

EU-U.S. Insurance Dialogue Project

SUPERVISION OF INTRA-GROUP TRANSACTIONS (IGTs)

The EU-U.S. Insurance Dialogue Project (EU-U.S. Project) began in early 2012, as an initiative by the European Commission, the European Insurance and Occupational Pensions Authority (EIOPA), the Federal Insurance Office of the U.S. Department of Treasury (FIO), and the National Association of Insurance Commissioners (NAIC) to enhance mutual understanding and cooperation between the European Union (EU) and the United States for the benefit of insurance consumers, business opportunity, and effective supervision. In 2018, the EU-U.S. Project's members continued the work focusing on the supervision of intra-group transactions besides the other focus areas relating to cybersecurity risk, the cyber insurance market and the use of big data.¹

I. Introduction

Since its establishment in 2012, one of the areas of focus for the EU-U.S. Insurance Dialogue Project (the "Project") has been to improve the mutual understanding between the EU and the U.S. on issues relating to group supervision of multi-national insurers. In 2018, one of the areas of focus for the Project has been obtaining a mutual understanding as to how regulators in the EU and U.S. ensure adequate supervision of the transactions reported between related entities in an insurance group (IGTs).

IGTs between member entities of an insurance group are commonly used for capital management and operational efficiency optimization. Examples are various affiliate agreements (e.g. management, service, and cost sharing, intra-group funding transactions), which aim to take advantage of financial synergies using inter-affiliate reinsurance, tax sharing, asset and liability sale transactions, and similar structures. IGTs can play an important part in managing risks with strong oversight and financial transactions that help to protect solvency and/or support recovery of undertakings within a group. However, in situations of financial distress, it could be possible for IGTs to increase liquidity risk, operational risk and/or solvency risk for entities relying on such transactions. In some cases, an inadequate understanding and managing of IGTs could have a more severe impact and can lead to contagion risks between affiliates across the group.

The main objectives of the Project's work on IGTs are to seek mutual understandings regarding definitions of IGTs and enhance the understanding of each other's practices for risk and impact assessment, supervisory review processes and reporting requirements in addition to discussing how to further enhance information exchange practices in global supervisory colleges.

¹ New initiatives for 2017 – 2019 including focus areas for 2018: <https://eiopa.europa.eu/external-relations/regulatory-dialogues>

II. Mutual Understanding of IGTs and supervisory objectives

In the EU and the U.S., there are supervisory requirements that support the same overall supervisory objective of protecting policyholders. To that point, both in the U.S and EU there are laws in place that provide for application of supervisory enforcement measures.

Categorization of IGTs - facilitating identification and risk analysis

The EU categories of IGTs are defined in the Solvency II Directive (SII Dir) and revolve around the concept of (i) significant IGTs, (ii) very significant IGTs and (iii) IGTs that need to be reported in all circumstances depending on the level of influence on the solvency and liquidity position of the group or one of the undertakings. For identifying the significance of IGTs, a minimum list of different types of IGTs needs to be considered.²

The U.S. categories of IGTs are defined within the Insurance Holding Company System Regulatory Act³, which can be summarized as (i) those specifically identified and (ii) those that the commissioner would otherwise determine to adversely affect the interest of policyholders. This Act requires all such transactions to be submitted to the state regulator for approval or disapproval before being completed. A common practice is that the domestic states within the group consult with each other before approving such transactions.

Service agreements, reinsurance agreements and equity type transactions and debt and asset transfers represent the most important IGTs observed in both jurisdictions.

Supervisors in both the EU and U.S. pay particular attention to potential risks that could result from specific types of IGTs, which could potentially weaken the financial and solvency position of an undertaking in a group. Those risks could arise from different sources. Examples include excessive dividend payouts, asset transfers in particular, exchange of low-quality assets for high quality assets from parent to subsidiary, inflated costs for intra-group services provided, service companies taking out capital through inflated prices, guarantees given by a service company without any real assets and guarantees by insurance entities of other affiliates.

Sound valuation principles – key to ensure robustness of the balance sheet and resilience to adverse developments

In the EU, general valuation principles for assets and liabilities apply to all asset and liability items including IGTs.⁴ In the U.S., while general valuation principles also apply, IGTs also are subject to more specific

² Art 245 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 (SII Dir), Art 377 of the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 (COM DR) which includes equity-type transactions, debt and asset transfer, derivatives, guarantees, swaps, internal reinsurance, cost sharing, contingent liabilities and other types.

