Intra-Group Reinsurance Transactions

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International Actuarial Association
Association Actuarielle Internationale
150 Metcalfe Street, Suite 601
Ottawa, Ontario
Canada K2P 1P1

www.actuaries.org
Tel: 1-613-236-0886 Fax: 1-613-236-1386

Email: secretariat@actuaries.org

Table of Contents

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This short note has been written by the reinsurance sub-committee of the IAA. It is a committee paper intended to help readers understand the rationale behind these transactions including some of the issues faced in their execution. The note is produced on the basis of the experience of sub-committee members and should not be read as a complete coverage of the range of such transactions nor of the issues that need to be considered. Unless described otherwise the note focusses on issues arising from transactions which cross national regulatory boundaries rather than transactions between entities within the same national regulatory environment.

The note describes the role of Intra-Group Reinsurance Transactions in managing and steering a (re)insurance group. Intra-Group Reinsurance Transactions, consistent with any reinsurance transactions between two separate legal entities, impact the level and emergence of profit within the two entities as well as the strength of the respective two balance sheets. For ease of reading the term IGR will be used for the remainder of this note when referring to Intra-Group Reinsurance Transactions.

IGRs are essentially the same as similar reinsurance transactions between two unconnected regulated legal entities and much of the rationale for entering and executing such transactions is identical. However the situation with IGRs that both legal entities have ultimately the same parent company and shareholder gives rise to the need for special considerations which this note attempts to describe. In particular the additional scrutiny that may arise from regulators, tax authorities, rating agencies etc. needs to be considered when setting up the appropriate approval processes. All such transactions clearly need to be shown to have been carried out for the benefit of both parties and agreed by both parties independently.

An alternative form of IGR arrangement arises when a number of companies within a Group participate in a pooling structure. Whilst much of the same considerations apply here as with a standard IGR between two companies there are some differences and these are outlined in the relevant sections of this note.

Another form of IGR includes the ceding of risks into a Special Purpose Vehicle (SPV). Usually SPVs are funded by capital raised from investors outside of the Group but they can be used to bring capital from one group member to meet risk in another. In this intragroup context the considerations are similar to those for an IGR. The presence of the SPV creates an additional legal entity which needs to meet the local legal, tax and regulatory requirements.

This note only considers Intra-Group "reinsurance transactions" rather than including other types of intra-group transactions such as "capital transactions" although for solvency and other purposes both have a role to play. It also excluded fronting arrangements.

1. Purpose of the transaction

There are various potential drivers for reinsurance. Capital requirements and the diversification of risks are common considerations that motivate reinsurance. In the context of capital the ceding company and its shareholders may need to consider the advantages and disadvantages of a reinsurance transaction as opposed to some other form of capital support. When the ceding company is a subsidiary of a Group then this decision has also to consider the needs of the shareholder including the shareholder's willingness or ability to inject capital or provide other forms of support.

Reinsurance is also used for risk management purposes. Frequently a company will have sufficient capital to support its volume of business but its management may consider that they are too exposed to certain risks and look to reduce these exposures through reinsurance. This is often the case when a company is looking to reduce the volatility of its profit and loss account or it has certain risks within its portfolio which they would like to reduce. Linked to this, internal reinsurance is also used to allow the transfer of risks from legal entities licensed to sell insurance in certain jurisdictions to the legal entities where Groups intend to manage and diversify the said risks.

An IGR by definition is between two related group companies and this effectively brings in 3 parties to the transaction. Not only do the needs and benefits of the two potentially transacting companies need to be considered but also that of the Group as a whole. In most circumstances Group is normally defined as the ultimate shareholders and who are represented by Corporate Centre type functions, however it is also possible for Groups to have sub-holding companies or subsidiary entities who are responsible for managing a number of companies within the sub-group. The Group corporate centre will normally have their own views on the appropriateness of any IGRs and in particular whether they are in line with group strategy and are beneficial to the Group as a whole. IGRs can take place between any two related companies within a group structure, ie either horizontally or vertically. It should be noted that a branch office cannot perform an IGR with its parent company as it is part of the same capital base but a subsidiary company can carry out an IGR with its parent as both companies will have the own individual regulated capital requirements to accommodate.

