

DRAFT OPINION ON THE SUPERVISION OF CAPTIVE (RE)INSURANCE UNDERTAKINGS

Cash pooling, Prudent Person Principle and
Governance

EIOPA-BoS-23/363
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1. LEGAL BASIS

- 1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Opinion on the basis of Article 29(1)(a) of Regulation (EU) No 1094/2010¹. This article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union by providing opinions to competent authorities.
- 1.2. EIOPA delivers this Opinion on the basis of the Directive 2009/138/EC² (the Solvency II Directive), in particular in relation to Articles 40, 41, 42, 44, 49, 132 and 245 thereof and on the basis of the related provisions of Commission Delegated Regulation³ (EU) 2015/35 (Delegated Regulation), in particular in relation to Articles 258, 260, 266, 268 - 274, 275a, 295 (2), 308 (3), and 309 (2).
- 1.3. This Opinion is addressed to the competent authorities, as defined in Article 4(2) of Regulation (EU) No 1094/2010.
- 1.4. The Board of Supervisors has adopted this Opinion in accordance with Article 2(8) of its Rules of Procedure⁴.

¹ Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

² Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (OJ L 335, 17.12.2009, p. 1)

³ Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1)

⁴ Decision adopting the Rules of Procedure of EIOPA's Board of Supervisors, available at: https://www.eiopa.europa.eu/system/files/2022-07/bos-rules_of_procedure.pdf.

2. CONTEXT AND OBJECTIVE

- 2.1. The Solvency II Directive takes account of the specific nature of captive insurance and captive reinsurance undertakings. As those undertakings only cover risks associated with the industrial or commercial group to which they belong, appropriate approaches should be provided in line with the principle of proportionality to reflect the nature, scale and complexity of their business.
- 2.2. Captives (re)insurance undertakings are defined in Article 13(2) and 13(5) of the Solvency II Directive. Supervision of the groups to which they belong is governed by Article 213(2)(d) in conjunction with Article 265, according to which only intra-group transactions in the meaning of Article 13(19) are to be supervised.
- 2.3. The specific business model of captive (re)insurance undertakings aims to provide the industrial or commercial group to which they belong a cost-efficient risk financing program, namely to efficiently obtain coverage for their risks and be protected in case an event happens on a pooled basis, i.e. together with all companies and individuals of this group that might be impacted by such an event, or jointly take these risks or parts of these risks. The peculiar aspects related to the business model of captive (re)insurance undertakings itself lead to specific supervisory expectations and the need to apply regulation proportionally. This might raise concerns regarding the level playing field. The reliance on specific approaches and the potential for regulatory and supervisory arbitrage led EIOPA to issue this Opinion.
- 2.4. This Opinion aims at facilitating a risk-based and proportionate supervision of captive (re)insurance undertakings and further harmonise, in the context of creating a level playing field within the EU, supervisory expectations in the topics touched upon. While further convergence of supervisory practices is needed, National Competent Authorities (NCAs) may take into account national specificities of the captive (re)insurance sector when implementing the principles included in this Opinion.
- 2.5. The Solvency II framework is principle based and takes particular account of the principle of proportionality. It has already led to some simplifications, for example for the calculation of the Solvency Capital Requirement of captive (re)insurance undertakings. Additional proportionality measures are being discussed under the review of Solvency II. This Opinion aims at supporting the implementation of the regulatory framework with a focus on intra-group transactions (especially cash pooling), on the consistent application of the Prudent Person Principle and on governance-related aspects in connection with key functions and outsourcing requirements, taking into account the proportionality principle.
- 2.6. Deposits and withdrawals in and out of a cash pooling arrangement⁵ with the aim of exploiting synergies and pooling liquidity within the group are common intra-group transactions used by

⁵ See further details in 3.1

captive (re)insurance undertakings. Despite the specificities of the investment portfolio, captive (re)insurance undertakings are expected to continuously comply with the Prudent Person Principle requirements, which require undertakings to ensure the security, quality, liquidity and profitability of their portfolio as a whole.

