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WORKING DOCUMENT

on Insurance and Reinsurance (Solvency II): on Group Supervision, MCR and Own Funds

Committee on Economic and Monetary Affairs

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I) Introduction

The present solvency framework for insurance and reinsurance undertakings, Solvency I, needs updating due to its rules based approach, creating a wide range of possibilities for different national rules and thus presenting an obstacle for a fully functioning internal market. It has therefore **failed to provide a level playing field** for companies and to ensure a similar level of protection for policy holders and beneficiaries, whilst preserving national discretions.

The new solvency framework, as outlined in the proposal for a Directive ("draft Directive") on the taking up and pursuit of the business of Insurance and Reinsurance (COM(2007)361), also called Solvency II, is introducing a **risk sensitive approach** with incentives for risk management, leading to a better allocation of capital, taking into account market-consistent valuation of assets and liabilities (with a view to developing a "fair value" concept) in accordance with the international accounting standards (IAS) and with timely calculations and more transparency.

Whilst Solvency II should be a Directive that deals with foreseen and potential problems, and should ultimately protect the consumer, it has been noted that consumers in the current draft Directive have been treated in an aggregate form.

Since there were several legal problems concerning the re-cast and codification part of the draft Directive, which was originally published by the European Commission in July 2007, the second version of the proposal will be submitted to the Parliament and the Council at the beginning of March 2008.[1]

The **timetable** for the presentation of the draft report in the Economic and Monetary Affairs Committee has therefore shifted a bit and the draft report will now be presented by the Rapporteur on 1 April instead of 26 February 2008.

This working document[2] has been drafted for the purpose of the **third exchange of views and focuses** on two Solvency II subjects, solutions to which are still under discussion: group supervision including group support mechanism and on Minimum Capital Requirement (MCR) with the fourth Quantitative Impact Study (QIS 4). In addition, the working document aims to clarify terminology related to own funds and eligible capital as used in the draft Directive as well as market risk modules in the calculations of SCR.

II) Group supervision and group support mechanism

a) Purpose and scope

Supervision at the level of a group of insurance and reinsurance undertakings (i.e. Group supervision), the main objective of which is to avoid the double use of eligible own funds (i.e. double gearing of capital), applies at the level of the **ultimate** (re)insurance undertaking or

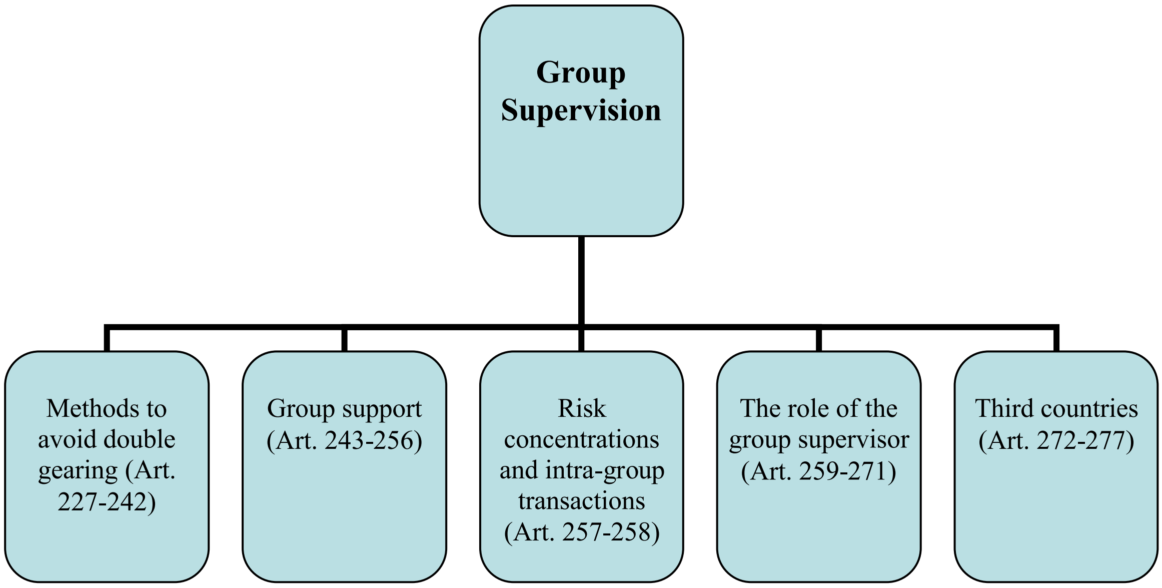
[1] In this working document the numbering of articles refers to the current version of the draft Directive and may change in the revised proposal.

