Good practice

Intra-group relationships in the insurance sector

DeNederlandscheBank
EUROSYSTEEM

Good Practices document for Intra-group relationships in the insurance sector

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1 Introduction

Intra-group agreements and positions between insurers and other group entities (hereinafter: intra-group relationships, IGRs) may pose risks to the solidity of an insurer and the solidity of the group to which the insurer belongs. For this reason, De Nederlandsche Bank supervises intra-group relationships in insurance groups[1] or financial conglomerates[2] (hereinafter: groups) as part of our group supervision activities pursuant to the Solvency II Directive (SII) and the Financial Conglomerates Directive (FCD). In certain circumstances, intra-group relationships may pose an obstacle to the resolution of an insurer or the entire group as referred to in the Act on the recovery and resolution of insurers (*Wet herstel en afwikkeling van verzekeraars*). Pursuant to this legislation, DNB has the option of requiring the group to remove such an obstacle.

Intra-group relationships may threaten solvency and/or obstruct resolution, because the underlying agreements may involve conflicts of interest, a risk of contagion, the circumvention of sectoral rules and/or concentration risks. These good practices have been developed to provide insight into applicable legislation and regulations in this area, along with insight into DNB's expectations in this regard. Initiatives are being developed as part of the European Insurance and Occupational Pensions Authority (EIOPA) to harmonise the approach to IGRs by national supervisory authorities. These good practices will be amended accordingly if necessary.

Section 2 provides a more detailed discussion of applicable laws and regulation. Section 3 focuses on the risks that are inherent to IGRs. Section 4 presents good practices, which are principles for an internal risk management framework for IGRs from a financial, operational and legal perspective.

1 This includes all manifestations of groups as referred to in SII.

2 In accordance with the definition of financial conglomerates in the FCD.

2 Relevant laws and regulations

This Good Practices document offers guidance in administering the following laws and regulations:

- Section 3:288h and Section 3:17(1) of the Financial Supervision Act (*Wet op het financieel toezicht - Wft*) and the rules pursuant to the second subsection of that Section;
- Section 26.2(1) of the Decree on Prudential Rules for Financial Undertakings under the *Wft* (*Besluit prudentiële regels Wft - Bpr*) and Articles 258 and 259 of the Solvency II Regulation;
- Sections 3:17, 3:269 and 3:299 of the *Wft*, and Section 4 of the *Bpr*;
- Articles 218, 222, 223, 224 and 246 of the Solvency II Directive;
- Articles 106, 335, 339, 342, 372 and 377 of the Solvency II Regulation;
- Section 3A:83 of the Measures regarding resolvability *Wft* (*Wft Maatregelen ten aanzien van afwikkelbaarheid*);
- Decree amending the Decree on Prudential Rules for Financial Undertakings under the *Wft* (*Besluit tot wijziging van het Besluit prudentiële regels Wft*), Decree on Special Prudential Measures, Investor Compensation and Deposit Guarantees under the Financial Supervision Act (*Besluit bijzondere prudentiële maatregelen beleggerscompensatie en depositogarantie Wft*) and certain other Decrees (Decree on the resolution and recovery of insurers – *Besluit herstel en afwikkeling verzekeraars*).

If DNB finds that sound and ethical business operations are insufficiently safeguarded, then we may issue an instruction to the insurer or group, an order subject to penalty or a fine.[3]
We may order an institution to rectify intra-group relationships if they form an obstacle to the institution's resolvability as referred to in Section 3A.82 of the Act on the recovery and resolution of insurers.

3 Instruction: Section 1:58e(1) and Section 1:75 of the *Wft*; Order subject to penalty: Section 1:79 of the *Wft*; Fine: Section 1:80 of the *Wft*.

