

CEA response to CEIOPS request on the calculation of the group SCR

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Introduction

This is the CEA's response to the request from CEIOPS on the calculation of group solvency requirements, dated 11th December 2008.

The comments expressed in this document represent the CEA's views at this stage of the project. As our work develops, these views may evolve depending, in particular, on other elements of the framework which are not yet fixed. The comments in this document also need to be considered in the context of the other publications by the CEA. The rejection of elements of our positions may affect the remainder of our comments.

1. How are different entities consolidated in the group calculations? (e.g. entities with less than a 20% capital participation, entities with between 20% and 50% participations, entities beyond a 50% participation, entities in the legal form of mutuals, entities in the legal form of joint ventures, entities in which the parent may have a moral or strategic stimulus to inject more funds than its legally proportional part)?

We agree that it is extremely important to clarify the issue raised in this question as it is clear that many groups found interpretation of this issue highly problematic and it is likely therefore that responses to QIS 4 were inconsistent and potentially misleading.

As a general point, the percentage bands quoted for the exercise of control or significant influence through a minority holding are relatively arbitrary (albeit widely used) and not a universal indicator of fungibility or transferability of the available surplus, or indeed of any obligation on the parent to provide further funding. We suggest that reference should be made to principles in addition to the very crude percentage bands.

In addition, we would like to emphasise that the Solvency consolidation should be as close as possible to the accounting consolidation. This would both enhance understandability of disclosures and reduce operational burden.

We have attached a paper setting out our views on the treatment of participations at both group and solo levels (see annex A). This paper covers the issues identified in question 1, and is also the general CEA position on the treatment of participations.

2. Do you think that there are restrictions on group own funds because of limits on the transferability of capital? If so, what are the limitations that impact specific capital instruments?
3. The IAIS in "Issue paper on group-wide solvency assessment" (draft of 18 November 2008) has proposed that:

"fungibility of capital means that an asset of the group is readily available for meeting any commitment of the group, regardless of the entity within which asset is held or commitment arises. Transferability of capital refers to the actual ability of one entity to transfer assets to another entity at the time when the financial support is needed. Fungibility and transferability may therefore be regarded as two aspects of the same issue. "

Does this description represent a good starting point for clarifying the definitions of fungibility and transferability? How would you in the insurance context define the terms transferability/non-transferability and fungibility/non-fungibility?

We have merged the two questions. Our views on the definitions in question 3 are linked to question 2. We will first cover question 3 and then explain our views on restrictions on group own funds because of limits on the transferability of capital.

Definitions of transferability and fungibility

The CEA agrees that transferability and fungibility are linked but distinct from each others. It is important to distinguish between the two. The key issue is whether own funds can be made available. Whilst there are a number of definitions for these terms, we believe the following distinction is perhaps the most relevant in the context of group solvency.

- Transferability may be said to refer to the physical transfer of (ownership) of assets from one legal entity to another.
- In a Solvency II framework, definitions of "transferability of own funds" and "fungibility of own funds" are more relevant than transferability/fungibility of capital. This is in line with the Solvency II Framework Directive. We therefore prefer "*Transferability of own funds refers to the actual ability of one entity to transfer assets to another entity at the time when the financial support is needed*".
- Fungibility means that a group can cover the capital requirements of another entity with own funds located outside that entity. In other words, fungibility refers to the ability to enable an increase in the own funds of another entity, without necessarily involving a physical transfer of assets.

Restrictions on group own funds because of limits on the transferability of capital

To be consistent with the Framework Directive, we refer to the transfer of own funds ("OF") instead of capital. Art. 220 (3) allows to include in the group own funds also own funds of the related undertaking up to the solo SCR of that undertaking even though these own funds cannot "effectively be made available to cover the [parent's] SCR".

