



PRA CP11/26 – A tailored regime for captive insurance

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Key points

The IFoA welcomes the opportunity to provide a response to this consultation based on our members' expertise of the captive insurance market, and broader context of the UK insurance market and its global competitiveness. We would be happy to discuss the details of our response with the PRA.

The IFoA acknowledges the stakeholder engagement the PRA has undertaken, prior to the consultation publication, and that the consultation has considered points raised in that engagement. We believe that the introduction of a UK captive regime is in the public interest, subject to appropriate risk management and regulatory guardrails.

The key areas of feedback in our response are as follows:

- We believe that a key aim of the finalised proposal should be to ensure appropriate outcomes for smaller companies and relevant third parties, where existing risk management systems may not sufficiently cover the risks of the new regime.
- The proposals place a heavy reliance on SMF1 and wider governance requirements for the captive. There may be examples of more complex structures that would benefit from wider expertise, including potentially actuarial involvement.
- Further consideration should be given to Captives being subject to recovery and resolution planning as there is a risk of a disorderly collapse impacting third parties
- For Stage 2, we would value the opportunity to discuss an extended scope for the captive regime and highlight that this would require additional robust risk management and governance to be put in place, including the potential need for more risk-reflective capital requirements.

Our response sets out areas where we believe the proposals could be refined to better reflect the risks associated with captives, whilst still achieving the PRA's stated objectives.

Detailed response

Section 1: Introduction

This response is submitted on behalf of the IFoA. We would welcome the opportunity to discuss any of the points raised below, and in particular in relation to Stage 2.

In developing our response, we have drawn upon input from the IFoA Captives Working Party, with review and oversight from relevant sub-committees of the IFoA Life and GI Boards, and the IFoA Policy and Regulation team. This provides a wide range of technical and domain knowledge, from a public interest perspective. Our response continues the positive engagement with prior significant consultations issued by HMT and the PRA.

We have set out our response in two sections below, commenting separately on the proposals for Stage 1 implementation, and the questions set out for potential future Stage 2 development of the captive regime.

The IFoA agrees to the publication of its name as a respondent to this consultation, and we confirm we do not view any of our response to be confidential. For any queries, please contact Alan Marshall / Review Actuary (alan.marshall@actuaries.org.uk) in the first instance.

Section 2: Stage 1 comments

1. **We are supportive of the main elements of the Stage 1 proposals** as a practical and proportionate introduction of a UK captive regime, in line with the HMT's proposed scope and objectives. We support the PRA focus on the safety and soundness objective, designing a framework to support genuine risk transfer, based on robust risk management and governance arrangements.
2. Larger corporates with sound risk management systems, and the insurance industry, should be well-placed to understand and appropriately manage the risks associated with the new regime. **We believe that a key aim of the finalised proposal should be to ensure appropriate outcomes for smaller companies and relevant third parties**, who may not have as well-developed risk management systems. Points we would highlight:
 - a. To what degree should related third parties be covered, and how are those third parties defined. The risk is that we end up with "real" insurance via the backdoor where third parties whose interests are not closely enough aligned with the captive parent are insured.
 - b. There is a risk that companies without a sophisticated risk management system use a captive as a substitute for commercial insurance of potentially complex risks. Well-managed companies, with developed risk appetites, are better placed to carry out appropriate risk assessment. However, there is a risk that less-well governed companies may be attracted by a lower-cost captive option, leading to a less robust assessment of complex insurance risks (e.g. public liability), and increased likelihood of adverse outcomes for entities and individuals.
3. That second point is key: **the successful operation of the regime depends heavily on risk management and governance**. The proposals place a heavy reliance on SMF1 and wider governance requirements for the captive to have or source the proper skills and experience and to understand the risks they are running. The likely involvement of professional captive managers will mitigate this to some extent, however, there may be examples of more complex structures that would benefit from wider expertise, including potentially actuarial involvement. Ensuring sufficiently strong risk management and governance of large, complex, or long-tailed risks would point towards such expert involvement.