3 Risks involved in intra-group agreements and positions

Intra-group relationships may give rise to risks due to:

1. **Conflicts of interest** between the insurer and its counterparties in IGRs that are resolved primarily or fully to the benefit of the insurer's counterparty. This may be the case if a transaction is executed under pressure following on from formal or informal group relationships rather than as part of the insurer's normal operations. Such transactions do not take place "at arm's length" as they should, which can have an impact on the conditions that apply to the transaction such as collateral and size. The result could be that an insurer might maintain a far larger risk position for one of its own group entities than it would for an external party that is interested in engaging in a transaction. This may also give rise to risk concentrations within the group. When conflicts of interests imperil the at arm's length principle in a transaction, there is a greater risk of inaccuracies both in price and balance-sheet valuation.

2. **Interdependencies** between entities of an insurance group due to IGRs, both of a financial and operational nature. Financial interdependencies may result in contagion risks: if no risk management system is in place that takes account of the financial interdependencies and risk concentrations, then financial setbacks in individual entities may have a negative impact on the financial health of other entities. Operational interdependencies may lead to contagion risks if the group lacks the administrative, organisational or legal control systems to account for activities outsourced internally, i.e. between group entities. Major or non-transparent interdependencies between the insurer and other group entities due to IGRs may impede an institution's resolvability.

3. **Supervisory arbitrage** between differing sector-specific frameworks. IGRs may give rise to a situation where sector-specific regulations are bypassed. This may be the case if an insurer acquires certain assets through IGRs that would be in conflict with the "prudent person" principle had they been acquired as direct investments. IGRs may also give rise to constructions involving more advantageous capital requirements for the group as a whole, without actually reducing risk.

4 Principles for appropriate control of intra-group agreements and positions

In view of the risks that IGRs may pose to solvency and resolvability, institutions must have risk management processes in place for IGRs to safeguard controlled and ethical operations.[4] The group's policy is laid down in strategies, procedures and measures to control relevant risks and it must be integrated into the insurance group's business processes and procedures.[5] Principles for sound IGR risk management are elaborated below. These principles focus on the policy framework in place, limiting financial risks, operational implementation and legal considerations. By applying these principles, it is possible to control IGR-related risks and enhance the resolvability of an insurer or the entire group.

DNB considers it to be good practice on the part of institutions to incorporate these principles into their risk management policies and procedures.

A Policy framework

1. A policy document is in place that contains the strategies, procedures and measures for controlling and mitigating the aforementioned risks.
2. The policy document in any case contains the following elements:
   a. the procedures for conducting periodic risk assessments of all IGRs present in the group.
   b. the procedures and measures in place that enable the insurer to sufficiently control and mitigate the financial, operational and legal risks associated with IGRs. This involves the following ten points at a minimum:
      i. the nature and/or type of IGRs that are permitted within the group and any conditions that apply;
      ii. for each type of financial transaction and counterparty: the limits and collateral to be received;
      iii. the procedures and measures in place that enable the insurer to ensure at arm's length conditions (at the minimum) for IGRs;
      iv. the procedures and measures in place that enable the group to monitor IGR-related risks and limits;
      v. the authorisations required when IGRs are created;
      vi. contractual requirements for IGRs;
      vii. requirements for Service Level Agreements in the context of operational IGRs;
      viii. the procedures and measures required to ensure that IGRs arise solely as part of the insurance company's regular pursuit of business;
      ix. the procedures and measures in place to monitor IGRs and to report on IGR-related risks to senior management.

4 Section 3:288h and Section 3:17(1) of the *Wft* and the rules pursuant to the second subsection of that Section.
5 Section 26.2(1) of the *Bpr*, and Article 258 et seq. of the Solvency II Regulation.

x. The role of second-line and third-line functions with regard to IGRs. In this context, the second line is responsible for establishing policy and for periodically assessing its implementation by the first line. The third line conducts regular audits of IGR risk management.

