Response to CBI guidance for (re)insurance undertakings on intragroup transactions and exposures

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Insurance Europe's Reinsurance Advisory Board (RAB) welcomes the opportunity to provide comments on the Central Bank of Ireland (CBI) consultation paper on its guidance for (re)insurance undertakings on intragroup transactions and exposures.

General comments

The RAB welcomes the CBI's recognition of the benefits of being part of larger groups, including the financial support a parent company can provide and the cost efficiencies and synergies that can be achieved.

In the RAB's view, the CBI should explicitly recognise the potentially most important benefit of membership of a (re)insurance group: diversification of risk. Diversification of risk is central to the concept of (re)insurance and provides for greater balance-sheet and profit stability to the benefit of policyholders and shareholders. Intragroup transactions (IGTs) are an essential tool for facilitating the diversification of group-wide risks, which enhance the financial strength of a (re)insurance group and its subsidiaries.

The CBI needs to be mindful that placing increased expectations on IGTs can undermine group diversification and financial strength, which in turn can have the counterproductive impact of undermining the financial robustness of the local subsidiaries the CBI seeks to protect.

Much of the CBI guidance reiterates existing Solvency II regulations and reiterates that the regulations on risk management and governance specifically apply at entity level equally to transactions that are internal and external to the group in which the (re)insurance undertaking sits. While Solvency II establishes that the regulation of individual (re)insurance undertakings remains the essential principle of insurance regulation, it also establishes a rich and comprehensive framework for the regulation of insurance groups. Given that current rules already cover both external and internal transactions, it is not immediately clear why additional requirements should now be introduced on internal transactions, for example with regard to counterparty default risk or risk appetite.

The CBI's recognition of its contribution to group supervision through membership of colleges of supervisors is welcome. However, in pursuing a proportionate and balanced approach to supervision, the CBI should explicitly recognise that the extent of its oversight and monitoring of IGTs at undertaking level should be informed by, and may be reduced because of, its engagement in colleges of supervisors.

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The CBI expects the same level of oversight to be applied to intragroup and external transactions. While the RAB acknowledges that Solvency II regulatory risk management requirements do not generally differentiate between intragroup and external transactions, the practical implementation of those requirements, under the scope of group supervision, will necessarily be easier for intragroup transactions precisely because of the synergies, close connections and established information-sharing between the subsidiary and parent company. The relative ease with which IGTs can be implemented can be valuable for companies needing, for instance, to maintain solvency in a crisis.

Part A: Introduction

The CBI expects (re)insurers to have sufficient local substance and governance procedures in place to continue to operate during severe stress to the group or even failure. The CBI's belief that a subsidiary should be able to withstand a failure of its group is highly concerning as it undermines the framework for group supervision under Solvency II, and needs to be addressed.

Part B: Governance and Risk Management

The RAB welcomes the fact that the CBI recognises (in para 12) that the measures should be adopted in a proportionate manner.

Part B2 (I): Key Exposures — Intragroup Assets

Box 2 point c) states that the CBI expects no single intragroup asset to be significant enough to threaten the (re)insurer's solvency or financial position. This requirement is too prescriptive and goes further than the requirements of the Prudent Person Principle (PPP) and Solvency II more generally.

There are extensive requirements in Solvency II regarding investment, concentration and counterparty risks which preclude the need for prescriptive requirements on investment assets as proposed by the CBI. As well as running counter to the risk-based principles of Solvency II with respect to the investment of assets, prescriptive criteria on asset holdings cannot in general be tailored to the specific nature of the asset held and, in the case of IGTs, to the circumstances (including financial strength) of the undertaking and the group.

Box 2 point d) first sentence states that (re)insurers are able to demonstrate that there is no material conflict of interest introduced by investment in intragroup assets. This also goes beyond the PPP, which merely refers to how conflicts of interests are managed (ie, in the best interests of policyholders).

Box 2 point g) sets out expectations for the stress testing of significant concentrations of intragroup loan arrangements, for example in the own-risk and solvency assessment (ORSA) or pre-emptive recovery plans. Any stress testing of intragroup loan arrangements needs to be proportionate, recognising the exposures arising from those concentrations and the purpose of the stress testing. For example, such stress testing should only be included in the ORSA if relevant for the assessment of the overall solvency needs of the undertaking, taking into account its risk profile. Similarly, such stress testing should only be included in the recovery plan if relevant for the purposes of recovery planning, ie, an assessment of the ability of the undertaking to recover from a significant deterioration in its financial position.

