

# Enhancing group supervision under Solvency II

## A discussion paper

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April 2008



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# EXECUTIVE SUMMARY

The purpose of the Solvency II Directive is to strengthen the Single Market in insurance and reinsurance services through a harmonised prudential framework which delivers a high standard of policyholder protection. Within Solvency II the Commission's proposals for group supervision, including the group support regime, can make a major contribution to achieving this goal.

The Commission's proposals are innovative and have as a result attracted a great deal of comment. They provide for a new model of group supervision which balances the traditional regulatory view of an insurance group as a collection of separate legal entities with an economic perspective which views the group as an integrated whole across which risks are pooled and diversified.

These proposals will allow diversification effects at group level to be realised and lower the costs of regulatory capital. This will support the objective of the Solvency II Directive to strengthen the international competitiveness of EU insurers and reinsurers. The potential for diversification effects at group level to provide greater financial stability is outlined in this discussion paper.

Ultimately, the proposals should promote better regulation and encourage more effective group supervision. This will be critical to achieving the high standards of policyholder protection required by the Solvency II Directive. HM Treasury and the FSA strongly support the Commission's proposals on group supervision. However, some understandable concerns have been raised and this document seeks to address them. It also puts forward some proposals to enhance the group support regime further.

Central to the proposals put forward is the establishment of colleges of supervisors for groups operating on a cross-border basis. Colleges can benefit both the supervisory authorities and insurance groups. They provide a platform for information sharing and co-operation; the college structure can contribute to the overall coherence of group supervision. Crucially, participation in the college enables supervisors to have oversight of the group's activities as a whole, enhancing their capacity to supervise the entity located in their jurisdiction.

It is critical that group supervision operates effectively for supervisors of subsidiaries whose parent company is in another Member State or in a third country. The size and openness of the UK's insurance markets means there are many such subsidiaries operating in the UK, writing a large volume of business. It is vitally important for policyholders that the requirements of the group support regime deliver a regulatory framework which is robust and effective including in stressed conditions that could affect the parent or subsidiaries within a group.

Solvency II provides an opportunity for the EU to set a global benchmark in prudential regulation of insurance through an economically realistic, market consistent and highly transparent approach. In essence the proposals on group supervision are the application at group level of the sound general principles elaborated in the framework Directive, especially the recognition of diversification effects at group level as well as at solo level.



# INTRODUCTION

**1.1** Many issues have been raised in response to the Commission's proposals on group supervision under Solvency II including in debates in the ECON Committee of the European Parliament, in the Council Working Group on financial services, in CEIOPS and in various public fora. As an introduction to the rest of this discussion paper, the first Chapter very briefly sets out key elements of the Solvency framework which provide the context for the proposals on group supervision.

**1.2** The Commission has set out the objectives and underlying principles of the Solvency II framework in the Explanatory Memorandum accompanying the Directive proposal and in the recitals. In addition the objectives of Solvency II and the reasoning behind the key choices which determine the framework are set out in the Impact Assessment. The four objectives of Solvency II, as defined by the Commission, are<sup>1</sup>:

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

**1.3** These objectives are mutually consistent and if they are achieved, Solvency II will deliver the outcome of enhancing the benefits that insurance services provide to consumers and businesses across the EU. Ultimately the real prize is to deliver high quality insurance services including high standards of policyholder protection and at the same time provide good value to policyholders. There are six essential elements of the Solvency II framework which are directly relevant to its application to group supervision:

1. An economic risk based approach which focuses on sound principles not arbitrary rules, and which promotes alignment of regulatory requirements and industry practice;<sup>2</sup>
2. A requirement on undertakings to adopt a holistic approach to the measurement and management of risk;<sup>3</sup>
3. A prospective approach to supervision;<sup>4</sup>
4. A proportionate supervisory response, including a ladder of supervisory intervention between MCR and SCR;<sup>5</sup>
5. The requirement on insurers to calculate a risk-based capital requirement, calibrated to 99.5 per cent VaR over one year or equivalent, and hold eligible own funds to meet it;<sup>6</sup> and

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<sup>1</sup> Amended proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) COM(2008) 119 final (hereafter "the Directive proposal"), Explanatory Memorandum, page 3.

<sup>2</sup> Solvency II Impact Assessment executive summary, page 4

<sup>3</sup> Recital 19 of the Directive proposal

<sup>4</sup> Explanatory Memorandum to the Directive proposal, page 6

<sup>5</sup> Recital 35 and Impact Assessment report, page 37

6. The importance of transparency and the principle that an economic approach to valuation is fundamental to achieving transparency for insurers and reinsurers.<sup>7</sup>

**1.4** All of these key elements of Solvency II will of course be applied to a solo undertaking. In our view a key question for Solvency II is – how are they best applied to undertakings in an insurance group? In summary this paper attempts to show that the approach to group supervision set out in the Commission’s proposal, including the group support regime, is fully aligned with these elements of Solvency II at group level.

**1.5** The focus of this document is on how the group support regime might work in practice. It also seeks to address some of the concerns that have been prompted by the Commission’s proposals and includes some suggestions as to how the Directive proposal might be amended to provide reassurance in response to those concerns. **The institutional arrangements for group supervision are a particular focus; especially, the proposal for a college of supervisors as central to the practical implementation of group supervision.** This is one application of a proposal for the development of colleges of supervisors as the fulcrum of the supervision of cross-border financial groups operating in the EU, whether in the insurance, banking or securities sectors. This proposal is outlined in a letter from the Chancellor of the Exchequer to the President of the Council.<sup>8</sup> A brief summary of the proposed enhancements to the group support regime is provided in the box at the end of this Chapter and in some more detail at Annex A.

**1.6** This document does not seek to articulate the reasons why the group supervision proposals and the group support regime put forward by the Commission will be strongly beneficial for the insurance sector across the EU and the policyholders it serves. The relevant arguments have been provided alongside the Commission’s proposals and on several occasions since then, above all by Commissioner McCreevy. In addition the Commission’s proposals enjoy the support of the insurance industry across the EU; notably the Comité Européen des Assurances,<sup>9</sup> the Chief Risk Officer’s Forum<sup>10</sup> and the Financial Services Round Table.<sup>11</sup>

**1.7** Before addressing the more detailed questions as to how the group support regime can operate, a reminder of the ultimate goal is worthwhile; Commissioner McCreevy expressed it succinctly at the Solvency II Launch Event at the European Parliament, July 2007:

“What the Commission is proposing today is a truly European solution. Group-wide supervision by a network of European supervisors will better enable an effective monitoring of the activities of a group and the early detection of potential problems. We must cast aside our narrow interests and strive for a genuine European answer”<sup>12</sup>.

<sup>6</sup> Recital 36 and Explanatory Memorandum, page 3

<sup>7</sup> Explanatory Memorandum, page 3

<sup>8</sup> Financial services supervision: Chancellor’s 3 March letter to Ecofin colleagues covering ongoing supervision, crisis management, and resolution 3 March 2008

<sup>9</sup> Comité Européen des Assurances, 12 February 2008

<sup>10</sup> CRO Forum, letter to Financial Times, 11 July 2007

<sup>11</sup> *Monitoring progress in EU prudential supervision*, European financial Services Round Table report, September 2007 (page 22)

<sup>12</sup> Commissioner McCreevy, July 2007.

**1.8** It is intended that this document will provide useful additional analysis, and some proposals for further enhancing the group support regime, in the context of the on-going debates of the Solvency II framework Directive in the Economic and Monetary Affairs Committee of the European Parliament and in the Council working group on financial services.

**Summary of possible enhancements to the Directive proposal on the group support regime**

- A reference in the Directive to the mandatory role of colleges of supervisors, in line with the proposals made in the Chancellor of the Exchequer's letter to the President of the Council;
- An Amendment to the derogation from Article 136 so that subsidiaries within the group support regime must notify their supervisor in the event of SCR breach
- A provision for Early Warning Indicators for emerging risks in a subsidiary in the group support regime
- A requirement to provide information on the main sources of group-level diversification effects
- Application of the Prudent Person principle to holding companies operating under the group support regime
- Direct application of Title III of the Directive to holding companies operating the group support regime

**1.9** Comments on this document are welcome. They should be addressed to: [duncan.mackinnon@hm-treasury.x.gsi.gov.uk](mailto:duncan.mackinnon@hm-treasury.x.gsi.gov.uk) or post them to:

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## Chapter 2 summary

1. Diversification of risk is the essence of insurance activity; from an economic perspective there is no material difference between diversification within a solo undertaking, across the branches of an insurer or at group level.
2. Wherever capital can be transferred it is capable of absorbing a wider range of risks; as long as those risks are not fully correlated the same protection for policyholders can be provided at lower cost.
3. Even modest amounts of diversification at group level can generate significant reductions in the risk of large unexpected losses occurring simultaneously across the group.
4. In a competitive Single Market ultimately consumers benefit from group level diversification through lower premiums with the same high standards of policyholder protection.

**2.1** There has been considerable debate about whether the group support regime is really necessary to allow the benefits of diversification to be realized at group level. In fact group-level diversification is just one instance of a more general phenomenon in insurance. In many kinds of different cases the question of the impact on capital requirements of diversification arises and brings with it the question of capital transferability, which is a core issue in the group support regime.<sup>1</sup>

**2.2** Insurance is the business of pooling and diversifying risk. If an insurance company were atomised into each of its liabilities and then assets were attributed separately to those liabilities and if capital requirements were then calculated in each case, writing insurance business could never be economically sustainable. In order to produce insurance services in an economically efficient way it is necessary to pool and diversify risk and to do this, the capital backing those risks must be capable of being transferred. The issue of group level diversification and the group support regime is just one example, albeit a very prominent one. Another example is the activity of reinsurance – in order for insurers to diversify risk through reinsurance treaties it has to be possible for capital to be transferred to the insurer if risks triggering the treaty crystallize.

**2.3** **Wherever risks are not fully correlated, capital which is transferable across any given boundary has greater potential to absorb unexpected losses and thereby protect policyholders than capital which is not transferable.** This is the real motivation for the group support regime – it gives capital in an insurance group loss-absorbency across a wider range of risks thereby allowing the group to hold less regulatory capital while still delivering the same level of protection for policyholders.

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<sup>1</sup> One example which is very familiar in the UK relates to with-profits life business; in the UK a with profits-fund is ring-fenced within the legal entity which operates the fund.

### An equivalent standard of policyholder protection

**2.4** Solvency II requires a solo undertaking to hold eligible own funds to meet its SCR. The valuation of technical provisions, of assets and of non-insurance liabilities are also vital, as are the elements of Pillars two and three. The SCR is therefore not the only source of protection for policyholders which the framework provides but clearly it is a key element. **In the group context the fundamental question is what requirements does an insurance group have to meet in order to provide the equivalent level of protection for policyholders as a solo undertaking which is complying with its SCR.** This section addresses the key issue of whether the group SCR, calculated on consolidated data, is the appropriate capital requirement for the group as a whole. It is generally recognised that there are group-wide diversification effects; if there were not, the answer to the question above would be trivial - a group would need to hold capital equal to the sum of the solo SCRs of the undertakings in the group.

**2.5** With some group level diversification benefits, the group SCR, calculated on consolidated data, is less than the sum of the solo SCRs of the undertakings within the group. Of course the group is committed to mitigate any unexpected loss in any of the subsidiaries up to at least the level of the subsidiary's SCR. So a key question is whether eligible own funds equal to the group SCR is a sufficient requirement to ensure that the probability that the commitment to policyholders in each of the subsidiaries will be met is equivalent to the level of protection afforded to policyholders in a solo undertaking.

### The group SCR

**2.6** The group SCR calculated on consolidated data will reflect the diversification between the risks of all of the undertakings in the group. It will therefore be different for each insurance group. Nevertheless it is possible to state under certain conditions the feasible range for the group SCR relative to the solo SCRs for the undertakings within the group:

- the group SCR cannot exceed the sum of the undertakings' solo SCRs
- nor can the group SCR be less than the SCR of the undertaking in the group which has the largest SCR

**2.7** The upper limit to the group SCR will be binding as long as the benefits of diversification at group level are not outweighed by possible costs; for example risk concentration at group level could in theory increase the group SCR above the level of the SCRs of the solo undertakings. This is a theoretical possibility but not a credible practical one – it would imply that the economic costs of the insurance group being constituted as a group were greater than the benefits. In such a case the rational outcome is that the group would be split up to unwind the net costs of the group.

**2.8** The lower bound to the range for the group SCR also holds good under certain conditions only. In essence the requirement is that the correlations between the risks in the undertakings in the group are not sufficiently negative overall<sup>2</sup>. This assumption is a credible practical lower bound on the extent of diversification at group level. One way to illustrate this is to consider the correlations between the various risks in the proposed specification of the standard formula for the SCR: none of these is negative. Of course this fact does not imply that correlations between certain risks in different subsidiaries cannot be negative, but it does indicate that it is not realistic that across all risks in the various undertakings in the group the weighted average correlation could be negative.

<sup>2</sup> This condition is based on the same approach to risks across the group that is used in the proposed standard formula for the SCR, i.e. risks are aggregated using linear correlation. If the correlations between all of the undertakings in the group are exactly zero, then the group SCR will still exceed the SCR of the largest undertaking.

**2.9** There are two main cases where correlations between entire risk factors are likely to be negative.<sup>3</sup> First, the case of mortality and longevity risk in life underwriting. Second, the possibility that for any two undertakings in a group one might have its maximum fixed interest stress where there is a rise in interest rates and the other where there is a decline. However, it is still not credible that they could be large enough to yield an average negative correlation across the group. A key reason for this relates to the fact that if the bilateral correlation between certain risks in any pair of subsidiaries is negative then any other subsidiary in the group which is exposed to the same risk factor must have a positive correlation with one of those two subsidiaries in respect of those risks.<sup>4</sup>

**2.10** The two conditions above are not especially demanding – they allow for a very wide range of group-level diversification effects, far in excess of any level that has been suggested as realistic for any actual insurance group. In practice the group SCR will generally be well above the solo SCR of the largest undertaking in the group. This mainly reflects the fact that the average correlation between risks in the undertakings in the group will be positive. The stronger is the positive correlation between unexpected losses in the subsidiaries, the higher will be the group SCR and correspondingly the lower will be group-level diversification effects.

**2.11** The actual level of diversification effects will be different in every group. It is important to keep in mind that those effects are *additional* to the diversification within each undertaking in the group which will already be reflected in its SCR. However even if diversification effects are comparatively modest, the potential impact on policyholder protection can be very large. This is shown in the next section which considers how group diversification relates to the probability of simultaneous losses occurring in each subsidiary equal to its SCR.

