

# CEA Paper on Treatment of participated undertakings

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## 1. Introduction

The Solvency II Level 1 Framework Directive leaves open the detailed treatment of participated undertakings when calculating the SCRs at various levels. Guidance is therefore required to ensure that this issue is addressed in a consistent manner at Level 2. The purpose of this note is to propose a consistent framework for the treatment of participated undertakings in Solvency II when calculating the SCR both at solo and group levels. The same principles apply to the treatment of mutuals and Special Purpose Vehicles.

While the note gives a general framework for the treatment of participated undertakings, further work is needed on the details. The CEA looks forward to working with CEIOPS on developing this further.

The present note does not deal with the detailed way to apply the criteria of proportionality in the calculation of group solvency (Art. 219). Also, the note does not deal with third country undertakings, whose treatment, among other things, would depend on the application of the equivalence principle as embedded in the Solvency II Framework Directive.

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.

## 2. Definition of participation

Clear definitions are a precondition for a proper treatment of participations. In this note, the term "participating undertaking" is used to mean an undertaking which has a participation in another undertaking. The term "participated undertaking" is used to refer to the undertaking in which the participation is held. For the purpose of this note, definitions should be based both on the level of control or influence a participating undertaking has over a participated undertaking and on the activity which the participated undertaking carries out.

### *Level of control or influence*

In this context, it is necessary to agree on the concept of "participation", i.e. the relationship between a participating undertaking and a participated undertaking, and of "control", i.e. the relationship between a parent undertaking and a subsidiary undertaking.

The Solvency II Level 1 Framework Directive Article 13.16 defines “participation” as the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking. For the purpose of title III (supervision of insurance and reinsurance undertakings in a group) of the Framework Directive, supervisory authorities shall also consider as participation the holding, directly or indirectly, of voting rights or capital in an undertaking over which, in the opinion of the supervisory authorities, a significant influence is effectively exercised (Article 210(2), subparagraph 3).

As to “control”, the Framework Directive Article 13.14 defines it as the relationship between a parent undertaking and its subsidiary, as set out in Article 1 of the Directive 83/349/EEC. This article, in summary, makes reference to the possibility, due to the ownership of capital or other relationships, to exercise a dominant influence over the subsidiary. Based on this definition “control” does not therefore necessarily need to presume that the parent holds more than 50% of the voting rights of the subsidiary.

This paper focuses on the methods that can be used for the treatment of participated undertakings, and not on determining the appropriate definitions to be used. Specific work should be undertaken on how participation and control (and other relevant concepts) can be defined, including on ensuring consistency with equivalent definitions existing in other regulatory frameworks, such as IFRS. However, in our view it is necessary to mention that definitions of participation and control which are relevant for the purpose of calculating the SCR, should be based, in line with the overall approach of Solvency II, on economic principles and not merely on legal grounds. Moreover, control and influence should always be appreciated firstly at a group level so that the significance of participations can be seen. This ensures that situations where several entities of a group have small participations in the same undertaking are not overlooked. This would also ensure consistency with the principles used in the accounting framework (IFRS).

While the definition of “control” provided by the Framework Directive takes into account of the economic substance of the relationship between the two undertakings (i.e. dominant influence), the definition of participation makes only reference to the ownership of a pre-defined percentage of voting rights or capital, excluding in this way situations where the actual economic substance is not reflected in the formal level of ownership (unless, only in the group supervision context, supervisors recognize that a significant influence is actually exercised). However, there can be situations where significant influence is exercised even though less than 20% of the voting rights or capital are held. At least for the purpose of SCR calculation, therefore, the inclusion in the definition of participation of the concept of “durable link” provided by the first sentence of Article 17 of Directive 78/660/EEC would be beneficial. This first sentence reads “...“participating interest” shall mean rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities”.

For the purpose of this note, in any case, the following distinction is being made based on the above concepts:

- 1) Participated undertaking which is a subsidiary of a (re) insurance undertaking;
- 2) participated undertaking which is **not** a subsidiary of a (re)insurance undertaking;
- 3) ownership of the capital of an undertaking which is not considered a participated undertaking (this type is not in the scope of this paper and is treated as an equity investment).

### ***Nature of the activity***

In the European Union some activities are subject to prudential supervision, which include imposition of capital requirements. Eliminating multiple use of capital for covering capital requirements is one of the main purposes of the treatment of participations for the solvency assessment of participating (re)insurance undertakings. In regulating the treatment of participations, therefore, it is relevant whether capital requirements are imposed or not and, if yes, which type of capital requirements.

The following distinctions have therefore been made:

- a) (re)insurers subject to Solvency II,
- b) financial undertakings subject to the CRD, and
- c) others.

### 3. Requirements under Solvency II

The Solvency II Framework Directive does not set any rules on the treatment of participated undertakings at solo level. Guidance is however given for the group level. Article 219 states that the calculation of group solvency shall take account of the proportional share held by the participating undertaking in its related undertakings. Article 218 provides that two methods can be used for the calculation of group solvency: the *accounting-consolidation* method (Article 228) or the *deduction and aggregation* method (Article 231). It is also possible to use a combination of the two approaches.

