Banc Ceannais na hÉireann
Central Bank of Ireland
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Updated Operational Guidance Applicable to Captive Insurance Undertakings, November 2009

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1. Introduction

The Guidance Note "Operational Guidance on Prudential Requirements applicable to Captive Insurance undertakings" issued in July 2007 (the "Captive Paper") set out that captive insurers may only write own risks, and cannot write any non-group risks. Included on page 4 was a footnote, which stated that Captive insurers must provide notification to the Central Bank of Ireland (the "Central Bank") prior to issuing any policies to Joint Ventures. As a result of communications received from a number of captive insurance undertakings, the Captive Paper was updated in April 2009 to formally set out the position of the Central Bank in relation to this matter. The intention of this further update is to provide greater clarity as regards the position previously outlined.

The Central Bank, on the basis of a review of the supervisory framework for captive insurers, decided that, subject to specific conditions being satisfied, a number of changes may apply to the authorisation and on-going supervision of captive insurance companies. These changes have been applied on a case-by-case basis with effect from 1 July 2007. The changes implemented are:

1. The increase in the maximum level of inward reinsurance permitted from 20% of Gross Premium Income to a new maximum level of 50%

2. A reduction of the 200% Solvency Margin for captives to a level of 125% Solvency Margin for captives writing pure property (Classes 8 and 9) and ancillary business interruption (Class 16) classes **only** and 150% Solvency Margin for **all** other captive companies

3. The waiver of the Solvency Ratio requirement

4. Credit will be given where a related reinsurance company providing reinsurance cover has an A rating or higher. Otherwise, credit for reinsurance with a related reinsurer will be given after satisfactory assessment of specified information to be provided by the firm.

This document is intended to provide clarity in terms of the information required from captive companies to satisfy these conditions and correspondingly ensure consistent application of these new arrangements by the Central Bank. Although no changes have been approved in respect of the notification requirement in relation to transactions with a related company or companies, in particular the provision of loans, as required under Article 15 of Statutory Instrument No. 359 of 1994, this document also clarifies the

material that shall be submitted to the Central Bank and the prudential requirements that must be complied with before a captive insurance company can enter into such agreements.

It is intended to review these requirements on an ongoing basis.

1.1 Prudential objective

The Central Bank is committed to maintaining a regulatory system that "fosters safe and sound financial institutions while operating in a competitive and expanding market of high reputation". The Central Bank seeks to be satisfied that any changes to existing provisions should not adversely affect the risk profile of the captive insurer. Companies complying with the definition of captive insurers as set out in Section 2 may apply to avail of these provisions. The principles that guide our regulatory approach are set out below.

Our Regulatory Principles

1. We conduct our functions in a transparent and accountable manner.

2. We expect financial service providers to act with prudence and integrity and in the best interests of their customers at all times.

3. We expect financial service providers to maintain at all times sufficient financial resources to meet all their commitments.

4. We expect financial service providers to have in place sound corporate governance procedures.

5. We expect financial service providers to have oversight and reporting systems that allow the board and management to monitor and control all operations.

6. We expect financial service providers to have in place internal controls that are adequate for the nature, scale and complexity of their operations.

7. We expect financial service providers to have risk management policies and risk control systems appropriate to the nature, scale and complexity of their operations.

8. We expect financial service providers to comply with any regulatory rules set down by the Central Bank.

9. We expect financial service providers, when required, to produce accurate, complete and timely information.

1.2 Relations with the Central Bank of Ireland

A captive insurer should deal with its regulators in an open and co-operative way, and must disclose in a timely manner to the Central Bank anything relating to the captive insurer of which the Central Bank would reasonably expect notice. Nothing should operate to obstruct or mislead the Central Bank in its supervision of the company.

2. Captive Insurance Company

2.1 Definition

Captive insurance is not defined or referred to in the Insurance Acts or Regulations, however the Statutory Instrument (S.I. No. 380 of 2006) transposing the Reinsurance Directive does define a reinsurance captive as "*an undertaking the purpose of which is to provide reinsurance cover that is limited exclusively to the risks of the undertaking or undertakings to which the reinsurance undertaking belongs or of an undertaking or undertakings of the group of which the reinsurance undertaking is a part*".