[2] This is the second working document on the subject. For further general information on Solvency II, please refer to the ECON first working document: "Working Document on Insurance and Reinsurance - Solvency II" (PE 394.207) of 27.09.2007.

insurance holding company, which has its head office in the EU.

Where the (re)insurance undertaking is a participation of a (re)insurance undertaking or insurance holding company with its head office outside the EU, other rules apply (see also "Third country").

Member States may allow their supervisory authorities to decide to apply group supervision to **subgroups** at the national level or covering several Member States. The Commission **may** adopt implementing measures specifying the circumstances under which such a decision can be made.



b) Groups: branches or subsidiaries

In the EU single market, insurance undertakings can operate across the Member States either by setting up branches or by setting up or acquiring a legally separate subsidiary in another Member State(s). Therefore the following two possible legal structures:

- ***Branch network*** – an undertaking based in one Member State sets up branches in other Member States and makes sales through these branches. The company is one single legal entity – i.e. the branches are not separate legal entities.
- ***Subsidiary structure*** - an undertaking based in one Member State (the parent undertaking) sets up or acquires subsidiary companies in other Member States. These subsidiaries are separate legal entities, which form part of a group structure under the parent undertaking.

From an economic point of view the two legal structures are similar, in particular when subsidiaries are wholly owned by the parent undertaking.

In the case of a branch structure the role of the local supervisor is limited to oversight of the day-to-day business of that branch, which includes if necessary rights to information and intervention (e.g. infringements of national law). There are some rights to information for the local supervisors in relation to the branch but there is no control over the branch, since prudential supervision remains a function of the supervisor of the parent undertaking.

This situation is completely different in the case of a subsidiary; because the subsidiary is a legal entity in its own right and therefore the supervisor has all the same powers over the subsidiary that it would have over a stand-alone insurance undertaking (i.e. which is not part of a group).

By introducing a possibility of the application of group support mechanism in case of the subsidiary structure, the draft Directive is giving the subsidiary structure a more equal footing with branch network as regard to financial requirements, with **Group's solvency requirements based on risk** rather than on its legal structure. It thus also changes the role of the Group's and local supervisor and the ways how they should cooperate when assessing Group's and subsidiaries' solvency.

c) Group and local supervisor

The "**group supervisor**" is responsible for coordination and exercise of group supervision and is automatically selected according to a procedure set out in the draft Directive. The choice depends on the exact structure of the insurance group in question. Deviations are possible and supervisors concerned may challenge the selection.

A "**local supervisor**" is prudential supervisor of any subsidiary (or branch) of the group which is located in a Member State other than the Member State where the group has its head office. The term is not defined in the draft Directive specifically.

The exchange of information between all supervisors overseeing a certain insurance group is limited to a) on request: all relevant information; b) on their own initiative: all essential information. Supervisors must consult each other on changes in shareholders, organisational and management structures, major sanctions, capital add-ons and limitations to the use of an internal model.

d) Methods of calculation

The group solvency (defined as the difference between eligible own funds and SCR (Solvency Capital Requirement) can be **calculated in 3 ways**:

1. Accounting consolidation-based method (Method 1), where eligible own funds and consolidated SCR are based on consolidated accounts;
2. Deduction and aggregation method (Method 2), where the SCR is the sum of the SCR's of all group companies;
3. A combination of methods 1 and 2, where the exclusive application of method 1 would not be appropriate.

If supervisors do not decide differently, Method 1 has to be applied. Method 2 does not provide diversification benefits to groups. The methods itself are based on the existing legislation (Solvency I).

The consolidated SCR (Method 1) and the SCR's of group companies (Method 2) may be calculated either by the standard formula or by an approved (partial) internal model. Capital add-ons are possible where the risk profile of the group is not adequately reflected in the standard formula or (partial) internal model.

