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Consultation Paper No. 68

Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II:

Articles 99 b) and 109(1)(fa) Ring-Fenced Funds

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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.¹
- 1.2. This Paper aims at providing advice with regard to the adjustments that should be made to reflect the lack of transferability of own funds and the reduced scope for risk diversification at the level of the SCR related to ring-fenced funds, as requested in Articles 99 b) and 109(1) (fa) of the Solvency II Level 1 text.²
- 1.3. The present paper deals with ring-fencing arrangements³ that are expected to remain following the introduction of Solvency II. The presence or absence of ring-fencing should be assessed by reference to the Level 1 Directive text. In cases where such assessment leads to the identification of a ring-fencing arrangement, the advice set out in this consultation paper will apply.
- 1.4. CEIOPS notes that ring-fenced funds do not arise in a number of Member States.

2. Extract from Level 1 text

Legal basis for the implementing measures

- 2.1. Article 99 – Implementing measures within the section on Own Funds:

"The Commission shall adopt implementing measures laying down:

(...)

b) the adjustments that should be made to reflect the lack of transferability of those own funds items that can only be used to cover losses arising from a particular segment of liabilities or from particular risks (ring fenced funds)"

- 2.2. Article 109(1) – Implementing measures within the section on Solvency Capital Requirement:

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

² 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>.

³ It should be noted that the paper aims to set out the principles of the treatment of ring-fenced structures but does not attempt to answer detailed questions on the calculations, for example for components such as deferred taxes.

"(...) the Commission shall adopt implementing measures laying down the following:

(...)

(fa) the methods and adjustments to be used to reflect the reduced scope for risk diversification of insurers related to ring fenced funds"

Other relevant Level 1 text for providing background to the advice

2.3. Recitals:

"(29b) Not all assets within an undertaking are unrestricted. In some Member States, specific products origin some ring-fenced fund structures which give one class of policyholders' greater rights to assets within their own "fund". Although these assets are included in computing the excess of assets over liabilities for own-funds purposes they cannot, in fact be made available to meet the risks outside the ring-fenced fund. To be consistent with the economic approach, the assessment of own-funds needs to be adjusted to reflect the different nature of assets, which form part of a ring-fenced arrangement. Similarly the SCR calculation should reflect the reduction in pooling/diversification related to those ring fenced funds."

3. Advice

3.1 Explanatory text

3.1.1. Ring-fenced funds in QIS4

- 3.1. QIS4 collected information on the potential effects of transferability restrictions on own funds held within ring-fenced funds.
- 3.2. The approach tested the effect on the own funds side only, by assuming that any amount of 'restricted own funds'⁴ within a ring-fenced fund can only contribute to the 'total own funds' of the undertaking up to the proportional contribution of the ring-fenced fund in the total SCR. This required, as an intermediate step, the calculation of notional SCR's at the level of each ring-fenced fund. QIS 4 also tested an approach to calculate the notional SCR which was rejected by supervisors and the industry because it did not reflect the change in diversification benefit.
- 3.3. The treatment proposed was developed for QIS4 purposes only and it was acknowledged that further analysis of this issue would be necessary under the Solvency II framework.

⁴ The term 'restricted own funds' is used in the context of this paper to refer to elements of the 'excess of assets over liabilities' and subordinated liabilities within ring-fenced funds that are not available to cover all types of losses within the undertaking.

- 3.4. QIS4 results reinforced that the issue of ring-fenced funds may be significant for at least seven countries, but both undertakings and supervisors had mixed views on the suitability and practicality of the QIS4 methodology in relation to the calculation of the notional SCR.
- 3.5. Most ring-fenced funds were reported by life insurers that write with-profit business, but ring-fenced funds resulting from regulatory requirements (for example, in relation to pension contracts) and ring-fenced funds in Protection and Indemnity Associations were also reported. The treatment of these funds may have a large impact for a small number of countries and potentially for other countries. Some supervisors considered that the quantitative results may even understate the number of ring-fenced funds in existence.
- 3.6. QIS 4 results showed that there is general agreement that only the amount of own funds within the ring-fenced fund that is needed to meet the 'notional' capital requirements of the ring-fenced fund can be used to meet the undertaking's SCR.
- 3.7. However, many participants and supervisors did not agree that using a proportionate amount of the SCR as the capital requirement for the ring-fenced fund is appropriate. This is mainly because the existence of ring-fenced funds could remove diversification benefits.

3.1.2. Identification of ring-fenced funds

- 3.8. With regard to the scope of application of the present advice, namely what type of arrangements should be considered as ring-fenced funds (hereafter: RFF), CEIOPS is aware that there is a large variety of ring-fenced-type funds across the EEA, and also that the issue is not of similar relevance to all Member States.
- 3.9. When assessing the solvency of an undertaking with ring-fenced funds, there are two relevant aspects that need to be carefully analysed, in order to reflect the economic effect of ring-fencing and the potential implications for the measurement of own funds and capital requirements.
- 3.10. The first aspect relates to the availability of own funds within an undertaking in the presence of ring-fenced funds and the measurement of the extent to which own funds held within the ring-fenced fund (restricted own funds) contribute towards the coverage of the total SCR of the undertaking.
- 3.11. The second aspect relates to the calculation of the undertaking's SCR when ring-fenced funds are in place. The problem lies in the fact that the existence of ring-fencing may reduce the overall level of diversification between risks, i.e. reduces the extent to which losses and profits observed in and out of the ring-fenced fund may compensate each other.
- 3.12. Considering the Level 1 text is open on how ring fenced funds should be interpreted, CEIOPS would like to put two potential interpretations for comments to the stakeholders.