## Diversification effects at group level and policyholder protection

**2.12** Solvency II requires, as a regulatory minimum, that insurers hold enough capital so that the maximum probability of an insurer falling insolvent over one year is 0.5 per cent or 1 in 200. **Group diversification implies that this level of policyholder protection can be achieved by subsidiaries within a group with less capital than would be required by undertakings operating on a solo basis.** An important question is how the probability of insolvency relates to the quantity of diversification effects. This gives an indication of the impact of diversification effects; for example one measure of the significance of diversification is the probability of a simultaneous loss in each subsidiary equal to its SCR.

**2.13** The only way to analyse the relationship between group level diversification and policyholder protection is to make an assumption about the probability distribution underlying the risks in the insurance group. In this analysis a normal distribution is assumed for groups with three, four and five subsidiaries and different levels of diversification effects.<sup>5</sup> On the basis of these assumptions it is possible to derive the

<sup>3</sup> For many major risk areas it's not credible that correlations between risks in different undertakings could ever be negative; this is true for equity risk, counterparty default risk, longevity risk, non-life underwriting risk and operational risk.

<sup>4</sup> The same applies for currency risk. Of course with the other undertaking the correlation will be negative, but the point is that only in a group composed of just two undertakings is it possible that *all* the undertakings in the group have risks which are negatively correlated.

<sup>5</sup> Specifically, the multivariate standard normal distribution is assumed.

probability of losses equal to the SCR of each subsidiary within the group, depending on the level of diversification effects. Some basic results are shown in the table below.

**Table 1: probability of a loss equal to the sum of subsidiaries' SCRs for different group sizes and correlations between the subsidiaries**

Assumed correlations between subsidiaries	Number of subsidiaries			
	2	3	4	5
+0.25	0.056%	0.013%	0.005%	0.002%
+0.50	0.147%	0.080%	0.056%	0.044%
+0.75	0.295%	0.239%	0.213%	0.199%

**2.14** The table indicates how much potential there is for diverse risks across a group to yield stronger policyholder protection. Taking the case of a group with three subsidiaries as an example, if average correlation between the subsidiaries is 50 per cent, the probability of a loss equal to the SCR in each subsidiary occurring simultaneously is 0.08 per cent, an event whose likelihood is six times lower than that of a loss which a solo undertaking must be capable of absorbing under Solvency II. The table also shows that for a group with four subsidiaries and average correlation between the subsidiaries of 25 per cent, the probability of an SCR-sized loss in each subsidiary is one hundred times less likely than an SCR-sized loss in a solo undertaking.

**2.15** These results are just the consequence of assuming a normal distribution; the tails of such distributions have little probability density or in other words the likelihood of simultaneous severe unexpected losses is limited. The assumed correlations between the subsidiaries, the number of subsidiaries in the group, and the underlying hypothesis that the risks across the group can be modelled using a multivariate standard normal distribution, generate an implied level of diversification effects at group level. These are shown below for the cases set out in Table 1.

**Table 2: Implied diversification effects**

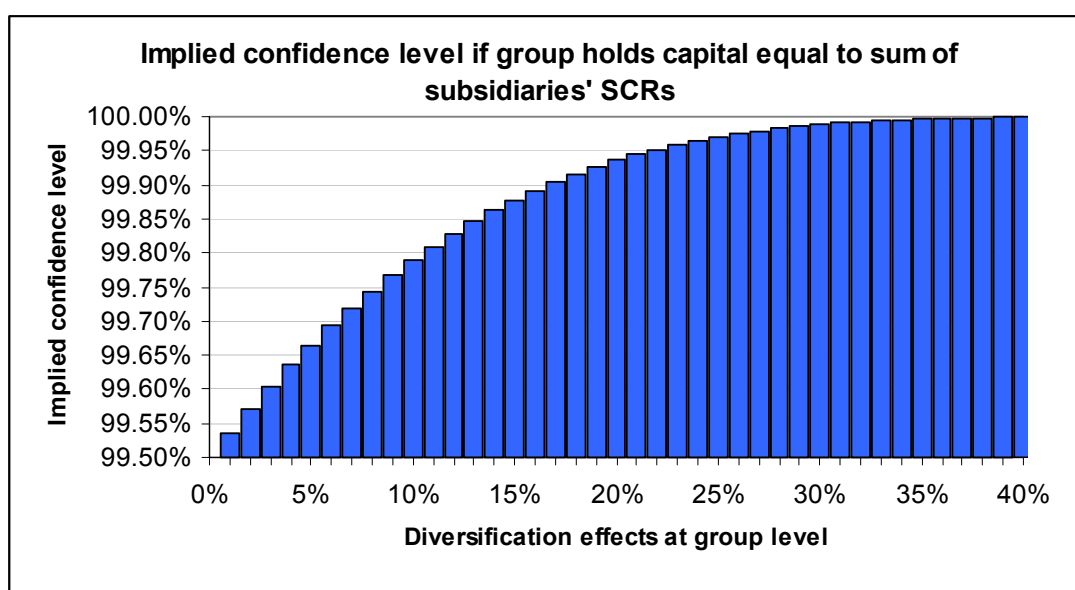
Assumed correlations between subsidiaries	Number of subsidiaries			
	2	3	4	5
+0.25	20.9%	29.3%	33.9%	36.8%
+0.50	13.4%	18.4%	20.9%	22.5%
+0.75	6.5%	8.7%	9.9%	10.6%

**2.16** A key point shown by the two tables together is that even a relatively modest level of diversification effects at group level can have large proportionate impacts on policyholder protection. For example, if we take the case of a group with three subsidiaries whose risks are correlated at 75 per cent, the level of diversification effects

is rather modest. Nevertheless, as Table 1 shows, the probability of a loss equal to the sum of subsidiaries' SCRs is still under one half of the probability of a solo undertaking falling insolvent if it were holding capital exactly equal to its SCR. Another way of stating this point is that a group with just 8.7 per cent diversification effects and which holds capital equal to the sum of subsidiaries' SCRs is more than twice as financially stable as a solo undertaking holding capital just equal to its SCR.

**2.17** Tables 1 and 2 indicate that the implied financial stability of a group increases rapidly as diversification effects increase. This is illustrated in a more general way in Chart 1 below which shows the implied confidence level of a group which holds capital equal to the sum of subsidiaries' SCRs as diversification effects vary<sup>6</sup>.

**Chart 1**



**2.18** The Chart shows that the financial stability of a group increases rapidly as diversification effects increase; for example, the confidence level of 99.90 per cent (i.e. a one in one thousand probability event) is attained when diversification effects are just under 17 per cent. The confidence level rises to 99.95 per cent (i.e. a one in two thousand probability event) when diversification effects are just under 22 per cent. **Clearly these levels of implied confidence in the stability of an insurance group are far in excess of that required by Solvency II. One of several important implications of the analysis is that the economic costs of ignoring diversification effects as an important source of policyholder protection are potentially very significant. Ultimately those costs are borne by policyholders through higher insurance premia.**

**2.19** The results derived in this section rely on the assumption that a multivariate normal distribution is a reasonable way of modelling the combinations of risks in different subsidiaries. Of course particular risks, notably non-life underwriting risk, might well conform to a different probability distribution. This would imply that the relationship between the quantity of diversification effects at group level and the probability of a loss across the group equal to the sum of subsidiaries' SCRs would differ

<sup>6</sup> Again the underlying assumption is that the risks across the group can be modelled using a multivariate normal distribution.

from the results presented above. But the overriding point remains valid, namely that group level diversification has the potential to generate significantly improved financial stability.

**2.20** A second observation commonly made in regard of the quantification of group level diversification relates to the possibility that correlations between risks may be different depending on the confidence level; and in particular that tail events may be correlated more strongly than is reflected by the average correlation between risk factors. The impact of this is to decrease the diversification that arises as a result of combining diverse risks, whether at solo or group level. In respect of the group overall capital requirement wherever this is a material factor the group SCR will be higher, so that the calibration standard of 99.5 per cent 1 year VaR is still met.

**2.21** In summary group level diversification has the potential to deliver strong policyholder protection to the standard required by Solvency II, while enabling the group as a whole to have lower required capital which reduces costs for the group and ultimately yields lower premiums for consumers.

**Summary of chapter 3**

1. The assessment of capital transferability within the group is central to the effective functioning of the group support regime.
2. Some capital may not be transferable, for example due to the rights that with-profits policyholders have to a fair share of the value in the with-profits fund.
3. There may be some legal impediments to the transfers of certain capital, or assets which embody that capital, subject to the general principle in the EC Treaty of free movement of capital.
4. Those possible impediments need to be assessed on a case-by-case basis; in general they may in some circumstances inhibit the extraction of capital from a subsidiary rather than the transfer of capital into a subsidiary.
5. The assessment of capital transferability needs to include the impact of stressed financial conditions affecting the group.

**3.1** In addition to the requirement that a group hold eligible capital to meet its consolidated group SCR the **second key condition which must be met if the group support regime is to provide policyholders of undertakings in an insurance group with equivalent protection to those of a solo undertaking relates to the transferability of capital.**

**3.2** It is likely that there will be a number of ways in which legally binding commitments can deliver the requirements imposed by the Directive proposal; for example one specific proposal is for a ‘first demand guarantee’. This Chapter however considers only the capital transferability principles the group support commitment must meet; as long as a legal instrument meets the conditions set out in the Directive proposal, limitations on the precise legal form of such commitments are best addressed in level 2 implementing measures.

**3.3** The Commission’s proposal places a key constraint on capital transferability – the requirement to hold eligible capital to meet the Minimum Capital Requirement (MCR) in each subsidiary. Capital cannot be transferred from a subsidiary if the transfer would cause the subsidiary no longer have to capital to cover its MCR.<sup>1</sup> These own funds are therefore not even potentially transferable capital in the group support regime.

**3.4** Own funds which are not required to be held in the subsidiaries which are in excess of the MCR are potentially transferable but may or may not be actually transferable. That depends on whether they meet the test in the Directive, set out in Article 237, in particular that: “there is no current or foreseeable material practical or legal impediment to the prompt transfer of own funds...”.

<sup>1</sup> Article 240(2)

**3.5** This test will have to be applied to any eligible own funds which the insurance group proposes to employ to deliver the group support commitment. There are three main stages to this test:

1. **Potentially transferable capital** - the first stage is to identify where in the group capital is held which exceeds the regulatory requirements for the undertaking in which it is held – this generates information on what capital is potentially transferable.
2. **Actually transferable capital** - the second stage is to identify the extent to which any material practical or legal impediments exist to the transfer of that capital, as required by Article 237 and demonstrate to the supervisor that there are no material practical or legal impediments to the transfer of capital relied upon – this generates information on what capital is *actually* transferable.
3. **Transferability of capital under stressed conditions** – for the third stage the group will need to have in place a capital management strategy to assess capital transferability in stressed financial conditions.

### Potentially transferable capital

**3.6** The first stage of the test will require an assessment of the solvency position of the legal entities within the group on a solo basis. The group SCR and the assessment of available capital across the whole group on the basis of consolidated data will not be sufficient to determine the location of capital in the undertakings in the group. To assess what capital is potentially transferable from a given subsidiary, in addition to knowing its MCR an assessment of its own asset and liability position will be necessary. A subsidiary which has no participations of its own is the trivial case of solo assessment for the purposes of evaluating what capital is potentially transferable. A more complex test is the assessment of what is potentially transferable from an intermediate parent company or holding company and from the ultimate parent company at EU level including where this is a holding company.

**3.7** In all these cases an assessment of the entity's solo position requires a treatment of the participations it has in other companies within the group. For the purpose of identifying where capital is held in the group, one method is to deduct the participations in subsidiaries in the group support regime. This leaves items on the balance sheet of the parent company relating to its insurance activities and the assets held to support those activities. Participations in undertakings outside the group support regime would be regarded as potentially transferable capital. The circumstances under which those participations represent capital that could actually be transferred would remain to be assessed.

### Actually transferable capital

**3.8** For the second stage of the test, the key condition for determining whether capital is actually transferable is that there are no 'material practical or legal impediments for the prompt transfer' of own funds (Article 237 (3)(b)). Article 245 provides powers for the Commission to adopt implementing measures which specify the criteria that will be used to assess whether the condition in Article 237(3)(b) has been satisfied. While the question of what exactly are the appropriate qualitative criteria to test the transferability of capital is an issue which will be addressed in level 2

implementing measures, it is nevertheless possible to set out the kinds of conditions that will be relevant for this assessment.

**3.9** The concept of testing whether capital is transferable between separate legal entities is also contained in the Banking Consolidation Directive.<sup>2</sup> In the UK, the FSA has developed qualitative criteria for banks using the concept in the BCD which are relevant to the more general issue of what issues need to be considered in making an assessment of the transferability of the capital<sup>3</sup>.

**3.10** In general the transfer of capital into a subsidiary does not generate legal obstacles; it is the process of identifying capital that could be extracted from a legal entity where any potential obstacles need to be considered. These may affect one or more of:

- the quantity of capital that can be transferred out of a subsidiary;
- the time needed to extract capital; and
- in more extreme cases, the ability of a parent company to extract capital at all.<sup>4</sup>

**3.11** One very clear case where a parent company may not be able to extract capital, including own funds which exceed the SCR attributable to the relevant business, is the example of a subsidiary writing with-profits policies; in the UK and in many other jurisdictions the own funds relating to the with-profits business will only be capable of being extracted by the parent company subject to certain restrictions.

**3.12** More generally there are a range of legal dimensions that will affect the ability to transfer capital out of a subsidiary that will need to be considered, including:

- minority interests and other shareholders of subsidiaries that may affect the amount of funds that can be transferred out of a subsidiary;
- whether transfers of capital will trigger tax liabilities which affect the quantity of transferable own funds;
- regulatory requirements which may restrict the transfer of eligible own funds – a key example will be the ring-fencing of own funds within a with-profits fund;
- the impact of the legal structure of the subsidiary undertaking and the relevant law of its jurisdiction on the ability of the subsidiary undertaking to transfer own funds, including company law and insolvency law;
- the impact of contractual relationships of the subsidiary undertaking with the parent undertaking or other third parties.

**3.13** There is no obligation to retain capital above the MCR as a consequence of the application of the company law Directives and therefore any surplus capital above the MCR should be transferable. However, it will be necessary for the group to show that they have considered how the relevant legal dimensions could impede a transfer of capital. For example, this might include consideration of whether a capital transfer

<sup>2</sup> Article 70 of the Banking Consolidation Directive (2006/48/EC).

