The *reinsurance* captive company

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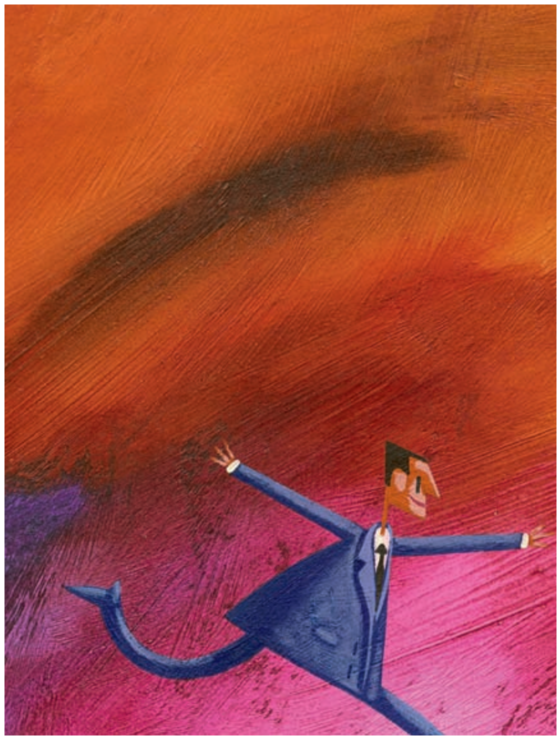
Insurance Law is one of the most prolific fields appearing in new business institutions. The reason behind this abundance can be found in the objective, shared by all businessmen and businesswomen, of limiting risks in their company´s activities. One of the novel forms, which has acquired its definitive configuration in the magma which is currently modern insurance Law, is the reinsurance captive company, created to underwrite the risks of its owner and which has recently been legally recognised under European Community Law.

Despite its apparent novelty, this form is not as new as it appears. Since the beginning of the 20th Century there are records of the practice of establishing captive finance companies by manufacturing or industrial companies to finance the purchase of goods that they were producing. However, it would not be until the decade of the fifties and sixties of the 20th Century that the captive company would appear, as such, from the understanding of a company operating outside the actual insurance sector. After the Second World War a new stage began in the evolution of captive insurance companies

Legal regulations

and *outlook*

ON A WORLDWIDE BASIS, SUCH AS IN THE PIONEER MARKET OF THE UNITED STATES, THERE IS LARGE MARKET FOR THE CAPTIVE COMPANY



which was to be characterized by its use as yet another instrument in modern business risk management.

This period is characterised by a change in the purpose of captive companies. It is no longer just a question of underwriting those insurance covers that the market is not capable of writing. Now, the purpose of this type of company is to carry out better risk management. During this period, another characteristic process of the phenomenon was to appear, such as the setting up of captive companies in offshore territories; preferably with a view to making the most of the regulatory advantages and, at the same time, there was an increase in the types of risk written.

In general, a series of factors should be mentioned that influenced in the proliferation of the captive company phenomenon at that time, the most significant of which was the practice consisting of writing risks via reinsurance, a technique called fronting. This involves one insurer (called the fronting company) writing the risks of an insured and, then, immediately ceding them, either partially or wholly, to another company (captive reinsurer) by means of a reinsurance contract.

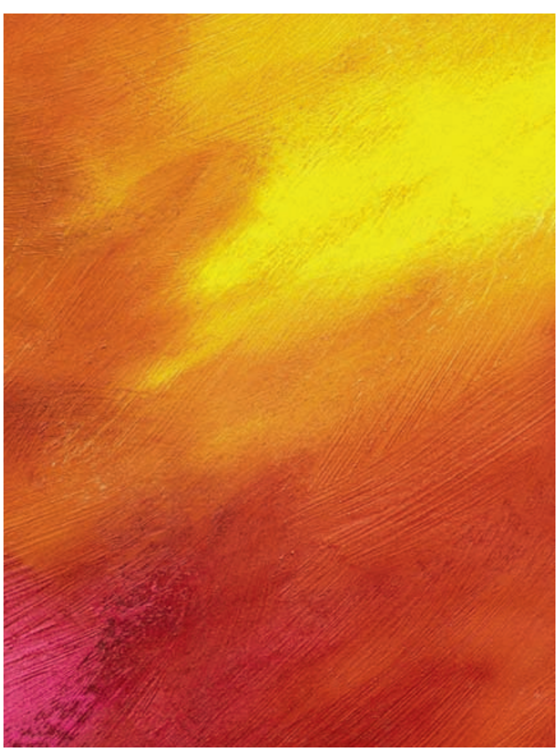
This factor represented another step forward in the evolution of captive companies by facilitating their development as reinsurance companies. The peculiarities of this contract, of which its international nature stands out, made it possible to underwrite all types of risk and, at the same time, widened the territorial scope to almost all countries. To a certain extent, this way of working made it possible to avoid the ever increasing state controls and supervision of direct writing insurers.