In case the group wants to use a (partial) **internal model** to calculate the consolidated group SCR, the supervisory authorities concerned shall cooperate to decide whether or not to grant permission. A joint decision should be reached within 6 months. In the absence of a joint decision within this period, the group supervisor makes its own decision. CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) may be consulted at the request of the group or any of the concerned supervisors, which extends the period by 2 months.

e) Third country

Where the **solo solvency regime** of a third-country is at least equivalent to that of the EU, the group solvency calculation shall take into account, as regards that third-country (re)insurance subsidiaries, the SCR and eligible own funds as laid down by this third country. The group supervisor shall carry out the verification of equivalence and shall consult the other supervisors concerned and CEIOPS before taking a decision. The Commission **shall** decide whether the third country solvency regime is equivalent.

Where the (re)insurance undertaking is a participation of a (re)insurance undertaking or insurance holding company with its head office outside the EU, the group supervisor will verify whether **group supervision** by this third country is equivalent and will consult the other supervisors concerned and CEIOPS before taking a decision. The Commission **may** decide whether the third country group supervision regime is equivalent.

In the absence of equivalence of group supervision, the EU regime will apply. However, group support will not be possible to be provided. The draft Directive is silent as to what happens with an application for group support if it was to be established that such equivalence existed.

f) Group support mechanism

The parent undertaking may provide "group support" to a (re)insurance subsidiary (including *not*-wholly-owned subsidiaries[3]) to the amount of the difference between the solo SCR and the MCR. This group support takes the form of a declaration from the parent to the group supervisor in which the parent guarantees that eligible own funds will be transferred to the subsidiary where and when necessary. The declaration has to be disclosed publicly. A joint

[3] Directive 83/349/EEC requires a group to produce consolidated accounts. It applies to groups of companies in general and not only to insurance groups. It thus supplies the core definition of a parent and a subsidiary in the EU. Art. 1 of Directive 83/349/EEC states "The key point is that a company is a subsidiary if another company (the parent) owns it or can control it and that includes cases where there is no complete control but only a dominant influence." In a similar manner, the draft Solvency II Directive defines as subsidiaries also those undertakings where the parent effectively exercises a dominant influence.

decision from the supervisors concerned whether or not to grant permission should be made within 6 months. This decision may include any further terms and conditions to which permission should be subject to. No role for CEIOPS is foreseen. The role of the subsidiary's supervisor is then limited to monitoring, not enforcing of the SCR. Nonetheless, and although the declaration is made to the group supervisor, the subsidiary's supervisor may request the capital transfer.

Where a transfer of capital is requested by the subsidiary's supervisor (and the group supervisor is informed), the transfer shall occur rapidly. In case of a parent (re)insurance undertaking fails to cooperate, its licence may be withdrawn. This is however not applicable in the case of a holding company. The intervening powers in case of a holding company not willing to transfer capital seem to be very limited if not non-existent, as the holding is not subject to supervision as such.

The total amount of group support declarations may and can be higher than the amount of eligible own funds available for transfer. In case several requests for capital transfer were made at the same time, reduction of the amounts would be made on a pro rata basis.

The rules on group support shall according to the draft Directive be **reviewed after 5 years.** The report on the review is foreseen to be submitted **only to the level 2 committee** (EIOPC - European Insurance and Occupational Pensions Committee).

g) Ladder of intervention

Gradual stages of procedural intervention by supervisors at the local or group level is known as the "ladder of intervention". The intervention could be qualitative or quantitative depending on the agreed processes within CEIOPS. Although the ladder of intervention is mentioned in the current draft Directive, it is vital that a working definition is established at Level 1, especially in the context of group support mechanism and when defining the level of support during any breach of the MCR.

III) Design and Calibration of MCR and QIS4

a) What is the function of the MCR?

The MCR represents a level of capital below which the insurer cannot guarantee the payments of obligations when they fall due and the supervisory authority withdraws authorisation from the insurance undertaking in question.

b) How is MCR defined in the current draft Directive?

The draft Directive defines the MCR (Art. 126) and sets out 4 characteristics, which MCR needs to satisfy: simplicity and ability of audit, safety net against unacceptable risk for policy holders, calibration and the absolute floor. It also prescribes for the MCR to be calculated and reported to the supervisory authorities on a quarterly basis. The draft Directive does not however outline which approach should be used for the calculation - it does not define design of the MCR formula nor its calibration. There is also no provision as of yet on whether the MCR should be dependent or independent of the SCR calculation.

c) What is QIS 4?