<sup>3</sup> FSA Handbook (BIPRU 2.1.24 R)

<sup>4</sup> The option to realise the capital in a subsidiary by selling it will of course always remain open to a parent company.

could be inhibited due to the duties on directors of an undertaking to that undertaking, including responsibilities towards shareholders, minorities in particular, and to any creditors.

**3.14** The Commission proposal provides a framework by which supervisors can gain assurance about the ability of the group to meet a commitment under the group support regime. The college of supervisors will test the assessment of actual transferable capital using the qualitative criteria developed in the level two implementing measures. That assessment needs to encompass the impact of scenario planning of how different financial stresses will impact on the actual transferable capital identified. As discussed in the following section this is a key element in enabling the college of supervisors to make an informed decision as to the accuracy of the group's assessment of what capital is transferable.

**3.15** It is important to keep in mind that the fundamental freedoms safeguarded by the Treaty include the right for a legal person to transfer capital freely within the Single Market.<sup>5</sup> Solvency II provides harmonized parameters within which this freedom may be applied to the free movement of regulatory capital in the insurance and reinsurance sectors.<sup>6</sup>

### Transferability of capital under stressed conditions

**3.16** The third stage of the assessment of the transferability of capital embeds that assessment in the wider risk and capital management strategy of the group.<sup>7</sup> Critically an insurance group must assess the availability of capital taking into account the restrictions a group faces under financial stress, including the speed with which the capital can be allocated under those conditions. This at least implies the following:

- a strategy on how to deal with financial distress in one or several legal entities is needed;
- contingency plans need to be formulated and be in place on how to raise and allocate capital in case of economic losses;<sup>8</sup>
- the group needs to define a number of adverse scenarios which capture the relevant stressed states to which the group might be exposed. The evaluation of the scenarios entails not only the assignment of a probability to the scenario and the economic loss to the group as a whole but the effect of the scenario on all affected legal entities.

**Conclusion 3.17** Taken together the three stages outlined in this section combine to provide the reassurance that there is a robust framework of criteria to ensure that a realistic assessment is made of the amount of actually transferable capital, as well as the transfers that would be required under different stressed circumstances and an evaluation of the impact of stress on the group's ability to execute capital transfers.

<sup>5</sup> Article 56. The Treaty establishes the principle of free movement of capital not only within the EU but also between Member States and third countries.

<sup>6</sup> The text of the Treaty goes further and explicitly states that the measures taken under the exceptions to the general principle of free movement of capital "shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital..." (Article 58 (3)).

<sup>7</sup> The description of these requirements is based on a working paper produced by the Swiss Federal Office of Private Insurance, *Modelling of Groups and Group Effects*.

<sup>8</sup> This issue is addressed in more detail in the next Chapter.

## Capital and asset quality - the application of “prudent person” under the group support regime

**3.18** This section considers the issue of the requirements in the Directive proposal on the quality of capital to be held at subsidiary level and the quality of assets held both at subsidiary level and at group level.

**3.19** The Directive proposal permits the difference between a subsidiary’s SCR and MCR to be met through capital held by the subsidiary which is eligible to cover the SCR or by group support or a combination. It also states that for the purposes of classification of own funds, group support is to be treated as ancillary own funds<sup>9</sup>. Article 94 requires that ancillary own funds shall in any case not be treated as Tier 1. It follows that at least the one third of any subsidiary’s SCR which must be covered by Tier 1 capital may not be covered by group support. Therefore there is a high quality capital requirement to be met by any subsidiary in the group support regime, separate from the requirement to hold the MCR. This also of course imposes a limitation on what capital is potentially transferable around the group, just as the MCR does.

**3.20** In addition to the capital requirements including on the quality of capital, key issues in the operation of the group support regime are the nature and quality of assets which are transferred in order to recapitalise a subsidiary. The Directive proposal imposes the “prudent person” principle on all undertakings, including those within the group support regime. This implies in particular that asset portfolios have appropriate quality, security and liquidity.<sup>10</sup> There are two important implications for the group support regime. First a parent undertaking must be capable of transferring suitable assets to meet the group support commitment so that the subsidiary’s asset profile will continue to be appropriate given its liabilities – for example, in respect of currency matching. Second, where the parent is a holding company the principle of prudent person should apply to the asset portfolios of the holding company wherever they are relied upon to back a group support commitment.

**3.21** Finally, where the parent company seeking to operate the group support regime is a holding company, there is also a broader issue of how holding companies are subject to the requirements of the Directive proposal on group supervision.

**3.22** Article 262, paragraph 2 of the Directive proposal requires Member States to put in place sufficient measures and sanctions to ensure that holding companies and the persons who effectively manage them comply with the requirements of Title III of the Directive. In addition, paragraph 3 of the same Article allows the Commission to adopt Level two measures in order to co-ordinate the relevant enforcement measures. This enables the requirements on fit and proper, and prudent person, to be imposed on a holding company with confidence that they will be effectively enforced.

**3.23** However, the provisions of Title III of the Directive proposal do not apply directly in the case of a holding company. Where a group operating under the group support regime has a holding company as its ultimate parent undertaking there is clearly a case for clarifying that the requirements of the Title apply directly to such holding companies, to avoid any uncertainty as how these obligations are imposed on the holding company. Further, with regard to the enforcement measures against the parent undertaking where it delays transfer of own funds to a subsidiary of (Article 240,

<sup>9</sup> Article 237, paragraph 1.

<sup>10</sup> Article 130.

paragraph 1) the powers available to the group supervisor in respect of a holding company are likely to differ from those it will have in the case where the parent company is an insurance or reinsurance undertaking.

**3.24** The ultimate sanction on a group headed by a holding company which is operating the group support regime is the removal of the entitlement to operate under that regime. Clearly such an intervention must be exercised only where it is justified. But if a group were materially in breach of the requirements of the regime and the parent company refused to redress that situation or took too long to implement the necessary remedial steps, ultimately removal of entitlement to operate under the group support regime would be justified.

# 4

## OPERATING THE GROUP SUPPORT REGIME IN PRACTICE

### Summary of Chapter 4

1. The Directive proposal enables key elements of Pillars 2 and 3 of the Solvency II framework to be applied at group level, supporting an integrated approach to the supervision of the group as a whole.
2. A key element of Solvency II is a shift to prospective supervision; it will be essential for effective group supervision that this fundamental change is fully implemented at group level.
3. A system of Early Warning Indicators which focus on the key risks in each subsidiary is an important element of delivering a prospective approach especially within the group support regime.
4. The group support regime prevents regulatory capital from being trapped in subsidiaries where it is not needed, so that it can be transferred to absorb unexpected losses occurring elsewhere in the same group, enhancing policyholder protection overall.

**4.1** The first chapter noted six key principles and cornerstones of Solvency II and explained that this document seeks to show how the Commission's proposals implement them in a group context. Two of those principles, both fundamental to Solvency II, are repeated here:

- a prospective approach to supervision
- trapped capital and the ladder of supervisory intervention at group level

**4.2** The first section of the Chapter highlights the importance for policyholder protection of applying pillars two and three at group level, in order to ensure the college of supervisors focuses on the overview of risks across the group as a whole. The second part of this Chapter deals with the question: how can these two principles be applied in a group context? The application of both is linked with the respective roles and responsibilities of the group supervisor and the supervisors of subsidiaries under the group support regime, and this aspect is also addressed in this Chapter.

### Application of pillars two and three at group level

**4.3** Much of the discussion on group supervision under Solvency II has focused on pillar one issues and specifically the question of capital requirements at group level. But the group SCR, although a key element in group supervision, is not the sole means of providing protection to policyholders across the group.

**4.4** One of the key elements in the preparation of the Solvency II project is the report of the London working party on insurance failures.<sup>1</sup> At the heart of that report is the proposition that the quality of risk measurement and management, along with other non-quantifiable elements such as the quality of governance in an undertaking or group, and the strength of its internal controls, are critical to avoiding insurance failures and near-misses.

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<sup>1</sup> Prudential supervision of insurance undertakings, Conference of Insurance Supervisory Services of the Member States of the European Union, 2002.

**4.5** Increasingly, insurance groups are seeking to achieve enterprise-wide risk management, a holistic concept of risk and capital management which aims to integrate the assessment of risk and available capital for the group as a whole. The framework for group supervision should also have as its starting point the concept that the group is an integrated economic entity, constituted of the undertakings in the group and the economic relationships between them. Clearly it must not ignore the separate legal identities of the undertakings in the group. The Directive proposal strikes the right balance by applying the pillar one requirements on technical provisions and the MCR at the level of each undertaking, while imposing the SCR as the binding capital requirement at group level and allowing the difference of the SCR and MCR of each subsidiary to be met by group support.

**4.6** In line with the Impact Assessment executive summary<sup>2</sup> Solvency II should adopt an economic approach which promotes alignment of regulatory requirements and industry practice including for insurance groups. It would be far better to acknowledge as a reality the trend in insurance groups towards enterprise-wide risk management and adopt a model for group supervision which works with the grain of this trend.

**4.7** Further, co-ordinating the application of pillar two requirements and adopting consistent supervisory methods across the group has the potential to contribute significantly to policyholder protection and could reduce costs for the undertakings in the group. The improvement in protection for policyholders would result primarily from an integrated approach to the measurement and management of the group's risks<sup>3</sup> and the resulting oversight which the college of supervisors has in the regulation of the group. The Commission's proposal is sympathetic to this approach especially through:

#### **Pillar two at group level**

1. the appointment of a single group supervisor responsible for the co-ordination and exercise of group supervision (Article 251)
2. the requirement that the risk management processes and internal controls of the parent company cover the subsidiaries incorporated in the group support regime (Article 234 (b))
3. the power to impose a capital add-on on the group SCR, including to address specific risks existing at group level (Article 230)
4. the requirement to conduct the Own Risk and Solvency Assessment (ORSA) at group level (Article 250)

#### **Pillar three at group level**

5. the requirement publicly to disclose the declaration of group support (Article 241)
6. the requirement to provide a solvency and financial condition report at the level of the group (Article 260)

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<sup>2</sup> Solvency II Impact Assessment executive summary, page 4

<sup>3</sup> Recital 19

**4.8** Together these elements amount to a step change in the concept of group supervision, moving away from the solo/supplementary model to a system where the risks in the group including in each of the subsidiaries are assessed using an integrated approach. Among other things this should significantly improve the quality of information that each subsidiary’s supervisor has on the solvency condition of the group as a whole. Further, the logical complement to the application of pillars two and three at the level of the group is a strengthened institutional framework for supervisors to develop stronger co-operation – this is discussed in Chapter 5.

## Prospective supervision and timeliness of intervention

**4.9** The idea of a prospective approach to solvency is one of the core ways in which Solvency II is differentiated from the current insurance Directives. For example, the concept of the SCR is premised on the undertaking as a going concern<sup>4</sup> and the approach to supervision is required to be “prospective and risk-oriented”<sup>5</sup>. Matching the prospective approach is the requirement for supervisors to intervene in a “timely and proportionate manner”<sup>6</sup>. These principles need to be applied in a group context, including to subsidiaries under the group support regime.

**4.10** There are several elements which together can deliver a sufficiently forward-looking approach and ensure timely intervention where there are risks to the financial condition of a subsidiary in the group support regime. These are described in more detail in the remainder of this section; in summary they are:

1. the requirement to report the risk of non-compliance with:
  - the subsidiary’s MCR
  - the subsidiary’s SCR
2. the requirement to report the risk of non-compliance with the group SCR
3. a proposal for Early Warning Indicators at subsidiary level
4. the power to require a recalculation of the subsidiary’s SCR

### Risk of non-compliance with the SCR and MCR at subsidiary level

**4.11** First, all undertakings are under an obligation to report not just non-compliance of the MCR but the risk of non-compliance within the following three months<sup>7</sup>. This provides a minimum time period to address emerging difficulties in a subsidiary. It is a useful back-stop but arguably not sufficient in itself as a means to ensure a prospective approach to supervision within the group support regime.

**4.12** The same obligation applies to the risk of breaches of the SCR. Article 238 requires the supervisor to continue to monitor the subsidiary’s SCR but the derogation that the subsidiary’s supervisor should not retain the responsibility to enforce the SCR by taking measures at the level of the subsidiary includes the obligation on the subsidiary to report a breach of the SCR, and the risk of a breach within the following three months.<sup>8</sup> However, it is clear that the same reasons for that notification

<sup>4</sup> Article 100, paragraph 2

<sup>5</sup> Article 28, paragraph 1

<sup>6</sup> Article 34, paragraph 6

<sup>7</sup> Article 136, paragraph 1

<sup>8</sup> Article 135, paragraph 1

requirement which apply in the case of a solo undertaking also apply in the case of a subsidiary under the group support regime. The sole difference is that it is now also vital for the group supervisor as well to be informed not just if there is an SCR breach but if there is a risk of one in the short-term. This provides a second element of policyholder protection through the early identification of risks emerging in the subsidiary.

### Risk of non-compliance with the group SCR

**4.13** Within the group support regime the group's financial strength overall is of utmost importance to achieving for each subsidiary the high standards of policyholder protection required by Solvency II. **It follows that the supervision of the group SCR is a key means by which a prospective approach to supervision can be adopted in respect of the subsidiaries in the group support regime.** By analogy with Article 136 a group is required to report not only non-compliance with the group SCR but also the risk of non-compliance within the next three months. In addition, Article 134 also applies at group level by analogy; this requires that:

“Insurance and reinsurance undertakings shall have procedures in place to identify deteriorating financial conditions and notify the supervisory authorities when such deterioration occurs”

**4.14** Together the application by analogy of Articles 134 and 136 provide a key mechanism for operating prospective supervision at group level.<sup>9</sup> The next Chapter discusses the institutional arrangements for group supervision. One of the suggestions made is that a breach of the group SCR and even the risk of such a breach within the following three months should be a trigger for the college to consider the most appropriate supervisory response.

### Early Warning Indicators

**4.15** In addition to the actions triggered by breaches of MCR and SCR at subsidiary level, and of the group SCR, **a further element which can make an important contribution to delivering a prospective supervisory approach in the context of the group support regime is a system of Early Warning Indicators.** All insurance undertakings are exposed to a range of disparate risks but almost always some of those risks are much more significant for the undertaking than others and the patterns of risk salience will vary. One important dimension in the context of cross-border groups is the possibility that certain risks in particular subsidiaries may have more significance or, more likely, change in their significance unexpectedly, and without this being a general phenomenon which would trigger changes in the risk profiles of other entities in the group.