- 3.13. The proposals neither seek to extend nor to narrow the scope of arrangements to be treated as ring-fenced funds under the Level 1 text. Different arrangements in different Member States may fall within the scope of the different proposals. CEIOPS is aiming at providing an appropriate pragmatic and principle-based **treatment** for ring-fenced-type funds across the EEA, and would not intend to harmonise the legal or contractual structure of ring-fenced funds nor the products which could give rise to them through its approach.
- 3.14. Furthermore, CEIOPS acknowledges that the general approach for the identification and treatment of RFF, presented in the following sections, will apply on arrangements that already currently exist. Different types of arrangement may occur in the future that would not meet the definitions set out. Therefore, a principle-based approach is necessary.
- 3.15. Besides the types of ring-fenced funds discussed in this Paper, an undertaking may have other specific items of own funds with restricted loss-absorption capacity. As discussed in CEIOPS-DOC-39/09 (former CP46, see (October 2009), see [http://www.ceiops.eu//content/view/17/21/.](http://www.ceiops.eu//content/view/17/21/)), CEIOPS is of the opinion that these items can only be eligible for inclusion in own funds in relation to the risks they cover and up to the contribution that these risks provide to the total SCR. CEIOPS believes that the treatment of these own funds items should be broadly consistent with the approach developed for ring-fenced funds.
- 3.16. Finally, the treatment of own funds in RFF should be consistent with the treatment of own funds in the group solvency assessment in order to prevent regulatory arbitrage. The treatment of RFF should not induce undertakings to transform a given RFF in a related undertaking in order to take advantage of the risk diversification if the related undertaking is consolidated with the default method. See Article 220(3) of the Level 1 text :

»If the supervisory authorities consider that certain own funds eligible for the SCR of a related insurance or reinsurance undertaking other than those referred to in paragraph 2 cannot effectively be made available to cover the SCR of the participating insurance or reinsurance undertaking for which the group solvency is calculated, those own funds may be included in the calculation only in so far as they are eligible for covering the SCR of the related undertaking«.

3.17. Questions to stakeholders:

Stakeholders are invited to answer the following questions, regarding proposed interpretations **(A)** and **(B)** of ring-fenced funds:

- a) Which proposed interpretation do you consider appropriate? Please provide concrete arguments based on your practical experience with ring-fenced-type funds which present a lack of transferability of own funds across liabilities and risks.
- b) If none of the proposed interpretations applies according to your experience and legal framework, please provide concrete proposals for identifying the ring-fenced funds (e.g. specific criteria which these arrangements should have in order to classify as ring-fenced funds under the Level 1 text).
- c) What type of specific arrangements at national level would be identified as ring-fenced funds under both proposals?
- d) For each of such arrangements, do you agree with the treatment that is proposed in the current paper, namely on the computation of the SCR and/or the adjustments to Own Funds? If not, please provide reasons.

A. Proposed identification of ring-fenced funds (Alternative A)

3.18. Some CEIOPS' Members consider that a ring-fenced fund is any arrangement where:

- a) There is a barrier to the sharing of profits/losses arising from different parts of the undertaking's business; and/or
- b) Own funds (restricted own funds) can only be used to cover losses on a defined portion of the undertaking's (re)insurance portfolio or with respect to particular policyholders or in relation to particular risks such that those restricted own funds are only capable of fulfilling the criteria in Article 93(1) (a) and/or (b) in respect of that defined portion of the portfolio, or with respect to those policyholders or those risks.

3.19. An analysis of the current situation within Member States highlights the existence of two main types of "ring-fenced" arrangements:

- a) Type 1: An 'experience fund' used to calculate discretionary benefits for a profit sharing arrangement, in particular when the arrangement is affected by legal, contractual or other constraints on the distribution of future profit sharing;
- b) Type 2: A fund where there are legal, constitutional or regulatory measures which give rise to restrictions on the use of assets or capital

between different parts of the firm's business. This may be because the assets are only available to cover losses arising in respect of particular policyholders or in relation to particular risks. As well as with-profits funds, examples of this type arise e.g. when two separate undertakings have been merged.

Type 1: An 'experience fund' used to calculate discretionary benefits for a profit-sharing arrangement

Key features

- 3.20. Policyholders share in the profits/experience from an identified pool of assets and liabilities. The assets/liabilities may be physically separated from the rest of the undertaking but do not need to be. The assets/liabilities form a ring-fenced fund (experience fund).
- 3.21. Providers of capital to the profit sharing arrangement may receive regular payments or charges but cannot use (fully or partially) the assets of the ring-fenced fund. The assets within the ring-fenced fund cannot be used (fully or partially) to meet the losses arising from liabilities outside the fund.
- 3.22. All assets within the fund are held to meet the benefits for the current policyholders. However, any surplus assets above those required to meet benefits to the current policyholders (i.e. any own funds within the ring-fenced fund) are fully transferable, can be returned to the shareholders/other providers of capital or can be used to absorb losses as and when they occur.