Pooling arrangements and the use of an SPV are variants to this standard IGR and are discussed separately later in this section.

All parties will have a reason for such a transaction and the following are a description of such possible reasons.

Capital/Solvency

As already mentioned reinsurance can represent an alternative form of capital, allowing the company to write a greater volume of business than would otherwise be possible for the same level of capital. Through reinsurance a ceding company will normally be able to reduce their capital requirements thereby improving their solvency ratios or other capital driven ratios. The driver may not necessarily be regulatory solvency but could be for rating agency capital adequacy or to meet group internal guidelines. The local subsidiary boards will normally articulate their own capital management policy and this can also be a reason for seeking reinsurance.

For the reinsurer, or assuming company, of such a transaction an IGR could be a good use of excess capital, particularly if the opportunity to use the capital by writing business externally is difficult. From a group perspective an IGR for these reasons can be more efficient and easier to execute than moving capital from one legal entity to another.

Risk (from a capital perspective)

Although a company may have sufficient capital for the risks on its balance sheet this could be an inefficient use of capital if the company has a single or a few peak risks which are out of balance with the other risks of the company. By reinsuring the peak risks the ceding company may not only reduce its overall capital requirement under certain regulatory regimes but gain proportionally more from diversification benefits and hence make more efficient use of its capital. The released capital can then be used, for example, to increase business or pay increased dividends. A more balanced portfolio from a risk perspective is also likely to reduce volatility in the profit and loss account and this could be a further reason for an IGR.

The assuming company will look at the transaction in a similar way. If they are receiving risks which are relatively small compared to other risks on their balance sheet then their own diversification benefits will probably increase proportionately for their size of business. From an overall Group perspective capital efficiency will be improved with less capital tied-up in individual subsidiary companies.

Risk (other perspectives)

Local subsidiary boards together with local management will normally determine the risk appetite for the local company. This will be based on numerous local factors and will also reflect the local company's views on the desirability of certain risks. These views may often differ from the larger group risk appetite for certain risks and hence whilst the local company will write certain risks for group purposes they will reinsure to other group companies such risks in order to keep within their own risk appetite and risk limits. The Group as a whole gains from such practice as it brings risks into the group that are attractive but at the same time an IGR will be able to move the risk from a local company that is not so keen on the risk to one that wants to write the risk. Additionally the Group may also use IGRs to bring together similar risks into a single legal entity in order to be able to better manage the business.

P&L Volatility

Subsidiary companies often have their performance measured by the amount of profit generated within the company on a net retained basis. In this instance the potential volatility of the profit and loss account may be of concern and one way to reduce this volatility is to reinsure part or all the risks that are the main contributors to the volatility. From an assuming company and from a a group perspective the volatility may be immaterial so an IGR allows the full potential profit to be kept within the group whilst allowing the subsidiary to reduce the volatility around its expected results.

Pooling Arrangements

These are specific agreements within a group whereby multiple companies from that group take shares of risks written on identical terms. The legal entities involved are typically domiciled within a single national jurisdiction and may be operated as if they were a single entity. Each of the companies involved in such an arrangement will write their own defined business but then cede pre-agreed percentage amounts to the other companies participating within the pool. This allows each Company to accept new business from a wider client base whilst managing the overall risk by ceding a certain proportion of their own originated business. This has diversification benefits as well as limiting exposure on any one risk or portfolio of risks.

Special Purpose Vehicles (SPVs)

An SPV is often used by Groups as a way of ceding risk to the capital markets. Group companies will cede certain risks via IGRs to the SPV in order that the SPV can package them for onwards risk transfer to investors. This helps both group companies and the Group itself limit its net exposures and is often an efficient way of reducing certain types of risk. The contractual terms between the Group Company and SPV will be similar to those found in other types of IGR and the necessary controls and governance should follow a similar process.

2. Types of transaction

The basic structure of an IGR follows the structure of any external reinsurance transaction. The actual structure will depend on the underlying drivers for the transaction and the most efficient method of execution. The typical types of reinsurance transactions that are used together with their primary purpose are now listed.

Quota share

This is normally the best method to cede risk across a line of business or across a company and thereby reduce risk and capital requirements proportional to the amount of business ceded.