It is the fourth quantitative impact study CEIOPS will undertake in the framework of Solvency II. This one will focus on testing the linear approach for calculation of the MCR since the first approach tested in the QIS3 (modular approach) has not proven in the appropriate relation to the SCR calculations for life insurance companies. It will among others also test solvency capital calculations for group, partial internal models as well as use of hybrid instruments as eligible capital.

d) What are the different approaches to MCR design?

Modular approach: MCR as aggregate of capital charges for different risks a company is exposed to. They are calculated in a simpler manner than it is the case for the SCR. Modular approach was tested in QIS3.

Compact approach: MCR as percentage of SCR, as proposed by the CEA (European Insurance Association). It is simple, but fails to achieve the criteria of independent calculation of MCR, although it has not been proven that such independence is necessary to satisfy all the criteria defined in the current draft Directive.

Linear approach: MCR as fixed percentage of insurers' technical provisions. It is somewhere in between the two approaches described above. However, because it is not risk sensitive, it may not be in line with the risk-based economic approach of the Directive. It will be tested as part of QIS4 exercise.

e) What are pros and cons of different approaches?

1 (min)-3 (max) points	**Compact**	**Modular**	**Linear**
Simplicity	3	1	2
Quarterly calculations	2	2	3
Risk sensitive	3	2	1
In balance with SCR	3	2	1
Independent calculation	1	3	3

<u>IV) Own funds and Eligible Capital</u>

a) What is meant by own funds or own capital?

The term own funds is referring to the technical term of own capital in accounting. There the term is used to describe the amount of capital that remains in a company after the liabilities stated in the company's balance sheet have been deducted from the assets stated in the balance sheet. Own capital does not necessarily mean liquid funds, though they can be a part of it.

Due to different accounting rules there are national difference of what items are regarded as own capital in various Member States. There is no Europe-wide accepted definition of own capital.

b) Own funds

The draft Directive does not give any legal definition of the term. It only describes own funds as:

- **basic own funds**, further described as the excess of assets over liabilities and subordinated liabilities and,
- **ancillary own funds**, further described as items other own funds that can be called up to cover losses;

Own funds are classified into **3 tiers** according to 5 criteria. The tiers refer to the quality of capital to absorb losses of the company. Basic own funds can be either Tier 1 or Tier 2. Ancillary own funds can only be Tier 2 or Tier 3. The classification criteria are:

- subordination (= in case of winding-up payment is refused)
- loss absorbency (= in case of winding-up the total amount is available)
- permanence (= availability)
- perpetuality (= the item has no time limitation)
- absence of serving costs (= no mandatory charges to redeem the nominal sum)

A three tier structure is already used in the capital requirements (banking) Directives. Taking it over for the purpose of Solvency II draft Directive, rather than developing a completely new approach, aims to enhance the comparability of balance sheets across sectors; that is between insurance companies, banks as well as financial conglomerates.

The implementing measures of the proposal assign the competence to the Commission to develop further subtiers and limits within them. This is also due to achieve cross-sectoral consistency with banking.

c) Eligible own funds

As in the case of own funds the term "eligible own funds" is not legally defined in the draft

Directive. The draft describes, however, which criteria own funds need to fulfil to be recognised as eligible for solvency purposes. Though eligible basic own funds are named to be part of eligible own funds, there is no explicit mentioning of eligible ancillary own funds.

The draft Directive determines which amount of own funds of a certain **tier quality** is eligible to cover the SCR and the MCR. It also sets **quantitative limits** to the amounts of the different capital quality. Thus, the SCR can be covered by capital coming from all tiers, while the MCR can be covered only by Tier 1 and Tier 2 items. It sets further limits and conditions (Art. 97), which lead to a quite complex system of tier-structured SCR and MCR. A clearer and simpler wording might be user-friendlier.

V) Calculation of the SCR - Market risk module

In the light of the current financial crisis, it is useful to look at the application of some articles regarding market risk in the valuation of assets and liabilities in the calculation of the SCR. (Re)Insurance companies have a stabilising influence on the financial markets and it is therefore important to have a proper calibration of the asset risk charges as well as problems arising in the estimation of duration when the Solvency test is done on a yearly basis. If applied too strictly, this could lead to forced asset sales, in order to comply with the SCR, increasing the natural volatility in the company's balance sheet as well as in the market.