4. **Further consideration should be given to Captives being subject to recovery and resolution planning** as there is a risk of a disorderly collapse affecting the operations of the parent companies and delaying or disrupting payments due to third parties. Such planning is required in other jurisdictions e.g. Ireland.
5. **The minimum capital requirements have been set at a very competitive level, with no differentiation across lines of business** (as articulated in the CP “*the CCR would tend to be at least three to five times lower than the average SCR for general insurers, though the extent can vary significantly depending on risk profile*”). Whilst this may not be unreasonable for captives with simple business models, it may be overly simplistic where the risks covered are more volatile in nature. In the first instance, we would recommend consideration of a two-tier approach to calculating capital for lines of business, with more volatile lines attracting higher capital charges, particularly where non-group undertakings are covered without a frontier. We would welcome a discussion with the PRA on the trade-off between risk and simplicity to assess how actuarial oversight may be able to provide assurance that capital is set at appropriately risk-reflective levels, ensuring potential claimants are not disadvantaged.
6. **The relatively low proposed minimum capital requirements may have unintended consequences and introduce friction.** Given the proposed capital regime is weaker than Solvency UK, frontiers may be hit with adverse counterparty risk charges when fronting for captives. This may push fronting prices up for captives or result in frontiers demanding stronger capital additional collateralisation requirements from the captives.
7. **There is a risk of mispricing for complex risks.** If the captive does not have the appropriate expertise in place to accurately price the risk the entity may fail. We believe this could be mitigated through robust business planning, including recovery and resolution, and is of particular importance where the captive covers material non-group undertakings. It is important for the business plan, including pricing frameworks, of the captive to be subject to sufficient governance and controls to ensure its ongoing viability. This may include the use of external assurance depending on the complexity of the captive and is an area where actuarial oversight could be beneficial (in particular for pricing).
8. **There is a potential conflict of interest for some lines of business, e.g. Directors and Officers (D&O) insurance.** This is particularly a risk for D&O cover because the beneficiary could also be the one on the captive board who ultimately has responsibility to determine the claim.
9. We acknowledge the detailed cost benefit analysis carried out, including the involvement of the CBA panel. We believe the points we make above may help to mitigate some of the risk of inappropriate use of the new Captives regime, including transfer of insurance business and risks from the existing commercial market to new captives.

Section 3: Stage 2 comments

6. Note that we answer a subset of the Stage 2 consultation questions below, restricting our responses to those questions where we have a specific point to raise. We provide responses to questions 3, 4, 6, 7, 9, 13, 14, and 15.

Question 3 (PRA): What objectives would firms seek to achieve through group or association captives that could not be met through single-parent captives or existing risk-sharing arrangements?

7. We consider the following objectives could be more viable through group or association captives.
 - Lower barrier to insurance and thus increasing insurance uptake by reducing the capital contribution and administrations costs borne from each individual member. This lowers the barrier to entry for new

members wishing to join the group or association and can support broader market participation and overall uptake of insurance if the insurance can be obtained more economically as a group.

- Enhanced collaboration through risk pooling and self-insurance arrangements can be achieved within an association captive structure. By aggregating risks across multiple members, association captives may be able to negotiate more effectively structured and competitively priced reinsurance\retrocession programmes compared with single-parent captives.
- Association captives are particularly well suited to organisations with subsidiaries or branches operating across multiple countries or jurisdictions, especially where these entities manage their finances independently, similar to a franchise model. Facilitating the establishment of association captives for such groups could also enhance the UK's attractiveness as a captive domicile and encourage registrations from international organisations.

There may be an imbalance in bargaining power between smaller firms participating in a group or association captive and the captive itself that may run opposite to the objectives above. Where non-group policyholders, such as franchisees or key suppliers, are economically dependent on the parent, captives should demonstrate that pricing is fair to those policyholders and that participation is genuinely voluntary.

The main substitute to a group or association captive is a commercial insurance facility. Instead of negotiating separate policies for each insured with multiple insurance companies, the broker uses the facility to offer standardised terms and streamlined placement.

Facilities that establish group captives could use the captive for more robust risk retention - allowing the members of the facility greater balance sheet stability.

There is some precedence of facilities that use captives in other jurisdictions. Some examples of facilities include:

A. Heathrow's OCIP

- Heathrow's OCIP (Owner Controlled Insurance Programme) is a construction wrap facility that provides insurance of its construction contractors without requiring each contractor to source its own insurance.
- Heathrow also operate LHR Insurance Services - a captive insurance company incorporated on Isle of Man which is used to support the OCIP programme.

B. Hydra Insurance Company Limited

- Hydra Insurance Company Limited is a collective captive structure that supports the global marine protection and indemnity (P&I) market.
- Hydra is a Segregated Accounts Company incorporated in Bermuda.
- Effectively operates as a mutual insurer.

Question 4 (PRA): What factors might prevent smaller firms from participating in captive-style risk-sharing arrangements, and how could group or association captives reduce those barriers while maintaining appropriate prudential safeguards?