In addition, Article 226 states that the two methods can be used when the undertaking is a participating undertaking in a credit institution, investment firm or financial institution. Some conditions apply. The accounting-consolidation method can only be used if the group supervisor is satisfied as to the level of integrated management and internal control regarding the entities which would be included in the scope of consolidation. The Directive also allows the use of the *deduction* method but this can only be used at the discretion of supervisory authorities, not at the discretion of participating undertakings.

The Level 1 Directive requires the adoption of implementing measures in relation to the treatment of participated undertakings with respect to the determination of own funds at solo level (Article 92).

### 4. Possible different methods for the treatment of participated undertakings in the calculation of participating undertaking's SCR

There are at least four possible ways for treating participated undertakings when calculating the solvency situation of the participating undertaking. These are the accounting-consolidation method (look-through approach), the deduction and aggregation method, and the simple deduction method.

In addition, participated undertakings could be treated as a particular class of equity investments and considered, through an appropriate methodology, in the calculation of the capital charge for the relevant market risk. In the latter case, however, the issue of multiple gearing of capital is not explicitly addressed. The main features of the first three methods are summarised below.

#### ***Accounting-consolidation method (look-through approach)***

Under this method, the solo entity replaces its solo own funds and solo SCR calculation with a group own funds and SCR calculation for the sub-group formed by itself and its subsidiaries or participated undertakings. The entity should follow the method for using accounting-consolidation method as explained in the Solvency II Framework Directive (Article 228). According to this method, the SCR and own funds for the sub-group would be calculated on the basis of consolidated data, which are the result of the line by line aggregation of the assets and liabilities of the undertaking concerned. In case of a joint venture, where the control is shared between two shareholders, the "look-through approach" continues to be based on consolidated financial statement. In this case, however, line by line consolidation is carried out based on the proportional share of the participation of each parent shareholder (no explicit recognition of minority interests).

#### ***Deduction and aggregation method***

Under this method, the solvency situation would be the difference between 1) the sum of the solo entity's own funds eligible for the SCR and the proportional share of the own funds eligible to cover the SCRs of its participated undertakings, and 2) the value of the participated undertakings in the solo entity, and the sum of the solo entity's SCR and the proportional share of the SCRs of its participated undertakings.

### *Simple deduction method*

The approach simply involves the deduction of participated undertakings from the own funds of the participating undertaking.

## 5. Proposed treatment of participated undertakings

We propose that the treatment of participations in the calculation Solvency Capital Requirement should be based on the following criteria:

- The SCR and MCR are only to be calculated either at solo level (level of the undertaking under assessment) or at group level (level of the ultimate parent company) e.g. in principle no sub-group supervision should be applied<sup>1</sup>.
- The classification and method of the participation should be based on economic principles and not merely on legal grounds. Moreover, control and influence should always be appreciated firstly at a group level so that the significance of participations can be seen. This ensures that situations where several entities of a group have small participations in the same undertaking are not overlooked.
- In line with the principle above, the consolidating methodologies used for accounting purposes should also be used for solvency purposes.
- Each treatment of participated undertakings should be accompanied with appropriate embedding in Pillar II and Pillar III.
- The choice of the method should be made under the proportionality principle as per Article 28 (nature size and complexity of the risks).

The proposal regarding the treatment of participations will be described separately for the calculation of the "Group SCR", " and the "Solo SCR".

Based on the above principles, we propose the following treatments for participations at group and solo levels.

### **Group SCR**

#### 1) Subsidiary:

The parent has assumed control of the participated undertaking. In principle the subsidiary is consolidated on a line by line basis. Three situations are considered according to the type of activity:

#### 1a) Insurance undertaking

If the subsidiary is subject to Solvency II supervision the "look-through approach" (accounting-consolidation) should be applied. The subsidiary is consolidated on a line-by-line basis with a full recognition of the diversification benefits and elimination of intra-group transactions and double gearing. If appropriate a minority interest is recognised as part of the own funds. The calculations of the own funds and capital requirements are made on the level of the group based on the consolidated financial statement data.

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<sup>1</sup> Unless as part of Group supervision a Member State has implemented the request for a sub-group supervision on the level of the Member State in compliance with Article 214 of the draft Framework Directive.

1b) Financial undertaking subject to CRD

If the subsidiary is subject to prudential supervision (e.g. Capital Requirement Directive) a partial “accounting-consolidation method” should be in principle applied, i.e. it should be applied to the calculation of own funds. As to capital requirement, pending further discussion on the degree of cross sector diversification to be recognised, they should be the sum of the SCR of the insurance participating undertaking and the capital requirement of the financial undertaking as laid down in the relevant prudential requirements. The available capital should instead be based on the consolidated financial statement. This is consistent with the treatment in the Financial Conglomerates Directive (see Annex I, II Technical calculation methods). If this approach is not attainable, because of valuation problems or other consolidation problems the “deduction and aggregation method” could be used.