- 2.7. Regarding governance arrangements in this specific business model, when the captive (re)insurance undertakings accept a limited number of risks and have a rather simple investment strategy, in practice it is considered in the majority of cases as economically unattractive for a captive (re)insurance undertaking to hire own staff. Instead, they rely on the parent undertaking or on professional captive managers. In the same vein, it is quite often observed that the Administrative, Management or Supervisory Body (AMSB) includes 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.
- 2.8. The Solvency II framework (see Article 42 and Article 268 of Directive 2009/138/EC (Solvency II)) already foresees that the persons who effectively run the undertaking can at the same time be a key function holder. This Opinion further explores cases specifically linked to the business model at stake and provides recommendations on how to address the presence of AMSB members coming from the industrial group and clarifies how to fulfil fit and proper requirements.

3. OPINION

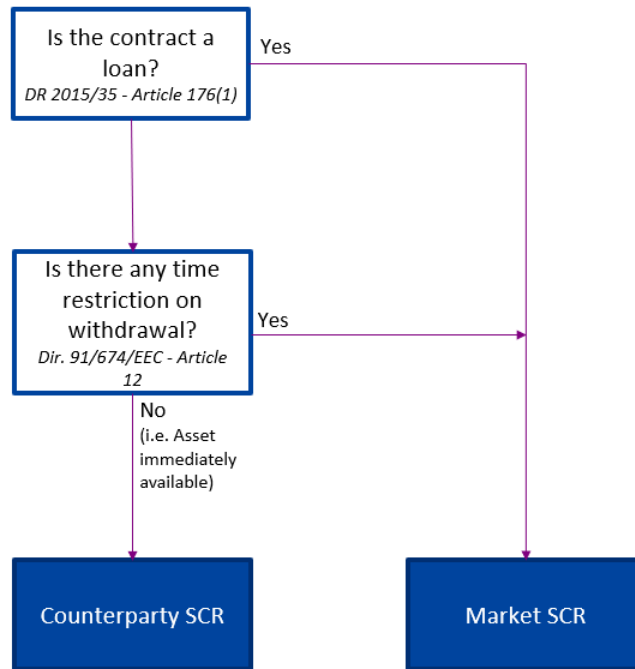
3.1 Cash pooling arrangements and application of the Prudent Person Principle

- 3.1. 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 liquidity surplus receive interest from entities with negative balances. Therefore, the term cash pooling describes the purpose of a set of transactions rather than describing the transactions themselves. Traditionally, one way to pool cash consists of mandating the parent company to manage the liquidity of the group (e.g. by setting up a treasury management company or an in-house entity/bank or an external entity/bank managing the cash pooling).
- 3.2. On one hand, cash pooling is expected to bring some benefits to the group, for instance in terms of higher interest rates (in case of a cash surplus) or reduced financing costs (in case of a cash deficit) as well as reducing the recourse to external financing. On the other hand, cash pooling also brings some disadvantages, such as the risk that pool members receive a remuneration not reflecting arm’s length interest rates⁶ (risk typical of all intra-group transactions), concentration risk, default risk or a liquidity risk in the event of insolvency of the parent company or other participants with negative balances. Indeed, contagion effects between the parent company and captive undertakings may arise from cash pooling in the case where the financial situation of the parent is deteriorating. This is especially relevant, if the cash pooling arrangement covers a material part of the captive’s assets.
- 3.3. NCAs should ensure that (re)insurance captive undertakings recognise and classify in the Solvency II Balance Sheet the asset and liability descriptions according to the economic substance of the cash pooling arrangement and also apply the proper calculation of the Solvency Capital Requirement (SCR).
- 3.4. If the classification of an asset under the cash pooling arrangement is as a loan, then according to Solvency II Standard Formula the asset needs to be taken into account in the relevant Market Risk submodules, including spread risk and concentration risk. Indeed, in the vast majority of cases it has been observed that assets under a cash pooling arrangement classify as loan and the participants usually bear the risk of losses on their liquidity contribution to the pool in the event of insolvency of the parent company or of the participants with negative balances.
- 3.5. If the classification of an asset under the cash pooling arrangement is not as a loan and the asset can be classified as cash at bank, then according to Solvency II Standard Formula the asset needs to be taken into account in the Counterparty Default risk module. NCAs should

⁶ In other terms, pool memers may invest their liquidity surplus on capital markets for a higher remuneration.

ensure that undertakings in the classification consider characteristics, such as the immediate availability of the asset (see EIOPA Q&A 2278⁷, under which an important consideration is whether or not there is a time restriction on withdrawal) and furthermore, that undertakings consider situations of deterioration of financial conditions of the counterparty of the (re)insurance captive.