Our interpretation of Article 220 is set out below:

- Our view is that the part of the own funds of an entity covering the solo SCR can be included in the group own funds and these do not need to be transferable. For example, an entity has a solo SCR of 100 and solo OF of 200, which are not transferrable. Thus, its contribution to the group OF is also 100.
- With regards to any excess solo own funds over the solo SCR, an entity can only contribute these to cover the group SCR as group OF to the extent that they are transferable.
- Diversification effects at group level or the use of group support declarations under the group support regime do not change the amount of local own funds that can be used to cover the parent's SCR.

There are the following limitations on transferability:

- As stipulated by Art. 220 (2) (a), profit reserves and future profits arising in a life insurance undertaking are not transferable own funds. As stated in art. 220 (2) 1st paragraph, they can contribute to group own funds only up to the local SCR. However, after they have been recognized through P&L, these profits are transferable and should be considered as such.
- Subordinated debts recognized as own funds raise a specific issue, depending on the covenants, as it is often not adequate capital outside the entity of subordination. Ancillary own funds raise a similar issue.
- Even when own funds are transferable, friction costs (e.g. taxes, legal costs, etc...) can decrease the amount of own funds practically available for the receiving entity, which should be taken into account.
- A further limit may be set by rating requirements which come on top of the regulatory solo SCR requirements.

An entity's deficit of OF to cover local SCR may only be filled by another entity's excess OF to the extent that they are transferable. However, as CEA has already outlined in the context of the group support regime (See CEA FAQ on group support), own funds can rather easily be transferred from one entity of a group to another, for example by means of subordinated loans. In this case, an entity may grant a subordinated loan, i.e. transfer assets. This would lead to an increase of the OF of the other undertaking. In principle, we do not see why any prudential provisions should prohibit such transfer, since the amount of OF of the granting undertaking are not affected. Supervisors should, however, consider the impact of the transaction on the SCR of the granting undertaking and the undertaking should ensure that it continues to cover its SCR.

We would also like to mention that restrictions on group own funds already arise from the way a group is organised and the way it manages itself. Examples of these would be the way a group manages its capital and liquidity, as mentioned before. Additional, external restrictions on transferability are therefore not necessary.

We have included below a number of examples to illustrate the points we have made in our answer to question 2:

EoF = Eligible own funds

Series 1

Group is adequately resourced but B is weak

	A	B	Parent solo	Group view
SCR	100	100	0	150
Assets(eg cash)	100	93		193
Sub debt	0			
SCR-EoF	0	-7		+43

B gets a sub debt of 7 from A

	A	B	Parent solo	Group view
SCR	100	100	0	150
Assets(eg cash)	93	93		186
Sub debt	7 (debt counts as asset)	7(holds the cash and the debt liability adds back to EoF)		7
SCR-EoF	0	0		+43

Similar but diversification of A*B is less and support to B from A is higher

	A	B	Parent solo	Group view
SCR	100	100	0	185
Assets(eg cash)	83	83		166
Sub debt	17 (debt counts as asset)	17(holds the cash and the debt liability adds back to EoF)		17
SCR-EoF	0	0		-2

Group calculation shows that the group is under resourced

Series 2

Parent has own business and assets. But group assets of 300 equal to Group SCR are distributed across group.

	A	B	Parent solo	Group view
SCR	100	100	200	300
Assets(eg cash)	100	50	150	300
Sub debt	0			
Value of subs			150 (full economic value)	
SCR-EoF	0	-50	+100	+0

P now funds B by subdebt

	A	B	Parent solo	Group view
SCR	100	100	200	300
Assets(eg cash)	100	50	100	250
Sub debt	0	50	50	50
Value of subs			150	
SCR-EoF	0	-0	+100	+0

Each entity is now OK and the group has adequate resources

Now A loses (or dividends out to parent who dividends to shareholders) 50 and gets funding of 50 as a subdebt.

	A	B	Parent solo	Group view
SCR	100	100	200	300
Assets(eg cash)	50	50	50	150
Sub debt	50	50	100	100
Value of subs			100	
SCR-EoF	0	-0	+50	-50

Each entity appears OK but the group is under resourced.

4. What are the key group-specific risks? Which of these are not covered by the standard formula? Please describe possible group-specific risks and their potential impact and probability in a group. The inclusion of concrete examples for definitions is welcomed.