Reasons for reduced loss-absorbency

- 3.23. Type-1 ring-fenced funds do not result in restricted own-funds in Solvency II as all assets within the fund are held to meet the benefits for current policyholders. It should be noted that the Solvency II valuation basis for technical provisions requires that all guaranteed and future discretionary benefits to current policyholders are included as liabilities.⁵ Even if an excess of assets over liabilities did exist within a fund, this would not be considered restricted own funds if such excess can be realised and taken out of the fund with no restrictions and is available to absorb losses as and where they occur (including outside that fund). If the own funds were not able to absorb all losses the treatment proposed would be the same as for Type 2 discussed below.
- 3.24. However, type-1 ring-fenced funds do affect the ability to pool risk as the emerging profit within the ring-fenced fund is immediately attributed to policyholders in the particular fund, resulting in an increase to technical provisions in relation to liabilities of that fund. It therefore cannot be used (or cannot be used in full) to cover losses outside the fund.

⁵ Except in the presence of surplus funds, but such cases are considered to be out of the scope of the type-1 ring-fenced funds discussion.

- 3.25. For instance, where a profit has been observed in the ring-fenced fund and losses occur elsewhere within the undertaking, there is an increase in technical provisions equivalent to the full (or partial) amount of such profit and therefore there are no additional own funds (or there are less additional own funds) that can be used to meet losses in other parts of the business. Profit can only be partly used, after the allocation of additional discretionary bonuses to the relevant policyholders. The extent of such constraints depends on the design of the profit sharing mechanism, on any contractual, legal and statutory requirements applicable and on the reasonableness of the assumed management actions.
- 3.26. While the amount of total eligible own funds would not necessarily need any adjustment (due to the fact that emerging profit within a ring-fenced fund would automatically increase technical provisions relating to liabilities of that fund, thus not generating restricted own fund items), the calculation of the SCR needs to properly reflect the potential lack of diversification between profits and losses in different areas of the undertaking.
- 3.27. In addition, the undertaking may often want to calculate an economic valuation in order to guide bonus policy, investment policy and other parts of the risk management based just on the assets and liabilities within the ring-fenced fund (i.e. the calculation of 'notional' SCR at the level of the ring-fenced fund). This assessment can be used to highlight the risks within the ring-fenced fund and calculate the likelihood of reduction in the undertakings' overall level of diversification (and the events which could cause this to occur). However, this should not be confused with the adjustments required to calculate the SCR for the whole undertaking, which are explained below.

Practical example

- 3.28. Assume that an undertaking has two 'experience funds' in place – funds A and B – which are used as the basis to calculate the amount of profit sharing for the corresponding two groups of policyholders.
- 3.29. Assume that, in a given scenario, fund A reports profits of 100 (above expectations) while fund B reports losses of 300 (after any loss absorbency capacity of future discretionary benefits in fund B). Looking from the perspective of the undertaking as a whole, it may seem that having own funds of 200 would suffice to compensate for the total losses. However, this is only true if the total profit of 100 reported in fund A can be used in full to absorb losses elsewhere in the undertaking.
- 3.30. But if the profit sharing mechanism in experience fund A imposes implicit or explicit restrictions on the use of profits to benefit other groups of policyholders or other areas of the undertaking, for example, because of legal requirements or contractual clauses, or even because such management action cannot be seen as realistic – the total loss at the level of the undertaking would necessarily be higher.
- 3.31. For instance, assume that the contractual clauses impose the distribution of a minimum of 80% of any profits generated in fund A to the relevant

group of policyholders. In such case, from the total registered profit of 100, only 20 could be taken away from fund A⁶ and used to compensate losses elsewhere in the undertaking. This then leads to a total overall loss of 280 (-300+20). Thus, in this example, the undertaking would need to have own funds of at least 280.

Impact on Own Funds and SCR

- 3.32. Own funds: By their nature, this type of ring-fenced funds does not generate restricted own funds. Therefore, no adjustment to the total amount of eligible own funds is necessary.
- 3.33. SCR: The undertaking's total SCR should reflect the potential reduction of the overall level of diversification, due to the existence of barriers in the full use of profits generated at the level of ring-fenced funds to compensate losses elsewhere in the undertaking. This can be achieved by assessing the impact of the individual risk charges at the ring-fenced fund level.

Type 2: A fund of assets and liabilities containing restricted own funds that are only available to cover losses arising in respect of particular policyholders or in relation to particular risks

Key features

- 3.34. Policyholders within the ring-fenced fund have distinct rights relative to other business written by the insurer, and shareholders have no direct obligations to policyholders.
- 3.35. There are restrictions on the use of assets held within this fund to meet liabilities or losses arising outside the fund.
- 3.36. An excess of assets over liabilities is usually maintained within the fund and this excess is then deemed to be "restricted" own funds since its use is subject to the restrictions referred to in paragraph 3.35.
- 3.37. There is often a profit sharing mechanism within the ring-fenced fund whereby policyholders receive a minimum proportion of the profits generated in the fund which are distributed through additional benefits or lower premium, and shareholders may then receive the balance of any distributed profits.

Examples

- 3.38. A typical example is a profit sharing mechanism where the profits generated inside the ring-fenced fund may be (partially or fully) retained, but not necessarily to increase the benefits of the current policyholders. It may be, for instance, to smooth returns between generations of policyholders (current and future).

