

Supervising insurance groups under Solvency II

A discussion paper

November 2006



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EXECUTIVE SUMMARY

1. The economic function of insurance is to enable households and firms to manage risk. Diversifying risk is fundamental to value creation in the insurance sector and therefore to providing economically efficient policyholder protection.
2. Solvency II is the EU's project to create a system of risk-based prudential regulation in the insurance sector. The overall aims of the project are to deepen the Single Market in insurance services, protect policyholders and strengthen the competitiveness of the insurance sector; these objectives are to be achieved within a framework which implements better regulation principles.
3. Reduced regulatory burdens on insurance groups will yield substantial benefits for policyholders through more competitive markets in insurance services and allow the insurance sector to operate more efficiently. Because of their market share and the fact that insurance groups which operate cross-border are uniquely placed to deepen the Single Market in insurance services, the approach to supervising insurance groups will be a litmus test of the success of the Solvency II project.
4. It is accepted as a cornerstone of the framework that Solvency II should incentivise insurers to diversify risks at the level of an individual insurance company. However, many major insurers are organised as a group of companies and diversification effects can arise not only within each company but also across the companies in the group because of their different risk profiles.
5. In particular where groups operate across several Member States, recognising these group-wide diversification benefits requires a fundamental review of how group supervision operates. It is hoped that this document will stimulate wider consideration of the issues raised by group supervision.
6. Any approach to insurance group supervision has to balance one view of the group as a single economic entity across which risks are pooled and diversified and another which sees the group as a set of separate legal entities. To promote greater efficiency in the insurance sector and the international competitiveness of insurance groups operating in the EU, Solvency II must achieve a step change towards treating an insurance group as a single economic entity.
7. This paper proposes a balance of responsibilities between the supervisor of an insurance group and the supervisors of the separate companies within the group. While ensuring that insurance groups meet the same high standards of policyholder protection as individual companies, the proposal enables them to benefit from diversification between their subsidiaries and gives them appropriate freedom to allocate capital across the group.
8. Solvency II is welcome because it brings a more sophisticated approach to insurance supervision but this carries the risk that duplicated supervisory processes for the group as a whole and the companies within it will increase the regulatory burden on insurance groups operating in the EU. That is why this paper proposes a streamlined approach which allocates supervisory responsibilities appropriately and encourages supervisory co-operation.

INTRODUCTION

1.1 This discussion paper sets out why the supervision of insurance groups should be fundamentally reformed as part of the Solvency II project and makes a proposal as to how this can be achieved. It is hoped that the document will stimulate wider consideration of the challenges of achieving efficient group supervision.

1.2 Chapter 2 sets out the reasons why the structure of group supervision should be very different under Solvency II than under the current Insurance Groups Directive; in particular it argues that the higher level of harmonisation that will be achieved by Solvency II enables control to be shared much more easily between supervisors in different Member States. Chapter 3 extends the argument for a new approach to group supervision by setting out the fundamental change that follows from the recognition of diversification benefits arising between subsidiaries within a group. The fourth chapter sets out the proposal for the structure of group supervision in some detail.

1.3 This introductory chapter covers two issues; first it sets out the key difference between the valuation of balance sheet items and risk capital which underlies the proposal for group supervision put forward in this paper. Second, it briefly notes what the objectives of Solvency II are and therefore what criteria are relevant for evaluating the merits of any proposed structure of group supervision, or indeed other policy options for Solvency II.

Valuation and risk capital

Two views of an insurance group

1.4 The challenge in putting forward a proposal for the structure of group supervision under Solvency II is to balance two competing views of an insurance group: one view sees an insurance group as a single economic entity within which risks are pooled and diversified, the second recognises the group as a collection of separate legal entities with segregated risks. The proposal in this paper aims to strike the right balance between the two by distinguishing the financial requirements that Solvency II will impose on firms into two parts:

1. those which relate to the estimate of the firm's current financial position; in particular, technical provisions; and
2. those which relate to the risks that the financial position may deteriorate; in particular, the Solvency Capital Requirement (SCR).

The distinction that separates the two applies to any prudential capital framework and it is so fundamental to be worth setting out in some detail.

1.5 The valuation of a portfolio of insurance liabilities must be independent of the firm on whose balance sheet it can be found, and independent of other assets and liabilities on that balance sheet. It is evident that this is a necessary condition of any accounting framework applied either for financial reporting or for prudential purposes: at any given point in time two identical portfolios of liabilities should have the same valuation.

1.6 The quantity of capital required to mitigate the risks inherent in the portfolio of liabilities is a function of the entire balance sheet of the insurer (or, more precisely, the risks to all of the assets and liabilities). This follows from the fact that the capital

required to achieve a given standard of policyholder protection mitigates the risks to the insurer as a whole.

1.7 The proposal advocated in this paper for the structure of group supervision in Solvency II follows directly from the distinction of these two classes of financial requirements:

- because the valuation of insurance liabilities is independent of where they are located within a group and of the group's overall risk profile, technical provisions should be held in each subsidiary;
- because the capital requirement for the group is a function of balance sheets of all the subsidiaries in the group, it should be imposed at group level and not in each subsidiary.

Chapter 3 explores in some detail the problems that arise in attempting to set a capital requirement in each subsidiary which has to reflect the risk position of the group.

1.8 This may appear to leave open the question of where the Minimum Capital Requirement (MCR) belongs in this framework. However it's clear that the MCR should be included with technical provisions and held in each subsidiary. This follows from the proposal that for an insurance group, the MCRs of its subsidiaries should be added and that together they form a notional group MCR at least in the sense that their sum is a floor to the group SCR.

Pillar 2 1.9 If risk based capital requirements should be evaluated at group level, Pillar 2 should be applied to the group as a whole, and not replicated at solo level. Supervisors of the subsidiaries in a group will have a key role to play in Pillar 2 and an assessment of the risk profile of each subsidiary should be captured. The proposal advanced in this paper is to have one coherent Pillar 2 process for the group but that does not mean supervisory review should only apply to the group on a consolidated basis; it should be a comprehensive assessment of risk across the group including subsidiaries' risk profiles and should involve all the relevant supervisors. Chapter 4 explains the proposed Pillar 2 process in more detail.

1.10 The box at the end of this chapter summarises the proposal put forward in this paper.

Solvency II's objectives

1.11 It is evident to all stakeholders that the supervision of insurance groups raises some of the most contentious and sensitive issues in the whole Solvency II project, in particular where cross-border groups are concerned. It is understandable that issues such as the balance of supervisory control should be prominent among supervisors' and Member States' concerns but there are only four objectives which should be considered in evaluating the impact of Solvency II; in order these are:

- Deepen integration of the EU insurance market;
- Protect policyholders and beneficiaries;
- Improve the competitiveness of EU insurers and reinsurers; and
- Promote better regulation.

This discussion paper argues that the right approach to the supervision of insurance groups will contribute in a major way to all four of these objectives.