The captive company is currently a global phenomenon. It is used by companies throughout the world and constitutes a fundamental instrument in enterprise risk management. Nevertheless, due to the very different concepts and types that exist, as well as the variety of legal systems that contemplate the model, there are no sole international sources or statistics on its evolution and/or current situation. This makes it difficult to acquire exact knowledge of the current position.

However, more important than its current volume, is its projected future growth. According to a recent study, 36% of large global companies still do not use a captive company, whether direct of reinsurance, as a technique for managing risk. In the United States of America, although 77% of the top 500 companies have set up at least one captive company, it is still considered that their margin for growth is significant. This means that, on a worldwide basis, such as in the pioneer market of the United States, there is large market for the captive company. Similarly, a strong expansion of the phenomenon is foreseen in Eastern European companies, as well as in the BRIC group (Brazil, Russia, India and China).

Statistics also show that the use of captive companies is no longer restricted to the large multinational companies but that it is becoming more frequent for medium sized companies to use this risk retention instrument, which is indicative of the increasing accessibility to the model.

In any event, regardless of its future projection, what is true is that these studies show a new phase in the evolution of captive companies, the start of which could be considered to have taken place in the first decade of this century. This is a period in which a step forward was taken with regard to the use of these companies. Their workings and the benefits of using them are well known but the maximisation of their possibilities is being sought in order to achieve better risk management for their supporters.



On the other hand, one cannot ignore that, as a consequence of the expansion experienced by the financial markets and their subsequent systematic crisis, the regulators have placed these companies under the microscope. In this way, the new demands in financial regulation contained under the Solvency II Directive can be understood, as well as the recent publication by the International Association of Insurance Supervisors of a detailed report on the regulation and supervision of captive insurers.

But it is not just the supervisors that are exercising greater pressure on captive companies but also those promoting their use are becoming more demanding. More recently, the creation of these companies are being subject to deeper and more rigorous analysis so that the owners of the captive companies fully understand their characteristics, workings and problems, amongst which the legal department and regulatory implications hold a prominent position.

The lack of regulation on reinsurance and its effect on the captive company

Up until recently, reinsurance has not received excessive attention from the legislator. Traditionally, authorities have preferred to concentrate on the more traditional insurance contract and insurance

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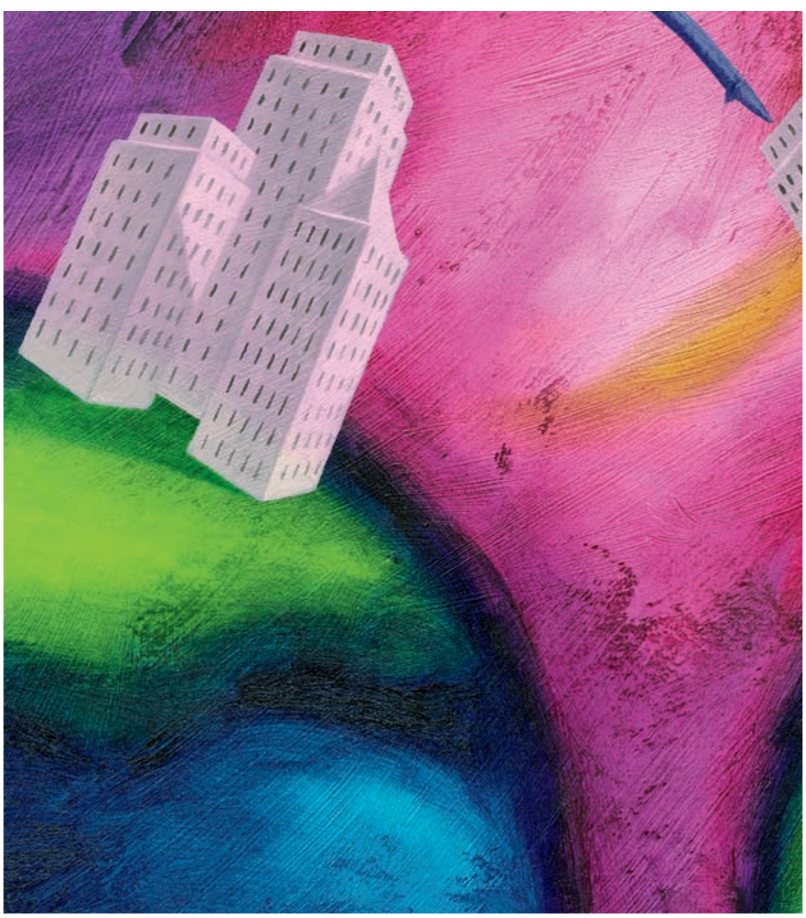
companies' activities rather than those undertaken by reinsurers with regard to reinsurance.