⁶ In line with what was said before, the amount of 80 would be used to increase the technical provisions for the group of policyholders in fund A, thus not generating restricted own fund items. Therefore, the contribution of fund A to total own funds would only be an increase by 20.

- 3.39. Thus, the main difference with the type-1 ring-fenced fund example is the existence of restricted own funds, in addition to the barrier to the sharing of profits/losses within the undertaking.

Impact on Own Funds and SCR

- 3.40. Own funds: Own funds available to meet losses within the ring-fenced fund (and not available to meet losses outside the fund) should be separately identified. The total amount of own funds at the level of undertaking should be reduced by the amount of the restricted own funds that are not being used for the purposes of meeting the notional SCR corresponding to the ring-fenced fund.
- 3.41. SCR: As with Type 1, the undertaking's total SCR should reflect the potential reduction of the overall level of diversification, due to the existence of barriers in the full use of profits generated at the level of ring-fenced funds to compensate losses elsewhere in the undertaking. This can be achieved by assessing the impact of the individual risk charges at the ring-fenced fund level.

B. Proposed identification of ring-fenced funds (Alternative B)

- 3.42. A number of other CEIOPS' Members have concerns with the effect of the above approach. They consider the following to be important for the identification of ring-fenced funds:

The barrier to transferability of the own funds in going concern and in winding-up situation. If the own funds held in the RFF would become transferable in a winding-up situation, this would not seem to be in line with Article 99 (lack of transferability). According to this view, policyholders in the RFF should be sheltered from the undertaking's failure resulting from its other lines of business or other RFF, on a going-concern basis and in the case of a winding-up. Following this criteria, the protection of the policyholders in a given RFF is independent from the protection of policyholders in another RFF in the same insurance undertaking or other policyholders in the remain undertaking. Consequently to this subordination, the policyholders in a given RFF have greater rights on a going-concern and in a winding-up basis to assets within their fund and the protection is not altered by the solvency position of the undertaking outside the RFF.

- 3.43. Consequently, some CEIOPS' Members suggest that the identification of RFF should be in line with following criteria:

- Condition 1: the assets and rights supporting the contract liabilities are isolated from those of the other insured (in certain case, they are legally isolated); that is, the contract holder is only subject to the insurer default risk on the assets held.
- Condition 2: the insurer must invest the contract holder's funds within the RFF as a result of contractual obligations and/or regulatory requirements (eg. the holder's funds are invested in agreed investment options or in accordance with specific investment objectives or policies)

- Condition 3: all investment performance, net of contract fees and assessments, must as a result of contractual or regulatory requirements be passed through to the individual contract holder. I.e. profits and own funds held in the RFF are restricted by contractual or regulatory requirements. Contracts may specify conditions under which there may be a minimum guarantee, but not a cap, as such a cap would prohibit all investment performance from being passed through to the contract holder.
- 3.44. This identification of the ring-fenced is based on a »contractual« or «legal» basis, which entails the establishment of a separate account and the regulation of the RFF under specific rules provided by national insurance law.
- 3.45. Finally, the proposed identification supposes that the own funds (restricted own funds) can only be used to cover losses on a defined portion of the undertaking's (re)insurance portfolio or with respect to particular policyholders or in relation to particular risks such that those restricted own funds are only capable of fulfilling the criteria in Article 93(1) (a) and/or (b) in respect of that defined portion of the portfolio, or with respect to those policyholders or those risks.

Key features of a RFF under proposed alternative B

- 3.46. Policyholders within the ring-fenced fund have additional rights (alternatively the providers of capital have additional obligations in respect of these policyholders) relative to other business written by the insurer. Thus there are restrictions on the use of assets held within this fund to meet liabilities or losses arising outside the fund.
- 3.47. Undertaking may receive regular payments or charges from the ring fenced fund (ie. kind of annual profit) but cannot otherwise use the assets of the ring fenced fund. In particular, the assets within the ring-fenced fund cannot be used to meet the losses arising from liabilities outside the fund.
- 3.48. An excess of assets over liabilities is usually maintained within the fund and this excess is then deemed to be "restricted" own funds since their use is subject to the restrictions described in paragraph 3.45.
- 3.49. There is often a profit sharing mechanism within the ring-fenced fund whereby :
- policyholders receive a discretionary participation benefit based on a minimum proportion of the profits generated in the fund which are distributed through additional benefits or lower premium, and
 - shareholders then receive the balance of any, immediately or not, distributed profits.

Thus, only a part of the profit could be transferable or used to absorb losses as and when they occur.

Practical example

- 3.50. Assume that an undertaking has two Ring fenced funds in place – funds A and B – which are used as the basis to calculate the amount of profit sharing for the corresponding two groups of policyholders.
- 3.51. Assume that, in a given scenario, fund A reports profits of 100 (above expectations) while fund B reports losses of 300. Looking from the perspective of the undertaking as a whole, it may seem that having own funds of 200 would suffice to compensate for the total losses. However, this is only true if the total profit of 100 reported in fund A can be used in full to absorb losses elsewhere in the undertaking.
- 3.52. But the profit sharing mechanism in ring fenced fund A imposes implicit or explicit restrictions on the use of profits to benefit other groups of policyholders or other areas of the undertaking – either through legal, contractual clauses– the total loss at the level of the undertaking would necessarily be higher.
- 3.53. For instance, assume that the contractual clauses impose the distribution of a minimum of 90% (since contract fees are 10%) of any profits generated into the fund A to the relevant group of policyholders, explicitly by increasing technical provisions or implicitly by increasing own funds held in fund A. In such case, from the total registered profit of 100, only 10 could be taken away from fund A and used to compensate losses elsewhere in the undertaking. This then leads to a total overall loss of 290 (-300+10). Thus, in this example, the undertaking would need to have own funds of at least 290.
- 3.54. The undertaking's total SCR should reflect the potential reduction of the overall level of diversification, due to the existence of barriers in the full use of profits generated at the level of ring fenced funds to compensate losses elsewhere in the undertaking. This can be achieved by assessing the impact of the individual risk charges at the ring-fenced fund level.