1.12 In fact the desire to achieve a particular balance or distribution of control between supervisors should be a much less important consideration in Solvency II framework than under the current insurance prudential directives. As described in Chapter 2, Solvency II will achieve a far higher level of harmonisation in solvency capital and in the supervisory system across the EU; the direct consequence is that the locus of supervisory control is greatly reduced in significance. As Commissioner McCreevy has recently stated, what matters to policyholders is the soundness of the supervisory method, not the identity of the Member State from which it is sourced:

By defending their own little turf and habits, supervisors create nightmares for companies and ruin the efforts made at EU level to agree common standards. And frankly, consumers do not care a second whether the supervisory method used comes from country X or Y. He wants the method to be sound and applied effectively, nothing else...¹

1.13 It can be inferred from these comments that the merits of any proposal on group supervision under Solvency II should be considered solely with regard to the objectives of the Directive listed above.

1.14 In addition, when considering the implications of different proposals on group supervision for the balance of supervisory control, it should be kept in mind that overall, Solvency II is adding significantly to the range of powers and tools at supervisors' disposal. There is no suggestion in this paper that this is inappropriate let alone that supervisors' powers should be reduced compared with those available under Solvency I. Rather, the argument put forward is that the additional powers should be allocated in an appropriate way between the supervisors responsible for an insurance group.

1.15 Comments on this paper would be welcome from all parties with an interest in the Solvency II project. Please contact:

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¹ Commissioner McCreevy, June 2006.

Group supervision in Solvency II – a summary of the proposal

1. Each legal entity within the insurance group must hold eligible assets at least up to the level of the solo MCR but the solo SCR is disapplied as a solvency control level;
2. The EU-wide group must meet the group SCR including any Pillar 2 capital adjustment and must perform an own assessment of risk and capital on a group-wide basis;
3. The group SCR defines the solvency control level for the group and should equal the solvency standard for a solo entity so that there is (e.g.) a 1 in 200 probability over a one-year horizon of the group as a whole falling insolvent;
4. However the protection of the policyholders of any subsidiary in the group must be the same as for an equivalent solo entity. The approach we set out in this paper envisages a solo SCR but as an informational requirement, not as a solvency control level. This means that in the event of a loss in a subsidiary which renders it insolvent the obligation to policyholders in each subsidiary is set by the solo SCR (which does not reflect group-wide diversification benefits);
5. Insurance groups should have the option of using the standardised approach to the SCR or a partial modelling approach but groups should have clear incentives to adopt a group-wide full internal model;
6. There should be a single set of Pillar 2 processes for an insurance group which takes account not just of the group risk profile on a consolidated basis but also the risk profile in each subsidiary, the possibility of contagion risks across the group and transferability of capital;
7. The insurer's own assessment of risk and capital will therefore be more wide ranging than that for a solo entity, to address group wide risk and capital management issues not just for the group on a consolidated basis but for each of the subsidiaries; and
8. Arrangements for approval of a group internal model, the group-wide supervisory review process and Pillar 2 capital adjustment should be in line with Article 129 of the CRD.

2

THE CASE FOR A FUNDAMENTAL REVIEW OF GROUP SUPERVISION

2.1 The Solvency II project will fundamentally change prudential supervision for insurance companies established in the EU and unavoidably the question of how group supervision should be conducted has to be addressed. For example, the option in Solvency II to use an internal model to calculate the Solvency Capital Requirement (SCR) requires new arrangements among supervisors to approve a group-wide model. However there are persuasive arguments in favour of going further to undertake a fundamental review of the supervision of insurance groups. These include:

- the complexity of group supervision under the Insurance Groups Directive¹ (IGD) and its significant administrative burden on firms;
- the potential to deepen the Single Market in insurance services through a more streamlined framework for group supervision;
- the fundamental differences in the nature of prudential supervision under Solvency II compared with Solvency I; and
- the overall costs and benefits of the Solvency II initiative.

The Insurance Groups Directive

2.2 In essence, the IGD is a supplement to the Solvency I framework, designed to eliminate “double-gearing” – the duplicate use of the same capital to support risks in two or more entities within the group. As a result the IGD does not consider an insurance group as a discrete economic entity within which risks are pooled and diversified. Instead it is targeted on the legal entities within the group where they have a subsidiary or a ‘participation’ (a financial holding in another insurer which exceeds 20 per cent of its value). There is a widespread sense amongst industry and others that the operation of the IGD can be burdensome and fails to reflect the extent to which a group of companies manage themselves as a group.

2.3 The 2005 paper published by CEIOPS, “Recommendations on the possible need for Amendments to the Insurance Groups Directive”², demonstrates the potential burden that the current structure of group supervision can impose. An illustrative insurance group is analysed which has eight insurance companies authorised across five Member States, two insurance holding companies in the EU and a further insurer located in a third country. This hypothetical group would be required to undertake a solo solvency calculation for each of the eight insurance companies located in the EU; in addition the IGD could require up to a further nine solvency calculations at various levels within the group to take account of the impact on solvency of the inter-relationships between the companies within the group.

2.4 As the CEIOPS paper goes on to point out, using the flexibility that does exist within the IGD, supervisors have taken steps under the Helsinki Protocol to limit the number of additional solvency calculations required. However, it is evident that supervisory practice is likely to vary around the EU leading to differing levels of administrative burden depending on the location of the legal entities within a group. But the complexity of the current IGD provisions also suggests more profound questions about

¹ Directive 98/78/EC, 1998

² CEIOPS, October 2005a.

the nature of group supervision. If policyholder protection requires that solo solvency margins are adjusted to take account of the inter-relationships within the group, it strongly suggests that the unadjusted solo solvency margin is not the appropriate solvency control level and therefore not an appropriate requirement of prudential regulation.

2.5 Equally it is possible to question whether the focus on each legal entity within the group is appropriate. Groups are typically organised with one central management administering the entire group so that the lines of effective control are actually simpler than the legal and financial relationships between the companies in the group. Prudential supervision of insurance groups needs to respect this by focussing on the legal entity which has this control and therefore must take responsibility for meeting solvency requirements and managing risks throughout the group.

Benefits for the Single Market

2.6 In addition to the benefits of a reduced administrative burden on insurance groups, there are large potential benefits for the Single Market of a rationalised approach to group solvency which considers the economic substance of the group not just its legal form. It is widely recognised that insurers' capacity to operate across the EU and in third countries is often most readily achieved through a group structure and therefore the extent to which Solvency II can contribute to a more dynamic financial services sector is heavily dependent on the quality of group supervision.

2.7 In this context it is worth recalling that while the rationale for prudential regulation is of course to achieve an appropriately high level of policyholder protection, Member States can also achieve this within their own jurisdictions through requirements additional to those in the existing prudential insurance directives. So while policyholder protection is fundamental to the purpose of Solvency II the primary objective for legislative action at the EU level must be to deepen the Single Market in insurance services.

2.8 Given the actual structure of the EU insurance industry, better regulation of insurance groups is indispensable to this objective. In 2004 the 20 largest insurance groups operating in Europe together had a 50 per cent market share of insurance business. Further, the 10 largest groups in each EU Member State had a market share of 75 per cent on average for general insurance business and 82 per cent for life insurance business³.

