

## Consultation Paper No. 67

### Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Treatment of participations

*CEIOPS welcomes comments from interested parties on the following Consultation Paper.*

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# 1. Introduction

- 1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence. On 12 June 2009 the European Commission sent a letter with further guidance regarding the Solvency II project, including the list of implementing measures and timetable until implementation.<sup>1</sup>
- 1.2. This Paper aims at providing advice on the solo treatment of participations in credit and financial institutions for the determination of own funds as required in Article 92 of the Solvency II Level 1 text (herein "Level 1 text").<sup>2</sup> Furthermore, this Paper provides advice on the approach to be used with respect to related undertakings in the calculation of the SCR and in particular the equity risk sub-module of the SCR as required by Article 109(1)(ja).
- 1.3. This paper covers all issues relating to the treatment of participations for solo purposes. In addition, it sets out how this treatment interacts with the treatment proposed at the group level and includes a discussion of the definition of participations, which will be the same definition as that applied for group purposes.
- 1.4. The analysis below is relevant to all types of participation and subsidiaries whether wholly owned or not and whether they are included within the scope of group supervision.

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<sup>1</sup> See <http://www.ceiops.eu/content/view/5/5/>

<sup>2</sup> Text adopted by the European Parliament on 22 April 2009, see <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20090422+SIT-03+DOC+WORD+V0//EN&language=EN>.

## 2. Extract from Level 1 Text

### 2.1 Legal basis for implementing measure

#### Article 92 - Implementing measures

1. *The Commission shall adopt implementing measures specifying the following:[...]*

*(b) the treatment of participations, within the meaning of the third subparagraph of Article 210(2), in financial and credit institutions with respect to the determination of own funds.*

*Those measures designed to amend non-essential elements of this Directive, by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 304(3).*

2. *Participations in financial and credit institutions as referred to in point (b) of paragraph 1 shall comprise the following:*

*(a) participations which insurance and reinsurance undertakings hold in:*

*(i) credit institutions and financial institutions within the meaning of Article 4(1) and (5) of Directive 2006/48/EC,*

*(ii) investment firms within the meaning of point 1 of Article 4(1) of Directive 2004/39/EC;*

*(b) subordinated claims and instruments referred to in Article 63 and Article 64(3) of Directive 2006/48/EC which insurance and reinsurance undertakings hold in respect of the entities defined in point (a) of this paragraph in which they hold a participation.*

#### Article 109 (1)(ja) - Implementing measures

*In order to ensure that the same treatment is applied to all insurance and reinsurance undertakings calculating the Solvency Capital Requirement on the basis of the standard formula, or to take account of market developments, the Commission shall adopt implementing measures laying down the following:[...]*

*(ja) the approach to be used with respect to related undertakings within the meaning of Article 210 in the calculation of the Solvency Capital Requirement in particular the calculation of the equity risk sub-module referred to in Article 105(5), taking into account the likely reduction in the volatility of the value of those related undertakings arising from the strategic nature of those investments and the influence exercised by the participating undertaking on those related undertakings.*

## 2.2 Definition of participation - other related articles of the Level 1 Directive

### Article 210 (Definitions)

1. *For the purposes of this Title, the following definitions shall apply:*
  - (a) *"participating undertaking" means an undertaking which is either a parent undertaking or other undertaking which holds a participation, or an undertaking linked with another undertaking by a relationship as set out in Article 12(1) of Directive 83/349/EEC;*
  - (b) *"related undertaking" means either a subsidiary undertaking or other undertaking in which a participation is held, or an undertaking linked with another undertaking by a relationship as set out in Article 12(1) of Directive 83/349/EEC;[...]*
2. *For the purposes of this Title, the supervisory authorities shall also consider as a parent undertaking any undertaking which, in the opinion of the supervisory authorities, effectively exercises a dominant influence over another undertaking.*

*They shall also consider as a subsidiary undertaking any undertaking over which, in the opinion of the supervisory authorities, a parent undertaking effectively exercises a dominant influence.*

*They 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 212 (Scope of group supervision)

[...]

2. *In the following cases, the group supervisor may decide on a case-by-case basis not to include an undertaking in the group supervision referred to in Article 211:*
  - a) *if the undertaking is situated in a third country where there are legal impediments to the transfer of the necessary information, without prejudice to the provisions of Article 227;*
  - b) *if the undertaking which should be included is of negligible interest with respect to the objectives of group supervision;*
  - c) *if the inclusion of the undertaking would be inappropriate or misleading with respect to the objectives of the group supervision.*

*However, where several undertakings of the same group, taken individually, may be excluded pursuant to point (b) of the first subparagraph, they must nevertheless be included where, collectively, they are of non-negligible interest.*

*Where the group supervisor does not include an insurance of reinsurance undertaking in the group supervision under one of the cases provided for in points (b) and (c) of the first subparagraph, the supervisory authorities of the*

*Member State in which that undertaking is situated may ask the undertaking which is at the head of the group for any information which may facilitate their supervision of the insurance or reinsurance undertaking concerned.*

#### Article 13 (Definitions)

*For the purposes of this Directive, the following definitions shall apply: [...]*

*(12) parent undertaking means a parent undertaking within the meaning of Article 1 of Council Directive 83/349/EEC<sup>3</sup>;*

*(13) subsidiary undertaking means any subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC, including subsidiaries thereof;*

*[...]*

*(15) control means the relationship between a parent undertaking and a subsidiary undertaking, as set out in Article 1 of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking;*

*(16) participation means the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking;*

*[...]*

#### Article 220 (Elimination of double use of eligible own funds)

The double use of own funds eligible for the Solvency Capital Requirement among the different insurance or reinsurance undertakings taken into account in that calculation shall not be allowed.

#### Article 227 (Non-availability of the necessary information)

*Where the information necessary for calculating the group solvency of an insurance or reinsurance undertaking, concerning a related undertaking with its head office in a Member State or a third country, is not available to the supervisory authorities concerned, the book value of that undertaking in the participating insurance or reinsurance undertaking shall be deducted from the own funds eligible for the group solvency.*

*In that case, the unrealised gains connected with such participation shall not be recognised as own funds eligible for the group solvency.*

## **2.3 Other key issues related to the definition of participation.**

2.1. As set out above, the Level 1 text defines participation as the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking. However, Article 92 makes clear that the definition of participations for the purposes of these implementing measures should be the definition that is set out in third subparagraph Article 210(2). This broader

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<sup>3</sup> OJ L 193, 18.7.1983, p. 1.

definition states that supervisory authorities shall also consider “as participation the holding, directly or indirectly, of rights or capital in an undertaking over which, in the opinion of the supervisory authorities, a *significant influence* is effectively exercised.”

