB networks help captives facing the Solvency II challenge?

VZ: Solvency II is ultimately an instrument used by regulators to force insurers to increase their levels of risk awareness, and to look at risks with a new level of attention.

In this perspective, the implementation of Solvency II is a game changer in the insurance industry in the way insurers collect, validate and analyse business data.

In this new regulatory scenario EB networks do play a fundamental role in providing to captives structured access to data and data analytics capabilities, which can enable them to integrate in the most efficient way the EB risks in their portfolio, as well as playing an increasingly important role in the strategic decisions of their parent companies.

EB networks are also often best placed to provide captives with solutions to optimise their risk retention, offering excess capacity to ring-fence their EB risks. 