1c) Other

If the subsidiary is not subject to prudential supervision the parent has to consider whether the “subsidiary” is eligible to be part of the accounting consolidation scope. In principle, this assessment should be based on the same criteria as set out in IFRS standards, which require consolidation of any entity of which the parent has control (IAS27, paragraphs 4 and 12). This is the case even if the business activities of an entity are dissimilar from those of the other entities within the group (IAS 27, paragraph 17). This is consistent with the economic approach of Solvency II. However, we acknowledge that the issue of accounting consolidation requires further analysis and reflection.

If the subsidiary is consolidated a “look-through” approach is automatically applied. If the subsidiary is not consolidated, the parent has to apply an equity stress over the net asset value and to apply a Pillar II assessment for any material risk not included in the Pillar I calculations. The stress that is applied to participated undertakings should be lower than the stress that is applied to other equity investments due to the specific and long term nature of participated undertakings.

2) Participated undertaking which is not a subsidiary

The parent has no control but exerts significant influence on the participated undertaking. The parent can influence the strategic, financial and operational policies of the undertaking.

2a) Insurance undertaking

If the participation is subject to Solvency II supervision the “deduction and aggregation method should be applied”. If more recent information is not available, the latest available SCR and Available Capital can be used. As part of the Pillar II assessment the parent should consider whether the SCR and Available Capital of the participated undertaking are considered to be appropriate. If new information becomes available the parent should assess whether its assessment is still valid. If not, a new calculation has to be made.

2b) Financial undertaking subject to CRD

Same treatment as under point 2a) but instead of the SCR the relevant sectoral capital requirement applies.

2c) Other

If the participation is not subject to prudential supervision a “reduced” equity shock should be applied to the net asset value of the participation. Within the Pillar II assessment the parent should consider whether all the risks are properly included and no other contagion effects exist.

## Solo SCR

### *Current requirements for insurers and reinsurers at solo level*

The Directive 2002/87/EC (on supplementary supervision of financial conglomerates) amends both the life and non-life directives on solvency requirements. In its Articles 22(2) and 23(2) it amends Directives 73/239/EEC (non-life) and 79/267/EEC (life) respectively. This amendment states that the available solvency margin at solo level is reduced by the value of participated undertakings held in (re)insurers and other financial institutions. However when shares are held for a temporary period for the purposes of a financial assistance operation designed to reorganise and save that entity, the regulatory authority may waive the deduction requirement.

The amendments also give Member States the option to allow the use of other methods for the treatment of participated undertakings in general. They can allow methods 1, 2, or 3 of Annex I to Directive 2002/87/EC (accounting-consolidation, deduction and aggregation, requirement deduction).

However, if the participating undertaking and its participated undertakings are subject to supplementary supervision in accordance with Directive 98/78/EC (insurance groups) or Directive 2002/87/EC (financial conglomerates), Member States can choose to waive the requirement to deduct participated undertakings.

Directive 2005/68/EC (reinsurance) provides the same treatment for reinsurance undertakings as the amendments of the financial conglomerates directive.

Directive 2006/49/EC (the capital adequacy of investment firms and credit institutions) allows for similar treatment as the requirements for insurers and reinsurers. Member States can waive the requirement to deduct participated undertakings from own funds provided that the credit institution is subject to consolidated or supplementary supervision.

### *Solo SCR related to an undertaking within a group*

CEA believes that, for the purpose of calculating the Solo SCR, any participation (related both to a subsidiary and a simple participated undertaking), which is included in the scope of the supervision (under the Solvency II regime) of the group the participating undertaking belongs to and, as a consequence, is included in the calculation of the related Group SCR (based on the above criteria), should not be subject to any method for eliminating double gearing and should be treated as an equity investment. This approach would avoid "sub-group" SCR calculations and would harmonise across EU what is now left to the discretion of each single Member State.

As is the case with the group SCR, the stress that is applied to participated undertakings should be lower than the stress that is applied to other equity investments due to the specific and long term nature of participated undertakings.

In the ORSA the solo undertaking should include in the assessment the actual risk the undertaking is facing due to the participation (either a subsidiary or a participation) and the relationship within the group.

This treatment should be appropriately disclosed, together with the indication of the relevant Group SCR calculation.

### *Solo undertaking not included in a group calculation*

If the participation is related to an undertaking which is not included in the Group SCR calculation of the group which the participating undertaking belongs to (or the participating undertaking does not belong to any group), the following treatment should apply.

### Subsidiary

In the case the participation is related to an insurance subsidiary, the participating undertaking and the participated undertaking form a group and, as a consequence, the treatment of the section titled “solo SCR related to an undertaking within a group” should apply.

If the subsidiary is a financial undertaking subject to CRD a “look-through” approach is applied according to the criteria under point 1b).

If the subsidiary is not subject to prudential supervision, the criteria under point 1c) should apply.

### Participated undertaking

In the case the participation relates to a participated undertaking which is not a subsidiary, the following treatment should apply.

If the participated undertaking is subject to Solvency II supervision the treatment explained under point 2a) should apply.

If the participated undertaking is a financial undertaking subject to CRD, the treatment under point 2b) should apply.

If the participation is not subject to prudential supervision a reduced equity shock should be applied to the net asset value of the participation, as explained under point 2c).

## 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.