

• NO CAPTIVE TO FORTUNE: GUERNSEY CONFIRMS STANCE ON SOLVENCY 2

On 25 January this year, in a joint statement, the States of Guernsey and the GFSC confirmed that it was not Guernsey's present intention to seek third country equivalence under the EU's 'Solvency 2' directive. Industry groups and trade publications in Guernsey and other offshore jurisdictions have applauded this strong clarifying statement, coming after what has been a concerted lobbying effort at local level. What is solvency 2, and why is equivalence not in Guernsey's interests?

SOLVENCY 2

Solvency 2 might be described as Basel II for Insurers. That is, it is a set of measures, the framework of which is set out in an EU directive, intended to ensure that insurers operating within the European Economic Area (EEA) meet certain minimum levels of capital adequacy, whilst also meeting minimum standards for systemic control of risk and providing transparency to regulators and others. In addition to the enhanced consumer protection for policy holders that these measures will bring, one of the key objectives of Solvency 2 is the harmonisation of national laws within the EEA which are at present inconsistent between member states.

The financial requirements are at the heart of Solvency 2. The directive sets up 3 basic financial limits or obligations:

1. A Solvency Capital Requirement, designed to be calculated at such a level that an insurer has sufficient coverage of its liabilities from its 'own funds' such that policyholders are likely to be protected from loss with 99.5% confidence (i.e. risk of exposure is a once in two hundred year event). Breach of the Solvency Capital Requirement is designed to act as a trigger for scaled regulatory intervention;
2. A Minimum Capital Requirement, corresponding to a level of own funds coverage of liabilities between 25% and

45% of the Solvency Capital Requirement (subject to certain absolute limits) designed as a trigger for immediate revocation of the insurer's authorisation to conduct business; and

3. A Technical Provision, being a liability in the insurer's accounts corresponding to the amount that the insurer would have to pay another insurer to take over its business obligations to policy holders. The purpose of the technical provision is to provide a further level of protection for policyholders by seeking to ensure that there is sufficient provision to transfer the business in the event of failure or be attractive enough to generate sufficient internal or external capital contributions to restore minimum solvency levels.

In this regard though, it is important to realise that the Solvency 2 directive itself is merely a framework. In line with the prevailing Lamfalussy process of European lawmaking, the directive itself imposes core obligations and prohibitions, enshrining the basic tenets of principle which are intended to be supplemented with detailed regulation in the form of 'implementing measures'.

This regulation comes into being in a two stage approach involving expert technical committees and then harmonisation work by EEA national regulators. Accordingly, whilst the formulas are in place, the devil will be in the detail, particularly in relation to the classification the assets and liabilities which will form the building blocks of the financial requirements.

GUERNSEY'S STANCE

Like previous EU directives in this field (i.e. the AIFM directive) there is provision for third countries (i.e. non EU states) to provide regulated services within the EEA without infringing the directive, provided that there

is the necessary degree of 'regulatory equivalence'. In determining not to seek regulatory equivalence Guernsey has effectively said that it will not be ensuring its regulated insurers meet the financial and other requirements imposed by Solvency 2 and therefore is effectively shutting the door to Europe for those businesses.

Why is this a good thing? To understand the position taken by the Guernsey financial authorities, and the rare 'pat on the back' they have got from industry for taking it, it is important to keep in mind the structure of the Guernsey insurance industry. Notably, Guernsey's insurance market is dominated by captive insurers. Almost all insurers licensed by the GFSC are captives. In fact, it is the pre-eminent domicile for captives in Europe and somewhat incredibly, the fourth largest jurisdiction in the world.

Whilst the Solvency 2 directive purports to apply to captives, there are good reasons why (at least for pure captives) it is unnecessary, and may be self-defeating. First, pure captive insurers have only a single ultimate client, by definition. This client may or may not have its own regulatory capital adequacy requirements in its field of business. Regardless, the risks of the captive failing will not fall on the 'mum and dad' policyholders of Europe, but the group itself. Whilst undoubtedly this may cause hardship to shareholders, employees and others connected with the group, the risk of such hardship is one that is faced by all companies and corporate groups. The mere involvement of a captive insurer within the group structure does not seem to provide sufficient justification, from a regulatory policy perspective, for the additional regulatory intervention embodied in Solvency

Second, pure captives do not need to actively market their products in Europe or anywhere else. This is a marked contrast from say, the AiFM directive, where the treatment of 'passporting' was keenly watched locally, given that too restrictive a result may have shut the door on one of the local industry's key markets. Accordingly, provided that the Solvency 2 Directive does not seek to regulate that provision of captive insurance in Guernsey (wherever the group may do its business), there simply is no need to voluntarily burden the industry with the compliance costs of increased regulation.

Finally, and in some senses this may emerge as the most important issue as the implementation progresses, Solvency 2 aims to achieve its objectives by constraining the freedom of insurers to manage their balance sheets. However, the business rationale for the very existence of captive insurers is the flexibility that insuring one's own risks can give a corporate group. Solvency 2 and Guernsey may just be fundamentally incompatible. However, it is relatively early days (the implementation of Solvency 2 being now delayed to early 2013), and the Guernsey authorities' joint statement certainly does have a bit of 'wait and see' about it - it may be that as implementation progresses the stance of the GFSC and other will change and Guernsey's insurers may find themselves caught by Solvency 2 after all.

**FOR MORE INFORMATION,
PLEASE CONTACT:**



MICHAEL ADKINS
SENIOR ASSOCIATE
t: +44 (0)1481 734231
e: michael.adkins@collascrill.com

Collas Crill **Guernsey**

Gategny Court, PO Box 140,
Gategny Esplanade, St Peter Port,
Guernsey, GY1 4EW
t: +44 (0) 1481 723191
f: +44 (0) 1481 711880
e: guernsey@collascrill.com
w: www.collascrill.com