- 2.2. The Level 1 text does not give a definition of *significant influence* and, therefore in order to enhance harmonisation, common principles on how to assess it should be agreed. This approach has already been recommended following earlier work by the JCFC<sup>4</sup>, as well as in Joint Conglomerate Financial Committee’s advice to European Commission on Financial Conglomerates Directive review.<sup>5</sup> CEIOPS’ Advice on Group solvency assessment also describes evidence of significant influence and this shall also be applied to maintain consistency.<sup>6</sup>
- 2.3. In addition, Article 109 (ja) refers to the definition of *related undertakings* within the meaning of Article 210; that includes subsidiaries, participations or an undertaking linked with another undertaking by a relationship as set out in Article 12(1) of Directive 83/349/EEC<sup>7</sup> - an approach that can be summed up as “unified management”.
- 2.4. The Level 1 text defines *control* as the relationship between a parent undertaking and its subsidiary, as set out in Article 1 of the Directive 83/349/EEC<sup>8</sup>. This Article includes a range of situations from that in which an

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<sup>4</sup> Recommendations to address the consequences of the differences in sectoral rules on the calculation of own funds of financial conglomerates, April 2008,

[http://www.ceiops.eu/media/docman/public\\_files/consultations/consultationpapers/IWCFCAdvice.pdf](http://www.ceiops.eu/media/docman/public_files/consultations/consultationpapers/IWCFCAdvice.pdf)

<sup>5</sup> Advice to the Commission on the review of the Financial Conglomerates Directive, 30 October 2009,

[http://www.ceiops.eu/media/docman/public\\_files/consultations/consultationpapers/FCD-Review/JCFC-advice-on-FCD-Review.pdf](http://www.ceiops.eu/media/docman/public_files/consultations/consultationpapers/FCD-Review/JCFC-advice-on-FCD-Review.pdf)

<sup>6</sup> Former CP60. CEIOPS-DOC-52/09 (October 2009), see <http://www.ceiops.eu/content/view/17/21/>.

<sup>7</sup> [Article 12 Directive 83/349/EEC](#)

1. Without prejudice to Articles 1 to 10, a Member State may require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if:

(a) that undertaking and one or more other undertakings with which it is not connected, as described in Article 1 (1) or (2), are managed on a unified basis pursuant to a contract concluded with that undertaking or provisions in the memorandum or articles of association of those undertakings; or

(b) the administrative, management or supervisory bodies of that undertaking and of one or more other undertakings with which it is not connected, as described in Article 1 (1) or (2), consist for the major part of the same persons in office during the financial year and until the consolidated accounts are drawn up.

<sup>8</sup> [Article 1 Directive 83/349/EEC](#)

1. A Member State shall require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking):

(a) has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); or

(b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; or

(c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for such contracts or clauses shall not be required to apply this provision; or

(d) is a shareholder in or member of an undertaking, and:

(aa) a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the preceding financial year and up to the time when the consolidated accounts are drawn up, have been appointed solely as a result of the exercise of its voting rights; or

undertaking has a majority of the shareholders' voting rights in another undertaking (a subsidiary undertaking), up to the right to exercise a *dominant influence* and the management on a unified basis. Article 210(2) is clear that an undertaking will be considered a subsidiary where a parent undertaking effectively exercises dominant influence.

- 2.5. Art. 109 (ja) also makes reference to the strategic nature of the investments and the influence exercised by the participating undertaking on those related undertakings. "Strategic", is not defined in the Level 1 text. CEIOPS supports that, for the purposes of harmonisation, "strategic" participations might be those, where a durable link<sup>9</sup> exists, which are intended to develop the business and achieve the goals of the participating undertaking.
- 2.6. For the purpose of this Paper the nature of the activity carried on by the related undertaking will also be relevant in order to assess if prudential sectoral rules are applied and whether capital requirements are imposed. In order to give a broad classification, it is possible to distinguish between (re)insurance undertakings and financial and credit institutions and investment firms. The latter, for the purpose of Article 92 includes credit institutions, financial institutions within the meaning of Article 4(1) and (5) of Directive 2006/48/EC, and investment firms within the meaning of point 1 of Article 4(1) of Directive 2004/39/EC. For other non-regulated undertakings, whether the activity carried on is related to the financial sector (e.g. hedge funds, private equity) or not (e.g. industrial, services) will also be relevant.

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(bb) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders' or members' voting rights in that undertaking. The Member States may introduce more detailed provisions concerning the form and contents of such agreements.

The Member States shall prescribe at least the arrangements referred to in (bb) above.

They may make the application of (aa) above dependent upon the holding's representing 20 % or more of the shareholders' or members' voting rights.

However, (aa) above shall not apply where another undertaking has the rights referred to in subparagraphs (a), (b) or (c) above with regard to that subsidiary undertaking.

2. Apart from the cases mentioned in paragraph 1 above and pending subsequent coordination, the Member States may require any undertaking governed by their national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking) holds a participating interest as defined in Article 17 of Directive 78/660/EEC in another undertaking (a subsidiary undertaking), and:

(a) it actually exercises a dominant influence over it; or

(b) it and the subsidiary undertaking are managed on a unified basis by the parent undertaking.

<sup>9</sup> 'Durable link' is defined in CEIOPS' Advice on Group solvency assessment (former CP60).

### 3. Feedback from QIS 4

#### *General approach*

3.1. The approaches to the treatment of participations tested in QIS4 were as follows:

Option 1 (differentiated equity stress approach): Undertakings should treat all participations and subsidiaries in the SCR calculation as if they were an equity investment. For participations and subsidiaries in which the undertaking owns more than 20% and for certain specific other participations and subsidiaries a reduced equity shock applies.

Option 2 (across the board approach): Undertakings should treat all participations and subsidiaries in the SCR calculation as if they were a standard equity investment. No reductions apply.

Option 3 (look-through approach): Undertakings may replace the solo SCR calculation with the group SCR calculation for the (sub)group formed by the undertaking itself and its subsidiaries and participations.

3.2. Views regarding the suitability of the approaches that were tested in QIS 4 were mixed. A summary of views from the QIS 4 report<sup>10</sup> is included below.

3.3. A vast majority of undertakings from one country and some undertakings from four other countries supported a differentiated equity stress approach, citing a stable relationship between undertaking and participation to substantiate their view. One supervisor supported a differentiated equity stress approach as being consistent with the long term nature of the investment in participation. Another supervisor supported this approach as being economically more realistic. However, several undertakings criticised this option as being too complex or questioned its rationale. Some supervisors remarked that the approach is too complex, that the rationale of the distinction of participations is unclear and that it produces a lower capital charge than the look-through approach.

3.4. Two supervisors preferred the across the board method whereby all participations were treated as standard equity investments on the basis that a reduced stress for participations is not reasonable and empirically not justified. They also noted that current market developments have shown that financial institutions are more volatile than assumed under option 1. The "look-through" approach was also supported by some undertakings and considered to be more consistent with the way in which the business is managed. Other undertakings complained that direct holdings in participations are treated differently to holdings via a holding company in the differentiated equity stress or across the board approaches.