The definition of a captive insurer as contained in the Solvency II Directive (Directive 2009/138/EC) states: "*captive insurance undertaking means an insurance undertaking, owned either by a financial undertaking other than an insurance or a reinsurance undertaking or a group of insurance or reinsurance undertakings* ***(…)*** *or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member".*

These definitions form the basis of how the Central Bank defines a direct writing captive insurer. A captive insurer must cover only risks of its parent or of entities that are part of the group in order to avail of the differentiated supervisory approach. For clarity, a captive insurer benefiting from the differentiated approach may only cover entities that are consolidated in the audited financial statements of the group. A captive insurance company wishing to include a risk in its captive insurance programme must ensure that all risks undertaken fall within the definition set out above. If there is any doubt relating to whether an entity consolidates into the group, it is for the board of the captive insurer to satisfy itself that the above criterion is met.

2.2 Non-Consolidated Entities

Captive insurers may currently be insuring non-consolidated entities. Such insurance coverage may be continued until the next renewal date when alternative arrangements will need to be put in place.

Where captive insurers wish to renew the existing insurance coverage for non-consolidated entities, the differentiated supervisory approach allowed for captives will cease. The Central Bank should therefore be notified in relation to proposed plans for compliance with the relevant requirements that apply to non-captive insurance undertakings.

3. The 80/20 Rule - Inward reinsurance

3.1 Policy

The prudential requirement concerning inward reinsurance limits the amount of premium received from reinsurance accepted, normally through a fronting arrangement, to 20% of the Total Gross Premium Income. Captive insurers frequently use fronting insurance companies to underwrite risks located in geographic regions where it is not feasible for the captive to write directly. The Central Bank recognises that captives may wish to reinsure fronting insurance companies up to 100%. In these circumstances the Central Bank may allow inward reinsurance up to 50% of Total Gross Written Premium, subject to the requirements below being fulfilled.

3.2 Requirements

Before considering any relaxation of the requirement for captive insurers, whereby a 50% reinsurance limit would be applied, the Central Bank requires that the captive insurer's Board of Directors confirms and is able to evidence that:

- The ultimate parent undertaking, and its subsidiaries, apply similar corporate governance standards and operational risk management procedures to all its operations irrespective of location of insurable risks;
- All risks reinsured are group specific risks only, and not assumed third party risks;
- The Board is satisfied with the underwriting and reserving criteria and approach, and that such criteria and approach are identical for the captive's reinsurance and insurance books of business;

• The risks being transferred by way of a reinsurance mechanism are risks that the company is considered to be competent to write in its own right, were it to be the direct insurer;
• Solvency I Requirements shall apply to the premium received from reinsurance business accepted by the captive insurer relating to liability classes; and
• They adhere to the Central Bank's guidance on corporate governance.

In order to evidence the above, the Company must maintain at its Head Office all relevant records and documentation, to be provided to the Central Bank on request. Such records and documents should include:

• Copy of the reinsurance and insurance agreements, in respect of the risks being assumed;
• Copies of operational manuals;
• Details of commission payable to the (re)insurer, if any;
• Details of collateral provided to the (re)insurer, if any;
• Details of the location of the risks being insured;
• Description of claims handling arrangements, including those in respect of the reinsurance business accepted; and
• Such other information or documents as the Central Bank may reasonably require for the purpose of determining the application.

4. Additional Solvency Requirements

4.1 Policy

The current solvency margin requirement is the higher of (a) 200% of the EU minimum Solvency Margin requirement or (b) the Minimum Guarantee Fund (MGF) for the initial three years of business. After three years and upon application to the Central Bank the Solvency Margin can be reduced to 150% thereafter. The higher requirements imposed for start-up companies reflect the higher operational risks posed by new firms, the greater vulnerability to the timing of claims and that new firms have an unproven business model. The Central Bank recognises that where a captive is being established with proven risk management and a detailed, credible claims history sufficient to allow for actuarial inferences to be drawn, the situation differs from that of a start-up third party insurance company, and accordingly the business model should have greater certainty. In such instances, firms may apply for the application of a lower solvency margin.

It is also recognised that certain business lines, such as pure property business, are inherently less risky than others. A captive insurer specialising in such business lines may also seek the application of a lower solvency margin.

In making a determination in this area, the Central Bank seeks to categorise non-life captive insurers into those writing (i) a pure property program (Classes 8 and 9) possibly with ancillary business interruption cover (Class 16) and (ii) all others.

In respect of a pure property program (Classes 8 and 9), or a pure property programme with ancillary consequential business interruption (Class 16) cover provided as part of the same policy, a reduction in the Central Bank's solvency margin requirements to 125% of the Solvency I Requirement for new and existing captive insurers may be permitted. The lower solvency margin requirement will not be extended to other types of Class 16 business beyond that directly connected to Class 8 and 9 business.