Non-proportional including catastrophe covers

These types of covers are used to reduce peak risks thereby reducing the overall capital requirements and improving the diversification of the remaining portfolio. They are particularly useful in reducing volatility in quarterly or annual results.

Surplus/Excess share

This is very similar to non-proportional covers whereby the ceding company reinsures an amount above some predefined per policy attachment point, for example the ceding company retains the first $1m of risk on each policy and reinsures the excess. Again this has the effect of reducing peak risks and P&L volatility.

Stop loss

A stop loss arrangement can be written for a portfolio, a line of business or across the whole company. From a group perspective giving a stop loss protection to a subsidiary company could be viewed as an alternative to capital provision. In the event of a severe loss the subsidiary company is reimbursed through the stop loss arrangement rather than through an injection of capital. Hence this type of arrangement can be a very powerful risk capital instrument.

Adverse development cover

A company may have significant reserve risk within its in-force portfolio that is requiring significant amounts of regulatory or risk capital to support. An adverse development reinsurance cover will protect the company from a deterioration of its reserves and reduce its associated capital needs. This capital can then be redeployed in other areas of the business. These covers are most common when a company has significant long-tail risks such as liability, including asbestos or environmental risks, workers compensation or motor liability.

Facultative risk

This is normally a single risk cover which can transfer unwanted risks from a ceding company balance sheet. These unwanted risks can be due to size or type of risk.

3. Roles and responsibilities

In agreeing an IGR there are many parties who should be involved in giving their opinion, although ultimate responsibility rests with the local company management teams and their respective local boards. In respect of an IGR between two group companies it is the responsibility of both sets of boards and management to look at a potential IGR from their own company perspective and decide whether such a transaction is in the interests of their local legal entity. A transaction which is beneficial for the group overall but adverse from a local perspective should normally be rejected.

Depending upon the type of transaction it is vital that staff with the relevant skills, for example, financial, risk, actuarial and tax are consulted and provide input into the decision process. These functions need to report on the impact of the transaction from their own perspective such that the ultimate decision makers understand the impact on the capital position of the company, on the overall risk profile of the company, on any implications to reserving and on the overall tax position. Depending on the structure of the transaction other specialists may need to be included such as treasury, asset management and underwriting. In addition there will be times when a company's external auditors and/or local regulator should also be consulted.

The corporate centre functions of the Group also need to be included in order to provide the group perspective and inform group management of any material group implications. A group function is also likely to run the overall IGR process by coordinating the dialogue between the legal entities and their appointed delegates.

For an IGR structured as an intra-group pooling arrangement the above comments are also generally applicable but with multiple parties involved, often within the same border, then the group will take much more of a lead role.

An IGR process can give rise to conflicts of interest for the people involved. It is important that the participants in the process understand for whom they are advising or for whom they are taking a decision. In particular when IGRs are between two group companies operating in different regulatory environments anyone giving advice or taking decisions should only consider the IGR from only one perspective of the ceding company, assuming company or the group as a whole, in order not to confuse issues between the different parties. In particular individuals who have an interest in both the ceding and assuming companies should normally take themselves out of the decision making process.

To make sure that good governance is followed it would normally be best practice for the Group to have an IGR governance policy detailing the roles and responsibilities of the various parties and individuals who would be involved in the process. This policy should also contain guidance on how individuals should deal with actual or potential conflicts of interest.

4. Negotiation process

For many IGRs, and particularly those which cross borders with differing regulatory requirements and tax regimes, pricing and negotiation should take place based on the arm's length principle. Both the ceding company and assuming company should be negotiating the contract as if the transaction was with a business partner from outside of the Group.

From a transfer pricing perspective it has to be able to be clearly shown that the transaction pricing is within the range of what could be observed within the market in which the company operates. If there is no market of similar type transactions then comparisons against other measures will need to be carried out and documented. In addition it should be clear that the transaction has been entered into for sound business reasons. If the transaction is not seen in this way then the local tax authorities may disallow any actual or perceived tax treatments.