2.9 Further, it is notable that many of the EU's leading insurance groups are at the forefront of developing innovative products, new risk management techniques and new ways of diversifying and transferring risk. These companies are also much more likely to be competing in third countries. For all these reasons they are key to strengthening the international competitiveness of the EU insurance industry.

2.10 The development of modern risk management concepts and techniques has progressed rapidly over the past two decades leading to a trend towards enterprise-wide risk management. Just as Solvency II should stimulate further advances in the quality of risk management in solo entities, the new framework should be supportive of the trends

³ Comité Européen des Assurances, 2006

in insurance groups to take a holistic approach to risks across the group⁴; indeed, this is one of the primary benefits of permitting the use of internal models.

Solvency I and II

2.11 The final argument in favour of a fundamental review of group supervision stems from the profound differences between the current Solvency I regime and the new risk-based framework of prudential supervision under Solvency II. These include:

- the introduction of a harmonised definition of technical provisions across the EU;
- the Solvency Capital Requirement within Pillar 1 will be far more risk-sensitive than the current solvency margin and will reflect asset risk;
- the need for additional prudential requirements at Member State level should be reduced to a minimum; and
- Pillar 2 of the new framework will require insurers to perform their own risk and capital assessments and permit a capital add-on to the Pillar 1 SCR.

2.12 These changes both facilitate a consolidated approach to group supervision, which treats the whole group as a discrete economic entity, and at the same time complicate and in some cases even obstruct the traditional approach where group supervision is supplementary to solo.

Solvency II and consolidated supervision

2.13 The current insurance directives are widely perceived as out-dated and in advance of Solvency II a number of Member States have introduced domestic arrangements for prudential regulation of insurance, including the UK. By bringing in a state-of-the-art framework of supervision at EU level Solvency II will dramatically reduce the need for additional Member State level legislation. As a result solvency requirements will be far more harmonised throughout the EU than is currently the case and the level of policyholder protection will be closely aligned between companies in different Member States, including where they are subsidiaries within an insurance group.

2.14 This alignment of solvency capital and hence policyholder protection between subsidiaries of a group which are located in different Member States is a necessary prelude to consolidated supervision i.e. treating the group as a whole as a single economic entity. Without it each national supervisor will treat the subsidiary for which it has responsibility as a solo entity with only the assets within the subsidiary available to meet its solvency requirement. But in a harmonised framework all of the various subsidiaries' policyholders enjoy an equal standard of protection through the common required level of solvency capital and therefore it is possible to envisage their claims as claims on the group as whole⁵.

2.15 A further example of the argument that a harmonised solvency framework is required before consolidated supervision can be introduced is the treatment of technical provisions. They are a core element in determining the total amount of eligible assets which an insurer is obliged to hold and define the threshold of regulatory solvency. With varying standards for technical provisions across the EU, the

⁴ As noted in CEIOPS 2005b, Call for Advice 18, paragraph 18.2

⁵ Of course in the normal run of business the equality in those claims is purely theoretical but in the event of insolvency the question of equal treatment of policyholders in different Member States is a practical one and is discussed further in Chapter 4.

subsidiaries of a group located in different Member States would have different levels of solvency and hence policyholder protection even if the risks in the insurance liabilities were exactly alike. Combined with the prospect of an International Accounting Standard for insurance contracts Solvency II will create a harmonised standard which will be an essential element of the protection which it will provide to policyholders.

2.16 A final example of how the changes which Solvency II will introduce will facilitate consolidated supervision is the treatment of asset risk. Under Solvency I there is no capital requirement relating to asset risk, creating another source of divergence between regulatory capital (or the solvency margin) and the protection being provided to policyholders. Of course through the Pillar 1 Solvency Capital Requirement Solvency II will create a balancing mechanism for the variety of asset risk profiles and as a result a more harmonised level of policyholder protection.

THE COSTS AND BENEFITS OF SOLVENCY II

2.17 The UK Government strongly supports the Solvency II project and it is clear that a broad consensus in favour of the project exists across Member States, supervisors and the EU insurance industry. For the UK Government the benefits of risk-based capital requirements, the application in the insurance sector of the Pillar 2 process first articulated within the Basel II accord and harmonised technical provisions which value insurance liabilities on a market-consistent basis justify the proposal to fundamentally reform prudential regulation of insurance in the EU⁶. But the breadth of support for the project should not be allowed to obscure an objective assessment of the costs and benefits of the policy options within Solvency II and of the project as a whole.

2.18 Like the Capital Requirements Directive (CRD) Solvency II will impose a significant additional administrative burden on insurance companies. This will derive from, inter alia, more complex capital requirements, the Pillar 2 processes and more extensive disclosures to regulators and the market. The FSA has estimated that the imposition of the CRD would bring a one-off implementation cost of approximately €1.5bn for credit institutions and investment firms in the UK alone⁷. Relative to the baseline of the current EU Directive requirements Solvency II, it can be expected to have a similar impact, in proportion to the number, size and complexity of regulated entities.

Compliance costs

2.19 However, unlike CRD, Solvency II is not expected to bring significant reductions in capital requirements, compared with the baseline of the current solvency margins. The FSA estimate of the reduction in regulatory capital for UK institutions due to the CRD is £24 billion or around 15 per cent. Even with conservative assumptions it is clear that the net present value of the benefits flowing from lower required capital exceeds that of the estimated implementation and on-going costs⁸. By contrast it is all but certain that on average across the EU insurance industry Solvency II capital requirements will exceed those of Solvency I; the fact that this is appropriate to achieve the desired level of policyholder protection does not reduce the significant additional policy-related costs for insurers operating in the EU.

⁶ The benefits of these changes and the key issues which have to be resolved in constructing the Solvency II Framework Directive are set out in HM Treasury and Financial Services Authority, February 2006.

⁷ FSA, 2005. The FSA estimates the on-going compliance costs in the UK at approximately €200m per annum.

⁸ For example, in the same document the FSA uses a weighted average capital cost of 3.4% per year to generate an estimated annual impact of expected changes in the level of regulatory capital. On this assumption the expected benefits of a permanent £24 billion reduction in regulatory capital would significantly out-weigh the estimated one-off and implementation costs of the CRD for UK credit institutions and investment firms.

2.20 It follows directly that as long as they do not jeopardise its prudential soundness the Solvency II project should employ all means of minimising the regulatory burden under the new framework. Group supervision is one area where it will be possible to reduce the complexity of the existing supervisory framework and along with it at least some of the costs of the new regulation. In the case of CRD, the FSA noted⁹ that in the UK around 80 per cent of implementation costs would fall on larger credit institutions. To the extent that this is replicated in the case of Solvency II it appears likely that larger insurance companies and insurance groups may bear the greater part of the administration-related compliance costs.

Capital efficiency

2.21 In addition to the potential to reduce the administrative burden, an approach to supervision which enables groups to benefit from diversification between companies within the group and removes unnecessary regulatory barriers to the flow of capital around the group will enable EU insurance groups to allocate capital more efficiently, strengthening their international competitiveness and benefiting policyholders through more capital efficient insurance products.

