

IAA Risk Book
Chapter 7 - Intra-Group Reinsurance Transactions
2013 Reinsurance Subcommittee of the
Insurance Regulation Committee

1. Executive Summary

Intra-Group Reinsurance Transactions (commonly known as 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. They are an important tool for groups and their subsidiary companies to manage capital efficiency and risk throughout the group structure.

The transacting legal entities of an IGR ultimately have the same parent company and shareholder and this gives rise to the need for special considerations. Additionally such transactions often attract increased scrutiny from regulators and other bodies.

2. Key Messages

1. The rationale for IGR transactions is similar to normal reinsurance transactions, but the relationship between the two related transacting companies gives rise to special considerations. In addition, the presence of a third party, namely the Group, who will exert their own influence, requires that good process and governance is in place.
2. IGRs are useful within a group for managing risk and capital across the entire organization. IGRs are often used in a group as an alternative to increasing the capital within a subsidiary company as they can transfer risk to another subsidiary company where there is surplus capital.
3. The IGR structure depends upon the intended outcome. One aiming to reduce the overall capital requirement of a ceding legal entity will be different to that seeking to reduce P&L volatility.
4. These transactions need to be executed as if they are between independent parties. Each legal entity takes responsibility that any transaction is beneficial from their own perspective.
5. Conflicts of interest will arise. The individual participants need to recognize potential conflicts and know to whom are they advising or for whom are they taking a decision.
6. Active negotiation needs to take place and be evident. Transaction pricing should be in the range of what is observable within the market that each company operates.
7. Where IGRs involve the use of Special Purpose Vehicles (SPVs) or other similar vehicles then additional considerations may apply.

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3. Background

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. 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.

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 where 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 these transactions clearly need to be shown to have been carried out for the benefit of both parties and agreed to 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, there are some differences, which 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 that 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 excludes fronting arrangements.

4. 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 the management may consider that they

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are too exposed to certain risks and search 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 subgroup. 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. Nevertheless 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.

Every party has its reason for such transactions, below the most common ones:

II. 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 while 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 the 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.

III. Risk (from a capital perspective)

Although a company may have sufficient capital for the risks on its balance sheet it 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

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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 that 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.

IV. Risk (other perspectives)

Local subsidiary boards, together with local management, will determine the risk appetite for the local company. This will be based on numerous local factors and will reflect the local company's views on the desirability of certain risks. For certain risks they may differ from the larger group risk appetite. 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. 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 the one that wants to write the risk. 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.

V. P&L Volatility

Subsidiary companies often measure their performance by the amount of profit generated within the company on a net retained basis. In this case, 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 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.

VI. Pooling Arrangements

Pooling arrangements 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

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their own originated business. This creates diversification benefits and limits exposure on one risk or several portfolio of risks.

VII. Special Purpose Vehicles (SPVs)

A 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 so that the SPV can package them for onwards risk transfer to investors. This helps both, group companies and the group itself, to limit its net exposures and is therefore often an efficient way to reduce 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.

5. Types of transaction

The basic structure of an IGR follows the structure of any external reinsurance transaction. The actual structure depends 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.

I. Quota share

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

II. Non-proportional including catastrophe covers

Non-proportional including catastrophe covers are used to reduce peak risks by 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.

III. 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.

IV. 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.

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V. 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.

VI. Facultative risk

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

6. Roles and responsibilities

Although ultimate responsibility rests with the local company management teams and their respective local boards, there are many parties who should be involved in giving their opinion before agreeing an IGR. In respect of an IGR between two group companies it is the responsibility of both sets of boards and managements 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 that 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 employees with the relevant skills, for example, financial, risk, actuarial and tax experts are consulted to 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 likewise be consulted.

The corporate center functions of the Group also need to be included in order to provide the group perspective and inform the group management of any material group implications. Furthermore, a group function is 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 generally applicable but with multiple parties involved. If these are often within the same border, then the group will take 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, then anyone giving advice or taking decisions should consider

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the IGR either from the perspective of the ceding company, the 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 company, should exclude themselves from the decision making process.

To make sure that good governance is applied, it is 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 contain guidance on how individuals should deal with actual or potential conflicts of interest.

7. Negotiation process

For many IGRs, particularly those which cross borders with differing regulatory requirements and tax regimes, the pricing and negotiation should take place based on the arm's length principle. Both, the ceding 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 possible to clearly show 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 a 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, otherwise the local tax authorities may disallow any actual or perceived tax treatments.

The actual approach to pricing the transaction and the subsequent negotiation will depend on how the group delegates pricing methodology and target returns. If the two companies have full control over pricing then each will use their own respective methodologies to form a view on what price will meet their respective target return. However, some groups impose consistent pricing methodology and target returns across the company. Some groups will have group-wide in-house models to price business. In this case both 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 in both, the ceding and assuming companies, with the only differences in respect of expenses, tax and capital assumptions.

Ideally, there should be evidence of active negotiation between the two parties. In most cases, 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, most possibly because of price return targets. In the 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. An example is if the group has the policy of a return of x% on economic capital. In this case the group may need to relax its approach (i.e. reduce the x%) to create 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 depends also on the actual tax regime in force in the

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particular environment. For example, depending on the exact structure of a pooling arrangement there is most likely 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 a strong coordination role.

8. Other points to consider

IGRs are basically transactions between two friendly companies. Therefore it should be possible to structure the transaction in a way that keeps administration at a minimum. 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 as well to be negotiated and agreed. Again, this should be relatively straightforward due to 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 that protects them in the same way as contracts with external parties would do. There is always a possibility that over time the group structures change as companies are merged or sold, which can change an Intra-Group Reinsurance contract from an internal into an external one.

Any impact on accounting should have been considered as part of the approval process. 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.

Generally, when an IGR is written cross-border, then they will be more complex. Different regulatory regimes and taxation approaches will need to be considered. Depending on the structure of the IGR, 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 an IGR transaction can be closed. If this is necessary and the transaction has a deadline, time needs to be allowed to get the regulators comfortable.

One of the issues that may concern regulators is that an IGR, or an increased use of IGRs could 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 has basically 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 be considered as part of the overall IGR process.

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

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The use of IGRs increases the interconnectedness between companies within the same group. Hence it could be regarded that there is increased possibility that a problem in one group company could also appear in one or more other group companies and thereby increases 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 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. This includes the exposures they have to other company failures, either to other group companies through IGRs or to external reinsurers. The group itself has the responsibility to look at crisis scenarios and consider how risks flow throughout the group during the failure of a group company.

9. Summary

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

This paper was originally completed in 2013 by the Reinsurance sub-committee of the Insurance Regulation Committee of the IAA at the request of the IAIS. It is reproduced as part of the Risk Book with very minor changes to make it consistent with the structure of the other chapters.

Michael Eves was the chair of the 2013 Reinsurance sub-committee at the time this paper was produced. He is a UK qualified actuary, member of SAV, is the group chief actuary of Swiss Re. Eves can be reached at michael_eves@swissre.com.

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