³ Section 5, model 440. The NAIC Insurance Holding Company System Regulatory Act provides the state insurance commissioner with broad authorities over the insurance holding company system, including but not limited to transactions between the insurer and any affiliates within the holding company structure, including the ultimate controlling party.

⁴ Article 75 (1) SII Dir, Art 7 – Art 16 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 (COM DR)

accounting requirements⁵, which are intended to mitigate the fact that affiliated transactions may be by their nature subject to abuse.

Both the U.S. and EU consider the review of the application of the arms' length principle an important aspect for supervisory analysis and assessment of IGTs. In some cases, the decision to perform such an assessment is based on supervisory judgement.⁶

III. Reporting of IGTs

Mutual objective – to ensure timely supervisory actions

Both the U.S. and EU regulatory frameworks define reporting requirements for IGTs including particular requirements and templates used to collate information. While there is a difference with regard to the format and structure of the reporting templates, the objective is the same - to ensure that supervisors can take timely actions to support their supervisory objectives. Reporting takes place at least annually or more often depending on the type and nature of the transaction.

Top-down versus bottom-up approach in supervisory reporting of IGTs

The U.S. and EU vary in their approach with regard to supervisory reporting of IGTs. The EU follows a top-down approach, which relies on supervisory reporting of IGTs from the group perspective, not prescribing preapproval of IGTs before the transaction. The U.S. applies a bottom-up approach for approval/disapproval of IGTs before the transaction can be completed, and a top down approach for disclosure.

Under the U.S. regulatory framework, IGTs are reported by individual undertakings while under the EU regulatory framework, the ultimate parent reports IGTs in the group by undertaking and type as part of group supervisory reporting requirements.

The US preapproval reporting requirement includes filings on all such transactions, and then post-transaction reporting is included in the Holding Company's Annual Registration Statement, which is supplemented with additional post transaction reporting requirements. Affiliated transactions are also separately disclosed in the Notes to Financial Statements, and detailed in the US insurer's public reporting schedules for debt and equity investments, derivatives, other invested assets and reinsurance transactions.⁷

The EU reporting templates are designed for a group to report IGTs to the group supervisor by type of transaction (equity type transactions, debt and asset transfer; derivatives; reinsurance; cost sharing, contingent liabilities, off-balance sheet and other items).⁸

⁵ SSAP No. 25- Affiliates and Other Related Parties

⁶ In the US, SSAP 25 defines arms' length transactions as "a transaction in which willing parties, each being reasonably aware of all relevant factors and neither under compulsion to buy, sell, or loan, would be willing to participate.

⁷ Preapproval reporting in Form D for filing on all transactions; post transaction reporting in the Holding Company's Annual Registration Statement, which is supplemented with additional post transaction reporting in the Schedule Y Part 2.

⁸ Implementing Technical Standards on Templates for submission of information to supervisory authorities, templates S.36.01, S.36.02, S.36.03, S.36.04

Applying thresholds for reporting IGTs - common practice in the EU and US

Thresholds are important as they set a parameter that supervisors can use as guidance in deciding the IGTs that must be reported.

In the EU, thresholds are derived from different variables. They can be based on the solvency capital requirements, technical provisions or both. When establishing thresholds, specific factors should be taken into consideration, for example the nature, scale and complexity of the group, importance of undertakings, group solvency and liquidity position.

In the U.S., there is a more detailed list of thresholds that vary depending upon the specific type of IGT.⁹ One example is that only IGT sales, purchases, exchanges of credit, or investments greater than 3% of the insurer's assets need to be submitted for approval.

Both in the EU and in U.S., there are cases which have to be reported without any thresholds being applied, e.g. management agreements, cost-sharing agreements, transactions requiring board approval.

Supervisors in both the U.S. and EU acknowledge the challenge in setting the threshold too low or too high as this may have an impact on the effectiveness of supervision.

Data quality - an important point of attention for supervisors across the EU and US

A common challenge for supervisors is to ascertain the adequacy and accuracy of the information received as this is the basis for supervisory analysis and assessment. If deemed necessary for appropriate supervision a comprehensive crosschecking work is carried out by supervisors in both jurisdictions to review data quality.

IV. Quantitative and qualitative analysis

Supervisory analysis of IGTs, both in the EU and U.S., respond to the same objective of protecting policyholders by strengthening the oversight of intra-group activities. A particular challenge arises when supervising cross-border activities across jurisdictions involving different regulatory systems for globally operating groups.

