IMPACT ASSESSMENT

Draft Opinion on the Supervision of Captive (Re)Insurance Undertakings

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European Insurance and Occupational Pensions Authority

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1. ANALYSIS OF COSTS AND BENEFITS

1.1 PROCEDURE AND CONSULTATION OF STAKEHOLDERS

1.1. This impact assessment analyses the costs and benefits of EIOPA's Consultation Paper on the draft Opinion on the Supervision of Captive Undertakings.

1.2. In developing the draft Consultation Paper on the Opinion, EIOPA conducted through the gathering of supervisory experience of NCAs and through the analysis of data provided by undertaking through regular reporting, a mapping of the areas where supervisory convergence could be further developed and level playing field enhanced.

1.2 PROBLEM DEFINITION

1.3. When analysing the impact from proposed policy options, the impact assessment methodology foresees that a baseline scenario is applied as the basis for comparison. This helps the identification of the cumulative and incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without the issuance of the Opinion in relation to captive undertakings supervision, with specific reference to the topics tackled in it.

1.4. In line with EIOPA's mandate to build a common supervisory culture and consistent supervisory practices in the European Union, EIOPA publishes every year its Supervisory Convergence Plan, which identifies EIOPA's main priorities for the year. Among the three priorities identified for 2023, the issuance of the Opinion on the supervision of captive undertakings tackles two of them:

- the implementation of the common supervisory culture and the development of supervisory convergence tools;
- the risks to the internal market and the level playing field;

1.5. After the proposal for a more proportionate treatment of captives insurance and reinsurance undertakings in the context of the review of Solvency II, EIOPA aims at using the Opinion as a set of recommendations to NCAs on how to supervise some specificities of captives insurance and reinsurance undertakings where divergences of practices have been found, such as for example governance-related aspects for the outscourcing of key function, treatment of cash pooling arrangements, with related prudent person principle implications.

1.6. With regard to the governance-related aspects, the Opinion aims at summarizing the issues identified, which are mainly triggered by the specific business model of captives. In this regard, the Opinion identified room for further supervisory convergence regarding outsourcing and AMSB composition.

1.7. With reference to the topic of intercompany loans and cash pools, the issue has been analysed through the help of data analyses supported by NCAs' and EIOPA data. The analyses highlighted an high use of intercompany loans and cash pools by captives and room for supervisory convergence was identified regarding the implementation of prudent person principle in terms of concentration of asset allocation and evaluation of counterparty rating within the coherent SCR module.

1.3 OBJECTIVE

1.8. Whilst the Solvency II framework is based on the overarching principle of proportionality[1] and already include some simplification for the calculation of the Solvency Capital Requirement of captive (re)insurance undertakings with additional proportionality measures being introduced by the review of Solvency II[2], this Opinion aims at complementing the regulatory framework with a focus related to cash pooling in the context of intra group transactions and proportional but consistent application of the Prudent Person Principle in the context of investment risk management and governance-related aspects in connection with key functions and outsourcing requirements and needs related to the specific business model at stake.

1.9. The Opinion aims at facilitating risk-based and proportionate supervision of captive (re)insurance undertakings and further harmonise, in the context of the creation of a level playing field within the EU, good practices with reference to the topics touched upon. To this end, this Opinion doesn't introduce any new regulatory requirements, but rather complement and clarify the Solvency II provisions in light of the specific business model at stake. While further convergence of supervisory practices of captives undertakings is needed, NCAs may take into account national specificities of the captive (re)insurance sector when implementing the guidance included in this Opinion.

[1] According which the requirements laid down in the Directive need to be applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking.

[2] Subject to the on-going negotiation process of the 2020 review of Solvency II, new proportionality measures will be applied to captives in the area of ORSA (bi-annual report)

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1.4 POLICY ISSUES AND OPTIONS

1.10. With the intention to meet the objectives set out in the previous section, EIOPA has analysed different policy options throughout the policy development process. The most relevant policy issues and policy options are summarised in the following table:

Policy issues	Options
1. Supervision of intercompany loans and cash pooling agreements (including Prudent Person Principle application considerations)	1.1 Keep status quo 1.2 Implement ad hoc captive-specific guidance 1.3 Provide clarity on already existing regulation provisions as applicable to all types of undertaking, providing further context, where needed, to captives' business model
2. Governance: AMSB composition, outsourcing (to the industrial group and to captive managers)	2.1 Keep status quo 2.2 Clarify the governance context to the specific business model