In respect of an All Others Program a reduction to 150% of the Solvency I
Requirement for new and existing captive insurers may be permitted. It should be noted that where a company has been writing solely pure property risks and ancillary business interruption cover if provided, any subsequent expansion in business to include any other classes will mean that the full 150% requirement would apply to the whole book of business, with effect from the date of the expansion.

In terms of the solvency ratio[1], the Central Bank proposes to waive this requirement for eligible captive insurance companies. It is recognised that a central rationale for the establishment of a captive insurer is access to the reinsurance markets and that captives typically cede significant risk exposures to this market. As their Net Written Premium Income levels are typically much lower than the norm in the commercial market, the Solvency Margin requirement is typically more significant than the solvency ratio requirement for captive insurance companies[2]. It is also recognised that the requirement on captive companies to provide an annual reinsurance strategy document should capture much of what this rule sought to achieve, in terms of risk mitigation.

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[1] Available Assets equal to 50% NWPI for new companies for first three years of business, 40% thereafter.
[2] IAIS guidance identifies a solvency ratio of less than 30% as a general early warning indicator.

4.2 Requirements

On application to the Central Bank, and subject to the requirements listed below, the Central Bank may reduce the uplift in Solvency Margin Cover and waive the Solvency Ratio for captive insurers. In order to make a determination, an application to the Central Bank should contain the following:

- Copy of its reinsurance strategy document, if not already submitted. This document should explain how risk is mitigated and justification for the proposed risk strategy to be pursued.

- Calculation and explanation of the "risk gap" and how the company seeks to address these gaps in the event of significant losses.

- The company should demonstrate that there are no negative liquidity implications arising from these solvency changes.

- Confirmation that the Central Bank shall be notified, as soon as practicable, of material deviations from the current business plan due to unforeseen circumstances. Planned material changes to the business plan should be notified at least 6 weeks before implementation in order to provide the Central Bank time to review the continued appropriateness of this waiver

Captive insurance companies availing of any reduction in their solvency uplift are required to submit quarterly returns (Forms 1, 10, 11 and 14) if not already doing so.

5. Inter-company loans

5.1 Policy

Article 15 (1) of S.I. No. 359 of 1994 sets out the notification requirements for transactions with a related company or companies. Regulation 11 of S.I. No. 366 of 2007 sets out the requirements for "Intra-group transactions". Both highlight the concern regarding the potential for contagion arising from transactions with related parties. This issue is of particular relevance to a captive insurance entity given that it is solely writing group risks and should the group suffer financial strain due to a series of large claims, its ability to repay the loans involved may suffer as a result. Similarly, the group's ability to inject additional capital into its insurance company is also constrained in these circumstances.

As a result, the Central Bank only allows a loan-back to the group to be applied from assets in excess of Technical Reserves and the Central Bank's solvency requirements, subject to the company demonstrating that the funds remaining once the loan has been deducted are adequate to support the insurer's risk profile. Such inter-company loan payments are allowed, subject to:

- The submission of a draft contract/agreement outlining the terms of the transaction prior to the captive insurer entering into such a transaction; and
- The captive insurer demonstrating that the funds remaining once the loan amount has been deducted are adequate to support the captive insurer's Solvency Requirements.

In order to avoid contagion and the concentration of assets, the Central Bank does not recognise an inter-company loan as a valid asset for purposes of meeting regulatory capital requirements. The conditions of authorisation issued to each non-life insurance company clearly state that a company must seek the Central Bank's **prior approval** before making any inter-company loan payments.

5.2 Requirements

The Central Bank does however acknowledge the need for clearer guidance on the level of information to accompany applications for inter-company loans. In submitting an application, the captive insurer should notify the Central Bank at least four weeks in advance of a loan being made. The notification should include an updated Form 14 to allow the Central Bank assess the current solvency requirement. All inter-company loans must comply with the following:

1. The company must have Available Assets in excess of:
    - The higher of the Applicable Solvency Margin required or the Minimum Guarantee Fund, **plus**
    - The inter-company loan amount.
2. The loan agreement must state that the loan is conducted on an arm's length basis
3. The loan agreement must state the loan payment is for a finite period – no automatic rollover is permitted
4. The loan agreement must state that the loan attracts a commercial rate of interest
5. The loan agreement must state that the loan is repayable immediately on the instruction of the Central Bank.

The Central Bank will keep this element of the supervisory regime under review as the broader supervisory regime evolves.