Chapter summary

- By creating a harmonised valuation of insurance liabilities and a consistent calibration standard for capital requirements, Solvency II will dramatically simplify consolidated supervision of insurance groups
- Because of Solvency II's far greater scope and sophistication compared with Solvency I, retaining the current IGD approach to supervision would yield an unreasonable regulatory burden on insurance groups without contributing to policyholder protection
- By contrast a reformed approach to group supervision is key to a deeper Single Market in insurance services, and a more capital efficient EU insurance sector. Substantial benefits for policyholders can be achieved without reducing the strength of policyholder protection

⁹ FSA, 2005.

GROUP-WIDE DIVERSIFICATION EFFECTS AND GROUP SUPERVISION

3.1 Diversification is fundamental to value creation in the insurance sector and therefore to providing economically efficient protection for policyholders; whether and to what extent diversification effects are recognised is a fundamental decision in constructing the regulatory framework.

3.2 The first half of this chapter argues that acknowledging diversification effects at group level has a major impact on the nature of group supervision. A decision to incorporate diversification effects into group capital requirements is a decision to treat the group as a single economic entity throughout which risks are pooled and diversified. This has profound implications for the application of the solo SCR as a solvency control level for a subsidiary in an insurance group.

3.3 The second part of the chapter discusses the relationship between supervisors which have responsibility for supervising the parent company and the subsidiaries of an insurance group. The decision to reflect group-wide diversification effects in the calculation of group capital requirements raises fundamental questions about the traditional conception of their respective roles.

THE SOLO SCR AS A SOLVENCY CONTROL LEVEL

3.4 In order to allow group diversification effects to be realised at least some of the subsidiaries in the group must hold less eligible capital (i.e. capital that would be eligible if the subsidiary were a solo entity) than their solo SCR¹. CEIOPS has set out two approaches to dealing with this², either through a downwards adjustment to the solo SCR or through an increase in available capital at the solo level through group contingent capital support. The approach we set out below envisages a solo SCR but only as an informational requirement, not as a solvency control level. These two different functions of the SCR need to be distinguished in order to clarify the role of the solo SCR in group supervision.

3.5 The Solvency Capital Requirement plays two distinct roles in the Solvency II framework:

- it is the first of the solvency control levels - it is the key intervention point where the supervisor will take action to protect the interests of policyholders and beneficiaries; and
- it sets the minimum acceptable level of policyholder protection, by defining the magnitude of unexpected losses that the company must be capable of meeting without becoming insolvent³.

The difference between these two functions is not commonly articulated but comparison with the MCR clearly demonstrates the SCR's dual role: the MCR operates

¹ Two different forms of diversification effect are identified in CEIOPS, 2006 (paragraphs 2.16-2.17). In one form diversification effects are said to exist where less eligible capital can be held in a subsidiary than its solo SCR only if there is balancing amount of surplus capital available at group level. This paper uses the second definition of diversification effects where no counterbalancing surplus capital is required at group level (the first definition relates to where capital can be held in a group rather than the total amount which must be held).

²CEIOPS, 2006.

³ The European Commission's Framework for Consultation (European Commission, 2006) explicitly states that Solvency II will be a non-zero failure regime and adopts as a working hypothesis that the 99.5 per cent one year VaR should be used as a calibration standard for the SCR.

only as a solvency control level and does not affect the level of loss which an insurer must be capable of absorbing.

3.6 For a solo entity the level of capital required by the two functions of the SCR is the same. If the SCR is defined as, for example, a 0.5 per cent probability of failure over a one year time horizon then, as long as the supervisor intervenes at the point when eligible capital falls to this level he will know that the solo entity can meet unexpected losses to the standard required by the Directive. However for an insurance group diversification effects mean that the levels of capital required by the solo SCR for each subsidiary are different for the two roles of the SCR.

Two functions of the SCR

3.7 It is straightforward to state the level of the solo SCR for the purpose of setting the minimum acceptable level of policyholder protection. The policyholders of a subsidiary must receive the same protection from the Solvency II framework as those of an equivalent solo insurance company. The group must therefore be capable of providing capital support to meet unexpected losses in any subsidiary up to the level of the solo SCR that an equivalent solo entity would be required to hold. Of course this means that this version of the subsidiary's solo SCR should not reflect diversification effects arising at group level.

3.8 By contrast, any solo SCR applied as a solvency control level would have to take account of group-wide diversification effects. The solvency control level for a subsidiary would therefore be set below the solo SCR which defines the protection provided to policyholders of that subsidiary. Otherwise it would impose on the group a required level of capital far in excess of that required to meet the group-wide SCR. The result is that taking the concept of the SCR from the context of a solo entity and transferring it to the group context involves two separate solo SCRs if the solo SCR is to be used as a solvency control level for subsidiaries in the group.

3.9 CEIOPS⁴ advice to date on this issue helpfully brings out this distinction between the two different functions of the solo SCR, although somewhat different language is used to describe it. CEIOPS has proposed⁵ that either the solo SCR should be reduced to reflect group wide diversification benefits or available capital should be increased at the solo level through group contingent capital support. In the first case there are two solo SCRs, one adjusted for group wide diversification effects and the other unadjusted⁶. In the second case there is a hard solo SCR which must be matched by real eligible capital (i.e. capital that would be eligible if the subsidiary were a solo entity) and a higher solo SCR with group contingent support allowed to meet the incremental capital requirement.

3.10 The second option goes some way to providing a reconciliation of the solo SCR in its two different functions. By allowing eligible capital to include group contingent support of some kind it appears possible to avoid a solo SCR as an explicit solvency control level on the subsidiary. However the solvency control level is still in place, implied by the difference of the solo SCR⁷ less the quantity of group contingent support. This raises the question of whether in appropriate circumstances the solo SCR as a control level may be dispensed with entirely for subsidiaries in an insurance group – as

⁴ The Committee of European Insurance and Occupational Pensions Supervisors.

⁵ CEIOPS 2006, paragraph 2.14

⁶ Although CEIOPS 2006 focuses on the SCR as a solvency control level, the solo SCR prior to adjustment for group-wide diversification effects will still be required – to show size of loss in the subsidiary which the group will be required to meet.

⁷ That is, the solo SCR which sets the minimum acceptable level of policyholder protection for the subsidiary and therefore does not reflect group-wide diversification.

proposed in this paper – allowing fuller freedom to groups in their internal capital allocation decisions.

3.11 However the two SCR functions are presented, if the solo SCR as a control level is retained, it will be driving capital allocation across the subsidiaries in the group. Since the calculation of this form of the solo SCR will be crucial to capital management in insurance groups and therefore the allocation of capital across the sector it is worth considering how it will be made. This is discussed in the next section of the chapter; before addressing that issue, a brief description is provided of how the amounts of capital required by the two functions of the SCR can be reconciled.

Reconciling the two functions of the SCR

3.12 Because of diversification effects across its subsidiaries, a group will have policyholder commitments whose total for all subsidiaries exceeds the total level of required capital in the group but this does not imply that the group is inadequately capitalised on a group or subsidiary basis. Suppose there is a major loss in a particular subsidiary and the group transfers capital into that subsidiary as required by the Directive. In all likelihood this could be achieved through use of available capital held in excess of the group-wide capital requirement either at group level or in other subsidiaries of the group, but if not the group would be obliged to recapitalise in order to meet the losses, the capital requirements at their new level and for business strategic purposes.