The actual approach to pricing the transaction and subsequent negotiation will depend on how the Group delegates pricing methodology and target returns. If the two companies have full control over pricing then they will each use their own respective methodologies to form a view on what price will meet their own respective target return. However some groups impose consistent pricing methodology and target returns across the group. In addition some groups will have group-wide in-house models to price business. In this instance both of the group companies will look at the potential deal in a similar way. The latter approach can also mean that many of the underlying assumptions will be viewed identically at both the ceding and assuming companies. The only differences may be in respect of expenses, tax and capital assumptions.

In these types of IGRs then ideally there should be evidence of active negotiation between the two parties. In certain instances this will end with an agreement to go ahead with the deal. In other instances the two companies may remain apart and unable to conclude a deal possibly because of price return targets. In this latter case the Group needs to get involved to see if the gap in price can be bridged because a good deal for all parties should not be stopped because of high target returns imposed by the Group, for example a return of x% on economic capital. The Group may need to relax its approach here (i.e. reduce the x%) thereby creating the opportunity for the ceding and assuming companies to be able to bridge the gap in price.

Pooling type arrangements or IGRs carried out within the same regulatory environment may require less negotiation although this will also depend on the actual tax regime in force in the particular environment. For example depending on the exact structure of a pooling arrangement then there is likely to be little negotiation between the differing parties, yet each party's interest will still be adequately represented because they are inter-connected and the group will play such a strong coordination role.

5. Other points to consider

IGRs are essentially transactions between two friendly companies. As such it should therefore be possible to structure the transaction to make sure that administration is not excessive. An IGR will add to the overall costs so it is in the interests of all parties to keep the additional costs to a minimum.

Contract wordings need also to be negotiated and agreed. Again this should be relatively straightforward because of the relationship between the two parties to the transaction. However given the potential long term nature of such business it is important that both parties have a contract which protects them in the same way as with similar contracts with external parties. It is always possible that over time group structures will change and companies merged or sold which can change an Intra-Group Reinsurance contract from an internal one to an external one.

As part of the approval process any impact on accounting should have been considered. Again the accounting should be efficient and not give rise to any excessive burden for either party. Reserving practices may differ between the ceding company and the assuming company, particularly when the transaction is cross-border. In addition reserving for insurance business may have different requirements to reserving the same business as reinsurance.

In general when an IGR is written cross-border then these will be more complex and several issues need to be considered in more detail. Different regulatory regimes and taxation approaches will need to be considered. In addition, depending on the structure of the IGR then currency risk could become relevant although this can normally be reduced with appropriate asset and liability matching.

In some countries regulatory approval may need to be obtained before such a transaction can be closed. If this is necessary and the transaction has a deadline then time needs to be allowed for in the process to get the regulators comfortable.

One of the points that may concern regulators is that an IGR, or an increased use of IGRs by the ceding company can give increased exposure to group risk. Reinsuring across the Group means that the ceding company's on-going solvency becomes more and more dependent on the on-going solvency of the wider group. The ceding company basically has a concentration risk to another group company or the Group as a whole. There are mechanisms, such as deposit of reserves, collateral triggers etc. to mitigate or partially mitigate this impact but the ceding company needs to consider what happens if the wider Group gets into trouble. Even on an on-going basis additional capital may be required to cover the risk of group failure and this should have been considered as part of the overall IGR process detailed earlier.

Finally both companies need to be able to carry out the on-going management and monitoring of any IGR and assess whether it performs in the way expected. This analysis needs to be reported to local management, local boards and Group.

The use of IGRs increases the interconnectedness between companies within the same group. Hence it could be conceived that there is a greater possibility that a problem in one Group Company could also appear in one or more other group companies thereby increasing systemic risk. The counter point is that the spreading of risk is the primary function of insurance which has the effect of lowering the overall level of risk. IGRs in themselves do not increase systemic risk as long as each company has good risk management practices and understands the different risks on its balance sheet including the exposures it has to other company failures, either to other group companies through IGRs or to external reinsurers. The Group itself has a responsibility to look at stress scenarios and consider how risks flow throughout the group in the event of the failure of one Group Company.

6. Conclusion

IGRs are an important tool for groups and their subsidiary companies to manage capital efficiency and risk throughout the group structure. They are essentially the same as similar transactions between two totally independent parties but the fact that the ceding company and assuming company are connected brings in additional considerations particularly around the appropriateness and governance of such transactions.