However, the limited interest on reinsurance by the legislator changed a little less than thirty years ago. In the eighth decade of the last century, this change of attitude by the authorities could already be appreciated. At the same time, and on an international level, a series of works on the subject came out, of which the more important were those prepared by the International Association of Insurance Supervisors (IAIS), the Organisation for Economic Co-operation and Development (OCED), the International Monetary Fund (IMF), or the Association of Insurance Superintendents in Latin America.



This interest in reinsurance and, more specifically, in the preparation of a new regulatory framework on the subject, are good examples of the trend towards greater supervision of reinsurance which, today more than ever, is an institution which is experiencing particularly the global phenomenon. For this reason, the economic and financial crisis which has been seriously affecting developed capital markets has again put reinsurance in a privileged position on the legislator´s agenda and the captive company with it.

The current captive company system: Spanish and European Community Law

In the European Community, up until very recently, reinsurance did not have harmonized regulations. Each member state had its own rules on the subject which did not happen on direct insurance where, on the contrary, there was a high degree of harmony. This situation was especially surprising in view of the cross border nature of the European project, especially if one takes into account the important economic and eminently international characteristics of international reinsurance and not forgetting that it is a very developed industry in some of the member states.

This divergence implied that reinsurance companies should comply with different requirements depending on the member state in which they operated. The variety of regulations was an impediment for achieving a real internal reinsurance market, an unjustified increase in costs, as well as the existence of different criteria and requirements in the supervision of a same company operating in different states.

Directive 2005/68/EC of the European Parliament and Council, of 16th November, 2005, on reinsurance and which modifies Directives 73/239CEE and 92/49/CEE of the Council and Directives 98/78/EC and 2002/83/EC, corrected this situation.

The passing of the Directive has meant the final recognition of the captive reinsurance company in the European Community culture and is defined as follows: «Captive reinsurance undertaking» means a reinsurance undertaking owned either by a financial undertaking other than an insurance or a reinsurance undertaking or a group of insurance or reinsurance undertakings to which Directive 98/78/CE applies, or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which the captive reinsurance undertaking is a member».

The Kingdom of Spain, in compliance with Directive 2005/68/EC, commenced procedures necessary to incorporate it into Spanish Law when the Government sent to Congress on 9th March, 2007, the Proposed Law nº 121/000129, which modified the Revised Text of the Private Insurance Regulation and Supervision Law (hereafter TRLOSSP), approved by Royal Decree 6/2004, on 29th,October, in relation to reinsurance supervision.

The second final legal requirement of the Law came into force on 9th December, 2007, in compliance with the order and timescale stipulated under Directive

2005/68/EC. The Declaration of Intent of the Law states that the incorporation of Directive 2005/68/EC into Spanish Law does not represent a significant change to the existing regulation but rather implies a completion and systemisation of the previous regulations in force. This statement is due to the fact that Spanish legislation on regulation and supervision of direct insurance companies applied *mutatis mutandis* to reinsurers. For this reason, the transposition has not represented a break or the introduction of great changes to the current norms applied in the Spanish insurance sector.

The first mention of a reinsurance captive company can be found in the Declaration of Intent of Law 13/2007, with a very similar meaning to that expressed in

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the preamble of Directive 2005/68/EC: «Directive 2005/68/CE is applicable to reinsurance undertakings which conduct exclusively reinsurance business and should also apply to the so-called 'captive' reinsurance undertakings created or owned by either a financial undertaking other than an insurance or reinsurance undertaking or by one or several non-financial undertakings, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertakings to which they belong».