1.4.1 POLICY ISSUE 1: SUPERVISION OF INTERCOMPANY LOANS AND CASH POOLING AGREEMENTS (INCLUDING PRUDENT PERSON PRINCIPLE APPLICATION CONSIDERATIONS)

1.11. As far as cash polling arrangements are concerned, EIOPA analysed captive (re)insurance undertakings reliance on these types of transactions and identified areas for which clarification and contextualisation to captives' business model was needed to further enhance supervisory convergence and improve the establishment of a level playing field.

1.12. While the treatment of intercompany loans could be addressed with clarification regarding the approach to be used for SCR calculation purposes, for cash pooling the Opinion provides further context.

1.13. More specifically, the term "*cash pooling*" refers to an arrangement, within a group, with the intention of sharing liquidity among entities of a group with the purpose of achieving an efficient cash management. Entities that are participating to the cash pooling and have liquiditiy surplus receive interest from entities with negative balances.

1.14. EIOPA identified, leveraging on NCAs' supervisory evidence, a set of core areas where additional guidance provided by EIOPA might be beneficial were identified, namely on SCR-related implications and on the implementation of the Prudent Person Principle set out in the Solvency II framework.

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1.15. Even though captive (re)insurance undertakings do have a high reliance on this type of transactions, while developing the Opinion EIOPA took into account the fact that this type of transactions is not only used by captive undertakings but also from other types of (re)insurance undertakings and therefore ensured that messages and recommendations provided in the Opinion are not conflicting or creating uncontrolled side-effects across different types of undertakings in the market.

Policy Option 1.1

1.16. Under this policy option, current divergent market practices would not be addressed. This would potentially imply that supervisors would have to keep running ad hoc supervisory activities, potentially asking undertakings to provide additional clarifications and insights on SCR calculations and further evidence on the correct application of the Prudent Person Principle.

1.17. The Option would enhance inefficiencies in the supervisory process and also demand captive (re)insurance undertakings to provide ad hoc and non-structured evidence to supervisors during performance of supervisory activities. Given captives' specific business model, this would not give relief to the administrative burden and not contribute to administrative costs reduction in the long term.

1.18. As a conclusion, given the explanation provided above, this Policy Option was not ranked as the preferred approach, given the objectives set out in the Opinion.

Policy Option 1.2

1.19. Implementing guidance and recommendations which is captive specific has been an highly-considered option, driven by the fact that captive (re)insurance undertakings are based on a very specific business model.

1.20. On the other hand, adopting this way of proceeding would expose both captives and supervisors to the risk of having to continuously check the provided guidance against the currently applicable regulatory framework. This might create potential for uncertainty in cases of regulatory framework review (see Solvency II 2020 review).

1.21. On the same vein, the Impact Assessment highlights that the aim of the Opinion should not be to introduce additional or amended requirements or guidance for captive (re)insurance undertakings, but providing clarity on existing provisions, with a strong link to the regulatory framework.

1.22. As a conclusion, given the explanation provided above, this Policy Option was not ranked as the preferred approach, given the objectives set out in the Opinion.

Policy Option 1.3

1.23. Based on the objectives set out in the Opinion, this policy option aims at providing clarity on already existing regulation provisions. This approach proves to be efficient, especially in the

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context of cash pooling arrangements and intercompany loans, as these are not necessarily captive specific issues only.

1.24. The possibility to leverage and clarify existing regulatory provisions[3] while, where necessary, targeting business model specifities was identified as a good balance for the recommendations to be included in the Opinion, thus accomplishing two main objectives:

- Not introducing new requirements
- Avoiding introducing recommendations that could have adverse impacts for non-captive undertakings

1.25. As a conclusion, given the explanations provided above, this Policy Option was ranked as the preferred approach, given the objectives set out in the Opinion.