**4.16** It makes sense for the supervisory authorities to agree wherever appropriate a set of Early Warning Indicators for the subsidiaries of the group, paying particular attention to the information they would provide which is specific to each subsidiary. The details of what sorts of information are relevant and their relative importance will be different in each insurance group so logically they are best left to level 3;<sup>10</sup> but some of the kinds of information that might reasonably be considered are listed here:

- significant unexpected changes in technical provisions;
- material changes to risk profile through e.g. new business classes, rapidly growing business lines, a changed asset strategy or changes to the reinsurance programme;

<sup>9</sup> Article 216, paragraph 4

<sup>10</sup> Effectively this suggestion is an elaboration of the requirement (Article 44, paragraph 2) on an undertaking to have in place “processes which enable it to identify and measure risks which it faces in the short and long term”. In the group context it makes sense to implement this requirement across the group so that all supervisors in the college have an overview of the risks to the group. Article 134 is also relevant in this context.

- large scale changes in senior management and/or internal structure;
- other significant unexpected departures from the business plan;
- unexpected changes in pricing, expenses and profitability;
- outlier results when compared against peers in the local market.

**4.17** Clearly the amount information that could be collected about even a single subsidiary is potentially very large and if an unreasonable reporting burden is imposed this will be almost as much a problem for the college of supervisors as for the insurance group. A good set of Early Warning Indicators would focus on the major risks to the subsidiaries in the group and enable the college of supervisors to have available an oversight of the risks across the group on a consistent basis.

**The power to require a recalculation of the subsidiary's SCR**

**4.18** Supposing that an early warning is triggered and as a result the subsidiary's supervisor decides that more detailed assessment of the suspected changes in the risk profile of the undertaking is needed, the optimal response is for the supervisor of the subsidiary to work together with the group supervisor in order to reach a joint decision on how to proceed. This could include requiring the group to recalculate the subsidiary's solo SCR. In the vast majority of such cases it is reasonable to expect that the group supervisor will agree with the concerns raised by the subsidiary's supervisor. However, in the event that there was no shared view, the subsidiary's supervisor clearly retains the power to require a recalculation of the SCR on the grounds of the evidence that the risk profile of the subsidiary has changed significantly since the SCR was last calculated.<sup>11</sup> If the risk profile of the subsidiary has changed materially this will lead to a new value for its SCR and as a consequence the necessary changes to the group support commitment.

**4.19** Together these elements provide the tools to enable a prospective approach to supervision under the group support regime. However, irrespective of the robustness of systems to enable prospective supervision and to encourage insurers to anticipate adverse events and their impact on the undertaking, breaches of the SCR will occur; of course it takes time for an insurer to respond to financial stress and for supervisors to agree on the proposed response. The next two sections therefore consider how policyholder protection can be enhanced during the period when an insurance group holds less eligible capital than its group SCR through:

1. the inclusion in the group Own Risk and Solvency Assessment of an evaluation of a group's ability to respond to a breach of the group SCR; and
2. the operation of the ladder of supervisory intervention at group level. This is central to supervision of a group in stressed financial conditions.

## Financial flexibility at group level

**4.20** One of the facts about insurance groups which underlies the logic of applying supervision to the group as a whole is that they typically manage risk and capital centrally, in particular the raising of new capital. As a result subsidiaries in an insurance group are typically reliant on the parent company when they are in need of recapitalisation.

<sup>11</sup> The power conveyed by Article 102, paragraph 2, from which Title III of the Directive proposal does not provide a derogation.

**4.21** A group SCR breach need not trigger the issuance of additional equity or subordinated debt as there are other options available to the group including changing its risk profile or releasing capital through the sale of subsidiaries. Further, until the financial stress which causes a group SCR breach actually occurs, or at least only shortly before, its specific nature and severity are unknown and therefore it is not possible to state with precision what is the most appropriate response. Nevertheless it is possible to envisage the options that are available to a group in the event of a group SCR breach, and how appropriate they may be depending on the size of the breach and the nature of the financial stress<sup>12</sup>. In particular, Article 250 requires that the Own Risk and Solvency Assessment apply at group level; this could readily include an assessment of financial flexibility<sup>13</sup> and the results of this assessment should be shared among all supervisory authorities<sup>14</sup>.

**4.22** The assessment of financial flexibility makes an additional contribution to applying a prospective approach to supervision at group level. Whether the same requirement should be imposed on a solo undertaking should be a matter for the responsible supervisor. However in a group context where risk and capital management is conducted at group level but ultimately recapitalisation occurs to protect policyholders of the various subsidiaries in the group, **it is logical for the group to provide supervisory authorities with an assessment of its capacity to respond to financial stress including where that leads to a breach of the group SCR.**

### **Trapped capital and the ladder of supervisory intervention at group level**

**4.23** As noted at the start of this Chapter the idea of a ladder of supervisory intervention is fundamental to Solvency II; it is in essence the application of proportionality to instances of non-compliance with the SCR. Policyholder protection is underpinned in normal circumstances by the maintenance of eligible capital at least to the level of the SCR. But when an insurer suffers significant unexpected losses other means have to be employed on a temporary basis until compliance with the SCR is restored. Those means require in any case more intensive supervision and the provision of a realistic plan to restore compliance with the SCR.

**4.24** The group support regime facilitates the operation of the ladder of supervisory intervention at group level. **If undertakings in a group are required to hold capital to meet their SCRs separately, own funds held to meet the SCR of a subsidiary which is not suffering financial stress cannot be transferred to support another subsidiary which has experienced unexpected losses.** By allowing capital to be transferred between undertakings, the group support regime maximizes the potential that any given quantity of eligible capital held by the group has to provide policyholder protection across the group.

**4.25** Annex C provides a simple example which demonstrates the ability to move capital around the group helps protect policyholders of subsidiaries which are experiencing financial stress. The scenario involves a very large loss to an insurance group – 50 per cent of its group SCR, which is concentrated in two subsidiaries. Under

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<sup>12</sup> Among others rating agencies devote considerable energy to assessing the financial flexibility of an insurer, in other words, its capacity to respond to unexpected losses and more broadly to deteriorating financial conditions

<sup>13</sup> Paragraphs 2 and 4 of Article 44 are especially relevant.

<sup>14</sup> Where paragraph 4 of Article 250 is applied and the group conducts an integrated ORSA, the group is required to submit the single document to all of the supervisors.

the group support regime it is possible to recapitalise the subsidiaries which experience unexpected losses while the parent company still holds further capital which could be transferred across the group to meet any subsequent unexpected losses. Of course the group will also need to re-capitalise to restore compliance with the group SCR.

**4.26** If instead solo/supplementary supervision is applied, because more capital is tied up in the subsidiaries where losses do not occur, there is no transferable capital available in the group. **In order to provide the same protection to policyholders as the group support regime does, a group regulated under solo/supplementary supervision, with the restrictions on capital transferability it entails, will need to hold additional capital if it wishes to maintain a surplus of transferable capital to absorb unexpected losses across the group.** As indicated in Chapter 2 the restriction on holding capital up to the SCR in each subsidiary either increases costs for the group which are ultimately borne by policyholders or it reduces the group's capacity to absorb unexpected losses.



## Summary of chapter 5

1. The balance of responsibilities between the group supervisor and solo supervisors within the group support regime seeks to facilitate effective joint supervisory action. Supervisors of a subsidiary retain all powers except those where an explicit derogation is set out; as a further check and balance CEIOPS can be asked to provide advice to facilitate key supervisory decisions.
2. Supervisory authorities should form a college of supervisors to plan and coordinate the supervisory activities of the insurance group to provide a forum for co-operation, joint action and sharing of information. The scope of joint decision-making would involve key areas of the group support regime.
3. A key benefit of participation in the college is the ability of supervisors to have oversight of the group's activities as a whole, enhancing their capacity to supervise the entity located in their jurisdiction.
4. Retaining flexibility in the co-ordination arrangements for colleges is key to enabling group supervision to be adapted to the specific circumstances of the group. To support this flexibility the supervisory college could establish smaller virtual supervisory teams comprising of a mix of different supervisors and with a responsibility to carry out specific supervisory tasks.

**5.1** This Chapter focuses on two aspects of the institutional arrangements for group supervision: the balance of responsibilities of the group supervisor and the supervisors of subsidiaries and a proposal for colleges of supervisors to apply group supervision, including specifying key areas where there would be a mandatory role for the college as a whole.

## Balance of responsibilities

**5.2** Many comments on the Commission's proposals for group supervision reflect concerns about the balance of powers between the group supervisor and the subsidiary's supervisor under the group support regime. The group support regime provides four derogations which affect the balance of responsibilities between the group supervisor and the solo supervisor of a subsidiary; these are:

1. in the absence of a joint decision by the college of supervisors, the decision on an application to adopt the group support regime would ultimately be taken by the group supervisor (Article 235);
2. if the application referred to in 1. is accepted, the subsidiary's supervisor may propose the imposition of a capital add-on at subsidiary level but may not unilaterally impose it (Article 236);
3. the facility to permit group capital support to meet some or all of the difference between the subsidiary's SCR and its MCR (Article 237); and
4. the responsibility for enforcing the subsidiary's SCR (Article 238).

**5.3** In addition, a group may apply for the approval of a group-wide internal model to calculate both the group SCR and the SCRs of the undertakings in the group whether or not it operates a group support regime.

**5.4** It is clear that the supervisor of a subsidiary retains all powers except those explicitly derogated.<sup>1</sup> The retained responsibilities are in fact the large majority of the responsibilities provided for in the Commission proposal.<sup>2</sup> It is nevertheless reasonable to consider whether the changes in powers under the group support regime are justified. In particular is each derogation necessary for the group support regime to operate effectively? This section considers each in turn.

**Power to veto the application of the group support regime**

**5.5** In the absence of a joint decision by the relevant supervisors, the group supervisor may decide whether to allow the group to apply the group support regime<sup>3</sup>. A supervisor of a subsidiary will therefore not be entitled to veto the extension of the group support regime to the subsidiary in its jurisdiction. There are some key reasons why this derogation is necessary to the operation of the group support regime and why it is reasonable. There are also safeguards to ensure the group supervisor's residual power to take this decision is exercised responsibly.

**5.6** If the supervisor of a subsidiary retained a veto of the inclusion of a subsidiary in the group support regime it is highly likely that different supervisors would use different criteria to reach a decision. In particular if some supervisors only allow a subsidiary in its jurisdiction to be included on highly restrictive conditions, this could severely limit the diversification benefits that can be realised at group level and therefore the benefits that can be derived from the group support regime. Further, the potential differences in the treatment of subsidiaries in the same group could undermine co-operation in the college of supervisors and increase the complexity of the regime.

**5.7** The text provides that supervisors must work together, in full consultation, to decide whether or not to grant the application to apply the group support regime<sup>4</sup>. Supervisors are also required to do everything in their power to reach a joint decision<sup>5</sup> - the ultimate decision of the group supervisor is a safeguard to ensure a decision is made. Finally, to ensure its decision-making power is exercised responsibly, where the group supervisor makes the final decision in the absence of an agreed position in the college of supervisors, a document must be provided by the group supervisor setting out the reasons for the decision and views and reservations of the other authorities<sup>6</sup>.

**Removal of the power to apply a capital add-on**

**5.8** Supervisors of subsidiaries are under an obligation to consult the group supervisor before they impose a capital add-on.<sup>7</sup> The derogation provides that in the group support regime a supervisor cannot apply a capital add-on in the case where the group supervisor believes this is inappropriate. There is an understandable concern that some specific country risks or businesses might not be considered adequately in

<sup>1</sup> Article 211, paragraph 1 states this explicitly.

<sup>2</sup> Examples of powers retained by the subsidiary's supervisor are: the approval of certain eligible elements of own funds (Article 89 & 95); monitoring of solo MCR and solo SCR (Article 238); the application of investment principles (Article 130-133); the appropriateness of the level of technical provisions and the power to require an increase in technical provisions (Articles 83 & 84); and the right to carry out on-site and off-site analysis on ongoing topics (Article 34).

<sup>3</sup> Article 235(3)

<sup>4</sup> Article 235(1)

<sup>5</sup> Article 235(2) f

<sup>6</sup> Article 235(3)

<sup>7</sup> Article 254

the solo SCR of the subsidiary, and the supervisor of the subsidiary would not be able to make the final decision on the solo SCR.

**5.9** There is a key reason for allowing the group supervisor to make the ultimate decision on each subsidiary's SCR. The group supervisor is in the best position to coordinate the validation of SCRs across the group as a whole and ensure their consistency with the group SCR, and hence also with the assessment of group-level diversification effects. Further, the Directive proposal sets out a clear mechanism to address the concern that the risk profile of its subsidiary might not be captured in its solo SCR.<sup>8</sup> First, in any case, a capital add-on only becomes relevant if the undertaking does not properly address the concerns of the supervisory authority.<sup>9</sup>

**5.10** Second, the cases in which a capital add-on can be applied are specifically defined in the Directive proposal. These are only in cases of a material failure in the system of governance, or where the subsidiary's risk profile is such that the SCR calculation, whether by the standard formula or an internal model, does not achieve a capital requirement consistent with the calibration of the SCR set out in the Directive.

**5.11** In the context of the group support regime, it seems unlikely that the first condition for a capital add-on in a particular subsidiary will be met. Given that the internal control mechanisms of the parent company must cover the subsidiary in order for an application to operate under the group support regime to be successful, it seems very unlikely that the governance of the subsidiary could be so deficient as to warrant a capital add-on. It seems much more plausible that the college of supervisors would conclude that the deficiency must be remedied directly before the particular subsidiary could be included in the group support regime in the first place.

**5.12** In the second case, where a divergence in the risk profile of the subsidiary from the assumptions underlying the SCR calculation is the cause of the capital add-on, there is a very clear objective standard – that the calibration requirement of Article 100, paragraph 3 is met. The fact that this standard is objective does not of course mean that there is no room for disagreement. But given that the implementing measures relating to capital add-ons refer not only to specifying the circumstances under which they may be used but even the method of calculation, in reality the scope for divergent views is quite limited.

**5.13** Finally, in those cases where there is no agreement between the group supervisor and the supervisor of the subsidiary about a capital add-on, the matter can be referred to CEIOPS for consultation.

**The facility to permit group capital support**

**5.14** This derogation is clearly necessary for the group support regime to operate in practice. The previous Chapter noted the importance of allowing the ladder of supervisory intervention to operate at group level. Clearly if supervisors of subsidiaries can veto group support as a legitimate means of covering the difference between the SCR and MCR, ultimately the group support regime could be prevented from functioning at all. A middle position where some supervisors allow some proportion of the difference of SCR and MCR to be met by group support would create complexity and tend to weaken supervisory co-operation in the college. (Further, the group support regime is limited by the requirements to hold capital to meet the MCR at subsidiary level and that one third of a subsidiary's SCR must also be matched by Tier 1 capital held in the subsidiary).