6. Solvency credit for risk ceded to a related reinsurance entity

6.1 Policy

The primary responsibility for the appropriateness and security of an undertaking's reinsurance arrangements rests with the Board of the captive insurer, who should be able to demonstrate the appropriateness of such arrangements to the Central Bank. In this regard, captive insurance companies should refer to the "Guidelines on the reinsurance cover of primary insurers and the security of their reinsurers" (available at www.centralbank.ie), which is based on the International Association of Insurance Supervisors' (IAIS) "Supervisory standard on the evaluation of the reinsurance cover of primary insurers & the security of their reinsurers".

Because captives generally retain a limited amount of the risk underwritten by them, reinsurance is particularly important to their financial soundness. The Central Bank should, therefore, be able to review reinsurance arrangements in order to assess their appropriateness and the degree of reliance placed upon them in determining the appropriateness for reinsurance credit.

6.2 Requirements

When the insurer uses a reinsurer from the same group of companies the potential for concentration risk is created. In order to assess the extent of such concentration risk in determining whether reinsurance credit should be allowed, the Central Bank will require in all cases:

1. Background information to the risk retention and risk transfer strategy of the Group and a statement of the objectives sought in ceding risk to the related reinsurer.
2. A copy of the reinsurance cover strategy document and details of the security of the reinsurers, including all relevant information pertaining to the related reinsurer.
3. Full retrocession panel details (sitting behind the related party reinsurer). The Central Bank expects to see and requires evidence of effective cut-through and insolvency clauses to retrocessionaires.
4. Copies of all contracts and amendments including descriptions and summaries.
5. Audited financial statements for the reinsurer including Group/consolidated solvency margin calculations in an agreed format.

6. Contract documentation available for review by the Central Bank should be complete and detail all obligations between the parties.

Specific Cases

Case 1 – Cessions to rated reinsurer

The position at present is that reinsurance credit is allowed in respect of cessions to reinsurers holding a rating of A or higher by a rating agency acceptable to the Central Bank. Credit for reinsurance with a reinsurer rated below A must have the prior approval of the Central Bank.

Case 2 - Cession to European reinsurer

Reinsurance credit will be allowed up to the full amount available under the relevant EU Directives. Under the Reinsurance Directive, Title IX "Amendments to Existing Directives", Article 57(2), (Amending Article 13(2) of Directive 73/239/EEC)) states that "The home Member State of the insurance undertaking shall not refuse a reinsurance contract concluded by the insurance undertaking with a reinsurance undertaking authorised in accordance with Directive 2005/68/EC." The Central Bank also recognises that such entities would be covered under the requirements of the Insurance Groups Directive in terms of a Group solvency calculation.

Case 3 - Cession to unrated non-EU reinsurer

This will need to be assessed on a case-by-case basis. Core considerations include the financial strength of the reinsurance entity, the degree of supervisory oversight the entity is subject to, the volume and nature of other reinsurance business the unrated group reinsurer is assuming and the extent to which claims from these other sources will exhaust limits and aggregate retrocession cover provided.

In the case of a cession to an unrated non-European related reinsurer, in considering whether to allow credit for such cession, the Central Bank requires the captive insurer to provide in respect of the unrated non-European related reinsurer, in addition to the information detailed above, the following information:

- Evidence of the financial strength of the reinsurance entity;
- Details of whether or not the reinsurer is regulated;

• The volume, nature and location of risks of any other reinsurance business accepted by the related reinsurance entity;
• The possibility and extent to which claims from these other sources will exhaust capital and aggregate retrocession cover; and
• Details on any due diligence checks performed.

It should be noted that in this area, where concern exists as to the ability of the reinsurer to discharge liabilities assumed (from a capital or operational perspective), the Central Bank may decide to refuse reinsurance credit. Where an insurance company becomes aware of such a potential it should notify the Central Bank within two working days.

Where concern exists as to the ability of the reinsurer to discharge liabilities assumed, or such other impediments that may impair a considered prudential assessment of the appropriateness of this cession the Central Bank may refuse reinsurance credit.

7. Timeframe

Captive insurers must apply individually to benefit from any relaxation to existing prudential requirements by the Central Bank, which will be decided on a case-by-case basis. The Central Bank may refuse approval of the changes to any or all of prudential requirements set out in this document.

Upon receipt of the information required, the Central Bank will endeavour to communicate its decision to the company within 4 weeks.
Captive insurers seeking authorisation to underwrite insurance business and previously authorised captive insurers need to apply to the Central Bank's Insurance Supervision Department to avail of the relaxation of the prudential requirements discussed in this paper.

The Central Bank intends to review the revised supervisory regime for captive insurance companies on an ongoing basis.

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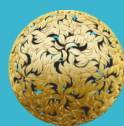

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