Policy issue 1: Supervision of intercompany loans and cash pooling agreements (including prudent person principle application considerations)		
Option 1.1: Keep status quo		
Costs	Consumers	No material impact
	Industry	Unpredictable and ad-hoc administrative costs, to fulfil evidence request from supervisors in case of unclear application of the Prudent Person principle or SCR calculations implementation.
	Supervisors	Additional costs brought by the need to adapt to very broad practices' environment and need to run targeted supervisory activities in different fashion for each captive undertaking. This is especially referred to the analysis of cash pooling agreements and the translation of the contractual provisions into the SCR calculations.
	Other	No material impact
Benefits	Consumers	No material impact
	Industry	No material impact
	Supervisors	No material impact
	Other	No material impact

[3] E.g. The decision tree provided in the draft Opinion shows more generally how the standard formula differentiates credit risk exposures between the market and counterparty default risk

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Option 1.2: Implement ad hoc captive-specific guidance		
Costs	Consumers	No material impact
	Industry	Limited to moderate adaptation costs might be needed, but would most likely be offset by economies of scale throughout a more efficient supervisory process and therefore reduced need to provide additional evidence to justify potential divergent approaches
	Supervisors	Limited to moderate adaptation costs might be needed, but would most likely be offset by economies of scale throughout a more efficient supervisory process
	Other	Auditors and outsourced services would need to continuously cross check the guidance against any changes applied to the regulatory framework
Benefits	Consumers	No material impact
	Industry	Reduced need to provide additional evidence to justify potential divergent approaches
	Supervisors	More efficient supervisory process
	Other	Auditors and outsourced services would benefit from additional specific clarity provided for captives' specific business model
Option 1. 3: Provide clarity on already existing regulation provisions as applicable to all types of undertaking, providing further context, where needed, to captives' business model		
Costs	Consumers	No material impact
	Industry	Limited to moderate adaptation costs might be needed, but would most likely be offset by economies of scale throughout a more efficient supervisory process and therefore reduced need to provide additional evidence to justify potential divergent approaches
	Supervisors	Limited to moderate adaptation costs might be needed, but would most likely be offset by economies of scale throughout a more efficient supervisory process
	Other	No material impact
Benefits	Consumers	No material impact
	Industry	More efficient supervisory process are likely to reduce the need to provide additional evidence to justify potential divergent

		approaches. No adverse impacts on non-captive undertakings would also ensure limited impacts on types of undertakings.
	Supervisors	More efficient supervisory process
	Other	Auditors and outsourced services would benefit from additional specific clarity provided for captives' specific business model

Conclusion on Policy Issue 1

1.26. EIOPA considered a number of policy options with regard to the recommendations to be included in the Opinion in order to foster supervisory convergence and ensure the enhancement of a level playing field.

1.27. Policy Option 3 is EIOPA's preferred option in terms of cost and benefits. While seeing some merits for Policy Option 2, EIOPA deeply evaluated the best option to avoid side effects on non-captive undertakings and highlighted a preference for Policy Option 3, which provides the right balance for all objectives set out in the Opinion. EIOPA discards Policy Option 1, because keeping the status quo would not bring any added value and would discourage supervisory convergence.

1.4.2 POLICY ISSUE 2: GOVERNANCE: AMSB COMPOSITION, OUTSOURCING (TO THE INDUSTRIAL GROUP AND TO CAPTIVE MANAGERS)

1.28. As Stakeholders reported multiple times to EIOPA and respective NCAs, given that captive (re)insurance undertakings often accept a limited number of risks and have a rather simple investment strategy, it is considered in the majority of cases as economically unattractive for a captive (re)insurance undertaking to hire own staff. In the same vein, it is quite often observed that Administrative, Management or Supervisory Body (AMSB) include at least one representative of the industrial group to which the captive belongs, in order to align interests of the captive (re)insurance undertaking and the parent undertaking.

1.29. The Solvency II framework, as part of its risk-based and proportionate supervision, already foresees that the person who runs the undertaking can at the same time be a key function holder. The Opinion further explores cases specifically linked to the business model at stake and provides essential recommendations on how to address the reliance on outsourcing and the need to fulfil fit and proper requirements.

Policy Option 2.1

1.30. Under this policy option, current divergent market practices would not be addressed. This would potentially hinder clarity on how to fulfil fit and proper requirements given the constraints and specificities brought by the business model at stake.

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1.31. The Option would enhance inefficiencies in the supervisory process and also demand captive (re)insurance undertakings to provide ad hoc and non-structured evidence to supervisors during performance of supervisory activities. Given captives' specific business model, this would not give relief to the administrative burden and not contribute to administrative costs reduction in the long term.