<sup>8</sup> Article 236

<sup>9</sup> Articles 236(2) and 236(3).

**Ability to enforce the SCR** **5.15** It is key to the group support regime being able to protect policyholders that supervisors cannot impede transfers of capital subject to the MCR. The Directive requires that the subsidiary's supervisor is not responsible for enforcing the SCR through measures taken at the level of the subsidiary<sup>10</sup>. However, the supervisor of the subsidiary retains responsibility for monitoring the subsidiary's SCR and the Directive proposal does provide for the supervisor of a subsidiary to request transfer of funds or a new declaration of support from the parent undertaking where the SCR is no longer covered.<sup>11</sup>

**5.16** The group text provides detailed provisions about the monitoring of a subsidiary's SCR and specifies circumstances where the supervisor of the subsidiary can request new commitments to be provided or transfers of eligible own funds by the group parent. In addition, the Commission's proposals build in several safeguards to maintain the balance between the group and solo supervisor of a subsidiary. These include the ability to request verification by the group supervisor of the group's continued compliance with the conditions where the supervisor has significant concerns relating to their on-going compliance.<sup>12</sup>

### The college of supervisors

**5.17** The Directive proposal appropriately maintains a principles-based approach to the issues of how supervisory co-operation will in fact be organised for insurance groups under Solvency II. This section outlines possible ways in which those principles could be enhanced in the Directive proposal, and also how they could be further developed through level 3 guidance, in order to ensure that enhanced co-operation is embedded in the actual institutional structures which have the task of implementing group supervision.

**Supervisory cooperation** **5.18** Title III of the Directive proposal includes articles laying down the general principles behind supervisory co-operation. These include the appointment<sup>13</sup>, roles and responsibilities<sup>14</sup> of a group supervisor, and the requirements for consultation and exchange of information.<sup>15</sup> The key aspects of these articles include:

- A single supervisor be given responsibility for the coordination of group supervision – the group supervisor – and that the procedures for choosing this supervisor are clear and transparent;
- Certain powers are derogated to the group supervisor to enable it to have the final say in instances where consensus cannot be achieved, in order to ensure effective decision-making;<sup>16</sup>
- All information necessary to facilitate supervision is to be shared effectively between supervisors to allow them to meet their objectives; and

<sup>10</sup> Article 238, paragraph 1

<sup>11</sup> Articles 238, 239, 242 and 243.

<sup>12</sup> Articles 242(1) and 243(2)

<sup>13</sup> Article 251

<sup>14</sup> Article 252

<sup>15</sup> Article 253

<sup>16</sup> These include for example the power to approve the group internal model as per Article 229.

- Supervisory authorities work together and delegate tasks appropriately, based on the structure of the undertaking, in order to properly supervise the group in accordance with the requirements laid down in the Directive.

**5.19** The objective of these provisions is to encourage supervisors of an insurance group to develop effective co-operation structures to use in day-to-day supervision and also in times of crisis management.<sup>17</sup> The Directive requires<sup>18</sup> that supervisory authorities must consult with each other in order to take decisions on major sanctions or measures against the undertaking, or in general when a decision is made which is based on information from more than one supervisor. The scope for joint decision making is potentially very wide, and below we outline how this could apply more specifically to group supervision under Solvency II.

### The concept of a college of supervisors

**5.20** Given the variety of groups in terms of their overall size and complexity, it makes sense for a range of different co-operation structures and coordination arrangements to be adopted by supervisors to facilitate group-wide supervision. The activity of different supervisors involved in the supervision of a cross-border financial institution is commonly referred to as a college of supervisors. The main elements of this concept are as follows:

- the objective of the college of supervisors is to plan and co-ordinate the supervisory activities of the group in the way best suited to the nature of the undertaking concerned;
- the college is the forum for communication, decision-making and collective action by the supervisory authorities;
- The specific coordination arrangements used by the college will depend on the nature, scale and complexity of the group and the resources of the supervisory authorities; and
- Supervisors of any subsidiary would have the right to participate in the college, which will be led by the group supervisor.

**5.21** A well-functioning college of supervisors has substantial benefits both for the supervisory authorities concerned and for the insurance group itself. It leads to greater co-operation between supervisors, as well as providing a platform for efficient sharing of information across the college. Taking part in the college also gives supervisors the opportunity to gain valuable knowledge of the group's activities as a whole – rather than just those of the local subsidiary – which enhances their ability to supervise the undertaking's activities in their jurisdiction. (It also enables all supervisors to share best practice with their colleagues in other supervisory authorities).

**5.22** For the insurance undertaking itself, there is the key benefit of a co-ordinated approach to supervision, leading to a reduction in the costs associated with having to deal with multiple regulators (which often involves duplication of supervisory activities and information requests). This has the potential to lead to material cost savings which ultimately will flow through to policyholders.

<sup>17</sup> Note that these provisions apply to the supervision of all insurance and reinsurance groups whether or not they use the group support arrangements. Similarly, the proposals described in this chapter would be applicable to the supervision of all insurance and reinsurance cross-border groups regardless of their Pillar 1 arrangements.

<sup>18</sup> Article 254

### Development of colleges in the legislative framework

**5.23** There is a strong case in favour of reinforcing and strengthening the role of colleges in EU legislation. To this end, the UK has published a paper which proposes the establishment of colleges in EU legislation.<sup>19</sup> Under this proposal colleges would be mandatory for the prudential supervision of all cross-border financial institutions with significant presence in more than one Member State, regardless of legal form of that presence. Consistent with this general approach, Solvency II should include specific provisions relating to the establishment of supervisory colleges. These provisions could include the following requirements:<sup>20</sup>

- The high level objectives for the operation of colleges for cross border insurance and reinsurance groups. In keeping with the structure of the Directive, these would not specify detailed, prescriptive rules that would deny supervisory authorities the flexibility necessary to develop cooperation structures appropriate to the individual group.
- Requirements on membership of the college, including that all supervisory authorities of jurisdictions in which the group has significant presence are entitled to join the college.
- A requirement for colleges to draw up a Memorandum of Understanding (MoU) outlining the responsibilities of the group supervisor and the solo supervisors as well as the allocation of tasks between supervisory authorities in the college, recognising the fact that specific arrangements would need to vary on a case-by-case basis.

**5.24** The Directive proposal includes a specific regime for insurance and reinsurance groups based on the ability to use group support guarantees. Because of this there are specific areas where the college would play an important role relating to the functioning of the group support regime, and we therefore propose that the framework Directive outlines key areas where the emphasis is on supervisors to work together in the college to reach a joint decision. Essentially this would be an extension of the areas where joint decision-making is already envisaged in the text which include the following specific circumstances:

1. The decision on approval of the group internal model.<sup>21</sup>
2. The decisions on the adoption of the group support regime.<sup>22</sup>

**5.25** In order to embed the college of supervisors as the key mechanism for operating group supervision it would be important to extend the range of areas where there is an explicit requirement for supervisors work together to make joint decisions wherever possible to the following key cases:

3. Instances where there is a breach of the undertaking's group SCR.
4. By analogy with point two, when a new subsidiary undertaking joins the group support regime.

<sup>19</sup> Chancellor's letter to the President of the Council covering on-going supervision, crisis management, and resolution, 3 March 2008.

<sup>20</sup> These requirements do not alter the powers and responsibilities given to the supervisory authorities in the Directive.

<sup>21</sup> Article 229

<sup>22</sup> Article 235

**5.26** All of the above circumstances are areas that would require collaboration by supervisors in the college in order to assess the impact of these events on the group as a whole, and to decide on any appropriate supervisory action. Such a requirement in the Directive would ensure involvement of relevant supervisors of subsidiaries in material events affecting the group. The college would make every effort to reach a joint decision on how to respond but, as set out in the Directive, the group supervisor would ultimately take a decision in cases of disagreement (this is especially important in emergency situations).

### CEIOPS' mediation role

**5.27** In order to help colleges work efficiently and ensure consistency in regulation of cross-border groups, CEIOPS should have a role providing advice in order to facilitate decision-making between supervisors, as well as providing level 3 guidance on the operation of colleges. The Solvency II Directive gives CEIOPS this role in areas where supervisors are required to seek a joint decision, such as approval of the group internal model. In such cases where CEIOPS is consulted, it is in the end up to the group supervisor to make the final decision.<sup>23</sup> As with other areas of the Solvency II Directive, the high-level principles for colleges of supervisors could be further developed with operational guidance at level 3.

**5.28** In its recent consultation paper<sup>24</sup> CEIOPS has provided draft advice on aspects of the Directive proposal relating to Group supervision. In this draft advice CEIOPS reiterates the importance of effective co-operation between supervisory authorities in the form a college of supervisors. CEIOPS also emphasises the need for sufficient flexibility in the development of colleges to allow them to use the co-operation structures appropriate to each insurance group. The draft advice also lays down some general guidelines as to how these colleges may operate. For example, CEIOPS has advised that the group supervisor should carry out a risk-analysis which would include an assessment of the roles and responsibilities of the various supervisors involved, in order to determine the most practical form of organisational co-operation for the college.

**5.29** It is important that, in formalising roles and responsibilities, the college retains the necessary flexibility of approach to ensure effective group supervision. One effective approach would be to establish smaller virtual supervisory teams,<sup>25</sup> comprising of a mix of different supervisors responsible for specific areas of group supervision, such as reviewing the group internal model application or the calculation of the MCR.

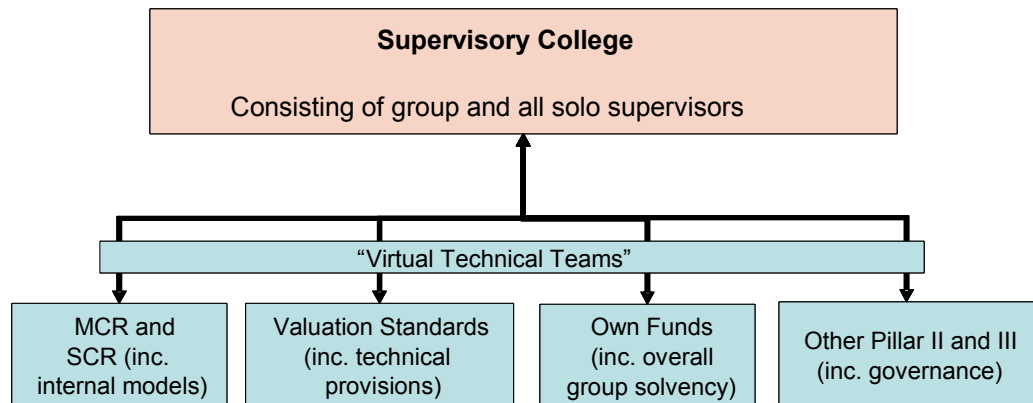
**5.30** Because Solvency II will harmonise prudential requirements across the EU, membership of the teams would be open to all supervisors based on their willingness and capacity to contribute to the workload. This structure is a way in which European supervisors can efficiently work together to achieve streamlined supervision of EU insurance and reinsurance groups, as envisaged by Commissioner McCreevy, in the speech referenced in Chapter One<sup>26</sup>. The diagram below indicates how the college structure might operate in practice:

<sup>23</sup> There is one instance where CEIOPS is given a decision-making role in cases where supervisors in the college disagree over the appointment of the group supervisor (Article 260); However, in general proposition level 3 committees have an advisory role rather than a decision-making one.

<sup>24</sup> CEIOPS' Draft Advice on aspects of the Framework Directive Proposal related to insurance groups: *Measures to facilitate the effective supervision of groups* (18 February 2008).

<sup>25</sup> These teams could be virtual in the sense that they would not necessarily be required to meet in person on an on-going basis, but would coordinate work-flow in an appropriate manner.

<sup>26</sup> See Chapter 1.



**5.31** In addition to disseminating information necessary for supervisors to fulfil their objectives and to delegate tasks appropriately, the college should consider the impact that on-going supervision has on the insurance group. For example, CEIOPS’ draft advice highlights the importance of avoiding duplication of reporting requirements. It is important that information flows effectively between the undertaking and all supervisors in the college and the virtual teams, while minimising duplication.

**5.32** The framework for the operation of colleges of supervisors can most appropriately be developed using level 3 guidance – however it may be useful to include in the Directive proposal a reference to colleges of supervisors as this institutional element is a key part of the approach to group supervision under Solvency II.

# 6

## OTHER ISSUES RELATING TO THE GROUP SUPPORT REGIME

**6.1** This chapter addresses a range of general issues that have arisen in response to the Commission's proposal for a group support regime. In each case the issue reflects important considerations in establishing the new approach to group supervision.

### Summary of chapter 6

The issues addressed in this Chapter are:

1. Measuring diversification effects at group level
2. Group wide reputational and other non-financial risks
3. Does the group support regime increase the risks of contagion across the group ?
4. Impacts on competition at Member State level
5. Equal treatment of policyholders across the group
6. Oversight of a Member State's insurance market
7. Merger and acquisition and the group support regime
8. The scope of the group support regime
9. The group support regime and the banking sector
10. Solvency II and insurance guarantee schemes

### Measuring diversification effects at group level

**6.2** One of the issues expressed in relation to the Commission's proposals on group supervision relates to the measurement of diversification effects at group level and whether it is possible to rely on them in assessing the group's solvency requirements. There are several different forms this issue can take:

- In its strongest form the concern is that diversification effects at group level are not a real economic phenomenon;
- Alternatively, even if group diversification is a reality, it is not possible to measure the quantity of group diversification at any point in time with sufficient confidence for the result to be relied upon for the purposes of prudential regulation;
- Finally, even if group diversification effects can be quantified at any point in time they are sufficiently volatile that any measurement cannot be relied on for a sufficient period to enable their use as part of group solvency assessment.

**6.3** The potential sources of diversification at group level and solo level are the same and therefore all of these points can be made in reference to diversification effects

within a legal entity.<sup>1</sup> A solo undertaking authorized in any Member State can write business throughout the EEA, obtaining diversification effects between lines of business, due to the geographical dispersion of risk and so on. It is equally capable as an insurance group with subsidiaries across Europe of obtaining any diversification effects relating to asset allocation and to the fact that the risks relating to assets and liabilities, as well as operational risk, are not perfectly correlated.

**6.4** One way to demonstrate the identity of the sources of diversification at group and at solo level is to consider the consequences of an insurance group deciding to transform its subsidiaries into branches. But if the group is transformed into a single legal entity with a branch network but retains its underwriting profile, its asset mix, its approach to reinsurance and risk mitigation, and so on, the sources of diversification are unchanged – the sole difference is that now they are internalised within a single legal entity rather than externalised between the parent company and subsidiaries.