3.5. Several supervisors had not reached a final view on the best way forward in relation to participations at the time of QIS 4. Some of them noted that the latter is of minor importance for their market, that they have not received sufficient feedback in QIS4 or that further analysis is necessary. One country

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<sup>10</sup> <http://www.ceiops.eu/media/files/consultations/QIS/CEIOPS-SEC-82-08%20QIS4%20Report.pdf>  
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proposed a specific treatment of participations which is consistent with the holding period of these assets. Neither method tested appeared to fully address these issues.

- 3.6. Industry views (from QIS4 feedback and suggestions for future implementing measures) were that there should be a consistent treatment of participations between concentration and equity risk modules.

#### *Quantitative outcome*

- 3.7. For most undertakings the difference between the differentiated equity stress and across the board approaches is small and differed by less than 10%. However, for some undertakings a significant difference was observed and the differentiated equity stress approach resulted in a capital charge up to 50% lower than the across the board approach.
- 3.8. On the level of the overall SCR, outcomes were more even. The number of undertakings for which the choice of approach made a significant difference to the overall SCR was lower, and also the relative difference between the overall SCR results was smaller.
- 3.9. Results of the look-through approach calculations were not collected in a systematic way in QIS4 due to its complexity. However, in one member state it was noted that the calculation that looks through to the underlying risks borne by the participation can result in a significantly higher SCR than other methods tested.

## 4. Key issues and regulatory objectives

### *The role of the solo capital calculation and double gearing*

- 4.1. The Level 1 text makes clear that both the solo and the group calculations of solvency have an important role to play in the regulation of the insurance industry. The solo capital calculation is necessary to see whether there is sufficient capital in each solo entity and each solo entity is subject to its own MCR and SCR requirement. The group calculations are designed to provide context to the solo calculation, and are not designed to replace it; as a consequence, the solo supervisor is able to assess the solvency position of the solo undertaking in relation to the risks it holds, whilst at the same time having consideration for the solvency position at group level.
- 4.2. The following explanation describes what is considered double gearing at solo level:
- 4.3. When one insurer (parent company) invests in a second insurer (subsidiary) there will be an increase in own funds for the subsidiary in the form of ordinary share capital<sup>11</sup>. At the same time the parent company has an asset (its investment in the subsidiary) that is included within the excess of assets over liabilities and therefore forms part of the parent's basic own funds. By investing in the subsidiary, the parent company appears not to have depleted its basic own funds but has created own funds in the subsidiary. This is shown in the example below.

<b>Parent's Solvency 2 balance sheet pre further investment in the subsidiary</b>				<b>Subsidiary's Solvency 2 balance sheet pre further investment by the parent</b>			
<b>Assets</b>	<b>1000</b>	<b>Liabilities</b>	<b>500</b>	<b>Assets</b>	<b>500</b>	<b>Liabilities</b>	<b>250</b>
Cash	500			Cash	200		
Other Assets	250	Ordinary Share Capital	500	Other Assets	300	Ordinary share capital	250
Investment in the subsidiary	250	<b>Own Funds</b>	<b>500</b>			<b>Own Funds</b>	<b>250</b>

<sup>11</sup> We have assumed for the purposes of this example that capital is invested in the form of ordinary shares, although capital could be in the form of subordinated debt or gifted from the parent.

4.4. As an example, the parent then injects a further 300 into the subsidiary:

<b>Parent's Solvency 2 balance sheet post investment in the subsidiary</b>				<b>Subsidiary's Solvency 2 balance sheet post parent's investment</b>			
<b>Assets</b>	<b>1000</b>	<b>Liabilities</b>	<b>500</b>	<b>Assets</b>	<b>800</b>	<b>Liabilities</b>	<b>250</b>
Cash	200			Cash	500		
Other Assets	250	Ordinary Share Capital	500	Other Assets	300	Ordinary Share Capital	550
Investment in the subsidiary	550	<b>Own Funds</b>	<b>500</b>			<b>Own Funds</b>	<b>550</b>

4.5. Whilst the own funds position of the balance sheet of the Parent remains the same, the injection causes the subsidiary's own funds position to increase.

4.6. Therefore, the same amount of own funds are being used by both undertakings to meet their capital requirements: this is known as double counting or double gearing. However, if a loss is suffered by the subsidiary the capital resources of both insurers will decrease. If own funds are being used by the subsidiary to absorb losses then the value of the participation in the parent company balance sheet will decrease, this will reduce the excess of assets over liabilities and thus the basic own funds of the Parent.

4.7. CEIOPS recognises that undertakings hold participations for a number of reasons and in many instances holdings in participations or subsidiaries are integral to the business. A vast majority of CEIOPS' Members agree that the aim of holding participations should be related to strategic businesses decisions rather than regulatory arbitrage. Given this, the double gearing issue can be seen as a consequence rather than a reason for creating the participation. Following on from this, a small minority of CEIOPS' Members underlines that the relevance of the issue of double gearing had therefore led to the decision to adopt the supplementary supervision for insurance groups i.e. Directive 98/78/EU (IGD): the solvency position at group level is a clear picture of the group's available own funds, where all the intra-group transactions are considered (not only capital and subordinated items). Under this small minority view, the treatment of participations at solo level, when they are included in the group SCR calculation, does not need to address the issue of double gearing. This is consistent with the Solvency 1 approach envisaging that the exclusion of participation held by insurance undertakings in regulated entities (either insurance undertakings or banks) can be waived if group supervision do apply (art. 16 of Directive 73/239 and art. 27(2) of Directive 2002/87). However, the vast majority of CEIOPS' Members considers that the issue of double gearing needs to be addressed at both the solo and the group levels, and this is fundamental so as to maintain the integrity of the solo solvency calculation.

4.8. In addition to double gearing, the vast majority of CEIOPS' Members think that the following objectives are also relevant when considering the treatment of

participations:

- ensuring that the capital held in each solo entity is commensurate with the risks run in that entity - this requires supervisors to have the ability to identify where capital and risks reside;
- limiting systemic risk;
- avoiding the contagion of risks within a group through subsidiaries/participations;
- avoiding incentives to regulatory arbitrage through group structuring.

4.9. It should be noted that some of these objectives will relate to both the solo and group treatment of participations, depending on the structure of the (re)insurance undertaking. An example of where objectives may only be met through the solo treatment of participations is the issue of dealing with systemic risk where the participation is not part of the undertaking's group.

4.10. In addition, the vast majority of CEIOPS' Members share the view that contagion risk will impact on all undertakings so even though the assessment may be done at group level, this is also relevant at solo level.

4.11. In determining an appropriate solo treatment of participations it is important to be consistent with the principles and objectives underpinning both the solo and the group regime.