Defining the question

We suggest that it is necessary to approach this question by first clarifying different aspects of it before proceeding to look at specific risks.

In answering question 4, we need to be clear about the definitions. Financial conglomerates for instance pose very different features to pure insurance groups. We assume in this context that the question refers solely to insurance groups. Secondly, we need to have a consistent approach to defining group-specific risks. We will consider group-specific risks to be those risks that can be particularly relevant for groups or for large single entities.

We believe that comparatively few risks are unique to groups per se but there are a number of generic risks which take on different features and dimensions within groups. Risks such as contagion risk, reputation risk, regulatory risk, strategic decision risk, liquidity risk and concentration risk are of course very relevant but they are not specific to groups. They can equally arise in large single entities with diverse operations and business lines. Our view therefore is that group-specific risks should not be used to design a group SCR to a more onerous standard than the solo SCR. There should not be a systemic increase in the group SCR because of risks that are perceived to arise at group level. We would like to emphasise that being part of a well controlled and managed group has also a positive impact on the risk profile, for example in terms of the parent being able to support subsidiaries who are in financial distress or in terms of the risk management knowledge within the group.

Regarding the question on which risks are not covered by the standard formula, we would anticipate that most groups will opt for an internal model. However there will be exceptions. Modelling group specific risks in group internal models should not prejudice that it is appropriate to include them in the (group) standard approach. Internal models differ in time horizon and complexity.

Risks which are particularly relevant for groups

The major risks that are particularly relevant for insurance groups (or large single entities) are operational. In the Solvency II Framework Directive Article 13 operational risk is defined as “*the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events*”.

Some examples of operational risks are set out below:

- ***Acquisitions.*** The control of mergers and acquisitions is a key risk. Groups may be poor in the execution of acquisitions, overestimating values and synergies and underestimating the problems from integrating cultures, brands, systems and management. Effective governance and oversight in the first few years of an acquisition is important.
- ***Governance.*** The governing bodies of local entities may be subject to pressures that conflict with the effective discharge of their responsibilities. In particular they may not consider themselves to be empowered to exercise full control over the firm, for instance because of an overlap with reporting lines to group control functions, or able effectively to challenge group strategy.
- ***Conflicts of interest.*** Conflicts of interest arise in many contexts and in both single entities and groups. There may, for example, be conflicts of interest between the parent and its subsidiaries. We believe that strong managerial requisites and a transparent governance policy are essential for dealing with this kind of risk.
- ***Management Information.*** Groups setting strategy may not have proper information to allow them to do this appropriately for local entities. They may not receive adequate information on the performance of local management and indeed upwards reporting may be intentionally misleading or incomplete. Local control functions may not be effective in meeting group control requirements.
- ***Legal/regulatory risk.*** This is particularly applicable to cross-border groups. Regulators may take action on a local entity which jeopardises the position of other group entities or the group as a whole, for instance by freezing the movement of funds, penalising a key manager who may have responsibilities elsewhere or impacting the brand or reputation of the group. Rating action could have similar impact.
- ***Political risk.*** Cross-border groups can be exposed to the risk of political instability which is difficult to assess or control. This risk would be particularly applicable to groups doing business outside the EU.
- ***Risk to be exposed to different legislation/taxation/regulation/bureaucracy.*** Certainly an international group which has to deal with different environments is more exposed to losses arising from inadequate or failed internal process or external events. This risk is structurally linked to what extent the processes and systems are centralized within a group. If control and coordination are centralized while responsibility and business implementation are left to local entities, then this risk is minimized and split into the different entities.

In addition to operational risks, groups could also be exposed to other types of risks. Examples of non-operational risks are set out below:

- ***Risks related to the funding structures.*** Arguably the funding structures of groups can present additional risks. Funding structures can be complex with a variety of cross investments, holdings and guarantees given. This should be recognised and transparency is a key requirement.
- ***Contagion risk.*** Contagion risk refers to the risk of spill-over effects from shocks to one part of the undertaking to another part. While this is particularly relevant for groups due to the complexity of their businesses, it can arise in other complex entities.

