CP150: Guidance for (Re)insurance Undertakings on Intragroup Transactions and Exposures

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Overview

On 4 July 2022, the Central Bank of Ireland (CBI) published a Consultation Paper (CP) inviting stakeholders to provide their views on the proposed Guidance for (Re)insurance Undertakings on Intragroup Transactions and Exposures.[1] The purpose of this briefing note is to summarise some of the key proposals in the CP.

The proposed guidance focuses on three key exposures:

- Intragroup assets
- Intragroup reinsurance
- Cash pooling/group treasury function arrangements

The consultation period will end on 22 September 2022.

Part A: Introduction

Many Irish (re)insurers are part of large international groups. These (re)insurers benefit from financial resources and other support the group can provide. Although intragroup relationships can create synergies, the CBI notes that such arrangements and a dependence on the parent for capital can also create a concentration of risks. The CBI believes it is often the case that intragroup arrangements are seen as less risky and so inadequate governance and risk management procedures are put in place to manage such arrangements.

Therefore, the CBI believes that management and supervision of intragroup arrangements merits special attention. Group supervision under Solvency II (SII) stresses the importance of the supervision of intragroup transactions (IGTs) and risk concentrations. The CBI believes that strong and robust oversight and monitoring of IGTs at the (re)insurer level is paramount in:

- Promoting good risk management
- Protecting policyholders
- Ensuring sound financial positions of the Irish (re)insurer

The CBI notes that the solvency and liquidity position of the (re)insurer as well as the group can be affected by IGTs. When considering recovery and resolution planning, the CBI believes that the (re)insurer needs to ensure it can withstand severe stresses in the group or failure of the group. In order to achieve this, the CBI deems it necessary for firms to identify and assess a range of possible actions that could be taken in order to restore their financial position or maintain ongoing viability at an individual and/or group level.

Application of the proposed guidance

As it stands, this proposed guidance would apply to insurance and reinsurance undertakings authorised by the CBI, which includes captive (re)insurers and branches of third-country insurance undertakings authorised by the CBI.

The date the proposed guidance will apply from has not been confirmed at the time of writing this note.

Status

The CBI states that the proposed guidance outlined in this CP does not introduce any additional requirements for (re)insurers but that it outlines the expectations of the CBI on what compliance with SII requirements for these companies might look like.

> We have noted below some areas of the guidance that companies might struggle to comply with, as well as areas where there is some uncertainty relating to how the CBI will perform some of the tasks it proposes to do.

Part B: Guidance

The CBI expects (re)insurers to consider the guidance and demonstrate that they have given due care to risks associated with IGTs. It adds that these risks should be considered with respect to capital requirements and governance and risk management frameworks. The CBI expects firms to take a ”comply or explain” stance with regards to this guidance.

Governance and risk management

In line with SII, the CBI notes that roles and responsibilities for identifying and managing the risks associated with IGTs for all key functions should be outlined and documented. In particular, the CBI notes that the internal audit function is expected to include regular audits of IGT risk management in its overall audit planning.

The CBI highlights that the materiality, concentrations and interdependencies of risks may not be fully appreciated or understood if risk appetites and risk registers are not appropriately defined. They add that this also introduces further operational risk

[1] CBI (4 July 2011). CP150 – Guidance for (Re)insurance Undertakings on Intragroup Transactions and Exposures. Retrieved 9 September 2022 from https://www.centralbank.ie/publication/consultation-papers/consultation-paper-detail/cp150---guidance-for-(re)insurance-undertakings-on-intragroup-transactions-and-exposures.

into the business. The CBI goes on to say that risk appetites and risk policies should contain detailed metrics which outline the (re)insurer's willingness to take on risk. In the CP, the CBI explains that IGT arrangements should be considered with respect to the defined risk tolerances and the risk management policy as well as to how it fits within the (re)insurer's overall risk appetite.

We have noted that the CBI suggests that concentration of risk in a single group undertaking is avoided or sufficiently mitigated. This might prove difficult for some (re)insurers due to expectations to comply with group policies relating to choice of investments and the placement of reinsurance.

Any risk policy should be tailored to the specific risks faced by the business; therefore, the CBI deems it insufficient for the (re)insurer to rely solely on the risk policy designed by the group. If reliance is being placed on the group's risk policy, the CBI believes that consideration should be given to the (re)insurer's own risk exposures, tolerances and requirements and the groups policy adapted accordingly.

Key exposures

The CBI expects (re)insurers to consider whether IGTs are appropriately and accurately reported.

It expects (re)insurers to apply the same level of oversight and due diligence to intragroup counterparty exposures as would be applied to external counterparties.

(I) Intragroup assets

When considering intragroup assets and setting expectations, the CBI has focussed on the most common form, intragroup loans. It states that all intragroup loans should be board-approved and formally documented, including any renewals or increases that are applied. The CBI advises companies to review these assets annually to ensure continued compliance with their policies and procedures.

Prudent Person Principle (PPP) requirements outlined in SII set out standards in relation to portfolio diversification, the use of financial derivatives, exposure to unregulated markets and risk concentration, asset-liability matching and the security, quality and profitability of the whole investment portfolio. In order to comply with the PPP, the CBI recommends that (re)insurers should avoid excessive concentration in any one asset or counterparty, especially when that asset is illiquid. The CP proposes that the (re)insurer's investment policy should outline limits on the amounts that can be invested and concentration limits on investments, regardless of whether they are internal or external.