CEIOPS has already expressed its views on cross sectoral consistency in CEIOPS' Advice on classification and eligibility of own funds,<sup>12</sup> with reference to the objective of promoting compatibility of the prudential supervision of insurance and banking. In addition, it should be noted that with specific reference to the treatment of participations the issue is also addressed through the current review of the Financial Conglomerates Directive.

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<sup>12</sup> See former CP46 CEIOPS' Advice on own funds.

## 5. Treatment of participations for own funds purposes

- 5.1. CEIOPS has considered a range of options for the treatment of participations in order to identify an effective prudential and harmonised approach. CEIOPS is of the view that the method should apply regardless of whether the related undertaking is a subsidiary or participation and therefore the issue of whether there is dominant or significant influence is not relevant. The options considered have been analysed based on whether the participation is included in or excluded from the group, and are also driven by the nature of the participation.
- 5.2. Therefore, CEIOPS sees the following as a suitable way to categorise the different types of participations and subsidiaries.

Included in the scope of group supervision <sup>8</sup>	Subsidiaries & Participations	Regulated	Financial and credit institutions <sup>13</sup>
		Regulated	(Re) insurers
		Unregulated	Related to the financial sector
		Unregulated	Not related to the financial sector
Excluded from the scope of group supervision <sup>8</sup>	Subsidiaries & Participations	Regulated	Financial and credit institutions <sup>14</sup>
		Regulated	(Re) insurers
		Unregulated	Related to the financial sector
		Unregulated	Not related to the financial sector

- 5.3. The above categorisation applies regardless of whether the investment in the participation is in the form of ordinary shares or other types of own funds such as subordinated debt instruments.
- 5.4. The Level 1 text only explicitly refers to holdings in subordinated debt in the case of participations in credit and financial institutions. However, CEIOPS considers that in the case of all regulated undertakings the investment in different types of own fund items other than ordinary shares is also relevant. As such the approaches below take a broader perspective and include subordinated claims and instruments that a (re) insurer holds in participating (re) insurance undertaking.
- 5.5. The “look-through” method was not considered as an option for the treatment of participations. Under this method, the participating undertaking’s investments in (re) insurance undertakings, credit and financial institutions and other related undertakings are consolidated into its solo SCR. The participating undertaking’s own funds are replaced with a consolidated calculation of the own funds of the sub-group, and similarly the participating undertaking’s SCR is replaced with a group SCR calculation for the sub-group. The look-through

<sup>8</sup> Defined as per Article 212 of the Level 1 text

<sup>13</sup> Defined as per Article 92.2 of the Level 1

<sup>14</sup> Defined as per Article 92.2 of the Level 1

approach results in a line by line aggregation of the assets and liabilities of the parent with those of the participation. The disadvantage of this approach is that supervisors are unable to identify what own funds reside in the solo entity commensurate to the risks that it holds on a stand alone basis.

- 5.6. In addition, where the participation is part of a group, the calculation will result in an overlap between the solo and the group SCR, creating an additional burden for undertakings. This approach does not make a clear distinction between the solo and the group SCR, which is inconsistent with Solvency II.

#### *Interrelation with SCR sub-modules*

- 5.7. The treatment of participations is a relevant issue also for the sub-modules within the SCR. As an example, if own funds derived from a participation were not recognised as eligible own funds in the participating undertaking, then there should be no concentration risk charge, since the value of the participation has been eliminated. CEIOPS is mindful of this matter and is striving to ensure that any approach adopted is commensurate with dealing with double gearing and the objectives considered above.

## **5.1 Participations – Included in the scope of Group Supervision**

### **5.1.1 Financial and credit institutions – CEIOPS’ Members majority view**

- 5.8. A vast majority of CEIOPS’ Members recommends that implementing measures under Article 92 of the Level 1 text should provide that the own funds arising from participations in financial and credit institutions should not be recognised as eligible own funds for the purpose of the SCR and MCR of the participating (re) insurance undertaking. CEIOPS notes the difference between the methods for calculating solvency and capital adequacy requirements for insurance firms versus credit and financial institutions.
- 5.9. The approach of fully derecognising (including goodwill of) the participations in financial and credit institutions also mitigates the risk of double counting at a solo level (double gearing), by ensuring that the parent cannot use the own funds it has invested in a participation. This is important as the supervisors have a meaningful picture of the solvency position of each solo undertaking.
- 5.10. This further reflects the fact that own funds of a participation will not be available to absorb losses of the parent in any possible situation, and particularly in times of crisis.
- 5.11. Any holdings in subordinated claims and other instruments in the participation will also be excluded.

### **5.1.2 (Re) insurers – CEIOPS’ Members majority view**

- 5.12. For participations in (re)insurers, the vast majority of CEIOPS’ Members took into account the most important consideration that the solo undertaking should

hold own funds that are commensurate with the risks that it holds.

- 5.13. These Members were also mindful of the key issues surrounding holding participations if the own funds held by the participation would be recognised as part of the own funds of the participating undertaking, due to double gearing as well as the additional risks as discussed above.
- 5.14. When approaching the treatment of (re)insurance participations, the Members were of the view that, as much as possible, a clear and transparent treatment was required, in order to maintain market confidence.
- 5.15. The vast majority of CEIOPS' Members considered that the own funds which arise from participations are not available to absorb losses of the participating undertaking, as at least the amount corresponding to the SCR of the related (re) insurance undertaking is needed to absorb losses in that undertaking, both on a going and a gone concern. The SCR represents the risks run by the participation, and at a minimum, there should be own funds available within the participation to meet this requirement. Consequently, the excess of assets over liabilities that is being used by the participation to meet its SCR cannot be used to meet, at the same time, the capital requirements in the participating entity.
- 5.16. Therefore, the amount of excess of assets over liabilities held by the participation to meet its SCR should be treated as a restricted item, and, as a result of its commitment within the participation, it has to be excluded from the participating entity's eligible own funds because it is not available to meet its function within the participating entity. CEIOPS notes that the Level 1 text recognises the principle that restriction is necessary where own funds or assets are only available to meet certain risks. The above approach is an application of this principle which is also evident in the treatment of ring-fenced funds.
- 5.17. The vast majority of CEIOPS' Members considers that the Level 1 text aims to secure the solvency position of the participating undertaking both in the case where the participation may be transferred, and also in the case where it is not possible to transfer the participation. Since reputational risk is a major risk of financial activities, and given that in crisis situations markets tend to become illiquid, a loss absorbency test whereby goodwill is given no value should still be considered i.e. – any inherent goodwill in the valuation should be excluded from own funds of the participating undertaking.
- 5.18. The vast majority of CEIOPS' Members also believes that the remaining portion of the participating undertaking's share of the participation's excess of own funds over its SCR ("the excess") needs to be tested as to whether it provides the required capacity to absorb losses, or whether there are some features that impede it.
- 5.19. As a consequence, the vast majority of CEIOPS' Members recommends that the excess should be assessed with regards to its ability to meet the criteria in Article 93, and a judgment be made on whether it should be further restricted, or, if included, as to the tier in which it would fall.
- 5.20. Through this approach, the double counting of capital is mitigated, and this is likely to provide supervisors with a better assessment of the solvency position of the participating undertaking.