**6.5** More generally, the SCR of any undertaking is a random variable which will fluctuate over time as the risk profile of the undertaking changes. This is necessarily true of the group SCR also. The key difference between an insurance group and a solo undertaking with a branch network relates not to the concept of the SCR but to the capital which is available to meet the SCR - in general transferability of capital is mainly an issue between legal entities rather than within them.<sup>2</sup> Transferability is therefore a key issue for the operation of the group support regime. But it is entirely independent of the measurement of the group SCR, the reliability of that measurement and its stability over time.

**6.6** Nevertheless, it is understandable that concerns have arisen relating to the reliability of group level diversification effects. Because of the expectation that the group SCR will typically be below the sum of the SCRs of the entities within the group, diversification effects at group level are far more conspicuous than those which arise within a solo undertaking. **This however does not affect the fact that the protection of policyholders through the requirement to hold own funds at least equal to the SCR is dependent on the reality of diversification effects within a solo undertaking just as much as at group level.**

**6.7** Insurance groups which use internal models to estimate group-wide solvency requirements are already capable of explaining the sources of diversification effects at group level. Firms should have the freedom to model their SCR, including at group level, but the counterpart to that flexibility is a number of requirements on the firm, including the use test, statistical quality standards and the calibration of the model in line with the SCR's 99.5 per cent 1 year VaR requirement, or equivalent. **An additional element which could reasonably be added in the group context is a requirement to explain the principle sources of diversification at group level.** This will provide the intellectual underpinning to the group-level diversification effects, by linking them to the underlying relationships between risk exposures. As with any requirement in an economic risk-based regime such as Solvency II this additional element for insurance groups should be applied proportionately.

<sup>1</sup> Diversification arises from the lack of perfect positive correlation between risks which an insurer or a group of insurers faces. Those correlations result from economic relationships, for example between the values of different assets, or the probability of simultaneous default of certain counterparties; they also arise from physical properties, for example the risks of severe weather events occurring simultaneously, or from the impact of technology on unexpected changes in longevity in different populations and so forth. All of these factors are exogenous to the legal form of an insurer. The only exception to this general principle is that it is possible to conceive of a relationship between legal structure and certain elements of operational risk.

<sup>2</sup> Though in respect of with profits life insurance in the UK, as in several other Member States, there are in fact ring-fencing arrangements which do create substantial issues of capital transferability within a single legal entity.

## Group wide reputational and other non-financial risks

**6.8** Another issue which touches on the reliability of the group SCR as a measure of the group's overall solvency needs is the impact of non-financial risks. In particular there is an argument that while in some respects a subsidiary may benefit from its group membership, it may also suffer costs in the form of risks which it faces solely due to its being a part of a group. A typical example is the reputational risk to a subsidiary which could materialize if another part of the group were facing financial difficulties.

**6.9** It is certainly true that in some scenarios this kind of group contagion could occur. However, this will be true not only for subsidiaries which are members of a group support regime, but also for subsidiaries which are outside such a regime. Indeed these kinds of non-financial risks have the potential to affect branches of a solo undertaking as well as subsidiaries, and also to spread across the boundary of an insurance group which is part of a financial conglomerate. They are therefore not especially connected to the group support regime per se.

**6.10** The suggestion has been made that these non-financial risks should, at least for groups, be brought within the scope of pillar 1 and therefore factored into subsidiaries' SCRs and the group SCR. Although any solo undertaking or group should consider non-financial risks in the broader sense, it does not appear that the best way to achieve this is through pillar 1 capital requirements. For this reason the Directive proposal specifically excludes "risks arising from strategic decisions and reputation risks" from inclusion in the concept of operational risk employed in the pillar 1 SCR.<sup>3</sup> In addition the Commission's proposal is very clear that group level risks which are difficult to quantify should nevertheless be considered as part of the decision as to whether a group capital add-on is required.<sup>4</sup>

**6.11** A second kind of non-financial risk which has been discussed in the context of the group support regime is operational risk in the sense defined in the Directive<sup>5</sup>. There is a concern that because the group support regime relies more heavily on the integration of risk management and control between different legal entities, correspondingly the operational risk to which policyholders in those subsidiaries are exposed is higher.

**6.12** This point is addressed in the Commission's proposal through the requirement in Article 234 that in order to be part of a group support regime a subsidiary's risk management and internal control must be integrated with that of the parent company. With the appropriate Level 2 measures articulating this principle in place, it is for the senior management and board of the parent undertaking to demonstrate compliance with the requirements of the group support regime.

## Does the group support regime increase the risks of contagion across the group ?

**6.13** A third argument which has been put forward and which relates to the issue of whether the group SCR accurately reflects the group's solvency needs depends on the idea that the group support regime itself increases the risks to subsidiaries in the group. The hypothesis is that the transmission of financial difficulties will spread across the

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<sup>3</sup> Article 100, paragraph 4; Recital 18 is also highly relevant to this point.

<sup>4</sup> Article 239, sub-paragraph (a)

<sup>5</sup> Article 13 (27)

group more rapidly under the group support regime and this will complicate supervision and ultimately place policyholders and beneficiaries at great risk than would otherwise be the case.

**6.14** If we assume that a group has eligible capital to meet its SCR and a severe unexpected loss occurs in a particular subsidiary, there is no reason to believe that the group support regime will lead to the resulting localized financial stress being transmitted across the group. Under these conditions the group's capacity to recapitalise the subsidiary will not be in doubt and as a result it is not clear why the financial difficulties there should be transmitted to other subsidiaries in the group. This of course is the benign set of circumstances in which the group as a whole is well capitalised.

**6.15** We have to consider also a much more problematic situation for the group where there are severe unexpected losses in several subsidiaries, their MCRs are breached and at the same time available group capital overall has fallen significantly below the group SCR. In these circumstances it is clear that any group, irrespective of the supervisory framework, will be facing severe challenges and there is a heightened risk to policyholders which supervisors will want to see rapidly addressed. But it would not be reasonable to think that a group operating without a group support regime will necessarily be significantly less vulnerable to the problems of intra-group contagion under financial stress. That will depend on the linkages among entities within the group.

**6.16** A subsidiary outside the group support regime is susceptible to the influence of the parent company and exposed to the kind of potentially contagious reputational risks described earlier in this section. This hypothetical subsidiary might well have significant intra-group exposures, perhaps to an internal reinsurer. Ultimately if the subsidiary suffers a major unexpected loss it will in most cases be reliant on the parent company to provide additional capital. The cumulative exposure of the subsidiary to the rest of the group is therefore potentially very considerable, but outside of the group support regime there is no obligation on the parent company to restore a capital breach in the subsidiary.

**6.17** The arguments as to whether policyholders of subsidiaries are better protected inside the group support regime than otherwise are only sketched here because they are fundamental to the practical operation of group supervision with the group support regime and therefore is discussed in detail in Chapter 4. Overall the balance favours the view that the group support regime strengthens policyholder protection because it prevents regulatory capital from being trapped in 'healthy' subsidiaries where it is not needed. **As a result any given quantity of transferable capital is capable of absorbing a greater range of risks emerging across the group and, as long as those risks are not perfectly correlated, the same quantity of capital can provide greater protection to policyholders.**

## Impacts on competition at Member State level

**6.18** It has been argued that one of the consequences of the group support regime is an unlevel playing field between a subsidiary of an insurance group and a solo undertaking. Because the former may hold capital on its balance sheet below its SCR there is a concern that a resulting lower cost of capital will give it an unfair advantage against solo undertakings operating in the Member State's market. However there are a number of points which can be made in response to this argument.

**6.19** First, the costs for any subsidiary within the group support regime go beyond the cost of holding capital on the balance sheet of the subsidiary itself; group support is a cost that the group bears relating to all subsidiaries in the group support regime - the costs the group incurs by holding eligible capital to meet the group SCR. **Of course this is likely to be lower than the cost of holding eligible capital to meet the sum of the subsidiaries' SCRs but that is just the inevitable consequence of recognising diversification effects at group level.** In addition there will be certain additional administrative costs associated with the group support regime itself, for example the need to demonstrate to the college of supervisors that the conditions for participating in the group support regime are met on an on-going basis.

**6.20** Further, if it were true that within any Member State subsidiaries in a group support regime held an unfair competitive advantage against solo undertakings, this must also hold good of branches operating outside of an insurer's home Member State. Branches need not even hold assets to match the technical provisions relating to the business written by the branch. If a subsidiaries in the group support regime benefited from an unfair competitive advantage, this would be true to an even greater extent for branches.

**6.21** Finally, and only as an ancillary point to the main arguments in this section, it turns out that any impact of the group support regime on Member States' insurance markets will be particularly large for the UK. Annex 3 contains data from the OECD for certain EU Member States on the size of insurance markets and the share which subsidiaries of foreign companies have in those markets. Because the UK insurance markets are relatively large and very open the amount of insurance business (as a percentage of GDP) in relation to which capital currently held in the UK subsidiaries of foreign groups could be held outside the UK is greater than for other Member States in the comparison.<sup>6</sup>

## Equal treatment of policyholders across the group

**6.22** Concerns have been raised about the group support regime in relation to the issue of fair treatment of policyholders across the group; however this issue does not arise only as a result of the group support regime; any intra-group exposures have the potential to create asymmetric outcomes for policyholders of different subsidiaries within a solo/supplementary framework of group supervision.

**6.23** The Directive proposal requires equality of treatment across policyholders by imposing symmetric capital requirements across the group and the principle of equality of treatment of policyholders. In particular it requires:

1. Under normal operation of the group support regime, each subsidiary holds eligible capital to meet at least its MCR and may rely on capital support from the parent company equal to the difference of its SCR less its MCR.
2. If a particular subsidiary is removed from the group support regime, including where it is wound up and found insolvent the parent undertaking must make good on the most recent group support commitment. Taken together with the requirements on own funds to be held in the subsidiary,

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<sup>6</sup> Because not all Member States are OECD members and even among those which are some data are missing the data unfortunately.

this implies that any losses up to the level of the subsidiary's SCR must be mitigated.<sup>7</sup>

3. If the group suffers such severe stress that it cannot provide sufficient capital to meet the MCR in each subsidiary, the allocation of available assets between subsidiaries is required to deliver equality of treatment between policyholders.<sup>8</sup>

**6.24** Finally, it is worth considering what would guarantee equality of treatment under a solo/supplementary regime. Of course each subsidiary would be required to meet its SCR but beyond this there is nothing to require the group to use any additional capital in an equitable manner. Superficially this may not appear to matter, as each subsidiary meets its SCR the allocation of additional capital may reasonably be seen to be a matter purely at the discretion of the group.

**6.25** However, it is possible to conceive of situations where a group were to operate a system of internal reinsurance, and there are then losses in several subsidiaries, each of which is reliant on an internal reinsurer but only one of which is located in the same Member State as the internal reinsurer. In these circumstances there is a risk that the supervisor which has responsibility for both the internal reinsurer and the co-located subsidiary would be in a position to facilitate preferential treatment for the policyholders of the subsidiary in its jurisdiction.

**6.26** Therefore the problem of treating all policyholders fairly does not simply disappear under a solo/supplementary regime. In itself the fair treatment issue is not a reason to prefer the solo/supplementary regime. The Directive's proposals on groups provides an effective framework to assess transferability of capital and the potential issues of fair treatment of policyholders of a small subsidiary within a large group.

## Oversight of a Member State's insurance market

**6.27** A further concern that has been expressed in response to the Commission's proposals is that in some Member States the market share of subsidiaries of foreign groups is very high and as a result the implementation of the group support regime will make it more difficult for the supervisor to retain oversight of the market as a whole.

**6.28** First, there is nothing in the Commission's proposals which reduces the quality of co-operation between supervisors or inhibits the flow of information. Therefore all the information that a supervisor currently has on its local market should continue to be available to it under the Commission's proposals.

**6.29** In addition the subsidiary's supervisor will have access to considerably more information about the financial condition of each insurance group, on a group-wide basis, than is currently the case. Without such access it is difficult to see how a college of supervisors could operate effectively. The Directive proposal provides detailed provisions for the exchange of information it also envisages implementation measures that will develop the detail of how co-operation should best be organised, and the arrangements for exchange of information in Level 2 and 3.<sup>9</sup>

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<sup>7</sup> Articles 238, 239 and 242.

<sup>8</sup> Article 244, paragraph 1.

<sup>9</sup> Articles 261(2) and 262(2)

**6.30** In the context of this concern it is worth keeping in mind that the solo supervisor retains all of the powers it has in respect of a solo undertaking, except those where there is a specific derogation. In particular the supervisor of a subsidiary has the right to require a recalculation of the subsidiary's SCR where justified, in its view, by new material information relevant to the subsidiary's risk profile.<sup>10</sup> This enables the supervisor to ensure that where there are relevant changes in the local market any material impact on the subsidiary's SCR will be recognised in the recalculation.

## Merger and acquisition and the group support regime

**6.31** The concern has been raised that the group support regime may lead to transitional problems when a subsidiary enters or exits the regime. However there is the potential for problems of transition whatever group supervision regime is adopted. For example, groups may choose to transform existing subsidiaries into branches, resulting in a wholesale shift of supervisory responsibilities. Any transition, whether it involves the acquisition of a solo entity insurer by a group which turns it into a subsidiary or the transformation of a subsidiary into a branch, necessarily involves some practical challenges.

**6.32** Second, the shift of responsibilities that will occur when a group acquires an insurance undertaking, transforming it into a subsidiary, are limited to the derogations from the application of the requirements of solo supervision. The derogations from solo supervision are only as extensive as is necessary to permit the group support regime to operate.

**6.33** Third the inclusion of a newly acquired subsidiary into an existing group support regime is not automatic. The Commission's proposals establish the general principle that if a subsidiary is to be included in the group support regime under which a group is regulated its risk management and internal controls must be integrated with those of the parent company. In addition the supervisory authorities concerned must be satisfied regarding the "prudent management of the subsidiary" (Article 234 sub-paragraph (b)). This immediately establishes a test which any group seeking to include a solo entity in a group support regime which it has acquired must pass.

**6.34** Further, Article 235 clearly establishes that where appropriate the consent to include subsidiaries in the group support regime can be subject to certain terms and conditions.

## The scope of the group support regime

**6.35** A further question about the operation of the group support regime is its application in the case of subsidiaries which have a large shareholder other than the parent company. Clearly it is possible that the extension of the group support regime may well not be the same as the group as a whole. An obvious example of a subsidiary which might not be capable of being included in group support is a joint venture. Typically joint ventures require a sharing of influence over the subsidiary and this implies that the condition required by Article 234 sub-paragraph (b) - that the risk management and internal control systems of the parent company cover the subsidiary - may not be met. However, to prohibit certain subsidiaries from inclusion in the group support regime solely on the grounds of their status as a joint venture, or due to a major

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<sup>10</sup> Article 102

holding by another company including a participation, is not necessary or appropriate in the framework Directive.