8. We regard the main barriers to be the availability of financial resources to participate in the captive and the ability to obtain favourable insurance terms. As a larger grouping, smaller firms may be able to negotiate better terms (either price or coverage) as a result of further diversification and reduction of volatility of the underlying insured risks. Safeguards can continue to exist to ensure equitable spreading

of the costs but recognising that the nature of insurance is the pooling of risk and cost. This is not dissimilar to the PCC framework in other jurisdictions albeit with strong boundaries around each cell.

Question 6 (PRA): What additional safeguards, relative to the proposals for the single-parent regime in this CP, may be necessary to address the risks associated with pooled ownership and insured interests?

9. Strong governance is important to ensuring sufficient safeguards exist. Actuaries can play a key role here, particularly where there is a wider scope of risks that a captive may cover. Having an appointed actuary will help the Board and management team identify risks to the captive as have been seen in other jurisdictions e.g. Ireland where the actuary is seen as important to upskilling the risk management capabilities of captives. This should sit alongside the SMF1 and SMF3 roles that the PRA has proposed.

Question 7 (PRA): How should capital and governance requirements and expectations differ from the proposals applicable to single-parent captives?

10. The group captive should be allowed to design its own governance and controls programme for the different stakeholders involved. However, the overall governance requirements and expectations at the total level should not be dissimilar to single-parent captives to avoid over-complicating the regime.

Question 9 (PRA): To what extent, if at all, should group or association captives be permitted to insure smaller or less sophisticated policyholders, and what implications would this have for policyholder protection and potential exposure of the FSCS?

11. The insuring of less sophisticated policyholders should be restricted as they may not fully understand what the captive can offer and/or have higher expectations than is designed through a captive set up. The insuring of smaller policyholders, provided they are not regarded as less sophisticated, should be subject to sufficient tests around their understanding of the risks involved in using a captive versus a more conventional insurance structure.

Question 13 (PRA): How should the financial resources framework proposed in this CP (including capital requirements and capital resources) be applied to the core and the cells?

(In particular:

- Should the core hold the baseline capital requirement, and the cells hold the captive capital requirement?
 - How should the PRA address the resulting risk of cells holding no cash assets?
 - What arrangements should apply where a cell's loss exceeds its allocated assets?)
12. Ultimately, the PCC as a whole should meet the requirements of the baseline capital requirement, and each cell individually. This assumes that the structure has no recourse, i.e. there is no recourse between the cells or the core. The core should hold operational capital to manage the run-off of the cells.
 13. The PCC should also be allowed to govern the asset and liquidity requirements of each cell. It seems unlikely that a PCC would permit cells to hold no cash assets given the operating nature of insurance cells and the need for liquidity to pay claims.
 14. The PCC should also be allowed to determine what happens when a cell is "insolvent", provided the PCC as a whole continues to meet its baseline capital requirement. This includes having fair consideration about the level of diversification in capital that cells can be credited with when determining their capital requirement. The PRA should be satisfied that any plans by the PCC in the event of a failure of a cell should be sufficient to avoid contagion across the PCC and ultimately the failure of the PCC.

Question 14 (PRA): How, if at all, should the governance and other proposals in this CP be adapted for PCC captives, given the relative complexity of PCC structures?

(For example:

- Which responsibilities should sit with the PCC board, each cell owner, the captive manager, and any outsourced provider?
 - What additional governance requirements should apply as the number, size or risk profile of cells increases?
 - What controls should apply where the same captive manager, directors, actuary, claims handler, reinsurer or fronting insurer serves multiple cells?
 - How should the PRA account for operational risks that may arise from managing a larger number of cells (for example, risks related to outsourcing, data, systems and controls, and effective oversight?)
15. The PCC should be treated akin to a captive for the purposes of this CP. Similar to Question 13, the PRA should then permit the PCC to manage its affairs provided it can demonstrate good governance, control and risk of contagion if a cell were to fail. The PCC should also be allowed to establish its conflict of interest processes. In some cases, efficiencies can be gained by having the same manager, director, actuary, etc. work across multiple cells. However, this should not be exclusively so to provide the market with choice and competition.

Question 15 (PRA): How should the reporting requirements for captives be modified for PCC captives? In particular, what cell-level data should the PRA request?

16. The PCC Core should be subject to more reporting requirements than a captive given the inherent systematic risk that is present should the governance and control of the Core fails. However, the level of reporting should not be burdensome or at the same level as Solvency II. Reporting should focus on the core individually and the total PCC level.
17. For individual cells, reporting similar to a single-parent captive could be emulated to reduce the regulatory burden on cells.