Analysis of IGTs - integral part of the risk assessment in the supervisory review process

In the EU, the analysis of IGTs is part of the risk assessment embedded in the Supervisory Review Process (SRP).¹⁰ Quantitative and qualitative aspects are analyzed taking into account scope, complexity and risk profile of the group and each of the solo undertakings. In the U.S., a similar approach is followed in the NAIC's Financial Analysis Handbook, which contains detailed Group-Wide Supervision procedures that are required to be used by all states under the NAIC's Accreditation Program.

⁹ Section 5, model 440 NAIC Insurance Holding Company System Regulatory Act

¹⁰ Article 36 of the Solvency II Directive defines the key elements of a supervisory review process and the areas where supervisory authorities shall in particular review and evaluate compliance. In addition, Article 245 of the same Directive, outlines that IGTs should be subject to supervisory review by the group supervisor.

Supervisors in the EU and the U.S. benefit from the data collated on regulatory reporting templates and any ad-hoc reporting outlining the type and volume of IGTs. From a qualitative point of view, supervisors pay a significant amount of attention to potential conflict of interests and contagion risks across the group increasing, among others, risks such as capital risk, credit risk, liquidity risk and operational risk.

Supervisors in the EU and the U.S. concur that they expect insurers to include in their Own Risk and Solvency Assessment (ORSA) a thorough analysis of the interlinkages between the various entities in a group and the exposures that could emanate from IGTs.

V. Enhancing cooperation and exchange of information across cross-border supervisory colleges

Discussions and cooperation in the college benefit from good understanding and thorough analysis of all risks, including those arising from IGTs. Enhancing information sharing, transparency and discussion of IGTs between college members and participants is of utmost importance to ensure a shared view on the risks, in particular for large and complex globally operating groups. Regular and structured information exchange and thorough analysis facilitate the supervisors' understanding of the substance of IGTs and their understanding of i) how risks, capital and liquidity are moved around the group, ii) what capital agreements and cash management agreements are in place, iii) where in the group risks, capital and liquidity ultimately reside.

Current approaches considering supervisory cooperation and information exchange

U.S. group-wide supervisors generally request from non-U.S. supervisors a listing of their material IGTs/or those that they consider to be higher risk. U.S. group-wide supervisors generally request from U.S. supervisors an IGT listing of material transactions (after the U.S. domestic state has performed more detailed analysis to get comfortable with the transaction), including guarantees and reinsurance transactions.

In the EU, the supervisors in the college agree as part of the Coordination Arrangement on a set of qualitative and quantitative information to be shared at group and solo level. This includes information about the group's business and performance, system of governance, risk profile and capital management with a strong focus on significant intra-group transactions. Beside quantitative data qualitative information about IGTs is also shared, i.e. rationale, risks, rewards and potential conflict of interests.

Mutual understanding, transparency and cooperation - crucial for effective cross-border supervision

Further cooperation and coordination among supervisors of globally operating cross-border groups and their undertakings in the EU and the US and improved understanding of the significance and implications of IGTs and, more generally, the overall business and financial position is important for the risk assessment and supervisory work. As a pre-condition, supervisors in both jurisdictions consider it important to have a good understanding of the data and information available under both frameworks. In addition, it is crucial that supervisors build trust and enhance sharing of confidential and sensitive information where needed for supervisory purposes subject to the appropriate professional secrecy and confidentiality

regimes being in place and the conclusion of any applicable MOU or college specific confidentiality agreements or coordination arrangements as outlined in relevant legislation/guidance.

Joint supervisory activities – enhancing effective supervision of cross-border operating groups

Building on effective and transparent information exchange on IGTs and understanding the business and financial position of the group, supervisors see the benefit to further enhance cooperation in colleges. This includes forming a shared view on risks, identifying issues of common concern as well as agreeing on joint off-site and on-site activities where appropriate, documented, and agreed to in a college work plan and subject to relevant laws and regulations. This will add further value and strengthen the supervision of cross-border groups and their affiliates with the objective to preserve their financial strength and resilience in adverse developments for the benefit of policyholders across jurisdictions.

VI. Proposals for future areas for development in 2019

The discussions in 2018 in the area of group supervision focused on IGTs with the conclusion that it is crucial for supervisors involved in cross-border operating groups to continue ensuring and enhancing the level of trust and commitment to cooperation and transparent information exchange. With this objective in mind, the following areas of further development and discussion in 2019 are proposed:

1. discussions of approaches and practices of supervisory risk assessments and judgments for the most important IGT types observed in both jurisdictions;
2. discussion of confidentiality and professional secrecy requirements regarding information exchange;
3. exploration of possibilities, practices and examples to conduct joint supervisory activities in addressing topics of common concern through common work plans, off-site and on-site examinations where appropriate and subject to relevant laws and regulations.