**6.36** What is important is that the objective requirements of the Directive and the implementing measures which specify them are met. One clear implication of the requirements of 234 sub-paragraph (b) is that a subsidiary cannot be a member of more than one group support regime. To meet the requirements of that sub-paragraph a parent company would need to have sufficient control over the subsidiary such that it could alter the risk profile of the subsidiary if it so chose. Clearly it is not possible for two parent companies to have this degree of control over an undertaking's risk profile.

## The group support regime and the banking sector

**6.37** The question has been posed whether acceptance of the group support regime in the insurance sector implies that the same or a similar approach should be adopted in the banking sector. The short answer is that the accepting the group support regime in the insurance sector does not carry any implication for its acceptance in the banking sector. The reasons relate to the fundamental economic differences between the activities of insurance and banking.

**6.38** Banks have highly liquid liabilities and typically invest funds in much less liquid assets; in general insurers, most obviously non-life insurers and reinsurers, are in the opposite position. Although the timing of cash-flows relating to non-life insurance liabilities is uncertain, the discretion of policyholders is not a major factor. In addition a typical insurer's asset portfolio is weighted towards government bonds, other liquid debt instruments and equities. As a result, while of course insurers may face solvency difficulties following unexpected losses, their exposure to adverse changes in the timing of cash-flows is much lower than in the banking sector.

**6.39** The different liquidity characteristics of typical liability and asset portfolios of insurers compared with those of banks is not the only important economic difference between the two sectors. By extending credit to businesses and households, banks are directly exposed to the economic cycle; further, the price of credit extended by the banking sector is itself a key input to that cycle. There are two important implications of these points which again differentiate the underlying economics of banks from insurers.

**6.40** First, the sources of diversification in the banking sector are ultimately limited by the extent of regional and sectoral divergences within an economy and the correlations between cycles of different economies. However, macroeconomic factors affect all regions and sectors of an economy and integration of the economies of Member States promotes increasing convergence in their co-evolution. In terms of their effects on the sources of diversification there are no analogues at least in non-life insurance to a macroeconomic factor, such as monetary policy, which has an impact across the economy or to the phenomenon of economic integration.<sup>11</sup> Second, the fact that the price of credit is itself a key factor influencing the economic cycle creates a powerful feedback mechanism between the banking sector and the real economy. Again, there is no comparable phenomenon in the insurance sector.<sup>12</sup>

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<sup>11</sup> The argument could be made that longevity risk may converge over time among different populations due to converging levels of health expenditure and access to technology.

<sup>12</sup> It may be thought that the insurance cycle in the non-life sector creates a similar feedback mechanism. Although this cycle may impact the price of insurance cover, it does not have the potential to affect the underwriting risks per se; in contrast, when, for example, the price of credit increases and its availability contracts this process has effects on the real economy which in turn *do* alter the incidence and intensity of credit risk.

**6.41** This is only a brief discussion of the differences of the economics underlying the banking and insurance sectors. However it is sufficient to demonstrate that the sectors are fundamentally different and therefore a decision to adopt a group support regime in the insurance sector is logically completely separate from the decision in respect of the banking sector.

## Solvency II and insurance guarantee schemes

**6.42** The Commission's proposal for a group support regime has understandably been linked to the debate on insurance compensation schemes. There are two reasons for making the link:

- first, because a subsidiary may hold less capital than its solo SCR under the group support regime it would appear to present a greater risk to any compensation scheme ; and
- second, because supervisory responsibilities are shifted towards the college of supervisors and the group supervisor under the Commission's proposal, the losses which a compensation scheme might absorb could be regarded as due to decisions made by the college or the group supervisor and which would not have been taken by the subsidiary's supervisor if it had retained all supervisory powers in respect of the subsidiary.

**6.43** The first reason implicitly relies on the proposition that under the group support regime the protection for policyholders of the subsidiaries of an insurance group is weaker than that provided by a solo undertaking. The text of the group support regime places a requirement on the group parent to transfer sufficient capital to recapitalise a subsidiary at least up to the level of the MCR or, in some circumstances, to provide additional capital to the level of the subsidiary's SCR<sup>13</sup>. Chapter 2 analysed the issue of equivalence of policyholder protection and concluded that as long as the requirements of the Directive proposal are met this is not the case and if the policyholders of the subsidiary are not put at greater risk by the group support regime, a fortiori neither is the guarantee scheme to which the subsidiary belongs.

**6.44** The second reason relates to supervisors in other Member States having an influence on the supervision of the group as a whole which may in turn affect the solvency condition of a particular subsidiary. Where that subsidiary is included in a guarantee scheme this could lead to cases where that scheme bears losses which it might be thought would not have occurred in the absence of the group support regime. However this argument relies on the proposition that the supervisory framework will increase the risks for policyholders of a subsidiary, and potentially a guarantee scheme because the supervision of the group will overlook particular issues in an individual subsidiary. Of course the viewpoint developed in this paper is that supervising the group as an integrated economic unit will lead to better outcomes overall and because each subsidiary's supervisor will have the right to participate in the college particular issues relating to individual subsidiaries will not be overlooked.

**6.45** In addition to the general view advanced in this paper that supervision of an insurance group on a more consolidated basis will lead to a more realistic view of the risks across the group and the capital available to meet those risks, there are other aspects of the Commission's proposal which safeguard against a situation in which a guarantee scheme is exposed to additional risk because of the group support regime.

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<sup>13</sup> Articles 247(2) and 247(3)

The critical supervisory judgement in respect of whether a subsidiary within the group support regime could place a guarantee scheme at greater risk is the level of the subsidiary's solo SCR.

**6.46** There are two ways in which the Commission proposal allows a decision on the subsidiary's solo SCR to be taken which conceivably might not be in accord with the views of the subsidiary's supervisor. The first relates to the approval of a group-wide internal model where in the absence of a joint decision by all of the supervisors in the college, the group supervisor will have to make a final determination<sup>14</sup>. This of course is not related to the group support regime per se and is therefore a more general issue relating to group supervision and guarantee schemes.

**6.47** The second does relate to the group support regime which requires that the supervisor of a subsidiary may not unilaterally impose a capital add-on on the subsidiary's solo SCR – the consent of the group supervisor is required<sup>15</sup>. However in both of these cases there is the safeguard that CEIOPS may be consulted. This should provide strong reassurance that any reasonable concern that the subsidiary's supervisor might have would be fully considered before any final decision is taken on the solo SCR for that undertaking. This should minimise any residual risk that the particular circumstances of a given subsidiary are overlooked and therefore any guarantee scheme should not be exposed to increased risk because of the operation of group supervision.

**6.48** In addition to these safeguards, it is important to keep in mind that the Directive proposal only removes certain powers from the solo supervisor and then only under certain conditions which the group must comply with on an on-going basis. In particular the supervisor of the subsidiary retains all of the powers which are provided in the event of the breach of the subsidiary's MCR. It is at this stage, when MCR is breached and the subsidiary will be removed from the group support regime if the breach is not rapidly restored, that the risk to any guarantee scheme is material.

**6.49** In conclusion it is not the case that the group support regime places a guarantee scheme at greater risk and therefore it does not affect the argument as to whether there should be an EU-wide framework for insurance guarantee schemes. For some time HM Treasury and the FSA have taken the view that there is a case for an EU wide framework for insurance guarantee schemes<sup>16</sup>, given that the framework enables appropriate approaches to scheme design.

**6.50** Finally it is not the case that the group support regime introduces any fundamentally new issue for the design of a framework for EU insurance guarantee schemes. An insurer with a branch network across different Member States also presents the issue of how to compensate policyholders of a branch located outside the undertaking's home Member State. In this case the responsibility lies with the home supervisor and therefore it would be natural that the branch should be included in the guarantee scheme of the undertaking's home Member State. If an EU wide framework for insurance guarantee schemes were introduced, it would be reasonable to consider the implications of the group support for the design of the regime: since responsibility for supervision is shared to a greater degree than under a solo/supplementary approach it would be appropriate to consider how the burden of compensation should be shared across the guarantee schemes of the parent company and the subsidiary.

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<sup>14</sup> Article 238, paragraph 5

<sup>15</sup> Article 245, paragraphs 2 and 3.

<sup>16</sup> A framework for Guarantee Schemes in the EU: A discussion paper, October 2005

# 7

## ALTERNATIVES TO THE GROUP SUPPORT REGIME

**7.1** This Chapter looks at alternatives to a group support regime; as noted in Chapter One a key aim of Solvency II defined by the Commission is to deepen the integration of the EU insurance market. The impact of Solvency II on the nature and extent of cross-border activity in insurance and reinsurance services is therefore a key consideration.

### Summary of Chapter 7

This Chapter looks at the principle alternatives to the group support regime:

1. Branching;
2. Internal reinsurance;
3. Intra-group transformation of external financing; and
4. Down-streaming of diversification benefits.

Unlike the group support regime none of these options provides the benefit of combining the recognition of group-level diversification effects with an integrated approach to supervision of the group as a whole with shared responsibilities and a platform for co-operation and joint decision-taking for the supervisory authorities.

### Branches and subsidiaries

**7.2** Under the insurance directives an insurance group always has the option of transforming some or all of its subsidiaries into branches. Currently, selling insurance through a branch network is much less common across the EU than through subsidiaries but the advent of Solvency II could materially alter the incentives. Unlike under Solvency I, under the new framework with a branch network all potential diversification effects will be realised within the undertaking and the higher capital requirement of the new framework provides a powerful incentive to change the legal form of the undertakings within the group.

**7.3** It is often pointed out that a branch network provides more security for the policyholders of a branch because in general all assets within the undertaking are potentially available to meet the liabilities due to the policyholders of the branch. However from the perspective of the host supervisor for each branch the fact that all assets in the undertaking may be available to cover policyholder claims is actually a double-edged sword. The additional security which appears to be offered by the undertaking with a branch network is off-set by the fact that every other branch enjoys exactly the same additional protection. So if there is a large unexpected loss in branch A in Member State X this may jeopardise policyholder protection for branches B and C in Member States Y and Z. The overall capital requirement for the undertaking is the solo SCR so a branch network cannot be regarded as providing greater protection for all policyholders of the undertaking, across all its branches, than a group, simply in virtue of the fact that the branch is not a separate legal entity.

**7.4** In addition, from the perspective of the host supervisor a branch network creates some particular challenges. Article 29 of the Directive proposal requires

explicitly that financial supervision should be reserved solely to the home supervisor<sup>1</sup>. Beyond information exchange this effectively eliminates any potential role in the prudential regulation of the branch for the host supervisor. This highlights the implications of very strong incentives favouring one particular legal form through which the benefits of the Single Market are accessed. There is a broader reason for preferring an approach which avoids very strong incentives for insurance groups to adopt a particular legal structure – the general proposition underlying Solvency II that it should introduce an economic risk-based regime which promotes alignment of regulatory requirements with industry practice.

## Internal reinsurance

**7.5** Because Solvency II is predicated on the idea that insurers should measure the risks to which they are exposed on a realistic basis, it follows that they must be allowed to take credit in capital requirements for the economic substance of the risks transferred – of course, net of the resulting counterparty default risk. This extends to intra-group risk transfers including reinsurance. In the absence of the group support regime the direct result is that the sum of the capital requirements for subsidiaries in the group will be a function of the distribution of risks between the legal entities in the group. As with the issue of branch networks there is a very strong incentive to adopt a particular legal structure in order to achieve economically rational capital requirements at group level.

**7.6** Just as transferring from a group structure with subsidiaries to a branch network does not alter the economic nature of the risks across the group as a whole this is also true when risk is transferred to an internal reinsurer. Both cases illustrate the problems that arise if Solvency II adopts an economic risk based approach at the level of a legal entity but not at the level of the group.

**7.7** Further, the possibility of, and incentive to, transfer risk on an intra-group basis will have implications for the supervisor of a subsidiary in the group<sup>2</sup>. If a subsidiary has portfolios of liabilities whose underwriting risks are diversified with those of other subsidiaries in the group, the impact on the sum of the solo SCRs of proportional reinsurance with an internal reinsurer will be significant. The consequences are not as severe as in the case of subsidiaries being transformed into branches where all supervisory powers relating to prudential regulation will be lost, but they are nevertheless substantial. A subsidiary's supervisor could easily be in the position that the undertaking in its jurisdiction is highly reliant on an internal reinsurer located in another Member State over which it has no oversight. This is just another example of the consequences of adopting an economic risk-based approach at the level of a solo undertaking but not at group level.

**7.8** On a related issue, the question has been raised why in the group support regime there is no additional capital requirement in each subsidiary undertaking which reflects its exposure to the parent undertaking. The reason is that the relationship between a parent undertaking and a subsidiary within the group support regime is fundamentally different from that between an undertaking and an unrelated counterparty to which it has an exposure:

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<sup>1</sup> Article 32 does convey the right for the supervisor in the host Member State to participate in any on-site verification of the branch of an undertaking established in another Member State.

<sup>2</sup> The possibility of refusing to accept an reinsurance contract with an internal reinsurer which is authorised under the Directive and the refusal is based on the financial standing of the reinsurer is explicitly ruled out by Article 31.

1. The subsidiary is subject to the group supervision applied to the group as a whole;
2. the test that the parent company's risk management and internal control mechanisms extend to the subsidiary has to be met.<sup>3</sup>

**7.9** Neither of these conditions could be imposed in the case where an undertaking has an exposure to an unrelated legal entity. These differences in the approach to supervision reflect the fact that although the group support regime contains separate legal entities, there are real economic links between those entities which differ fundamentally from the case where an insurer has an exposure to an unrelated counterparty. Finally, the nature of the group support commitment reflects this difference:

3. it has to meet certain conditions including to ensure that eligible own funds will be transferred promptly when needed and the group supervisor has to verify that these conditions are met;<sup>4</sup>
4. the group support must be publicly disclosed;<sup>5</sup> and
5. the group supervisor must enforce the group support commitment and is entitled to use all powers available to ensure that the transfer of own funds is executed rapidly;<sup>6</sup>

**7.10** The requirements relating to group support therefore go well beyond a legal contract that the subsidiary could have with an external counterparty; such a contract would not be subject to prior supervisory approval, there would be no requirement for public disclosure and crucially its enforcement would not be a matter for supervisors.

**7.11** Having considered how groups might respond to the Solvency II framework in the absence of the group support regime proposed by the Commission, the next section looks at the alternatives to that proposal.