3.13 This implies losses for the existing shareholders of the group and possibly wider implications including through the capital markets' valuation of the group's equity and debt and on the group's wider business strategy. The need to raise new capital should not be seen as a risk to policyholder protection; indeed it reflects the effectiveness of solvency regulation in transferring risk from policyholders to shareholders.

THE SOLO SCR CONTROL LEVEL FOR A SUBSIDIARY

3.14 Diversification benefits across the group are a function of the capital requirements and the correlations between the risks in all the subsidiaries in the group. It is possible to devise rules to allocate diversification benefits arising at group level into the subsidiaries, just as in the solo entity context it is possible to allocate company-wide effects down to business lines or risk factors. Two possible rules have been suggested which, if this is needed, allocate diversification benefits either proportionally across all subsidiaries or as a function of each subsidiary's marginal contribution to the group wide capital requirement⁸.

3.15 These rules provide the best available measure of how small changes in the capital requirements of the subsidiary will impact on the group's overall capital requirement; however the fundamental problem of allocation – that it is necessarily arbitrary – will remain in any attempt to apply a group capital requirement at a solo level. The level of the solo SCR becomes a function of the undiversified capital requirements in all the subsidiaries across the group, and the correlations between the risks in the subsidiaries, but these are not relevant to determining the appropriate level of capital at which a supervisor should intervene in any particular subsidiary's activities⁹.

⁸ Groupe Consultatif Actuarial Européen, 2005. The paper notes that the second rule is technically the more sound approach.

⁹ Even in the simplest case of two subsidiaries whose risks are uncorrelated the marginal contribution of each subsidiary to the group's diversified capital requirement is still a function of the other subsidiary's undiversified capital requirements.

Varying solo SCR control levels **3.16** Further, because different groups will have different sizes of diversification effect the implied solo SCR control level will vary between groups. This is at odds with one of the fundamental principles of Solvency II, namely that the calibration standard for solvency control levels (both the SCR and MCR) should be harmonised. Indeed some apparently reasonable rules for allocating diversification benefits imply not only that the calibration of the solvency control standard varies between groups, but that it varies even between subsidiaries within the same group. For example, this situation would result if the rule were that diversification benefits are allocated in proportion to the size of the balance sheet of each subsidiary¹⁰.

3.17 In addition to the lack of a harmonised solvency control level, the fact that any allocation of group-wide diversification benefits is arbitrary with respect to the solo SCR control level creates a co-ordination problem for supervisors who would be obliged to agree the calibration standard for each subsidiary.

Summary 3.18 The fundamental cause of the arbitrary and varying solvency control standard is the attempt to apply a group capital requirement at a solo level. The calibration of the solo SCR becomes arbitrary, differs from the standard applied in the context of a solo entity, differs between groups and even within a group. This does not appear to be an appropriate way to set a solvency control level for subsidiaries within EU insurance groups.

Sub-groups and Pillar 2 capital add-ons

3.19 In general all of the considerations on the problematic nature of a solo SCR control level in a group context flow through to the sub-group level. Indeed applying sub-group and solo level supervision illustrates the problems of the arbitrariness of any sub-group or solo SCR which reflects group-wide diversification. Some diversification effects can be expected to exist at sub-group level which are absent at solo level; as a result a sub-group SCR control level which reflected group wide diversification effects would have an implied calibration standard which is different from that for each of the legal entities within the sub-group.

Pillar 2 capital add-ons 3.20 The co-ordination problem for supervisors created by setting variable solo SCR control level in each subsidiary across a group will also arise if the supervisors of subsidiaries were able to impose a Pillar 2 capital add-on at solo level. If the capital add-on does not add to the total group capital requirement it will lead to a reduction in eligible capital elsewhere in the group – which may well not be acceptable to other supervisors. On the other hand if capital add-ons at solo level do flow through to higher group capital requirements, although one co-ordination problem is tackled another is created: each subsidiary’s supervisor has the power to influence the overall group capital requirement which could create conflicts of interest that would not be acceptable in the Solvency II framework.

Summary There are major technical obstacles to setting a solo SCR control level which is not arbitrary, is calibrated to a consistent standard across EU groups, achieves a meaningful level of solvency control above the MCR and does not create incentives for firms to arbitrage the requirement, nor for supervisors to unreasonably tie up capital in the subsidiaries for which they have responsibility.

¹⁰ Variation between subsidiaries could be avoided if the rule for allocating diversification benefits is that the solo SCR is adjusted to equalise the calibration standard e.g. by finding the implied value of the confidence level for a one year VaR across all the subsidiaries.

3.21 These obstacles are sufficient to provide a strong case for the approach proposed in Chapter 4 – that the SCR should not be applied as a solvency control level to the subsidiaries of an insurance group. Before discussing the proposal in detail the next section of this Chapter deals in a general way with the issue of supervisory responsibilities and powers which is the counterpart to the allocation of the various financial requirements between the group and other supervisors.

GROUP-WIDE SUPERVISION

3.22 Chapter 2 noted the complexity of the operation of the Insurance Groups Directive (IGD) and the modest progress in developing a consistent approach to group supervision across the EU. Under Solvency I there are two concepts of supervision: solo supervision under the Non-life, Life Insurance and Reinsurance Directives and supplementary supervision under the IGD. These concepts will be problematic to apply to insurance groups under Solvency II and especially so if it recognises group-wide diversification effects.

3.23 Solvency II will apply risk-based capital requirements and the necessary complement to any such requirement is an assessment of how well it matches the risk profile of the insurer, whether it is a group or solo entity. This is one of the clearest findings of the research work conducted at the beginning of the Solvency II project, that while an appropriate level of solvency is required for policyholder protection, the quality of the insurer's risk management and internal controls are potentially even more important¹¹. If this is accepted it makes little sense to apply risk-based capital requirements without the complementary risk and capital assessment.

3.24 The processes envisaged under Pillar 2 of the framework of each insurer conducting an own-assessment of its risk profile and capital needs and of supervisory review including the possibility of a capital add-on are all significant regulatory burdens on the firm. They can be fully justified from a better regulation perspective as long as they are necessary to policyholder protection. However, with effective supervisory co-operation in place, it will not be necessary to apply them separately at solo and group level. Doing so will not achieve incrementally stronger protection for policyholders and is certain to increase regulatory costs for firms.

Key elements of Group-wide supervision

3.25 The solo and supplementary conceptions of supervision do not fit into a risk-based model of supervision where the risks to policyholders in each subsidiary are inextricably linked with the financial strength of the rest of the group and where the subsidiary relies on capital support from elsewhere in the group because of diversification effects between subsidiaries. A conception of supervision is required which is not focussed on a solo entity exclusively, nor on a simple consolidated group basis. Supervision should be group-wide in the following sense:

- group-wide capital requirements should reflect the consolidated position of the group, in particular diversification effects between subsidiaries;
- there should be a single group wide set of Pillar 2 processes applying to the group including both the risk profile across the group on a consolidated basis, and also the risk profile of each subsidiary;
- there should not be additional supervision at solo level of the solo SCR, nor a Pillar 2 at solo level; and

¹¹ Sharma, 2002.