- 5.21. The supervisor is also better able to address where capital and risks reside.
- 5.22. In addition, this approach does not offer any disincentive so that participating undertakings can ensure participations are well capitalised as the parent will be able to benefit from the surplus own funds in the participation that are in excess of the participation's capital requirement, provided that the 'availability' test is satisfied.
- 5.23. Since the participation is subject to the same capital requirements as the participating entity, the SCR amount that is excluded from the participating entity's eligible own funds should accurately reflect the risks relating to the participation.

Stakeholder comments are specifically welcome on this approach.

- 5.24. The Commission considers that the approach recommended would not meet the specific terms of the Level 1 text. CEIOPS reiterates its majority view on the grounds of cross-sectoral consistency, the need for Solvency II to deliver a sound prudential regime and an approach consistent with the principles underlying the Level 1 text. If notwithstanding CEIOPS' advice, there is no scope for the exclusion of the eligible own funds of the (re)insurance participation used to meet its SCR, then the risk inherent in the participation must be properly addressed in the SCR standard formula, in particular in the equity risk sub-module. Further detail as to how this approach might be developed is discussed in the Annex.<sup>15</sup>

### **5.1.3 Financial non regulated undertakings – CEIOPS' Members majority view**

- 5.25. These undertakings fall outside the scope of Article 92; however, a vast majority of CEIOPS' Members notes the importance of economic substance, and the fact that a notional SCR is required in respect of financial non regulated undertakings is evidence that Solvency II should take an economic view of these undertakings. It therefore recommends that the same approach used for regulated financial and credit institutions should be adopted for financial non regulated undertakings.

### **5.1.4 Non financial non regulated undertakings – CEIOPS' Members unanimity view**

- 5.26. The loss absorbency capacity of the own funds derived from participations may also be restricted in the case of non financial non regulated undertakings. However CEIOPS has concluded that the risk arising in these cases are of a different order to those discussed above. CEIOPS proposes that these undertakings have a standard equity risk charge approach applied to them, subject to the criteria in Article 109(ja).

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<sup>15</sup> This could be adapted where necessary if the investment in the participation also extends to subordinated claims and other instruments.

### **5.1.5 Financial and credit institutions, (Re) insurers and Financial non regulated undertakings – CEIOPS’ Member minority view**

- 5.27. One member of CEIOPS believes that all participations included in the scope of group supervision should be treated as equity investments at the solo level, and therefore be subject to an equity risk charge approach.
- 5.28. The rationale for this proposal is that, given the requirements established on the financial position of the group, where all intra-group transactions are considered, there is no need to eliminate double gearing also at solo level, since it is already dealt with at group level and the duplication is deemed unnecessary under a prudential point of view.
- 5.29. Furthermore, the requirements on risk management, internal control, and monitoring of intragroup transactions and risk concentrations imply that the risks carried out by the participation are already considered at group level.
- 5.30. The valuation of the participation should be carried out on a market consistent methodology, by applying either mark to market if market prices are available, or mark to model procedures, including the net asset value method, in absence of market prices.
- 5.31. According to Article 109(ja) the equity risk shock should be reduced, in order to take into account the likely reduction in volatility due to the strategic nature of the related undertakings and the influence exercised by the participating undertaking. An appropriate reduction considered is 50% of the standard shock (as in QIS 4).
- 5.32. For the subordinated claims and instruments referred to in Article 63 and Article 64(3) of Directive 2006/48/EC which (re)insurance undertakings hold in respect of the credit institutions and financial institutions in which they hold a participation the counterparty default risk module applies.

### **5.2 Participations – Excluded from the scope of Group supervision – CEIOPS’ Members unanimity view**

- 5.33. Those supporting the majority view in respect of participations falling within the scope of group supervision believe that the same arguments can be applied here. However all members support the following approach. In the case of participations excluded from the scope of group supervision in accordance with Article 212(2) or Article 227, CEIOPS proposes that the solo supervisor shall consider whether the circumstances leading to that exclusion also apply to the assessment of the solo solvency position of the relevant undertaking. If the solo supervisor concludes that the circumstances do not apply, then the participation should be treated as if it were included in the scope of group supervision.
- 5.34. If the solo supervisor concludes that these circumstances do apply, and that the loss absorbency of the own funds derived from the participation is affected, then the amount should not be recognised as eligible own funds. This

assessment should be carried out in respect of participations in (re)insurers, financial and credit institutions<sup>16</sup> and financial non regulated undertakings.

- 5.35. Any holdings in subordinated claims and other instruments in the participation should also be excluded.
- 5.36. The rationale is that the capital requirement or notional capital requirement that applies to these participations restricts the loss absorbency capacity of the own funds of the participating undertaking.
- 5.37. The loss absorbency capacity of the own funds derived from participations may also be restricted in the case of non-regulated non-financial undertakings where the participation is excluded from the scope of group supervision. However, CEIOPS sees merit in a consistent treatment of such participations regardless of their inclusion in the group. Therefore it is proposed that a standard equity risk charge approach be used, subject to the criteria in Article 109(ja). CEIOPS has yet to agree the appropriate equity risk charge. This will need to take into account whether a non-regulated non financial undertaking that is excluded from the group should ever be considered a strategic investment.

#### *Further considerations*

- 5.38. These treatments mitigate, to an extent, the risk of double counting at a solo level (double gearing), as for (re)insurers, the parent cannot use its share of the own funds that are being held by the participation to meet its SCR. For financial and credit institutions, the complexities that arise from different capital adequacy requirements for banks and other credit institutions are avoided as the participating undertaking's share of own funds in the participation is excluded.
- 5.39. The treatments help minimise to an extent the potential for systemic risk which results when multiple regulated undertakings each hold participations in other regulated undertakings. Along with this, it also may act as a disincentive for excessive cross-holdings between firms.
- 5.40. In addition, the use of a standard equity risk approach as well as an assessment of the excess against Article 93 criteria gives the opportunity to maintain a more flexible approach, in order to get the benefits of the various options, differentiating the treatment of participations taking into account their different natures and risks.