Apart from mentioning it in the Declaration of Motives, Law 13/2007 modifies TRLOSSP by incorporating into Spanish regulations, amongst other things, the legal concept of a captive reinsurance company. According to the new wording, reinsurance captive companies are defined as: «reinsurance companies owned by either a financial undertaking other than insurance or reinsurance undertaking or by one or several non-financial undertakings, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertakings to which they belong».

The legal definition in the Spanish Law coincides fundamentally with that of Directive 2005/68/EC. A captive reinsurance company is considered to be a reinsurance company owned by a company or various companies, except insurance or reinsurance companies or belonging to a consolidated group of insurers or reinsurers, the aim and objective of which is to offer reinsurance solely to the owners or to the group of companies to which it belongs.

The differences with the definition of Directive 2005/68/CE are minimum. There are only small unimportant terminological variations as the Spanish definition uses «captive reinsurance company» instead of «captive reinsurance undertaking», «reinsurance company» instead of «reinsurance undertaking», as well as «financial company» and «non-financial company» instead of «financial undertaking» and «non-financial undertaking».

Similarly, and of little importance, it should be pointed out that the Spanish definition alters the order of the captive´s owners, so that, under Directive 2005/68/EC, reference is first made to financial companies and, subsequently, to non-financial companies, and in the Spanish version the non-financial companies are mentioned first and then the financial companies.

Lastly, it should be mentioned that, whilst Directive 2005/68/EC makes reference to «reinsurance companies owned by either a financial undertaking other than insurance or reinsurance undertaking to which Directive 98/97/CE is applicable», the Spanish regulation uses the term «reinsurance undertaking owned by a financial undertaking which does not form part of a consolidated group of insurers or reinsurers». In this case, the terms are different but equivalent.

Nevertheless, Directive 98/78/EC has been revoked by Directive 2009/138/CE, Solvency II, so that the said reference should be understood to be that stipulated under article 214 of the latter. As far as the Spanish regulation is concerned, the concept of consolidated group should be understood according to the definition in article 20 of the TRLOSSP, as per the wording provided by Law 5/2005 on the supervision of financial conglomerates and by which other laws of the financial sector are modified.

The immediate future: Solvency II

Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on life insurance, the taking-up and pursuit of the business of Insurance and Reinsurance, better known as Solvency II, states under article 310 that, with effect from 1st November, 2012, amongst others, Directives 64/225/EC, 98/79/EC and 2005/68/EC are revoked. At the same time, article 309 establishes that the states must adopt it before 31st October, 2012 and must be fully in force by 1st November, 2012.

The first reference to captive companies is found in the preamble to the regulation when it recognises specifically that: «References in this Directive to insurance or reinsurance undertakings should include captive insurance and captive reinsurance undertakings, except where specific provision is made for those undertakings».

The Directive specifically refers to the special nature of the captive company: «This Directive should also take account of the specific nature of captive insurance and captive reinsurance undertakings. As those undertakings only cover risks associated with the industrial or commercial group to which they belong, appropriate approaches should thus be provided in line with the principle of proportionality to reflect the nature, scale and complexity of their business».

In this way the Solvency II Directive not only announces a regime for the reinsurance captive company but also for direct insurance companies, which are defined as follows: «[An] insurance undertaking' means an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c) or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member».

In the case of the reinsurance captive company, it is the same concept as Directive 2005/68/EC, with small modifications to