Impact on Own Funds and SCR

- 3.55. Treatments of Own Funds and SCR are the same as the one developed for Type 2 funds (see para 3.40 and 3.41).

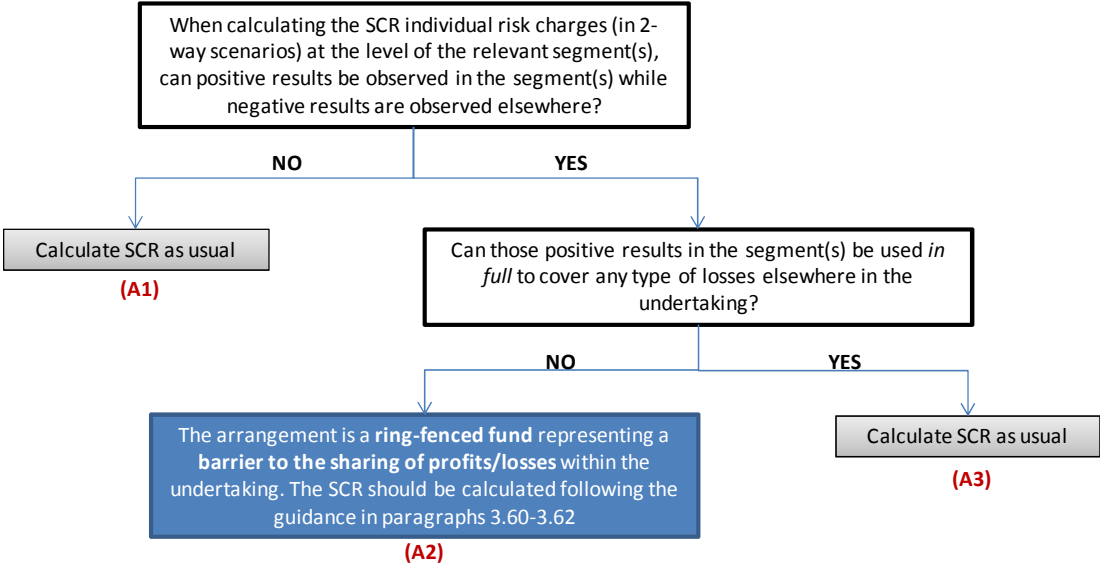
3.1.3. General approach for the identification and treatment of ring-fenced funds

3.56. The present section sets out a general approach for the identification and treatment of ring-fenced funds which, aims to provide a common ground to capture ring-fenced funds with the same issues of lack of transferability of own funds and/or reduced scope of risk pooling and diversification but that may not correspond exactly to the examples given above.

3.57. In order to determine if a particular arrangement should be considered a ring-fenced fund, the following 2 tests should be performed. A positive answer in at least one of these tests is a sufficient condition:

- a) Test A for impact on total SCR, i.e. if the arrangement represents a barrier to the sharing of profits/losses arising from different parts of the undertaking's business;
- b) Test B for impact on total eligible own funds, i.e. if the arrangement gives rise to own fund items with restricted loss absorbency capacity (restricted own funds).

3.58. The following decision-tree illustrates the determination of Test A (Test for impact on total SCR):⁷



3.59. The following decision-tree is applicable to determine the result of Test B (Test for impact on total eligible own funds):

⁷ Note that the reference to positive results should be understood as positive impacts of the SCR scenario (ΔNAV) where the change in NAV is calculated before taking into account any additional increase of liabilities implied by the arrangement.

- c) In parallel, the capital charges at the level of each ring-fenced fund should be calculated net of the mitigating effect of future discretionary benefits. Where the ring-fenced fund relates to the existence of profit sharing mechanisms, the assumptions on the variation of future bonus rates should be realistic, with due regard to the impact of the shock at the level of the ring-fenced fund and to any contractual, legal or statutory clauses of the profit sharing mechanism. The relevant (downward) adjustment for the loss absorbency capacity of technical provisions should not exceed, in relation to a particular ring-fenced fund, the amount of future discretionary benefits within the ring-fenced fund;⁹
- d) For each of gross/net, the total capital charge for the individual risk is given by the sum of the capital charges calculated at the level of each ring-fenced fund and that calculated at the level of the remaining sub-portfolio of business;
- e) For each of gross/net, the total capital charges for each individual risk are then aggregated using the usual procedure of the standard formula to derive the total SCR.