B Limiting financial risks[6]

3. The extent of an insurer's exposure to another group entity is proportionate to the independent repayment capacity of that group entity. If this is not the case[7], the insurer's risk is covered by collateral that is not correlated to the credit quality of the group entity concerned.
4. IGRs in the form of marketable instruments such as shares, bonds or covered bonds are also proportionate to the independent repayment capacity or financial solvency of the group entity in question. If these financial instruments are not traded on a regulated market or if market liquidity is insufficient[8], the insurer's risk is covered by collateral that is not correlated to the credit quality of the group entity concerned.[9]
5. Intra-group current accounts between the insurer and other group entities (including other insurers in the group) arise only in respect of specific activities that are in line with the insurance company's normal business operations. As an example, this includes the settlement of costs for internal services or the bundling of group cash flows (premiums, benefits, investments) in a payment centre, investment centre or central treasury. Periodic settlements should take place to ensure that the extent of an insurer's exposure to another group entity is proportionate to the independent repayment capacity of that group entity. Intra-group current accounts are not to be used for long-term financing of group activities. Central treasury exposures may not affect the liquidity of current account receivables. The current account must be available on demand, and the counterparty's solvency may not jeopardise this liquidity.
6. IGRs that result from centralised risk hedging (e.g. through the establishment of a "derivatives desk" or underwriting by an internal reinsurer) are subject to the same conditions that apply to the central entity with regard to external risk hedging. This applies in any case to risk-mitigating aspects in the conditions such

6 The SII Directive contains a number of provisions regarding the limitation of financial risks for specific IGRs, including Article 222 (Elimination of double use of eligible own funds) and Article 223 (Elimination of the intra-group creation of capital). It goes without saying that these provisions are in full force.

7 For example, in the case of a loan from the insurer to a group entity that can only reimburse the insurer if this entity receives, either directly or indirectly, dividend from the insurer, or if reimbursement depends to a significant extent on dividends because the entity does not have sufficient other revenues.

8 Liquid markets are those on which instruments can be traded expediently and without capital losses. It must be clearly demonstrated that the insurer can sell its position and that the particular instrument's liquidity can easily absorb it.

9 With regard to Covered Bonds, the composition provides for sufficient collateral.

as requirements for margins and collateral. Agreements with the central entity are terminated upon resolution and replaced with third-party agreements.

7. Both the insurer and the entire group fully apprise at all times of the size of the IGRs and their exposure to financial risk. This involves monitoring the independent repayment capacity of the group entities where the insurer faces exposure.
8. No single IGR is so large that it forms a threat to the insurance company's solvency. Concentration of risks in a single group entity is avoided or sufficiently collateralised.

C Operational implementation

9. The purchase or sale of assets or liabilities between group entities take place in accordance with the at arm's length principle.
10. Products and/or services supplied or shared between group entities are subject to SLAs and take place on market terms. This applies, for example, to ICT or facilities services staff who perform work for multiple group entities. If an insurer outsources activities to another group entity, it adheres to the precepts in the Good Practice document for Outsourcing by Insurers.[10]
11. With regard to IGRs, operational management structures foster coherence between the aforementioned measures and procedures. Furthermore, they are thoroughly integrated into the risk management procedures of the individual insurers and of the entire group.

D Legal considerations

12. Each IGR is clearly documented in a binding legal contract between the insurer and the counterparty in which all rights and obligations are clearly defined.

10 See the Open Book on Supervision: https://obtinternlive.dnb.nl/en/2/51-237170.jsp.

DISCLAIMER

This Good Practices document provides non-binding recommendations to insurers and to groups of insurers for implementing the Financial Supervision Act (*Wft*), Solvency II and the Act on the recovery and resolution of insurers. It sets out our expectations regarding observed or envisaged behaviour in policy practice that reflects an appropriate application of the rules to which this Good Practices document pertains.

We encourage insurers and groups of insurers to take our expectations into account in their considerations and decision-making, without being obliged to do so, while also taking their specific circumstances into consideration. The Good Practices document is only indicative in nature, and therefore does not alter the fact that some financial institutions should apply the underlying regulations differently, and possibly more strictly. It is the institution's responsibility to take this into account.

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