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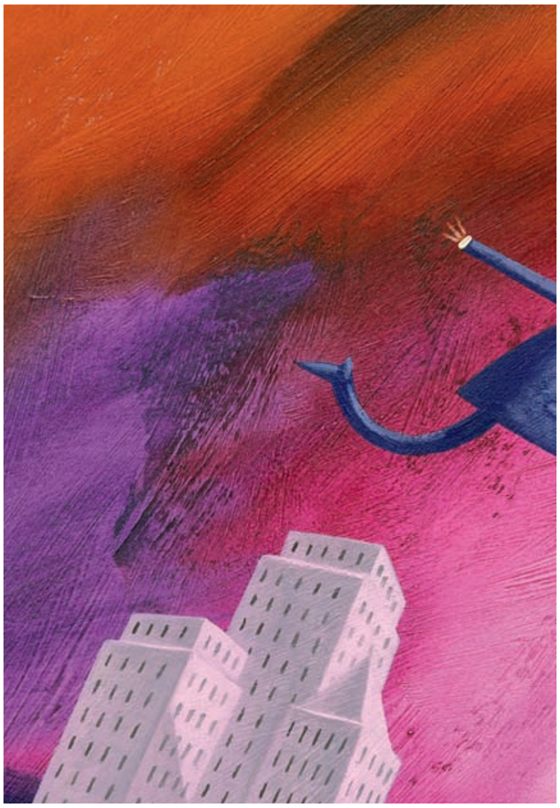
SMALL COMPANIES PLAY AN IMPORTANT PART IN THE EUROPEAN INSURANCE MARKET AND ITS ECONOMY SINCE THEY PROVIDE COMPETITION FOR THE LARGE COMPANIES AND, SOMETIMES, CAN OFFER BETTER PRICES FOR THE SMALLER INSURANCE CONSUMERS



the terms used in the wording. If the latter refers to the fact that the reinsurance captive company can belong to a group of insurance or reinsurance companies to which Directive 98/78/CE is applied, Solvency II refers to a group of insurance or reinsurance companies in accordance with article 212.1.c).

The regulations applicable to direct insurance companies are very different to those of reinsurance. Whilst the reinsurance captive companies fall under the scope of the application of the Solvency II Directive stipulations, it is not the same for direct writing insurance companies. Solvency II requires that insurance companies to have gross annual premium income in excess of 5.000.000 euros, amongst other requirements. This requirement could give rise to the fact that between approximately 40 or 50% of European direct insurance captives fall outside of the Directives prescriptions for not reaching this volume of business.

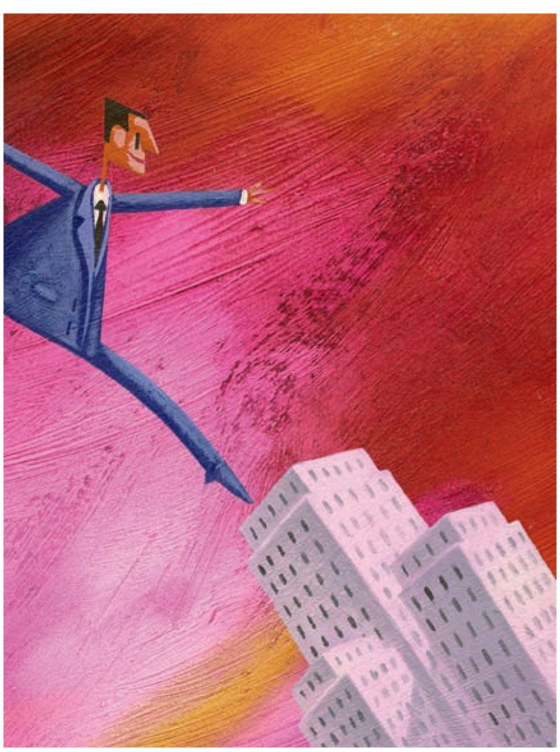
This circumstance started alarm bells ringing in the European Federation of Insurance and Reinsurance (CEA) that argued that the survival of these companies could be threatened since it would limit the number of clients prepared to take out insurance with them as they could be considered to be second class companies, subject to specific regulations and not being harmonized, even though Solvency II also takes into account that those that do not comply with the requisites of the Directive can request an authorization or maintain the one they have.

The differences in the regimes between the two types of captives also affect the minimum capital requirements. The absolute minimum capital for insurance captive companies is set at 2.200.000 euros for those companies that are not life insurers and 3.200.000 euros in the case of life insurance companies, identical to those ordinary insurance companies. However, for a reinsurance captive company, the figure is 1.000.000 euros, which is far lower than the 3.200.000 euros that are demanded of the normal reinsurers. The calculation of this capital is defined as that amount of basic admissible funds below which the policyholders and beneficiaries would be exposed to an unacceptable level of risk if the insurers and reinsurers were to continue with their activity. At least quarterly, insurance and reinsurance companies must calculate and communicate their obligatory minimum capital to the supervisory authorities.

The application of the principle of proportionality to captive companies

The European insurance market is shared mainly by the large companies (85%),13% corresponds to medium sized companies, and 2% to small companies. On the other hand, by number of companies, out of a total of 5.000, 79% are small companies, 15% medium sized and only 6% are the large companies.