## **Intra-group transformation of external financing**

**7.12** The first suggestion is that groups would be required to hold eligible own funds in each subsidiary to meet the solo undertaking capital requirements, and of course the group as a whole would be required to meet the group SCR with appropriate eligible own funds. However, the group would be permitted to finance the difference between these two capital requirements using unsubordinated debt; this would be issued at group level and then down-streamed into the subsidiaries.

**7.13** There are a number of problems with this idea. First, the proposed approach is inconsistent with Solvency II as it imposes a financing requirement which is inconsistent with the 99.5% 1 year standard for the SCR. If the group SCR is the appropriate value and approved by the college of supervisors or the group supervisor, the corresponding diversification effects at group level are tested at least as rigorously as those reflected in the SCR of a solo undertaking. In this case there is no reason to seek additional finance at group level. On the other hand, if the diversification effects are not

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<sup>3</sup> The satisfaction of this requirement is supervised on an annual basis - Article 251, paragraph 1.

<sup>4</sup> Article 246, paragraph 3.

<sup>5</sup> Article 250.

<sup>6</sup> Article 249, paragraph 1

fully underpinned by the economic reality of the group and the group SCR should not have been approved, then additional unsubordinated debt at group level is not sufficient as it cannot substitute for what the group actually needs – additional eligible own funds.

**7.14** Further, how would a group respond under financial stress if it held unsubordinated debt at group level to make-up the difference between the consolidated group SCR and the sum of the solo SCRs? If there are unexpected losses in one subsidiary, capital held elsewhere in the group to meet the solo SCRs of other undertakings cannot be transferred to assist the particular subsidiary. The group would therefore need to acquire more capital from external sources which could be down-streamed into the subsidiary with a capital shortfall; because more capital is tied up in the subsidiaries, the financial strain on the group is greater for any given level of unexpected loss.

**7.15** One of the key ideas underlying Solvency II is the benefit of transparency and the principle that an economic approach to valuation is fundamental to achieving transparency for insurers and reinsurers (as noted in Chapter One). The requirement to hold unsubordinated debt to match group wide diversification effects reduces transparency by enabling unsubordinated debt at group level to provide capital at solo level. In practice the lack of transparency would not prevent providers of capital to insurance groups from perceiving that the supposedly unsubordinated debt issued by the group would in reality be subordinated to policyholder claims. As a result the price of the debt would increase to the level required for a subordinated capital instrument. So in all probability the group would not receive the benefit of diversification effects at group level and in the unlikely event that it did, this benefit would be dependent on a misconception about the economic reality of the group.

### Down-streaming of diversification benefits

**7.16** The second option which would enable groups to benefit in some degree from diversification effects at group level envisages a group-wide capital requirement set by the group SCR combined with the attribution of the own funds to the subsidiaries within the group support regime. So the own funds meeting the group SCR have to be attributed to the various subsidiaries.

**7.17** However, if the requirement to hold capital in each subsidiary is binding then this alternative prevents the group support regime operating at all. In order to function the group support regime requires that capital can be transferred; if all of the capital that is held to meet the consolidated group SCR is localized in particular subsidiaries, clearly the group will have to hold transferable capital above this level in order for the group support regime to operate. This implies that diversification effects at group level are not being recognized. Further, if diversification benefits are down-streamed into the subsidiaries, it is clear that there still needs to be a group support regime – otherwise subsidiaries will not be able to hold less capital than the solo SCR and still provide adequate policyholder protection.

# SUMMARY OF POSSIBLE DEVELOPMENTS TO THE DIRECTIVE PROPOSAL

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This chapter provides a brief summary of possible enhancements suggested in this paper that might be included in the Directive proposal. Six possible amendments are suggested and these are listed below.

## 1. Reference to the role of colleges of supervisors

**A.1** It is clear that the operation of the group support regime requires much enhanced supervisory co-operation, which is in any case a worthwhile goal. One additional way of embedding this is to make reference to the college of supervisors concept. While the organisation of such colleges is best left to the participating supervisors, introducing the concept in the framework Directive should help to clarify that group supervision under Solvency II will be conducted as a co-operative exercise by the relevant supervisors, and not mean simply the reallocation to the group supervisor of responsibility for the group as a whole. As set out in Chapter 5 in order to embed the college of supervisors as the key mechanism for operating group supervision there is a case for an explicit requirement for joint decision-making in the following key cases:

- Instances where there is a breach of the undertaking's group SCR; and
- Cases where a new subsidiary undertaking joins the group support regime.

## 2. Amendment to derogation from Article 136

**A.2** Article 238 provides a derogation from Article 136 so that the supervisor of a subsidiary under the group support regime is no longer responsible for enforcing its SCR "by taking measures at the level of the subsidiary". This derogation includes paragraph 1 of Article 136 which requires that an undertaking notify its supervisor if the SCR is breached or if there is a risk of such a breach in the next three months. It seems useful to limit the derogation to paragraphs 2 to 4 of Article 136. There is no reason why a subsidiary under the group support regime should not inform its supervisor of an SCR breach or the risk of one. Of course both the parent undertaking and the group supervisor will be involved in taking measures to rectify the situation and therefore informing them is also essential.

## 3. Early Warning Indicators for emerging risks in a subsidiary in the group support regime

**A.3** It makes sense for the college of supervisors to agree wherever appropriate a set of Early Warning Indicators, paying particular attention to the information they would provide which is specific to subsidiaries in the group. The details of what sorts of information are relevant and their relative importance will be different in each insurance group so logically this is best left to level 3 but a level 2 implementing measure which established that Early Warning Indicators could help ensure consistent implementation for cross-border groups in particular.

#### **4. Requirement to provide information on the main sources of group-level diversification effects**

**A.4** The main sources of diversification at group level should be reported to the group supervisor as part of the process of approving a group-wide internal model. Article 229 could be amended accordingly. For example the directive could reasonably require that the application to use a group internal model should include information allowing a proper understanding of the principle causes of the difference between the group SCR and the aggregate of the SCRs of the insurance and reinsurance undertakings in the group. In addition and subject to considerations of commercial confidentiality a summary of the main sources of diversification could be required as part of Pillar 3 disclosures, by analogy with Article 50 paragraph 1 (e) (iii).

#### **5. Application of Prudent Person principle to holding companies operating under the group support regime**

**A.5** Where an insurance group has a holding company as its ultimate parent undertaking at EU level, this company may hold some of the assets which are used to provide group support commitments. In general these asset holdings will not be regulated so for the purpose of operating the group support regime the Prudent Person principle should apply to the holding company. Article 261 already applies the fit and proper person requirements to those persons who effectively run an insurance holding company and Article 42 applies by analogy. This needs to be extended to the application of Article 130 to a holding company which has applied to operate the group support regime.

In addition parent undertakings operating the group support regime should be required to demonstrate that they can make good the group support commitment by means of a transfer of assets of appropriate security, quality and liquidity for the subsidiary into which the transfer may take place.

#### **6. Direct application of Title III of the Directive to holding companies operating the group support regime**

**A.6** As discussed at the end of Chapter 3, the direct application of the provisions of Title III of the Directive proposal to a holding company which is the parent company of a group operating under the group support regime would avoid any uncertainty as how these obligations are imposed on the holding company. In addition the group supervisor's powers against a holding company are likely to differ from those against an insurance undertaking, and this suggests that the ultimate sanction on a group headed by a holding company which is operating the group support regime should simply be the removal of the entitlement to operate under that regime.

# B

## MARKET SHARES OF FOREIGN SUBSIDIARIES

Life and non-life gross premium written by foreign subsidiaries in certain Member States, 2004 data

2004	LIFE			NON-LIFE			TOTAL		
	Mkt size €m	Foreign subsidiaries mkt share		Mkt size €m	Foreign subsidiaries mkt share		TOTAL €m	GDP €m	TOTAL/ GDP %
		%	€m		%	€m			
Austria	6,151	22.9%	1,410	9,496	43.4%	4,120	5,531	236,149	2.3%
Czech Rep.	1,387	84.4%	1,171	2,146	92.0%	1,975	3,145	88,262	3.6%
Germany	86,666	11.2%	9,715	149,569	8.2%	12,250	21,965	2,211,200	1.0%
Hungary	972	87.2%	847	1,420	89.4%	1,269	2,116	82,322	2.6%
Italy	69,425	23.8%	16,488	39,569	33.1%	13,105	29,594	1,391,530	2.1%
Netherlands	25,339	23.0%	5,823	23,765	18.6%	4,411	10,234	491,184	2.1%
Poland	2,310	56.4%	1,303	3,798	40.0%	1,517	2,820	204,237	1.4%
Portugal	6,131	9.0%	551	4,290	31.1%	1,333	1,884	144,128	1.3%
Spain	19,846	5.2%	1,030	28,045	20.0%	5,601	6,631	841,042	0.8%
Slovakia	485	98.6%	479	720	100.0%	720	1,199	34,023	3.5%
Sweden	13,235	5.1%	675	11,304	49.1%	5,550	6,225	287,690	2.2%
UK	167,710	36.5%	61,264	103,731	38.1%	39,511	100,776	1,745,051	5.8%
<b>TOTAL</b>	<b>399,656</b>		<b>100,758</b>	<b>377,852</b>		<b>91,361</b>	<b>192,119</b>	<b>7,756,818</b>	<b>2.5%</b>

\*The data covers only a selection of Member States because not all Member States are also OECD members and, among those which are, relevant data are missing in some cases.

Source: Premium and market share data from OECD Insurance Statistics Yearbook 2006, converted using an average rate €/€ for 2004 of 1€ to \$1.24. GDP data from Eurostat.



# C

## EXAMPLES OF CAPITAL TRANSFERS UNDER THE GROUP SUPPORT REGIME

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**C.1** The assumptions underpinning the example are:

1. the group has six subsidiaries; the parent company is a holding company;
2. the scenario involves unexpected losses concentrated in two subsidiaries which together equal 50 per cent of the group SCR;
3. under the group support regime each subsidiary holds only its MCR before the loss event, the rest of the group's capital is held by the parent company and this is assumed to be transferable across the group.

**C.2** The scenario is applied to three cases:

- solo/supplementary supervision where each subsidiary holds eligible capital exactly equal to its SCR;
- the group support regime where the group is assumed to hold total eligible capital to equal the sum of the subsidiaries' SCRs; and
- the group support regime where the group is assumed to hold total eligible capital to equal to the group SCR.

**C.3** The scenarios show that the group support regime provides protection for policyholders which is at least as good as that provided in the solo/supplementary regime. The final available capital positions of the subsidiaries which suffer losses are the same in each case but under the group support regime the group holding company has transferable capital remaining after the unexpected losses have triggered transfers into the two subsidiaries affected. This is true including in the case where under the group support regime the group only holds capital exactly equal to the group SCR.

**Solo/supplementary supervision  
(group holds capital equal to sum of subsidiaries' SCRs)**

	Subsidiaries						Group-wide position	
	A	B	C	D	E	F		
<b>Required and available capital prior to loss event</b>								
Solo SCR	100	75	220	40	130	150	Sum of solo SCRs	<b>715</b>
Solo MCR	33	25	73	13	43	50	Minimum consolidated group SCR	<b>236</b>
Eligible capital	100	75	220	40	130	150	Eligible capital in the subsidiaries	<b>715</b>
							Surplus in the parent company	<b>0</b>
							Capital which can move around the group	<b>0</b>
<b>Loss event occurs</b>								
Loss event	0	0	<b>160</b>	0	0	<b>108</b>	Loss across group	<b>268</b>
Available capital after loss event	100	75	<b>60</b>	40	130	<b>42</b>	Eligible capital after loss event	<b>447</b>
<b>Consequence of loss event</b>								
Capital support transferred	0	0	0	0	0	0	Total capital transferred following loss event	<b>0</b>
Final eligible capital	100	75	<b>60</b>	40	130	<b>42</b>	Final capital which can move around the group	<b>0</b>

**Group support regime  
(group holds capital equal to sum of subsidiaries' SCRs)**

	Subsidiaries						Group-wide position	
	A	B	C	D	E	F		
<b>Required and available capital prior to loss event</b>								
Solo SCR	100	75	220	40	130	150	Sum of solo SCRs	<b>715</b>
Adjusted solo SCR	80	60	176	32	104	120	Group SCR	<b>536</b>
Solo MCR	33	25	73	13	43	50	Minimum consolidated group SCR	<b>236</b>
<b>Eligible capital</b>								
Eligible capital	33	25	73	13	43	50	Eligible capital in the subsidiaries	<b>236</b>
Surplus capital (eligible less MCR)	0	0	0	0	0	0	Surpluses in the subsidiaries	<b>0</b>
							Surplus in the parent company	<b>479</b>
							Capital which can move around the group	<b>479</b>
<b>Loss event occurs</b>								
Loss event	0	0	<b>160</b>	0	0	<b>108</b>	Loss across group	<b>268</b>
Available capital after loss event	80	60	<b>-87</b>	32	104	<b>-58</b>	Eligible capital after loss event	<b>447</b>
<b>Consequence of loss event</b>								
Capital support transferred	0	0	<b>147</b>	0	0	<b>100</b>	Total capital transferred following loss event	<b>247</b>
Final eligible capital	33	25	<b>60</b>	13	43	<b>42</b>	Final capital which can move around the group	<b>232</b>

**Group support regime  
(group holds capital equal to group SCR)**

	Subsidiaries						Group-wide position	
	A	B	C	D	E	F		
<b>Required and available capital prior to loss event</b>								
Solo SCR	100	75	220	40	130	150	Sum of solo SCRs	<b>715</b>
Adjusted solo SCR	80	60	176	32	104	120	Group SCR	<b>536</b>
Solo MCR	33	25	73	13	43	50	Minimum consolidated group SCR	<b>236</b>
Eligible capital	33	25	73	13	43	50	Eligible capital in the subsidiaries	<b>236</b>
Surplus capital (eligible less MCR)	0	0	0	0	0	0	Surpluses in the subsidiaries	<b>0</b>
							Surplus in the parent company	<b>300</b>
							Capital which can move around the group	<b>300</b>
<b>Loss event occurs</b>								
Loss event	0	0	<b>160</b>	0	0	<b>108</b>	Loss across group	<b>268</b>
Available capital after loss event	33	25	<b>-87</b>	13	43	<b>-58</b>	Eligible capital after loss event	<b>268</b>
<b>Consequence of loss event</b>								
Capital support transferred	0	0	<b>147</b>	0	0	<b>100</b>	Total capital transferred following loss event	<b>247</b>
Final eligible capital	33	25	<b>60</b>	13	43	<b>42</b>	Final capital which can move around the group	<b>53</b>

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