- group-wide supervision should be conducted jointly by the group supervisor and the supervisors of the subsidiaries and their responsibilities and powers allocated accordingly.

3.26 This conception of group supervision is the complement to the widely recognised industry trend towards enterprise-wide risk and capital management. The link between the two would come primarily through the insurer's own assessment of its risk profile and capital needs which the group would be required to perform on the group as a whole and on its subsidiaries.

Principles for supervisory co-operation

3.27 The corollary of a group-wide approach to supervision is the need for much stronger supervisory co-operation; indeed any system of group supervision which allows diversification benefits between subsidiaries and therefore less (real) eligible capital in at least some of them clearly necessitates stronger co-operation. This requires appropriate information flow between supervisors and sharing, not duplication, of responsibilities and powers between the supervisors. Duplication should also be avoided in the process of assessing risk and capital across the group. This leads to six general principles of supervisory co-operation for Solvency II:

- for each insurance group a lead supervisor should be appointed who is responsible for co-ordinating the supervision of the group jointly with the supervisors of the subsidiaries;
- the Pillar 2 risk and capital assessment should be a single consistent process analysing risk and capital in each subsidiary as well as group-wide;
- the supervisory powers and tools available under Solvency II should be shared, not duplicated between supervisors;
- wherever the Directive imposes a specific responsibility on a supervisor it must provide the commensurate power;
- each supervisor is entitled to the information necessary to the exercise of its powers;
- each supervisor is under an obligation to transmit information necessary to the exercise of another supervisor's powers.

3.28 The next chapter describes how these principles can be applied to the supervision of insurance groups under Solvency II.

Chapter summary

- Any solo SCR control level for insurance subsidiaries which reflects diversification effects arising at group level will be arbitrary
- Solvency II should not impose arbitrary solvency control levels which vary between groups, or within a group, and which reflect different implied calibration standards
- Effective supervisory co-operation is key for any risk-based prudential framework, especially given that the group SCR will be below the sum of the subsidiaries' SCRs
- Pillar 2 for an insurance group should be consolidated into a single process at group level; the principle for co-ordination between supervisors should follow Article 129 of the Capital Requirements Directive

4

A PROPOSAL FOR GROUP SUPERVISION UNDER SOLVENCY II

4.1 This chapter sets out a proposal for the structure of group supervision under Solvency II. The challenge of constructing a framework for group supervision can be summarised as finding the right balance between one view of an insurance group as a single economic entity within which risks are pooled and diversified and a contrasting view which focuses on the separate legal status of the companies within the group. This chapter aims to find that balance:

- **within the Pillar 1 requirements** it distinguishes elements such as technical provisions (which relate to the current financial position) from the SCR which relates to risks to that position; and
- **within Pillar 2 and in the allocation of supervisory powers and responsibilities** it employs the concepts of Article 129 of the Capital Requirements Directive and distinguishes elements specific to each legal entity from elements of risk and capital assessment which are group-wide.

4.2 The first two sections of this chapter explain the proposal and elaborate on these points. The benefits of the proposal are summarised and a number of other specific areas including third country issues, partial modelling, and how insolvency should be handled are discussed.

Pillar 1 requirements

4.3 The group will be required to hold eligible assets and capital of sufficient quality in each of its subsidiaries equal to the sum of the technical provisions and the solo MCR. Because the valuation of insurance liabilities is independent of where they are located within a group and of the group's overall risk profile, it is appropriate that assets equal to technical provisions should be held in each subsidiary. A comparable argument applies to the MCR in that it is not intended as a fully risk-based capital requirement.

4.4 Because the risk-based capital requirement for the group is a function of balance sheets of all the subsidiaries in the group, the SCR should be imposed at group level and not in each subsidiary. The group will be required to meet the group-wide SCR by holding eligible capital equal to the difference of the group-wide SCR and the sum of the subsidiaries' MCRs somewhere within the group. The allocation of this capital is for the group to decide subject to appropriate conditions on transferability of capital.

4.5 The group SCR defines the solvency control level for the group and should equal the solvency standard for a solo entity so that there is (e.g.) a 1 in 200 probability over a one-year horizon of the group as a whole falling insolvent. The sum of the subsidiaries' MCRs should provide a floor to the group-wide SCR. The calibration of the MCR should be set to ensure that this requirement does not prevent the group from benefiting from the diversification effects.

4.6 The SCR should not be set as a solvency control level in each subsidiary but the calculation of the solo SCR as if the subsidiary were an equivalent solo entity is an informational requirement on the group: the value needs to be known so that in the event of a loss in a subsidiary which renders it insolvent the group's obligation to policyholders is known.

Transferability of capital 4.7 The group must be able to meet a significant unexpected loss in any subsidiary in a timely manner; if capital falls below the MCR in any subsidiary the group must remedy this very rapidly or, if it were to wind up the subsidiary, it must meet unexpected losses up to the standard defined by the solo SCR for that entity on a solo-equivalent basis. As a result the group must be able to transfer capital into any subsidiary equal to the difference of the solo SCR and the amount of capital available in the subsidiary. The harmonisation of the prudential regulations in Solvency II should reduce the level of regulatory restrictions that may currently prevent the transferability of capital.

Group contingent support 4.8 As discussed further in the section below on insolvency, because eligible capital may be below the solo SCR in any given subsidiary, any proposal that allows group-wide diversification effects to be recognised requires procedures to guide supervisors in the event that a subsidiary within the group is wound up. However, because the solo SCR is not applied as a control level in each subsidiary it is not necessary to define a form of eligible capital such as ‘group contingent support’ which makes up the difference between the solo SCR as a control level and the solo SCR which reflects the group’s commitment to policyholders.

4.9 Although clearly feasible, it seems likely that the structure of the contingent support could well be legally complex and therefore a potential significant administrative burden for EU groups. In the end protection for policyholders of any subsidiary in the group relies on the capacity of the real eligible capital available in the group to absorb losses and the group’s capacity to raise new capital¹.

4.10 The concern that a group parent may be capable but unwilling to transfer capital support to a subsidiary can be dealt with more simply, and directly, by a requirement on the group to transfer capital and a requirement on the group supervisor to ensure that the group parent complies in a timely way. The key points of how this could work are set out in the section on insolvency below.

Estimating the group-wide SCR 4.11 In general there will be clear benefits to an insurance group from using an internal model to estimate its group-wide SCR, just as there will be for solo entities. However groups should have the option to use partial models and the standardised approach to the SCR. Partial models may be justified in a number of cases, for example, where a particular business within the group is small relative to the group as a whole; in that case the standardised SCR should be used for that business. Similarly a group may have the objective of constructing an internal model over time but have reached a stage where only some categories of risk are modelled.

4.12 In cases where a firm uses a partial model or the standardised SCR to estimate its group-wide SCR it should be allowed to benefit from diversification effects between its subsidiaries, however there should be a test to assess whether the magnitude of diversification effects is appropriate. By contrast a full internal model must reflect the impact of assumptions about the correlation of risks across the whole group so that if the internal model is approved in effect the estimate of diversification effects between subsidiaries is as well. (Of course the internal model might need adjustments prior to approval but no separate test of diversification benefits should be required).