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<sup>16</sup> Also means investment firms

## 6. CEIOPS' Advice

- 6.1 The treatment of participations must ensure that the supervisors have a meaningful picture of the solvency position of each solo undertaking.
- 6.2 CEIOPS' Members consider that the issue of double gearing needs to be addressed at both the solo and the group levels, and this is fundamental so as to maintain the integrity of the solo solvency calculation.
- 6.3 The following objectives are also relevant when considering the treatment of participations:
- ensuring that the capital held in each solo entity is commensurate with the risks run in that entity - this requires supervisors to have the ability to identify where capital and risks reside;
  - limiting systemic risk;
  - avoiding the contagion of risks within a group through subsidiaries/participations;
  - avoiding incentives to regulatory arbitrage through group structuring.
- 6.4 The vast majority of CEIOPS' Members share the view that contagion risk will impact on all undertakings so even though the assessment may be done at group level, this is also relevant at solo level.
- 6.5 CEIOPS has already expressed its views on cross-sectoral consistency in its advice on classification and eligibility of own funds, with reference to the objective of promoting compatibility of the prudential supervision of insurance and banking. In addition, it should be noted that with specific reference to the treatment of participations the issue is also addressed through the current review of the Financial Conglomerates Directive.
- 6.6 CEIOPS considers that options for the treatment of participations need to create an effective prudential and harmonised approach. The proposed treatments are presented based on whether the participation is included in or excluded from the group, and are also by the nature of the participation. Consequently, CEIOPS proposes the following:

### ***Participations – included in the scope of Group supervision***

#### ***Financial and credit institutions – CEIOPS' Members majority view***

- 6.7 The own funds arising from participations in financial and credit institutions should not be recognised as eligible own funds.
- 6.8 Any holdings in subordinated claims and other instruments in the participation should also be excluded.

(Re) insurers – CEIOPS’ Members majority view

- 6.9 The vast majority of CEIOPS’ Members believes that the amount of own funds held by the participation to meet its SCR should be treated as a restricted item, and excluded from the participating entity’s eligible own funds.
- 6.10 If the participating undertaking chooses to invest in a subordinated claim or any other instrument in the participation that was regarded as eligible own funds, the limit set for Tier 2 and/or Tier 3 (depending on the subordinated liability/instrument’s ability to satisfy key features required for Tier 2 or Tier 3 instruments) to meet the participation’s SCR<sup>17</sup> would be considered and that amount represented by Tier 2 or Tier 3 instruments would be excluded from the own funds of the participating undertaking.
- 6.11 Any inherent goodwill in the valuation should be excluded from own funds of the participating undertaking.
- 6.12 The vast majority of CEIOPS’ Members believes that the remaining portion of the participating undertaking’s share of the participation’s excess of own funds over its SCR (“the excess”) needs to be tested as to whether it provides the required capacity to absorb losses, or whether there are some features that impede it.
- 6.13 The vast majority of CEIOPS’ Members recommends that the excess should be assessed with regards to its ability to meet the criteria in Article 93, and a judgment be made on whether it should be further restricted, or, if included, as to the tier in which it would fall.
- 6.14 If notwithstanding CEIOPS’ advice, an alternative approach to address the risks of participations in insurance and reinsurance undertakings is required, then the risk inherent in the participation must be properly addressed in the SCR standard formula. This should apply an equity capital requirement which takes the particular risk-profile of the participation into account. Further detail as to how this might be developed is set out in the Annex.

Financial non regulated undertakings – CEIOPS’ Members majority view

- 6.15 CEIOPS recommends that the same approach used for regulated financial and credit institutions should be adopted for financial non-regulated undertakings.

Non financial non regulated undertakings – CEIOPS’ Members unanimity view

- 6.16 CEIOPS proposes a standard equity risk charge approach is applied to these undertakings, subject to the criteria in Article 109(ja).

Financial and credit institutions, (re) insurers and Financial non regulated undertakings – CEIOPS’ Member minority view

- 6.17 One CEIOPS’ Member believes that all participations included within the scope of group supervision should be treated as equity investments at the undertaking level, and therefore be subject to an equity risk charge approach, as explained in the explanatory text.

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<sup>17</sup> As defined in CP46 ‘Final Advice on Own Funds – Article 97 and 99 – Classification and eligibility’  
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- 6.18 According to Article 109(ja) the equity risk shock should be reduced, in order to take into account the likely reduction in volatility due to the strategic nature of the related undertakings and the influence exercised by the participating undertaking. An appropriate reduction considered is 50% of the standard shock (as in QIS 4).
- 6.19 For the subordinated claims and instruments referred to in Article 63 and Article 64(3) of Directive 2006/48/EC which (re)insurance undertakings hold in respect of the credit institutions and financial institutions in which they hold a participation, the counterparty default risk module applies.

***Participations – Excluded from the scope of Group supervision – CEIOPS’ Members unanimity view***

- 6.20 In the case of participations excluded from the scope of group supervision in accordance with Article 212(2) or Article 227, CEIOPS proposes that the solo supervisor shall consider whether the circumstances leading to that exclusion also apply to the assessment of the solo solvency position of the relevant undertaking. If the solo supervisor concludes that the circumstances do not apply, then the participation should be treated as if it were included in the scope of group supervision.
- 6.21 If the solo supervisor concludes that these circumstances do apply, and that the loss absorbency of the own funds derived from the participation is affected, then the amount should not be recognised as eligible own funds. This assessment should be carried out in respect of participations in (re)insurers, financial and credit institutions<sup>18</sup> and financial non regulated undertakings.
- 6.22 Any holdings in subordinated claims and other instruments in the participation will also be excluded.
- 6.23 In the case of non-regulated non financial undertakings where the participation is excluded from the scope of group supervision, it is proposed that a standard equity risk charge approach be used, subject to the criteria in Article 109(ja). CEIOPS has yet to agree on the appropriate equity risk charge. This will need to take into account whether a non-regulated non financial undertaking that is excluded from the group should ever be considered a strategic investment.

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<sup>18</sup> Also means investment firms

## Annex A - SCR calculation as an alternative treatment of participations in (re) insurers within the scope of group supervision

- A.1. For this risk assessment, use can be made of the risk assessment in the related undertaking. If the related undertaking is an insurance or reinsurance undertaking subject to EEA supervision, then it has to calculate the solvency capital requirement  $SCR_{related}$  that reflects the risks of the undertaking. A straightforward approach for the measurement of the risk in the participation is to base the equity capital charge of the participating undertaking on  $SCR_{related}$ . In case of an x% participation in the related undertaking, the equity capital charge of the participating undertaking for this participation could be calculated as

$$Mkt_{eq}^{participation} = x\% \cdot SCR_{related}$$

- A.2. From a risk-theoretical point of view this approach has several merits. It is risk-based. There is an obvious connection between the market value of the participation and the basic own funds of the related undertaking.  $SCR_{related}$  quantifies the potential loss in own funds and therefore a good measure of the potential loss in the market value of the participation. Moreover, this approach automatically reflects "the likely reduction in the volatility" in the market value that may be caused by the nature of the investment (cf. Article 109(1ja)).
- A.3. However, a drawback of the approach is that the diversification between  $Mkt_{eq}^{participation}$  and other sub-risks of the SCR may be overstated. For example,  $SCR_{related}$  may mainly consist of underwriting risk. In the SCR calculation of the participating undertaking,  $Mkt_{eq}^{participation}$  is treated like any other investment under the assumption that there is high diversification with the underwriting risks of the participating undertaking. (The correlation factor for market risk and the underwriting risks is only 0.25.) In order to correct for this artificial diversification and to prevent arbitrage opportunities, the capital requirement should include an add-on as follows:

$$Mkt_{eq}^{participation} = f \cdot x\% \cdot SCR_{related} ,$$

where  $f$  is a fixed factor larger than one.