3.62. The procedure outlined in the previous number assumes that the modular approach is used to calculate the adjustment for loss absorbency of technical provisions. With respect to the alternative approach – termed equivalent scenario approach – the procedure would be equivalent, except that step c) above would be applied at the SCR level (step c) would only need to be applied at the individual risk charge level if the equivalent scenario is derived using net capital charges as inputs).¹⁰

3.63. It should be noted that this description of the SCR calculation does not constitute a 'new' approach conceptually. In fact, the above approach (as recognised by recital 29b) intends to highlight the importance of performing the calculation of the individual risk charges at the more granular level when ring-fenced funds are in place. A calculation of the SCR charges which only looks at the overall impact at level of the undertaking, thus ignoring these arrangements, can lead to significant underestimations of the 'true' capital charges.

General procedure to calculate the total eligible own funds in the presence of ring-fenced funds

3.64. In the presence of ring-fenced funds which have restricted own funds or the potential to have restricted own funds (result B2 in test B), the diversification benefits between the ring-fenced fund(s) and other funds is reduced since there are restrictions with regard to the transferability of capital from the ring-fenced fund. This loss of diversification should be reflected through an adjustment to own funds.

⁹ In such cases, the decision on which scenario should be taken on board (upward or downward shock) should relate to the worst overall result to the undertaking (net charges) after the potential increases in liabilities referred in the previous bullet point.

¹⁰ For detailed information on the approaches to derive the adjustment for the loss absorbency capacity of technical provisions, consult CEIOPS Advice on SCR- Loss absorbing capacity of technical provisions, CEIOPS-DOC-46/09 (October 2009), see <http://www.ceiops.eu/content/view/17/21/> (former CP 54).

3.65. The appropriate adjustment to own funds, to allow for both restrictions on transferability and loss of diversification, should be determined based on the following principles:

- If the ring-fenced fund has sufficient own funds to cover the notional SCR for that ring-fenced fund, then any surplus over the notional SCR that cannot be used to cover risks in the rest of the firm and diversification between the ring-fenced fund(s) and other funds should be excluded.
- If the ring-fenced fund does not have sufficient capital to meet the notional SCR for that ring-fenced fund, then the deficit may be assumed to be covered by own funds outside the ring-fenced fund that could be transferred to meet the deficit. Diversification between the ring-fenced fund(s) and other funds may be included but only, as a maximum, to the extent that it is required to cover the deficit arising from within the ring-fenced fund (i.e. the burn-through amount) (and to the extent that the other funds are not themselves ring-fenced funds).

3.66. The following steps outline a possible method for determining the appropriate adjustment to the eligible own funds in practice. A numerical example is also included in Annex A.2.

- a. Calculate a notional SCR for each ring-fenced fund as well as a notional SCR for risks outside any ring-fenced fund. Note that the notional SCR should be calculated for each ring-fenced fund as if that fund were a standalone entity, i.e. should be based on the worst case scenario for that each ring-fenced fund where there are bidirectional scenario tests. It is therefore possible (and acceptable) that the notional SCR may be based on different scenarios (for bidirectional risks) for different funds.
- b. If a ring-fenced fund has sufficient own funds to cover its notional SCR, then the total own funds in excess of the SCR for the undertaking as a whole should exclude the excess own funds in the ring-fenced fund as well as any diversification benefit between that ring-fenced fund and other funds. Own funds being used to meet the notional SCR for the ring-fenced funds would be included in total own funds¹¹.
- c. If a ring-fenced fund does not have sufficient own funds to meet its notional SCR, then the undertaking should, in the first place, consider whether the deficit in the ring-fenced fund exceeds the diversification benefit gained from pooling the risks within that ring-fenced fund with those outside any ring-fenced fund¹².
 - Where this is the case, full diversification should be allowed between the risks within that ring-fenced fund and those risks outside any ring-fenced fund¹³.

¹¹ See Case 1 in the example in the Appendix.

¹² The difference between the aggregate SCR for the undertaking, calculated as set out in paragraph 3.52, and the sum of the notional SCRs for the ring-fenced fund and the notional SCR for risks outside any ring fenced fund.

¹³ See Case 2 in the example in the Appendix.

- Where this is not the case, the case outlined in (b) above applies¹⁴.
- d. The adjustment to eligible own funds is then equal to the difference between total own funds after SCR calculated in the usual way and total own funds after SCR determined based on a to c above.
- 3.67. Where an undertaking has more than one ring-fenced fund, the principles outlined above should be applied separately for each ring-fenced fund. However, in line with the principle of proportionality, some adjustments to this approach may be appropriate for those undertakings with a large number of ring-fenced funds which contain restricted own funds.

3.2 CEIOPS' advice

- 3.68. Some CEIOPS members consider that a ring-fenced fund is any arrangement where:
- a) There is a barrier to the sharing of profits/losses arising from different parts of the undertaking's business; and/or
 - b) Own funds (restricted own funds) can only be used to cover losses on a defined portion of the undertaking's (re)insurance portfolio or with respect to particular policyholders or in relation to particular risks such that those restricted own funds are only capable of fulfilling the criteria in Article 93(1) (a) and/or (b) in respect of that defined portion of the portfolio, or with respect to those policyholders or those risks.
- 3.69. Some CEIOPS members suggest that the provisions set out in that consultation paper only apply on Ring Fenced Funds which meet all of the following conditions:
- Condition 1: the assets and rights supporting the contract liabilities are isolated from those of the other insured (in certain case, they are legally isolated); that is, the contract holder is only subject to the insurer default risk on the assets held.
 - Condition 2: the insurer must invest the contract holder's funds within the Ring Fenced Funds as a result of contractual obligations and/or regulatory requirements (eg. the holder's funds are invested in agreed investment options or in accordance with specific investment objectives or policies)
 - Condition 3: all investment performance, net of contract fees and assessments, must as a result of contractual or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a cap, as such a cap would prohibit all investment performance from being passed through to the contract holder.