4.13 It’s clear that it will be difficult to assess diversification effects between subsidiaries where the group uses a partial model or the standardised approach. In this

¹ Of course in addition to the contribution to policyholder protection provided by solvency capital there are other vital elements which will contribute including the effectiveness of the risk management of the group and its subsidiaries and the robustness of the group’s systems and controls.

case it would be reasonable to be cautious in their attribution not least because this provides the right incentive for the group – to progress the development of a full internal model. The only viable benchmark for groups using a partial model or the standardised SCR will be the range of diversification effects found for groups using a full internal model.

Model approval and Article 129 of CRD

4.14 It is to be expected that many EU insurance groups will want to use internal models to estimate their group-wide SCR. Solvency II will need to allow this just as it will allow a solo entity insurer to use an internal model. Article 129 of the Capital Requirements Directive² provides clear procedures which Solvency II can follow.

4.15 The key paragraphs from Article 129 are:

The competent authorities shall do everything within their power to reach a joint decision on the application within six months. This joint decision shall be set out in a document containing the fully reasoned decision which shall be provided to the applicant by the competent authority referred to in paragraph 1³.

and

In the absence of a joint decision between the competent authorities within six months, the competent authority referred to in paragraph 1 shall make its own decision on the application. The decision shall be set out in a document containing the fully reasoned decision and shall take into account the views and reservations of the other competent authorities expressed during the six months period. The decision shall be provided to the applicant and the other competent authorities by the competent authority referred to in paragraph 1.

Supervisory review process

4.16 The general principle expressed in these paragraphs, that all supervisors of the legal entities within an insurance group should endeavour to agree on key issues relating to the risk and capital assessment of the group, should be applied to the conduct of the group-wide Pillar 2. In particular, supervisors of subsidiaries should agree with the group supervisor on:

- whether the group should set up a full or partial model for the group as a whole or for some part of the group⁴;
- the validity of the solo SCR generated by the internal model for the particular subsidiary (which is used to estimate the group's commitment to the subsidiary's policyholders);
- whether the internal model accurately reflects the risk profile of the particular subsidiary;
- appropriate stress and scenario tests to assess the risk to the particular subsidiary; and

² Strictly, Article 129 of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast).

³ That is, "the competent authority responsible for the exercise of supervision on a consolidated basis of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies."

⁴ For example, where a group is already using an internal model and then acquires an insurance business which at the time of acquisition is using the standardised approach to the SCR.

- the quality of risk management and internal controls in each subsidiary and remedies necessary to rectify any inadequacies.

4.17 This not intended to be an exhaustive list but only to bring out the key areas where supervisors should co-operate along CRD Article 129 lines to conduct internal model validation and more widely the Pillar 2 supervisory review process.

Responsibilities and powers of the supervisor of an insurance subsidiary

4.18 As noted in Chapter 3 Solvency II should allocate the powers and responsibilities available to supervisors between the group supervisor and the supervisors of the group's subsidiaries without duplicating them. In addition to its full participation in the group-wide Pillar 2 processes as described in the preceding section, the supervisor of an insurance subsidiary will have the following powers and responsibilities:

1. its own assessment that eligible assets and capital of sufficient quality are held by the subsidiary equal to technical provisions plus the MCR;
2. all the powers available to a supervisor in the event of MCR breach;
3. its own assessment of the governance system, of the fitness and propriety of the subsidiary's directors, of the appropriateness of the subsidiary's market conduct and adequacy of related internal controls; and
4. general powers which the supervisor has under the Solvency II Directive and its own national legislation including to apply appropriate remedies for inadequacies in all the areas specified in 3.

Information exchange In addition to these powers the supervisor of a subsidiary would be entitled to key information from the group-wide Pillar 2 process to ensure that the policyholders are protected:

5. information on the risk profile and solvency of the subsidiary, including the results of stress and scenario tests specific to the subsidiary;
6. information on the risk profile and solvency of the group as a whole, in particular that the group meets is group-wide SCR; and
7. knowledge of the level of the solo SCR which defines the magnitude of unexpected losses calibrated to the standard required by the Directive for an equivalent solo entity.

Finally, the supervisor of a subsidiary would be able to rely on key requirements in the Framework Directive that:

8. the group transfer capital into the subsidiary to meet losses up to the standard stated in 7; and
9. the group supervisor impose sanctions, including by using all the powers available to the group supervisor if the parent company were in breach of its MCR, if the group fails to comply without delay.

Group supervisor's powers **4.19** The powers and responsibilities of the group supervisor would include those listed at 1. to 4. but with respect to the group parent. In addition, the group supervisor would have the responsibilities to monitor the group's compliance with the group SCR

and the key requirements in 8. and 9. The group supervisor would also be responsible for leading the model approval and group-wide supervisory review processes. As a result it would also be for the group supervisor to decide whether a Pillar 2 capital add-on was required at group level. Of course the principle that agreement should be achieved with all the relevant supervisors should be followed, subject to the time limit after which the group supervisor reaches a decision.

Key benefits of the proposal

4.20 The remainder of this Chapter considers the other key issues raised by group supervision which will have to be treated in the Solvency II Framework Directive, namely third country issues and co-operation between supervisors in the event of insolvency. Before addressing those issues, the key benefits of the proposal are summarised in the box below.

Key benefits of the proposal

1. It contributes to a deeper Single Market in insurance and more efficient allocation of capital across the EU insurance sector through:

- allowing groups to get the full regulatory capital benefit of diversification across their subsidiaries; and
- allowing groups freedom to allocate capital across subsidiaries to best meet their business needs.

2. It reduces the regulatory burden of group supervision by:

- imposing the SCR and Pillar 2 capital add-on at group level only, avoiding an arbitrary and varying solo SCR control level;
- consolidating Pillar 2 into one coherent group-wide process, avoiding duplicated effort through parallel supervision at solo and group level; and
- avoiding complex legal arrangements to provide notional capital in the form of 'group contingent support' at subsidiary level.

3. It secures policyholder protection by:

- allocating the Pillar 1 financial requirements appropriately, with technical provisions and the MCR held at subsidiary level and the SCR at group level;
- clearly specifying the group's commitment to each subsidiary's policyholders and ensuring that this commitment is met; and
- encouraging stronger co-operation and better information exchange between supervisors while balancing their responsibilities and powers.

Third country groups and EEA groups operating in third countries

4.21 Groups whose parent is located in a third country should be able to provide insurance services in the EEA provided that their EEA subsidiaries meet the requirements imposed by Solvency II. The test of whether Solvency II's requirements are met can be applied by means of an EEA supervisor regulating the third country

group's EEA subsidiaries under the Solvency II framework or by the EEA recognising the solvency regime of the third country where the parent is located as equivalent to Solvency II.