- 3.6. NCAs should ensure that there is no arbitrage in the classification of the asset as loan or not and for this purpose consider also the application of the correct credit rating (see 3.7 ff. below).The decision tree below can be used by NCAs to assess the SCR treatment of cash pooling arrangements:



- 3.7. NCAs should ensure that when calculating the SCR⁸, captive (re)insurance undertakings are applying the credit rating of the identified counterparty or counterparties in the cash pooling arrangement(s), in compliance with Article 5(3) of the Delegated Regulation .
- 3.8. In the Standard Formula SCR calculation of counterparty default risk, which applies only if the arrangement does not classify as a loan, where the cash pooling arrangement is with an unrated intra-group entity, the probability of default of that counterparty is to be calculated

⁷See https://www.eiopa.europa.eu/qa-regulation/questions-and-answers-database/2278_en

⁸ The Standard Formula SCR calculation of market risk allows a simplification for the calculation of the concentration risk in case the conditions of Article 106 (1) of the Delegated Regulation (EU) No 2015/35 are met

on the basis of the “unrated” credit exposure and can’t be based on the rating of the parent company of the group to which the captive belongs.

- 3.9. The rating of the parent company can only be used where a letter of credit, a guarantee or an equivalent arrangement is provided by the parent, satisfying the requirements of Article 199 (10) of the Delegated Regulation.
- 3.10. As cash pooling arrangements may take different forms, this opinion is based on the definition provided in Point 3.1. There are two main types of cash pooling arrangements known in the wider financial market, i.e. physical and notional cash pooling⁹.
- 3.11. In case of a physical cash pooling, where all accounts represent a resource or an obligation (i.e. legal relationship) of the bank¹⁰ vis-à-vis the entities that participate in the pool, the surplus liquidity from the individual accounts (including the captives’) is transferred to the master account giving rise to an inter-company transaction of the same amount. The SCR calculation of such transaction depends on its classification.
- 3.12. In case of a notional cash pooling¹¹, the notional top account only virtually consolidates the positions of the pool members. Notional cash pooling is a legal agreement that does not include real liquidity transfer¹². The pooling is performed by the entity/bank creating a notional top account that virtually consolidates the positions of the pool participants but does not represent itself a resource or an obligation of the bank. The SCR calculation of such cash pooling arrangements needs to follow the economic and legal substance (e.g. it will depend on the default risk and any of the risk drivers of the underlying asset).
- 3.13. In addition to the SCR calculation, NCAs should ensure that the captive (re)insurance undertakings assess all risks and benefits brought by intra-group transactions, for example assessing the impact on liquidity and concentration risks linked to a material reliance on these types of transactions. In cases of material reliance on these types of transactions such assessment should be reflected in the Own Risk and Solvency Assessment. Furthermore, the risk exposure relating to the availability of the funds in a cash pooling needs to be evaluated in a stress scenario and depends on the role of the cash pool leader managing the cash pooling.

⁹ See for example “The statistical classification of cash pooling activities”, Antonio Colangelo, ECB Statistics Paper Series (July 2016) and “Transfer Pricing Guidance on Financial Transactions”, OECD, February 2020.

¹⁰ In some cases, physical cash pooling arrangements can use an intermediary other than a bank.

¹¹ It is an arrangement where there is no physical transfers of funds and “the bank notionally aggregates the various balances of the individual accounts of participating members and pays or charges interest according to the net balance, either to a designated master account or to all participating accounts under a formula determined in the cash pooling agreement” (Source: Transfer Pricing Guidance on Financial Transactions, OECD, February 2020).

¹² In this case, the fair value of the underlying position should reflect the effects of the notional cash pooling agreement

Regarding cash pooling agreements, limits should be set by the group in particular concerning assets held to cover liabilities towards policyholders.