The PPP also requires that the assets used to back the technical provisions (TPs) must match the nature and duration of the (re)insurer's insurance and reinsurance liabilities and the best interests of all policyholders and beneficiaries must be taken into account. The CP states that the (re)insurer should be able to demonstrate that an investment in an intragroup asset is in the best interests of policyholders and beneficiaries and can be considered appropriate to cover the TPs or Solvency Capital Requirement (SCR).

When valuing intragroup assets, the CP notes that the (re)insurer should comply with the arm's length criteria[2] and avoid or appropriately manage conflicts of interest. This criterion requires both parties to the transaction to be knowledgeable and willing parties acting in their own self-interest and to not be subject to any pressure from the other party. The CBI adds that, if the asset is not valued according to this criterion, then it can create additional risks for the (re)insurer and/or group.

In the CP the CBI states that it will consider the (re)insurers' application of arm's length criteria to the valuation of intragroup assets. It is unclear when and how it proposes to do this.

It should be noted that intragroup assets may impact the assessment of the compliance with regulatory capital requirements (eligible own funds) and whether the (re)insurer is complying with these requirements. The CP mentions that, although intragroup assets generally will not create own funds, the required criteria or features for classification of existing own funds into certain tiers may no longer be met when the intragroup assets are considered, due to the nature of some intragroup assets. The CBI believes that (re)insurers should be able to demonstrate how they have taken intragroup assets into account in classifying the (re)insurer's own funds in compliance with the criteria set out under SII.

The CBI also has an expectation that (re)insurers with significant concentrations in intragroup loan arrangements will perform suitable stress testing of the relevant exposures such as in the own risk and solvency assessment (ORSA) or in a preemptive recovery plan.

The CBI suggests that companies should perform additional stresses in the ORSA to assess the additional risks associated with IGTs. (Re)insurers will need to consider whether they will have the resources to examine all of the recommended stresses on top of other scenarios they would like to examine. An option which companies could consider is point-in-time sensitivities instead.

[2] Assets shall be valued at the amount for which they could be exchanged between knowledgeable and willing parties in an arm's length transaction

(II) Intragroup reinsurance

The CP highlights that intragroup reinsurance is an efficient risk mitigation and management tool that is frequently used within large groups. Intragroup reinsurance can create a reinsurance asset on the balance sheet which creates an exposure to the group for the (re)insurer. For this reason, the CBI's view is that this exposure must be considered with respect to the PPP and arm's length criteria. The PPP requirements outlined in Section (I) above apply to all assets, which is inclusive of intragroup reinsurance.

The CBI suggests that the use of the standard formula to assess these exposures may not be appropriate with the use of intragroup reinsurance. It notes that downgrade risk and concentration risk associated with intragroup reinsurance may not be adequately captured in the standard formula and should be considered within the overall risk management strategy. In addition to this, the CP says that the (re)insurer should also include scenarios and reverse stress tests in its ORSA which examine the default or downgrade of the group (re)insurer, and should consider such stresses in its preemptive recovery plans.

We have noted that the CBI suggests that the risks reflected in intragroup reinsurance may not be reflected in the standard formula and so it may be inappropriate. This is something that companies may not have considered previously. Companies could consider this within their ORSAs when assessing their risk profiles, standard formula appropriateness and their own solvency needs, but this may entail extra work.

The CBI also proposes that all intragroup reinsurance arrangements should be presented to the board for consideration and approval prior to their coming into effect and that intragroup reinsurance arrangements should be covered by the Head of Actuarial Function opinion on reinsurance.

(III) Cash pooling/group treasury arrangements

The CBI notes that many (re)insurers rely on group treasury arrangements or have "cash pooling" arrangements in place and that such arrangements vary considerably and have different implications on liquidity and counterparty risk and hence the SCR. The CBI further notes that although the structuring commonly takes the form of an intragroup loan, "cash pooling" arrangements can also be structured in such a way as to meet the accounting definition of "cash" (or cash equivalents).

The CBI expects that:

- (Re)insurers entering into "cash pooling" or similar arrangements can demonstrate a clear understanding of the structure and how it will be reported in the financial statements and Solvency II balance sheet.
- (Re)insurers should have a clear understanding of how the arrangement is to be treated in the SCR calculation, including the correct counterparty credit rating.
- Where (re)insurers choose to enter cash pooling arrangements, they are clearly defined in risk policies (e.g., liquidity policy, counterparty policy).
- (Re)insurers with significant cash pooling arrangements perform suitable stress testing of the relevant exposures (e.g., in the ORSA, or in a preemptive recovery plan).
- The CBI states that it will review and assess any cash pooling arrangements for compliance with PPP requirements.
- No single cash pooling arrangement is so large that it threatens the (re)insurer's solvency or financial position and concentration of risk in a single group undertaking is avoided or sufficiently mitigated.

The CBI also notes that cash pooling transactions do not form part of the own funds; however, they might have an impact on the tiering of other instruments used. The CP notes that special consideration should be given to whether they limit the liquidity and loss absorbency of items included in the own funds.

In the CP the CBI states that it will review and assess any intragroup cash pooling arrangements for compliance with the PPP. It is unclear when and how it proposes to do this.

Conclusion

This CP from the CBI demonstrates the growing importance of a holistic approach to risk management. It highlights the necessity to consider the impact of IGTs on the risk profile of the business. Although many (re)insurers may have historically viewed IGTs as less risky than alternative arrangements, the CBI expects there to be adequate governance and risk management procedures in place to manage the risks associated with and created by such arrangements.

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