¹⁴ See Case 3 in the example in the Appendix

3.70. CEIOPS is currently discussing the scope of application of the present advice implied by the Level 1 text, namely what type of arrangements should be considered as ring-fenced funds. Stakeholders are invited to provide their views on this (see question to stakeholders in the explanatory text).

3.71. As a practical explanation of the definition in order to determine if a particular arrangement should be considered a ring-fenced fund, the following 2 tests should be performed. A positive answer in at least one of these tests is a sufficient condition:

a) Test A for impact on total SCR, i.e. if the arrangement represents a barrier to the sharing of profits/losses arising from different parts of the undertaking's business. The calculation of the SCR shall follow the procedure outlined below (3.72) if:

i) The calculation of any SCR individual risk charges can give rise to simultaneous positive and negative results in segments of the undertaking which are relevant to capture the effect of ring-fenced funds; and

ii) In those cases, positive results cannot be assumed to be used in full to cover any type of losses elsewhere in the undertaking.

b) Test B for impact on total eligible own funds, i.e. if the arrangement gives rise to own fund items with restricted loss absorbency capacity (restricted own funds). The calculation of the amount of own funds eligible to cover the SCR should follow the general procedure outlined below (3.73-3.74) when:

i) The ring-fenced fund generates or has the potential to generate restricted own funds, i.e. own fund items which cannot be used to cover any type of losses elsewhere in the undertaking.

General procedure to calculate the SCR in the presence of ring-fenced funds

3.72. In the presence of ring-fenced funds which affect the calculation of the SCR, the calculation needs to be modified in relation to the risks where a barrier to the sharing of profits/losses exists. These individual risk charges should be calculated at ring-fenced fund level to reflect, in particular, the impact of the ring-fenced funds where there are bidirectional scenarios e.g. interest rate, currency and lapse risk. A calculation of the SCR charges at the level of the undertaking can lead to significant underestimations of the 'true' capital charges as it ignores the ring-fencing arrangements. The total capital charge for the individual risk is given by the sum of the capital charges calculated at the level of each ring-fenced fund and that calculated at the level of the remaining sub-portfolio of business. The aggregation of the individual risk capital charges to derive the total SCR follows the usual procedure of the standard formula-

General procedure to calculate the total eligible own funds in the presence of ring-fenced funds

3.73. In the presence of ring-fenced funds which have restricted own funds or the potential to have restricted own funds, the diversification benefits between the ring-fenced fund(s) and other funds is reduced since there are restrictions with regard to the transferability of capital from the ring-fenced fund. This loss of diversification should be reflected through an adjustment to own funds.

3.74. The appropriate adjustment to own funds should be determined based on the following principles:

- If the ring-fenced fund has sufficient own funds to cover the notional SCR for that ring-fenced fund, then any surplus over the notional SCR that cannot be used to cover risks in the rest of the firm and diversification between the ring-fenced fund(s) and other funds should be excluded.
- If the ring-fenced fund does not have sufficient capital to meet the notional SCR for that ring-fenced fund, then the deficit may be assumed to be covered by own funds outside the ring-fenced fund that could be transferred to meet the deficit. Diversification between the ring-fenced fund(s) and other funds may be included but only, as a maximum, to the extent that it is required to cover the deficit arising from within the ring-fenced fund (i.e. the burn-through amount) and to the extent the other funds are not themselves ring-fenced funds.

ANNEX – Examples of calculation

A.1. Calculation of the SCR in the presence of ring-fenced funds - Applicable for profit sharing mechanism with and without restricted own funds (Types 1 and 2)

- A.1.1. Assume an undertaking has two profit sharing mechanisms that benefit different groups of policyholders A and B. Those mechanisms are such that, by contractual laws, 80% of any future emerging profit (irrespective of the source, i.e. underwriting or financial) has to be allocated to the respective group of policyholders and technical provisions increase by the value of the 80% emerging profit. Only the remaining 20% can be released to shareholders.
- A.1.2. The blocks of business A and B constitute two ring-fenced funds. Within each ring-fenced fund, the expected value of future profit sharing should be part of the value of technical provisions (following Solvency II valuation rules). The amount of future discretionary benefits for groups A and B is 100 and 300 respectively.
- A.1.3. Additionally the undertaking holds a block of non-participating business C. The undertaking has total own funds of 2.000 (assets minus liabilities), with no restricted own fund items.
- A.1.4. The undertaking needs to calculate the SCR following the approach outlined in paragraph 3.61.¹⁵
- A.1.5. For instance, the calculation of the interest rate risk charge, step a) would require the computation of the impact of both the upward and downward scenarios at the level of each ring-fenced fund (and at the level of the remaining business, C):

	A	B	C	(Sum)
ΔNAV before any adjustment (per relevant segment)				
upward shock	250	-100	-400	-250
downward shock	-80	200	500	620

- A.1.6. Step b)¹⁶ requires the reduction of positive ΔNAV partial results, due to barriers of sharing the profits generated within a ring-fenced fund to other areas of the business. In the current example, where positive, the ΔNAV results are reduced by 80% (such amount is retained in the ring-fenced fund and used to increase the benefits of the corresponding groups of policyholders).