1.32. As a conclusion, given the explanation provided above, this Policy Option was not ranked as the preferred approach, given the objectives set out in the Opinion.

Policy Option 2.2

1.33. The recommendations related to this Policy Option include business-model specific guidance on the implementation of fit and proper requirements. More specifically, the text highlights the need for proportionality application to the business model at stake, while reminding about the structural boundaries set by the Solvency II regulatory framework and the need to implement all necessary safeguards with respect to key function holding.

1.34. This topic has been object of the continuous dialogue with Stakehholders and EIOPA, while having touched upon the policy issue already through some proposals in the Solvency II 2020 review, has worked with NCAs to identify further potential for supervisory convergence and to include them in the Opinion.

1.35. More in detail, specificities of the four key functions[4] in the captive context include:

- Internal audit: often the key function holder for internal audit is a Board member who takes on the ultimate responsibility of the function and ensures compliance with fit and proper requirements by being a member of the internal audit department of the industrial group to which the captive belongs. With respect to the operational aspects related to the function, these are generally carried out either by the internal audit department of the industrial group or by a professional service provider via outsourcing agreements.

- Risk Management: the key function holder, that retains ultimate responsibility for the function, is often a member of the Board of the captive (re)insurance undertaking and ensures compliance with fit and proper requirements by covering a role in the risk management department of the industrial group. Regarding the operational activities of the function, since (re)insurance is often not the main focus of the industrial group to which the captive belongs, these tasks are generally either carried on by the captive manager or by a professional service provider via outsourcing agreements.

[4] As highlighted in the Opinion outsourcing agreements might also be subject to national restrictions

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- Actuarial Function: the key function holder, that retains ultimate responsibility for the function, is often either a member of the Board or a representative of an actuarial services provider, who is in turn member of a specific committee set up by the captive (re)insurance undertaking under the Board's governance structure. Regarding the operational activities of the function, since (re)insurance is often not the main focus of the industrial group to which the captive belongs, these tasks are generally either carried on by the captive manager or by a professional service provider via outsourcing agreements.

- Compliance: the key function holder, that retains ultimate responsibility for the function, is often a member of the Board. Regarding the operational activities of the function, these are generally either carried on by the captive manager or by a professional service provider via outsourcing agreements. In this regard, the Opinion, while advocating for the necessary proportionality application, recommends NCAs to pay particular attention to the independence of the compliance function holder, in order to ensure that this person is free from influences that may compromise the function's ability to undertake its duties in an objective, fair and independent manner, in line with article 268 of the Commission delegated regulation 2015/35.

Policy issue 2: Governance: AMSB composition, outsourcing (to the industrial group and to captive managers)		
Option 2.1: Keep status quo		
Costs	Consumers	No material impact
	Industry	Unpredictable and ad-hoc administrative costs, to fulfil evidence request from supervisors in case of needed evidence on fit and proper requirements fulfilment
	Supervisors	Additional costs brought by the need to adapt to very broad practices' environment and need to run targeted supervisory activities in different fashion for each captive undertaking
	Other	No material impact
Benefits	Consumers	No material impact
	Industry	No material impact
	Supervisors	No material impact
	Other	No material impact
Option 2.2: Clarify the governance context to the specific business model		
Costs	Consumers	No material impact

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	Industry	No material impact
	Supervisors	No material impact
	Other	No material impact
Benefits	Consumers	No material impact
	Industry	Gradually reduced administrative burden
	Supervisors	Reduced costs brought by supervisory convergence and gradual fading out of complex governance structures which generally demand for ad hoc supervisory approaches performed on a case-by-case basis (i.e. not leveraging on a common baseline for governance implementation)
	Other	No material impact

Conclusion on Policy Issue 2

1.36. EIOPA considered a number of policy options with regard to the recommendations to be included in the Opinion in order to foster supervisory convergence and ensure the enhancement of a level playing field.

1.37. Policy Option 2 is EIOPA's preferred option in terms of cost and benefits. EIOPA discards Policy Option 1, because keeping the status quo would not bring any added value and would discourage supervisory convergence and would potentially increase supervisory costs that follow the complexity of undertakings to be assessed.

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