3.14. In the same vein, NCAs should ensure captive (re)insurance undertakings' compliance with the Prudent Person Principle considering the portfolio as a whole. In assessing such compliance NCAs should ensure that the following is considered:

- a) Security and quality: in the context of cash pooling arrangements classified as loans, the assets provided by counterparts with no rating should be considered as "unrated" to reflect the lack of information on the credit quality regardless of the rating of the entities within the group. In this context, the number and credit-worthiness of different counterparties within the whole portfolio should also be duly taken into account. The exposure in terms of amount and number of counterparties within the whole portfolio should ensure an adequate level of security and quality of the portfolio as a whole.
- b) Liquidity and availability: in the context of cash pooling arrangements (loans or cash/deposits), assessment of the duration of the cash pooling arrangements, including the time needed to convert the assets into cash, taking into account the conditions on any time limitations on withdrawal agreed in the arrangement and the captive liquidity plans, if applicable. However, an important aspect regarding the availability of the funds is the potential guarantee given by the cash pooling leader.
- c) Profitability: assessment of the profitability of cash pooling arrangements, taking into account the context of the macro-economic situation, as it is expected that cash pool members earn higher interest rates thanks to the better use of the centralised resources.
- d) Asset-Liability Management: assessment of duration (mis)matching and of cash-flow matching considering any particular rules described in cash pooling arrangements.
- e) Conflict of interest: assessment as to whether the best interests of policyholders have been appropriately taken into account, such as assessing the arm's length price of cash pooling transactions, if needed in collaboration with the statutory external auditor.
- f) Diversification: evidence that the degree of portfolio diversification is adequate considering the risk-profile of the undertaking. Diversification should be assessed regarding the exposure to asset type, issuer/counterparty, issuer/counterparty group, currency, country and sector.

3.15. NCAs should ensure that captive (re)insurance undertakings are able to provide at any time information about cash pool arrangements in sufficient detail to clearly identify the related asset classification (e.g. cash pooling giving rise to deposits or cash or to intercompany loans) and the legal basis of the arrangement. NCAs should also ensure that material amendments to existing material cash pooling arrangements are submitted to NCAs by the captive (re)insurance undertakings without delay. NCAs should also ensure that captive (re)insurance undertakings are able to provide evidence supporting the arm's length price of cash pooling

transactions (in collaboration with the statutory auditor, if needed), in particular if amendments to cash pooling arrangements impact the asset classification.

3.2 Governance: Administrative, Management, Supervisory Board (AMSB) composition and outsourcing of key functions

3.2.1 AMSB composition

3.16. NCAs should ensure that the AMSB as a whole possesses the necessary seniority, qualifications, competency, skills and professional experience. There is no exception from this requirement for captive (re)insurance undertakings.

3.2.2 Outsourcing of key functions

3.17. NCAs should ensure the compliance of key functions' outsourcing arrangements based on Article 49 of the Solvency II Directive and Guideline 14 of the EIOPA System of Governance Guidelines (EIOPA-BoS-14/253).

3.18. Key function tasks can be outsourced, however the captive undertaking should designate a person within the undertaking with the overall responsibility for the outsourced key function who is fit and proper and possesses sufficient knowledge and experience regarding the outsourced key function to be able to challenge the performance and results of the service provider¹³.

3.19. At the level of the captive (re)insurance undertaking, due to their specific business model and subject to national regulatory restrictions, NCAs should ensure that the designated person considered to be the person responsible for the outsourced key function for captive (re)insurance undertakings are represented by :

- a person having an employment contract with the captive (re)insurance undertaking;
- a person under NCA supervision regardless of the employee status within the captive undertaking having a link to the undertaking via its membership in a dedicated committee set up specifically by the undertaking and dealing only with the matters of that undertaking;
- a person employed by a company that belongs to the same group as the captive (re)insurance undertaking, as long as the this role is properly documented within the outsourcing arrangements and fitness and propriety process

3.20. In case the captive adopts the solution involving outsourcing above (i.e. not an employee of the captive), the NCA should ensure that adequate safeguards are in place to mitigate any

¹³ In line with Guideline 14 of the EIOPA System of Governance Guidelines

conflict of interests (for example brokerage services performed by the captive manager) or operational risk arising from such outsourcing.

3.21. NCAs should ensure that, in case of multiple services provided by the same service provider or captive manager from captive undertakings, the segregation of duties is clearly agreed and documented.

3.22. Given the high degree of outsourcing operated by captive (re)insurance undertakings, NCAs should ensure that the initial and ongoing due-diligence on the service provider operated by the captive on the service provider is embedded in strong processes and procedures which should be made available to the NCA upon request.

4. MONITORING BY EIOPA

4.1. This Opinion will be published on EIOPA's website.

Done at Frankfurt am Main, on 05 October 2023.

[signed]

For the Board of Supervisors

Petra Hielkema

Chairperson