Part B2 (II): Intragroup reinsurance

In paragraph 27, the CBI states that where intragroup reinsurance results in a reinsurance asset on the balance sheet of the (re)insurer, this asset contributes to the exposure of the group, and must be considered under the arm's length criteria and the PPP.

In this context, the RAB suggests that the CBI should distinguish between the different types of reinsurance asset, particularly those which may primarily be of an investment nature and those which primarily represent a reduction or offset of insurance liabilities.

The PPP relates to the investment of assets, whereas traditional reinsurance reduces the risk associated with liabilities. For example, insurance companies hold balance-sheet reinsurance recoverables and receivables directly corresponding to and offsetting insurance balance-sheet liabilities. A large reinsurance receivable, following a major catastrophic event, is not the result of an investment decision but rather the outcome of an insurance event. For this reason, the requirements in Solvency II relating to the risk management of reinsurance and other risk management techniques are sufficient for the management of risks related to reinsurance, and the PPP, relating as it does to invested assets, is generally not relevant.

In paragraph 29, the CBI expects (re)insurers to include robust group counterparty risk stress tests and reverse stress tests in their ORSA, including a scenario of group failure, and the resulting impact on the (re)insurer's solvency capital requirement (SCR) and minimum capital requirement (MCR). It may be appropriate to carry out stress tests on group counterparty risks as part of overall stress testing in the ORSA. However, such stress testing needs to be proportionate to the extent of the group transactions in place and the risks faced. In line with the Solvency II regulation, it should only be necessary to include group counterparty stress tests in the ORSA where those IGTs are relevant for the firm's overall solvency needs, taking into account their risk profile (and related to this the risk profile of the group).

In this context, a blanket expectation to test group failure in the ORSA is not proportionate and could undermine the company's own assessment of key risks, diverting attention and resources from the risks more pertinent to the firm's risk profile.

Furthermore, the assessment of own risks in the ORSA is compromised if that assessment is disconnected from the likelihood of the risk materialising, ie, group failure in this instance. Even in the event of failure, the group may remain in a position to honour most of its obligations to the undertaking if it fails.

The analysis of group failure in the ORSA needs to be proportionate and reflect its purpose. Stress testing group exposures may be useful to the undertaking in identifying, measuring, managing, and reporting risk exposures. However, the CBI should clarify in its guidance that the purpose of such analysis is not to undermine proper group capital management. The CBI should make clear that its expectation is not that undertakings are capitalised to withstand the failure of the group. Expecting all undertakings to be capitalised to withstand the failure of a group would preclude the benefits of group diversification allowed for in Solvency II and would directly undermine group supervision as envisaged by Solvency II.

It should be acknowledged that undertakings already account for counterparty default risk for their IGTs according to Solvency II, where there is actually no privileged treatment for capital charges. These are risk-based and defined depending on the probability of default (eg, via credit rating) between external and internal reinsurance. While (extensive) IGTs may be used to increase the security of the undertaking to the security level of the group, there is a risk that additional requirements in relation to IGTs might prevent the tool from being used effectively. It also would not be appropriate to expect that the security of undertakings should be generally higher than the security of the group.

Similarly, the analysis of group failure or downgrade in the recovery plan needs to be proportionate and appropriate given the recovery plan's purpose of assessing the capacity of the undertaking to recover from a severe stress scenario. A realistic assessment of the impact of group failure on a subsidiary undertaking would necessitate a group-wide assessment of group failure including the conditions or scenarios under which that failure would take place, ie, a group-wide recovery and resolution plan. With this proposal the CBI is, in effect, mandating a group-wide resolution plan, responsibility for which would rest with the group-wide supervisor.

It is for this purpose that recovery and resolution planning is recognised in international standards and emerging EU regulation as a group-wide exercise for most (re)insurance groups. Article 7 of the proposed EU Directive on Insurance Recovery and Resolution requires recovery planning to be carried out at the level of the group, reflecting the reality that insurance group and entity recovery are closely connected. Where it provides a possibility for the local supervisor to request a subsidiary plan, this is only under the specific circumstances in which the group-wide plan either does not exist or does not sufficiently capture local entity considerations.

Furthermore, the RAB would ask that the CBI refrain from increasing expectations on recovery planning at this point, particularly with respect to the linkages between group and solo recovery, until such time as the IRRD becomes EU law.

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