- A.4. The accurate value of  $f$  depends on the risk-profile and size of risks that the participating undertaking and the related undertaking are exposed to. Within the scope of the standard formula, it appears to be appropriate to disregard this variability and choose an average fixed value for  $f$ . Such an average value can be derived by analysing a model situation as follows:

Let the participating undertaking M hold a 100% participation in the related undertaking P. Let us further assume that if we ignore the risk of the participation in P that M is exposed to, then the risk-profile of M and P coincide both in relation to the absolute size of the overall risk as well as the relative

importance of the risks. Such a situation could for example be the result of M setting up P and transferring half of its business to P.<sup>19</sup> Therefore, if the Basic SCR of M before transfer is 200, then the Basic SCR of P is half of that amount ( $BSCR_P=100$ ) and the Basic SCR of M after transfer ignoring the risk of the participation is also half of that amount ( $BSCR^*_M=100$ ). The accurate value of the Basic SCR of M after transfer including the risk of the participation is still 200, because the setting up of P has not changed the risk position of M:  $BSCR_M=BSCR^*_M+BSCR_P=200$ .

- A.5. Further, let the order of risks that M (ignoring the risks of the participation) and P are exposed to coincide with the average order as measured in QIS4 for a non-life undertaking:<sup>20</sup>

<b>(Sub-)module</b>	<b>SCR</b>
market risk	55
interest rate risk	22
equity risk	36
property risk	8
spread risk	6
concentration risk	10
currency risk	4
counterparty default risk	6
life underwriting risk	1
health underwriting risk	17
non-life underwriting risk	62
<b>BSCR</b>	<b>100</b>

- A.6. If the SCR of M was calculated with the approach defined in the first paragraph (i.e. without the factor  $f$ ), then the equity SCR of M would be  $36 + 100 = 136$  and the resulting Basic SCR of M would be 182.<sup>21</sup>
- A.7. Compared to the accurate  $BSCR_M$  of 200 (see above), that approach underestimates the risk by 18. In order to arrive at a Basic SCR of 200, the equity requirement for the participation needs to be increased by 20.<sup>22</sup> Hence, in order to arrive at the accurate result,  $f$  must be set at 1.2, because this factor takes the SCR for the participation of 100 to 120.

<sup>19</sup> For example, M transfers half of its assets to P so that the asset structure of P and M (let alone M's participation in P) coincide. M further transfers half of its liabilities to P, for instance by a 50% proportional reinsurance. (The credit risk of M in relation to P is ignored in the following calculation.)

<sup>20</sup> For each national market an average composition of the BSCR was determined in QIS4. The European average was calculated by weighting the market averages with the number of QIS4 participants.

<sup>21</sup>  $BSCR_M$  is calculated by aggregating the equity SCR of 136 and the other sub-module and module SCR from the table above.

<sup>22</sup> It is not sufficient to increase the equity charge by 18 because of diversification effects between equity risk and the other risks. But it is possible to calculate that an equity SCR of  $136+20$ , aggregated with the other sub-module and module SCR, results in a Basic SCR of 200.

- A.8. If the size of the risk of P is larger than the risk of M (ignoring the risk of the participation), then  $f$  would be lower. On the other hand, if the risk of P was smaller than the risk of M, then  $f$  would be higher. This is because the relative diversification effect decreases with the size of P. <sup>23</sup> If the risk profile of P included less underwriting risk than the risk profile of M (ignoring the risk of the participation), then  $f$  would be higher. Alternatively, if the risk profile of P included more equity risk, then  $f$  would be lower. In this sense, the above model situation can be considered to be an average situation.
- A.9. The factor  $f$  to correct for artificial diversification effects of the standard formula in relation to the risk of the participation should be set at 1.2.
- A.10. If an undertaking holds several participations in (re)insurance undertakings, the capital requirements for the participations should be summed up to derive the overall capital requirement. Within the equity sub-module, the overall capital requirement for participations should be added to the other equity requirements.
- A.11. In addition to the equity charge, it may be necessary to capture the risk of participations in the concentration risk sub-module. Moreover, the fungibility of the participation may be addressed in the assessment of own funds of the participating business.

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<sup>23</sup> For example, a similar calculation with  $BSCR_p=200$  leads to a value of  $f$  of 1.13 and the case  $BSCR_p=50$  produces a value of  $f$  of 1.3.

## Annex B - Impact assessment

- B.1. In its Call for Advice of 1 April 2009, the Commission has asked CEIOPS to contribute to the Commission's impact assessment of the Level 2 implementing measures.<sup>24</sup> To this end, a list of issues has been set up by the Commission and CEIOPS, identifying the Level 2 implementing measures that should be accompanied by an impact assessment. The objectives of the issues have been selected among the list of objectives used by the Commission in its Level 1 impact assessment.<sup>25</sup> On 12 June 2009, the Commission has issued an updated list of policy issues and options, to which reference is being made.<sup>26</sup> This impact assessment covers issue 7 of the list of policy issues and options. A summary table accompanying the impact assessment is published in a separate excel document.
- B.2. The impact assessment takes into account the results produced through the QIS4 exercise. Nevertheless, there is an acknowledgment that QIS4 data does not provide enough information regarding the nature of each participation, nor is there enough disaggregated data in relation to the capital requirements of each participation of the undertaking.
- B.3. Therefore, stakeholders are invited to comment on the impact assessment and provide additional quantitative information.
- B.4. The high level impact assessment templates which follow are an indication of CEIOPS' views. However given that on some aspects of this draft advice CEIOPS is unanimous and on others there are majority and minority views this has been balanced in arriving at the assessment of impact and alignment with objectives. Based on further consideration and feedback from consultation CEIOPS may be able to differentiate more between options 1 to 4 always recognising that none of these meets in full the objectives CEIOPS considers fundamental to a regulatory treatment of participations.

### **1. Description of the policy issue**

- B.5. The issue deals with the treatment at solo level of holdings in participations and subsidiaries held by (re)insurance undertakings.
- B.6. The issue relates to how participations and subsidiaries should be treated in the SCR standard formula, in particular in the calculation of the equity risk sub-module, taking into account the likely reduction in the volatility of the value of those related undertakings arising from the strategic nature of those investments and the influence exercised by the participating undertaking on those related undertakings.
- B.7. This issue is also connected with how holdings in participations and subsidiaries in financial and credit institutions should be treated with respect to the determination of own funds.