**The
equivalency
test**

4.22 There are many benefits of recognising a third country's solvency regime as equivalent to Solvency II if the regime provides a comparable high standard of policyholder protection. Above all, EU consumers will benefit from a more competitive and dynamic insurance market. Further, there are potential benefits to the EU industry; it seems reasonable that if a third country regime is equivalent to Solvency II the converse is also true. Recognition of equivalency may help facilitate access to for EEA groups to the relevant third country markets. Finally, a determination of equivalency can help reduce the supervisory burden.

4.23 The EIOPC⁵ should make the final decision on whether a third country solvency regime is equivalent to Solvency II. CEIOPS will play a key role in the decision by providing technical advice to the European Commission on the basis of which the Commission would make a recommendation to the EIOPC. Finding a solvency regime to be equivalent to Solvency II is just as fundamental a decision as agreeing the level one Framework Directive for Solvency II itself. It is therefore appropriate that such a decision should remain at the level of the Member States through their EIOPC representatives.

4.24 A decision finding a third country regime equivalent to Solvency II should be binding across the EEA otherwise its benefits are significantly diluted. Further if the EIOPC fails to agree that a regime is equivalent this should not imply that it has expressed the view that the regime is not equivalent. The Financial Conglomerates Directive⁶ provides for procedures to supervise companies whose parent undertaking is located in a third country where the supervisory regime has not been found equivalent.

**Defining
equivalency**

4.25 Two very general points about equivalency should be noted; first given their complexity there are bound to be material differences between any two given risk-based solvency regimes. The relevant test of equivalency is not whether particular elements of each regime are similar but whether the regimes achieve comparable standards of policyholder protection overall. The second general point is that the temptation should be avoided of focussing too much attention on equality in particular values in the quantitative requirements of any two solvency regimes. Equivalency should not require that the calibration of capital requirements in a third country regime is identical to the calibration in Solvency II. For example, different risk measures, confidence levels and time horizons can achieve a comparably high standard of policyholder protection. Finally, the test of materiality should be applied throughout the equivalency assessment.

**Third country
groups**

4.26 Where an insurance group parent which is located in a third country has subsidiaries in the EEA, subject to appropriate conditions, it should be allowed to benefit from diversification effects across the subsidiaries of the EEA sub-group. This is simply the proposition that the Solvency II Directive should apply the same treatment to groups irrespective of whether their parent is located in the EEA or a third country.

4.27 In general the conditions for allowing a third country group to benefit from diversification effects across its EEA sub-group will be the same as those for an EEA

⁵ The European Insurance and Occupational Pensions Committee.

⁶ Directive 2002/87/EC, 2002

group. However the test of whether risk and capital are being managed in an integrated way across the group will need to be considered at the EEA sub-group level. In general this assessment should be light-touch in nature where the third country insurer's home solvency regime is equivalent to that of Solvency II.

4.28 Where an EEA group has a subsidiary operating in a third country the issue arises of how Solvency II will be applied to the group as a whole. If the third country regime is equivalent then it should follow that its operations will not be permitted to present risks to the group as whole and hence to EEA policyholders as capital should be transferable from that third country to meet obligations elsewhere in the group. If the regime is not equivalent the EEA supervisors will have to co-operate to ensure that any such risks are mitigated. This is not the same as requiring that de facto Solvency II requirements are imposed on the business written in the third country subsidiary. For example, the commitments to policyholders in third country subsidiaries in the event of insolvency must be defined by the third country regime, not by Solvency II. The materiality test should be applied to the assessment of risks deriving from the third country subsidiaries.

Insolvency of a group or one of its subsidiaries

4.29 The proposal advanced in this paper envisages that a group will be able to move capital freely between its subsidiaries as long as eligible capital is held by each subsidiary up to the level of its MCR. Because capital may be below the solo SCR in any given subsidiary, procedures have to be developed to guide supervisors in the event that a subsidiary within the group or even the group as a whole is wound up. This problem is common to all proposals on group supervision which permit groups to benefit from group-wide diversification effects.

4.30 The simpler case occurs where a subsidiary or several subsidiaries of the group becomes insolvent. Assuming these insolvencies do not render the group as a whole insolvent, the group is required to meet its commitments to policyholders in each subsidiary as defined by the Directive for an equivalent solo entity. In practice both the supervisor of each subsidiary and the group supervisor will have information on the solo SCR for each subsidiary and will use this to determine the quantity of assets that must be transferred.

4.31 The decision to run off or wind up an insurance business will clearly remain with the local supervisor and the courts in the relevant Member State, and there will be an obligation on the group supervisor to ensure that assets are transferred into it in a timely way. In order to ensure that the group supervisor can implement sufficiently strong sanctions in the event that the group parent fails to transfer assets in a timely way, it should have all the powers available to it that it would have if the parent itself were in breach of its MCR. This is the appropriate counterbalance to the freedom permitted to the group to deploy capital as it sees fit, subject to meeting the MCR in its subsidiaries: the group and its supervisor are obliged to treat insolvency in any part of the group just as seriously as insolvency of the group as a whole.

4.32 If a group as a whole becomes insolvent and is run off or wound up there are likely to be losses for policyholders, just as there are if a solo entity becomes insolvent. There is a self-evident principle that should guide the allocation of assets across the policyholders of all of the group's subsidiaries: that they have equally valid claims in proportion to their outstanding entitlement. It follows that in the event of group insolvency assets should be allocated to the subsidiaries in order to meet the technical provisions in each; if assets are insufficient to achieve this they should be allocated so

that the ratio of assets to technical provisions is the same in each subsidiary. The group supervisor should be required to arrange this distribution of assets when it reaches the decision that the group parent should be run off or wound up.

Insurance Guarantee Schemes **4.33** The treatment of insolvency in a subsidiary of an insurance group or the group as a whole provide the key elements needed to protect Member States' Insurance Guarantee Schemes from disproportionate risk from the subsidiary of an insurance group whose parent is located in another Member State.

4.34 As a separate legal entity requiring its own authorisation, a subsidiary of an insurance group will in general be required to contribute to any Guarantee Scheme operated in the Member States where it is located. It is for Member States to determine the terms of these contributions but clearly it is possible for them to be arranged so that a subsidiary makes the same contribution as an equivalent solo entity. Given the guarantee that in the event of the subsidiary's insolvency the group must meet commitments to the policyholders to the standard required by the Directive for an equivalent solo entity, the subsidiary should not present a greater risk to any Guarantee Scheme.

Chapter summary

- The proposals advanced in this chapter aim to strike the right balance between an approach based on treating the group as a single economic entity across and on treating the group as a set of separate legal entities;
- The proposals envisage complementary, not duplicated, responsibilities and powers for the supervisors of a group parent and its subsidiaries. Along with a consolidated supervisory review process this is essential to prevent a significant increase in the regulatory burden on insurance groups;
- Solvency II should aim to for a level playing field in prudential standards and decisions on the equivalence of a third country's solvency regime should be made by the EIOPC. Third country groups, in particular their EEA sub-groups, should benefit from diversification effects;
- EU groups must ensure that protection of their policyholders in the EU is not jeopardised by third country operations but if de facto Solvency II is applied to EU groups operating in third countries their competitiveness will be undermined;
- The problems created by insolvency of an insurance subsidiary or a whole group are common to any proposal which recognises group-wide diversification benefits, and not specific to this proposal.

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