¹⁵ For practicality reasons, it will be assumed that the adjustment for the loss absorbency capacity of technical provisions is calculated using the modular approach.
¹⁶ Note that this step only needs to be performed when calculating capital charges based on the worst of a range of scenarios – namely on interest rate, currency and lapse risks.

	A	B	C	(Sum)
After increase of liabilities within the RFF				
upward shock	50	-100	-400	-450
downward shock	-80	40	500	460

A.1.7. Step c) is concerned with the calculation of the net capital charges, and highlights the importance to assess the extent by which the management is able to reduce future discretionary bonuses *at the level of each ring-fenced fund*. In this example, it is assumed that the 1/3 of the negative ΔNAV results is mitigated by the reduction in future discretionary bonuses (note that on block of business C this is not possible because it is non-participating business).

	A	B	C	(Sum)
Net charges - after adjustment for loss absorbency of TP				
upward shock	50	-67	-400	-417
downward shock	-53	40	500	487

A.1.8. Based on these results, the upward shock scenario is chosen to compute the SCR, as it corresponds to the worst scenario at the level of the undertaking. In summary, the gross and net capital charges for interest rate risk are respectively 450 and 417 (step d)). Note that ignoring step b) would lead to much lower capital charges – respectively 250 and 217.

A.1.9. The calculation would then progress in an analogous manner for the remaining individual risks within the market risk module and, after that, for the individual risks within the other risk modules.

A.2. Calculation of total eligible own funds in the presence of ring-fenced funds - Applicable only for profit sharing mechanism with restricted own funds (Type 2)

Case 1: Ring fenced fund in surplus

A.2.1. Where there are sufficient own funds within the ring-fenced fund to cover the notional SCR for that ring-fenced fund:

- a) There should be no allowance for diversification between the ring-fenced fund and other funds.
- b) The total own funds in excess of the SCR for the undertaking as a whole **[A]** should exclude the excess own funds in the ring-fenced fund as well as any diversification benefit between the ring-fenced fund and other funds. In practice, this is calculated by deducting the notional SCR relating to risks outside the ring-fenced fund **[B]** from the total amount of own funds held outside the ring-fenced fund **[C]**.

	Ring Fenced Fund	Other	SII Balance Sheet
Assets	600.0	800.0	1,400.0
Liabilities	400.0	400.0	800.0
Own Funds	200.0	400.0 [C]	600.0
SCR Risk A	125.0	10.0	135.0
SCR Risk B	10.0	125.0	135.0
SCR	130.3	130.3 [B]	233.8
Own funds in excess of SCR	69.7	269.7	366.2
Restrictions due to transferability of capital			-96.5
Total own funds in excess of SCR			269.7 [A]

Case 2: Ring fenced fund in deficit

A.2.2. Where there are insufficient own funds within the ring-fenced fund to cover the notional SCR for that ring-fenced fund and the deficit within the ring-fenced fund exceeds the diversification benefit gained by pooling the risks:

- a) There should be an allowance for diversification between the ring-fenced fund and other funds.
- b) The total own funds in excess of the SCR for the undertaking **[A]** should be equal to the amount of own funds given that the risks within the ring-fenced funds are pooled with the risks within other (non ring-fenced) funds **[B]**.
- c) No adjustment to own funds is required since all the own funds within the ring-fenced fund are being used to meet the SCR of that ring-fenced fund.

	Ring Fenced Fund	Other	SII Balance Sheet
Assets	450.0	800.0	1,250.0
Liabilities	400.0	400.0	800.0
Own Funds	50.0	400.0	450.0
SCR Risk A	125.0	10.0	135.0
SCR Risk B	10.0	125.0	135.0
SCR	130.3	130.3	233.8
Own funds in excess of SCR	(80.3)	269.7	216.2 [B]
Restrictions due to transferability of capital			-
Total own funds in excess of SCR			216.2 [A]

Case 3: Ring fenced fund in deficit

A.2.3. Where there are insufficient own funds within the ring-fenced fund to cover the notional SCR for that ring-fenced fund but the deficit within the ring-fenced fund is less than the diversification benefit gained by pooling the risks:

- a) There should be no allowance for diversification between the ring-fenced fund and other funds.
- b) The total own funds in excess of the SCR for the undertaking as a whole **[A]** should exclude the excess own funds in the ring-fenced fund as well as any diversification benefit between the ring-fenced fund and other funds. In practice, this is calculated by deducting the notional SCR relating to risks outside the ring-fenced fund **[B]** from the total amount of own funds held outside the ring-fenced fund **[C]**.

	Ring Fenced Fund	Other	SII Balance Sheet
Assets	520.0	800.0	1,250.0
Liabilities	400.0	400.0	800.0
Own Funds	120.0	400.0 [C]	520.0
SCR Risk A	125.0	10.0	135.0
SCR Risk B	10.0	125.0	135.0
SCR	130.3	130.3 [B]	233.8
Own funds in excess of SCR	(10.5)	269.7	286.2
Restrictions due to transferability of capital			-16.5
Total own funds in excess of SCR			269.7 [A]

A.2.4. Note: for all three cases, a correlation of 50% between Risk A and Risk B is assumed, for the purposes of this example.