These figures indicate that the small companies play an important part in the European insurance market and its economy since they provide competition for the large companies and, sometimes, can offer better prices for the smaller insurance consumers. This factor is essential for understanding that the legislator takes into account the final application of the Solvency II regulations through the principle of proportionality.



This principle has been taken into account from the start of the Solvency II legislative process. In the first round of specific calls for advice of the European Committee of Insurance and Pension Fund Supervisors (CEIOPS), in July, 2004, it was mentioned on various occasions. In this way, in the first point of the document, in relation to internal control and risk management, it referred to the fact that some of the principles applicable on the matter could be applied with flexibility for the small insurance companies, always provided that the nature and volume of permitted it. Similarly, in the fifth point of this public consultation, on the question of investment management, mention was made also of certain practical aspects on proportionality that should be taken into account in this regard.

The Solvency II Directive refers to the principle of proportionality throughout the text, both in the preamble and in the different rules.

The first mention is made in the preamble when it states that «in order to ensure the effectiveness of the supervision all actions taken by the supervisory authorities should be proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking, regardless of the importance of the undertaking concerned for the overall financial stability of the market», to which it adds: «This Directive should not be too burdensome for small and medium-sized insurance undertakings», so that «one of the tools by which to achieve that objective is the proper application of the proportionality principle. That principle should apply both to the requirements imposed on the

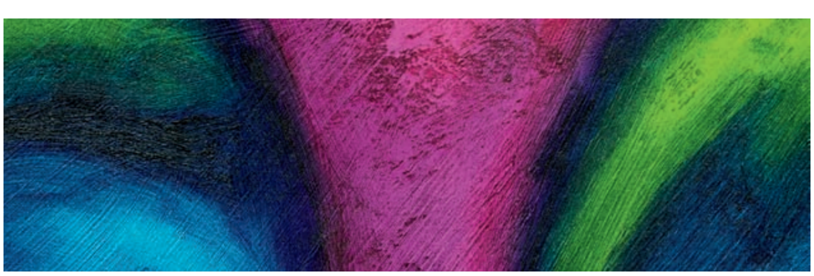
SOLVENCY II EXPRESSLY RECOGNISE THAT SPECIALIZATION IN CLIENTS OR FIELDS OF ACTIVITY MAY BE A VALUABLE INSTRUMENT FOR EFFECTIVE AND EFFICIENT RISK MANAGEMENT

insurance and reinsurance undertakings and to the exercise of supervisory powers».

The Directive also echoes the concern that the cost of compliance with the ruling should not be excessive for the more modest companies. «… this Directive should not be too burdensome for insurance undertakings that specialise in providing specific types of insurance or services to specific customer segments». These types of insurance or reinsurance companies tend to be of a much smaller size and have a more limited scope of action. However, the Directive does expressly recognise that specialization in clients or fields of activity may be a valuable instrument for effective and efficient risk management. It also recognises that the small companies should not be unappreciated or undervalued and, even on occasions, that their small size can be an added value for better risk management.

The principle of proportionality is fundamentally manifest in the compliance with the solvency requirements: «In order to reflect the specific situation of small and medium-sized undertakings, simplified approaches to the calculation of technical provisions should be provided for».

The principle of proportionality, on an imperative basis, is referred in the Directive under the article relating to the supervision of insurers and reinsurers: «The Member States will ensure that all the requirements established under this Directive will be applied in proportion to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking», and with the implementing measures «the Commission shall ensure that implementing measures take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular to small insurance undertakings».



The principle of proportionality is also applicable to the governance system of insurers and reinsurers; to the internal evaluation of the risks and solvency of the companies; to the technical reserving calculations in order to guarantee that the actuarial and statistical methodologies used for calculating the best estimates are in proportion to the nature, volume and complexity of the risks borne by the insurance and reinsurance companies; and to the calculation of the standard formula for calculating the obligatory solvency capital.

In the last two examples, mention is expressly made to the principle of proportionality for captive companies, which does not mean that this principle cannot be more expressly personalized for this type of company. In fact, the preamble states that the Directive should take into account the specific nature of captive insurance or reinsurance companies that only cover risks associated with the commercial or industrial group to which they belong. For this reason, it is foreseen that appropriate measures should be adopted taking into account the principle of proportionality in order to reflect the nature, size and complexity of the commercial activities of these types of companies.

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