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<sup>24</sup> <http://www.ceiops.eu/media/files/requestsforadvice/EC-april-09-CfA/EC-call-for-advice-Solvency-II-Level-2.pdf>.

<sup>25</sup> [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/impactassess/final-report\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf).

<sup>26</sup> <http://www.ceiops.eu/media/files/requestsforadvice/EC-June-09-CfA/Updated-List-of-policy-issues-and-options-for-IA.pdf>.

- B.8. Five options have been identified by the Commission depending on the relationship with the related entity, and the nature of the related entity.
- B.9. Nevertheless CEIOPS has decided to follow the proposed direction of treatment of participations described above.
- B.10. The main differences with the five options are related to the application of the same treatment to all holdings, regardless if participations or subsidiaries while a distinction has been made between those included in and those excluded from the group SCR.
- B.11. In additions, CEIOPS recommends that the same approach used for regulated financial and credit institutions should be adopted for financial non regulated undertakings. These fall outside the scope of Article 92; however, a vast majority of CEIOPS members notes the importance of economic substance, and the fact that a notional SCR is required in respect of financial non regulated undertakings is evidence that Solvency 2 should take an economic view of these undertakings.
- B.12. Furthermore, a different treatment is proposed by the vast majority of CEIOPS members in relation to holdings held in re(insurance) undertakings.
- B.13. Indeed, those CEIOPS members recognise the issues that surround the inclusion of participations as own funds of the participating undertaking, in particular the relevance of the double counting (double gearing) issue as described above and they believe that this is not adequately addressed by any of the policy options.
- B.14. CEIOPS is also aware that there are a variety of additional objectives to consider for the treatment of participations, which have been described in paragraph 4.8 in the explanatory text of the advice.
- B.15. CEIOPS took into account, first and foremost, the lessons learned from the recent financial crisis, where the real threat existed that holdings would be unable to provide the own funds required to the participating entity in times of stress, especially if the own funds were being used to meet the participation's own losses.
- B.16. CEIOPS also appreciated that this threat would be substantially higher where holdings existed that were not included in the scope of group consolidation. The lack of information and ambiguity surrounding these holdings, makes it extremely difficult to justify their inclusion in the own funds of the participating undertaking, as most important, that holdings present different risks according to their type as well as the jurisdiction in which they operate. The loss absorbency capacity of these holdings' own funds is likely to be restricted where holdings are excluded from the group SCR.
- B.17. With holdings included in the scope of group SCR, CEIOPS was concerned that the lack of like for like comparisons between financial and credit institutions and insurance undertakings would mean that there would be little scope to come up with an adequate means of treating these holdings, which would also be consistent with the Level 1 text.
- B.18. For participations included in the scope of group SCR one Member State support the application of a differentiated equity stress to holdings. This is because the

requirements established on the financial position of the group, where all intra-group transactions are considered, there is no need to eliminate double gearing also at solo level, since it is already dealt with at group level and the duplication is deemed unnecessary under a prudential point of view.

- B.19. Furthermore, the requirements on risk management, internal control, and monitoring of intra-group transactions and risk concentrations imply that the risks carried out by the participation are already considered at group level.

## **2. Detailed description of policy options and assessment of the relative impacts on the different affected parties**

**Option 1:** Apply a differentiated equity stress (compared to the standard equity stress) to all holdings in participations and subsidiaries, including (re)insurance holdings and holdings in financial and credit institutions.

**Option 2:** Apply a differentiated equity stress to all non-financial and (re)insurance holdings in participations and subsidiaries. Apply a different approach to holdings in financial and credit institutions (e.g. deduction/aggregation).

**Option 3:** Apply a differentiated equity stress to all non-financial holdings in participations and subsidiaries. Apply an alternative approach to (re)insurance holdings, which makes use of the additional information available in these cases to determine the holding's contribution to the overall risk profile of the undertaking. Deduct holdings in financial and credit institutions.

**Option 4:** Apply a differentiated equity stress to all non-financial subsidiaries. Apply a standard equity stress to non-financial participations, which are not subsidiaries. Apply an alternative approach to (re)insurance holdings in subsidiaries and participations, which makes use of the additional information available in these cases to determine the holding's contribution to the overall risk profile of the undertaking. Deduct holdings in financial and credit institutions

**Option 5:** A combination of the previous options

- B.20. As mentioned in paragraph 1, the vast majority of CEIOPS proposes for holdings included in the group SCR the treatment described below (which is not subject to IA):

Apply an equity stress to all non-financial non regulated holdings in participations and subsidiaries. Deduct holdings in financial and credit institutions and in non regulated financial undertakings. Apply an alternative approach to (re)insurance holdings, which deals with the double gearing issue.

- B.21. One Member State supports the treatment described as option 1 apart from when the participations (other than non-financial non regulated holdings) are excluded from the scope of group supervision.

The approaches recommended combine a number of those covered in Options 1 to 4.

## **Impact on industry, policyholders and beneficiaries and supervisory authorities**

### **Costs and benefit**

#### **• Industry**

- B.22. CEIOPS expects that some members of the industry are likely to support option 1, which leads to a lower impact in terms of capital needed with respect to option 2, 3 and 4.
- B.23. The impact, however, is difficult to quantify, namely because the QIS 4 data does not provide enough information regarding the nature of each participation, so that the proposed treatment can be followed. Nor is there enough disaggregated data in relation to the capital requirements of each participation of the undertaking.
- B.24. Option 3 and 4 are likely to have the greater impact in terms of capital needed, since they envisage the full deductions from own funds of participations held in financial and credit institutions, and therefore will lead to increased capital costs for regulated firms. This could also lead to the reduction of these participations or to a less stringent risk monitoring.
- B.25. Option 1 is the less complex with reference to the calculation of the SCR standard formula.
- B.26. CEIOPS is also of the view that the effect of increasing the eligible own funds within each undertaking and its respective participation will serve to aid the industry to withstand any future systemic shocks.

#### **• Policyholders and beneficiaries**

- B.27. Policyholders and beneficiaries can be affected in two different ways. An effect is that under options 2, 3 and 4 the participating (re)insurance undertaking will need to hold a greater amount of capital. This will result in a higher cost-of-capital rate, and consequently higher premiums to pay if premiums were to fund rise in the cost of capital.
- B.28. However, policyholders will benefit from the increased capital available to absorb unexpected losses, that is a greater protection.

#### **• Supervisory Authorities**

- B.29. As explained above, the majority of CEIOPS' Members is concerned that under option 1 own funds held in the parent company will not be available to absorb losses because they are restricted in the participated undertaking. This is particularly relevant for holdings held in regulated entities (insurance, financial and credit).
- B.30. On the other hand, option 2, 3 and 4 could increase the burden on supervision, particularly for undertakings with complex portfolios, since it envisages a differentiated assessment.