- *Strategic decision risk.* Groups may set a strategy that does not take account of local circumstances and is not appropriate for them. As a consequence local management may ignore or resist the strategy. It may be set but not monitored or enforced. Local entities conversely may pursue a strategy that conflicts with group policy and appetite.
- *Reputation risk.* Our view is that being part of a group can have a positive or negative impact on reputational risk. There is a risk of spillover from one entity to another, in particular when a common brand is used. However, a group structure can also have a positive impact; for example, a group has an interest in protecting its brand.
- *Concentration risk.* This risk is not solely applicable to groups and can be managed with appropriate risk management processes.
- *Liquidity risk.* Liquidity risk is less of an issue for insurance groups than to other financial services groups or to financial conglomerates. This is due to the specificities of insurance business model. Liquidity risk can be managed through appropriate liquidity risk policies.

5. Which group-specific risks should be mapped quantitatively and which should be mapped qualitatively? Please describe in detail the reasons, advantages and disadvantages for choosing each of these alternatives.

General remarks

As stated in our answer to question 4, we believe that the risks that can arise for a business with multiple operations are mainly operational risks. Hence many of the risks are already sufficiently taken into account within the operational risk module and there should not be an increase to the group SCR. According to article 106 of Solvency II Framework Directive, the capital requirement for operational risk shall reflect operational risks to the extent they are not already reflected in the risk modules explicitly indicated in article 104, legal risks included, but with the explicit exclusion of 'reputation risk' and 'strategic decisions risk' (article 101). Similarly to our point on operational risk module, some other risks may already be sufficiently captured within the other risk modules and there should not be a systematic increase to the group SCR.

Furthermore we think that risks that are particularly relevant to groups or large single entities, if any, and the interactions of these with other types of risks, should be best considered under Pillar 2. The Supervisory Review Process should evaluate whether the insurer's risk management, governance and various other relevant issues are adequate for an entity of its size and complexity. This also allows for the application of proportionality principle.

We have divided the risks mentioned in our answer to question 4 into two categories: 1) risks that can be mapped quantitatively and 2) risks that can be mapped qualitatively. Of course many of the risks or their components could fall into either of the categories. In dividing the risks in this way, we refer to their existing treatment under Solvency II. Some of the risks are already modelled quantitatively and included in operational risk or other risk modules. However, in general risks that are more relevant to groups are best considered under Pillar 2.

Risks that can be mapped quantitatively:

- *Legal/regulatory risk.* This risk is specifically included under operational risk in the solo SCR calculation (art. 101) as it is not considered a group specific risk.
- *Concentration risk.* There are both quantitative and qualitative elements. Art. 105(5-f) of SII FD request the calculation of a particular capital requirement for this kind of risk. QIS4 TS restricted its definition to the risk regarding the accumulation of exposure with the same counterparty excluding other types of concentrations (geographical area, industry sector,...). Concentration risk is not a group-specific risk. We believe groups should have adequate risk management processes in place to manage group-wide risk concentration through for example setting limits to exposure per counterparty. It should also be stressed

that a level of concentration should be in the context of the business strategy which has been carefully analysed and contemplated by the group itself and which should not be unduly penalized by capital requirements.

Risks that can be mapped qualitatively:

- *Strategic decision risk.* This risk is specifically excluded from the solo SCR according to art. 101(4) of the SII FD because it is quite problematic to furnish a quantification under Pillar 1. Certainly it is not a group-specific risk only. We think it is possible to take care and mitigate this kind of risk by a combination of management discussion and the insurer's risk management system under the Pillar 2 review.
- *Reputation risk.* This risk is specifically excluded from the solo SCR according to article 101(4) of the SII FD because it is regarded as a type of loss resulting rather than as risk category. This risk is best addressed under Pillar 2.
- *Risks related to inadequate governance.* This covers acquisition, governance and management information risks specified in our answer to question 4. These risks can be addressed under Pillar 2.
- *Contagion risk.* Contagion is not a fundamental source of risk but a consequence of risk events (typically the failure or the economic/financial difficulties of another entity within the group). Where models - under a Pillar 2 review - allow for the fundamental risk events and assess the impact consistently across the whole group, including how the events flow through intra-group commitments, that aspect of contagion is integral to the model and does not require additional capital elements.
- Another aspect of contagion is where events in one entity provoke events in another although there is no direct link. This is a risk which is more likely to happen in the banking environment because of a possible investors' loss of confidence. Insurers operate under a different dynamic where a demand for payment by a policyholder requires a claim event. Certainly life insurers are at risk from unanticipated surrenders, particularly where there are guaranteed surrender values and no possibility to defer or modify payment.
- *Conflict of interest.* Certainly there may be conflicts of interest between local and group interests. These should be controlled, in a qualitative way, by risk management processes which will include ensuring group representation on local boards and effective communication and review between entities and group functions.
- *Liquidity risk.* Groups are expected to have robust liquidity management processes, which may include where necessary quantitative elements. Art. 43 of SII FD recognize liquidity risk as one of the risks that insurers should cover through risk management rather than capital. This means that liquidity risk should be managed in a holistic way and one should not focus on specific instruments or risk mitigation actions. Groups are expected to have robust liquidity management processes. We note that some supervisors support this point (QIS4 CEIOPS' Report – pg 240). Evidently it is not a group-specific risk even if, in a group SCR context, this risk can assume a particular meaning for groups in the context of fungibility/transferability of capital (link to answers 2/3).
- *Risk to be exposed to different legislation/taxation/regulation/bureaucracy.* This kind of risk, peculiar to trans-border groups only, should be mapped in a qualitative way by taking into consideration the governance structure of the group, which shall ensure that decision makers at different levels possess the competences necessary to consider local/national regulatory environment etc. This requirement should be relevant regardless of business model chosen by the group.

Additional remarks

We also note that no credit has been given in Solvency II to the value of a firm's business franchise as part of the own funds (market power, growth opportunities, existing distribution networks and renewal rights on existing business, specialized knowledge, ...). Franchise value is not a monetary asset, it is indeed an intangible asset, yet

nonetheless it has great value to a firm as a going concern. Some of the above mentioned risks affect franchise value rather than ability to meet policyholder obligations.

In the context of ORSA, we would like to draw attention to CEIOPS issue paper (CEIOPS-IGSRR-09/08), which states that "ORSA helps undertakings to ensure that they continuously meet the regulatory capital requirements, as well as the internal capital targets they set themselves". We believe this is particularly true and valid for insurance groups. Group ORSA should be performed taking into consideration the need to handle issues specific to group structure and targets which cannot be captured by factor-based formula. In this context a balance between qualitative mapping of group-specific risks and group strategy can be obtained with no penalization to group's own ambitions.

6. How can group-specific risks be mapped quantitatively? What are the pros and cons of modelling group-specific risks?

As explained above, we do not think that risks are specific to groups. Rather, certain risks are more likely to be relevant to groups or large single entities with complex business. Operational risk module already captures quantitatively some of the fundamental sources of risk and the combinations of them. There is no need to recalibrate this module for the group SCR. The remaining few risks previously identified are best captured and considered in a qualitative way under Pillar 2 review. Risk management, internal control policies, and governance are key elements for a genuine and effective protection of insurance groups, as is the holding of adequate capital. Groups should have good risk management processes, with policies and procedures approved by the board of directors, and an active oversight by both the board and senior management. There should also be clearly assigned responsibility for the measurement and monitoring of risks (both quantifiable and non-quantifiable risks).

Also, we would like to stress that concepts like group supervision and group support, are the key qualitative way to manage and oversee all the risks in an insurance group, group-specific risks included. In fact, 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 any group-specific risk. On the other hand, group support, with the obligation on the parent company to restore a capital breach in the subsidiary, strengthens policyholder protection against possible, if any, group specific risks.

About the CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA, which is based in Brussels, represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 122bn, employ one million people and invest more than €7 200bn in the economy.